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THE IMPACT OF BANK MERGERS ON CANADIAN FARM AND RURAL COMMUNITIES

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THE IMPACT OF BANK MERGERS ON CANADIAN FARM AND RURAL COMMUNITIES

Calum G. Turvey, David Sparling, and Erna van Duren*

Abstract

This paper indicates a discussion on the probably impacts of bank mergers on Farms and Rural Communities in Canada. Motivated by the Early 1998 merger announcements by four of Canada's largest banks, this paper discusses the economic drivers behind merger activity, and then addresses specific issues related to agriculture. Although the proposed mergers were cancelled by the end of 1998, our research and analysis indicates that the overall effect would not have been grossly negative, and in many aspects would have been positive. Subsequent attempts to merge banks are likely, and the discussion and analysis of this paper provide a basis to analyze and discuss the merger issue.

Introduction

The Merger announcement in January and February of 1998 by the Royal Bank of Canada and the Toronto-Dominion Bank to merge respectively with the Bank of Montreal and the Canadian Imperial Bank of Commerce will have a profound impact on the landscape of the Canadian financial system. The mergers follow a series of mergers and acquisitions across the Canadian financial system over the past few years including the acquisition by certain banks of trust companies. Moreover, a phenomenal number of mergers and acquisitions throughout the world have dwarfed the size of Canadian banks by a significant amount. Perhaps more important are changes to U.S. laws which deregulated that country's banking industry therefore allowing a number of significantly sized national banks to emerge with continental and international reach. Within the U.S. system mergers such as Chase Manhattan and Chemical Bank have created some

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of the largest financial institutions in the world.

Within an economic environment with global reach it is not surprising that Canadian banks would ultimately merge. The banks claim that any gains in economies of size, scale and scope, will allow them greater flexibility to provide more products and services to the consumer, but more importantly more would provide greater strength to profitably participate in global financial markets.

There are of course concerns among Canadians. First of all, Canada is defined by only seven commercial banks. Of the three banks not involved in the merger (Bank of Nova Scotia; Laurentian Bank; National Bank of Canada), only the Bank of Nova Scotia is truly national and international in scope and will make up the third part of the "big three" (formerly the "big five"). The non-merging banks will certainly be diminished in relative size; and while the pre-merger concentration of the big five, in regards to deposit-taking and lending, was already high across the financial system, the post-merger economy is going to significantly increase the level of concentration of the merged banks and those could potentially upset the balance of power currently observed.

A more concentrated banking system comes with some social costs, particularly in terms of employment and the maintenance of neighbourhood bank branches. In addition, there are fears that consolidation will reduce competition leading to fewer services at a higher price as well as the loss of age-old customer-banker relationships.

While the bank mergers will undoubtedly have a profound impact on the landscape of the Canadian financial system, this paper's ultimate aim is to investigate the possible impacts that these (or any future mergers) mergers might have on rural communities in general and farming in

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necessarily reflect or represent their views.

particular. To fully appreciate the economic significance of the proposed mergers, this report first provides an overview of the Canadian financial system, factors affecting change in the system, the position of Canadian banks vis à vis international banking, and the economic impact of bank mergers and acquisitions in the United States. Then the bank mergers are discussed within the context of lending to agriculture and the (possible) implications for rural communities and farming discussed. The paper is then concluded.[1]

An Overview of the Pre Merger Financial System

The Canadian financial system, like so many others, has been built on four economic pillars comprising banks, trust, insurance companies and securities dealers (including mutual funds). However, throughout the 1990s the Canadian financial system went through unprecedented change, and in 1996 the Federal Minister of Finance, Paul Martin, commissioned a detailed overview of the system with the aim of discovering how the industrial organization is changing and what policies and issues would be important from the perspective of corporations, consumers, and government. The t ask force report (Mackay) was released on September 14, 1998. In this report Mackay points out that the four pillars are crumbling as convergence takes place within the sector. With mortgages, commercial lending, and deposit-taking, the historical and primary thrust of commercial banks, the new financial economy has seen a host of developments which include brokerages, mutual fund sales, and insurance products and services being sold through banks. The convergence function is driven by change in many aspects of modern culture. The two most forceful forces for change are demographics, particularly the

1This manuscript was written prior to the December 14, 1998 decision by the Minister of Finance to disqualify the mergers. The conclusions are followed by an epilogue on this event. Even though the mergers were cancelled it is widely believed that a second attempt will be made in the future. This paper provides an initial discussion for that

incredible gain in wealth for the baby boomer generation, and globalization brought about by increased use of information technologies and the modernization of risk management theories into viable commercial applications.

The first pillars fell when lenders realized the amount of wealth being accumulated by the population. Savings moved out of bank accounts into stock market investments, and then diversified mutual funds. Consequently banks expanded the mandate of their investment subsidiaries or created/acquired new ones in order to tap into an expanded set of stock based investment vehicles. Personal and commercial lenders were trained in the sales of these instruments and with this zero-marginal cost sales force, the investment arm of the commercial banks flourished. The significance of changing consumer patterns is illustrated in Table 1.

What is indicated in Table 1 is that consumer investing patterns were changing. Deposits in financial institutions were decreasing as a percent, as were relatively secure fixed income securities such as bonds. Stock market shares were being held less as mutual funds investments increased. While consumer preferences for financial instruments changed in terms of the percent holdings, a key motivation for banks to extend services is undoubtedly in response to this pattern.

The Canadian financial system is summarized in Table 2. In total there are 55 banks in Canada with total assets in excess of $1.3 trillion dollars. Of these, only 11 are Canadian banks, but the concentration of these banks is such that they control over $1.2 trillion in assets (see Table 3). The largest financial institution is the Royal Bank of Canada whose 12.1% market share exceeds the total market share of all credit unions and Caisses Populaires combined. Only life insurance companies, which numbered 131 in 1996, exceeded the Royal Bank share. In terms of revenue generation, the commercial banks have the largest share of the consumer dollars

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eventuality.

as well as the highest income of any group in the financial system. In fact, the net income from commercial banks is only slightly lower than the net income reported from all other financial institutions combined.

One of the main concerns of the Mackay Task Force was the competitive position of the various player in the Canadian Financial System. It is clear that banking has always been concentrated relative to the U.S. in 1933 there were 10 chartered banks in Canada, in 1964 there were 8, and there are currently 11 Canadian controlled chartered banks. In 1964 the top 3 banks held 70% of all the assets but in 1997 the top 3 had only 52% of the assets. The distinctive difference is that there are now 40 foreign owned banks in Canada, whereas in 1964 the market was not as open to foreign banks. Consequently, even though the top 3 banks control 52% of the asset base, the total asset base has increased significantly in the last 30 years.

Still, competition has increased substantially for the banks. Mackay reports that between 1987 and 1997 bank loans have fallen from 44% to 34% of corporate debt outstanding, and corporate bond issues make up 31% of corporate debt and has grown at a pace of 4 times that of bank loans. Equity markets have also played a role in this decline as mutual funds and pension funds increased their position in common stock. Between 1987 and 1997 mutual fund companies increased their total sector assets from 2.9% to 11.5%, and pension plans from 14.6% to 17.0%.

In the small business credit market, credit unions and caisses populaires account for 14% of the market, whereas they were insignificant in 1964 and specialized asset-based lending companies held 16% of the market, with an increase of 9% in the past 4 years alone.

While the above may indicate a diminishing role for chartered banks, it must be put in perspective that relative positions are increasing and decreasing in an overall increasing market. That is, even though the % share of business garnered by the chartered banks is decreasing in

relative terms, it has been increasing in absolute terms (as have the competitors).

The degree of specialized money services is also increasing and this is coming from foreign banks as well as new Canadian banks. Citizen Bank, a Canadian charter and ING Bank (Holland) are offering officeless or virtual banking services. Other U.S. banks, such as Citibank, Bank One, and Capital One Financial are setting up Canadian subsidiaries in order to capture some of the Canadian credit card market. Rabobank from Holland received a charter in early 1998 and its objective is to provide investment banking services to the agricultural sector and will stay out of the consumer/small business credit market. The Bank of Hong Kong appears to be the only new Canadian foreign owned bank that will accept deposits and make personal, consumer, and small business loans.

Change in consumer preference, one-stop shopping, and deregulation of the financial service industry has seen the commercial banks increase the bundle of products offered to consumers. The asset base of the banks is being increased by diverse business units such as leasing, insurance, market fund sales, brokerage, and other investment and merchant banking activities.

However, even though the Canadian banks are rapidly becoming a single pillar within the Canadian system, they are not of any great significance when compared to other banks around the world. As indicated in Table 4, mergers and acquisitions in the financial industry worldwide have been accelerating in recent years. In 1987 there were approximately 1,000 mergers/acquisitions and this number has increased by over 400% to exceed 4,000 in 1996 and 1997. Consequently the Canadian banks are rapidly being dwarfed by some international banks. Japan's merged Bank of Tokyo and Mitsubishi Bank has assets of $887.8 billion (Cdn) which is approximately equal to the total asset value of Canada's top five banks combined. Even with the

mergers Canadian banks still don't have the size to effectively compete. For example, the Royal Bank - Bank of Montreal merger will result in a $387.7 million bank while the TD Bank - CIBC will result in a $324.6 billion bank. With respect to increasing size the Royal-Montreal merger will move the banks from 49th and 54th to 22nd in the world, while CIBC-TD will move from 51st and 69th to 27th. The question of whether this size is necessary to compete internationally is the subject of debate.

In support of the mergers, the banks argue that they need to increase in size because they do not have the necessary capital base to compete in multi-billion dollar financings. The current system of syndication across domestic and international banks has allowed Canadian participation in international finance, but syndication comes at an increased cost and less control.

The issue of international finance is not trivial. Indeed, many of Canada's banks are reporting more revenue and contribution margin from their international operations than from their domestic operations. Notwithstanding shareholder benefits arising from international finance, the main concern of Canadian legislators and the Minister of Finance is the impact of the bank mergers on the Canadian domestic economy. In the next section a review of the literature in the U.S. leads to certain conclusions in this regard. If increased concentration in the Canadian domestic market follows the same pattern as in the U.S. then the persistent focus on international markets to justify the mergers is warranted.

Market Structure and Concentration of the Banking Industry

The Canadian Banking industry acts as an oligopolist bank in the sense of cournot whereby competing banks will react to a product or service innovation by an innovative bank, and in the context of price adjustments in the sense of Edgeworth's conjectural variation in price.

While such conjectural variations describe the market in terms of revenue generating output, there has been in recent years a collusive or cooperative effort among the banks to reduce costs on the input side. These efforts include the consolidation if back-office operations such as cheque clearing.

As Mathewson and Quigley discuss, much of the momentum for merger activity has been driven by technology, which has led to an increase in the average fixed costs of branch offices. Their theme is that technology has provided so much choice to consumers that only a small percentage are truly willing to pay the incremental charges for branch bank services resulting from a decrease demand for those services. Whether or not a branch office is a cost centre or a profit centre depends on a number of factors including concentration within the immediate vicinity of the bank, the demographic makeup and travel time of customers to the bank, and the range of services offered by the bank. Ideally, from a corporate perspective, the economic goal would be to drive the cost of some branch banks to zero by closing them (in a proximal area), or merging the more inefficient branch with the more efficient branch.

The process of consolidation of the branches comes in two forms. The first is where branches for both the merging banks are in one location, and the second is where one of the two banks does not have a presence in the immediate market. Clearly the synergistic benefits to each case will be different, but the overriding cross sectional goal will be to increase market presence and/or increase economic efficiencies.

The economic efficiencies considered in mergers are typically economics of scale, size, and scope and these can be measured in a number of ways. Unfortunately the dearth of publicity available information relating pre and post merger economics has resulted in no known studies measuring these efficiencies in Canada. However, a substantial number of studies have been

done in the U.S.A., some of which are summarized below. Unfortunately, if, as Mathewson and Quigley argue, the primary motivation of merger activities is technological, the U.S. studies which predate the early 1990s may exclude some very important information.

Measurement of merger/acquisition activity falls into three broad categories of 1) scale economies and economic efficiency, 2) economies of scope and 3) market concentration.

Economies of scale are measured by one or more of Ray Scale Economies which measures the elasticity of cash with respect to output, and holding the output bundle constant; Expansion Path Scale Economics which measures efficiency along the bank expansion path as the output bundle changes; and X-efficiency which states that firms with superior management or production technologies have lower cash and higher profits.

Overall, the evidence from U.S. studies does not support the view that mergers and acquisitions within the banking system can increase economies of scale. Mitchell and Onvural find that the Ray Scale Economies of banks reveal, for the most part, either increasing or constant returns to scale, with some of their models showing decreasing returns over a small range of bank sizes. Expansion Path Scale Economies generally showed constant return to scale. Perishiani, upon investigating if U.S. bank mergers had a beneficial impact on the U.S. system, found pre-merger that X-efficiency was fairly constant for small banks, but lower for large banks and Ray Scale efficiency was lower for smaller and larger banks. Post-merger, Perishiani concluded that X-efficiency decreased, likely due to the acquisition of incompatible management or resources, while scale efficiency slightly increased, especially if the merged bank was originally smaller and less efficient than the acquiring bank. Berger, in contrast finds that scale economies cannot explain profits in the banking sector, but superior management as measured by X-efficiency could explain some of the profits. Clark finds that cost inefficiencies are widespread across banks,

perhaps due to banks concentrating too much on cost reduction rather than the opportunity cost associated with those reductions.

Scope economies are measured by economies of scope which measures the percentage cost savings from producing two or more output joints in a single bank rather than in multiple and specialized facilities. A related measure of scope is called Expansion Path Subadditivity. This results from a situation in which Bank A produces outputs Y_1^A and Y_2^A jointly; bank B, a smaller bank/facility, produces $Y_1^B = Y_1^A$; and bank C specializes in producing $Y_2^C = Y_2^A$. In this economy $Y_1^A + Y_2^A = Y_1^B + Y_2^C$, and if the economies or joint production are subadditive, A can produce Y_1^A and Y_2^A and be competitive with B and C. If economies are superadditive then bank A could not produce Y_1^A and Y_2^A jointly while remaining competitive and the bank, in time, would not be viable (Mitchell and Onvural).

The evidence against scope economies appears to be substantial. Mitchell and Onvural find no evidence of scope economies which implies that across U.S. banks cost efficiencies are needed with regard to the bundle of goods sold, and the scale of the banking operations are independent of services offered as a bundle of goods or specialization. While there was no evidence of economies of scope they did find evidence of subadditivity which implies that banks offering a multitude of services can compete and remain viable, and coexist in an economy with smaller, more specialized banks. Likewise, while Clark finds no economies of scale he too finds evidence of subadditivity and in a symmetrical argument to Mitchell and Onvural, concludes that smaller specialized banks can remain viable and compete with larger banks.

The final category of analyses examines the relationship between market share, market power, and bank profits. The Mackay report examined concentration ratios from a number of countries and matched these to the interest rate spread. These are found in Table 5. It does not

appear that there is any relationship between increased concentration and spreads. For example, in Canada the top 5 banks hold 44% of assets and the spread over deposit rates is only 1.5%. In Germany, the top 5 banks have a concentration of only 21% but the spread is 4.29%.

Berger investigates the issue of market power under several different hypotheses. The first is the structure-conduct-performance hypothesis which states that the setting of prices are less favourable to consumers as market share and concentration increase. Second, the Relative Market Power hypothesis states that only firms with large market shares and well differentiated products are able to exercise market power in pricing and earn super normal profits.

Berger's motivation is an important one. Relative to economies of scale, if the mergers reveal excessive market power which impose an externality on consumers, then broadening antitrust legislation might be prudent. Berger finds no evidence to support the structure-conduct-performance hypothesis which implies that consumer externalities are not present in the market place. However, he does find evidence linking market share or concentration with profits. He then investigated whether profits were due to superior X-efficiency and found that X-efficiency was present, but uncorrelated, with market share and concentration. Hence, evidence which might point to profitability arising from relative market power theories are weakened. Ultimately, Berger concludes that banks with significant market share do not adversely affect consumer prices for goods and services, and upon finding no evidence of scale economies, concludes that profitability is best explained by X-efficiency. Consequently, bank profits arise from efficient management practices and advertising and exposure rather than the exercise of market power.

Paradoxically, Berger and Hannan, in a follow-up study investigating the finding of no economies of scale with increased concentration, suggest that super normal profits are not

realized even though in some concentrated markets, market power may exist. In other words, banks in concentrated markets may impose a cost externality on consumers, but because of cost inefficiencies which ultimately reduce profits, measures of market power may not be revealed under scrutiny. Why these inefficiencies occur is under question and Berger and Hannan hypothesize that managers, in essence, become complacent in the efficient operation of the bank and can hide this from shareholders with positive and attractive cash flow. This has been coined the "Quiet Life Hypothesis." Importantly, Berger and Hannan do not explicitly or implicitly test for the existence of market power, but presume its existence. However, they do measure cost inefficiencies and do find a negative relationship between increased concentration and cost efficiency. They argue that the cash profit potential due to the "quiet life" creates a social cost which could be as much as 20 times that of any social costs of mispricing to consumers. The key hypothesis and result is that it may be possible for firms in concentrated markets to exercise a market power that allows them to avoid minimizing costs without exiting the market. Whatever the cause of such an outcome, it might be due to a number of managerial responses which are inconsistent with profit maximization.

In the commissioned report to Mackay's report, McKinsey and Company (McKinsey) analysed 125 of the largest U.S. banks to determine if size improves financial performance. They found that the top 25 firms had revenue growth over 1992-1996 but was slightly higher than the average, and lower than the second quintile. McKinsey did not find any hard evidence of cost efficiencies with size, but did find that larger banks use capital more efficiently and with greater leverage than smaller banks. (They also find that these economies do not necessarily lead to increased share value.) McKinsey also found that larger banks were better positioned to absorb risk than smaller banks.

However, McKinsey and Company report that the 1997 annual report of the Chase Bank (from the 1996 merger between Chase and Chemical banks in New York) the (efficiency ratio) ratio of operating non-interest expense per dollar of operating revenue fell from 0 .63 in 1995 to 0.55 in 1997. This implies that there are, and may be opportunities for the Canadian banks to increase cost efficiencies.

Implications for the Canadian Bank Mergers

Subject to the obvious caveat that the above studies are based on the U.S. banking system, the results have significant implications for the Canadian financial system. The first implication is that the merging banks may not achieve the desired cost reduction due to increased economies of scale. The evidence suggests that for the level of output of the merging banks, the cost curves are so flat that any additional output will not improve costs.

The evidence also shows that the cost structure is quite independent of economies of scope. Although the banks are diversifying into other areas and offering new products to consumers there is little to justify offering these products and services as a bundle to consumers, or in the extreme setting up niche "boutique" operation with each operation offering a different service. In other words, there is no evidence to suggest that the banks will be better or worse off through a straight merger and full consolidification of products and services.

In addition to the lack of economies of scope, there is evidence of subadditivity in the joint delivery of products. This implies that in the absence of economies of scope there is no real competitive pressure to cause the banks to divest or apportion specific products. It appears that the large banks can viably coexist with smaller financial institutions which offer specialized but competing products, and vice versa. A further, and more important implication is that trusts,

credit-unions and other near-banks or lenders (such as the farm credit corporation) can also coexist. This latter conclusion arises not only from the U.S. findings on subadditivity, but also on the general finding that highly concentrated banks may become cost inefficient.

One of the biggest concerns is that the merging banks will have such a large share of the market that they will have the ability to exercise market power. There is no evidence in the U.S. studies to suggest that output prices would rise above competitive levels. In fact, any evidence of high profits in the U.S. was attributed to increased X-efficiency which increased market share, and not market power. For such profits to emerge in the Canadian banking system there must be clear synergies in management between merging banks, and cost inefficiencies due to the "quiet life" syndrome will have to be monitored.

The Impact of Mergers on Agriculture and Rural Communities

Domestically, one of the main criticisms of the mergers is that the increase in banking concentration will reduce competition and increase costs to the consumer. Of particular interest in this paper is the impact on agricultural lending. Total lending to agriculture has been increasing at a steady rate as shown in Figure 1. During that time the market share of agricultural lending by banks has been expanding as well B from 30% in 1971 to 46% in 1997 (Figure 2). The four banks proposing to merge account for a large proportion of the lending to agricultural and fishing as shown in Figure 3. Using 1997 year-end data, the merged Royal Bank/Bank of Montreal will account for 50.3% of outstanding loans by banks and the merged TD/CIBC will control another 31.3%. Between them they will also account for 84.5% of banking customers in the category of agriculture, fishing and trapping (Table 6).

With more than 80% of loans by banks and almost 85% of banking customers, will the

concentration in rural banking adversely affect costs and competition? As discussed earlier, the issue of concentration and competition was of significant concern in the MacKay Report. One frequently cited measure of industry concentration is the Herfindahl-Hirschman Index[2] that considers the market share of the four largest competitors in a market. According to the Horizontal Merger Guidelines of the U.S. Department of Justice and the Federal Trade Commission, a merger will raise concerns about competition if the HHI is between 1000 and 1800 and the change will increase the HHI by 100 or more, or if the post-merger HHI is above 1800 and the change is 50 or greater. If the market is considered to be Canadian Agricultural lending, the mergers will raise the HHI from 397 to 783. This would not pose a concern under U.S. criteria. However, if the market is considered to be agricultural lending by banks then the HHI will increase from 1872 to 3673. In our opinion, the former measure is more accurate for evaluating competition in agricultural lending since farmers are familiar with alternatives to borrowing from Canadian banks.

The situation is different when one examines rural banking services. While these shares are not sufficient to affect competition in agricultural lending they will change the face of rural banking in Canada. In locations where merged banks have multiple outlets the opportunity to cut costs by eliminating duplication exists and branches will disappear. This is cited as a reason for proceeding with the mergers in a report by the C.D. Howe institute. The move to increased reliance on electronic banking means that excess capacity exists in the Canadian banking system in the form of too many branches and branches with more physical space than they require. The merger would facilitate a reduction in capacity and costs associated with that capacity. Many

[2]The HHI equals the sum of the squares of the market share of the four largest competitors in a market. A market is defined as the smallest group of products and geographical area such that a monopoly in that market could raise prices by a certain amount.

communities will ultimately be serviced by one or two bank branches at most. Whether this negatively impacts consumers depends on access to alternatives. Alternatives are limited. The largest independent trust company in Canada, Canada Trust, has only 422 branches while credit unions have 934 branches. With more than 8,000 bank branches in Canada, banks dwarf the competition.

Finally, the last economic consideration relates to the assimilation and management of bank branches. There are two opposing economies which will impact the overall efficiencies of the mergers. First, if in any market the cross price elasticity of substitution between product bundles is positive, then the merging bank branches will be complementary. The merging of complementary products comes at an increased cost to the merger, and consequently the optimal response would be to close at least one branch, and incur the specific costs associated with this action. Second, there will exist markets in which the product offerings are substitutes. With the merging banks providing essentially the same bundle of products and services, the cross elasticity of substitution will likely be negative when two distinct or overlapping markets are merged. Under this scenario the costs can be reduced by offering the products of the merged bank at joint market locations.

As a result of these economies the likelihood that consumers of bank services will see any incremental cost increases post-merger is remote. The absence of a sustainable exertion of market power outside of the oligopoly model, coupled with the observation that smaller competing non-bank financial institutions can compete and thrive will almost certainly ensure this conclusion. The only real externality (which may not be costless) imposed on consumers will likely be increased travel costs (to a new branch of the merged company) and a changeover in management which could negatively impact long-standing lender-borrower relationships.

It would appear that in the absence of economies of scale, economies of scope, and market power, that the only remaining justification for the banks is to compete in international financing and investment. For the most part, all four merging banks have emphasized this rationale, and based on the above noted experience in the U.S. , as well as New Zealand and Australian experiences as discussed by Mathewson and Quigley, the rationale appears to be sound. Furthermore, claims by the merging banks that consumers will not be negatively impacted in price also appear to be sound; the Canadian financial system currently exists as an oligopoly in the pre-merger state. Shareholders will benefit, not so much from efficiencies and synergies brought about in the domestic financial market, but through better access to the international financial markets.

Epilogue

On December 14, 1998, the Federal Minister of Finance, Paul Martin, announced that he would not allow the bank mergers to go forward. The reaction was swift. The Bank of Commerce and Toronto Dominion banks immediately cancelled their merger, while the Royal Bank and Bank of Montreal announced that they would assess their options.

The rationale behind the cancellation appeared to be both political and economic. Mr. Martin, openly opposed to the mergers from the very beginning waited until a report from the Competition Bureau was released. While the possibility of future mergers was left open Mr. Martin made it clear that any "new proposals would have to demonstrate...that they do not unduly concentrate economic power, significantly reduce competition, or restrict our ability to

address prudential concerns" (Alan Toulin, National Post)[3]. Prudential concerns would include the political aspects of the mergers decision and the somewhat verocious stand against the banks taken by a number of interest groups and business organizations mostly representing concerned customers and small business.[4]

Politics aside, Mr. Martin's decision was based on the reports by the Competition Bureau and the Superintendent of Financial Institutions (who is in charge of ensuring the security of the financial system). In terms of the Competition Bureau's report it was based on defining 224 local markets across Canada for the Royal–Bank of Montreal merger and 179 markets for the CIBC-TD merger. Aside from concerns regarding merged entities issuing VISA and Mastercard, and Merchant/investment banking issues, the issues related to concentration and efficiency can be summarized as follows.[5]

- The RB-BM merger would create excessive (45%+) concentration in 104 of 224 markets while the CIBC-TD merger would create excessive concentration in 36 of 179 markets.
- The mergers would have lessened competition and caused higher prices, lower service levels, and less choice.
- The CIBC-TD merger would lessen competition for consumer loans in PEI, the Yukon and Northwest Territories while the RB-BOM merger would hurt business banking in B.C., Saskatchewan, Manitoba, Ontario and Nova Scotia.

Our results and conclusions which were not modified post December 15, 1998 are at odds with these conclusions. Although the Bureau could have had the resources for discovery,

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3 Toulin, Alan "Martin Hits Banks with both Barrels". National Post 1(43) Dec. 15, 1998.
4 In the years preceeding the merger announcements it is important to keep in mind that commercial lenders were under constant scrutiny in their lending practice to high risk, small, and new business.
5 Schofield, Heather "Financial Regulations Raised Serious Concerns About Alliance" The Globe and Mail December 15, 1998, page B1, B16. Vardy, Jill "Bureau Chides Banks for not Playing Ball" National Post,

much of the conclusions are speculative. Our review of the U.S. system in concentrated and unconcentrated markets does not show any instance wherein increased market concentration reduced competition, and indeed here is emerging evidence that new lenders, boutique financiers, and other financial institutions can compete and thrive in concentrated markets: Economies of scope is not a driver for change. Also our analysis for agriculture and rural communities, (which does not separate out separate markets) does not find undue market concentration in general. It is unclear whether the Competition Bureau included only banks in its measure of concentration, or all financial institutions. Our results would raise concerns if concentration focused only commercial banks but this would clearly be incorrect.

Even though we did not separate markets it is clear that in some local markets brances would merge or close altogether, and this would have been of economic necessity since holding complimentary products in one market is inefficient. However, based on the U.S. experience, branch closings and increased concentration does not imply that services will be offered at less than competitive rates. The Canadian banking system operates as an oligopoly not a monopoly, so that any mispricing in any one market would bring swift rebuke form competitive lenders and regulators. (The Competition Bureau would have us believe that Canada is comprised of 403 distinct markets, with each concentrated market operating as a monopolist independent of tangential or overlapping market, competition from other non-bank institutions, and macro-economic conditions).

In our opening statement to this paper we stated that the bank merger impact on agriculture and rural communities cannot be discussed in isolation of the broader issues facing Canada's macro economy and international financial markets. In our conclusions we admit that

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December 15, 1998, page C1, Financial Post.

there will be dislocation and increased concentration in rural markets, but given the broader issues facing the Canadian financial system, we were unable and unwilling to conclude that the mergers were bad.

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Table 1: Household Financial Assets by Product (% of Financial Assets)

	1977	1982	1987	1992	1997
Mutual Funds	1.0	0.9	3.0	5.2	14.2
Pension Claims	9.6	12.4	15.4	17.6	21.6
Shares	19.6	22.1	20.8	16.7	14.2
Bonds and Money Market	11.1	10.5	10.9	8.0	5.3
Deposits	31.0	34.1	30.0	52.5	25.1
Life Insurance	10.15	10.0	10.6	11.4	10.7
Other	17.2	10.0	9.3	8.6	8.9
Total Financial Assets ($ Billions)	307.2	570.1	916.3	1,533.7	1,791.0

Table 2: Overview of the Canadian Financial Services Sector, 1997

	No. Of Companies	Total Assets ($ Billions)	Capitol ($ Billions)	Total Revenue ($ Billions)	Net Income ($ Billions)
Banks	55	1,321.9	55.7	83.7	7.5
Canadian	11	1,229.9	50.7	78.0	7.1
Foreign	44	92.0	5.0	5.7	0.4
Trusts (exc. Bank subsidiaries)	34	53.5	2.3	5.4	0.6
Credit Unions/ Causses Populaires	2,289	107.0	6.8	7.9	0.5
Life Insurance Co.[6]	131	233.4	28.0	58.3	2.6
Canadian	45	208.4	23.6	N.A.[7]	2.4
Foreign	86	25.0	4.4	NA	0.2
Property and Casualty Insurance	236	53.3	15.5	21.6	1.8
Canadian	89	NA	NA	6.9	NA
Foreign	147	NA	NA	14.6	NA
Securities Dealers	187	158.2	3.5	8.5	0.8
Mutual Funds	78	280.1	NA	NA	NA
Asset Based Financing/leasing	130	50	NA	NA	NA

Source: Report of the Task Force on the Future of the Canadian Financial Services Sector September 1998, Page 43.

[6]Based on 1996 figures

[7]N.A. not available

Table 3: Competition in the Canadian Financial Sector: Share of Total Asset

Royal Bank	12.1%
TD Bank	6.8%
CIBC	10.0%
Bank of Montreal	7.8%
National Bank	3.4%
Bank of Nova Scotia	7.4%
Credit Unions/Causses Populaires	10.2%
Other Deposit Accepting Institutions	8.9%
Trusts	5.9%
P & C Insurers	3.4%
Life Insurers	13.8%
Consumer and Business Finance	5.4%
Other Financial Intermediaries	4.9%

Source: Royal Bank of Canada in CBA Submission to Task Force.

Table 4: Accelerated Trend Toward Consolidation

Mergers and Acquisitions in Financial Industry Worldwide

1987	1000	
1988	1200	
1989	1900	
1990	2300	
1991	2900	
1992	2800	
1993	3000	
1994	3400	
1995	4100	
1996	4200	
1997	2200	(Part of 1997 only)

Source: Canadian Bankers' Association, Submission to Task Force

Table 5: Competitive and Concentration in the Banking Sector

Country	5 Top Banks' Concentration	Interest Rate Spread
Finland	43%	-1.0%
France	32%	0.75
U.K.	17%	1.0%
Japan	10%	1.49%
Netherlands	55%	1.49%
Canada	44%	1.5%
U.S.	5%	2.0%
Italy	17%	2.25%
Switzerland	80%	3.0%
Sweden	29%	3.8%
Germany	21%	4.29%

Source: Adapted from CBA Submission/OECD and IMF

Business Lending By Major Canadian Banks

Table 6. Merged Bank Shares of Agricultural Lending

Agriculture and Related Services, Fishing and Trapping

Bank	Loans Authorized ($,000)	Percentage of Authorized	Loans Outstanding ($,000)	Percentage of Outstanding	Customers ($,000)	Percentage of Customers		
Bank of Montreal and Royal Bank	$7,789,185	*49.4%*	$6,021,026	*50.3%*	$63,749	*54.2%*		
TD and CIBC	$5,109,665	*32.4%*	$3,749,158	*31.3%*	$35,631	*30.3%*		
Bank of N.S.	$1,718,429	**10.91%**	$1,459,625	**12.18%**	$13,237	**11.25%**		
National Bank	$1,028,893	**6.53%**	$668,253	**5.58%**	$4,732	**4.02%**		
Hongkong Bank	$111,917	**0.71%**	$83,626	**0.70%**	$290	**0.25%**		
7 Bank Total								
						Authorized	**Outstanding**	**Customers**
	Percentages							
Bank of Montreal	17.47%		18.11%		24.61%	2752790	2169636	28953
Royal Bank	31.96%		32.14%		29.58%	5036395	3851390	34796
TD	13.22%		12.32%		12.34%	2083587	1476185	14518
CIBC	19.20%		18.97%		17.95%	3026078	2272973	21113
Bank of N.S.	10.91%		12.18%		11.25%	1718429	1459625	13237
National Bank	6.53%		5.58%		4.02%	1028893	668253	4732
Hongkong Bank	0.71%		0.70%		0.25%	111917	83626	290
7 Bank Total						15758089	11981688	117639

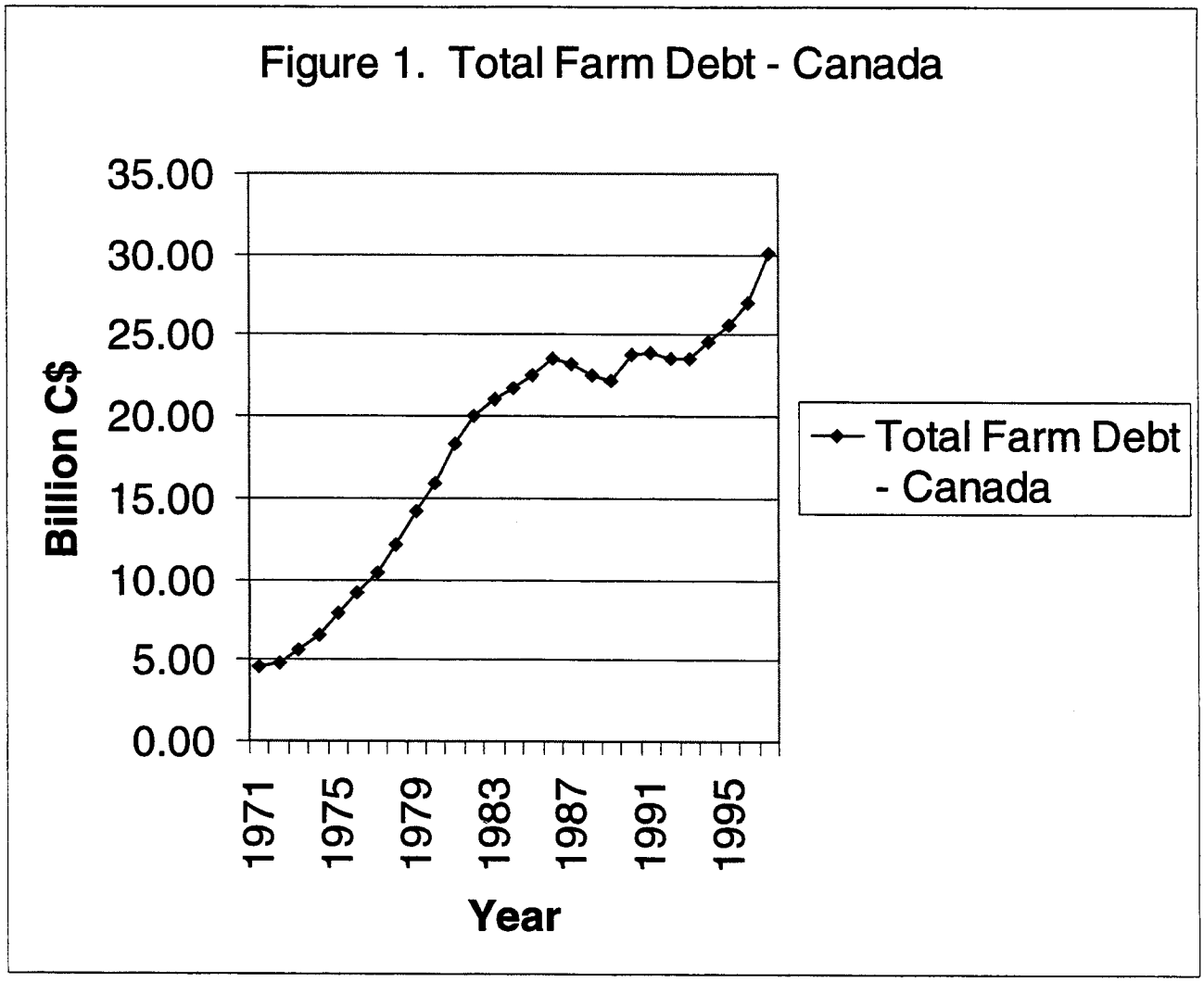
Figure 1. Total Farm Debt - Canada
35.00
30.00
25.00
20.00
15.00
10.00
5.00
0.00
Billion C$
1971
1975
1979
1983
1987
1991
1995
Year
Total Farm Debt - Canada

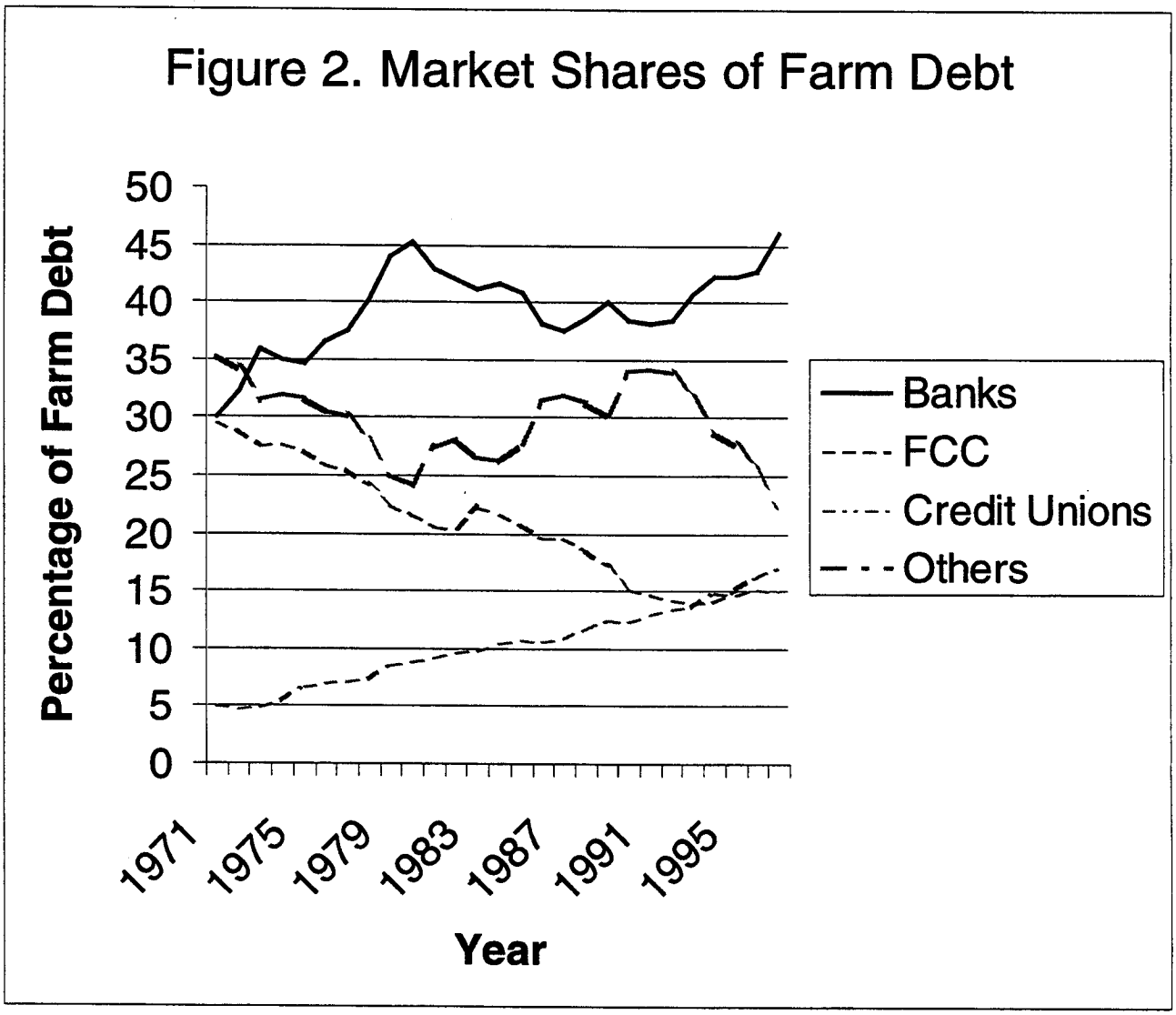
Figure 2. Market Shares of Farm Debt
Percentage of Farm Debt
50
45
40
35
30
25
20
15
10
5
0
1971
1975
1979
1983
1987
1991
1995
Year
Banks
FCC
Credit Unions
Others
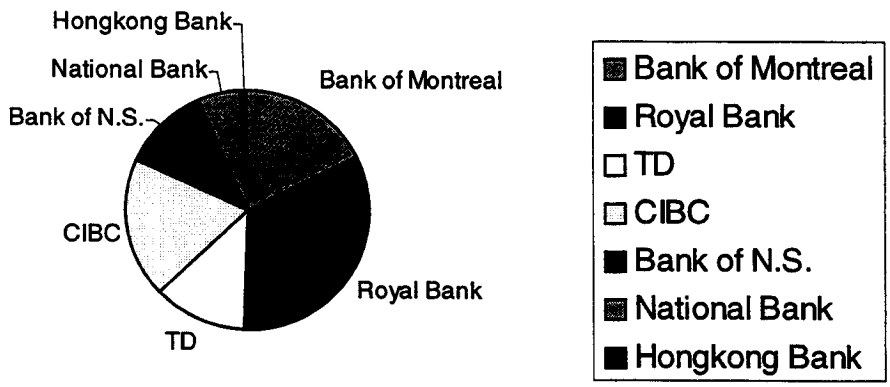
Figure 3. Share of Outstanding Agricultural Bank Loans