CONSUMERS ASSESS MERGERS AMONG BIG BANKS

Presentation by the

Consumers' Association of Canada

to the

Honourable Ralph Goodale

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The Consumers' Association of Canada (CAC) is a 54-year-old independent, not-for-profit, volunteer based organization with a National office in Ottawa and Provincial/Territorial branches. Our mandate is to inform and educate consumers on marketplace issues, to advocate for consumers with government and industry, and work with government and industry to solve marketplace problems.
CAC focuses its work in the areas of food, health, financial services, trade, standards, communication services and other marketplace issues as they emerge.

All CAC policies on specific issues are framed within a set of general, consumer-oriented principles. Eight such principles govern consumer associations belonging to the worldwide federation of consumer groups, Consumers' International. Among these are the right to choice, safety, information, a healthy environment and a right to be heard.

L'Association des consommateurs du Canada (ACC) a été crée en 1947. C'est un organisme à but non lucratif indépendant qui dépend en grand partie pour son fonctionnement de l'apport de nombreux bénévoles à travers le pays. Son mandat consiste à informer et à éduquer les consommateurs canadiens au sujet des questions reliées au marché de la consommation, à les représenter auprès des instances gouvernementales et des industries et, enfin, à travailler avec les gouvernements et les industries dans le but de résoudre des problèmes de consommation au bénéfice des parties en cause.

L'ACC travaille plus particulièrement dans les domaines de l'alimentation, de la santé, du commerce, des normes, des services financiers, des communications, des industries, et s'intéresse également à d'autres domaines en fonction des questions qui surgissent à l'occasion, et qui ont un impact en matière de consommation.

Toutes les politiques de l'ACC au sujet de questions spécifiques sont fondées sur des principes généraux qui tendent tous à assurer la défense des intérêts des consommateurs et à faire valoir leur point de vue là où cela s'avère nécessaire. Les associations qui composent la Fédération internationale des regroupements de consommateurs, mieux connue sous le nom de ***Consumers´International***, ont établi huit principes de base, dont le droit de choisir, celui d'être entendu et celui d'obtenir satisfaction.

OVERVIEW

The bulk of economic evidence does not support a case for mergers among big Canadian banks. Much of this evidence can be assessed by the Competition Bureau while prudential matters are appraised by the Office of the Superintendent of Financial Institutions. However, additional appraisal of proposed bank mergers by the House of Commons is necessary for at least three reasons. These issues are: downstream impacts on costs in the economy, the concentration of power, and effects on the *quality* of financial services.

1. THE OVERALL COMPETITIVE IMPACT ON CANADIAN FIRMS

Economic assessment has been guided by the assumption that efficiency gains, when they exist, are to be assessed on an "overall" basis - they need **not** be judged on the basis of the incidence - or the distribution - of such gains. For an important intermediary input like financial services, this means that gains to merger-makers need not be shared with those who lose from a merger. The result is that thousands of Canadian firms can be disadvantaged in the marketplace in a manner that makes them less competitive after a bank merger is permitted. This is a dynamic - ongoing - impact. The *distribution* of losses over all firms and individuals is not a thought to be crucial in economic theory, and it is therefore not fully accounted for by competition authorities. It is, however, taken into account by members of parliament from a wide variety of ridings who see a need to be reelected. This point goes well beyond the recognition - important as it is - that most mergers that do take place eventually fail the market test as measured by the destruction of shareholder value.

2. CONCENTRATION OF POWER.

Canadians have long been concerned about the concentration of power.[1] Some are anxious about the excessive attention elected officials would have to pay to the new giants, a matter receiving attention in informal proposals on campaign financing.

3. THE INADEQUATE ASSESSMENT OF QUALITY.

[1] In 1975, the Royal Commission on Corporate Concentration (Bryce Commission), received no fewer than 287 briefs, one from the Consumers' Association of Canada and more than one from most of the then big banks.

Vigorous competition has many effects, one of which is innovation and improvement of service. A plausible reason for the lack of success of Canadian banks in the international marketplace is that - coming from an oligopolistic base, they are not well tuned to move at the speed of vigorous competitors. In this regard, there is more promise in mergers with agile foreign banks - or with Canadian insurance firms which have demonstrated the ability to succeed internationally.

Banks have not been leaders in customer satisfaction. It was a competitive trust industry - once led by Canada Trust - that obliged banks to offer better hours to customers. In research conducted for the MacKay Task Force,[2] several service characteristics were identified and service levels in eight countries were assessed. Canadian banks do well in some competitive dimensions (e.g., technology) and poorly in others (e.g., document clarity). 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 twenty-one.[3] More important, evidence indicates that the more monopolised an industry is, the lower the lower it scores when customers assess service quality.[4] Customer service is the only path to long-run success, and monopolized sectors have a poor record on this score. Quality is a complex thing and not all evidence is on one side. Current assessment mechanisms are thoroughly inadequate to determine Canada's interest.

For at least these two reasons, we need a more comprehensive review of proposed bank mergers than is provided by the two assessment agencies outside the House of Commons Committee.

ASSESSMENT BY ECONOMIC AGENCIES

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[2] See the two-volume Report edited by Robert Kerton, ***Consumers in the Financial Services Sector***, Volume 1: Principles, Practice and Policy - the Canadian Experience, pp. 267. Volume**:** ***Consumers in the Financial Services Sector: International Experience***, pp 224; Research Papers for the Task Force on the Future of the Canadian Financial Services Sector. Ottawa. 1998. ISBN 0-662-27146-7 and ISBN 0-662-27147 **http://finservtaskforce.fin.gc.ca/research/research.htm** Les consommateurs et le secteur des services financiers disponible à: **http://finservtaskforce.fin.gc.ca/research/recherch.htm** As one response to these studies and the Report of the MacKay Task Force, in 2000 a Financial Consumers Agency was established with important information and educational responsibilities: **http://www.fcac-acfc.gc.ca/**

[3] ***How Canadians View the Quality of Goods and Services, 1997 National Report***, National Quality Institute, Etobicoke, 1998; p. 17: **http://www.nqi.com**

[4] Claes Fornell, "A National Customer Satisfaction Barometer: The Swedish Experience," ***Journal of Marketing***, January 1992.

The Office of the Superintendent of Financial Institutions (OSFI) appraises prudential matters. The Competition Bureau appraises market issues.[5] The following two issues may or may not be adequately assessed by these two agencies. It is an open question whether OSFI feels any responsibility for the "Too big to fail" risk to taxpayers. It does seem certain that the price impact of further mergers will be assessed with more expertise by the Competition Bureau than by any other agency. Factors to be considered by the Bureau and expressly referred to in the Competition Act are seven in number:

1. The amount of foreign competition,
2. Whether a party to the merger has failed or is likely to fail,
3. The availability of substitute products,
4. Any barriers preventing new competition from entering the market,
5. The extent to which effective competition remains in the market,
6. The likelihood of removal of a vigorous and effective competitor, and,
7. The nature and extent of change and innovation in a relevant market.

4. PRICE IMPACTS OF MONOPOLY

Prices increase as competition is reduced.[6] This is an increase in cost for virtually every Canadian firm - affecting the consumer's cost of living and affecting international competitiveness of exporters. Some proponents of mergers who feel certain that economies of scale must exist, cannot explain how the reduced competition will increase the quantity of loans to borrowers or how it will result in more attentive service or lower bank fees.[7] In fact, much evidence exists from studies on bank mergers showing that, over a certain size level, economies of scale are absent or

[6] Evidence from ***Business Week*** (June 3, 1998) shows that, compared to regular sellers, the offerings from one-stop financial supermarkets are more expensive for consumers on grounds of both time and money.

[7] Economists usually do not concern themselves with the distribution of the benefits so long as they really exist. For most people, including elected representatives, it=s **all** about who wins and who loses. At the time the merger law was being created, CAC was pleased that most provisions it wanted were put into the Act but in 1986: CAC felt that merger proponents should be required to state, in advance, how gains would be distributed.

unimportant.[8] Thus, there are no gains that could reduce prices even if the market were competitive enough to get them passed along to consumers.

The evidence on price increases from recent mergers among Canadian banks is compelling: it is harder to get loans in local markets after a merger and it definitely comes at a higher price. There is a single study that suggests there are unexploited scale economies - contrary to all other evidence. In that study, the abnormal result relies on the assumption that there is *one national market* while most consumers and firms operate in a *local* market, one with fewer competitors after a big merger. This crucial point (local, or national, market) has been carefully researched for firms making loans. The result? What matters is indeed the local market: when other factors are allowed for, branch closings in Canada are associated with higher interest on loans to small businesses.[9] Mergers among the existing giants are contrary to Canada's interest.

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 already too big to fail. It is sobering to contemplate the losses that might have been earned in the telecom and tech sectors if the earlier proposals for blockbuster mergers had been approved.

CONCLUSION

Growth of banks - at home and abroad - relies on the ability to offer new and competitive services at the world level of excellence. Virtually all evidence on economies of scale agrees that banks of the size of the big five are already capturing scale efficiencies and further increases in size offer little or no additional gains. Banks are big enough right now. As we stated in an earlier report "The competitive race may go to the swift - to the agile - not to the one with the most heft. When

[8] ***Business Week***, October 14, 2002; Cover Story: A*Mergers: Why Most Big Deals Don=t Pay Off.*@ CAC's technical paper surveys the evidence: **Being Big or Being Good**? Most of the evidence is included in the CAC presentation to the Senate at the hearings held in November, 2002. The Senate report is**: Competition in the Public Interest: Large Bank Mergers in Canada**, Report of the Standing Senate Committee on Banking and Finance; Senate of Canada, Ottawa, December, 2002.

[9] Ted Mallett, and Anindya Sen, "Does Local Competition Impact Interest Rates Charged on Small Business Loans? Empirical Evidence from Canada," ***Review of Industrial Organization***, 19(4), December 2001, pp.435- 450.

we merge two giants, we paste together two different networks of information and we often try to combine two corporate cultures. This can result in Tyrannosaurus Rex."[10]

There are factors important to the public interest that are beyond prudential matters, and beyond competitive issues. It is by no means clear that tests by OSFI, and by the Competition Bureau, necessary as they are, will be sufficient to ensure overall benefit to Canada. *So far, the proponents of mergers have not provided one shred of evidence to show that the use of higher revenues from more monopolized markets at home will lead to international levels of service quality abroad.* With mergers among big banks, all small Canadian firms will be less competitive internationally and at home. While there is every reason for Canadians to want to see our banks succeed in international markets, success must be earned in a way that, to quote a Senate report (2002) "…helps to improve the prosperity and competitiveness of the national economy," not in a manner that harms those important factors.

[10] See Consumers Association of Canada: "Thinking Big: The Consumer Interest in Bank Mergers", testimony before the House of Commons Committee on Banking Trade and Economic Affairs, January 30, 2003; Ottawa. A plain language explanation is in Robert R. Kerton, **"Can Consumers Bank on Mergers?"** *Policy Options / Options Politiques*; March; pp. 16-18. March, 2003.