HCP NOTES

Are the Canadian Banks Becoming Too Powerful?

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Expanded version of article entitled "How to Break the Banks' Market Dominance" published in the Globe and Mail on July 27, 2012.

Over the past few years, the Canadian banks have been praised for avoiding the worst of the global financial crisis. This success is firmly rooted in public policy (and good management) since, for much of the past century, Canadian policy makers – i.e., governments and regulators – sought to create a very powerful and Canadian-controlled banking system.

They succeeded.

However, as the banks' market dominance continues to grow, perhaps it is time for policy makers to ask the question: *are the Canadian banks becoming too powerful?* We contend that the answer is yes, and believe that preventing further concentration should be a key priority for policy makers.

Policy Makers Create a Powerful Domestic Banking Sector

To understand why, it is useful to review how bank policy in Canada has evolved. This process largely took place in two stages.

Stage #1: Facilitating Domestic Consolidation (Early 1900's to 1990's)
The first phase took place through most of the 20th century, during which policy makers embraced bank (and trust) mergers with the clear objective of creating national banks that would be competitive with foreign banks, especially their more fragmented U.S. counterparts. This process continued through the 1990's when the banks acquired virtually the entire trust sector, essentially removing a noteworthy segment of the retail banking market.

Although this consolidation removed some notable competitors, it was in keeping with the policy objective of creating a powerful Canadian banking sector. The domestic bank consolidation stage essentially ended with the failed merger proposals in the late 1990's, and since then, there has been a de facto moratorium on bank mergers.

Interestingly, throughout most of its history, American banking policy had the opposite objective. In other words, American policy makers have sought to create and maintain a fragmented system in order to limit the power and influence of the NYC-based money center banks. Emphasis on unit banking and limitations on branch banking, combined with restrictions on interstate banking (especially in the early 1900's), were the key tools used by legislators.

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Like their Canadian counterparts, U.S. policy makers succeeded in their objective and created a highly fragmented system. In fact, the system had approximately 14,000 banks and thrifts for the better part of the 20th century. Only in the past 30 years have U.S. policy makers removed barriers to consolidation, allowing the number of banks and thrifts to decline by approximately half.

Stage #2: Embracing the Universal Bank Model (1980's to present)
The second phase of Canadian banking policy evolution, which began in the late 1980's and continues today, was a full embrace of the universal bank model with the acquisition of the broker-dealers, including their highly profitable and strategically valuable retail brokerage networks[1].

The acquisition of the brokers occurred at approximately the same time as financial deregulation was taking hold in both the U.K. and the U.S.[2] At approximately the same time, the Canadian investment banking industry was in need of capital, as it struggled for ways to cope with the transformation from an agency model to a more capital intensive principal model. As a result, the sector was encouraged by Canadian regulators and legislators to combine with the banking system as a way to prevent its takeover by foreigners (namely, U.S. banks and brokers).

As we highlighted in our essay "*The Canadian Banks – the End of an Era*" (May 2011), no other policy change in the last twenty years did more to transform the banks and contribute to their outsized EPS growth. As a result, we were surprised when Sandy Weill, the successful and long-time CEO of Citigroup, recently disavowed his support of the universal bank model (and the removal of Glass-Steagall, which he championed). The near collapse of the U.S. independent *investment* banks during the Credit Crisis and their spread of financial contagion were factors and would seem to belie this view. In fact, the performance of the Canadian banks during this time clearly demonstrated the benefits of this model, i.e. the diversification of revenues, earnings and geography, all of which make for a stronger, not weaker, banking system.

Policy Makers Succeed in Creating Durable Banking System
The results of these policy efforts were a huge success. Without a doubt, Canadian policy makers helped to create a very durable financial system less vulnerable to shocks, pleasing both capitalists and economic nationalists.

So, why propose any changes?

While the current system is excellent, the ongoing concentration of power is not entirely benign to either consumers or businesses. The biggest negative to the system is obvious: because the banks enjoy de facto protection against foreign acquisitions, wide swaths of the wealth management and investment banking sectors have also become protected, creating what is now effectively a closed market.

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[1] This did not extend to bancassurance (following the demutualization of much of the life insurance sector).

[2] This change occurred before the U.S. government officially repealed Glass-Steagall, which as part of the historic *Banking Act of 1933* required the separation of commercial and investment banking activities. Glass-Steagall was officially removed in 1999 with the passage of Gramm-Leach-Bliley. However, it had been substantially diluted well in advance.

In fact, there is not a single business where foreign competitors pose a serious threat to the Big Five banks. Under this umbrella of protection, they have used their overwhelming size and distribution power to achieve domestic market dominance against their smaller domestic competitors, earning significant returns on equity in the process.

In exchange for the banks' protected status, policy makers need to ensure their accumulated market power doesn't hurt competition.

Three Policy Recommendations to Increase Competition

Recognizing that there are no perfect solutions, and many policy prescriptions require trade-offs, we believe there are some basic steps policy makers can pursue to enhance competition, and curb the ongoing accumulation of market power by these five companies.

<u>Proposal #1</u>: Introduce a Deposit Cap to Prevent Further Market Dominance

First, policy makers should introduce a domestic market share cap for retail deposits that would prohibit acquisitions *within Canada* of other Canadian retail banking platforms once a bank achieves a certain deposit market share, say 10%. Beyond this limit, growth in domestic retail banking would have to be organic.

The objective of this policy, which exists in the U.S., would be to enhance competition by preventing excess market concentration in retail banking. It would also ensure that the banks do not use their massive size and market power to buy assets coming up for sale, thereby preventing smaller platforms from merging and becoming larger, more formidable competitors.

Preventing further concentration is one of the most important – and simple – reforms for the system that is already extremely concentrated. In a business where scale is critical to success, the Big Five banks now control over 70% of the retail deposit market; the two largest banks represent over 35%![(3)].

One could argue that this level of concentration is particularly problematic since this market share is not evenly distributed nationally, with two of the larger remaining competitors (National Bank and Desjardins) operating primarily in Quebec. This policy change would effectively mean, for example, that none of the Big Five banks would be allowed to acquire HSBC Canada, Laurentian Bank or Canadian Western Bank, if they came up for sale.

Banks might argue that the current system works fine and that such a cap is unnecessary, citing the plethora of competitors. However, this competition is arguably overstated because most of these competitors are dwarfed in size by their larger peers. Moreover, the Big Five enjoy a product advantage, making their smaller competitors, by and large, price takers, attempting to compete primarily on service.

In short, there are simply no policy benefits to further concentration.

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[3] Source: OSFI. Market shares are approximate and reflect the Big-Five's market share of "Demand and Notice" deposits and "Fixed Term" deposits for Individuals. The market is defined as all banks, trust companies, and co-op/retail for a total of approximately $800 billion (total retail deposits, which include foreign subsidiaries, is approximately $1.1 trillion).

Therefore, in the event of further system consolidation, a key policy objective should be to facilitate the creation of other large competitors outside the current oligopoly with the scale to better compete. If successful, this would be a positive for the system as it should increase access to credit.

Proposal #2: Allow 100% Foreign Ownership of All Banks, Except the "Big Four"
Second, the restriction on foreign ownerships should be removed to allow foreign competitors to acquire, in a friendly transaction, 100% of: CIBC[(4)], National Bank, Canadian Western Bank, Laurentian Bank, and all other small banks.

This would allow a smaller bank lacking a foreign platform to augment growth to take on a larger partner to help offset its scale and/or strategic disadvantages. The four largest banks, Royal Bank, Scotiabank, Bank of Montreal, and TD Bank, would remain as "national champions", continuing to benefit from government protection, thereby retaining a key policy objective.

This proposal has the potential to introduce additional competition to the system by strengthening the smallest banks. Does anyone not believe that market competition would rise if the highly respected Wells Fargo acquired CIBC? With over 10.5% of the U.S. deposit market[(5)], Wells Fargo is restricted from growing via acquisitions in U.S. retail banking, and has made previous small forays into Canada. With more than three times the assets of CIBC and an excellent reputation in retail banking, it would be a formidable partner. This is but one example. National Bank also has an excellent franchise, but it too could benefit from having the strategic option of taking on a larger partner, if desired.

Proposal #3: Require Open Architecture for Third Party Mutual Funds in the Retail Branch System
Policy makers should require the banks to offer for sale third party domestic mutual funds– for a fee – in their retail branch networks (note, Hamilton Capital does not sell mutual funds). This change, which is referred to as open architecture, exists in the retail brokerage channel, and the same principles apply to adding it to the retail branch system.

Open architecture is arguably more important in retail banking than retail brokerage, because bank customers, generally speaking, have less investment knowledge than retail brokerage clients. For example, many bank fund complexes are terrible, but grow nonetheless, as they sell to customers less familiar with other investment options.

The banks may ask why they should have to open up their branch networks to other competitors. The banks built their branch networks at their expense. Should they not benefit exclusively? Or at least be able to offer third party funds at their own option?

[4] CIBC is the smallest of the Big Five, with total assets of about $387 billion. It is unique among the Big Five in that it does not have a significant foreign platform in which to allocate the ongoing accumulation of excess capital, and as a result, has less strategic options (hence its inclusion on this list).

[5] As of June 30, 2011. Source: SNL Financial.

The reason for advocating this policy lies in the unique nature of investment products, since, unlike selling watches for example, you cannot "return losses". As a result, investment products have a unique status within the legal and regulatory system. Companies selling mutual funds (and most other investment products) must meet certain regulatory and licensing requirements, including, among others, "duty of care" and "know your client". The seller also inherits a "fiduciary responsibility" and is regulated as a result.

In captive channels, there are also concerns that compensation schemes can be devised to encourage employees to sell their customers the most profitable but not necessarily the most appropriate product. For this reason, many believe the sale of proprietary financial products, in absence of open architecture, creates a conflict of interest.

Therefore, allowing the sale of third party funds is an appropriate remedy, as it would enable the licensed financial planner to offer products that they consider the most appropriate for their client, which may or may not be an in-house product. This eliminates, or at least minimizes, this real or perceived conflict.

Improving Competition in the Banking Sector

If introduced, none of these recommendations, which are forward looking in nature, would negatively impact the Canadian banks as they are currently constituted. Nor do they require additional cost to taxpayers. But they all have the potential to help create a more competitive Canadian financial system, which should ultimately benefit consumers and businesses.

Canadian banks are very well run organizations. However, over the past several decades, our financial system has become increasingly organized to the benefit of the five giant banks. Policy makers can take steps to impede this advancement, and ensure the system evolves in a way that serves all Canadians, not just bank shareholders. The fact that virtually all Canadian bank investors believe these are "can't lose" stocks says a lot.

Disclosure: At the time of distribution, no HCP fund held any Canadian bank shares, either long or short.