Banks: gladiators or castaways

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Canadian financial sector reform is once again at political centre stage. Last week, Paul Martin, the Minister of Finance, presented his legislation, while ever-patient industry players offered their support and business media pundits fired their darts. "Financial bill already close to irrelevancy," was one commentary's headline. "Much ado about nothing," echoed another.

We are ignoring fundamental realities. Canada's financial services industry, already one of the economy's most heavily regulated sectors, is a major national asset that deserves to be nurtured. The current reform package should be seen, at the most basic level, as the government's best platform for industry players to operate in their fiercely competitive environment.

Canada must assess what kind of financial services sector will emerge under this legislative framework. Will Mr. Martin's bill allow for necessary structural changes in the industry? In today's global economy, will we see the industry turning into — with apologies to the new crop of Oscar nominees — a competitive *Gladiator* or an isolated *Cast Away*?

The bill's major features raise troubling questions. Consider these three components: the new ownership regime, the banking-insurance divide and the government's large bank merger review policy.

Our largest institutions — those with over $5-billion in equity — will enjoy a new "widely held" ownership rule that will allow a single investor to own up to 20% of a major Canadian bank's voting shares. At the other end of the scale, to encourage new entrants, a single investor may wholly own a small bank (equity below $1-billion).

Many tout the new widely held ownership rule for facilitating new strategic alliances and joint ventures, along with capital infusions into the Canadian banking system. Bearing in mind that the decades-old 10% rule was designed to protect Canadian ownership (and later praised in Ottawa for preventing systemic commercial-financial links), one is hard pressed to identify many major potential investors within our borders.

To manage the new ownership regime, Mr. Martin's legislation will prohibit a major investor from exercising effective control over a large financial institution. Rules are being drafted to stipulate what constitutes control, but this issue has traditionally focused on corporate structures such as boards of directors.

Other industries provide vivid examples — AMR's "investment" several years ago in Canadian Airlines is but one — of where business alliances led to a real change of control. The new widely held ownership rule raises the spectre of a creeping foreign takeover of our largest financial institutions.

The banking-insurance divide, the last vestige of our system's four pillars, remains intact in several key aspects. Banks still can't sell insurance. More importantly, as a matter of policy, large banks can't acquire or merge with the large demutualized insurance companies.

The contrast with the U.S. situation is startling. American legislation has once again steamed past us by green-lighting cross-industry mergers like the massive Citigroup deal, which combined banking (Citibank), insurance (Travelers and Primerica) and investment banking (Salomon Smith Barney). Although Manulife Financial is rumoured to be interested in a similar partnering with a large Canadian bank, the potential for a Canadian-based financial powerhouse with global reach will continue to be off limits.

In the late 1980s, Canada showed leadership by allowing our banks to enter the securities field while the United States was mired in depression-era restrictions.

All that has changed dramatically in the past 24 months, with the United States allowing world-beating giants.

In 1998, Mr. Martin blocked bank mergers saying they would reduce competition, concentrate economic power and limit the government's ability to address potential financial system instability. His bottom line at the time: The government would consider no big bank mergers until a new financial institution framework was in place. In publishing its new Merger Review Guidelines, the government has now detailed the review process for any forthcoming merger proposals.

One measure against which they should be assessed is the business community's need for certainty. Few things are more highly valued. To the extent these Guidelines move from the purely *ad hoc* to a better understood and more transparent process, they represent a positive development. But the new rules contemplate a gauntlet-run of review and decision-making. Merger proponents must now prepare and make public a Public Interest Impact Assessment. To get a deal done, the parties will require contemporaneous reviews by the Competition Bureau and the Office of the Superintendent of Financial Institutions, hearings before committees of both the House of Commons and the Senate and an ultimate decision by the Minister of Finance.

The government's target of a five-month time frame for getting to decision is commendable, but previous experience teaches that bank merger review will be a complex, politically charged process. The absence of a fixed time frame (the European Union has a very successful five-month maximum) and the need for Senate Banking Committee review merely adds to this. All players would benefit from greater process certainty. In any event, any future bank merger planning will need heavy front-end loading to prepare adequately for a new public interest impact assessment process that requires early identification of remedial steps to address merger issues.

Ultimately, all Canadians must assess the consequences for the Canadian financial services industry without the needed structural change. Once large by world standards, Canada's banks today are small and shrinking fast. According to a *Euromoney* ranking, no Canadian bank makes it into world's largest 50 banks measured by shareholder equity. Less than 15 years ago, Canada's largest bank, RBC, ranked 22nd, and the smallest of Canada's big five banks ranked 39th. As Canada's position erodes further, Canadian financial institutions could be forced into a defensive posture to fend off would-be foreign predators.

With mergers, comparative strength and the ability to become proactive improve dramatically. If Canadian banks are not positioned to acquire, ultimately they face being acquired. Make no mistake: The new ownership regime poses this potential threat. Allowing mergers and cross-industry alliances to create stronger national financial institutions will ensure that Canada continues to reap the benefits of globally competitive institutions housed here. The alternative risks Canada's control of its strategic financial services industry as decision-making centres and research and development jobs relocate to the United States, a real *Cast Away* scenario. Clearly, we're rooting for a *Gladiator* outcome.

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