CONCENTRATION, CONGLOMERATES AND CONTESTABILITY

By D.F. McKinley*

I. Introduction and Summary

In March of this year, the President of the Canadian Bankers' Association held a press conference to mark release of a study entitled Concentration of Power in The Financial Services Industry. This CBA study examines the traditional measures of concentration, discusses allegations of bank dominance in financial services, and suggests replacement of the conventional approach to the analysis of banking with a model based on free entry and exit. The CBA's executive summary of the study is appended hereto.

The timing of the study's distribution (March, 1985) indicates the likelihood that it was prepared to influence public discussion of the green paper, The Regulation of Canadian Financial Institutions, released in April, 1985 by the Department of Finance in Ottawa.

The present paper comments on each of the three above-mentioned sections of the CBA study.

On the matter of concentration, it observes that the Canadian Bankers' Association makes all the right noises about the need for policy-makers to focus on market concentration - but the bankers fail to provide one scintilla of empirical support for the strong position they have taken.

Data are presented in this paper to show that the CBA study grossly overestimates the relative size of nine of Canada's largest conglomerates. They are big! There is no question about that. There is no need to embellish their already awesome reach and scope.

This paper ends with a puzzled air. Why would the authors of the CBA brief reject so strongly conventional economic wisdom based on the competitive model when it has never much inhibited the operational success (profit and growth) of chartered banking? And finally in light of the repeatedly revealed priority of authorities in the trade-off between the demise of any large corporation (financial or otherwise) and the stability of the financial system, the question is whether the new so-called contestability approach which the CBA espouses, with its emphasis on ease of exit, can serve banking any better than the much maligned competitive model.

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* Economics Department, Bishop's University

II. Measures of Concentration

Starting from the premise that the traditional model of perfect competition leads inevitably to the proposition that concentration and competition are inversely related, the CBA study sets out early to mount a frontal attack on the notion that, because chartered banks are highly concentrated, they are not competitive. The qualitative argument used is a compelling one - namely that the measures of concentration usually employed are flawed to the extent that they are not market-oriented.

Interestingly, after stressing the incontrovertible need to focus on individual markets, the CBA study presents no data at all on the market-oriented basis that it embraces. Instead of presenting information on market concentration, data categorized by industry group (banks vs trust co's., investment dealers, etc.) are presented. And instead of distinguishing clearly among aggregate-, industry- and market-oriented measures of concentration and the significant difference in their relevance for analysis of the presence and quality of competition, the paper retreats temporarily from the conceptual front to attack on a more mundane level what it calls the "global asset approach" to the measurement of concentration. The CBA argument here is that comparing the corporate assets of banks with the corporate assets of other industry groups in the financial sector is apples and oranges. At issue is the treatment of two items, one important for banks - foreign assets, and the other important for trust companies and other financial institutions, namely administered domestic assets. Mirabile dictu, the exclusion of foreign assets and inclusion of administered assets, allows the Canadian Bankers' Association to reduce the banks' share of total financial sector assets from 61 percent to 48 percent.

Whether or not adjustments such as the two just mentioned are in order depends entirely on the particular purpose at hand. With the focus on the presence or absence of competition for example, it would be quite meaningless to include the external sector when examining consumer credit. However, analysis of business financing would be incomplete if the foreign sector was not taken into account. If the object was the measurement of wealth, then administered assets would be of no interest, but foreign assets would be, and if the focus was on the extent of economic influence, then both administered and foreign assets would be included.

III. CBA Estimates of Conglomerate Size

The Canadian Bankers' Association appears to have adopted numbers that appeared last August in the Globe and Mail as acceptable estimates of the relative size and reach of a small selection of very large conglomerates. "Nine prominent families effectively control 46 per cent of the value of the Toronto Stock Exchange 300 Composite Index ----". "---- if the value of the major chartered banks is removed from the TSE 300, the same nine families hold control of over 53 percent of the value of the shares". "---- concentration of power in the hands of fewer individuals poses a serious threat to the integrity of

Canada's financial markets" (CBA study, p. 10). Since these comments form a major part of the fulcrum from which the bankers attack conglomerates on the basis of their size, it is instructive to review the calculation of these estimates in some detail.

The elements of the conglomerate calculations contained in the CBA study and presented earlier in the Globe and Mail are as follows:

(1) The numerator in both estimates (i.e. 46 percent and 53 percent) represent quoted market values in mid-1984 of companies included in the TSE 300 in which one of the nine conglomerates held an interest of 20 percent or more. The table that follows identifies the nine giant holding companies and the assets of Index companies that they control.

TABLE I
SHARE VALUES OF TSE 300 COMPANIES CONTROLLED BY THE NINE CONGLOMERATES

	Market Value in $ Billions
Thomson	3.8
Bronfman (Cemp)	5.0
Desmarais	12.9
Bronfman (Edfer)	9.8
Reichman	0.6
Weston	1.3
Black	1.1
Southern	1.9
Seaman	1.1
Total	$37.5

(2) One denominator used by the CBA is the quoted market value for the TSE 300, which was about $80 billion at mid-1984. Expressing $37.5 billion as a percent of $80 billion gives rise to the 46 percent figure presented in the study ("...nine prominent families effectively control 46 percent of the value of the TSE Index", page 10).

(3) Another denominator used in the study is the TSE 300 total minus the market value ($10.7 billion) of the shares of the five largest chartered banks - or $69.3 billion. Again, using the market value of the nine families ($37.5 billion) as numerator and the $69.3 billion as denominator gives rise to the figure of 53 percent presented in the study. (Excluding 5 top banks ... "the same nine families hold

control of over 53 percent of the value of the shares", p. 10).

Both figures are quite misleading. The errors may result from misunderstanding the TSE 300 Index. The index is composed of "float" only. Float is the term used to describe the shares avilable on the market after excluding control blocks of common stock not available to investors. Thus, the CBA has omitted from its calculations those particular shares that give conglomerates the widespread control that defines their very being. The "float" itself represents only about 60 percent of the total value of TSE 300 stocks, when control blocks are included.

Assuming the Globe and Mail/CBA estimates of the market value of companies controlled by the 9 giants (the $37.5 billion used in the numerator) are correct, the revised denominators should be $146 billion and $135 billion.

Thus, these nine families actually account for about 26 percent of the quoted market value of shares in the TSE 300 - not 46 percent as shown in the CBA/Globe and Mail estimates.

Similarly, if the five banks are removed from the denominator, as the CBA does, the nine families account for 28 percent - not 53 percent as prescribed in the CBA study.

Even with revisions that cut the CBA estimates almost in half, serious reservations remain concerning the interpretation of these data. Consider the emerging evidence in Table II below that the recent tendency may be for "float" to constitute a declining portion of the total market values of the corporations it represents. In other words, technically speaking the TSE 300 Index may be becoming less directly representative of those 300 companies whose shares make it up.

TABLE II

TSE COMPOSITE RELATIVE TO ALL ISSUED SHARES OF THE 300 COMPANIES IT REPRESENTS

		'80	'81	'82	'83	'84
			(Billions of $ Canadian)			
A.	Quoted Market Value of TSE 300 Stocks Including Control Blocks*	121	110	106	145	146
B.	Quoted Market Value of TSE 300 Stocks Excluding Control Blocks	78	64	64	89	88
	B as Percent of A	65%	58%	60%	61%	60%

* Includes market values of blocks of shares that represent 20 percent or more of the total value of shares outstanding.

More importantly, when the value of shares in the composite is related to the broader universe of all Canadian-based companies listed on the TSE, the 300 companies account for less than half, as shown below in Table III. Directly relevant to the concentration of power issue raised by the CBA is the fact that the market value of listed companies controlled by the nine families accounts for about 21 percent of all Canadian-based companies listed on the TSE. Finally, if foreign-controlled TSE listings are included - although these values seem less relevant for this purpose - the share represented by the nine conglomerates is less than 8 percent.

TABLE III

QUOTED MARKET VALUE OF TSE 300 COMPANIES AS A PERCENT OF THE TOTAL MARKET VALUE OF ALL CANADIAN BASED FIRMS LISTED ON THE TSE

Year	Percent
1965	69.1
1970	62.7
1975	60.7
1980	56.2
1981	51.0
1982	50.0
1983	51.0
1984	49.6

Thus, if the object is to demonstrate the relative size/reach/influence of these nine megacorps in the Canadian economy (as seems to have been the CBA intention), then the TSE 300 as a broadly-based reference point falls well short. And the extension suggested here could be made more complete as well. It could take into account the unduplicated listing of corporations on other exchanges, certain federal and provincial crown corporations, the several large private corporations such as Olympia & York, Eaton and Irving, the thousands of smaller private corporations, and finally the tens of thousands of unincorporated businesses in Canada. If it did, and if a satisfactory procedure was established to make the transition from stock market quotations to balance sheet numbers, it seems likely that the final percentage (that is, the nine conglomerates' share of "business" assets in

Canada) could be as low as five percent.(1)

Two points flow from this analysis. The first is that the relative size of the nine conglomerates is grossly overstated in the CBA brief. The second is that there is no denying the scope and reach of these diversified giants. But the TSE 300 is a poor proxy for the totality of Canadian industry. And progress in the public debate can only be retarded by building on fundamentals that are so badly distorted.

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(1) It may be noted as well that the data presented by the bankers (in Appendix III of the CBA brief) to show that the assets of the six top financial holding companies rival those of the six biggest banks are not adjusted in a consistent fashion. For example, Genstar's total assets in 1983 include $2.7 billion in U.S. assets under administration which, by CBA's own rules should be excluded - but were not. The result is that the asset figure used for Genstar in Appendix III of the brief is about 20 percent larger than it would be otherwise. Similarly, the CBA brief lists Trilon's assets at $48.8 billion which is only equivalent to the total assets (including ET and A) of Royal Trustco, Trilon's largest subsidiary, while it appears to omit London Life, Wellington and other financial institutions. Perhaps the data simply are not available to make the appropriate adjustments. In these circumstances, the margin of error would be narrowed by using total assets, that is by reverting to the "global measure" (ET and A plus foreign assets) that the CBA brief rejects.

These comments do not deal with the conceptual correctness of the CBA position. For instance, it can be argued that foreign currency assets in fact should be included anyway when the object is to compare overall magnitudes of economic influence in the two sets of institutions. Or, it could even be argued that foreign currency assets can be easily converted - indeed, that only the stroke of a pen lies between domestic and foreign currency assets.

IV. INTERNATIONAL BACKDROP

The table that follows provides an international perspective to understanding concentration in stock market capitalization.

TABLE IV

PERCENT OF TOTAL MARKET CAPITALIZATION IN SPRING 1985

	TOP TEN COMPANIES	TOP COMPANY	TOP TWO COMPANIES
	Percent (rank)	Percent (rank)	Percent (rank)
CANADA	30(4)	5(4)	10(4)
UNITED STATES	15(8)	5(7)	7(7)
BRITAIN	28(5)	5(7)	9(5)
WEST GERMANY	45(3)	9(3)	17(2)
SWITZERLAND	59(1)	12(1)	22(1)
SWEDEN	47(2)	9(2)	15(3)
JAPAN	18(7)	2(8)	4(8)
FRANCE	24(6)	5(5)	8(6)

It shows that the few largest listed companies in Canada account for 30 percent of total market capitalization. In isolation, it would be difficult to say whether such a distribution is excessively skewed in the direction of large firms or not. In international terms however, data in the above table indicate that in terms of concentration in capitalization, Canada is located right in the middle of the pack. Among eight industrial countries, Canada is (1) fourth in terms of the capitalized value of the ten top companies relative to total capitalization of listed companies, (2) fourth in terms of the relative size of the largest company and (3) fourth in terms of the relative size of the top two companies listed on the stock market in Canada.

On this basis it may be observed that in terms of overall stock market sensitivity to the movement of one, or two, or ten top companies, Canada is about average. Such observation serves as something of a counterpoise to the impression of size distribution in Canada obtained from more common measures of aggregate concentration obtained via revenue, assets or employment.

V. BANK DOMINANCE IN FINANCIAL SERVICES

Notwithstanding repeated earlier emphasis in the CBA study on the need for market-oriented measures and analysis, it states without any empirical support that "banks do not have monopoly power in any market" (CBA study, p. 14). What about the hundreds of small and/or remote communities in Canada with access to only one chartered bank branch and no other financial intermediary? Banking markets are only discussed by the CBA in terms of major categories of banking activities such as commercial lending, residential mortgage financing etc. Surely the unit of observation that is relevant for example to the personal term lending market is not nation-wide!

Market concentration is the only version of concentration directly relevant to the analysis of competition. It derives its analytical meaning from the recognition that single products seldom meet the demands of all customers. As a result, financial institutions frame their marketing and operations according to market segments. The logic of market segmentation rests on the realities that although single financial products do not meet the needs of all customers, they almost always meet the needs of more than one category of customer. Rather than trying to compete everywhere, institutions identify the parts of the market they can serve effectively. Market boundaries then arise out of variations in the preference patterns of customers, geography, size and number of customers etc. For example, even simple products like credit cards meet different needs - convenience, prestige and independence. Along the same line, consider the shifts within the banking industry triggered by the emergence of smaller companies in international trade and the differences in export-related financial needs of these firms compared with those of much larger multinational exporters who dominated this financial market in the past.

On the basis of such considerations, it becomes quite clear that categorical statements about the total absence of monopoly that are based solely on nationwide data showing institutional shares (e.g. trust, bank) of major market segments (e.g. commercial loans, time deposits) are not at all well-founded.

Since it is only the banks that are likely to have the kind of disaggregated data required for market-oriented analysis, the following national data are presented simply to show that banks account for the lion's share in two out of three major lending areas, and that in general terms, the banks' share has risen over the past 15 years and has been on something of a plateau in the eighties.

TABLE V

DISTRIBUTION OF BUSINESS WITHIN FINANCIAL SECTOR OF THE THREE KINDS OF LENDING MOST IMPORTANT TO CHARTERED BANKS

	Business Financing		Consumer Credit		Mortgage Financing	
	Banks*	All Others	Banks*	All Others	Banks*	All Others
1966	47.0	53.0	41.1	58.9	N/A	100.0
1968	49.6	50.4	45.9	54.1	12.9	87.1
1979	50.9	48.9	66.1	33.9	29.2	70.8
1981	57.8	41.7	67.7	32.3	32.2	67.8
1982	57.0	42.1	68.0	32.0	32.2	67.8
1983	50.7	47.5	67.1	32.9	32.8	67.2
1984	50.1	48.1	67.0	33.0	33.2	66.8

*Includes mortgage companies that are directly associated with chartered banks.

On the basis of arguments that neither monopoly power in banking, nor economies of scale in the provision of combined financial services are very significant phenomena, the CBA is able to dispense in summary fashion with contentions of predatory pricing and tied-selling.

VI. ULTRA-FREE ENTRY IN BANKING

In four separate instances the CBA study warns against reliance on traditional theory in the analysis of banking performance. Economists using conventional theory we are told, simply count firms and take relative measurements of assets or sales to assess the competitive structure of an industry. And pricing is accepted as the sole indicator of conduct. The high incidence in residential mortgage lending, deposit rates and elsewhere of price convergence (identical or almost identical rates) is said to be unrelated to the kind of oligopoly pricing or forebearance that might be suspected from conventional theory. Instead, the CBA states that "price convergence means the financial industry closely reflects a perfectly competitive market --" (p. 17). The study asks rhetorically "what other industry has a comparison of the prices charged by major firms --- published on a weekly basis in major newspapers?" The answer, of course, is that financial institutions are not at all

alone in facing this kind of challenge. Supermarkets, department stores and car dealers all must meet their own industry's versions of the Wednesday night test!

The diatribe on the injustices visited upon banking by conventional economic theory serves as the study's springboard to introduce Baumol's contestability theory. A few years ago Baumol, a renowned Princeton scholar and two younger colleagues, Panzer and Willig introduced a new theory into the field of industrial organization - a model of economic behaviour based on perfectly free entry and exit in the context of complex multi-product firms. Replacing perfect competition as the norm, Baumol's theory involves three conditions, themselves alleged to be as rarified as the unreal setting (i.e., perfect competition) they are designed to replace: (1) the new entrant is assumed to be able to establish himself in the market before an incumbent can react; (2) the new entrant is able to replicate the output of an existing firm or firms; (3) and exit is costless, that is, there are no sunk costs. (The purpose here is not all all to trivialize contestability theory - which may well be the most important development in industrial organization since the fifties. Whether the passage of time will show contestability to be a breakthrough displacing earlier theory, or a curiosum merely addng new insights, is not yet known. In any event, the purpose here is to draw attention to certain core features of the new theory that seem to make it as remote from the real world for the purpose at hand as the competitive model that is the basis of so much of the CBA's criticism).

In a very real sense the key to Baumol's new approach is ease of exit. The nature of competition from new entry, actual or latent, will depend importantly on whether exit is expected to be financially painless. Because of this emphasis on ease of exit, contestability theory implicitly opposes the propensity of regulators to deter or prevent the closing of uneconomic establishments. Recent reactions of Canadian authorities to financial problems at the Canadian Commercial Bank and similar responses in the U.S. to the Continental Illinois Bank's difficulties strongly suggest that exit (via business failure) is not likely to be permitted where it is perceived to threaten system stability. In these circumstances, one must await the operational application of contestability theory to the financial sector in order to determine whether the Canadian Bankers' Association has reached the right decision in embracing it so completely.

And while we are standing around, the time might be well used by extending and deepening our knowledge of the behaviour of conglomerates in a Canadian setting and to be much more articulate about the market segments in which banks and other financial institutions operate. If data collection and analysis was done in a way that would permit testing of the Canadian Bankers' Association statement that "banks do not have a monoply in any market", this as well would contribute to the formulation of sound public policy.

APPENDIX: EXECUTIVE SUMMARY FROM THE CBA STUDY, CONCENTRATION OF POWER IN THE FINANCIAL SERVICES INDUSTRY

- Concentration of power is increasingly becoming a public policy concern in light of the increased integration of Canadian financial markets, despite evidence that bank entry into new markets in the past has benefitted the consumer through enhanced competition and improved access to services.

- Concentration has been raised as a concern by those who believe that the banks will come to dominate any new market entered in such a way as to prevent smaller firms from competing. Arguments raised in support of this concern are typically based on traditional economic theory which equates the number and size of firms in an industry with the degree of competition and on misleading measures of the banks' relative size in financial services markets.

- When more accurate measures are used, it becomes clear that the banks, with a share of the total financial industry domestic assets of only 40%, are not as dominant a force within financial markets as some critics would argue. In fact, some of the recently-emerged financial conglomerates are larger than the domestic operations of the major Canadian chartered banks.

- Moreover, recent developments in the study of competition speak to the inherent problems in traditional economic theory and suggest new approaches. These problems are particularly evident when traditional theory is applied to the financial services industry. Applying this more modern approach to competition to the financial services industry yields the following conclusions:

  - Price convergence in the industry, rather than being a sign of a lack of competition, is a function of the portability of deposits and loans and the high degree of information on rates available to consumers.

  - Looking beyond strict "price" competition to other "non-price" dimensions, there is active competition in the financial services industry as evidenced by the variety of options available to consumers within deposit and loan instruments, the increased use of AIMs and other specialized services.

  - The financial services industry is characterized by relatively low barriers to entry which imply that entry by new competitors and the threat of entry by others make the industry highly competitive and dynamic.