

REGULATORY AND TRADE DEVELOPMENTS

REVIEW OF BANK MERGER GUIDELINES

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Introduction

On July 15, 1998, the Bureau of Competition Policy released its first sector-specific guidelines on the application of the *Competition Act* ("the Merger Enforcement Guidelines as Applied to a Bank Merger", "Bank Merger Guidelines").

A question posed by many observers is whether the Bureau's Bank Merger Guidelines represent any substantive change to the Bureau's longstanding (1991) Merger Guidelines (e.g. with respect to market definition, evaluation of substantial lessening of competition, and the efficiency exemption).

If there is in fact a substantive difference, it must be asked what factors merit a more or less stringent assessment of bank mergers or a different approach to banking service market definition in relation to all other firms in the economy. And if there is a substantive difference it is worth asking what future value the Bureau's general Merger Guidelines have as a tool for assisting possible merging parties in their merger related decisions.

If there is in fact no substantive difference between the Bank Merger Guidelines and the Bureau's general Merger Guidelines in these areas, then it must be asked why, apart from procedural clarifications discussed below, such a publication was needed in the circumstances and what contribution to the development of Canada's relatively new merger law or to the understanding of the public or the merging parties of the Bureau's role, such a unique publication could provide.

It might be argued that the heightened public interest in the proposed Bank of Montreal/Royal Bank, and Canadian Imperial Bank of Commerce/Toronto Dominion Bank mergers, and the Bureau's early solicitation of public comment on the utility of its Merger Guidelines to these proposed transactions alone would have merited the detailed document ultimately published on July 15. It might be suggested that had the Bureau not published the document, the Bureau might be (unfairly) characterized as weak or publicly remote. However, it is not clear that there are valid reasons for publishing sector-specific guidelines which, if only by their size or outward complexity, give the initial impression that the chartered bank sector merits a special law, and which will inevitably encourage other merging parties having a high public profile or relatively large economic significance to pursue similar dispensations when it is to their commercial advantage.

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The Bureau's stated reasons for publishing these sector specific guidelines are:

- (a) importance of the sector to the economy;
- (b) general public interest in the two current major bank mergers;
- (c) a policy of openness, and, perhaps more substantively; and
- (d) "both these transactions involve a large number of products and services which are provided by many market participants across a large number of geographic areas".

Of course grounds (a) to (c) by themselves do not necessarily support sector specific guidelines where economy-wide guidelines already exist; each ground could have equally been satisfied by a public statement that the general Merger Guidelines would be applied, if the Bureau indeed felt such a position to be appropriate. This approach could easily have been followed even after soliciting, as the Bureau did, general comments on the utility of the general Merger Guidelines to this sector.

Ground (d) merits more careful consideration, since it implies that the current Merger Guidelines may be inadequate in dealing with mergers of multi-product firms which supply to a variety of geographic and product markets and face differing competitive backdrops in each market. If that were indeed the case, it would be a serious indictment of the Merger Guidelines and the Bureau's enforcement of the merger law. It could be taken to indicate that the Bureau is at an analytical disadvantage in relation to really big firm mergers, where inevitably many geographic and product markets

come into consideration, and that the Bureau may only be able to get results in applying the merger law in relation to smaller mergers involving firms that supply fewer products, i.e. catching the little ones but letting the big ones get away.

This possibility cannot, however, be completely tested as not all Bureau challenges to proposed mergers are publicized. However, the Bank Merger Guidelines themselves provide a partial answer by noting that numerous financial institution mergers, including bank mergers, have already been reviewed by the Bureau under the general Merger Guidelines as well as "other industrialized sectors involving large numbers of product and geographic markets". The Bank Merger Guidelines identify ten financial intermediary mergers that have been examined by the Bureau.

Thus the substantive basis advanced by the Bureau, for these sector specific guidelines would appear to be somewhat thin. One is left unfortunately, with the conclusion that the Bureau will in the future elect to publish sector specific guidelines either to be better positioned to enforce the merger law in relation to parties who have very large resources to bear on the issue or to create a public impression that it was doing its job. Neither reason should, however, support sector-specific guidelines where there is no substantive difference from the general guidelines.

Subsequent to the publication of the Bureau's Bank Merger Guidelines Report, in September the Report of the federal government's Task Force on the Future of the Canadian Financial Services Sector (the McKay Task Force) was released. Not surprisingly, the Report recommends that the long-standing policy prohibition against Canadian chartered Bank mergers, administered via the discretion of the

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Minister of Finance to approve or disapprove bank mergers, should be lifted and that the *Competition Act* should apply insofar as the effect of such transactions on competition is being considered. The Report also endorses the Bureau's approach to the merger evaluation as suitable to financial service firm mergers, and strongly counsels in favour of a case-by-case assessment of financial institution mergers. This Report also makes numerous recommendations relating to the removal of regulatory entry barriers in a large number of financial services markets, prudential (i.e. solvency, monetary system stability) regulation and bank investment practices, consumer protection and rights, and financial institution corporate governance. However, the Report's numerous recommendations on barriers to entry require legislative and policy changes which cannot realistically be taken into account in the current Bureau assessment of the two proposed chartered bank mergers. If eventually implemented, this proposed market access liberalization could well be a factor in the Bureau's assessment of the future proposed bank mergers, including the two under consideration in the event that either or both of the parties elect, or are pushed into postponing their transactions. As well, the Report makes a number of observations regarding the current state of competitors in the Canadian financial services industry as a whole that may well be taken into account by the Bureau, or by the Minister of Finance if called upon to address these transactions following the Bureau's communication of its evaluation to the parties. Significantly the Task Force's Report reaches the following conclusion on the effects of past financial institution mergers:

The evidence we have reviewed does not sustain a case that, for most purposes, size is a strategically important variable or that all, or even most, mergers tend to bring about gains in

efficiency. In the banking industry the research appears to demonstrate that economies of scale are important for particular functions over asset size ranges that appear to be increasing. However, research has not addressed the size ranges of the major Canadian life insurance companies or banks. In our view, McKinsey & Company summed up the evidence well, concluding:

While it is true that larger institutions have more opportunities for improved performance, it does not hold that larger institutions always capture these opportunities or realize the advantages of increased size.

This comment is significant since the Canadian banks proposing to merge in their public statements emphasize the benefits of firms as *per se* in "global" markets, and imply that scale economies will be realized that are needed to support further product diversification and firm growth.

Procedural Considerations

A valid reason for some sector-specific statement by the Bureau on bank mergers arises from the concurrent jurisdiction of the Competition Tribunal and Minister of Finance with respect to a bank merger, and the unique power of the Minister of Finance to override any possible remedial order of the Competition Tribunal with respect to mergers of federally regulated financial institutions. Some guidance on the process to be followed by the Bureau in assessing bank mergers, given the special jurisdictional considerations, was certainly warranted to ensure better understanding of the Bureau's role on the part of the public and merging parties.

However, clarifying this procedural issue would not require an elaboration of all of the substantive provisions of the merger law. Rather, the Director could simply sell the public and the merging parties, as the guidelines do, simply that:

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- (1) there is concurrent jurisdiction of the Competition Tribunal and the Minister of Finance to review and prevent (or approve but not as proposed) mergers of banks, and federally regulated trust, loan, and insurance companies;
- (2) because the Director brings review applications to the Competition Tribunal and the Minister of Finance can only override the jurisdiction of the Competition Tribunal from issuing a remedial order (thereby effectively ousting any role for the Bureau) if at any time he certifies to the Director that the merger is "in the best interest of the financial system in Canada", and that unless the Minister does so the merger law will be applied; and
- (3) the Director in applying the merger law does not report to the Minister of Finance not accountable to the Minister, and can take no direction from the Minister of Finance or his officials (the Director independent of Cabinet in enforcing the *Competition Act* is accountable, not accountable to the Minister, and can take no direction from the Minister of Finance or his officials.

This can be laid out in a one page letter.

Still, the override power of the Minister of Finance applies to a wide range of financial service firms, and not just the big Schedule I chartered banks, and would have applied to almost all of the 10 financial intermediary mergers noted in the Bank of Merger Guidelines. The concurrent jurisdiction issue would also have been addressed in relation to these

prior mergers. Therefore, the procedural information set out in the Bank Merger Guidelines can hardly be regarded as newly developed by the Bureau and the Minister just for the two big bank mergers.

It should come as no surprise that the Bank Merger Guidelines provide that the Bureau will conduct its merger assessment and advise the merging parties of the results. What does, in the first instance, seem innovative is that the Director will also provide his merger assessment to the Minister of Finance. It is, however, doubtful that the Director could do so unilaterally and without the prior consent of the merging parties, given the statutory obligation of the Director to conduct all inquiries in private (which has always meant even excluding the Minister responsible for the Bureau).

Thereafter, the merger review process continues, as it typically does, with an opportunity being given to the parties to remedy the anti-competitive aspects of the transaction identified in the Bureau's assessment, with the Director keeping the option open of resolving these remedies by way of a consent order proceeding before the Competition Tribunal.

On balance, this procedural information hardly seems novel or hard to derive from the legislation and the general Merger Guidelines. Further, the Director should have been clear to the public that the Minister of Finance has no right to obtain a Bureau's bank merger assessment - he can only get it if the merging parties, for which it is prepared, agree to give it to him. Generally, it should be in the interests of merging parties which also required the approval of the Minister to do so, since it saves on an unproductive parallel competition analysis being conducted by the Minister's officials.

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But in some instances, that may not be the case. For example, in a bank merger based upon the so-called "failing firm defense", but for which the Bureau may not agree with the failing firm proposition, the merging parties may elect to pay lip service to the *Competition Act* or simply disagree with the Director's analysis, because their basic objective is to obtain the Minister's override certificate. This certificate arguably is available to ensure that failing banks can be merged with successful banks in order to stabilize the banking system (a practice that has been followed with very mixed results recently in Asia). It is presently hard to imagine that the Minister of Finance would consider overriding the Competition Tribunal because he considers that a bank merger is not anti-competitive or the remedies sought by the Director or determined by the Competition Tribunal were extreme or ineffective.

In the case of the two currently proposed big bank mergers, the parties' arguments currently have nothing to do with protecting the financial system from a weaker failing chartered bank, and, as noted, appear outwardly to be based upon positioning the firms to be more effective competitors in international transactions and more cost-effective and innovative in domestic financial services. The parties, therefore, appear to have no incentive to keep the Bureau's assessment of the proposed transactions from the Minister of Finance, given the fact that the Minister of Finance must be persuaded that each proposed transaction is in the public interest, and that this finding is unlikely to be made unless there is no competition law cloud over either of them.

Assessment

A side-by-side comparison of the general Merger Guidelines and the Bank Merger Guidelines reveals

that, true to the Bureau's stated purpose of clarifying rather than amending, the two documents are virtually identical. The basic differences are the addition of numerous non-binding industry, specific examples in the Bank Merger Guidelines and the deletion of much of the obscure economics jargon which led an aura of economic sophistication, but which add in practice little incremental value to the general Merger Guidelines.

If perhaps there is any real news in the Bank Merger Guidelines it arises from the perspective of some advocates of the proposed mergers who had expected, unrealistically, that the Bureau might be swayed by arguments, largely restricted to luncheon addresses, that banking is an industry unlike the others and that a massive explosion of entry into Canadian financial markets is just around the corner as a result of increased electronic delivery of financial services and entry by huge foreign competitors.

Not surprisingly, then, some commentators have, in an effort to find "news" both restated generally applied merger assessment techniques as bank specific, or asserted that the Bureau has already arrived at conclusions about market definition and the relevance or irrelevance of certain postulated forms of future competitive rivalry.

At most, there is a change of emphasis, but no change in substance between the general and the bank-specific guidelines. The Bureau has suggested the kinds of evidence that might be particularly helpful in conducting a particular sub-analysis although these suggestions will be unlikely to restrain the merging parties and their professional advisors who have to date, at least publicly, advanced a kaleidoscope of arguments with the dominant spectrum being modified in accordance with the

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audience at hand. To date, there is little public information that might suggest that the two sets of parties in each transaction have developed a coherent set of arguments to establish that the two transactions, once implemented in whole or in part, are unlikely to lessen competition substantially in the Canadian financial services markets in which they participate.

Following the structure of the general Merger Guidelines, the most germane observations of the Bank Merger Guidelines are as follows:

(1) Scope of Analysis:

Not surprisingly given the proximity in time of the two merger announcements, the Bureau will assess the combined effects of both transactions on competition, and will not conduct a "first-in first-out" assessment. To do so could allow one merger to pass and another to be challenged purely for timing reasons while the overall impact on competition will undoubtedly be a combined result of both mergers.

(2) Dimensions of Analysis:

The guidelines make it clear that the Bureau's established "functional" approach to product and geographic market definition and competition impact assessment will be followed for banks. Through nuanced shading of factors already developed fully in the general Merger Guidelines, and non-binding anecdotes or examples, the Bank Merger Guidelines provide some emphasis as follows:

- (a) Service levels in addition to price effects will be an important aspect of the Bureau's impact assessment.
- (b) Assessment of the likelihood of future competition limiting interdependent behaviour among the merged parties and their competitors (a weak form of anti-competitive arrangement including exclusionary behaviour such as in automated teller cooperatives and clearing systems) will be examined as much as will the prospect for the exercise of unilateral market power in particular markets by a merged bank (the more traditional concern of merger law).
- (c) The identification of discrete product and geographic markets for the services of the merging parties will start with a presumption that the principal product market categories in banking are deposits, loans, mortgages, credit cards and brokerage. For geographic market definition, commuting pattern data and shopping pattern data (first used effectively over 10 years ago by the Bureau in its evaluation of the Safeway/Woodwards Food Floor merger in Western Canada) are presumed to be a useful indicator.

Nevertheless for both market definition dimensions, the Bureau itemizes the several traditional and more judgmental factors that have been taken into account in merger reviews:

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(i) for product markets:

- (a) views, strategies, behaviour and identity of buyers;
- (b) trade views, strategy, and behaviour;
- (c) end use of products;
- (d) physical and technical product characteristics; and
- (e) switch costs.

(ii) for geographic markets, the above factors, plus:

- (a) transportation costs;
- (b) local set up costs;
- (c) particular product characteristics;
- (d) price relationships and relative prices;
- (e) distribution channels; and
- (f) foreign competition.

(d) a multi-faceted approach to evaluating the exercise of market power will be taken in financial services (which covers among other matters interest rate reductions, higher service fees, increased loan rates, lightening credit conditions, increased retail fees, and reduced service quality and choice).

(3) Supply Responsiveness:

Significantly the Bureau has advised that initially in calculating market shares (i.e.

available capacity) the extent and robustness of remaining competition, and the prospects of new entry post merger, the assessment will initially take into account competitive expansion or entry that would likely occur within one year for the purpose of calculating market shares and two years of the mergers for the purpose of assessing the impact on competition.

Not wishing to be bound to a cut off that might be vulnerable to attack on the basis of arbitrariness or short-sightedness, the guidelines do still indicate that supply improvements arising from foreseeable technological change will be taken into account as best as possible. However, there does appear to be a strong, but rebuttable presumption expressed in the Bank Merger Guidelines that prospects of more fluid entry through electronic banking and substantial entry by foreign controlled banking businesses (particularly in the principal banking product market identified in these Guidelines) will be given little weight in the Bureau's assessment.

It should be kept in mind that foreign ownership in the Canadian banking sector is severely restricted. General concentration of share ownership limits Canadian banks which effectively requires Schedule I banks, at the least, to be very broadly held, making the establishment of new players more difficult than in less well regulated industries. Under the *Bank Act*, the branching and product offerings of foreign controlled banks

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operating in Canada is significantly restricted with respect to electronic or computer based banking, a degree of skepticism may be in order as the promotional language for such innovations has not apparently been matched by actual product offerings and consumer uptake of them.

(4) Initial Screening:

In what appears to be a useful, but probably necessary, procedural innovation the Bank Merger Guidelines advise that the Bureau's established concentration thresholds would be applied to a predefined set of offerings and areas using Statistics Canada mapping software in order to screen out probable "no issue" aspects of the mergers. Generally, the Bureau will not challenge a merger in a given market on the basis of unilateral market power where the post-merger market share of the merging parties would be less than 35%, and will not challenge a merger on the basis of interdependence exercise of market power where the market share of the four largest firms post-merger would be less than 65% and the merging parties hold less than 10% of the market.

The Bureau has elected to use the Canadian Bankers Association database on product offerings for their screening test. This database provides branch level sales information on a number of product offerings for many of the CBA members and non-members (including the four merging parties) based on the first three digits in the postal code of each represented branch. Statistics Canada mapping software will match the

market shares for each reporting financial institution for each pre-defined product within each predefined geographic area.

Product and geographic areas not excluded by this screening are then to be subject to a full competitive effects analysis.

(5) Efficiency Exemption:

The proposed big bank mergers have been explained to date by the merging parties, not as a means to avoid firm failure, but as a means of increasing overall efficiency, and in particular international competitiveness. It is quite probable that a variety of product and geographic markets will not be screened out from further assessment and that, from these, a subset may be found by the Bureau to be likely to experience a substantial lessening of competition as a result of the combined effect of the two proposed mergers. Accordingly, the "efficiency exemption" may well be a very active consideration in the Bureau's assessment and in any subsequent proceedings before the Competition Tribunal.

Section 96 of the *Competition Act* provides that notwithstanding that a merger is likely to lessen competition substantially, the Competition Tribunal may not make a remedial order if it finds that the merger is likely to bring about gains in efficiency that will be greater than, and will offset the lessening of competition, and that these efficiency gains would not likely be attained if the Tribunal made the contemplated remedial order. The Bureau considers that

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efficiency gains, to be relevant to this analysis, must represent "real savings in economic resources, rather than private gains to the merging parties". The Bureau has traditionally taken the position that the onus on demonstrating efficiencies rests with the merging parties.

Far more than the other elements of the Bank Merger Guidelines, the discussion of the efficiency exception tracks very closely the discussion of this exception in the general Merger Guidelines, and provides no real illustrations or suggestions of how this aspect of the merger law would be applied to bank mergers. Perhaps this is to be expected as the merging parties would appear to be poised to pursue this exemption vigorously in the event that the Bureau challenged aspects of their plans.

The principal elements of the Bureau's approach to the efficiency exception (repeated in the Bank Merger Guidelines) are:

- (1) A prospective efficiency gain will not be considered in the Bureau's trade-off analysis if it is likely to be attained through less anti-competitive means (common examples being internal growth, unilateral rationalization, a "no-issues" merger with a third party, joint venture, specialization agreement, or other contractual mechanism).
- (2) Where remedies are sought against a portion of a merger, then only those efficiencies relating to that portion of the merger will be

considered in the trade-off analysis.

- (3) Efficiencies likely attained through cooperation short of a merger won't be considered (Here the Bureau provides its only sector specific illustration networking as cooperative arrangements such as Interac and Simcor assuming of course that the industry arrangement does not have an exclusionary or other anti-competitive effect).
- (4) Cost savings arising from income redistribution alone (e.g. through greater bargaining power) will not be considered, although true economies of scale will be (an often difficult and judgmental distinction for the Bureau).
- (5) Measurable efficiency gains and anti-competitive effects will be weighed in relation to whether the efficiency gains are "greater than" the anti-competitive effects. Efficiency gains and anti-competitive effects that are not measurable or comparable will be weighed in relation to whether the efficiency gains "offset" the anti-competitive effect (This framework in practice, is exceedingly difficult to apply with any rigour, and arguably is more of an attempt by the Bureau to make sense of what is really redundant drafting and a singular test).

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- (6) "Anti-competitive effects" means the "deadweight" or "welfare" loss to the Canadian economy. Again, distribution effects are not considered, although plainly the measurement of such impacts prospectively and within the time frames adopted by the Bureau for a full merger review (6-12 months) is an obvious challenge.
- (7) Where there is a strong likelihood of substantial prevention or lessening of competition and the parties assert efficiency gains, the Bureau will bring the merger before the Competition Tribunal for resolution.

Conclusion

On balance, the publication of the Bank Merger Guidelines was not necessary; a simple reconfirmation of the general Merger Guidelines would have sufficed as the sector specific guidelines do not amend the general guidelines in any material sense. Arguably, the merging parties resources, as well as the Bureau, could from the outset have been better directed, not to jockeying for amended rules, but immediately and fully towards the provisions of the general Merger Guidelines, and in particular the development of clear positions and evidence relevant to applying the efficiency exemption "trade-off".
