FROM A BANG TO A WHIMPER — TWENTY YEARS OF LOST MOMENTUM IN FINANCIAL INSTITUTIONS

Stanley H. Hartt

Twenty years ago this month, the failure of two small banks, and the possibility that some of Canada's large ones might need rescuing, began the move toward consolidation of Canada's financial services industry. Margaret Thatcher's "Big Bang" in London in 1986 was followed by Canada's "Little Bang," knocking down three of the four pillars separating banks, trusts, and brokerage and insurance companies. While banks were allowed to acquire trust companies and securities dealers, a furious lobby by the insurance industry prevented the arrival of one-stop shopping in Canada. Twenty years later, the question of large-bank mergers and cross-pillar mergers with insurers remains unresolved in Canada, despite persuasive evidence they should be permitted to enable our financial services industry to remain competitive in a global market. Stanley Hartt, who was deputy minister of finance during the "Little Bang," suggests it may have ended in a whimper.

Il y a vingt ans ce mois-ci, l'échec de deux petites banques canadiennes et le naufrage qui menaçait certaines des plus grandes ont provoqué une vague de fusions dans le secteur des services financiers. S'inspirant de la politique de choc imposée en 1986 par Margaret Thatcher, le Canada en a appliqué une version édulcorée qui a tout de même renversé trois des quatre piliers séparant les banques, sociétés de fiducie, maisons de courtage et compagnies d'assurance. Tandis qu'on autorisait les premières à acquérir les deux suivantes, le lobby de l'assurance se déchaînait en vue d'empêcher l'introduction d'un guichet unique. Deux décennies plus tard, les grandes fusions bancaires et avec les assureurs restent interdites, même si tout indique qu'elles maintiendraient la compétitivité du secteur des services financiers dans un marché mondialisé. Selon Stanley Hartt, à l'époque sous-ministre des Finances, la vague n'était pas tout à fait une vague de fond.

When I was sworn in as Canada's deputy minister of finance on September 1, 1985, my colleagues threw a bombshell at me as soon as the words of the oath were out of my mouth. "Deputy," they told me, "you need to know that this morning we closed two banks."

I was well aware of the problems that had beset the Canadian Commercial Bank in the fall of 1984 and the winter and spring of 1985. As chair of the Private Sector Advisory Committee for the National Economic Conference, which Prime Minister Mulroney had convened in Ottawa that spring, I had noticed the absence for prolonged periods of time of senior Finance officials, and, at times, the minister himself, culminating in a support package for the institution, which proved to be insufficient.

But I was not prepared for the fact that two Schedule "A" banks (Northland Bank was the second) — which funded themselves by raising wholesale deposits, mostly through brokers attracted by marginally higher interest paid to depositors — had not been able to sustain themselves and had been certified as not being viable by the Inspector General of Banks. Nor was anyone prepared for the consequences — a Royal Commission chaired by Mr. Justice Willard Z. Estey, recently retired from the Supreme Court of Canada, into the causes of the collapse, the payment by the government of uninsured deposits brought about by the "moral hazard" of the inadequate rescue package, the subsequent run on deposits at other Canadian banks that did not have stable, retail based funding as a "flight to quality" raced through our

banking system, and far-reaching reforms to our regulatory regime and our financial institutions policy.

Estey essentially found that the banks in question had compensated for having to pay more to attract deposits by taking on riskier loans in the expectation of higher returns, and that the risk-assessment systems at the banks were ineffective at controlling the portfolio imbalance that resulted. Sectoral and geographical concentration of loans contributed to the debacle, because of inordinate reliance on clients in the energy business and inordinate exposure to industry cycles.

The deposits in both banks had, of course, been insured by the Canada Deposit Insurance Corporation, but that insurance had a limit of $60,000 per account. Because Bank of Canada Governor Gerald Bouey had declared, at the time of the rescue package, that access to his lending window of last resort was limited by statute to solvent institutions, depositors concluded that CCB must be safe. As a result, the banks' failures forced the government to introduce special legislation reimbursing depositors for unrecoverable losses beyond the $60,000 limit.

The damage could not be limited to two banks. Because of their reliance on wholesale deposits, in short order the Bank of British Columbia was conveyed to the Hong Kong Bank of Canada (as it was then known, now HSBC Bank Canada); Continental Bank was sold to Lloyd's Bank, which in turn later left Canada, selling to HKBC; Mercantile Bank (the former subsidiary of First National City Bank of New York, which still held 25 percent at the time) was shored up by a loan package from the Big Six plus Citibank and then sold to National Bank of Canada; two small Western-based banks (Bank of Alberta and Western Pacific Bank) were merged as Canadian Western Bank, and Morguard Bank was sold.

The policy and regulatory framework that had been in place for these bank failures, the first since the 1920s, was subjected to a critical rethinking. The Office of the Inspector General of Banks was combined with that of the Superintendent of Insurance to form the Office of the Superintendent of Financial Institutions. CDIC introduced prudential standards of its own so as not to be obliged to rely solely on the supervisory expertise of the banking regulator.

A White Paper explored ways in which the financial sector might be modernized, both to replace the lost competition brought about by the disappearance of so many smaller institutions in such a short space of time, and to examine ways to prevent a repetition of the events.

The conventional wisdom about what happened next is that Canada tried to emulate the 1986 development in Margaret Thatcher's United Kingdom that has come to be known as the "Big Bang." While there is an element of truth to this, Canada was actually driven more by its own domestic policy needs. The CEOs of the Big Six banks asked the minister of finance, Michael Wilson, for an emergency meeting, which was held at the Château Montebello, Quebec, site of the G7 summit in 1981.

There was no one present other than the six CEOs, the minister, me as his deputy, and Don McCutchan, a trusted advisor in the minister's office. The bankers made a plea to be allowed to enter the securities business, which had been denied them for decades so as to minimize the risk to bank capital resulting from securities market volatility. Their thesis was that lending had become securitized: the banks' best customers could finance themselves directly in the London Interbank Market, in essence in competition with the banks themselves, by issuing Eurodollar securities, leaving to the banks the worst credits, on which spreads could be as little as 3/8 percent. Dick Thomson of the Toronto-Dominion Bank, speaking for the group, pointed out that while we were still dealing with the frightening implications of the recent run on virtually all of the country's smaller banks, the government needed to consider the possibility of failures among the Big Six.

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The representations were persuasive: not only were market standards changing so that CEOs of borrowers were increasingly indifferent to whether a bank funded itself as a principal, added a spread and made a loan to the client, or designed a piece of paper that the client signed and the banker then sold to the street; but there was a policy inclination among the minister and his officials to question the validity of the "four pillars" tradition of financial institutions regulation, which saw banks, insurance companies, trust and loan companies and securities dealers all relegated to their respective regimes of operation and supervision.

The Glass-Steagall mentality that produced the separation of the pillars was now increasingly subject to serious questioning. One-stop financial supermarket shopping was coming into vogue as a model for growing and consolidating financial institutions. The public policy imperative was to generate new kinds of competition, and the creative juices that would be unleashed by combining commercial and investment banking was seen as a highly desirable outcome.

It should be remembered that no one expected the single model of

bank-owned investment dealers, which eventually emerged to be the sole and solitary solution. At first, it seemed as if the hoped-for diversity of bank/dealer combinations would come to fruition. Wood Gundy made a deal with First Chicago (a deal that foundered after the stock market meltdown of October 19, 1987, when the Dow lost 23 percent of its value in a single session: Wood Gundy was nearly itself a fatal victim because of a huge bet the firm had made on the privatization of BP, following which Wood Gundy was "rescued" by CIBC with the help of Jack Cockwell's Brascan).

Burns Fry sold a minority interest to Security Pacific, before undoing that arrangement and merging with Nesbitt Thomson in 1994. Bank of Montreal had acquired Nesbitt in 1987, just as Bank of Nova Scotia had purchased McLeod Young Weir, and Royal Bank of Canada had acquired Dominion Securities. National Bank of Canada bought the venerable Quebec-based house of Lévesque Beaubien. Only Toronto Dominion Bank opted to build instead of buying their securities dealer arm, although even they eventually went on to purchase several top quality boutiques in subsequent years to round out their offering.

So Canada's "Little Bang" (or, more pejoratively, "whimper") was born of a philosophical view favouring cross-pillar pollination through competition in each other's previously watertight compartments. As we will see, this approach has become mired in a new but equally stultifying batch of regulatory restrictions since the events that originally produced this policy shift, which has led to an unfortunate loss of momentum and opportunity.

The advent of bank-owned securities dealers raised the inevitable constitutional issue: which level of government would regulate what? Banking is a federal matter under section 91 of the *Constitution Act*, whereas securities regulation has been characterized as a matter of property and civil rights in the various provinces. This being Canada, the most vigorous debate was reserved not for the underlying policy, but for the dispute over powers and jurisdiction. While the discussions involved the ministers responsible from every province, they ultimately resulted in the so-called Hockin-Kwinter Accord, between then minister of state for financial institutions in the federal government, Tom Hockin, and Monte Kwinter, his Ontario counterpart.

The accord listed which securities activities could be carried on in banks, while all other securities-related functions were reserved for the provincially licensed securities dealers. This was the first of the sclerotic limitations placed on cross-pillar competition by governments, which never quite permitted financial markets to capitalize on the original reason for breaking down the pillars.

Ironically, within the newly integrated institutions resulting from the "Little Bang," the bright line between functions has been steadily and inexorably erased. This corresponds with reality: financing with the optimal mix and the lowest cost of capital often involves a combination of bank debt, capital markets debt and equity, and it is finding the right mix, not the right pillar, that the corporate world cares about.

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The bank towers of Bay Street reflect the wealth and power of Canada's big banks. Canada's "Little Bang" of the late 1980s allowed banks to own security dealers and trusts, but not insurance companies. The question of large-bank mergers, and cross-pillar mergers with insurers, is again on the table. Will it end with a bang or another whimper?

But while Canada was still in the process of unleashing the competitive forces that would spur variety in product offerings and multiply the sources of capital, the negotiations for the Free Trade Agreement with the United States became a major preoccupation for the government. Simon Reisman, our forceful and effective chief negotiator, and Gordon Ritchie, his deputy, developed a sectoral approach to the bargaining, which was essential to ensure the necessary domestic consultation and the expertise to negotiate the best arrangements possible. The very able Bill Hood, one of my predecessors as deputy of finance, headed the financial sector working group.

Unfortunately for us, the US had not yet come around to the deregulation that both the UK and Canada had already completed, and so, in offering us "national treatment," as we were offering them, there was precious little of interest they could concede. We had to content ourselves with a promise that, if the Glass-Steagall restrictions ever went away and the lines between banking and securities were erased, Canadian institutions could benefit from that liberalization regardless of what the institutions from any other country could do. The same was true for a contemplated future removal of the restrictions on inter-state bank branching. We also obtained some easing of the ability of our bank-owned dealers to participate in government debt offerings, which would not otherwise have then been available to any dealer with bank ownership.

When the legislation governing banks, insurance companies and trust and loan companies was revised by Parliament in 1992, it was disappointing to see that, while banks were allowed to own insurance companies, they could not offer their own products over the counter in their branches (other than creditor life insurance on such products as mortgages and car loans, which had long been legal). This was the result of a fierce lobby from the insurance industry. The owners of insurance companies feared that their franchises would be stolen by the banks (staying just clear of prohibitions in the *Competition Act* against tied selling) by making the borrower believe that the bank would be sufficiently gratified if the house insurer were used that the loan might be more likely to be forthcoming. The prohibition against in-branch insurance sales was initially intended to be temporary, until insurance shareholders had an opportunity to monetize their investments.

Then there were the agents and brokers. Mostly self-employed, or at least masters of their own hours of work, and representing an element of society that was well-educated, financially comfortable and politically involved, it would be fair to say that every candidate for the two leading national parties had and has a cadre of insurance industry personnel on his or her campaign team. These agents and brokers feared the commoditization of their product if sold by bank personnel over the counter in bank branches and made their opposition known.

This was another lost opportunity to open our financial markets to challenge from competitive forces. The truth is that plain vanilla insurance would be appropriate to sell in bank branches, while the more complex and rewarding cases involving estate planning, business succession and buy-sell arrangements will always be sold in living rooms or offices after multiple meetings. The bifurcation of the market between commodity products and highly individualized ones might actually help the most skilled professional agents and brokers

Having given away the "10/25" rule, (by virtue of which individual foreign owners were restricted to 10 percent of a financial institution, and foreign ownership collectively was limited to 25 percent) in the FTA negotiations, Canada attempted to preclude foreign banks seeking to buy our previously protected institutions, as well as to prevent further domestic consolidation. "National treatment" meant no shareholder, Canadian or foreign, could hold more than 10 percent of a large financial institution (now moving to 20 percent), and the government declared that "big shall not buy big." This and other policy enunciations were also aimed at cross-pillar combinations between banks and insurance companies.

The government has permitted four large insurance companies to demutualize, and, based on size, the two smaller ones to be purchased by two larger companies. The banks have absorbed the trust companies; most, though not all, were bought in circumstances that qualified as acquisitions of "failing firms." In the latest version of the *Bank Act*, smaller banks qualify as targets to the extent of 100 percent or 65 percent, based on size.

The United States has now caught up in the modernization of financial institutions regulation. Not only has the separation between commercial and investment banking been repealed, but laws now accommodate the "bancassurance" model, where banks and insurance companies co-exist in the same corporate structure. Canada's government, on the other hand, has unfortunately, lost sight of the promise, and the purpose, of dismantling the four pillars, and progress is stalled in liberalizing our financial system.

We are still waiting for the final word on whether the current government will permit bank mergers and/or cross-pillar mergers. It would be the ultimate reversal of the thrust toward openness, begun in harsh circumstances in 1985, if the MacKay Committee report, the ensuing White Paper, the *Bank Act* amendments permitting bank mergers, the Kolber Report of the Senate Banking Committee, the regulations, and the long-awaited public interest guidelines amounted to a Potemkin village, offering the illusion of policy development, but masking the reality of a reluctance to permit the changes that would allow us to reap the benefits of really mattering in the world.

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