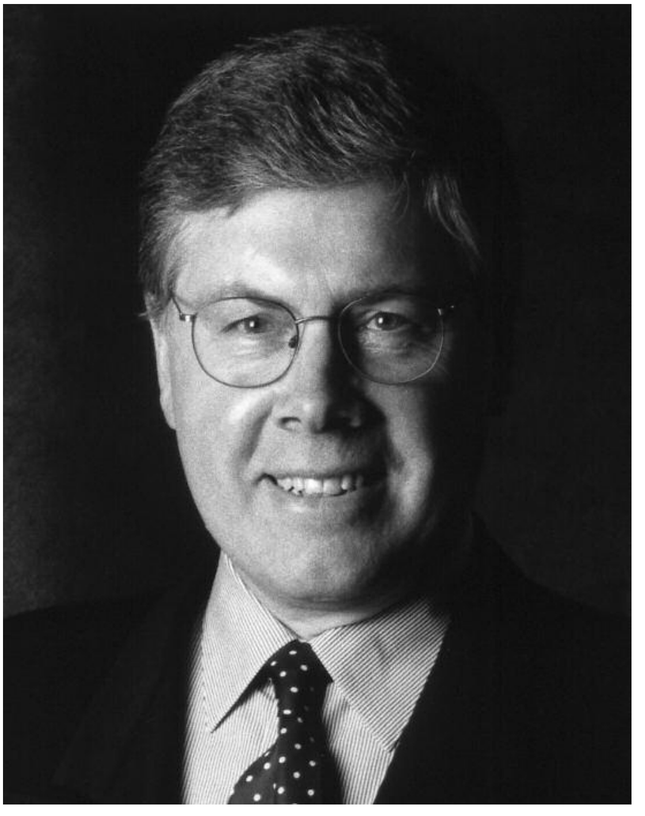
A Case for Bank Mergers

An Interview with the Royal Bank's Chairman, John Cleghorn

Earlier this year, the Royal Bank, Canada's largest bank, announced its plan to merge with the Bank of Montreal, Canada's third-largest bank. Similar merger plans have been announced throughout North America, leading many to wonder about what is going on in the banking industry. John Cleghorn is the Chairman and CEO of the Royal Bank. Over the past year he has emphasised the need for Canadian banks to achieve North American scale in order to succeed in an increasingly competitive market. He was interviewed in his Montreal office by Christopher Ragan, Editor of World Economic Affairs.



WEA: How did you get into banking?

Cleghorn: I originally got into banking because I was interested in international activities. After I got my CA, I became a sugar-futures trader and I was really wired into what was going on in the world. Any event affected the world price of sugar. Then I was looking at what was happening in banking at that time, because being a sugar futures trader was a fairly narrow field. And after reading about some of the international banks, and after seeing an article on Citibank, I joined their Canadian operation— the Mercantile Bank— with the hope that I could go on and work overseas. I was with them for nine years and lived in New York, Montreal, Winnipeg, Vancouver and got to travel to Asia and extensively in the western United States.

My sense was that this was a good career path because Canada had to trade and become part of a much broader picture. "Globalisation" is the term we use today but it was simply called international business in those days. The importance of international trade was just a fact of life for Canada and its banks. In Royal's case, as in most, we opened offices outside of Canada and developed our international business.

WEA: You mentioned the word "globalisation". During the 35 years that you have been in the financial sector, have you witnessed the increase in the "pace" of globalisation that we all hear about? Or is this just hype?

Cleghorn: Globalisation is just a name. It refers to the level of trans-border competition that has increased rapidly as trade barriers have been reduced and technology has permitted easier and cheaper access to new markets. I think what hasn't moved quickly enough—certainly in our field of financial services—is regulation, at least in Canada. For a long time regulation was ahead of the process, and Canada's financial institutions, especially those with an international perspective, were kind of on the leading edge.

The debate we are trying to wrestle with today is whether we should keep the walls up and protect ourselves. Some people argue "we are okay in our own country, we don't have to worry about what's going on in the rest of the world". I have customers—both small and large business customers—who, as they expand their capability in Canada, are forced to go outside Canada to sell. What's going to happen is that, with new electronics and new technology, foreign banking competitors will come in to

Canada. And that part of the population that is happy to deal with somebody by phone or over the Internet, which is going to be a growing part of the population, will be happy to deal with those competitors from outside. It's pretty hard to put up walls around telephone and Internet business. So, regulation is now trying to catch up to the speed of change taking place. And this rapid pace of technological change is very relevant in the debate over bank mergers.

The debate we are wrestling with today is whether we should keep the walls up and protect ourselves.

The Drive for Bank Mergers

WEA: So let's move on to the issue of bank mergers. In January, the Royal Bank and the Bank of Montreal (BMO) announced their intentions to merge. A little later, CIBC and TD announced their engagement. In the United States, Citicorp and Travelers, as well as Nation's Bank and BankAmerica, revealed their merger plans. Not surprisingly, these announcements raised the eyebrows of politicians, policy-makers, consumer groups, and small businesses. What is going on in North American banking? Why is there a drive for bigger banks and why is it happening now?

Cleghorn: We started to talk about this in public speeches and elsewhere about three years ago. We talked about the need to increase our scale if Canada still wanted to have banks included among the leaders in the world—not the top one or two or three, but in a reasonable position. As a trading nation, Canada needs some strong globally competitive financial institutions. The model I think about is Holland. Holland is a country half our size. It has always been a trading nation and saw eight or ten years ago that it was very important to have competitive financial institutions. And with consolidation taking place in Europe, and European financial institutions looking for scale there, the Dutch authorities permitted consolidations at that time in order to ensure that there were two or three strong Dutch banks.

So this isn't something that has just arrived. There have been waves of consolidations in financial services in the past, primarily in banks. Our last big merger was with the Union Bank of Canada in 1925. This was the same year the Bank of Montreal acquired the Molson Bank. So for us in Canada the early 1900s right up through the 1920s was also a merger period. The Royal Bank grew through mergers. Now, part of that process was that, as the country was growing, we just couldn't acquire enough new talent except through mergers. Today it's a combination of the needs for talent and technology that's driving the mergers.

Investment in new technology is the big part of the budget every year that gets cut back. This could be a disaster in the long run, but we can only afford so much within our revenue streams. When we are cutting back we are saying no to R&D and no to new programmes. That's why there is no Canadian bank today providing payroll services. The US competitors have North American scale—they have a 30% cost advantage. So what's driving the mergers today is technology.

The reason for the mergers today is the cost of technology and the need to have a large enough customer base to absorb fixed costs and keep your costs low. Because the threat from any competitor is their quality and low cost—that's what it's all about. Cynics will say the point of the mergers is just to cut costs by dumping jobs. The real issue is the ability to afford to innovate and be close to the front lines of technology, to have a capital base so you can afford to diversify your risk and be there.

WEA: Your mention of Holland suggests that in order for an economy to be successful, it needs a financial sector with world-scale institutions. Why is this necessarily true? In Canada's case, for example, why can't Canada be a healthy economy that just happens to use the services of large, foreign-owned banks?

Cleghorn: I'll give you the other end of the spectrum. New Zealand's financial system is dominated by foreign banks—it has no major home-based banks. We'll see the effects of this in years to come when it hampers their ability to generate high value, high paying jobs. We're watching this now in California which has an economy and a population the size of Canada's. The merger of BankAmerica with Nation's Bank, which was a home-grown bank and at one time the biggest bank in the United States, is moving its headquarters from San Francisco, where it was born in this century, to Charlotte, North Carolina. Wells Fargo will then be the last major bank to have a headquarters in California. Wells Fargo had a market capitalisation equal to what the Royal Bank and the Bank of Montreal will have if we are allowed to merge. And yet they still felt compelled to merge with Norwest in order to remain competitive. At least when we're at the level we are going to be (after the merger), we then have the capacity to do acquisitions in the United States. We will be strong enough. With the size we are today, we can't make meaningful acquisitions in the United States and become a meaningful North American player.

This isn't something that has just arrived—there have been waves of consolidations in the past.

WEA: But I still don't understand why having a domestically owned and located large financial sector is central to having a well functioning economy.

Cleghorn: It's a combination of two things. First, it's the high value jobs that you want located at home. Second, you need home banks there for Canadian players when they are out there bidding on export deals and requiring project finance and so on. You look to your friends first to give you a hand, and you look to the international players because they've got reach. When you're up against the Germans, the British, and the French, and they've got their banks with them, you have to have your own banks there. But in order to be there in an effective way, helping out the domestic players, scale is important.

A scale Canadian operation in financial services will guarantee that you keep costs low. If your earnings are excessive then you're going to be charging too much for your customers and that will leave the field open to competitors as long as you've got an open economy. There is always room for the niche player who can buy technology from somebody else. But they are going to be a follower, not a leader. If you are a large player you've got to try to be the best you can be at that level, and what you are offering is scale and low cost and reach. If you are a mid player you are constantly fighting—you don't have the reach, you don't have the capital to compete, you don't have sufficient resources to invest in technology and you are always struggling to be a low-cost player. So what I'm saying is that scale helps the domestic economy.

WEA: Do recent changes in the nature of the market have implications for how we think about "size" of financial institutions?

Cleghorn: Yes. The biggest shift taking place today is toward "financial services" and away from traditional "banking". Personal deposits are dropping by 3%-4% while mutual funds are skyrocketing. The big six banks have got 60% of the personal deposit market in Canada but they've only got 25% of the mutual-fund market. And mutual funds are a fee-generating business. So that is one of the big issues that we see taking place. In the United States, mutual funds have already passed personal deposits. It will be a few years in Canada before that takes place. But that is the big shift happening and so you cannot judge the "size" of a financial-services firm based only on assets because mutual funds don't appear on the balance sheet. Assets count partially but they are no indication of what financial institutions are going to look like five and ten years out. For example, the CIBC is already bigger than we are in terms of assets, yet we are more profitable because we have more clients than they do, as well as a more stable revenue stream.

Twenty years ago we looked at assets and we thought that meant something because banks were not in to investment products. But now it's a different era. People still say that banks just take deposits and make loans—that is what they think we do. The fact is that for a number of years now we have been a universal bank because we would like to retain our clients as they age and migrate into investments. That is why we would like to be in insurance—because at least we then have a crack at keeping a client all their life. And that's what the battle is all about. To try to keep your client and have them do as much of their financial activity with you as possible.

Competition and Efficiency

WEA: The Mackay Task Force just recently presented its report on the future of the Canadian financial services sector. What is your response to their recommendations? Were there any surprises in the report?

Cleghorn: The MacKay report acknowledges that financial services has become a global business, and that it is undergoing profound and rapid change. These changes will be driven by increased competition and rapidly evolving technology. The Report also recognises that if we want to retain a strong, Canadian-owned financial system, which can succeed at home and abroad, we must create a more flexible regulatory system in Canada that should, among other things, allow large financial institutions to merge.

It's a combination of the needs for talent and technology that's driving the mergers.

While endorsing change, the MacKay Report also acknowledges it will have an impact on customers, and that they should be adequately protected. We agree.

Competition is healthy. It drives down prices and improves service for consumers and small business. And as long as our Canadian banks have a freedom to compete on a level playing field with much larger foreign financial companies, we welcome rules that encourage more competition.

WEA: I'd like to consider the merger the way the Competition Bureau will. They are going to think about the likely efficiency gains and trade them off against the probable reduction in competition. How do you respond to the claim that the mergers will unduly reduce competition?

Cleghorn: There are two things. First of all, competition is not just about bricks and mortar. Electronic access matters, and so does the ability of a mobile sales force to reach the client. Go back to the argument about mutual funds, which is the fastest growing market. Who reaches these clients for mutual funds? Not just the bank with the local branch—there's also the mutual-fund salesperson and the financial planner. And don't think these people are in business just to sit in their office and do nothing. They're out there in the farms and communities and going straight to the kitchen table for their sales. So it's a combination of the ability to reach the client by telephone or the Internet or the debit card. What we are now investing in is a mobile sales force. That was the reason we wanted to acquire London Life—they have 3500 people. We just acquired Mutual of Omaha with 700 agents.

The second thing is the myth out there that the merged bank will have 70% of the core banking market. But what is core banking? If you are talking about deposits, credit unions and trust companies offer deposits. If you are talking about residential mortgages, all these institutions offer residential mortgages, including life-insurance companies. If you are talking about mutual funds, there are 65 mutual-fund companies with 1400 funds in Canada today. The banks only represent 25% of the mutual-fund market. You want to buy a car? Half of all new cars today are financed by leases—and you can't even get a car lease from a bank! So what we would say to the Competition Bureau is: if you guys want competition, then why don't you let us sell more, like they do in the States?

I'll give you an example in insurance. We have 1500 people in our insurance operation right now. They are all from the insurance industry. They all worked for an insurance company before. Allow open competition in insurance and you're going to find that some firms will have to consolidate because their costs are out of whack with their revenue generation—and the good people will be hired by others, including us. What we've been saying for several years is that the government should allow people to compete against each other and allow consolidation so that you will get people lining up along different business lines. What we are now facing from the United States is exactly that. And such competition and consolidation is in the national interest. That's what globalization does for you.

WEA: You make the marketplace sound like a battlefield—like there will be no significant reduction in competition.

Cleghorn: Yes.

WEA: In which case it comes down to the efficiency gains. And your argument is that, in order to do well in the battle, you need to get bigger in order to spread those costs over a large customer base?

Cleghorn: Right. A great example is the credit-card market. How is it possible that Citibank can win part of the Canadian government's business—and we can't even come close? Because they have got a base of 50 million cards whereas Royal Bank has a base of only five million. We can't come close to matching their unit costs. The whole Canadian market is only 25 million. But we don't bid as a whole industry, we bid as individual players and so we when we bid we get creamed because they're 10 times larger than we are.

WEA: But the Competition Bureau must trade off these efficiency gains with the reduction in competition. You might take the battlefield as an accurate description of the market and then argue that the merger will be irrelevant—and that may be true. But in small towns across Canada it will be hard to convince people that there is not going to be a reduction in competition, and a closing of some branches. How do you convince the man on the street that the reduction in competition is either small or non-existent?

Cleghorn: Where we have closed out in a lot of communities is *not* where we were the only bank. Those cases are rare—you read about those because we were the last to go. Where we were closing out, in large and smaller communities, was often where we were the number 3 bank or the number 4 bank and we couldn't make it—but we tried. Or the community did not need that number so one of us was gone and usually the least profitable one. So in some cases we would go and in some cases someone else would go. So what I am saying is that our small community operations now are very good businesses and we've got client bases that can sustain them.

I've looked at the map of branches between the BMO and Royal in Saskatchewan, for example. There are many communities that we would like to be in, frankly, but there is no point opening because the economy is not growing. We are not going to attract business fast enough to be able to justify the investment. Similarly, there are many communities where we have a presence but BMO doesn't. So now, the combined organisations will have a platform for their customers in communities where before we didn't.

In short, we don't want to leave rural Canada. It is very profitable for us. People think it's a millstone around our neck, but it isn't. If we were to drop our small communities, we would lose a very stable client base and very stable employees. The only problem with small communities is to try to have management go there, from time to time. We lose people because they don't always want to go to a small town. It is sometimes very hard to recruit for these small communities.

We don't want to leave the rural markets—people think it's a millstone around our neck, but it isn't.

But let me be very clear. We have made a commitment that, in any town where we are the only bank, either the Royal Bank or Bank of Montreal, we are not going to close. And where there is only the two of us there, there will be no job losses for at least five years. We *may* consolidate the premises, and I say *may*, because to go and build a new building may be prohibitive in terms of cost. So we may put small business services in one branch and put retail services in the other. With the centralisation of administrative functions, which has been going on now for several years, most of the functions in the branch are direct client service. In other words, you've got a person handling several hundred accounts at the Bank of Montreal and a similar person over at the Royal Bank. But you can't now create one job that is handling 1000 accounts. You just can't do it.

Foreign Competition

WEA: One possible outcome is that the government permits the mergers but at the same time opens up the domestic market to foreign competition. Do you have any problem with such an outcome?

Cleghorn: Not at all. I don't have any problem with that because I think that if you are protected you are not going to be able to compete. We expect to be a Northern American player. If you are protected at home, how can you go out in the competitive war zone in the United States and expect to have the right attitude, the right management skills, the right competitive skills?

WEA: Do you think most Canadian bankers share that view?

Cleghorn: I think some do, because they are on record as having said that. Not all, though, and not all insurance people. Some insurance people want protection. But I don't think it gives you a strong competitive attitude or capability, nor do I think it gives you the desire to be a low-cost player.

WEA: One of the political ironies is that many of the people who bash the banks are also economic nationalists. They generally don't like banks—and they certainly dislike the idea of bank mergers. But perhaps even worse to them is the idea of opening us up to foreign competition, because that introduces the possibility of foreign ownership.

Cleghorn: But the fact is that we've already got foreign competition in the fastest growing area of personal financial services—mutual funds. Let's talk about Fidelity. I recently asked a bunch of high-school kids if they had heard of Fidelity. Seventy-five percent of the class had heard about it. That is very high brand recognition. The largest mutual-fund company in the world is doing business here and during the recent RRSP season was hitting the third highest volumes in the country. So don't tell me they're not already here. The federal government chose to deal with Citibank for its credit cards. When Mutual Life (based in Waterloo) was raising capital for its acquisition of MetLife in Canada, they used Goldman Sachs to handle their new Canadian debt issue. The foreigners are already here, and they're here because Canadians have chosen to deal with them, including our governments. So you can't have it both ways.

Public Relations

WEA: Let's talk about public relations. People love to hate banks. When the economy is weak and bankruptcies

are high, banks get blamed. When the economy is strong and profits are high, banks are blamed for being too profitable. Why are banks such a popular target?

Cleghorn: Part of it is that we are big. Of course, so are pension funds, but people don't look at those in the same way. We capture the savings and investments of a lot of people and we re-direct them and re-invest them and that is a large business base. I think there are many people who think that we are a protected industry and that we don't have to work for our profits.

There are also many people who don't realise that they are shareholders of the banks. If their union has a pension fund they own bank shares—big time. If they have our mutual funds themselves, that mutual fund is invested in bank shares. Many Canadians have got mutual funds, and many Canadians have got a pension fund—they just don't realise that we're part of that. So it's not our profits—it's theirs.

WEA: For the past hour we have been talking about how much competition there is and how people don't appear to recognise it. Has there been a failure on your part to explain the changing nature of the industry?

Cleghorn: Yes.

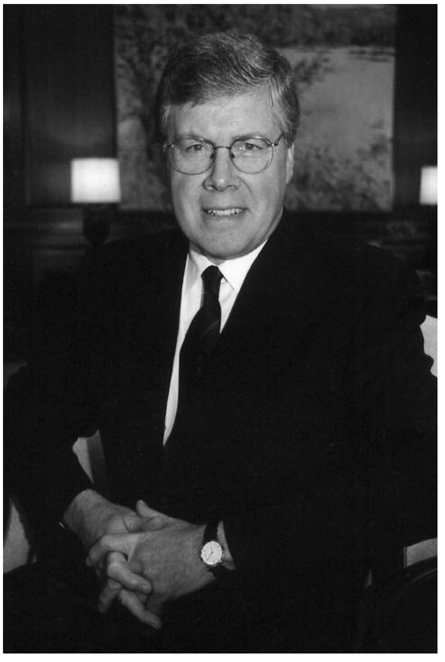
WEA: And what do you do about that?

Cleghorn: Try to communicate more, try to communicate better. What we need to do is increase awareness of what we do, and of how our industry is changing. We have been talking about the need for larger scale throughout the last three years, but when there is no burning issue to talk about, it's difficult to get anybody to take us seriously. But since January 23rd, when we announced our plans to merge, people have been interested.

The credit unions are not against the mergers. They think they've died and gone to heaven, because they think they're going to get all kinds of customers coming their way who will feel disenfranchised from the banks. We are going to have to work very hard to convince our clients to stay with us.

WEA: So how do you do it? How do you convince the average guy on the street to keep his business with you?

Cleghorn: It is going to come down to individual cases, to our people talking to the clients and saying "this is going to be okay for you—you still have choice." It will depend on the street corner, on the town, on the person. The choice will have to remain. It comes down to that. People do not even realise how much competition exists out there because they have not had to seek it.



WEA: How do you get them to realise the extent of the competition? The nature of this competition is that it's electronic, it's through the mail, it's over the telephone. How do you get them to see that the market is much bigger than just the bricks-and-mortar bank branches?

Cleghorn: What we have to describe goes beyond the past and present and goes into the future. That is difficult for people who only see what they have got today. For example, in a recent survey in the United States, 60% of the respondents were not even aware of the mergers taking place there—not even aware of it! So you are starting from a population of almost 60% saying "I have never heard of banks merging so why should this affect me?". This is why public policy has to really get to the root of where we're going in the future. The next five years is going to see a tremendous change in the industry because of the changes in technology.

We in the industry know it. I've been here for 35 years and I can see the changes—they're coming a lot faster now then they ever did before and they are coming right at our core business. Until electronics, it was very difficult for a foreign bank to compete against established domestic banks. I tried at the Mercantile Bank in the 1960s. But now with electronic delivery the foreign banks can come in and cherry pick. They can come in and target their market and use loss-leader pricing, which you do whenever you enter a market.

Wrap-up

WEA: Why does the Royal Bank often appear among the country's list of best employers? What's your secret?

Cleghorn: This is an exciting career. There are a whole bunch of experiences that you can have. You have to like working with people, that has got to be number one. You are working with exciting people and we are team players and I think we have a good culture. When we go to hire somebody outside we don't have any problem getting our number-one choice. The reason is that we treat our people fairly, pay them good salaries, and invest more than $100 million annually to upgrade their skills. We also have a culture that values diversity and promotes balance between work and family. Our employee satisfaction is very high.

WEA: So if and when this merger goes through, what then?

Cleghorn: That's going to be a hell of a job over the next three or five years.

WEA: So what happens five years down the road?

Cleghorn: This isn't the end game. We will be doing a few other things in that same period, especially in the United States. We have been wanting to grow. We want to grow in insurance, we want to grow in mutual funds, and we want to grow in wealth management and personal/commercial activities. So, maybe in the first year we will have our heads down concentrating on the merger, but we have other ideas. We missed on some of them before because we didn't have something to bolt them to, but with the merger in place we will have that foundation.

WEA: Are these exciting times?

Cleghorn: They sure are. The whole organisation is that much more energised.

WEA: Thank you very much for spending time with me today. ♦