OFFICE OF THE SUPERINTENDENT OF FINANCIAL INSTITUTIONS

REPORT TO THE MINISTER OF FINANCE

SUBJECT: PROPOSED MERGERS BETWEEN THE ROYAL BANK OF CANADA AND THE BANK OF MONTREAL, AND THE CANADIAN IMPERIAL BANK OF COMMERCE AND THE TORONTO-DOMINION BANK

OTTAWA, CANADA

DECEMBER 10, 1998

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Subject: **Proposed mergers between the Royal Bank of Canada and the Bank of Montreal, and the Canadian Imperial Bank of Commerce and the Toronto-Dominion Bank**

Purpose and Background

In the course of discussions taking place in August of this year, you asked my Office (OSFI) to advise you whether there are prudential reasons why you should not consider two bank merger proposals, one from the Royal Bank of Canada and the Bank of Montreal, and the second from the Canadian Imperial Bank of Commerce and The Toronto-Dominion Bank. This report responds to that request.

Questions to be Answered

In advising you on these merger proposals, OSFI has sought to answer two questions:

1. If the merger proposals were to be allowed, would there be circumstances or issues which would be likely to have a material, adverse impact on the financial viability of either merged bank going forward, or would there be other material concerns as to the safety and soundness of either merged bank?

2. If the merger proposals were to be allowed and one of the merged banks were to experience serious financial problems, would the resolution of those problems be more difficult than would be the case if any one of the predecessor banks experienced such problems?

Work done by OSFI

To develop a view on the prudential aspects of the two merger proposals, OSFI began with an analysis of the current financial condition and risk profile of each of the merging banks, based on existing supervisory information. OSFI then considered relevant literature on mergers, consulted with other regulators on their merger experience, and worked with the banks to review and analyze the merger proposals, financial forecasts and relevant reports, and to discuss merger strategies and integration plans. The views of several banks and federal government agencies were also sought on issues to be considered in the resolution of any serious financial problems encountered by the merged banks.

Limitations on OSFI's review

There were certain limitations on OSFI's review which included the following:

- Canadian experience with large mergers, particularly in the financial sector, is limited. Therefore, much of the merger literature reviewed by OSFI related to American transactions, and most dealt with acquisitions as distinct from "mergers of equals".

- As requested, OSFI considered the merger proposals as presently structured, and did not consider the prudential consequences of any potential modifications to the merger proposals.

- Because it has not yet been decided whether the proposed mergers can proceed, and there have been constraints on the merging banks in sharing confidential and proprietary information with their potential merger partners, planning for the mergers has not yet reached an advanced stage. Since many merger risks arise out of the integration process and detailed integration plans have not yet been completed, OSFI is not in a position to make conclusive recommendations on the prudential risks of these merger proposals, and nor have such recommendations been sought.

OSFI's Findings

Based on the work completed and subject to the limitations described above, OSFI's findings are as follows:

1. It is not possible to make generalized statements as to whether larger banks are financially stronger than smaller banks or whether mergers of financial institutions increase or decrease their financial strength. The record is mixed. There are examples of both increased and decreased financial strength.

2. Mergers of large institutions are difficult to accomplish and create major challenges in developing a coherent strategy for the new organization, and in integrating people, processes, technologies and risk management frameworks. The quality of the strategy and the integration process can impact significantly on the success of the merger. Because of the importance of the integration process, the merged institution is at greatest risk in the period following the merger, during which most of the integration activity takes place.

3. It is evident that mergers of more or less equal-sized institutions are more difficult to accomplish successfully than mergers which are, in effect, acquisitions.

4. Despite the evident risks in mergers, OSFI has not identified circumstances or issues which would be likely to have a material, adverse impact on the financial viability of either merged bank, nor has OSFI identified other material concerns as to the safety and soundness of the merged banks. Therefore, subject to the above-described limitations, OSFI is not able to identify any prudential reasons, in and of the two merger proposals themselves, why you should not consider them. In OSFI's view, this finding is supported by the following:

   - All four banks showed a high degree of awareness of the risks of mergers and the need for a clear merger strategy and careful, well-thought-out integration planning.

   - The banks have invested considerable time researching previous mergers and those factors which make them more or less successful. They have met with executives of other banks participating in past mergers and have engaged consultants with substantial merger experience.

   - The banks demonstrated a good understanding of possible merger integration issues and provided plausible and well-thought-out approaches for dealing with each, particularly in such important areas as people, processes, technologies and risk management frameworks.

   - The banks have put in place organization structures to manage the integration process and minimize the risk of disruption to their core businesses.

   - OSFI's stress testing of the financial forecasts for the merged banks shows considerable capacity to absorb a combination of moderate financial shocks without falling below required capital or other prudential limits.

5. Although there are important differences between the merger proposal put forward by the Royal Bank of Canada and the Bank of Montreal and that of the Canadian Imperial Bank of Commerce and The Toronto-Dominion Bank, those differences do not affect OSFI's overall findings.

6. The increased size and complexity of the merged banks would create supervisory challenges and could require new approaches. These issues do not affect OSFI's overall findings.

7. In considering the issue of resolving serious financial problems encountered by either of the merged banks, prior experience must be taken into account. While Canadian financial institutions have experienced problems in the past, in some cases leading to failure, there have been few failures of large financial institutions and, for many years, no failures of major Canadian banks.

8. The four merging banks have argued that their merger proposals, if allowed, would enhance financial strength and would reduce the risk of significant financial problems, thus diminishing the possibility that any resolution issues would arise. The banks have also discussed with OSFI strategies, building on the two merger proposals, which are intended to reduce the risk profiles of the merged banks. However, OSFI is not able to conclude, on the basis of existing evidence, that the merged banks arising out of the two merger proposals would necessarily be financially stronger than their predecessors. They could be stronger, but much would depend on success achieved in integrating the merging banks and in executing strategies directed at reducing their risk profiles. In this regard, it is also important to consider OSFI's mandate, which makes clear that financial institutions by their nature take risks, and thus can face financial problems which can lead to failure. This mandate does not distinguish between financial institutions based on size. Therefore, in OSFI's view, the resolution issue remains relevant.

9. If a major Canadian bank were to experience serious financial problems now, there would be a range of options available to the bank, its shareholders and creditors as well as OSFI, the Canada Deposit Insurance Corporation and, if necessary, the Bank of Canada, for resolving these problems. These options could include one or more of recapitalization, sale of individual businesses, various forms of restructuring, liquidation and piecemeal or en bloc sales of individual assets and business lines, and an outright sale of the bank to another financial institution. If the mergers were approved and one of the merged banks experienced serious problems, these options would probably remain, but, given the relative size of the institution in relation to potential buyers and investors, some would be more difficult and more time consuming to implement, and a "least cost" resolution could be more difficult to achieve. Furthermore, to make full use of certain options, changes to ownership, competition and other policies might be required. For example, a resolution involving a merger or sale to a non-Canadian financial institution might not be acceptable under the government's ownership policy, while a resolution involving a transfer of assets or sale of a business unit to one or more large financial institutions might breach the thresholds established under competition policy. The importance of these issues to your decision can only be assessed by the government, because they would involve trade-offs between potentially conflicting policy objectives.

John Palmer
Superintendent