The Merger Enforcement Guidelines as Applied to a Bank Merger

OVERVIEW

1. This document articulates the analytical framework used by the Competition Bureau (the "Bureau") when assessing the competitive effects of a merger, under the *Competition Act*, (the "*Act*") involving two or more Schedule I banks. The Bureau's general approach to assessing a merger is described in the Director's Merger Enforcement Guidelines (the "MEGs").[1]

2. This is the first time that the Bureau has released a document that describes how the general guidelines would be applied to a specific industry sector. While the *Act* is a law of general application and the MEGs are intended to be applied across all business sectors, the Bureau believes that this precedent is appropriate for several reasons. The current policy debate with respect to bank mergers has raised the question of how the Bureau will apply the MEGs to the proposed mergers between the Royal Bank of Canada and the Bank of Montreal and between the Canadian Imperial Bank of Commerce and Toronto Dominion Bank. Both of these transactions involve a large number of products and services which are provided by many market participants across a large number of geographic areas. While the Bureau has experience reviewing mergers in the financial services sector[2] and in other industry sectors involving large numbers of product and geographic markets, the importance of this sector in the economy and to the general public has encouraged the Bureau to provide a clearer view of how the merger review process will

---

[1] These Guidelines were issued by the Director of Investigation and Research in 1991.

[2] Mergers involving banks which have been examined by the Bureau include the following: Bank of Nova Scotia/National Trust; Royal Bank of Canada/Royal Trust; Bank of Tokyo/Mitsubishi Bank; Republic National Bank of New York (Canada) /Bank Leumi Le-Israel (Canada); Republic National Bank/Bank Hapoalim; Bank of Montreal/Banca Nazionale; and, Swiss Bank/Bunting Warburg. The Bureau has also assessed a number of transactions involving trust companies, including: Canada Trust's acquisition of the pension custody business of National Trust; the corporate reorganization of Co-operative Trust Company of Canada; and, Trust la Laurentienne du Canada Inc./Trustco Prêt et Revenu Inc.

be applied. It is also in keeping with the Bureau's open, transparent, and predictable approach to enforcing the *Act*.

3. The Bureau is assessing the proposed transactions between the Royal Bank of Canada and the Bank of Montreal and between the Canadian Imperial Bank of Commerce and Toronto Dominion Bank simultaneously. In addition, the Bureau will take into account any other merger transactions which may come to its attention pending completion of its reviews of the present two mergers. As with other industries in transition, the Bureau will assess, to the best of its ability, the current transactions in relation to the probable evolution of the financial services sector as a whole. The recommendations of the Task Force on the Future of the Canadian Financial Services Sector will be of particular importance.

4. The approach that the Bureau intends to use in reviewing bank mergers is consistent with the approach described in the MEGs. Rather than articulating a different analytical framework, this document provides a more practical and industry-specific tool for applying the MEGs than is found in the MEGs themselves. The approach outlined herein is applied to what banks do rather than what banks are. As a result, it is not a tool solely applicable to banks, but it may also be used to analyse other mergers in the financial services sector. Indeed, the activities of other financial and non-financial institutions are important considerations in determining whether any single merger among Schedule I banks is likely to contravene the *Competition Act*.

5. The main objective of the merger review process is to maintain and promote competition within the Canadian economy in order to provide consumers with a wide variety of high quality products that are competitively priced. More specifically, section 92 of the *Act* states that the Competition Tribunal may order remedies when a merger prevents or lessens, or is likely to prevent or lessen, competition substantially. However, section 96 of the *Act* provides an efficiency exception to otherwise anti-competitive mergers when there

are sufficient cost savings to outweigh the competitive harm likely to arise as a result of the merger and these cost savings would not be attained without the merger. In such circumstances, the Competition Tribunal shall not make an order against the merger under section 92.

6. A merger lessens or prevents competition substantially when it creates, enhances or preserves market power. Market power is the ability to profitably maintain prices, quality, service and/or product variety for a significant period of time at levels that are less favourable to consumers than would exist in competitive markets. While the Bureau is often focused on post-merger prices, service levels are recognized as being particularly important when analysing bank mergers.

7. A merger can substantially lessen or prevent competition in two ways. First, a merger, by reducing the number of competitors in a market, can facilitate interdependent behaviour among firms, including firms that are not party to the merger. Interdependent behaviour refers to explicit or implicit understandings among firms in the market to jointly exercise market power or limit competition on price, quality, service, variety, or any other dimension.[3] In order to determine whether a merger is likely to increase the scope for interdependent behaviour, the Bureau will consider whether market conditions are conducive to reaching, monitoring, and enforcing such understandings. Second, a merger can lessen or prevent competition substantially by enhancing the market power of the merging firms, even absent co-operation with other firms in the market. This is referred to as an unilateral exercise of market power. A merger allows firms to unilaterally exercise market power if the merger, by placing the pricing and supply of the products of the merging firms under common control, enhances the profitability of increasing prices and restricting supply (or

[3] This type of behaviour is distinct from co-operative behaviour that has the effect of increasing the efficiency with which firms supply their products. Banks have several such co-operative ventures, including the Interac network, and the Bureau recognizes that such ventures can benefit consumers.

limiting competition on some other dimension). When assessing whether a merger will promote the unilateral exercise of market power, the Bureau will consider various factors, most importantly the extent to which the merging firms exert a competitive influence on each other prior to the merger, the remaining choices available to consumers, and the likelihood that lost competition will be replaced by supply responses by existing suppliers or by new entry into the market.

8. The Bureau's review of a merger begins with relevant market definition, which consists of determining the extent to which the merging parties supply substitute products and identifying all suppliers with which the merging parties compete.[4] Market definition has both a product and geographic dimension. Banks provide a large number of products from many locations through various means of distribution (e.g. branch tellers, automated banking machines, telephone banking, personal computer banking, or use of debit or smart cards) to different types of customers (e.g. large corporations, small and medium-sized businesses, retail customers). Consequently, there are many relevant markets in an assessment of a bank merger.

9. Each relevant product market includes all products to which customers would likely turn in response to a small but significant, non-transitory increase in the prices of the offerings of the merging parties, and/or a reduction in quality, service or variety of the product offerings of the merging firms.[5] As a result, the inclusion of several products within

---

[4] The term "product" is defined in the *Act* to include both articles and services. Throughout the remainder of this document, the term product will be used to denote both a product and a service.

[5] As discussed below in the section on Market Definition, the conceptual tool normally used by the Bureau to define the boundaries of relevant markets is the hypothetical monopolist test. When using this tool, the Bureau generally postulates a price increase by the merging parties, and asks whether consumers are likely to switch to other products in sufficient numbers to render such a price increase unprofitable, and therefore unlikely. In many cases, considering consumers' responses to price increases will be sufficient to determine whether a reduction in quality, service or variety is likely to be profitable. However, when the information gathered by the Bureau suggests that such a test may fail to identify an important dimension of competition, the test will be adjusted accordingly.

a single market occurs when these are closely substitutable for each other, from the viewpoint of customers. Where price discrimination is possible, product markets will be further related to particular types of customers.[6]

10. The geographic boundaries of the relevant market are determined in a similar manner: the geographic market includes all areas in which there are suppliers to which customers would likely turn in response to an attempt by the merging firms to exercise market power. The size of a geographic market varies with the characteristics of a product and the customer, and also the means of distributing the product. As a result, one would expect that different geographic markets will be associated with different products.

11. The next stage in the analysis is the application of market share and concentration thresholds, which distinguish mergers that are unlikely to have anti-competitive consequences from mergers that require further analysis. Generally, mergers will not be challenged on the basis of concerns relating to the unilateral exercise of market power where the post-merger market share of the merging parties would be less than 35 per cent, and mergers will not be challenged on the basis of concerns relating to the interdependent exercise of market power where the share of the market accounted for by the largest four firms in the market post-merger would be less than 65 per cent and the merging parties would hold less than 10 per cent of the market.[7]

12. Should the Bureau's review of a bank merger indicate that local geographic markets exist for certain products, the Bureau will need to expedite its review by employing an initial screening test given the large number of branches which any of the Schedule I banks operate. The purpose of such a screen is to quickly eliminate from further review the

---

[6] Price discrimination occurs when firms price similar products based on what individual customers, or groups of customers, are willing to pay for the product. Thus, an airline is able to sell a seat on a particular flight at different prices to business travellers versus leisure travellers.

[7] With concurrent merger examinations underway, the concentration ratios will be calculated assuming that both transactions were to proceed.

products and geographic areas which are not likely to give rise to competition concerns in order to focus the Bureau's review. This initial screen is described in paragraphs 54 to 58. The products and geographic areas which "fail" the initial screen are then subject to a complete competitive effects analysis[8].

13. In the banking industry, as in other industries, any review of a merger has to consider recent trends in technology, regulation, and other factors that occur independently of a merger, but that are likely to have an impact on the competitive effects of a merger. These developments may, for example, result in the introduction of new savings and loan vehicles or new means of distribution, possibly by suppliers who are not currently market participants. The delineation of relevant markets and the calculation of market shares and concentration levels on the basis of existing products and suppliers may therefore not accurately reflect the likely competitive effects of a merger. In evaluating the competitive significance of such changes in market conditions, the Bureau will consider whether these changes are likely, timely, and sufficient to offset any enhancement of market power that would otherwise arise because of the merger. The use of electronic banking is of particular importance in this regard, and will be very carefully assessed by the Bureau. Equally important will be the recommendations of the Task Force on the Future of Canadian Financial Services Sector which may alter the current regulatory environment.

14. The remainder of this document is structured as follows. The next section discusses the definition of a "merger" as stated in section 91. This is followed by a description of the anti-competitive threshold for mergers, relevant product and geographic market definition, market share and concentration level calculation as well as the Bureau's initial screening test, and the factors that are used to assess the likelihood that a merger will

---

[8] More accurately, market shares and concentration threshold tests are applied to the relevant markets defined around the products that fail the initial threshold test, and the complete analysis is conducted for the markets in which the thresholds are surpassed.

lessen or prevent competition substantially. The last section deals with the efficiency exception.

15. While the authority of both the Director and the Minister of Finance are spelled out in the *Competition Act* and the *Bank Act*, both acts are silent on how the Director and the Minister should interact and how this process should unfold. To ensure that the merging parties are informed of both the competition and other public interest concerns in an efficient, predictable and transparent manner, Annex I, attached hereto, sets out the banking merger review process to be employed by the Competition Bureau.

THE DEFINITION OF "MERGER"

16. Section 91 of the *Act* defines a merger as any transaction in which control over, or a significant interest in, the whole or a part of a business of another person is acquired or established. With respect to corporations, "control" is explicitly defined in section 2(4) of the *Act* to mean *de jure* control, i.e., a direct or indirect holding of more than 50 percent of the votes that may be cast to elect directors of the corporation, *and* which are sufficient to elect a majority of such directors. Although significant interest is not defined in the *Act*, the Bureau's position is that a "significant interest" in the whole or a part of a business is held when one or more persons have the ability to materially influence the economic behaviour (e.g., decisions relating to pricing, purchasing, distribution, marketing or investment) of that business or of a part of that business. Given the range of management and ownership structures which exist, a determination of whether a significant interest is likely to be acquired or established must be made on a case by case basis.

THE ANTI-COMPETITIVE THRESHOLD

17. Section 92(1) of the *Act* provides that the Tribunal may make an order in respect of a merger where it finds that the merger "prevents or lessens, or is likely to prevent

or lessen, competition substantially". A prevention or lessening of competition can only result from a merger where the parties to the merger are, or would likely be, able to exercise a greater degree of market power, unilaterally or interdependently with others, than if the merger did not proceed.

18. Market power refers to the ability of firms to profitably influence price, quality, variety, service, advertising, innovation or other dimensions of competition. The exercise of market power by a bank or banks could be manifested in numerous ways, including a reduction in interest rates or an increase in the service fees charged on demand deposits, credit cards, RRSPs, brokerage fees or other investment vehicles; an increase in interest rates on loans or mortgages or a tightening of the conditions for obtaining financing; an increase in the fees charged to retail businesses for point-of-sale terminals or for credit card purchases; or an increase in the price of other services. An exercise of market power can also result in a lowering of product quality or service and a loss in the variety of available products. In all cases, the prices used in the analysis are actual transaction prices, rather than posted prices.

Lessening Competition

19. A merger among banks can lessen competition if it enables the merged entity to unilaterally raise price, or if it is likely to bring about a price increase as a result of increased scope for interdependent behaviour in the market. Interdependent behaviour includes an understanding among firms in the market to profitably increase price or to compete less vigorously. Competition can also be lessened if the merger allows firms to profitably lower quality or service, or to reduce product variety.

Preventing Competition

20. Competition can also be prevented by conduct that is either unilateral or interdependent. Competition can be prevented as a result of unilateral behaviour where a merger enables a single firm to maintain higher prices than what would exist in absence of the merger, by hindering or impeding the development of increased competition. For example, the acquisition of an increasingly vigorous competitor in the market or of a potential entrant would likely impede the development of greater competition in the relevant market. Situations where a market leader pre-empts the acquisition of the acquiree by another competitor, or where a potential entrant acquires an existing business instead of establishing new facilities, can yield a similar result. Competition can also be prevented where a merger will inhibit the development of greater rivalry in a market already characterized by interdependent behaviour. This can occur, for example, as a result of the acquisition of a future entrant or of an increasingly vigorous incumbent in a highly stable market.

Substantiality

21. In assessing whether competition is likely to be prevented or lessened substantially, the Bureau generally evaluates the likely magnitude, scope and duration of any price increase or reduction in quality, service or variety that is anticipated to result from the merger. In general, a prevention or lessening of competition will be considered to be "substantial" where the price of the relevant product is likely to be materially greater, in a substantial part of the relevant market than it would be in the absence of the merger, and where this price, quality, service or variety differential would not likely be eliminated within two years by new or increased competition from existing or new competitors. The Bureau is not confined to pricing measures and will consider any impact on quality, service, or variety, to the degree that competition is substantially lessened or prevented.

MARKET DEFINITION

22. The first stage in the Bureau's review of a merger involves defining the relevant market or markets in which the merging parties operate. Banks supply a large number of products to different types of customers, through various means of distribution and across a large number of geographic areas. As a result there are many relevant markets which will need to analysed in any review of a merger between two Schedule I banks.

23. The Bureau normally defines relevant markets by reference to actual and potential sources of competition that constrain the exercise of market power. However, the vast number of products and services offered by banks, and the similarity in the inputs that are required to offer many of these products, make it difficult to identify and measure the constraining effects of all potential suppliers in a timely manner. As a result, when analyzing a bank merger, relevant product markets are initially defined by actual sources of competition. The potential constraining influence of firms that can participate in the market through a supply response is considered subsequent to an initial market definition. The suppliers that will likely be added to the market within a year are included in market share calculations. This approach to merger assessment is consistent with the approach articulated in the MEGs, but considers supply substitution at a different stage in the analysis. It is also consistent with the merger review process undertaken by the Antitrust Division of the U.S. Department of Justice.[9]

24. The main advantage of using this approach in a bank merger assessment is that it allows the Bureau to quickly identify the markets in which there are likely to be concerns regarding market power arising from the merger. The market share and concentration thresholds discussed above will initially be applied to relevant markets defined with reference

[9] Antitrust Division of the U.S. Department of Justice and U.S. Federal Trade Commission Horizontal Merger Guidelines (April 2, 1992)

to demand substitution.[10] Unless there is information to suggest otherwise, product and geographic markets for which the thresholds are not surpassed will be given no further consideration. For product and geographic markets where the thresholds are surpassed, the supply of output that is likely to be added to the market by firms not currently producing output in the market, but likely to do so within a year and without incurring significant start-up costs, will be calculated.[11] Market shares and concentration levels will then be re-calculated. The potential constraining influence of competition from sellers who would not likely respond to the postulated price increase in the relevant market within one year is considered subsequent to market share calculation, in connection with the assessment of future entry into the market.

25. In some circumstances, sellers with market power can identify and discriminate against certain buyers. When such discrimination is feasible, it may be appropriate to define relevant markets that associate products with certain classes of buyers. For example, a bank may be able to profitably set higher interest rates for loans to smaller businesses than for similar-sized loans to larger corporations, if the larger corporations have greater access to alternative sources of capital. Price discrimination in banking markets is facilitated by the exchange of information between buyers and sellers -- lenders normally require that borrowers disclose certain information, relating to income, type of business, assets, etc. in order to assess risk before loans are approved. Lenders may use this type of information to distinguish borrowers who are likely to have access to many substitutes from those with few substitutes by charging higher loan rates for borrowers with higher risk or

---

[10] As noted earlier, with concurrent merger examinations underway, the concentration ratios will be calculated assuming that both transactions were to proceed.

[11] The calculation of likely supply responses is discussed in paragraphs 51 to 53.

inelastic demands.[12] In such cases, an assessment of the competitive effects of a merger would take into account the potential differential effects of the merger on various customers by defining relevant markets with reference to the characteristics of buyers.

26. Relevant markets are normally defined through use of the "hypothetical monopolist" test. Under this test, a relevant market is the smallest group of products (which includes those of the merging firms) and the smallest geographic area such that a sole supplier of these products could profitably maintain a small but significant, non-transitory price increase than would prevail absent the merger.[13] The hypothetical monopolist test is applied to define both the product and geographic boundaries of the relevant market.

27. In general, the base price that is employed in postulating a significant and non-transitory price increase is whatever is ordinarily considered to be the price of the product. As the base price for loans and deposits, the Bureau will use the interest rate, or alternatively, the total interest paid on a loan or received for a deposit. The base price for deposits and loans may also include any relevant service fees. For other types of transactions where the banks provide some service (such as wealth management, etc.) the base price will be the service fee.

The Product Dimension

28. The purpose of defining relevant markets is to identify the suppliers with which the merging parties compete. Each relevant market includes all substitute products and services to which consumers would likely turn in response to a significant and

---

[12] In certain limited circumstances, price discrimination may contravene section 50(1)(a) of the *Competition Act*. The Bureau's enforcement policy with respect to price discrimination is articulated in the Director's Price Discrimination Enforcement Guidelines.

[13] Significant in this context usually means five per cent, and non-transitory means a price increase lasting at least one year.

non-transitory price increase on the part of the merging banks.[14] Generally speaking, products are placed in separate product markets if consumers are unwilling and/or unable to switch from one to the other in response to a change in relative prices. 29. When defining relevant product markets, the Bureau will consider the following factors: views, strategies, behaviour and identity of buyers; trade views, strategy and behaviour; end use of products; physical and technical characteristics of products; the costs incurred by buyers in switching from one product to another; and, the relationship between the price movements of products and differences in relative prices.[15]

30. Banks supply products that generally fall into one of the following categories: deposits; loans; mortgages; credit cards; brokerage services; and other services, such as wealth management. Within each of these categories, there may be separate products or groups of products, differentiated from other products, that constitute relevant markets. Whether or not such a subset of products constitutes a relevant market depends on whether customers are willing and/or able to substitute towards other products in response to a significant and non-transitory price increase.

31. Using the hypothetical monopolist test, a given set of products constitutes a relevant product market if a sole supplier of these products could profitably raise prices by a small but significant amount. This is possible only if consumers would not switch a sufficient amount of demand to products outside the set to render the price increase unprofitable. The boundaries of the relevant product market therefore separate the products that are close substitutes for a given product of the merging banks from products that are not close substitutes. Products in the relevant market need not be supplied by banks or other deposit-taking institutions; what matters for the purposes of market definition is not the

---

[14] Or a decrease in interest rates in the case of deposits.

[15] These are discussed more fully in section 3.2.2 of the MEGs.

identity of the supplier, but the characteristics of the products and consumers' willingness to switch their consumption from one product to another in response to changes in relative prices.

32. As an example, loans that differ in their size, amortization, collateral, etc., may not be close enough substitutes to merit inclusion in the same relevant market. Two loans with different characteristics are considered to be demand substitutes only if borrowers would switch from one to the other in sufficient numbers to render an increase in the interest rate of the first loan unprofitable. Thus even loans for different amounts may be in separate markets: a borrower will not necessarily substitute a $100,000 loan for a $10,000 loan in response to an increase in the interest rate on the latter.[16]

33. Similarly, deposits that differ in their characteristics, such as size, maturity, and risk, may be in separate product markets. Deposits with different characteristics will be considered to be in the same relevant market if a sufficient number of depositors is likely to switch to other types of deposits in response to a significant decrease in the interest rate offered.

34. A "grouping" of diverse banking products may also constitute a relevant product market even though the individual products within the grouping are not regarded as close substitutes for each other. A grouping would include a set of products and services that buyers tend to purchase from the same institution (e.g. RRSP investments plus loans to purchase RRSPs; or mortgages with mortgage insurance). A grouping is not necessarily sold as a bundle, but the price or availability of some components of the grouping may be more favourable for the buyer when purchased in conjunction with other products from the same institution.

---

[16] This is not to say that an institution that supplies $100,000 loans cannot respond to a profit opportunity created by an increase in the interest rate on $10,000 loans. The supply responses of firms not currently supplying the market are considered in paragraphs 51 to 53.

35. A grouping of banking products constitutes a relevant market when the individual components purchased separately are not a close substitute for the grouping for a significant number of customers.[17] This will be the case when consumers will not, in response to an increase in the price of a grouping, purchase the various components separately from different institutions. This may be because of the "transactions" costs associated with using a number of suppliers (physical transportation costs, the time taken to make several applications) and economies of scope. If the cost to a supplier of providing the grouping is less than the sum of the costs of providing the components individually, the price a consumer pays for the elements purchased separately is likely to be higher than the price of the grouping.[18]

36. The Bureau will conduct the necessary factual enquiry to determine whether consumers purchase their banking products in groupings and if so what products are included. The Bureau will not be assuming *a priori* that banking product markets should be delineated on the basis of particular "clusters" of products. Thus, the analytical framework adopted for product market definition is consistent with the approach of the Antitrust Division of the U.S. Department of Justice and does not follow the approach of the U.S. Federal Reserve Board.[19]

---

[17] This is akin to purchases of groceries from a supermarket as opposed to purchases of the same products individually from a butcher, green grocer, warehouse club etc.

[18] The purchase of various banking products as a group is not necessarily caused by tied selling on the part of banks. Tied selling is prohibited, in certain circumstances, under the tied selling (section 77 (2)) and abuse of dominance (section 79) provisions of the *Competition Act*.

[19] The U.S. Federal Reserve Board traditionally defines relevant banking product markets to be clusters of products and services denoted by such terms as "commercial banking" with total deposits used as a proxy for the ability of commercial banks to provide this cluster to businesses and households. By rejecting the notion that each banking product or service line may constitute a relevant market, the cluster approach reduces the number of competitors considered to those who currently or potentially offer deposit services. In contrast, the Antitrust Division of the U.S. Department of Justice focuses on specific products or services that customers would regard as close substitutes, assessing any particular bank merger as a merger of multi-

37. With respect to whether a grouping of products constitutes a relevant market, the Bureau will consider the following information:

i) survey or industry data on consumers' propensity to purchase a number of products from a single institution;

ii) data on the number of products purchased per person and the number of products purchased from a given institution per person;

iii) survey data on consumer preferences; and,

iv) data on the extent to which consumers have broken up their purchases of a grouping of products in response to relative price changes.

The Geographic Dimension

38. Geographic markets for various types of banking services may be local, regional, national, or international. The size of the geographic market for a particular banking product depends on the extent to which the buyer values being in close proximity to the supplier. This, in turn depends upon the characteristics of the product, the characteristics of the customer, the means of delivering the product, and the nature of the transaction. In particular, one needs to establish what is the need for personal contact between supplier and customer and what are the costs, in terms of time and transportation, of accessing more distant suppliers for the given product. It is the relative cost of personal contact that is important. A customer needing a small loan may not be willing to travel regularly to make personal contact just to obtain a loan with slightly lower lending rate. However for a larger size loan, the cost of this travelling may be worthwhile.

---

product firms with current and potential competition available from other multi-product or single-product firms depending upon the product under consideration.

39. Consumers of certain types of banking products may be unable and/or unwilling to switch to suppliers outside of their local areas in response to an increase in the prices of these products in their own areas. Where there are sufficient number of consumers in such circumstances, geographic markets will be local.

40. To make this determination, the Bureau will examine the following factors[20]: views, strategies, behaviour and identity of buyers; trade views, strategies, and behaviour; switching costs, transportation costs; local set-up costs; particular characteristics of the product; price relationships and relative price levels; distribution channels; and, foreign competition.

41. In the U.S. experience of reviewing bank mergers, one of the most useful data sources for the purpose of defining the boundaries of local markets where these are relevant geographic markets is data on commuting patterns. Markets have been found to be local when frequent interaction between the customer and the bank (or other service provider) is required, and the value of the transaction is relatively small. This interaction need not take place close to the customer's place of residence, and may rather occur near the customer's place of work. Thus, the competitive conditions facing a "bedroom" community may not accurately reflect the choices available to customers living in these communities where a large percentage of these customers commute to work in adjacent urban centres. Banks operating in the bedroom community may not find it profitable to exercise market power if a sufficient number of their customers would turn to competitors in the urban centre. In such circumstances the geographic market should be expanded beyond the bedroom community to also include the adjacent urban centre. Data that indicates the proportion of a population that commutes to some other area (typically an urban centre) to work, and may therefore be able to do their banking in this other area, has been useful in defining markets.

---

[20] Merger Enforcement Guidelines, section 3.3.2.

42. American experience also indicates that for rural areas, from which there may be less commuting to urban centres for the purpose of work, information about the location of nearby shopping areas or any other location that is visited frequently for non-banking purposes is useful, as is information about how often such trips are made. However, areas in which the destinations of interest are visited relatively infrequently, such as appliance stores and hospitals, may not be included in the relevant market since interaction with a bank may be more frequent than visits to such locations. Again, the competitive conditions facing a particular rural area may not accurately reflect the choices available to its residents where a large percentage frequently commute to adjacent areas. In such circumstances, the relevant geographic market would need to be expanded to include the adjacent areas along lines similar to those described in paragraph 41.

43. The Bureau will gather information to determine whether similar patterns exist in Canada. If this is found to be true, commuting data available from Statistics Canada will be one of the data sources used when delineating the geographic boundaries of relevant product markets, particularly for retail and small business customers.

44. Other important information to be used will include banks' current drawing areas for customers, although these areas are more likely to define the inner bound of a market (that is, banks outside this drawing area may be close substitutes for some consumers within its bounds). This data can often be acquired through survey data.

CALCULATION OF MARKET SHARES AND CONCENTRATION LEVELS

45. Although information which demonstrates that market share or concentration will be high cannot provide a sufficient basis, in and of itself, to justify a conclusion that a merger is likely to prevent or lessen competition substantially, it is a necessary condition that must exist before such a finding can be made. Absent high post-merger concentration or

market share, the effectiveness of remaining competition in the relevant markets is generally such as to likely constrain the merged entity from acquiring, increasing or maintaining market power by reason of the merger.

46. Accordingly, the Director generally will not be concerned that the merging parties will be able to unilaterally exercise greater market power upon merger, where the post-merger market share of the merged entity would be less than 35 percent in the market. Similarly, the Director generally will not be concerned about a merger on the basis that the interdependent exercise of market power by two or more firms in the relevant markets will be greater than in the absence of the merger, where:

the post-merger share accounted for by the four largest firms in the market would be less than 65 percent; and,

ii) the post-merger market share of the merged entity would be less than 10 percent.[21]

47. If the sum of the merging firms' pre-merger market shares is below 35%, there are likely to be sufficient products and suppliers to which consumers can turn in response to any attempt by the merged entity to exercise market power. If the four-firm concentration level is below 65%, then coordination among firms in the market is likely to be too difficult to raise competition concerns. If there is other information to suggest that competition is likely to be lessened or prevented substantially even though these thresholds are not surpassed, the Bureau will consider this information in its assessment. These thresholds simply serve to identify mergers that are unlikely to have anti-competitive consequences from

[21] Given that the Bureau's definition of the market may differ from that of the parties, full information should be provided to the Bureau regarding the merger and its likely effect on competition, where either the anticipated four-firm concentration level (CR4), or the market share accounted for by the merged entity, is close to the above-described thresholds.

mergers that require more detailed analyses, before any conclusions regarding likely competitive impact can be reached. In all cases, an assessment of market shares and concentration is only the starting point of the Bureau's analysis.

48. Market shares are calculated both for firms that currently produce output in the relevant market, and also for firms that can potentially participate in the relevant market through a supply response. The market shares of existing market participants can generally be measured in terms of dollar sales, unit sales, or production capacity. In cases where products are undifferentiated and firms have excess capacity, capacity is normally a better reflection of a firm's relative market position and competitive influence than output.

49. In the case of bank mergers, it is inherently difficult to quantify capacity. Although the capacity of a bank or other financial institution to provide credit is partly determined by its access to deposits or other sources of funds, capacity can also be affected by the size of the delivery network, including the branch network, the availability of trained personnel who are familiar with the market or industry, and other factors. Since data on sales of banking products (i.e. loans and deposits) is more readily available than capacity data, the shares of market participants will be calculated on the basis of actual sales volumes. Information that suggests that this does not accurately reflect a particular firm's competitive significance in the market will be taken into account in the assessment of the potential anti-competitive effects of the merger.

50. With respect to firms that can participate in the market through a supply response, only the output that is likely to be diverted to the relevant market within one year will be included in market share calculations. The Bureau will not in general assume that an institution that does not supply the relevant products (or supplies a minimal quantity of these products) is likely to respond to an increase in the price of the relevant products by diverting sales simply because it supplies similar products. For example, an institution that

offers primarily large loans to large corporations will not be assumed to be able to easily switch to supplying smaller loans to small and medium-sized businesses. The profitable supply of different types of loans may require different types of activities (for example with respect to screening and monitoring), and an institution that is well adapted to supplying large loans may not be well adapted to supplying small loans, and may not be able to quickly supply such loans without expending considerable resources. The criteria used to assess whether a supply response is likely, and the likely magnitude of such a response, are discussed in the following section.

Firms That Can Participate in the Market Through a Supply Response

51. Firms that are likely to respond to a price increase in the relevant market within one year with minimal investments are considered at the market share stage of analysis. Firms that are likely to have an impact in the market after one year, but within two years of the merger, or whose entry requires considerable investment are considered when analysing Barriers to Entry (see paragraphs 76 to 87).

52. The following factors are relevant to determining if a firm will divert sales within one year in response to a post-merger price increase:

i) the cost of substituting production in the relevant market for current production ("switching costs");

ii) whether, and to what extent the firm is committed to producing other products or services; and,

iii) the profitability of switching from current production.

53. In general, the Bureau will determine whether a firm not currently supplying the relevant product can profitably respond to a small but significant increase in the price of this product within one year. Only the volume of output that is likely to be supplied in the relevant market at this price will be included in market share calculations.

The Initial Screening Test

54. In analyzing the competitive effects of a bank merger, it is difficult in practice and likely unnecessary for the Bureau to define markets associated with each product supplied by merging banks and with each location from which these products are supplied, and identify potential supply responses and evaluate the likelihood of entry into each of these markets. The fact that banks offer a vast number of products and services at a large number of locations to different types of customers implies that such an exercise would be extremely resource intensive and time-consuming. In practice, the Bureau will apply an iterative approach which, although entirely consistent with the framework described in the MEGs, allows the Bureau to more quickly identify the products and geographic locations which are more likely to create concern with respect to the loss of competition.

55. The Bureau will begin its analysis by conducting an initial screening test. The objective of this test is to "screen out" product offerings and geographic areas where a bank merger is unlikely to pose competition problems. The Bureau will apply the market share and concentration threshold tests, as outlined in paragraphs 46 and 47 to a pre-defined set of product offerings and geographic areas. Because the focus is to screen out markets from further analysis, the set of pre-defined product offerings and geographic areas will be narrow, and will depend on the availability of data.[22] As a result, use of this initial screen will tend to

---

[22] Having explored available data sources at the Bank of Canada, OSFI and the Canadian Bankers Association (CBA), the Bureau intends to use the CBA database in its initial screening test as this is the most comprehensive, readily available database. The data consists of 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 (referred to as FSAs or forward sorting areas). While the database does not contain information on financial activity in all FSAs in Canada, it does cover all of the branches of the four banks currently proposing mergers. The Bureau will also be gathering additional information from other sources, including the parties directly and their existing and potential competitors.

overreport the number of geographic areas where potential competition concerns might arise. This is not problematic, however, since this is only an initial screen and is not determinative for the transactions as a whole. The Bureau will rectify this deficiency in its subsequent competitive effects analysis, as described more fully in paragraphs 59 to 100.

56. If the post-merger market share and concentration thresholds are not exceeded for a given pre-defined product offering and a pre-defined geographic area, the Bureau is unlikely to be concerned that competition in the supply of that product in that area will be lessened substantially as a result of the merger. In the absence of information suggesting otherwise, the Bureau will have no cause to conduct a further review of this product offering and geographic area.[23]

57. Finally, the product and geographic areas which are not excluded by this screening process will be subject to a full competitive effects analysis, as described in paragraphs 59 to 100.

58. In order to make the initial screening test analytically tractable, the Bureau will use a geographic mapping software program developed by Statistics Canada.[24] This program is capable of quickly matching the market shares of each reporting financial institution for each pre-defined product offering within each pre-defined geographic area. The software program will also apply the market share and concentration thresholds to each area and list the results in tabulated form.

---

[23] As noted in paragraph 55, the pre-defined geographic areas based on the CBA database are likely to be narrow and do not necessarily represent defined geographic markets. This will reduce the chances that true relevant geographic markets are incorrectly ruled out of any further competitive effects analysis by the screen.

[24] Statistics Canada has assisted the Competition Bureau in developing a spatial analysis tool to examine multi-product mergers in a local market context, which can be used for banking or other industrial sectors.

THE POTENTIAL ANTI-COMPETITIVE EFFECTS OF MERGERS

59. The Bureau will not conclude that a merger is likely to substantially lessen or prevent competition solely on the basis that the market shares or concentration levels in the relevant markets are above the threshold levels.[25] Rather, the Bureau will undertake a full competitive effects analysis for those markets where the thresholds are exceeded. When undertaking such analysis, the Bureau focuses on certain factors which make it more likely that a merger will result in a substantial lessening of competition through the unilateral exercise of market power by the merged entity post-merger as described in paragraphs 60 to 64. The section following this discusses the factors that increase the likelihood that firms in the relevant market will engage in interdependent behaviour post-merger.

Lessening of Competition Through Unilateral Effects

60. A merger can enhance the ability of the merging firms to profitably raise price by placing pricing and supply decisions under common control, thereby creating an incentive to increase prices and restrict supply or limit any other dimension of competition. In a competitive market, where consumers can choose among many suppliers offering comparable products, a firm's incentive to increase price is limited by consumers diverting their purchases to substitute products in response to the price increase. When two firms in a market merge and one of the firms increases its price, some demand may be diverted to the firm's merger partner, thereby increasing the overall profitability of the price increase and thus increasing the incentive to increase price. A price increase is likely to be profitable when the merging firms account for a significant share of the market. In assessing a merger, the

[25] Section 93(2) of the *Act* directs that the Competition Tribunal cannot find that a merger lessens or prevents competition substantially based solely on evidence of market shares or concentration.

Bureau will consider whether the characteristics of the relevant market are conducive to such a post-merger price increase.

61. In some markets, firms are distinguished primarily by differences in their products, while in other markets, firms are distinguished by their capacities or costs. In differentiated product markets, a merger is more likely to enhance the ability of merging firms to exercise unilateral market power when a significant number of consumers view the product offerings of the merging parties to be their first and second choices. In these circumstances, a post-merger price increase is more likely to be profitable because a price increase by one of the merging firms is likely to divert demand toward its partner. If, on the other hand, the merged firms' products are not first and second choices for a significant number of consumers, then a price increase by one of the merging parties may not be profitable, because demand will be diverted to other firms in the market.

62. In order to assess whether a merger among suppliers of differentiated products is likely to enhance the ability of the merged entity to unilaterally exercise market power, the Bureau will use any information which indicates whether the products of the merging firms are first and second choices for a significant number of consumers. Evidence of past consumer switching behaviour in response to changes in relative prices is particularly useful. The Bureau will also consider whether other firms in the market are likely to re-position their products to replace any competition lost as a result of the merger.

63. In markets in which firms are distinguished primarily by their capacities, a post-merger price increase may be profitable if the merger removes a competitor to which consumers would otherwise turn in response to the price increase. Such a price increase is unlikely to be profitable if other firms in the market are able to absorb the demand that is diverted from the merged entity. This is possible only if the remaining firms have sufficient capacity to absorb this demand, or if capacity can be expanded quickly and at low cost.

64. Capacity in the context of a bank merger is likely to be limited to some extent by access to funds for the purpose of lending, but it may also be limited by the availability of trained personnel with knowledge of the market and the availability of other inputs required to supply banking services.

Lessening of Competition Through Interdependent Behaviour

65. The term "interdependent behaviour", also known as coordinated behaviour, refers to conduct by a group of firms that is profitable for each of them only because of the accommodating co-operative conduct of the others. Such behaviour is more likely in markets in which firms can recognize and reach a co-operative understanding, monitor one another's behaviour, and respond to any deviations from the co-operating behaviour by others.[26] This type of behaviour may include tacit or explicit agreements on price, service levels, or any other dimension of competition.

66. A high level of concentration in the relevant market is a necessary, but not sufficient, condition for a determination that competition is likely to be lessened or prevented through interdependent behaviour. An understanding among firms in a market to limit competition is easier and less costly to reach and enforce if the number of firms accounting for a large proportion of total market output is small. However, high concentration levels in themselves do not imply that a merger will increase the likelihood of the exercise of market power through interdependent behaviour. In addition to high levels of concentration, interdependent behaviour requires the ability to reach an understanding and to detect and deter deviations from the cooperative understanding.

---

[26] These responses, typically known as punishments, may take the form of low prices in the relevant market or in other markets.

67. Reaching terms of understanding is likely to be easier when products and/or firms are homogeneous, and when important information about rival firms and market conditions is readily available. On the other hand, complex products and differences in product offerings, and rapid and frequent product innovations, make it more difficult to reach an understanding. The existence of industry organizations that facilitate communication and dissemination of information among market participants can also facilitate anti-competitive cooperation.

68. The following are important factors affecting the ability of firms to detect and successfully deter deviations from a co-operative understanding:

i) Transparency of the terms of market transactions. When prices are transparent to market participants, deviations are more easily detected;

ii) Stability of underlying costs. When costs fluctuate, it may be difficult to determine whether a price change represents a deviation from an understanding or is rather a response to a change in cost conditions;

iii) Size and frequency of product sales. When sales occur in large discreet blocks and are relatively infrequent, then deviations from understandings are relatively more profitable and effective deterrence of deviation is more difficult; and,

iv) Multi-market exposure. When firms participate in multiple geographic or product markets, there are greater opportunities to discourage firms from deviating from the co-operative understanding.

69. The Bureau will examine whether there is a history of market participants having engaged in interdependent behaviour in the past. The effect of "maverick" firms, who may impede successful coordination, will also be considered.

70. In previous assessments of bank mergers, the Bureau has found that geographic markets for some products are often local, but the participants in these markets are national or regional. When geographic markets are local, the concentration level threshold will be applied at the local level, but an assessment of ease with which a co-operative understanding can be reached and maintained will be undertaken at both the local level and the national level. If competition occurs locally, then a high level of concentration at the local level is necessary in order to facilitate interdependent behaviour. However, coordination can occur either among decision-makers in local markets or among decision-makers at the national or regional level: that is, senior executives may have the ability to reach and sustain an agreement about prices in a particular local geographic market, even if concentration at the national level is low.

EVALUATIVE CRITERIA

71. Several of the key evaluative criteria listed in Section 93 of the *Act* play a major role at the market definition stage. However, once the relevant markets have been defined and market shares have been determined, it is important to also assess these factors in relation to each of the relevant markets where the merged entity's market share exceeds either the 35% threshold or the four-firm concentration level exceeds the 65 % threshold and the merged firm holds more than 10%, to determine whether the merging parties can sustain price increases for more than two years.

Foreign Competition

72. The assessment of foreign competition (section 93(a)), particularly important in the context of the globalization of markets, involves a determination of the extent to which foreign products or foreign competitors provide or are likely to provide effective

competition to the businesses of the merging parties. To determine the constraining influence of foreign competition, a number of factors are considered, including the extent to which the effectiveness of foreign competition is likely to be hindered or impeded by domestic ownership restrictions.

73. For example, current regulations restrict the entry of foreign banks by requiring that they establish bank subsidiaries rather than simply operate through branches within Canada. The 10% ownership rule also limits foreign entry, and while this rule is typically viewed as a constraining factor on domestic mergers, it also serves to restrict the ability of foreign companies from acquiring a significant interest in Canadian financial institutions. Moreover, the extent to which foreign entry has been facilitated by technological change, particularly through the feasibility of electronic banking, is another factor considered in determining the constraining influence of foreign competition.

The Availability of Acceptable Substitutes

74. In addition to identifying which products compete with the products of the merging parties and therefore warrant inclusion in the relevant market or in market share analysis, it is necessary to assess whether the supply of these products would likely increase or be made available within a two year period in response to an attempted exercise of market power (section 93(c)). In this regard, an assessment is made as to whether:

i) competing sellers collectively have, or could easily add, sufficient capacity;

ii) it is likely that the total supply of acceptable substitutes in the market will increase sufficiently; and,

iii) buyers are likely to switch a sufficient quantity of their purchases to acceptable substitutes

to ensure that a material price increase cannot be profitably maintained in the relevant market post-merger.

75. For example, although telephone banking services are available to most retail customers, other electronic banking services requiring a computer are not readily available to many households and small businesses at this time. Although the number of electronic-based transactions has increased substantially in the last decade and new products are continuously being introduced, customer acceptance may take longer than two years. As a result, these alternative means of delivering banking products may not represent a sufficiently widely available, acceptable substitute to the provision of the same banking products through branches such that they may not constrain a potential exercise of market power by the merging banks. This will be an important component of the Bureau's analysis of any bank merger.

Barriers to Entry

76. Section 93(d) draws attention to "any barriers to entry into a market, including:

i) tariff and non-tariff barriers to international trade;
ii) interprovincial barriers to trade; and,
iii) regulatory control over entry

and any effect of the merger or proposed merger on such barriers".

77. Examination of this issue is directed toward determining whether entry by potential competitors would likely occur on a sufficient scale in response to a material price increase or other change in the relevant market brought about by the merger, to ensure that such a price increase could not be sustained for more than two years. This generally involves an examination of whether entry is likely to be delayed or hindered by absolute cost

differences or the need to make investments that are not likely to be recovered if entry is unsuccessful (referred to as sunk costs).

78. When assessing whether entry is likely, the Bureau will give primary consideration to the profitability of entry. This takes into account the barriers that must be overcome in order to enter the market, and the potential profit opportunities created by the merger. The analysis focuses on whether entry is profitable at prices that are below the postulated, elevated post-merger level.[27] The profitability, and therefore the likelihood, of sustainable entry depends primarily upon absolute cost disadvantages faced by the entrant, the degree to which start-up costs associated with entry are sunk, and the probability that entry will be successful.

79. The Bureau will conduct an analysis of entry conditions for each of the relevant markets in which it has been determined that, absent entry, competition would likely be lessened or prevented substantially as a result of the merger. When there are several such markets, as with a bank merger, entry may be more profitable, and therefore more likely, only when it is into several product or geographic markets. This may be the case if there are significant economies of scope that can be attained through the simultaneous offering of multiple products or through simultaneous entry into several geographic markets.

80. In assessing the extent to which future entry into banking markets would likely occur, the Bureau's analysis starts with an assessment of the likelihood of entry by banks, other deposit-taking institutions, and any other potential suppliers that appear to have an entry advantage. For example, when product markets are local, the likelihood that banks and other institutions that supply the relevant product in other geographic markets, or similar

---

[27] Entry prior to the merger may not have been profitable because such entry would have reduced prices to below pre-merger levels.

products in the same geographic market, will expand their supply of the relevant product in the relevant geographic market will be considered. Following this, the Bureau will turn to examining the likelihood by other potential entrants, such as non-financial institutions.

Absolute Cost Advantages

81. Incumbent firms can gain important cost advantages relative to potential entrants through a variety of sources. The *Act* highlights three sources of cost advantage that can present potential entrants with considerable, and in some cases insurmountable, barriers to entry.[28] In the case of banking, there are several regulatory barriers to consider, including those pertaining to: other domestic financial institutions which are not Schedule I banks; domestic non-financial institutions; foreign banks; and other foreign financial institutions. The extent to which regulatory barriers to entry by foreign banks facilitate the exercise of market power in domestic markets is discussed in paragraphs 72 and 73.

82. Other potential cost advantages include control over access to scarce resources and influence over access to membership in cooperative ventures, such as Interac and the Canadian Payments Association.

Sunk Costs[29]

83. The term "sunk costs" refers to the proportion of the total entry costs which have continuing value if the firm stays in the market, but that are not recoverable if the firm exits the market. New entrants are often required to incur various start-up sunk costs, such

---

[28] These three sources are: i) tariff and non-tariff barriers to international trade; ii) interprovincial barriers to trade, and; iii) regulatory control over entry.

[29] Further background information about sunk costs is contained in Appendix I of the Director's Merger Enforcement Guidelines.

as acquiring market information, developing and testing product designs, installing equipment, engaging new personnel and setting up distribution systems. In addition, sunk costs may be incurred by potential entrants when making investments in market specific assets and in learning how to optimize the use of these assets (these investments may include training personnel and obtaining information about local market conditions), overcoming reputation-related advantages enjoyed by incumbents, and/or overcoming disadvantages presented by the strategic behaviour of incumbents.

84. In the case of local banking markets, sunk costs may include establishing distribution facilities required for making loans or offering deposits and other banking products, and in establishing or expanding specialized computer systems, etc. In assessing the likelihood of entry, the Bureau will take into account developments in technology that may reduce sunk costs by allowing for the profitable use of a lower cost means of distribution that does not require a physical bricks and mortar presence. However, in keeping with the purpose of entry analysis, such prospective changes must be found to be both likely and sufficient to prevent post-merger material price increases. Where the available information suggests, for example, that a new entrant with a limited physical presence in the market is unlikely to gain acceptance by a significant number of consumers, such entry will not be considered to be sufficient to prevent a post-merger price increase.

85. In general, since entry decisions are typically made in an environment in which the probability of success is uncertain, the likelihood of significant future entry decreases as the proportion of total entry costs accounted for by sunk costs increases. The Bureau's assessment of sunk costs is focused upon whether the likely rewards of entry, the likely time required to become an effective competitor and the risk that entry will not ultimately be successful, taken together, justify making the sunk investments that are required.

86. Information about commitments that must be made and the time required to become an effective competitor can often be obtained by examining past entry attempts into the relevant market or other similar markets. However, evidence of past entry attempts will not, in itself, be taken to demonstrate that entry is likely to occur in the relevant market. Firms enter and leave markets for a number of reasons, and it will not be assumed that entry that may have occurred in response to changes in market conditions unrelated to the merger implies that entry sufficient to discipline a post-merger price increase will occur. The Bureau will generally conclude that a merger is not likely to prevent or lessen competition substantially where it can be established that, in response to the merger or to the exercise of increased market power resulting from the merger, sufficient entry into the relevant market would occur to ensure that a material price increase would not likely be sustained in a substantial part of the relevant market for more than two years.

Time

87. An important aspect of the assessment of entry conditions involves determining the time that it would take for a potential competitor to become an effective competitor in response to a material price increase or other change in the market brought about by a merger. In general, the longer the time required for potential entrants to become effective competitors, the less likely it is that incumbent firms will be deterred from exercising market power by the threat of future entry in the first place and the longer any market power that is exercised can be maintained. Account is also taken of whether the delay and losses that potential entrants expect to encounter before becoming effective competitors will likely increase the sunk costs, risk or uncertainty perceived to be associated with such entry, and thereby reduce the likelihood that entry will occur.

Effective Remaining Competition

88. Effective remaining competition is a broad concept that refers to the collective constraining influence of all sources of competition in a market, including those afforded by individual competitors, as well as foreign competition, available and acceptable substitutes, new entry and innovation. In this regard, an assessment is made of the nature and extent of forms of rivalry such as discounting and other aggressive pricing strategies, innovative distribution and marketing methods, product and packaging innovation, and aggressive service offerings that have been evident in the relevant markets. These and other forms of competition give rise to a competitive environment that contrasts sharply with markets where competitors accept stability or are content to follow attempts at price leadership or other initiatives of existing or aspiring market leaders. An assessment is also made of how existing competitors will likely respond to a merger, particularly in relation to their vigor and effectiveness in the marketplace. This analysis will take into account any proposed or likely mergers among remaining competitors, and how such transactions, if not challenged, would affect competition remaining in the relevant markets.

89. Where it is clear that the level of effective competition remaining in the relevant market is not likely to be reduced as a result of the merger, this alone will generally justify a conclusion not to challenge the merger on the basis that the merger will enhance the ability of the merging firms to unilaterally exercise market power. This is so whether the absolute level of effective competition in the market in question appears to be high or low.

Removal of a Vigorous and Effective Competitor

90. By assessing the competitive attributes of the acquired firm, more direct attention is drawn to what is likely to be lost as a result of the merger. A wide variety of factors can indicate whether the acquiree, either large or small, is or has been a vigorous and

effective competitor, including its level of innovation, its role in the marketplace as price leader or price follower, its use of discounting or other aggressive pricing strategies, its role as a disruptive force in a market that appears to be otherwise susceptible to interdependent behaviour, its role in providing unique service to the market, or in helping to ensure that similar benefits offered by other competitors are not reduced.

91. Although competition is prevented or lessened to some degree when a vigorous and effective firm is eliminated from the relevant market through a merger, the removal of such a competitor is not generally sufficient, in and of itself, to warrant enforcement action under the *Act*. It must also be established that prices will be materially higher than in absence of the merger; i.e., there must also be findings unfavourable to the merger in terms of other factors, in particular, effective remaining competition and future entry.

Change and Innovation

92. Although already incorporated to some extent in evaluating the impact of the other section 93 factors, an analysis of change and innovation includes general dynamic developments in products, distribution, service, sales, marketing, buyer preferences, firm structure, the regulatory environment and the economy as a whole. The pressures imposed on remaining competitors in a market by the nature and extent of dynamic developments in any of these areas may be such as to ensure that a material price increase is unlikely to occur or will not be sustainable. The stage of market growth is also considered.

93. Although traditional banking is typically viewed as a mature industry, new developments in distribution and buyer sophistication have prompted changes to the way the financial sector operates. For example, the rising importance of electronic delivery of banking services may reduce the importance of a bank's local branch presence, since buyers

may readily access the services of more distant suppliers of financial services through electronic means. Electronically delivering traditional banking services is also a considerably less expensive means of distribution, and may allow for greater entry opportunities for firms not currently involved in Canadian financial services. In addition, with the evolution of leasing and financing companies, disintermediation may be displacing the traditional role of banks as the intermediary between the needs of lenders and borrowers. This and other trends are critical elements in determining the ability of the merging parties to exercise market power.

94. When a merger is likely to enhance or facilitate the maintenance of existing market power, representations regarding how the merger may be likely to give rise to innovation-related synergies and other efficiencies will be considered pursuant to section 96.

Business Failure and Exit

95. Section 93(b) draws attention to the importance of assessing "whether the business, or a part of the business, of a party to the merger or proposed merger has failed or is likely to fail". The opening clause of section 93 makes it clear that this information is to be considered "in determining, for the purpose of section 92, whether or not a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition substantially". The impact that a firm's exit can have in areas other than competition are generally beyond the scope of the Bureau's assessment.

96. Probable failure of a party to a merger is not sufficient to warrant a conclusion that the merger is not likely to prevent or lessen competition substantially. An assessment must be made of whether acquisition of the failing firm by a third party, retrenchment by the failing firm, or liquidation, would likely result in a materially higher level of competition in

the relevant market than if the merger proceeded. The Bureau applies the same rationale when analyzing situations where a firm wishes to exit a market for reasons other than failure, such as unsatisfactory profits, or a desire by a diversified firm to focus its efforts elsewhere. Similarly, these considerations are equally applicable to failure-related claims concerning a division or a wholly owned subsidiary of a larger enterprise.[30]

97. At the same time, the Bureau recognizes that its analysis should not be blind to the unique circumstances that arise in a failing firm situation. The MEGs acknowledge that there are factors that serve to constrain the competitive implications of a merger involving a failing firm. First, the loss of the competitive influence of a failing firm cannot be attributed to the merger if the firm would have exited the relevant market in any event. Second, the extent to which the acquisition of a failing firm can increase the market power of the acquiror is often reduced as the failure of the former becomes increasingly likely, and as its relative market position weakens. Third, the likelihood that any market power effects that will materialize subsequent to the merger can be avoided through retrenchment or liquidation is reduced as the failure of the firm in question becomes increasingly likely.

98. Following receipt of full information, the Bureau generally requires up to six weeks to assess the extent to which a firm is likely to fail if the merger does not proceed. The time required to make this assessment will vary from case to case. Parties intending to invoke the failing firm rationale and/or anticipate that they may be required to undertake a search for a competitively preferable purchaser are encouraged to make their submissions/search as early as possible. As soon as the absence of a competitive preferable

---

[30] In assessing submissions relating to the failure of a subsidiary or a division, attention will be paid to: transfer pricing within the larger enterprise, intra-corporate cost allocations, management fees, royalty fees, and other matters that may be particularly relevant in this context. These allocations will generally be assessed in relation to the values of equivalent arm's length transactions.

alternative is established, the assessment of the likely effects of the merger on competition becomes moot.

99. These time requirements may be a significant factor in the financial services market where delays may raise uncertainty about the deposits of customers. The Bureau has reviewed transactions in this sector where firms are in financial difficulty and it was able to complete its review within the time frames of the merging parties. However, the Bureau cannot always guarantee this outcome and it would encourage all parties who find themselves in these circumstances to approach the Bureau at the earliest opportunity. Firms may wish to consider consulting the Bureau at the same time as they advise OSFI of their status and the efforts they are making to resolve their financial problems. It will be important for the Bureau to consult with the Minister of Finance in these situations since this is a possible scenario for the Minister to use the override authority set out in section 94 of the *Act* to allow a merger that the Bureau would otherwise challenge.

Additional Evaluative Criteria

100. Finally, section 93(h) recognizes that other factors relevant to competition in markets that are or would be affected by a merger may also be assessed to determine the likelihood that a merger will result in a substantial lessening or prevention of competition. The likelihood that firms in a market will employ practices such as exclusive contracts, tied selling, and price discrimination, that may be harmful to competition is considered at this stage.

THE EFFICIENCY EXCEPTION

101. The Bureau recognizes that changes in regulations, developments in technology, and globalization will have implications for the structure of the financial services

sector. It is expected that banks will respond to these and other changes through various forms of restructuring, including mergers. Notwithstanding the fact that a bank merger may substantially lessen or prevent competition, the Competition Tribunal may not make an order against the merger if the elements of the efficiency exception set out in section 96 are met. First, the efficiencies must represent cost savings to the economy that would not be attained if a remedial order against the merger were made. Second, the cost savings must represent real savings in economic resources, rather than private gains to the merging parties that result, for example, from an increase in bargaining power with suppliers.

102. The onus of demonstrating efficiencies rests with the merging parties. To facilitate expeditious assessment of the nature and magnitude of merger-related efficiencies, merging parties are encouraged to make their efficiency submissions to the Bureau at an early stage of its review of the transaction. It is not necessary to wait until a finding is made that the merger is likely to prevent or lessen competition substantially.

Efficiencies that Would Likely be Attained if an Order Were Made

103. In order to consider cost savings in the efficiency analysis, it must be the case that these savings would not be realized if remedial action was taken against the merger. If any of the claimed cost savings would likely be attained through less anti-competitive means such as internal growth, unilateral rationalization, a merger with a third party, a joint venture, a specialization agreement, or a licensing, lease or other contractual arrangement, then they are not considered in the trade-off analysis.

104. In cases where the Tribunal would order remedies for only a portion of the overall merger, then the relevant efficiencies for consideration are those that arise from this part of the transaction. Efficiency claims related to other parts of the merger that would not be challenged will be achieved in any event, and hence they are not considered in the trade-

off. For example, if the Bureau concludes that a bank merger lessens competition in certain local markets, the remedy sought in the Director's application may be divestiture of assets in these markets. In this case, claimed efficiencies that would be outside these local markets will not be considered in the trade-off analysis.

105. The Bureau will also not consider any efficiencies that would likely be attained through some form of co-operation short of a merger. The Bureau recognizes that the nature of the financial services industry, in particular its "network" features, implies that cooperation among institutions often facilitates the efficient provision of products and services to consumers. Past instances of co-operation among banks, including the Interac network and Simcor, suggest that forms of cooperation short of a merger may, in some circumstances, be sufficient to attain the desired efficiencies while decreasing the potential that competition will be substantially lessened. In other circumstances, for example a merger that may facilitate entry into foreign markets, a joint venture with a foreign firm, a joint venture among domestic players solely for the purpose of operating in those foreign markets, or an acquisition of a foreign player may be less anti-competitive. To assess whether efficiencies that have been claimed would likely be attained through a merger with a third party or some other form of cooperation if a remedy against the merger were sought, consideration will be given to existing alternative merger proposals that are less anti-competitive and that can reasonably be expected to proceed if the order in respect of the first proposed merger is made. Efficiencies generally will not be excluded from the balancing process on the speculative basis that they *could* be attained through a merger with an unidentified third party.

Cost Savings that are Redistributive in Nature

106. Claimed efficiency gains are not considered where they would likely be brought about by reason only of a redistribution of income between two or more persons. For example, gains that are anticipated to arise as a result of increased bargaining leverage that enables the merged entity to extract wage concessions or discounts from suppliers that are not cost justified represent a mere redistribution of income to the merged entity from employees or the supplier, as the case may be. Such gains are not brought about by a saving in resources. This contrasts with the situation where the supplier is able to offer better terms as a result of the fact that larger orders from the merged entity will enable the supplier to attain economies of scale, reduce transaction costs or achieve other savings.

"Greater Than" and "Offset"

107. The words "greater than" are considered to signify that the efficiency gains must be more weighty than, more extensive than, or of larger magnitude than the anticompetitive effects that are likely to result from the merger. By comparison, the term "offset" is considered to suggest that the efficiency gains must neutralize, counterbalance or compensate for the likely anticompetitive effects of the merger.

108. The expressions "greater than" and "offset" are considered to each have qualitative and quantitative connotations. To be assessed in terms of "greater than", efficiency gains must be capable of being weighed in similar terms as all or some of the anticompetitive effects that will likely result from the merger. Efficiency gains and anticompetitive effects that cannot be weighed in similar terms will be evaluated in terms of whether the gains offset the anticompetitive effects. This evaluation can be subjective in

nature and will ordinarily require the exercise of the Director's discretion.[31] In short, efficiency gains and anticompetitive effects that can be measured in dollar or other similar terms are weighed to determine whether the "greater than" requirement is met; whereas efficiency gains and anticompetitive effects that cannot be balanced in such terms are compared to determine whether the "offset" requirement is met. Where all of the efficiency gains and anticompetitive effects can be measured in similar terms, and where the efficiency gains are "greater than" the anticompetitive effects, they will also be considered to "offset" the anticompetitive effects.

Anticompetitive "Effects"

109. Section 96(1) requires efficiency gains to be balanced against "the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed merger". Where a merger results in a price increase, it brings about both a neutral redistribution effect[32] and a negative resource allocation effect on the sum of producer and consumer surplus (total surplus) within Canada. Ordinarily, the Director measures the efficiency gains described above against the latter effect, i.e., the deadweight loss to the Canadian economy.

110. Quantifying the likely anticompetitive effects of mergers is generally very difficult to make. This is particularly so with respect to the measurement of losses related to

---

[31] Accordingly, if part of the efficiencies likely to result from the merger include dynamic R&D efficiencies (which cannot be measured in similar terms as any of the likely anticompetitive effects) and if part of the anticompetitive effects likely to result from the merger include a reduction in service, quality or variety (which cannot be measured in terms that are similar to any of the likely efficiencies) the Director would exercise his discretion in assessing whether the R&D efficiencies would likely "offset" the effects of a reduction in service, quality or variety.

[32] When a dollar is transferred from a buyer to a seller, it cannot be determined *a priori* who is more deserving, or in whose hands, it has a greater value.

a reduction in service, quality, variety, innovation and other non-price dimensions of competition. Insofar as such losses often cannot be quantified, they receive a weighting that is essentially qualitative in nature. In view of the difficulties associated with arriving at precise estimates of both the elasticity of market demand and the magnitude of the prevention or lessening of competition that is likely to be brought about by the merger, several trade-off assessments are generally performed over a range of price increases and market demand elasticities.

111. In calculating the magnitude of likely efficiency gains, cost savings are generally measured across the reduced level of output that will be required to bring about the anticipated material price increase. In estimating the extent of negative resource allocation effects of mergers, the Bureau includes the additional losses in total surplus that arise when market power is being exercised in the relevant market prior to the merger. Similar losses that arise as a result of foregone contribution to fixed costs (due to restricting levels of output) are also recognized.

112. Given that section 96(1) requires efficiencies to be balanced against the effects of "any" prevention or lessening of competition that will result from the merger, anticompetitive effects that are likely to arise in other markets affected by the merger are also considered in the trade-off analysis. However, anticompetitive effects in markets that are not targeted by the remedial order generally will not be substantial in nature.

113. It is the Director's policy that in cases where there is a strong likelihood of substantial prevention or lessening of competition, and yet the parties to the merger are claiming efficiency gains, the Director will bring such cases before the Competition Tribunal for resolution.

114. While alternative interpretations have been proposed for applying the efficiency exception, the Director's enforcement approach has been to adopt a "total welfare"

approach to the section. Hence, anticompetitive effects refer to the part of the total loss incurred by buyers and sellers in Canada that is not merely a transfer from one party to another, but represents a loss to the Canadian economy as a whole, attributable to the diversion of resources to lower valued uses. This standard is no different from the traditional benefit-cost analysis applied to other public policies. The Director is not convinced that the nature of potential cost savings and the possible anticompetitive effects stemming from bank mergers are sufficiently distinct from mergers in other sectors of the economy to adopt a different standard for analysing efficiencies from that described in the MEGs.

Annex I: Banking Merger Review Process

Introduction

This annex sets out in detail the banking mergers' review process to be employed by the Competition Bureau.

Current Legislative Provisions

Mergers are reviewed by the Director of the Competition Bureau under the Competition Act to assess their impact on competition. Should the Director conclude that a merger is likely to substantially lessen or prevent competition he may proceed to the Competition Tribunal to seek a remedy.

A merger among any of the banks also requires the ultimate approval of the Minister of Finance under the *Bank Act*.

In addition, the Minister of Finance also has the unique authority under section 94 of the *Competition Act* to prevent the Competition Tribunal from issuing any order in those circumstances where he has certified that a transaction among banks is desirable in the interest of the financial system. In short, exercising this authority would over-ride the Director's and the Tribunal's roles.

While the authority of both the Director and the Minister of Finance are spelled out in the *Competition Act* and the *Bank Act*, both acts are silent on how the Director and the Minister should interact and how this process should unfold.

Review Procedures

In order to continue the Bureau's practice of ensuring predictability and transparency, the Director, after consultations with the Minister of Finance, has decided to adopt the following procedure for all Schedule I bank mergers:

1. The Bureau will follow its practice of gathering information about proposed bank mergers and in analysing any possible anticompetitive effects.

2. The Bureau will identify to the merging parties on an ongoing basis any likely anti-competive issues that may arise.

3. Immediately after having completed its analysis of the merger as proposed, the Director will provide to the parties and to the Minister of Finance, a letter setting out the Director's views on the competitive aspects of the proposed merger. In the event the merger raises competitive concerns the Director will set out in general terms the sort of measures that have historically been applied to deal with competition concerns.

4. After receiving the letter from the Director and after taking into account any public interest concerns expressed by the Minister of Finance on behalf of the Government of Canada, the parties to the merger would then be in a position to determine if it is appropriate to explore potential remedies with the Bureau in relation to any anticompetitive concerns raised by the Director.

5. In the event the parties subsequently succeed in suggesting competetive remedies acceptable to the Director such remedies may, if appropriate, still require the approval of

the Competition Tribunal; and the resulting merger itself still needs to be approved by the Minister of Finance pursuant to the *Bank Act*.