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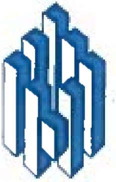
Commentary



C.D. Howe Institute

No. 44, April 1993 ISSN 0824-8001

The NAFTA Papers

Implications of the NAFTA for Canadian Financial Institutions

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The financial services chapter of the North American Free Trade Agreement (NAFTA) establishes a comprehensive, principles-based approach to disciplining government measures that regulate financial services. This approach draws heavily on the insights gained during recent negotiations on services in the Uruguay Round of the GATT and is a notable departure from the *à-la-carte* approach pursued under the Canada-US Free Trade Agreement (FTA).

The NAFTA offers significant new opportunities for Canadian providers of financial services to enter the potentially large Mexican market. However, Canada and the United States missed an opportunity to further liberalize trade in financial services with each other and to redress some of the imbalances contained in the financial services chapter of the FTA.

The NAFTA's principles of "equality of competitive opportunities" and "market access" may lead (a) to the liberalization of restrictions still facing the Canadian financial industry in the United States; (b) to pressure on Canadian financial regulators to allow US banks to branch directly into Canada; and (c) to greater regulatory harmonization within the NAFTA countries.

Main Findings of the Commentary

- The NAFTA offers significant new opportunities for Canadian providers of financial services to enter the Mexican market — a market that is underbranched, undermortgaged, underinsured, and has underdeveloped corporate lending and derivative markets, and hence has tremendous potential for future growth.
- Canadian financial institutions are generally well positioned to benefit from the opening of Mexico's financial markets since they are better capitalized than most US banks and have greater expertise in operating large, multibranch networks. US securities and insurance firms may have a comparative advantage over their Canadian counterparts because of their significantly larger capital bases and greater recent experience in serving the Mexican market.
- Significant benefits will also accrue from the NAFTA's introduction of a binding dispute settlement mechanism for the financial services industry.
- Canadian financial institutions that wish to enter the Mexican market should keep in mind that, since Mexico will apply transitional market-share limitations in aggregate to Canadian and US firms as well as to non-NAFTA firms incorporated in either country. If they do not act before those limits are reached, Canadian firms may not be able to establish themselves in Mexico until well into the next century, by which time securing market shares in a deeper, more mature Mexican market would be more difficult and almost certainly costlier.
- The inability of Canada and the United States to further liberalize trade in financial services with each other in the NAFTA is disappointing for the Canadian financial community, which had pinned hopes on seeing the trilateral agreement redress some of the imbalances contained in the financial services chapter of the FTA.
- The NAFTA incorporates the principles of "equality of competitive opportunites" and "market access," which may lead to increased pressures (a) to liberalize restrictions still facing the Canadian financial industry in the United States, (b) on Canadian financial regulators to allow US banks to branch directly into Canada, and (c) for greater regulatory harmonization within the NAFTA countries.

On August 12, 1992, the governments of Canada, the United States, and Mexico completed negotiation of the North American Free Trade Agreement (NAFTA). Formally signed by the leaders of the three countries on December 17, 1992, the NAFTA establishes a new trading framework for North America by providing a new set of rules to cover investment and more than $300 billion in three-way trade. If ratified by the three countries' relevant legislative bodies, the NAFTA will create the world's largest free trade zone, encompassing some 360 million consumers whose combined output of goods and services amounted to some $7 trillion in 1991.[1]

Marking a significant departure in economic relations between industrial and developing countries, the NAFTA extends to Mexico the rights and obligations of the 1989 Canada-United States Free Trade Agreement (FTA). It also expands on the FTA, both by broadening its coverage (to include, for instance, transportation and intellectual property) and by deepening the treatment applying to sectors and issues already covered under the bilateral pact (for example, by expanded disciplines for services, investment, and rules of origin).

As a result of the NAFTA, the treatment of the financial services sector was *both* broadened and deepened. The financial services chapter of the NAFTA represents an important development in trade agreements because it establishes, for the first time ever in this sector, a principles-based approach to trade liberalization — a notable departure from the *à-la-carte* approach pursued under the FTA. Furthermore, it provides for significant new market-access opportunities for NAFTA financial service providers in the Mexican market.[2]

This *Commentary* examines the main features of the NAFTA that pertain to financial services. To do so, it addresses three issues. First, it reviews the reasons that prompted the adoption of a principles-based approach to liberalization, focusing in particular on the perceived shortcomings of the FTA and on the lessons drawn from the negotiations on financial services in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). Second, the paper describes the architecture of the NAFTA's financial service provisions, focusing both on the key trade principles to which the three countries agreed, as well as on the specific liberalization commitments made by each country. Third, the paper offers some thoughts on the possible implications of the NAFTA for the operation of Canadian financial institutions in the US and, especially, Mexican markets.

Toward a Principles-Based Approach to Liberalization

Unlike the FTA, or any other existing financial services agreement, the NAFTA establishes a comprehensive principles-based approach to disciplining government measures that regulate financial services. The adoption of a principles-based approach to liberalization marks an important new development in the area of financial services. It stems from the recognition — largely absent within the international community of financial regulators even a decade ago — that the twin pursuits of business globalization and trade liberalization require that participating countries agree on a guiding set of rules and disciplines relating to matters of establishment, market access, standards of treatment, transparency of regulations, and dispute settlement.

Of all the sectors addressed by both the FTA and the NAFTA, financial services stands out as the one to which the NAFTA introduces probably the greatest number of substantive changes. This is hardly surprising given the shared perception in both FTA countries' industry and regulatory circles of the shortcomings of the bilateral agreement's treatment of financial services (see Box 1). Chief among these are the absence of general rules or principles enshrining the right to market access and nondiscriminatory treatment, the absence of disciplines on measures of subnational governments and self-regulatory organizations (such as stock or futures exchanges), the lack

Box 1: *Financial Services in the Canada-US FTA*

The FTA chapter on financial services, crafted as a series of specific liberalization commitments, exempted US and Canadian institutions from certain existing regulations that appeared to be significantly impeding bilateral trade and investment in financial services. The chapter's provisions govern bilateral trade in banking and securities services but not insurance services, which are subject to the chapter on trade in nonfinancial services. This division came about because, in the United States, the Department of Commerce rather than the Treasury is responsible for regulatory oversight in the area of insurance. This partition meant that only insurance services benefited from principles-based liberalization under the FTA, including the agreement's binding dispute settlement provisions.

In terms of specific commitments, the FTA saw Canada exempt US financial firms from certain laws limiting the aggregate foreign ownership of federally regulated financial institutions to 25 percent, and individual ownership to 10 percent (the so-called 10/25 rule). However, the individual 10-percent ownership limitation continues to apply to both US and Canadian investors having equity in a Schedule I bank. Additionally, US bank subsidiaries operating in Canada gained other concessions: exemption from the aggregate ceiling on the size of the foreign banking sector; permission to transfer loans to their parent companies, subject to certain prudential considerations; exemption from the requirement to obtain approval from the minister of finance prior to opening additional branches within Canada; and entitlement to nondiscrimination treatment with respect to the establishment or acquisition of federally regulated financial institutions. Canada further agreed not to review US applications for establishing subsidiaries in Canada in a manner inconsistent with the agreement.

The United States, for its part, agreed to permit domestic and foreign banks and bank holding companies to deal in, underwrite, and purchase without limitation Canadian government-backed securities (including provincial government debt). Previously, the US *National Bank Act* restricted such practices to US government-backed securities. The United States also agreed to grandfather certain rights related to interstate banking and nonbanking activities of Canadian banks under the *International Bank Act of 1978*. Finally, the United States committed to provide Canadian financial institutions with the same treatment as that accorded to US firms with respect to any amendment to the Glass-Steagall Act.

of any direct links to the agreement's investment disciplines, the absence of a binding dispute settlement mechanism, and the lack of a built-in dynamic for future liberalization.[3]

The shortcomings described above owe much to the unease felt by both countries' finance officials in seeing the financial sector subjected to trade policy disciplines. This, to a large extent, helps explain the "stand alone" nature of the FTA's financial services provisions. Still, it is noteworthy that both countries acknowledged the FTA's unfinished bilateral agenda by admitting, in Articles 1702.4 and 1703.4 of the agreement: "[These parts] shall not be construed as representing the mutual satisfaction of the Parties concerning the treatment of their respective financial institutions."

Canada's financial industry took particular exception to the FTA outcome, arguing that the bilateral commitments exchanged between Canada and the United States resulted in a deal largely unbalanced in terms of effective market access. Given the persistent asymmetries in regulatory reform between the two countries — which have actually widened during the four years since the FTA's implementation[4] — the commitment to a nondiscriminatory regime has had the effect of providing US financial institutions greater access to Canada's financial markets than vice versa.[5] For both of the above reasons, the Canadian financial industry believed that the NAFTA could provide a unique opportunity to redress the FTA's flaws.

The adoption of a principles-based approach to liberalization resulted from the confluence of several other factors. Chief among these were the lessons drawn from a series of parallel exercises conducted during the latter part of the 1980s dealing with the interplay

between financial market reform and trade liberalization. These included wide-ranging discussions of financial market liberalization held within various committees of the Organisation for Economic Co-operation and Development (OECD), as well as work on capital adequacy standards and the harmonization of other supervisory practices conducted by the Committee on Banking Supervision of the Bank for International Settlements (BIS). The development of an integrated market for financial services within the European Community — embodied in a number of directives on regulatory harmonization in banking, insurance, and other financial services — played an equally pivotal role. More important still from a NAFTA perspective, though clearly influenced by the above exercises, were the Uruguay Round negotiations aimed at developing a General Agreement on Trade in Services (GATS).

Launched in 1986, the GATS talks encouraged a healthy *rapprochement* between the trade and finance communities and provided a ready-made laboratory in which to test and fine-tune the application of trade policy concepts and disciplines in the financial services sector. Not surprisingly, the NAFTA provisions on financial services — in both architectural and substantive terms — draw heavily on the insights gained in the six years of GATS negotiations. For example, all of the following provisions were developed in the GATS context prior to their adoption and further development in the NAFTA: provisions dealing with *de facto* national treatment (that is, the development of a nondiscrimination standard to secure equality of competitive opportunities between domestic and foreign firms); commercial presence; the carveout of measures taken for prudential considerations; the mutual recognition of supervisory practices; the right to purchase financial services on a crossborder basis; disciplines on payments and transfers and on the movement of information and specialized personnel; as well as the tailoring of dispute settlement procedures to meet the needs of the financial sector.

Failure to conclude the Uruguay Round on schedule and, in particular, the inability of the Group-of-Seven countries to gain from developing countries support for the financial services provisions of the GATS ironically strengthened the resolve of Canadian and US officials to ensure that the NAFTA's financial services negotiations "[did] it right." In essence, this meant reaching agreement on a clear set of GATS-like trade principles, an objective the Mexican negotiators also came to share.

Two further factors strengthened the case for a principles-based approach. First, the nature of Mexico's regulatory environment — in particular the traditional lack of procedural transparency and the tendency for administrative and executive fiat when making regulatory changes — suggested the need for clear and predictable rules. A second factor — of some significance from a Canadian standpoint — related to the willingness of US authorities, particularly within the Department of the Treasury, to use the NAFTA (and the GATS) as a means of anchoring trade-liberalizing principles in a legally binding treaty to which future domestic legislation would need to conform. Following recent failures at gaining congressional approval for overhauling the country's financial system, the US Treasury probably saw merit in a rules-based approach for underpinning future attempts at domestic financial reform.[6]

Key Features of the NAFTA's Financial Services Chapter

The financial services provisions of the NAFTA are composed of three related sections: a first section dealing with general principles, a second one describing the specific liberalization commitments made by each NAFTA country, and a third section outlining each country's reservations — that is, those discriminatory practices each wishes to retain after the agreement's entry into force. Completion of the third section will take up to two years, since many nonconforming measures of subna-

tional governments remain to be listed, particularly in the United States and Canada, where state and provincial governments have regulatory jurisdiction over some financial market segments.[7] (In Canada, for example, securities firms are regulated at the provincial level.) Under the NAFTA's negative-list approach to coverage, failure to list a nonconforming measure within the agreed time frame implies its full and immediate liberalization.

Principles

One of the main characteristics of the NAFTA's financial services chapter — its "principles" approach — provides general rules that the parties must observe. These encompass several areas, as follows.

Scope

Unlike the draft financial services annex of the GATS, which adopts a product-specific (or "list-of-services") approach, the financial services chapter of the NAFTA primarily follows an institutional approach. The chapter focuses thus on the provision of services by regulated financial institutions. The specific financial services or products that different institutions may provide varies in each country, so the chapter does not dwell on the individual services.

A product-based approach has some conceptual advantages, notably in addressing the increasing blurring of institutional boundaries between traditional financial institutions, as well as the proliferation of financial services offered by nonfinancial firms (such as non-bank banks and retailers). Despite these, the three countries opted for an institutional approach, based mainly on concerns that any list of financial services faced a high risk of rapid obsolescence given the dizzying pace of financial market innovation. Moreover, as in other countries, the regulatory regimes of all three NAFTA countries ultimately focus on financial institutions rather than on the services they provide. To mitigate some of the drawbacks of the institutional approach, the services of non-financial firms were specifically dealt with as "limited scope" financial institutions, thereby allowing those nonfinancial firms that provide financial services in one NAFTA country but not in others to be subject nonetheless to the provisions of the NAFTA's financial services chapter.

Establishment

Marking a significant departure from the *à-la-carte* approach to liberalization pursued under the FTA — albeit without creating a legal obligation to amend existing practices — the NAFTA countries have agreed to recognize the following market-access principles:

- Financial service providers of a party should be permitted to establish financial institutions in the territory of another party in the juridical form determined by the provider — thereby making direct branching a feasible form of bank entry, for instance.
- Financial service providers of a party should be permitted to participate widely in the market of another party, by being able to expand geographically within that territory — thereby eliminating restrictions to interstate branching.
- Financial service providers of a party should be allowed to provide in another party's territory a range of financial services through separate financial institutions as may be required by the host party — thereby eliminating Glass-Steagall-type restrictions affecting banking securities affiliations and US restrictions on bank insurance linkages, for instance.

Moreover, the NAFTA's establishment provisions note that when the United States "significantly" liberalizes its existing measures to permit commercial banks of another party located in its territory to expand throughout all of the US market either through subsidiaries or direct branches, the parties will review and assess market access provided by each

party according to the principles described above, "with a view to adopting arrangements permitting investor choice as to juridical form of establishment by commercial banks." The onus for setting in motion the liberalization process embodied in the financial services chapter's provisions on establishment thus rests on the United States.[8]

Crossborder Trade

Borrowing from the similar, albeit less ambitious, language contained in the GATS' *Understanding on Commitments in Financial Services* — the more liberalizing provisions of which complement the draft agreement's financial services annex and to which GATS signatories may accede on a voluntary basis — the NAFTA countries have agreed to grant each other the right to provide financial services from the territory of another country (that is, without establishment in the country where consumers are located).

In general, the NAFTA countries have agreed to permit their residents to purchase financial services provided from the territory of another party. However, the transaction must be originated at the request of the consumer. Without establishment, therefore, service providers cannot actively solicit business in the territory of another party. In an improvement over both the FTA and draft GATS provisions, NAFTA countries have also agreed to a standstill (a regulatory freeze) on the impediments to crossborder trade that currently exist. In other words, no new restrictions may be imposed by a party. However, with respect to crossborder trade in securities, Canada (generally perceived to have the most permissive set of regulations) did not commit to the standstill — largely in response to a refusal by US negotiators to grant Canadian securities firms equivalent crossborder access into the US market. Consequently, the United States also declined to commit to a standstill in the area of crossborder trade in securities with Canada, while they did commit to one *vis-à-vis* Mexico.

Transparency

In a significant improvement over the FTA, particularly in view of the highly regulated nature of many financial market activities, the NAFTA signatories have agreed to abide by several provisions to publish all measures of general application; to allow for prior consultations wherever possible on proposed changes to existing measures or the introduction of new ones; to render administrative decisions within 120 days where possible on completed applications for licenses lodged by foreign financial institutions; and, finally, to ensure that enquiry points exist by 180 days after the NAFTA's entry into force, to which all "reasonable" inquiries may be directed. The transparency obligations agreed to under the NAFTA should prove particularly useful for Canadian and US firms operating in Mexico's financial markets, given the long-standing complaint that Mexican authorities often enact regulatory changes without prior consultation with the private sector.

National Treatment

The NAFTA also borrows from the GATS for its national treatment standard, which was largely developed in the GATS financial services working group. The core liberalizing principle of national treatment is defined in the NAFTA's financial services chapter in terms of "equality of competitive opportunities," or *de facto* national treatment. Unlike the traditional, GATT-like, *de jure* standard of national treatment, *de facto* national treatment takes into account the potential inequality in the effects of regulatory requirements, even if applied equally to domestic and foreign institutions. *De facto* national treatment may allow laws and regulations applied to foreign financial institutions to differ from those applying to domestic firms, so long as their effects are equivalent and do not place the former at a competitive disadvantage in the host-country market.

To make these two concepts clear, assume, for example, that all banks (domestic and foreign) established in a particular country were to pay a certain tax if they engaged in trade financing. This law would constitute *de jure* national treatment because it applies equally to domestic and foreign banks. However, now assume that trade financing in this particular country is exclusively (or mostly) done by foreign banks. While not violating *de jure* national treatment, it could be argued that the effect of this law contravenes the principle of *de facto* national treatment.

This potential dichotomy of interpretation could also be directed to the effects of the Glass-Steagall Act, which restricts all banks established in the United States from engaging in securities activities. Although this law certainly complies with *de jure* national treatment, it is seen by some non-US financial institutions as placing them at a competitive disadvantage.

In this regard, a complaint voiced by some Canadian financial institutions relates to the "Section 20" limited exemption from Glass-Steagall restrictions.[9] The so-called Section 20 subsidiaries of banks or bank holding companies are permitted to underwrite, deal, and distribute ineligible debt (including equity securities) as long as the revenues from this source represent no more than 10 percent of the total gross revenues obtained from both ineligible and eligible securities activities. For the purposes of this test, eligible securities include both US government securities as well as Canadian government securities.

While clearly not in conflict with *de jure* national treatment, some Canadian financial institutions have expressed concerns about their opportunities to compete on an equal footing *vis-à-vis* US firms, which have a comparatively larger base of eligible securities (resulting from their significantly larger holdings of US government securities). Legislation preventing foreign banks from branching directly into Canada has similarly been viewed as inhibiting effective access into the Canadian market.[10]

Given the inherently subjective nature of such interpretations, it is doubtful that the principle of *de facto* national treatment could be administered in practice without a binding and enforceable dispute settlement mechanism.

Most-Favored-Nation Treatment

A second core instrument of nondiscrimination, the most-favored-nation (MFN) treatment principle, provides for the full and immediate sharing of the benefits of liberalization by ensuring that any NAFTA country must extend to all other NAFTA countries any advantage it grants to any other country, whether or not that country is a party to the NAFTA.

Mutual Recognition

Building on language developed in the financial services annex of the GATS, the NAFTA would allow regulators of any two countries to negotiate bilateral arrangements providing for regulatory or supervisory harmonization. Such arrangements may involve special treatment being granted to certain financial institutions. In an agreed departure from the MFN principle, any two countries agreeing to such special treatment need not extend this treatment automatically to the other signatory country if the prudential measures of the latter are deemed unequivalent. For example, bilateral arrangements between the US Securities and Exchange Commission (SEC) and Canada's provincial securities commissions granting unique treatment to Canadian securities firms in the United States could remain in place under the NAFTA without necessarily being extended to Mexico. However, the NAFTA affords each signatory country the opportunity to negotiate access to a mutual recognition pact that the other parties may have negotiated (including those with non-NAFTA countries) if its prudential measures do become equivalent.

Prudential Carveout

Also drawing on a related GATS provision, the NAFTA's financial services chapter guarantees that, notwithstanding any other provision of the agreement, each country retains the right to take "reasonable" prudential measures, including measures to protect depositors and safeguard the safety and soundness of the financial system. This provision aims to ensure that the obligations of the agreement do not in any way impinge on the ability of regulatory authorities to take necessary action when they do so for prudential reasons.[11] No attempt was made in the NAFTA to develop criteria for determining what constitutes a "reasonableness" test, though such criteria could emerge, if required, through recourse to the chapter's dispute settlement procedures.

New Financial Services

The NAFTA negotiators opted for somewhat less liberal language than that contained in the GATS' *Understanding on Commitments in Financial Services*, which would authorize financial service providers — established in a GATS country acceding to its provisions — to offer *any* new financial service. In contrast, the NAFTA countries have agreed to permit the financial institutions of any party to provide any new financial service — but only so long as the host NAFTA country already allows a similar service to be offered. Host countries retain the right under the NAFTA to determine the juridical and institutional forms through which a new financial service may be provided and may require authorization for the provision of the service. Decisions to authorize the provision of a new financial service must be made promptly and may only be based on prudential considerations.

Rules of Origin

The financial communities of non-NAFTA countries paid careful attention to the rules-of-origin provision throughout the trilateral discussions. This provision focuses on the ownership rules that a firm established in any of the three countries must observe to qualify for NAFTA benefits. Both Mexico and the United States opted for a liberal approach by choosing to apply the criteria of "country of incorporation." This means, for example, that a wholly owned European or Japanese financial firm incorporated in the United States or Mexico qualifies for NAFTA treatment in both countries.[12] In keeping with its more restrictive domestic legislation, Canada retained a *"de facto"* control test for determining the ownership of a financial firm when dealing with limitations on total domestic assets of foreign bank subsidiaries in Canada. Thus, a US- or Mexican-incorporated financial institution, ultimately controlled by Japanese or European capital, would be deemed by Canada to be Japanese or European.[13]

The chief concern of most financial institutions from non-NAFTA countries relates to their ability to share equally — that is, on a nondiscriminatory basis — in the benefits of the far-reaching opening of Mexico's financial markets. However, Mexico's decision to allow outside firms to benefit from NAFTA treatment through expansion into Mexico from their Canadian or US operations has largely allayed fears over the creation of a "Fortress North America" in financial services.[14]

Nonetheless, given that the gradual opening of Mexico's financial markets will involve the maintenance of aggregate foreign-market-share limitations, the treatment afforded by Mexico to non-NAFTA firms could prove controversial. This could be the case in instances during the transition period, when the aggregate ceilings are close to being met, if Mexico were to give precedence to Canadian or US financial institutions over non-NAFTA applicants.[15]

Dispute Settlement

In addition to encouraging informal conciliation, mediation, and consultation, the NAFTA marks a significant and welcome improvement over the FTA by providing for formal dispute

settlement procedures applicable to all types of financial services, including banking, securities, and insurance. While following the general rules of the NAFTA's generic dispute settlement process, these procedures have been tailored to meet some of the particularities of the financial services sector, especially with regard to ensuring appropriate panel expertise.

If a party chooses to initiate a formal proceeding under the NAFTA,[16] the panel that will hear the dispute would generally consist of five members chosen from a roster of up to 30 experts in international trade and from a roster of up to 15 with additional expertise in financial services law or practice. The parties will appoint such experts by consensus for terms of three years. Where the parties agree that a matter is financial in nature, the panel may be composed entirely of financial service experts. The NAFTA also provides for mixed panels to address issues that are both financial and non-financial in nature, such as taxation matters.

The dispute settlement provisions of the financial services chapter stipulate that retaliatory action taken pursuant to a panel decision must be confined to the financial services sector to the extent to which the measure in question affects that sector.[17]

The chapter on investment provides private investors with the right to seek recourse — and to avail themselves of the chapter's investor-state arbitration mechanisms — in the financial services area with respect to a limited number of measures governed by the chapter, such as expropriation. However, if the defending country argues that the investment-related measures are taken for prudential reasons and the Financial Services Committee established under the NAFTA (see "Other Provisions" below) agrees, then normal state-to-state dispute settlement procedures apply.

Other Provisions

The chapter on financial services contains a number of other trade-facilitating provisions. Recognizing, for instance, the central importance of information technology to the efficient and cost-effective provision of financial services, the NAFTA permits financial institutions to transfer information in electronic form into and out of a party's territory for purposes of data processing. The chapter also handles a typical impediment faced by financial firms in deploying their key personnel, by prohibiting a NAFTA signatory from requiring that a financial institution of another party hire individuals of any particular nationality as senior managerial or other essential personnel. Moreover, no country may require that more than a simple majority of the board of directors of a financial firm of another NAFTA party be nationals or residents of the host country.

The NAFTA also provides for the establishment of a Financial Services Committee to be composed of representatives of the finance ministries of each NAFTA country (as well as officials from the US Department of Commerce for insurance-related matters). The committee will supervise the implementation of the financial services chapter and its further elaboration; consider issues regarding financial services that are referred to it by a party; participate in certain dispute settlement proceedings; and examine technical issues under the chapter. This committee is required to meet annually and inform the Free Trade Commission of the results of such meetings.

The financial services chapter allows a party to request consultations with another party regarding any matter under the agreement that affects financial services, including matters relating to the extraterritorial application of a country's regulatory regime. The identification of issues on which NAFTA parties may wish to consult will be facilitated by the transparency obligations to which they have agreed. By providing for expert consultations in the first instance, the chapter's consultations' provisions also serve as a means of dispute avoidance.

Country-Specific Commitments

Mexico

Marking a significant departure from past policies, which have traditionally protected do-

mestic financial institutions, Mexico agreed in the NAFTA to sweeping liberalization of its financial markets (see Table 1). Financial firms organized under the laws of another NAFTA country will be able to establish wholly owned subsidiaries in Mexico — subject to certain market-share limits, both aggregate and firm-specific — that will apply during a transition period ending by the year 2000. Thereafter, Mexico may apply certain temporary safeguard provisions in banking and securities.[18]

In banking, the aggregate market share that Canadian or US firms may capture — expressed as a percentage of the capital of all Mexican commercial banks[19] — will increase from a limit of 8 percent at the time the agreement enters into force to 15 percent on January 1, 2000. For securities, the analogous aggregate market-share ceilings are 10 and 20 percent, respectively. Banks will also be subject to individual market-share limitations of 1.5 percent during the six-year transition period, while securities firms will face individual limits of 4 percent. Except for what they can achieve through internal growth, individual foreign banks will face a permanent size limit of 4 percent of the capitalization of Mexico's domestic banking system. This limitation aims principally at preventing takeovers of Mexico's largest banks by institutions incorporated in the United States or Canada.

The opening of Mexico's market for insurance services provides Canadian- and US-based firms with three routes of access. First, those with a current ownership stake in a Mexican insurance company of at least 10 percent may move to 100 percent ownership by January 1, 1996. Second, firms forming joint ventures with Mexican insurers may increase their foreign equity participation in such ventures in steps, from 30 percent in 1994 to 51 percent by 1998 and to 100 percent by the year 2000 (with incremental increases in interim years). Such firms will not be subject to aggregate or individual market-share limits. Third, foreign insurers may establish wholly owned subsidiaries, subject to aggregate limits scheduled to increase from 6 percent of market share in 1994 to 12 percent in 1999 and to individual market-share caps of 1.5 percent. Both types of limitations will be eliminated on January 1, 2000. When the NAFTA comes into force, Mexico will allow intermediary and auxiliary insurance services firms, such as brokers, claims adjusters, providers of actuarial services, to establish subsidiaries with no ownership or market-share limits.

Mexico will also extend national treatment to Canadian and US nonbank financial institutions engaged in consumer lending, commercial lending, mortgage lending, and credit card services. Such limited scope finance companies will, however, be subject to aggregate (but not individual) market-share limitations during the transition period.[20] NAFTA factoring and leasing companies will be subject to the same transition limits on aggregate market share as those applying to securities firms, but with no firm-specific limitations. Meanwhile, the NAFTA will allow financial institutions such as bonding companies, foreign exchange houses, mutual funds management companies, and financial warehouses to enter Mexico free of ownership or market-share limitations when the agreement enters into force.

In the establishment of wholly owned subsidiaries in Mexico, the NAFTA requires minimum capital levels identical to those applicable to Mexican financial institutions. In the case of securities firms, for instance, the minimum capital currently required equals about US$10 million, roughly the same as that applying to banks.

The number of foreign financial institutions able to establish wholly owned subsidiaries in Mexico between 1994 and 2000 will depend on whether individual firms use only the minimum capital required or choose to utilize the maximum level allowed.

Canada and the United States

In what the financial industries of both countries have already described as a disappointing outcome, Canadian and US negotiators were unable to secure any new liberalization com-

Table 1: ***Transition Limits for Entry by NAFTA Financial Institutions into Mexico***

Type of Institution	Aggregate Foreign Limit on Industry Capitalization	Individual Firm Limit on Industry Capitalization	Subsequent Aggregate Safeguard
	Limit to increase in steps between 1994 and 2000. Limit subsequently removed.	Limit in force only between 1994 and 2000.	Safeguard applies between 2000 and 2007 (Mexico has one opportunity to freeze aggregate capital share if it reaches a safeguard threshold between 2000 and 2004. The freeze may not exceed 3 years).
Banks	8–15%	1.5%[a]	25%
Securities dealers	10-20%	4.0%	30%
Insurance companies			
Options for *de novo* establishment:			
(a) Foreign-controlled	6–12%[b]	1.5%	n.a.
(b) Joint ventures	Firms entering Mexico with a Mexican partner are not subject to aggregate or individual market capital-share limitations. However, they are limited in terms of their equity participation in the joint venture. Such firms may enter with a maximum 30 percent equity, and they may hold a controlling interest by 1998. In the year 2000, all restrictions are eliminated.		
Factoring and leasing companies	10–20%	n.a.	n.a.
Other financial institutions	Financial warehousing firms, bonding companies, foreign exchange houses, and mutual fund management companies will be permitted to establish subsidiaries free of ownership or market-share limitations when the agreement goes into effect.		

[a] After 2000, bank acquisitions may be subject to an individual 4 percent capital-share limitation on the size of the resulting institution.

[b] These lower numbers reflect the fact that they do not include either joint ventures or previously established insurance companies from NAFTA countries in Mexico. Those with a current ownership stake in a Mexican insurance company of at least 10 percent may move to 100 percent ownership by January 1, 1996.

Source: NAFTA, Annex VII.

mitments from each other in the NAFTA.[21] The NAFTA, therefore, introduces *no* changes to the specific bilateral commitments exchanged in the FTA (see Box 1). However, the commitments made in the context of the FTA are now subject to dispute settlement — a welcome change.

In the area of financial services, the chief US negotiating objective consisted of obtaining the right for US banks to branch directly into Canada (where establishment is now possible only via the subsidiary route).[22] Canada's key negotiating objectives *vis-à-vis* the United States, on the other hand, consisted of obtaining relief, through either regulatory or legislative means, from Glass-Steagall Act restrictions affecting the US operations of Canadian bank-linked securities firms (and bank-linked insurance firms) and from McFadden Act restrictions on interstate branching. Recognizing that a full repeal of either of the above regulatory impediments was unlikely in the NAFTA negotiations, Canada had sought to obtain specific regulatory accommodation aimed at allowing Canadian financial institutions to widen the scope of their US operations.

As regards the treatment of Mexican financial institutions in the markets of their northern neighbors, Canada has agreed in the NAFTA to accord Mexico the same treatment granted to the United States under the FTA. Canada will thus exempt Mexican firms and individuals from its prohibition against nonresidents individually and collectively acquiring 10 and 25 percent, respectively, of the capital of domestic financial institutions.[23] Similarly, Mexican firms will not be subject to the combined 12 percent asset ceiling applying to non-NAFTA banks; nor will they be required to seek the approval of the minister of finance in order to operate multiple branches in Canada.

The United States, for its part, has agreed to permit any Mexican financial group that has lawfully acquired a Mexican bank with operations in the United States to continue to operate a securities firm there for five years after the acquisition.[24] It will not permit a Mexican bank's US securities affiliate to expand the scope of its activities or acquire other securities firms in the United States during the five-year period, and its operations will be subject to Glass-Steagall restrictions on transactions between it and its affiliates. The United States will not be providing the same concessions to Mexico under the NAFTA as some of those granted to Canada under the FTA. In particular, the United States will not be amending its *National Bank Act* to permit domestic and foreign banks and bank-holding companies to deal in, underwrite, and purchase without limitation Mexican government-backed debt securities. The United States will not, moreover, exempt Mexican-based broker-dealers that conduct securities activities in the United States from the requirement to maintain reserves in the United States.[25]

Implications for Canadian Financial Institutions

With Respect to the United States

With no new liberalization commitments secured from the United States under the NAFTA (beyond those agreed to in the FTA), the impact of the agreement on the US operations of Canadian financial institutions will likely be marginal through the medium term.

Nonetheless, Canadian financial institutions do stand to derive gains from the clearer "rules of the road" flowing from the adoption of a principles-based approach and, especially, from the development of a binding mechanism to arbitrate future disputes. Canada's financial industry also stands to gain (in both the United States and Mexico) from the "ratchet" effect provided by the NAFTA's freeze on the introduction of new discriminatory practices at the federal and subnational levels (except in the area of securities).

Because the NAFTA parties have formally committed only to recognizing the agreement's market-access principles and to reviewing them at a future time if US interstate branching restrictions are "significantly" curtailed, the impact of the agreement's establishment pro-

visions is difficult to assess. While Canadian financial institutions have legitimate concerns about the lack of new market opening commitments by the United States in the NAFTA, they are likely to view the liberalization dynamic embodied in the agreement's financial services chapter as an improvement over the approach of the FTA. This is so largely because the NAFTA places much of the burden for further regional liberalization on US shoulders by making US financial market reform the triggering mechanism for further liberalization. The logic of the NAFTA's establishment provisions may, similarly, increase pressure on Canada to allow US banks the right to branch directly into Canada, since this right is now recognized as a trade-liberalizing principle. This signals a potentially significant departure from past Canadian regulatory practices.[26] Finally, both parties may invoke the agreement's *de facto* standard of national treatment — including recourse to dispute settlement — to challenge a number of current regulatory practices viewed as impediments to effective access to both countries' financial markets.

With Respect to Mexico

The far-reaching financial market liberalization agreed to by Mexico in the NAFTA provides Canadian financial institutions with new opportunities to enter a dynamic market with strong growth prospects. Until quite recently, Mexico had kept its financial markets virtually closed to foreign competition. Foreign minority ownership has been permitted since 1989, allowing for an aggregate of 30 percent of foreign equity in the case of banks and securities firms (although no single investor can hold more than 10 percent of the equity). However, full foreign ownership of domestic financial institutions has until now been severely restricted.[27]

Although notable changes have resulted from the process of domestic financial reform launched in the late 1980s,[28] foreign competition could increase both the depth and the efficiency of Mexico's financial markets, in several areas. Note the following:

- Mexico remains significantly under-branched in the area of retail banking, with one branch serving an average of 18,500 people, compared with roughly one branch per 2,000 people in both Canada and the United States. It is further estimated that only 8 percent of Mexicans have chequing accounts. The less-intensive use of financial services in Mexico stands out even in large cities, where significant segments of the population enjoy relatively high incomes. Many of those living outside the major cities have no banking relationship at all. Rising incomes and the greater economic stability expected to derive from the NAFTA, as well as recent institutional reforms aimed at raising Mexico's level of aggregate savings, should sharply increase demand for financial services.[29]
- The market for mortgages is almost nonexistent, largely because of the very high inflation and interest rates experienced during the 1980s. It is estimated that only 1 percent of Mexican households now have mortgages. Significantly lower inflation and continued strong growth in residential construction in Mexico should fuel a rising demand for mortgage-related products.
- Mexican firms and individuals are significantly "underinsured." For example, it is estimated that, out of a population of some 86 million people, only 1.5 million — or less than 2 percent of the country's population — have life insurance policies.
- Large Mexican corporations typically bypass the country's capital markets — where high nominal and real interest rates, large spreads between deposit and lending rates, and lagging financial innovation have been the norm — to finance themselves in the Euromarkets.
- Smaller enterprises have only limited access to domestic financing, owing in part to the banks' limited experience in assessing commercial risks. During most of the 1980s,

bank lending to the private sector was nearly nonexistent, since commercial banks were burdened with large reserve requirements used to finance government deficits.[30]

- Mexico's regulatory authorities are currently planning to create a full-fledged domestic derivatives market.

Reflecting the large rents typically associated with heavily protected markets, Mexican financial institutions have been highly profitable. The average return on equity in 1992 for Mexico's 12 largest banks was 27.2 percent, while the average return on assets for these banks was 1.7 percent. This compares favorably with figures of 12.7 percent and 0.9 percent respectively in the United States (all banks). Similarly, return on equity averaged 9.7 percent for Canada's six largest banks during 1991–92, while return on assets averaged 0.5 percent during the same period.[31] The anticipated profitability of financial intermediation in Mexico was fully evident when the Mexican government reprivatized the country's banks: Mexican investors paid between 2.5 and 5.3 times book value for the banks' shares.[32] The securities business has produced equally impressive profits, with the ten largest Mexican brokerage houses showing a nearly 180 percent rise in profits in the second quarter of 1992, compared with a year earlier.[33]

Mexico's financial system is, in some respects, similar to that of Canada; this should enhance the opportunities open to Canadian institutions. The similarities include a significant concentration of institutions in the banking and securities sectors;[34] few restrictions to branching throughout the country's whole territory; and a financial sector currently in the process of restructuring in the wake of domestic financial reforms.[35]

Canadian financial institutions are generally well positioned to take an active part in the further development of Mexico's financial markets — and to benefit from the effort. While Mexican banks seek to establish large retail banking networks and to broaden the range of wholesale and corporate lending services available to businesses, they generally lack the technological expertise and capital required to do so most efficiently. Mexico's weak competitive environment has, indeed, contributed to the relative inefficiency of the country's domestic financial institutions. Operating expenses as a percentage of banks' assets for 1991 provide evidence of such inefficiency: 4.6 percent in Mexico versus 2.6 percent in Canada.[36] The average Mexican branch employs 54 percent more employees than its Canadian counterpart.[37] Furthermore, Mexican financial providers typically lag in their technological development, which is the key to offering efficient wholesale banking and securities services. Thus, Mexico's needs can be seen as matching Canada's banking strengths: relatively strong capital positions — stronger in fact than many US competitors — and greater experience than most of their US counterparts in operating large and integrated multibranch networks. The need of Mexican banks and securities firms to upgrade their information technology also offers Canadian financial firms — and their software suppliers — new market opportunities, though competition from US and foreign firms will likely be fierce in the area of software services.[38]

While the NAFTA provides Canadian financial institutions with attractive new market-access opportunities, individual firms will have to weigh a number of factors in deciding on the scope and form of a possible foray into the Mexican market. Among these are questions relating to the direction of corporate strategies. Coinciding with the end of the decade-old Latin American debt crisis, which saw Canadian banks incur significant losses on their sovereign loan portfolios, the NAFTA comes after many Canadian banks have completed a significant curtailment of their already limited presence in Latin America.[39] By offering scope for expansion of a substantially different nature — that is, through the establishment of full-fledged financial operations, as opposed to loan booking through representative offices — the NAFTA poses an interesting dilemma for

Canadian financial institutions: Should they take a second look at their international corporate agendas just when many of them have concerns about their domestic operations?

For many Canadian and US firms, large investments in Mexico may indeed be delayed because of impaired domestic profitability. The nonperforming assets of Canadian banks have risen sharply during the current recession, with problem loans in the commercial real estate sector having made the single largest contribution. To cover problem loans, banks have increased their loan-loss provisions significantly, thereby reducing both overall profitability and the capital available for investment in Mexico. These considerations may limit the ability of Canadian firms to take advantage of the opening of Mexico's market and may also influence the form of entry they choose; for example, they might opt to invest in a joint venture rather than establish a wholly owned subsidiary.

Matters relating to "familiarity" and client relationships will also likely affect corporate decisions. In Mexico, Canadian financial institutions face a language and corporate culture that are far less familiar to them than to US institutions based in Texas, California, and Florida, or even in Illinois and New York. Except for those few Canadian-owned banks that have already aggressively expanded their non-US international businesses and may choose to establish wholly owned subsidiaries in Mexico, many Canadian financial institutions interested in a Mexican foray may opt to form a limited partnership with a domestic firm.[40] One such example, Scotiabank, recently announced the acquisition of a 5 percent stake in Inverlat, Mexico's fourth-largest financial group. Inverlat controls a securities firm, and recently purchased the commercial bank Comermex (the country's fourth-largest bank).[41] Because Inverlat — and particularly Comermex, which controls about 6 percent of Mexican banking assets — constitutes a middle-sized Mexican financial organization, Scotiabank will not have the option of acquiring control over its Mexican partner. The rules agreed to in the NAFTA do not allow for total acquisition of a Mexican bank or securities firm if it accounts for more than 4 percent of the market. (In the case of banks, this limit will be retained permanently.) This suggests that Scotiabank's undertaking in Mexico could be limited to a minority joint venture, unless it uses this vehicle to gain the experience and exposure to the Mexican market it needs if it wants to establish an independent presence.

Canadian securities firms have also had a very limited involvement in Mexico, and their participation in the recent surge of Mexican placements of equity and bond issues in international capital markets has been modest. Since 1990, Mexico has launched over 40 international bond issues, raising more than US$6 billion in the process. In 1991, nearly US$10 billion in foreign portfolio equity investments were placed in Mexico's stock market or in Mexican funds traded primarily in New York. The underwriters in these placements have predominantly been US firms.

The Mexican market for insurance-related services — which ranked first in Latin America and twenty-seventh worldwide with US$3.5 billion in life and nonlife premiums in 1991 — offers strong growth potential. Sales of life insurance, in particular, offer potentially significant new opportunities for Canadian and US insurers. Demand for new nonlife and reinsurance products may similarly exhibit strong growth in the face of surging three-way trade and rising demand for insurance of transportation equipment, particularly automobiles. The liberalization of the Mexican insurance market was particularly welcomed by the US industry, whose size and prior experience in the Mexican market combine with geographical proximity to give it a distinct edge over Canadian insurance providers — most of which have had little or no exposure to the Mexican market.[42]

A further consideration, setup costs, may also affect how Canadian financial institutions — particularly securities firms — enter the Mexican market. A number of Canadian securities firms have indicated informally that the

US$10 million in capital required to establish a subsidiary in Mexico is too large an amount to consider establishing wholly owned operations, noting that the largest Canadian dealer in the United States has a capital of only about three times that amount.[43] The validity of this argument will be tested over time as individual firms evaluate these setup costs against expected returns. Although for many of Canada's smaller securities dealers, this minimum capital threshold may indeed represent a prohibitive amount, it still constitutes less than 5 percent of domestic capital for at least six of the larger Canadian securities dealers. For Canadian banks, the minimum capital threshold required to establish wholly owned operations in Mexico should not prove unduly onerous.

The dampening effects of factors such as familiarity and setup costs can be expected to subside over time as both financial and nonfinancial Canadian businesses become better acquainted with the market opportunities in Mexico. The limited presence of Canadian financial institutions in Mexico is, after all, hardly surprising given the fairly anemic pre-NAFTA trade and investment links between the two countries and the past restrictions on access to Mexico's financial markets.

The issue of the speed with which Canadian financial institutions enter Mexico's financial markets is far from trivial since transitional market-share limits in Mexico will apply in aggregate to Canadian and US financial institutions. The aggregate cap means that Canadian firms must act before their US competitors capture the overall limit. Moreover, the liberal rules of origin accepted in the agreement (see "Principles") mean that non-NAFTA institutions incorporated in the United States or Canada could fill Mexico's quotas. Given the keen interest in Mexico expressed by the United States — which sees the NAFTA outcome on financial services as a major achievement — as well as the European and Japanese financial communities, failure to act quickly may have the effect of forcing Canadian financial institutions to wait until well into the next century before establishing wholly owned subsidiaries in Mexico.

Concluding Remarks

The most obvious impact of NAFTA on Canadian financial institutions will come as Mexico's financial markets open up. However, significant benefits will also accrue from clearer "rules of the road" and especially from the introduction of a binding dispute settlement mechanism. The adoption of a principles-based approach to financial market liberaliza-

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$6.00; ISBN 0-88806-318-0

tion marks an important new development in trade agreements and a significant improvement over the terms of the Canada-US Free Trade Agreement.

The inability of Canada and the United States to agree to new liberalization commitments *vis-à-vis* each other in the NAFTA represents a disappointing outcome for the Canadian financial community, which had hoped to see the trilateral agreement redress some of the imbalances contained in the financial services chapter of the FTA. The NAFTA may nonetheless add to domestic pressure in the United States to renew efforts at a comprehensive reform of the country's financial system by making such reform the trigger of further regional liberalization. The national treatment and establishment principles incorporated in the NAFTA may also lead to increased pressure on Canadian financial regulators to allow US banks to branch directly into Canada, thereby signalling a potentially significant departure from past Canadian regulatory practices. The adoption of a principles-based approach to liberalization may also heighten interest in — and pressure for — greater regulatory harmonization within the NAFTA countries,[44] much as has been the case in the European Community as a result of further financial market integration among its member states.

Canadian financial institutions are generally well positioned to benefit from the opening of Mexico's financial markets. However, a number of considerations — ranging from domestic profitability to the level of setup costs — will likely condition both the ability of Canadian financial institutions to enter the Mexican market and the corporate form they take to do so. On the one hand, both the existing structure of Mexico's financial markets and the nature of its liberalization commitments under the NAFTA appear to favor the entry of Canadian banks into Mexico's banking system, particularly as they are better capitalized than most US banks and have greater expertise in operating large multibranch networks. On the other hand, US securities and insurance firms would appear to enjoy some degree of comparative advantage over their Canadian counterparts in view of significantly larger capital bases and greater recent experience in serving the Mexican market.

Since transitional market-share limitations in Mexico will be applied in aggregate to Canadian and US firms, in addition to non-NAFTA firms incorporated in either country, Canadian financial institutions must not delay entering the Mexican market for too long, lest the overall quota be captured by their chief international rivals. Procrastination could well mean that Canadian firms would have to wait until well into the next century before establishing themselves in Mexico. By then, securing market shares in a deeper, more mature Mexican market would be more difficult and almost certainly costlier.

Finally, one should note that, despite its promising growth prospects, Mexico's financial market remains comparatively small; in 1991, the entire Mexican banking industry had assets amounting to only US$140 billion, compared with US$2.5 trillion in the United States and about C$550 billion in Canada. Although the NAFTA suggests a positive outcome for Canadian financial institutions, this should not deter Canada from aggressively pursuing its trading interests in the financial services area on a number of fronts. Chief among these is the Uruguay Round, the successful outcome of which would multilateralize the benefits of a principles-based approach to financial market liberalization and provide Canadian financial institutions with significant new opportunities in a host of emerging markets (particularly in Latin America and Southeast Asia) as well as some developed country markets (Japan's, for example) that have hitherto been heavily protected. On a final point of consideration, one should note the paramount importance to Canada's financial community of achieving greater effective access in the US market.

Notes

The views expressed in this paper are solely those of its authors and should not be attributed to the Bank of Canada, the Department of External Affairs and International Trade, or the Government of Canada. The authors are indebted to Meriel Bradford, Rory Edge, Patricia Evanoff, Jonathan Fried, Clyde Goodlet, Bruce Montador, Sean O'Connor, Brian O'Reilly, Joanne Osendarp, Dan Roseman, Bruce Stockfish, and Frank Swedlove for helpful comments and discussions.

1 If, as expected, the NAFTA is ratified by the three countries' legislatures during the course of 1993, the agreement will come into force on January 1, 1994.

2 The far-reaching liberalization of Mexico's financial markets appears all the more significant when one considers, first, the strategic importance of the financial sector to a country that, until fairly recently, was prone to experiencing notable macroeconomic instability and, second, the political sensitivities raised by the almost simultaneous pursuit of domestic financial deregulation *cum* privatization and trade liberalization.

3 Summarizing Canadian financial industry views on the FTA, an official of the Canadian Bankers' Association recently noted that "a further shortcoming of the FTA with regards to financial services is that it is a 'one-shot' deal....As it stands, the FTA is a static document, allowing little room for change and offering no real incentives for further liberalization or regulatory cooperation." Robyn Gafford, "Three for Free Trade," *Canadian Banker* 99 (March-April 1992): 10.

4 For a review of recent reform measures that have further increased the scope of activities available to federally regulated financial institutions in Canada, see Fred Daniel, Charles Freedman and Clyde Goodlet, "Restructuring the Canadian Financial Industry," *Bank of Canada Review* (Winter 1992-93), pp. 21–46.

5 To be specific, Canada's and Mexico's financial industries view Glass-Steagall restrictions on affiliations between banks and securities firms, as well as interstate branching restrictions for banks, as constituting significant impediments to effective (or comparable) market access in the United States. See Canadian Bankers' Association, *A Canadian Banking Perspective on Trade in Financial Services under a North American Free Trade Agreement* (Toronto, December 1991).

6 Two of the market-access provisions contained in the NAFTA deal with the right to provide the full range of financial services permitted by the host country, as well as the right to expand geographically throughout the host country. These provisions target obstacles to regulatory reform that both the US Treasury and its NAFTA partners have sought to alleviate or remove in recent years: the Glass-Steagall Act restrictions on affiliations between banks and securities firms and the McFadden Act restrictions on interstate branching.

7 Canada has undertaken to complete its list of existing nonconforming measures maintained at the provincial level by the time the NAFTA comes into force. The United States has agreed to list by then the nonconforming measures maintained by those states accounting for much of the country's international financial market activity: California, Florida, Illinois, New York, Ohio, and Texas. The United States will list the existing nonconforming measures of all other states by January 1, 1995.

8 From Canada's perspective, the possibility of allowing direct branching as a form of bank entry into Canada would only be reviewed if US interstate branching restrictions and Glass-Steagall limitations were eliminated.

9 Section 20 of the Glass-Steagall Act prohibits a member bank from being affiliated with a company that is "engaged principally" in underwriting and dealing in bank ineligible securities.

10 The United States views Canada's subsidiary requirement for direct bank entry into Canada as "the most significant remaining barrier to equality of competitive opportunity for U.S. banks in Canada." See United States, Department of the Treasury, *National Treatment Study* (Washington, DC, 1990), p. 122.

11 The chapter on financial services groups prudential carveout, under "*Regulatory Measures*," with a provision to exclude from the agreement all "non-discriminatory measures of general application taken by any public entity in pursuit of monetary and related credit policies or exchange rate policies." This means that discriminatory actions against nonnationals taken by central banks, for example, could be subject to dispute settlement. Thus, the NAFTA requires that all central banks must adhere to clear criteria concerning admissible counterparties in areas such as foreign exchange operations, swaps transactions, and so on.

12 Given Mexico's current rules restricting the establishment of non-NAFTA foreign financial institutions, such institutions will be able to establish wholly owned subsidiaries in Mexico only by incorporating first in the United States or Canada.

13 The financial services rules of origin adopted by the United States in the NAFTA also entrench the right of non-NAFTA financial institutions established in a NAFTA country to benefit (alongside Canadian and Mexican firms) from any future liberalization of US regulatory practices.

14 To be sure, non-NAFTA financial institutions, particularly from OECD member countries, would have preferred to see Canada extend NAFTA privileges on a most-favored-nation basis, an issue Canada has indicated it was prepared to discuss in the Uruguay Round context.

15 Mexico's financial services reservations under the NAFTA suggest that, in administering license applications, the Mexican authorities will attempt to ensure, *inter alia*, that they do not deny benefits to enterprises controlled by US and Canadian nationals because of

expansion in Mexico of institutions controlled by non-NAFTA parties. A recent publication of the US Chamber of Commerce gives a clear indication of the expectations of the US financial industry in this regard, noting that "in cases where Mexico's market share limit is being neared, US- or Canadian-owned firms would gain access over foreign-owned subsidiaries." See US Chamber of Commerce, *A Guide to the North American Free Trade Agreement: What It Means for U.S. Business* (Washington, DC, 1992), p. 14.

16 Disputes between or among parties arising from the financial services chapters of both the NAFTA and the GATS may be settled under either agreement's dispute resolution provisions, upon their enactment.

17 Specifically, a complaining party under the NAFTA is authorized to suspend benefits of equivalent effect only in accordance with the following: (i) if the measure affects only the financial services sector, the complaining party may suspend benefits only in the financial services sector; (ii) if the measure affects the financial services sector and any other sector, the complaining party may suspend benefits in the financial services sector to the degree to which only the financial service sector has been affected; (iii) if the measure affects only a sector other than the financial services sector, the complaining party may not suspend benefits in the financial services sector.

Upon request by any disputing party, the Free Trade Commission responsible for overseeing the overall agreement must establish a panel to determine if the level of benefits suspended by a party is "manifestly excessive."

18 Under the terms of the agreement, Mexico may reimpose market-share caps if the specific foreign ownership thresholds agreed to — 25 and 30 percent, respectively, for banks and securities firms — are reached before 2004. Mexico may only have recourse to such market-share limitations once during the 2000–04 period and may only impose them for a three-year period. Under no circumstances may such measures be maintained after 2007.

19 Transition limits for any given category of financial services — including banking, securities, and insurance — are framed in terms of the capital of foreign firms relative to that of the corresponding Mexican financial sector. Mainly because of prudential requirements, firms' assets tend to represent a more-or-less constant multiple of their capital, with multiplying factors differing for each type of financial service provider — for example, an 8 percent risk-weighted capital-asset ratio in the case of banks. Accordingly, market-asset shares are often used as an approximation of capital in Mexico's liberalization schedule for financial services. It should be noted, however, that where no well-defined leverage limits (asset-capital ratio cap) exist for some financial activities, market shares could differ significantly from capital shares. This may be the case for certain types of insurance and securities activities.

20 These limitations have been set at 3 percent of the combined aggregate assets of all commercial banks and all limited-scope finance companies in Mexico, excluding lending by affiliates of automobile manufacturers.

21 Shawn Cooper, vice-president of financial services at the Canadian Bankers' Association was quoted as saying recently that "there has been very little tangible improvement in our opportunities in the US [with respect to the NAFTA]." (*Financial Post*, August 14, 1992).

22 According to Canadian regulators — as codified in the *Bank Act* and supervisory practices — entry through subsidiaries provides the most prudent way to regulate the activities of foreign banks. In addition, the subsidiary form constitutes an important element of Canada's financial legislation, which relies fundamentally on corporate governance.

23 Canada's "widely held" rule, by which no single individual can own more than 10 percent of the equity in a Schedule I bank, continues to apply to both nationals and nonnationals.

24 Such acquisition must occur before the NAFTA comes into force. In addition, the bank and securities firm involved must have been operating in the US market on January 1, 1992 and June 30, 1992, respectively. This US commitment is important to Mexico because a number of the recently privatized Mexican banks with US operations have been acquired by financial groups that also operate securities firms.

25 The broker-dealers' exemption secured by Canada flows from prudential recognition agreements reached between the US Securities and Exchange Commission and provincial securities commissions.

26 The significance of this potential departure rests on the fact that "when a country permits [bank] entry by a foreign branch, it is implicitly or explicitly accepting the adequacy of home-country [in this case the United States or Mexico] regulation and supervision, including enforcement of those rules." Sydney J. Key and Hal S. Scott, *International Trade in Banking Services: A Conceptual Framework*, Occasional Paper (Washington, DC: Group of Thirty, 1991), p. 21.

27 Citibank, which operates seven branches in Mexico, is the only foreign bank currently established in the country. Though it set up its Mexican operations in 1929, Citibank does not enjoy full banking powers in Mexico.

28 The process of domestic financial reform in Mexico proceeded in four stages: first, the abolition, in 1989, of controls on interest rates and on the allocation of credit; second, the elimination, in 1991, of foreign exchange controls, a move destined to allow Mexican banks and securities firms to engage more freely in international transactions; third, the streamlining, during 1990–92, of the country's regulatory and supervisory regimes; and, fourth, completion, in July 1992, of the privatization of 18 Mexican banks nationalized a decade earlier at the onset of the country's debt crisis.

Privatization has resulted in the creation of large financial service conglomerates offering universal or multiservice banking.

29 For example, under a new government-sponsored pension-fund system, firms will deposit a percentage of each employee's salary into a bank account.

30 In 1991, the government eliminated marginal reserve requirements for commercial banks, which had reached 90 percent in the mid-1980s. Also, the Mexican government's overall fiscal position is currently in surplus.

31 Data on Mexico and the United States comes from E. Laderman and R. Moreno, "NAFTA and U.S. Banking," *Federal Reserve Bank of San Francisco Weekly Letter*, no. 92-40 (November 13, 1992), p. 3. Data on Canadian banks comes from the *Globe and Mail* (Toronto), January 18, 1993, p. B1.

32 Canadian banks, in contrast, trade at between four-fifths and one and one-half times book value. The large premium applying to the valuation of Mexican banks owes in part to the rents that Mexican buyers anticipated in the light of pre-NAFTA restrictions against foreign bank entry. The far-reaching opening of Mexico's financial markets in the NAFTA may be expected both to exert downward pressures on the current level of rents and to heighten the need for Mexican banks to improve the overall efficiency of their operations. The increase in competition arising from the NAFTA and the need to enhance efficiency may in turn encourage some Mexican financial institutions to seek foreign partnerships.

33 *El Financiero International*, August 10, 1992.

34 Mexico's three largest institutions control about 60 percent of the country's total banking assets. In Canada, the five largest banks control over 90 percent of total banking assets (including foreign assets).

35 In the recently concluded privatization of Mexico's commercial banks, the investors who control the securities firms acquired most of the banks. The resulting partnerships have begun to form "financial groups" providing all types of financial services (although "Chinese walls" theoretically exist between different types of financial institutions). Thus, although under a slightly different structure than in Canada (where the subsidiary form is required), Mexican banks can also be linked with securities firms and insurance companies under a modified "universal banking" model based on a holding company structure.

36 See *The Banker* (August 1992).

37 It should be noted, however, that differences in relative wages argue in favor of greater labor intensity in Mexico. A low capital-labor ratio, induced by relatively low wages, may have also contributed to the slow pace of technological change in Mexico's financial industry.

38 Beyond the direct effects of Mexico's commitment to liberalize its financial markets, the greater economic stability that the NAFTA should encourage in Mexico will foster important positive externalities for Canadian financial institutions. One example relates to the anticipated increase in foreign direct investment into Mexico by nonfinancial firms, resulting from the agreement's strong investment disciplines and the opening of many sectors previously closed to outside competition. This will provide a strong incentive for Canadian financial institutions to follow their corporate clients. Moreover, because foreign direct investment typically generates strong trade multiplier effects, investment liberalization can be expected to open up new opportunities in trade financing. An additional benefit from the NAFTA relates to Mexico's strengthening links with the rest of Latin America. Canadian firms that locate or expand into Mexico also stand to gain better access to Central and South America.

39 Whereas many large US banks and securities firms have maintained close links with their Mexican clients — in both the public and private sectors — the Canadian presence, which at best has always been small and concentrated in banking, has been further diluted. In the early part of the 1980s, Canada's five largest banks had representative offices in Mexico; today there are three (Bank of Montreal, Royal Bank, and Scotiabank). One other Canadian bank (CIBC) keeps only a secretary to take messages. Others (notably Toronto Dominion but also CIBC) sold nearly all of their Mexican portfolio at a discount in the secondary market for developing country debt in the latter part of the 1980s.

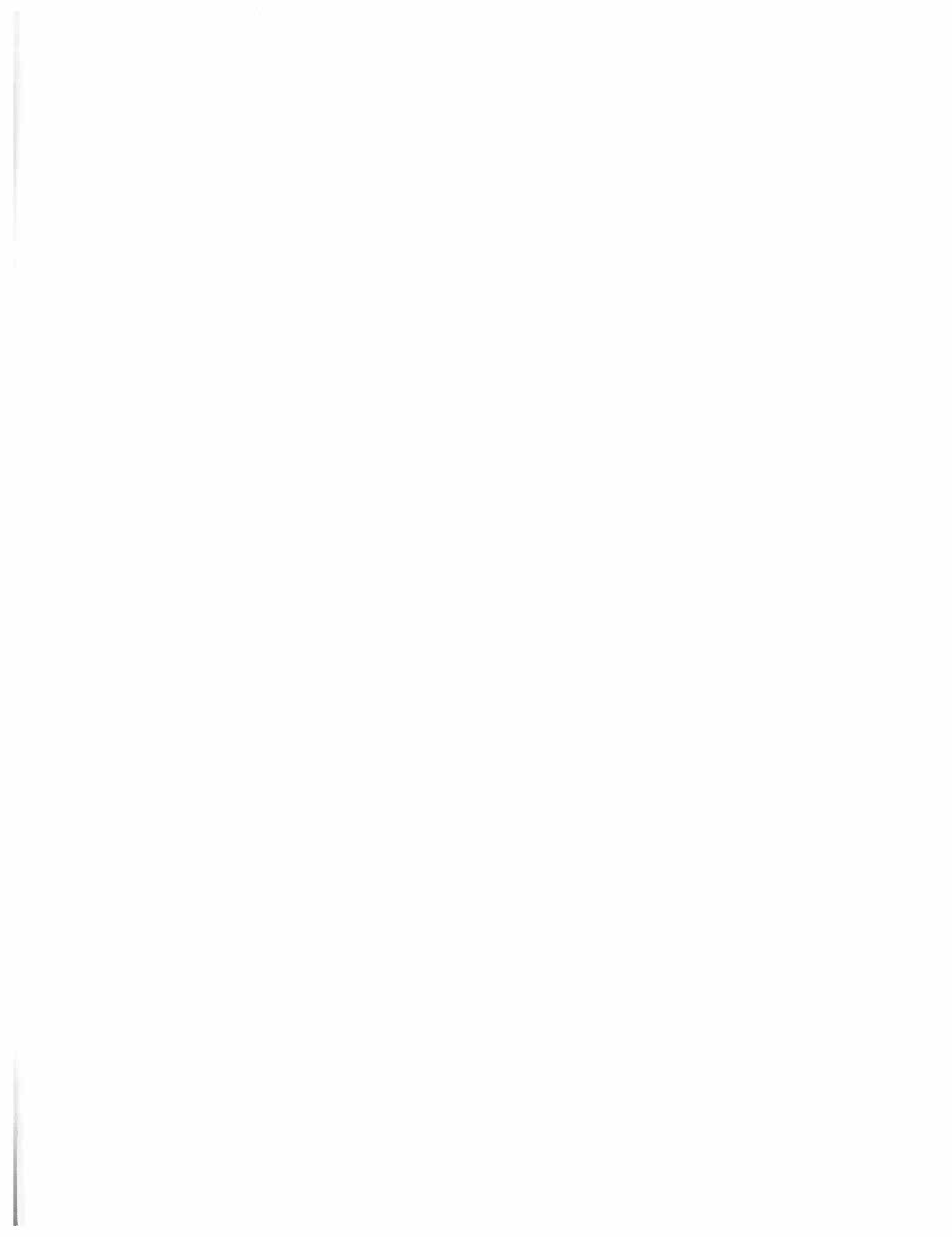
40 It is interesting to note that the Canadian banking presence in Spain and Chile, with financial markets fully open to foreign participation and comparable in many respects to the Mexican market, is limited to one branch in Spain (Royal Bank) and one minority ownership in Chile (Scotiabank with 25 percent equity in Banco Sudamericano).

41 See *Globe and Mail* (Toronto), August 29, 1992. Scotiabank is the only Canadian financial institution to have suggested publicly what route it would take in Mexico as a result of the NAFTA. Although the option of holding a minority position in a domestic financial institution predates the NAFTA, having been available to foreign financial institutions since 1989, it may now appear more attractive as a result of Mexico's improving economic prospects under the NAFTA.

42 Many of the largest US insurance companies, such as Chubb Group, Aetna Life and Casualty, American International Group, and Cigna Corp., already have a presence in Mexico as minority partners in joint ventures.

43 In Canada and the United States, there are several categories of securities dealers, engaging in different activities and requiring different minimum levels of capital. Mexico has only one category of securities dealers that may engage in all types of securities activities. Mexico agreed to review, within two years of the NAFTA coming into force, the possibility of permitting some limited-scope securities dealers (to which smaller minimum levels of capital would apply).

44 Even more pressure will come to bear if other countries become signatories of the NAFTA.



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