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Protecting the Public Good: Canada's Standing Policy on Foreign Financial Institutions

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Introduction and Overview

This paper explores the evolution of Canada's domestic and international policies dealing with foreign financial institutions. Domestic regulatory reform and deregulation are separate but interrelated processes to that of making commitments in regional or international trade agreements. Considering the substance and timing of policies at the domestic level is key to understanding the commitments made at the international level. The time frame examined begins with the revisions to the Bank Act in 1980 and finishes at present, winding a path through three major free trade agreements: The Canada-United States Free Trade Agreement (FTA), the North American Free Trade Agreement (NAFTA), and the World Trade Organization's (WTO's) General Agreement on Trade in Services (GATS). Trade is considered important to Canada's financial services industry because Canada is well represented in international financial markets.[1] Reciprocally, one of the benefits of allowing foreign financial institutions to operate in Canada is thought to be the greater innovation in the range of financial products available to Canadians.

The deregulation and liberalization of Canada's policies dealing with foreign financial institutions has occurred gradually over the last two decades. This paper argues that while Canada's policies in this regard have been conservative compared to the international standard, the Canadian market has in fact remained accessible for foreign financial institutions. The issue is complicated by several factors that are unique to financial services and to Canada. Industry-specific regulations, such as those dealing with financial services, can be slow if the government lacks the bureaucratic resources to make the changes. Furthermore, governments recognize that the benefits of reform to industry-specific regulations do not reflect back on the government, but are absorbed by the industry itself. This is a considerable problem in Canada because while the banks are private corporations, they are still required to fulfil some public responsibilities. In a

[1] The six major domestic banks have a significant presence outside of Canada in the US, Latin America, the Caribbean, and Asia. International operations accounted for approximately 50 per cent of net revenue earned by Canada's "big six" banks in 2000. See Finance Canada, Publications, "Canada's Banks", August 2001.

market-based economy, these opposing interests place the regulators and the regulated at odds. Finally, this paper argues that Canada's historical circumstances and the condition of the economy have been a major factors behind the reforms and international commitments made in the financial sector. Canada's financial sector is closely associated with its natural resource-based economy and most importantly, to the economy of the United States (US). During the FTA negotiations, both Canada and the US wanted to preserve the existing access that financial institutions had to the other's financial market. This indicated that sufficient market access already existed and that most of the benefits from trading in financial services had already been achieved. The NAFTA negotiations reflected the growing sophistication that had been developing in international financial markets, yet attempted to work around the different approaches that each country had towards prudential regulation in the financial sector. Finally, in the GATS, Canada did make some important incremental changes regarding the market access of foreign banks, but the changes were very much in line with the 'status quo' liberalization achieved by the GATS.

The government has long played a role in shaping the economic landscape in Canada in order to achieve economic growth. The state of the economy has also directed many of our policy choices in this regard.[2] The recent changes which have been happening at the international level have also placed greater urgency for countries to maintain an updated regulatory framework relating to financial services. In Canada, these changes have been the focus of 'regular' reviews since the 1950's initiated by the 'sunset clause'.[3] The subject of these reviews has been related to increased internationalization and securitization[4], the review and liberalization of regulatory regimes[5], and the expansion of international financial markets. Under the heading of globalization, technological innovations such as electronic clearing

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[2] John Odell makes the case for a 'rational' understanding of international trade policies by showing how market conditions and factor endowments shape trade policy. He quotes Magee and Young who write: "Our empirical work indicates ... 2/3 of the changes in US tariffs this century are explained by unemployment, inflation, and the US terms of trade. See Odell, John, S., "Understanding International Trade Policies: An Emerging Synthesis", *World Politics*, 43, October 1990, 141-143.

[3] A "sunset clause" in the Bank Act requires regular review and updating of laws governing financial institutions (the Bank Act, the Trust and Loan Companies Act, the Insurance Companies Act, and the Cooperative Credit Associations Act). Amendments were done in 1954, 1967, 1980, and 1992, 2002. WTO Trade Policy Review, Canada (1998), 97.

[4] Securitization means the displacement of bank loans by securities markets - an important factor behind the deregulation of securities markets and the proposed reform to Glass-Steagall in the US. This has also been related to the emergence of conglomerates in the non-bank area including insurance and trust companies and other financial institutions under a common ownership.

[5] Tax and other regulations have been reformed regularly for decades in industrial countries to allow greater foreign access.

systems compress the time and space necessary for financial transactions to occur. While these changes have happened mostly in the absence of leadership from any particular country, they are in turn matched by a process of re-regulation involving enhancements in the capability to supervise financial firms.

Canada is an interesting case-study in the context of WTO financial services because prior to comprehensive liberalization in the WTO in 1997, valuable experience had been previously gained in two other free trade agreements. Canada and its free trade partners in North America had already developed significant financial services liberalization and a framework through which it could take place. Canada's bilateral experience in the Canada-United States Free Trade Agreement, and its multilateral experience in the North American Free Trade Agreement created the necessary conditions for the movement and success that has been achieved in the WTO financial services agreement. Nevertheless, Canada still maintains a guarded financial policy framework which has evolved from certain political and economic considerations. This framework is sufficiently liberalized in most respects, but has made less progress in other areas compared to what is found in other advanced nations. In maintaining certain restrictions like limiting foreign ownership of big banks and domestic mergers, the government has recognized its responsibility to ensure that regulatory policies are prudential, that they balance conflicting social and private interests, and that they must effectively manage the financial system. In broad terms this can be called financial *governance* - a process in which the government effectively exercises its regulatory authority.[6]

This perspective also recognizes the difficult choices faced in Canada when considering changes to sensitive financial legislation. Canada is a country with a highly concentrated banking sector[7], a dependency on natural resources, a relatively small population, and has a huge and financially integrated trading partner, the United States, to the South. Even though progress has been made in important areas, the existing literature tends to be largely critical of Canada's progress in both autonomous liberalization and that formally committed in trade agreements. In the GATS, Canada's financial services commitments to allow limited foreign bank branching and have gone hand-in-

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[6] Litan, Robert, E., Pomerleano, M., Sundararajan, V., eds., *Financial Sector Governance: The Roles of the Public and Private Sectors*, (Washington, D.C., Brookings Institution Press, 2002), 2.

[7] As of October 2002, Canada's five major domestic banks accounted for 92% of the assets held by the banking industry, while foreign banks accounted for only 6.2% of assets. See WTO Trade Policy Review, Canada (2003), 127.

hand with national financial regulatory reforms. The government has seen it in Canada's interest to bring foreign bank legislation in line with policies that have already been implemented in other developed economies. The financial services activity in the WTO, however, has not been a major pressure on Canada to make these changes. Canada debated the benefits of liberalization decades before.

The opening of the financial sector to complete foreign competition in Canada has been slower than in many other industrialized countries because we have gone more through a process of restructuring than revolution. The delays in this internationalization reflect the long-standing concerns from much of the Canadian public about foreign ownership and control in key sectors of the economy.[8] Foreign ownership in financial services cannot be based solely on economic factors and must consider other prudential issues. In Canada, many of the changes have been due to rapid shifts in the financing requirements across the economy - changes which have occurred in response to changing market conditions and the evolving economic environment. These realities were seriously recognized as early as 1984 in the federal government's Agenda for Economic Renewal. It recognized that "Many of the recent changes have both benefitted the Canadian public and increased the efficiency of the Canadian capital markets ... However, the current regulatory framework has not come to grips with the evolving needs of the financial community or the public and there is a need to ensure that legislation reflects the reality of a rapidly changing financial sector."[9]

Another potential source of delay is outlined in a now classic book on Canadian banking, "Different Drummers", by Robert MacIntosh who argues that the banking system in Canada has been a mirror of social and political change.[10] The most visible sign of this was the Canadian

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[8] Handfield-Jones, Stephen, "Adjusting to New Market Realities: The Canadian Financial Services Industry in Transition", *Conference Board of Canada Report* # 31-88 (1988), 9.

[9] Finance Canada, "A New Direction for Canada: An Agenda for Economic Renewal", presented by the Hon. Michael H. Wilson on November 8th, 1984.

[10] MacIntosh, R., *Different Drummers: Banking and Politics in Canada*, (Toronto,

perception that banks are a part of the public domain - "quasi-public utilities" as some suggest.[11] Essentially we have been conditioned to believe that banking services should be available to us at very little cost and that the banks should accommodate social and political objectives before thinking about their profits.[12] Probably the most sensitive issue is based around our expectations that bank branches should continue to service rural areas and to provide basic and affordable banking services. Canada's big banks have therefore had to sustain their established branch network across the country which is costly in economic terms, but which is politically very difficult to streamline.

MacMillan, 1991), 3.

[11] Bond, David, "Financial Services Reform will Eviscerate Bank Sector", *Globe and Mail*, Friday March 10, 2000, B11.

[12] Public goods by definition are characterized by non-rivalrous consumption (consumption by one individual does not detract from that of another) and non-excludability (you cannot exclude anyone from using the good).

Aside from the economic and political debates, Canada's policies with respect to foreign financial firms are not significantly different from the international standard. This argument is elaborated in the sections to follow. As Neufeld and Hassanwalia have noted: "The ownership policy governing banks has two apparent objectives: separating [general] commerce from finance [financial services] and maintaining Canadian control over the financial system.[13] On both counts, Canada's policies are not that different from policies of other countries. Through explicit laws or *de facto* practice, most countries have a separation of banking from commerce, and almost all the largest banks in the world are free from [corporate] commercial control. Furthermore, most jurisdictions have explicit or implicit provisions to prevent control of the financial system from slipping into foreign hands."[14] In fact New Zealand is the only country in the OECD that has allowed its banks to become foreign-owned.[15]

<u>History of Canadian Foreign Bank Legislation</u>

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[13] The separation of "commerce" from "financial services" refers to the fact that most countries have prudential laws which prohibit the cross-ownership of general companies and financial services firms (real-estate and banking, for example).

[14] Neufeld, Edward, P., and Hassanwalia, Harry, (1997), "Challenges for the Further Restructuring of the Financial Services Industry in Canada", in von Furstenberg, George, M., *ed., The Banking and Financial Structure in the NAFTA Countries and Chile*, (Boston, Kluwer, 1997), 91.

[15] New Zealand's banks are still largely owned by neighboring Australians. See Dobson, Wendy, "Memo to Mr. Martin: For Higher Productivity, Our Financial Sector Needs More Freedom", Institute for Research on Public Policy, *Policy Options*, May 1999, 51-53.

Banking in Canada falls exclusively under federal jurisdiction, while the regulation of securities companies falls under provincial control.[16] Insurance and trust and loan companies are free to incorporate under either federal or provincial law, but are required to be licensed in the province(s) in which they operate.[17] The Department of Finance plays the lead role in defining domestic banking and insurance policy as well as Canada's trade stance on these issues, but usually does so only after consultation with the financial sector itself. Although this basic level of consultation exists between the government and the financial sector, it is important to note that the two parties remain as rivals defending their respective realms of the financial system, a theme that would emerge clearly in the FTA negotiations.[18] Because all securities and some insurance matters fall under provincial jurisdiction, cooperative procedures exist between the federal and provincial regulators for information exchange and to harmonize approaches.[19] Another important institution in Canada is the Office of the Superintendent of Financial Institutions (OSFI) which was formed in 1987 and is both a regulator and supervisor for all federally chartered financial institutions. Its regulation function involves developing and interpreting legislation and regulations, issuing guidelines, and approving institutional requests while its supervisory function involves assessing the safety and soundness of federally regulated financial institutions. Also involved is the Canada Deposit Insurance Corporation (CDIC), a federal Crown Corporation which was formed in 1967 and provides deposit insurance and contributes to the stability of the financial system. The coordinating arrangements in the financial community tend to internalize most differences which occur across several agencies. They also tend to gather the necessary technical expertise by exchanging position papers and views. All of the agencies involved, including Finance, OSFI, CDIC, maintain close contacts with associations and individual firms.[20]

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[16] The regulation of securities firms has been under constant discussion recently. While some provinces argue for a single national regulator, others have wanted to retain their regulatory oversight. At the national level, a self-regulated forum called the Canadian Securities Administrators (CSA), consisting of the thirteen provincial and territorial securities regulatory authorities coordinate and harmonize the regulation of Canadian capital markets.

[17] Over 80% of insurance companies in Canada are incorporated federally, representing over 90% of premium income. Since the largest insurance and trust & loan companies operate nation-wide, they have incorporated under federal law. Each province's insurance regulator oversees terms of contracts, licensing, and incorporation matters. See WTO, *Trade Policy Review* (TPR), Canada, 1996, 104-106.

[18] This is a main characteristic of a capital market-based system. See Zysman, John, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change*, (Ithaca, NY, Cornell University Press, 1983), 81.

[19] Personal interview, January 2003.

[20] Coleman, William, D., " The Banking Policy Community and Financial Change", Chapter 4 in Coleman, W., and Skogstad, G., *Policy Communities and Public Policy in Canada: A Structural Approach*, (Mississauga, Copp Clark Pitman, Ltd., 1990), 105.

The legislation governing banking in Canada is found in the Bank Act and was initially passed in 1871. The Bank Act established a "rules" approach to banking regulation in Canada based on the idea the government only intervenes if the rules are broken. The Bank Act is an example of industry-specific regulation wherein regulations are structured particularly to the operation of the banking industry in Canada. Banks are also subject to the general regulations dealing with operating a business in Canada including tax laws, employment regulations, etc,. Industry-specific regulations can be difficult and slow to change because the government usually has to spend considerable resources to administer and supervise the increasingly complex sets of regulations. Another problem is that the benefits of the whole structure of regulations and potential benefits are seen to go mainly to the regulated industry and does not directly benefit the government in return.[21] The Canadian government should take more responsibility in this regard, however, given that the banks are private entities that are required to fulfil some limited public responsibilities.

[21] Personal interview, March 2002.

Prior to 1964 there were no constraints on foreign banks entering Canada. After 1964, Canada introduced new restrictions on foreign entry into banking, but applied a relatively laissez-faire approach to existing banks. Over the next several decades several Royal Commissions, White Papers, and Senate Committees would consider the state of the Canadian financial system and reactions against foreign banks in Canada. One of the first was the 1957 Royal Commission on Canada's Economic Prospects (the Gordon Commission). Reflecting the statism of the time it strongly argued for maintaining Canadian control of domestic financial institutions and recognized the importance of maintaining domestic control of financing in Canada. It noted: "...the role of banks and insurance companies in financing economic activity in Canada might be adversely affected, if control of these important institutions were in the hands of non-residents with major interests in other countries to consider."[22]

Similar ideas were echoed in the 1964 Royal Commission on Banking and Finance (the Porter Commission). It noted various concerns about unrestricted ownership and control in the financial sector as well as the potential benefits of some foreign participation in Canadian banking. The Commission did however make an effort to argue for greater competition, less regulation, and more consistency into the federal government's treatment of foreign banks. It suggested the establishment of foreign bank 'agencies' which would could bring some innovative products to consumers. The agencies, however, would be restricted from the more desirable business of taking deposits and expanding their number of offices.[23] The Commission also thought it important to define more specifically what "banking" meant in Canada. Because of this the government eventually avoided defining the term because it wanted to maintain the ambiguity surrounding the separation of bank subsidiaries and bank branches. The government's official reasoning was that it would be easier to regulate a foreign bank if it was required to incorporate locally as a subsidiary.[24]

[22] Royal Commission on Canada's Economic Prospects (1957), 397.

[23] Royal Commission on Banking and Finance (1964), 373-4.

[24] MacIntosh, *Different Drummers: Banking and Politics in Canada*, 169.

The reworking of the Bank Act in 1967 established a more formalized structure for dealing with foreign financial institutions and it seems that it had heard the concerns being voiced in the Commissions. With respect to foreign participation, it introduced a limit of 25 per cent on foreign ownership of any chartered bank and a limit of 10 per cent on any single interest in the shares of a bank (the "10/25 rule"). The 10 per cent limitation was the first appearance of a "widely-held" rule.[25] It was enacted in response to the controversial acquisition of Mercantile Bank by First National City Bank (FNCB, predecessor to today's Citibank) and the fear that the Toronto-Dominion was an intended target of a takeover by Chase Manhattan bank.[26] Thus, the rule was clearly designed to prevent foreign (i.e., US) takeovers of Canadian banks. Nevertheless, it was becoming harder to exclude US banks from the Canadian market and there were sentiments forming that maintaining the restrictions on foreign banks could draw retaliation from the Americans.[27] The restrictions on foreign financial institutions throughout the 1970's

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[25] The widely held rule is designed to prohibit control of a large financial institution by any single shareholder, or group of shareholders. It originally achieved this by limiting any singly interest to 10 %. This was increased to 20 per cent under the newest legislation, Bill C-8.

[26] Walter Gordon was the Minister of Finance who discouraged the takeover by FCNB, a dominant US bank, though it was eventually successful. From the 1950s to the 1970s Walter Gordon was a strong voice for English Canadian nationalism. In the late 1960s many Canadians supported Gordon's arguments for limits on the level of American investment and influence in Canada.

[27] Chant, John, F., "Canada's Economy and Financial System: Recent and Prospective Developments and the Policy Issues they Pose", in von Furstenberg, George, M., ed., *The*

were seen as becoming out of step as Canadian banks and insurance companies expanded their operations abroad following the trend of increased internationalization in the industry.[28]

Legitimate signs of change occurred just before the scheduled revision of the Bank Act scheduled for 1976. The Economic Council of Canada (ECC) prepared a report entitled "Efficiency and Regulation: A Study of Deposit Insurance" to provide some independent input into banking legislation. The Council suggested that the limitation on equity holdings by any one interest (the 10 per cent limit) constituted a major obstacle to entry into banking. It proposed a 'foreign-owned banks act' that would equalize the conditions for new banks whether established by foreign or domestic concerns. The only difference would be that a foreign bank would have its power to branch and expand restricted.[29]

Banking and Financial Structure in the NAFTA Countries and Chile, (Boston, Kluwer, 1997), 12.

[28] Coleman, " The Banking Policy Community and Financial Change", 96.

[29] Chant, John, F., "The Canadian Treatment of Foreign Banks: A Case Study in the Workings of the National Treatment Approach", *Trade and Investment in Services: Canada/US Perspectives*, (Toronto, Ontario Economic Council, 1985), 226-7.

In 1976, the federal White Paper on the Revision of Canadian Banking Legislation repeated some of the sentiments in the ECC Study, but also stressed the need for dispersed ownership. The 10 per cent rule, it stressed, "ensures that a chartered bank does not become captive to a person ... who have business interests other than banking, thus avoiding ... conflicts of interest or possible risks to the bank's depositors."[30] During this period, foreign banks continued to criticize Canada's restrictive measures including the ceiling on overall foreign bank participation, the need for license renewals, the need for branch approvals, and most importantly, the power of exercise of discretionary power by the inspector general with respect to foreign banks operating in Canada.[31] The government believed that Ministerial approval would ensure reciprocity across the border and better regional distribution of foreign bank subsidiaries. The critical view suggests that these measures reflected a 'statism' of the time wherein the economic levers in Canada needed to be kept in line with national objectives.[32]

In Canada we have a nation-wide bank branching system which reflects the absence of jurisdictions across provincial boundaries. In the US by contrast, each state has its own legislation for regulating banks which has made national branching impossible. A common problem faced by both systems of regulation is that foreign banks do not all fit into a common category of regulation and therefore can be difficult to classify. This difference in regulatory approaches in banking between Canada and the US has been one of the main reasons that rapid liberalization was avoided through the FTA and the NAFTA. The revisions to the Canadian Bank Act in 1980 tried to deal with the foreign bank issue by creating two classes of banks - (Schedule A and Schedule B banks) - a division which stood until very recently. Schedule A banks was the category for existing large Canadian banks that were subject to the widely-held rule. The Schedule B category allowed the entry of foreign banks subject to the same restrictions as domestic Schedule B banks (smaller banks).

With respect to their operations, Canadian banks have been active in the US for a long time (prior to confederation), while US banks have only been able to provide a full range of banking services in Canada since 1980. [33] In Canada, the development of federal bank branching legislation is thought to hinder such freedom. Prior to 1980, US firms did have a presence in Canada through representative offices, but the revision of the Bank Act in 1980 formally gave US banks limited access to the Canadian market. The Bank Act allowed for entry of foreign banks via the establishment of Canadian subsidiaries, but not as branches of the parent bank. This remains an important feature of foreign bank presence in Canada. By 1984, the limits

[30] White Paper on the Revision of Canadian Banking Legislation (1976), p.27.

[31] Chant, "The Canadian Treatment of Foreign Banks: A Case Study in the Workings of the National Treatment Approach", 230.

[32] Owens, Richard, C., and Guthrie, Neil, "Foreign Banks and the Business of Banking: Reforming Canada's Foreign Bank Access Regime for the Global Marketplace", *Banking and Finance Law Review*, 13, 3, August 1998, 347.

[33] Fry, Earl, and Radebaugh, Lee, *The Canada-US Free Trade Agreement: The Impact on Service Industries*, (Provo, Utah, Brigham Young University, 1987), 12.

imposed on foreign bank expansion were more relaxed and provincial governments deregulated securities markets and offered unrestricted access. At the federal level, the government was taking steps to significantly alter the regulation of financial institutions and was paving the way for greater foreign presence in Canada.[34] These measures relaxing specialization and establishment rules marked the real beginning of deregulation in the Canadian financial services sector.

[34] Rochon, Paul, "Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement", Conference Board of Canada Report from the Financial Services Research Program # 45-89-DF, (1989), 2.

More pressure came in 1983 when the Standing Committee on Finance, Trade and Economic Affairs argued on the side of more openness and noted that even if Canada removed its ceiling limitation on foreign banks (the 16 per cent participation limitation), other features of Canadian legislation could still constrain their operations. These included reciprocity rules with the home country of the foreign bank and the contribution of the foreign subsidiary to competitive banking in Canada.[35] These arguments however were soon calmed by the news of some troubled institutions and the 1986 failures of the Canadian Commercial Bank and Northland Bank.[36] This reflected the fact that one of the most important forces that has allowed legislative change in financial services has been the condition of the economy.

The Canada- United States Free Trade Agreement (FTA)

On October 4th 1987, officials from Canada and the US signed the Canada-US Free Trade Agreement (FTA). The financial sector components of the FTA are contained in the pages of provisions of Chapter 17. During this time the idea of rules for international trade in services was a relatively new concept, and also was not covered by the General Agreement on Tariffs and Trade (GATT).[37] The resulting priority in the negotiations for services in the FTA was to 'cast the net as wide as possible' to capture the greatest number of services sectors. There was no common definition for what the term 'services' encompassed or what service sectors should be included in the agreement and this required some work.

The financial services negotiations were kept entirely separate from the general services negotiations because banking and trade had traditionally operated as separate areas of the economy. The financial services chapter was negotiated by the US Treasury Department and the Canadian Department of Finance, while the general services agreement was negotiated by the

[35] Standing Committee on Finance, Trade and Economic Affairs (1983), p.31.

[36] Chant, "Canada's Economy and Financial System: Recent and Prospective Developments and the Policy Issues they Pose", 15.

[37] A notable precedent was the establishment of broad principles for trade in services including right of establishment and national treatment in the mid-1985 preparatory discussions leading up to the US-Israel FTA.

US Trade Representative's Office and the Canadian Trade Negotiations Office. While the Treasury and the Finance Department both had the necessary authority and expertise to conclude the financial services chapter, the lack of coordination with the trade negotiators was thought to be largely an extreme over-sensitivity based on intra-agency 'turf'.[38]

[38] Fry, and Radebaugh, *The Canada-US Free Trade Agreement: The Impact on Services Industries*, 58.

The resulting financial services agreement did make progress by reducing some existing trade barriers. However, by pursuing an entirely separate course, the financial service negotiators failed to establish broad trade principles that would apply to most other services under the agreement. Part of this was because both parties wanted to preserve the existing access they had to each others' financial systems. There were concerns that changing regulations might have restricted some types of activities which already existed between the two countries.[39] Liberalization therefore was bargained item-by-item, rather than as part of an expansion of the general services regime.

A proper analysis of the FTA negotiations in financial services requires an understanding of the context of Canada-US bilateral relations at the time. The motivations of each country were important because there was significant concern about political issues resulting from what was happening in goods trade and the auto pact. The common goal was to reach a formalized arrangement in free trade in the midst of intense trade attitudes about steel, lumber, and agricultural trade. A big problem for negotiators was that there was no model agreement in existence dealing extensively with financial services.[40] Throughout the process leading up to the FTA, papers were presented and exchanged among those involved which discussed the subject of national treatment and modeled how specific GATT ideas could be altered for the purpose. The important financial services-related issues that were discussed in the negotiations included the general principles of national treatment, transparency, compatible language, and labor mobility. The US was not committed to these in principle at the time as they only saw the financial services negotiations as a way to get what they wanted in other areas of trade. The GATT text itself was not the best model for services, including financial services, but it's principles were eventually utilized.[41]

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[39] Chant, John, F., "Free Trade in the Financial Sector: Expectations and Experience", Centre for International Studies/Fraser Institute Conference, *How is Free Trade Progressing?*, November 18 & 19, 1991, Toronto, 10.

[40] Personal interview, March 2002.

[41] The financial services provisions in the FTA and NAFTA were both scheduled according to a "negative-list" approach whereby a basic agreement was agreed upon and supplemented with lists of exceptions.

Domestic politics in Canada also played a significant role in slowing and complicating the progress of the negotiations in financial services. First, the banks themselves were divided on the free trade issue both during the negotiations and after the agreement was signed.[42] While some of the banks supported the agreement for its potential to help economic growth, others opposed it because of the perception that the agreement would favor the US banks. Second, many politicians and bureaucrats were not admirers of the banks.[43] The banks themselves perceived that the government of Brian Mulroney, including many MP's, generally disliked and mistrusted them.[44] The priorities of the Conservative government were focused on the lead-up to another round of deregulation in the banking industry, and so the government was less concerned with the issue of liberalization of foreign entry in the FTA. As a result, the Conservative government did not need the banks on its side through either the negotiations or for electoral support in the 1988 Federal election.[45] Furthermore, the interests of the banks were at odds with those of the securities industry in Canada. Finance Minister Michael Wilson was originally from

[42] Doern, G. Bruce, and Tomlin, B., *Faith & Fear: The Free Trade Story*, (Toronto, Stoddart Publishing, 1991), 117.

[43] Personal correspondence, April 2003.

[44] Doern and Tomlin, *Faith & Fear: The Free Trade Story*, 118.

[45] Personal correspondence, April 2003.

the securities industry, which had a long history of conflict with the banks.[46] In addition, the pressures for financial deregulation had been building, particularly after the "big bang" deregulation of the London financial market.[47] In Britain and in Canada, one of the major factors for reform had been the relative decline of their securities markets. In December 1986, Ontario decided to fully deregulate its securities industry for competitive reasons and allow banks to buy securities firms.[48] The domestic banks were given one year to purchase securities firms before foreign banks were allowed to do so, giving them a strong incentive to do so. The overall effect kept the banks detached from the FTA negotiations in financial services for fear that their industry was one that was being traded-off for gains in other sectors.

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[46] Doern and Tomlin, *Faith & Fear: The Free Trade Story*, 118.

[47] The British "big bang" involved the liberalization of fixed commissions, the removal of the Independent Certification System which limited members of the stock exchange from performing certain activities, and the restriction over non-stock exchange members investing in stock members' companies was removed.

[48] In June 1982, the Ontario Securities Commission (OSC) liberalized commissions, over four years before the London big bang. See Harris, Stephen, L., "The Globalization of Finance and the Regulation of the Canadian Financial Services Industry", Chapter 16 in Doern, G. Bruce, Hill, Margaret, M., Prince, Michael, J., and Schultz, Richard, J., eds., *Changing the Rules: Canadian Regulatory Regimes and Institutions*, (Toronto, University of Toronto Press, 1999), 373.

The FTA was also negotiated amidst a vigorous movement towards financial deregulation in both countries.[49] While there were additional fears that a trade deal would tie the hands of either government on fiscal and monetary policy, Canada was successful in its demand to keep these issues out of the trade discussions.[50] The creators of the FTA did not intend to integrate or harmonize the Canadian and US financial sectors, but rather wanted to preserve the existing status quo.[51] Although the FTA intended to liberalize financial services, there were perceived to be changes forthcoming that could have cut off some existing access, such as the existing powers of Canadian banks in the US or the access that US banking professionals had to Canada. These concerns led each country to make specific requests based on their own interests and failed to give any 'bilateral balance' to the commitments between Canada and the US.[52] Article 1701 (2) clearly limited the scope of financial services commitments by stating that financial services would not apply to political subdivisions in Canada or the US (i.e., provinces or states). This excluded its application to important provincial and state laws and regulations governing financial institutions.

With respect to bank branching, the American requests to liberalize Canadian legislation was a sensitive issue for the Canadians for many reasons. First, it was politically difficult given the history of debates surrounding banking in Canada outlined above. Second, Canada had little experience with bank subsidiaries to that point and wanted to wait longer for this area to mature. Third, the fast action taken against the fraudulent activities of the Bank of Credit and Commerce International (BCCI) was a case-study of good prudential control and the potential dangers of branching in the minds of Canada's policy-makers at that point in time.[53] Finally, Canada lacked the staffing and expertise to administer a potential branching regime. Branching regulation is very difficult requiring special people who are experts in the field and who have the necessary tools and knowledge. In 1987 the Inspector General of Financial Institutions office was all that existed, and it had minimal staffing.

It is also important to understand just how relevant the retail branching issue was in the big picture. Prior to the FTA, US banks were already receiving national treatment in practice in Canada and faced few restrictions. The US banks had also realized that cracking the concentrated Canadian market is difficult because it is dominated by Canadian firms and those firms had traditionally been highly protectionist. While domestic Canadian banks are now fully

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[49] Chant, "Free Trade in the Financial Sector: Expectations and Experience", 12.

[50] Personal interview, March 2002.

[51] Chant, "Free Trade in the Financial Sector: Expectations and Experience", p.10.

[52] Personal interview, October 2001.

[53] Described as the 'biggest bank fraud in history', BCCI encompassed a network of bad lending practices, financial shell companies and institutions operating in nearly 70 countries and which had managed to escape full regulation. Though it was officially shut down July 5, 1991, regulators were examining its activities through the mid to late 1980's but were unable to take action until the bank's activities were sorted out (Erisk.com Case Study).

supportive of greater foreign competition, the concentration issue persists. For example, Citibank is the world's largest retail banker and Merrill-Lynch is the largest securities dealer, yet neither has been able to gain a significant foothold in Canada for this reason.[54]

[54] Personal interview, March 2002.

In the area of securities, many assumed that the Glass-Steagall Act in the US would be a major obstacle in the financial services area.[55] In fact, Canadian firms operating in the US were already doing a combination of banking and securities-related activity. This was because existing Canadian securities firms operating in the US had as their main business the underwriting of Canadian government business (i.e., hydro deals, etc.) and this is where they primarily made their money. Glass-Steagall was however changed in the FTA to accommodate such corporate underwriting and Canadian securities firms were allowed to operate with disregard for Glass-Steagall.[56] Thus, Glass-Steagall was not in fact limiting for Canadian banks and it represented merely a convenient lobby issue at the time for the Canadian banks in their attempt to discredit Glass-Steagall itself.[57] The US was granted their request in the FTA which was the approval to acquire securities dealers in Canada.

<u>The Provisions of the Free Trade Agreement</u>

The provisions on financial services in the FTA applied to banking and securities services only . Insurance was covered under the general services chapter and not under financial services.[58] The special characteristics of the FTA financial services provisions should be noted. First, the understandings on financial services were distinct from other FTA chapters. Financial services required special consideration in the FTA because of the general need to include freedom of establishment beyond that found in free trade in goods. Where the rest of the FTA required observance of measures by state, provincial, and local governments, the financial services provisions did not apply to state or provincial measures. The agreement did not apply, for example, to state US bank branching laws or Canadian provincial securities regulations. Second, financial services provisions were exempt from the dispute settlement mechanism applied elsewhere in the FTA. The term "dispute settlement" is not found in Chapter 17, but Article 1704 does allow for "Consultation" between the Canadian Department of Finance

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[55] Recall that the Glass Steagall Act of 1933 in the US required the separation of commercial banking and securities functions for prudential and conflict of interest reasons.

[56] Personal interview, March 2002.

[57] Personal interview, March 2002.

[58] The US did not categorize insurance as a 'service'. While the Treasury Department was responsible for banking and securities, the Department of Commerce handled insurance.

(Finance) and the United States Department of Treasury (Treasury). The details of the procedure were not outlined.

Dispute settlement is a recurring peculiarity in financial services because even in the WTO there have been no initiations of dispute settlement cases. Peter Nicholson, Senior Vice-President, The Bank of Nova Scotia, said in testimony to the Standing Committee on Foreign Affairs about its absence in the FTA: “There is not even any language suggesting that an aggrieved party is entitled to take retaliatory measures of equivalent commercial effect.”[59] While the negotiations protected the status quo in terms of actual legislation for Canadian firms, it did not protect against discretionary changes in the *application* of regulation.[60] There are two possible explanations for the lack of dispute settlement in financial services. The first relates back to the tradition of secrecy in the financial policy-making arena discussed earlier in this chapter. It has been described as an ‘old boys network’ where policy makers from one country would not want to initiate a formal complaint for fear of seeming out of step with the expectations of policy makers in other countries.[61] In trade negotiations, the problem of secrecy in Canada is further complicated by the fact that specific trade negotiation objectives are not in the public domain due to cabinet confidence rules.[62] The other reason could be that trade in financial services has just not been as economically significant as disputes which have been happening in other areas such as steel and softwood lumber.

In the negotiations, the concept of reciprocity was impossible between the US and Canada because of the huge differences in national regulations (i.e., minimal harmonization existing between the two countries and the dissimilar regulatory structures). Under the US regulatory model, the universal application of NT is more difficult because of shared banking jurisdiction between the states and the federal levels. For example, US states themselves tend to have widely varied rules with respect to treatment of foreign financial institutions. In Canada by

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[59] Quoted in Rochon, “Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement”, 5.

[60] Chant, “Free Trade in the Financial Sector: Expectations and Experience”, 18.

[61] Personal interview, October 2001.

[62] Personal interview, January 2003.

contrast, banking jurisdiction is exclusively under the power of the federal government so regulatory changes apply equally to all institutions in all provinces. What resulted from this disparity was a "menu" option for requests and offers, where each country chose the issues most important to them and this has been described as a "pragmatic application of the principle of national treatment".[63] In the end, the FTA left each country's powers unchanged with respect to financial sector domestic regulation.

Canada's Commitments in the FTA understanding

[63] Rochon, "Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement", 6.

There were some major sticking points in negotiating the financial services agreement. The first was that Canada had been imposing severe limits on foreign ownership in the Canadian market. Canada had been treating so called Schedule A and Schedule B banks (this latter class included foreign banks) differently and this was obviously incompatible with the principle of national treatment. The differential treatment of banks in Canada was a source of friction between Canada and the US, but the reality of the situation was not so clear. Unlike the US system, Canada's banking legislation was completely a federal responsibility and provincial securities markets were already highly deregulated. So the reality was that US banks operating in Canada, in relation to Canadian banks operating in the US, were already being treated very fairly (de facto) aside from actual regulations.[64] The second sticking point, discussed above, was that while the US market for financial services was generally open, the Canadians did have reason to be concerned that the US could impose new limits on Canadian firms. And it was a primary objective of the Canadians that the US would move toward deregulation of financial services. One of the biggest problems in this area was the Glass-Steagall Act that barred common ownership of banks and securities firms. The worry for the Canadians was that they would actually have to reduce their activities in the US while American firms expanded in Canada under the FTA. Based on these concerns the FTA offered some solutions.

First, there was a relaxation of the acquisition of Canadian-controlled firms under the so called "10/25" rule. Also, foreign bank subsidiaries in Canada, as a group, were not allowed to hold more than a 16 percent share of the total capital of the Canadian banking industry. This limit would be removed for US banks and their assets would no longer be included in the calculation of the asset ceiling, so the ceiling was reduced to 12 per cent for non-US foreign banks.[65] Foreign bankers operating in Canada had stated that while the asset ceiling was an irritant to their operations in Canada, it had not served as an effective barrier to their growth.[66] Instead, the main barrier to growth in the Canadian market was recognized to be the prudential lending limits applied to all banks, regardless of nationality.

Second, US-controlled banks in Canada would now be permitted, subject to prudential requirements, to transfer assets to their parent banks.[67] Prior to the FTA, it was possible for Canadian borrowers to book loans directly with the US parent bank, however, transfers of loans between the Canadian subsidiary and the parent bank were not permitted.

Third, US banks were no longer required to obtain Ministerial approval prior to opening additional branches in Canada.[68] However, US banks have not typically moved into the Canadian retail banking market because there are significant capital costs associated with

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[64] Personal interview, March 2002.

[65] FTA, Article 1703 (2).

[66] Rochon, "Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement", 11.

[67] FTA, Article 1703 (2) (d).

[68] FTA, Article 1703 (2) (c)

entering the highly concentrated Canadian market and the level of retail service offered in Canada was already high. Furthermore, the growing involvement of insurance and trust companies in the retail market made the retail banking sector even less attractive as an area for expansion.[69]

[69] Rochon, "Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement", 13.

Finally, Canada agreed not to apply the review powers contained in section 307 of the Bank Act in a manner that was inconsistent with the agreement on financial services.[70] Section 307 required foreign banks to obtain consent from the Governor in Council before establishing or acquiring an interest in a financial institution in Canada. The agreement on financial services, therefore, could be taken to imply that US financial institutions would be subject to review on that basis of prudential regulations only.

Commitments of the US

In 1989 regulatory reform in the US was far less advanced than in Canada because control over institutions was still divided between state and federal levels. Nevertheless, Canadian institutions had generally had access to the US market for some time and enjoyed national treatment there.[71] The 1978 International Bank Act (US) offered market access on national treatment basis. The commitments of the US would be less broadly based than those of Canada but did however include improved market access in a few areas This was because most foreign financial institutions were already offered de jure national treatment. The US negotiators were also under considerable pressure to go beyond broad principles to ensure that the Canadian financial services barriers were eliminated in the overall trade deal.[72] The US made three main commitments. First, it committed to allowing both domestic and foreign banks to deal in and underwrite securities of Canadian governments and their agents.[73] Second, the right of Canadian banks to engage in retail and other banking operations in the US which were previously "grand fathered" for 10 years in the 1978 International Bank Act, were now done so indefinitely under

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[70] FTA, Article 1703 (3).

[71] Personal interview, March 2002.

[72] Fry and Radebaugh, *The Canada-US Free Trade Agreement: The Impact on Service Industries*, 55.

[73] FTA, Article 1702 (1).

the FTA.[74] Finally, national treatment was promised when the changes to Glass-Steagall were completed and would apply equally to Canadian-controlled financial institutions and to US financial institutions.[75] Possibly because they recognized the shortfalls of the FTA with respect to full national treatment, both the US and Canada finally agreed to "...consult and to liberalize further the rules governing its markets and to extend the benefits of such liberalization to [the other party]."[76]

The National Treatment Issue

[74] FTA, Article 1702 (2).

[75] FTA, Article 1702 (3).

[76] FTA, Article 1702 (4) [US], Article 1703 (4) [Canada].

In the eyes of the Canadian negotiators, National treatment in the US had a very different significance than it did in Canada because of the difference in the division of powers. In the US, branching powers are administered by individual states. In Canada, national treatment means nation-wide branch access because banks are federally-regulated. Therefore, any bargaining in the FTA put Canadian banks at a disadvantage from the start. While the negotiators made this case, the reality was that the US was already more open (de jure) to foreign banking than Canada. When the Canadian government asked the Canadian banks to make a list of barriers to the US market, this fact was confirmed by the short list that was produced.[77] The other problem was that in 1988, the 16 US bank subsidiaries operating in Canada could own full-service investment dealerships. In the US, however, commercial banking and investment was separated by Glass-Steagall Act. Thus, "national treatment" meant that Canadian banks could not own securities firms in the US on paper, even though the major Canadian dealerships were already there. The compromise allowed them to continue operating in the US with the promise that this would be officially extended once Glass-Steagall was amended. From the perspective of services negotiations, this makes the concept of national treatment very ambiguous because there is no common working definition. John Chant notes that the concept of national treatment was designed for a system of nation to nation bargaining, so implicit in its definition is that national authorities have full jurisdiction over banking regulations.[78] A better application of the concept of national treatment would require both federal and state jurisdictions in the US to accord equal treatment to both domestic and foreign banks in their jurisdiction.

These issues also necessitate a more detailed discussion of the difference between de jure and de facto treatment (barriers that exist in law and those that exist in practice). The US position was that they were essentially working with a trade policy based on national treatment. However the reality was that the US was offering more de jure, but not de facto treatment. There were arguably many more barriers to Canadian banks operating in the US. These included individual state barriers to entry, the requirement of standby letters of credit, or rules discouraging foreign banks from obtaining FDIC insurance. At the state level, some states restricted foreign banks from establishing a federal agency in their state. Other states restricted branches, while others required state charters. Regional reciprocity rules also discriminated against foreign banks because of specific requirements on geographical concentration of deposits. There were also barriers that could be set up under the Interstate Banking Act and Branching Efficiency Act. In addition, the volume of US financial legislation and regulations at over 220, 000 pages was and is in itself a barrier as it raises the costs of entry and compliance. [79]

[77] Doern and Tomlin, *Faith & Fear: The Free Trade Story*, 118.

[78] Chant, "The Canadian Treatment of Foreign Banks: A Case Study in the Workings of the National Treatment Approach", 236.

[79] Pattison, John, C., "Trade in Financial Services in NAFTA: A Public Choice Approach", Chapter 7 in von Furstenberg, George, M., ed., *Regulation and Supervision of Financial Institutions in the NAFTA Countries and Beyond*, (Boston, Kluwer Academic Publishers, 1997), 152.

Final Analysis of FTA Chapter 17

One major area the agreement did not deal with was the liberalization of cross-border trade in financial services. That is, firms that were not established in Canada could not offer financial services in Canada, but would have to establish a subsidiary. The reason this was left out is thought to be that the regulators on either side were unwilling to give up their authority within their boundaries. Also, and as with most other areas covered in the FTA, the financial services agreement did not cover provincial or state restrictions on financial services. This wasn't a problem since most had been eliminating those restrictions as time progressed. Another closely related drawback of the financial services agreement was that it did not provide for any mechanism to actively promote further liberalization. Another major concern was that the financial services agreement was not covered by the FTA dispute settlement mechanism. Rather, consultations were to be conducted solely by the Canadian Department of Finance and the US Treasury Department.

Despite some of the drawbacks, the FTA financial services agreement showed promise in that it represented a major first step in long term process of further liberalization. By reducing significant existing barriers and making a promise for resolving future problems, the agreement provided resolution for discrimination and protectionism. Another lesson drawn from the overall FTA services agreement was that the two-tier approach to negotiations was workable; a framework of principles could be supplemented by a series of sectoral agreements. However, the negotiations for specific service barriers within the framework was not easy. Real progress could only be made by a 'hard bargaining' process where trade-offs are made between sectors.[80] It is considered that progress was achieved in financial services because the agreement on financial services emerged as an essential condition of the overall FTA.[81] Many of the omissions and difficulties in the FTA financial services agreement that were not fully fleshed out in the Canada-US bilateral context pointed to the possible challenge that would lie ahead for liberalization at the multilateral level.

Financial Services in the North American Free Trade Agreement (NAFTA)

The financial sector again became the subject of trade negotiations when the FTA was expanded in 1994 to include Mexico under NAFTA. The NAFTA agreement represented more than just a routine expansion of the FTA to another country. Instead of each country's adopting a different set of obligations as in the FTA, the members agreed to a more common set of principles governing the treatment of each other's institutions.[82] Chapter 14 dealing with

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[80] Personal interview, March 2001.

[81] Fry and Radebaugh, *The Canada-US Free Trade Agreement: The Impact on Services Industries*, 60.

[82] von Furstenberg, George, M., ed., *The Banking and Financial Structure in the NAFTA Countries and Chile*, (Boston, Kluwer, 1997), 18.

financial services maintained the FTA's separation of a general framework agreement and the specific reservations to the agreement which are to be declared by each party in Annexes (i.e., the "negative list" approach to scheduling). NAFTA Chapter 14 also differs substantially in other respects from the FTA in its approach to free trade in this sector. Essentially the NAFTA took a more comprehensive approach to national treatment and was drafted around the broader principles of free trade in financial services.

Leading into the negotiations Canada, the US, and Mexico each maintained a separate agenda which was largely a reflection of the bilateral experience in the FTA and their economic interests.[83] For Canada, the NAFTA negotiations were an extension of the protective measures that were achieved for Canadian financial institutions in the FTA. Canada's general attitude in the NAFTA financial services negotiations was to protect Canadian businesses and their well-established activities in the US. For the US, the negotiations were seen as an opportunity to open up Mexican financial markets to US institutions because it was believed that the Mexican markets were at a key stage of development for such participation.[84] For Mexico, the timing of the NAFTA negotiations was coincidental with a financial crisis, so the negotiations were a trade-off between the preservation of a national presence in their vulnerable financial system and the benefits to be had in other areas.

The negotiations on Chapter 14 were carried out relatively quietly among government officials and the relevant industry players. Where other areas of the NAFTA were hotly and openly debated, Chapter 14 received little attention from the press or consumer groups.[85] In the 1992 domestic financial sector reforms, in the midst of the NAFTA negotiations, the big banks maintained their objections to the easing of regulations dealing with foreign ownership. They argued that Canada would become the only major industrialized country that permitted concentrated ownership of major financial institutions. Broad ownership, they argued prevented any misuse of depositor's funds and argued that the existing rules prevented conflicts of interest where credit may denied to competitors of the firm in question.[86] Their concerns were somewhat addressed by NAFTA's rules on regulatory safeguards and the maintenance of the widely-held

[83] Wethington argues: "...all three participating countries believed that a liberal financial services regime would facilitate the efficient flow of capital between the countries and thereby promote economic growth.", Wethington, Olin, L., *Financial Market Liberalization: The NAFTA Framework*, (New York, McGraw-Hill, 1994), 4.

[84] Chant, John, "The Financial Sector in NAFTA: Two Plus One Equals Restructuring", in Globerman, Steven, and Walker, Michael, eds., *Assessing NAFTA: A Trinational Analysis*, (Vancouver, BC., The Fraser Institute, 1993), 180.

[85] Schefer, K.N., *International Trade in Financial Services: The NAFTA Provisions*, (Boston, Kluwer Law International, 1999), 118.

[86] Chant, John, F., "Canada's Economy and Financial System: Recent and Prospective Developments and the Policy Issues they Pose", in von Furstenberg, George, M., ed., *The Banking and Financial Structure in the NAFTA Countries and Chile*, (Boston, Kluwer, 1997), 20.

rule, but the momentum of the changes that were happening at both the North American and international levels also marked the beginning of an about-face by the bankers in favor of foreign competition.

NAFTA Chapter 14: Financial Services provisions

In general, Chapter 14 of NAFTA provides a declaration of principles with respect to openness of the financial sector and safeguards to permit participating parties to maintain distinct approaches to the regulation of their financial sectors.

(1) Regulatory Safeguards

In both the FTA and NAFTA, the financial sector provisions required that the countries would be assured openness to suppliers in the other countries while being able to preserve distinct national approaches to regulation. This was especially relevant for Canada and the US because they had traditionally maintained distinctly different, even incompatible approaches to the prudential regulation of their financial sector.[87] The article also addresses 'national sovereignty' which assured that the agreement would not interfere with any country's ability to carry out stabilization policies in regards to its national interest. This was thought to be important for both Canada and Mexico in regards to their monetary and exchange rate policies.[88]

(2) Cross-Border Trade

In the FTA, cross-border trade was of little importance because interference in regards to cross-border trade in financial services was a rare occurrence. This issue became more important with the inclusion of Mexico, which had a history of substantial interferences to cross-border trade in financial services.[89] Chapter 14 requires each party to permit its residents to purchase financial services from suppliers of other parties located anywhere in the free trade area. The agreement also states explicitly that it does not make any obligation on the parties to permit service providers either to do business, or to solicit in their territory - so falls short in this respect. NAFTA did allow limited branching of foreign banks in Canada, but this allowance came with very strict limitations. Foreign banks were also still restricted by the widely-held rule

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[87] "Prudential" refers in this context to mean the *careful management* and *exercise of good judgement* which could only be achieved by each country in regards to their distinct approaches to financial services regulation.

[88] Personal Interview, March 2002.

[89] Chant, John, "The Financial Sector in NAFTA", 182.

which excluded any person or group from controlling 10 per cent or more of a schedule I bank unless first obtaining the approval of the Minister of Finance.

(3) Establishment and National Treatment

The most significant progress in regards to financial services was made in the area of market access. On the right to establish, NAFTA requires that a member must allow financial service providers from other member countries to participate fully in its markets (under the principle of national treatment), either by establishing branches or subsidiaries or by acquiring existing financial institutions in the host country. Furthermore, once a foreign supplier has established a financial institution in the host country, the conditions of national treatment apply to its operations, and they may expand to establish branches. This represented a compromise based on the positions of Canada and the United States. [90] Under the FTA, Canada required foreign banks to operate through the establishment of separate Canadian subsidiaries in order to facilitate greater transparency. On the other hand, the US permitted banks to operate through the branches of the parent organization. The US bankers argued that their approach allowed for greater efficiency for expanding into another country because the firm would not have to endure the costs of establishing subsidiaries. In the end, Chapter 14 (4) left the decision to "investor choice" to be reconsidered after establishment in the foreign country.

(4) Dispute Settlement

The dispute settlement provisions in the financial sector generally follow the general model for dispute resolution outlined in Chapter 11 and Chapter 20, but they were geared to the needs of the financial sector.[91] Initially, a party may request consultation regarding any matter in the agreement and expect sympathetic consideration. The agreement also provides for a Financial Services Committee to supervise implementation and to participate in the dispute settlement. The Agreement also fills a major shortcoming of the FTA by making disputes in the financial sector subject to the Dispute Settlement Procedures found in Chapter 20 of NAFTA. Under this procedure, disputes are referred to a Tribunal consisting of panelists drawn from a roster of individuals with expertise in the financial sector. If the complaint is upheld by the Tribunal, the complaining party may suspend benefits in the financial services sector.

Reservations on Chapter 14 of NAFTA

Under the FTA, each country made specific commitments directed at easing the other countries' concerns about access to financial markets in that country. This approach had little need for statements of exceptions because they could be made in the specific commitments themselves. However, as a multilateral agreement, NAFTA required the establishment of a

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[90] Aguirre, Ernesto, "International Economic Integration and Trade in Financial Services:", *Law and Policy in International Business*, 27, 4, (1996), 1064.

[91] NAFTA Chapter 11 deals with investment issues, but provided dispute resolution in the form of international arbitration on a state-to-state basis and the investor-state level. Chapter 20 is the general dispute settlement chapter for NAFTA.

general set of principles rather than specific commitments. The measures taken in the Agreement were designed to incorporate the greatest commitment to openness that any of the parties would be prepared to make.

Conclusions on NAFTA

The agreement in NAFTA provides a clearer framework of commitments than the FTA, along with a wider encompassing agreement and a common set of principles. It carries over the two-tier structure of the FTA agreement that consisted of a framework agreement along with appropriate supplements. More significantly, it duplicates the negotiating format of the FTA where trade-offs between service sectors are made, but services commitments could not be tied to those in goods. This was a structural problem in financial services negotiations in general that would become more serious in the shift to encompass the developing countries into the GATS framework. Though the NAFTA established a principles-based approach to liberalization in financial services, Canada and Mexico ensured their biggest banks would remain under domestic control. Canada tried to give the appearance of a liberal system by engaging in banking legislation reform, but in actuality it clung to protecting the big banks from foreign take-overs. Mexico's subsequent liberalization in the GATS was advanced by its experience in the NAFTA.[92]

Finally, it is significant that the NAFTA financial services negotiations took place at the same time as the WTO's GATS negotiations. Some of the same negotiators worked on both agreement drafts and those who did not were at least aware of the other agreement's proposed texts. The negotiators working on the NAFTA also purposely worked to make its text compatible with the GATS.[93] One main difference between the two agreements is that the NAFTA gives more direct consideration to the principles of free trade and less thought to the interests of financial services regulators and practitioners, than does the GATS FSA.[94] This is thought to be so because most of the negotiators in the NAFTA came from a free market background and because the GATS gives more extensive treatment to domestic regulation and special and differential treatment for developing countries.

Canada and the GATS Financial Services Agreement

[92] Schefer, *International Trade in Financial Services: The NAFTA Provisions*, 394.

[93] The concepts of right of establishment, national treatment, and prudential regulations are meant to be GATS-compatible. See Ibid, 119.

[94] Ibid, 120.

While the NAFTA and GATS financial services provisions were designed to be compatible, the agreements are fundamentally different. The GATS represents a rule-oriented framework for financial services liberalization while the NAFTA focuses more on specific institutional obligations.[95] Canada's original obligations under the GATS required that it maintain the level of access that was enjoyed by foreign financial service providers under the existing legislative, regulatory, and policy framework of the time. The Canada Bank Act has also been gradually changed to accommodate changes in the domestic financial landscape and what has been going on at the WTO, but hasn't been changed because of any direct pressure from the WTO FSA.[96] Unlike some other countries, the changes in Canada's legislation also did not occur in response to crises or general dissatisfaction with the system's performance. The limited duration of the legislation (a built-in 5 year review limit) has allowed for incremental changes. Change has however been induced in trade negotiations with other countries and other relevant international agreements have been prompts for change to improve standards.[97] While the WTO FSA is generally viewed to be legitimate and useful by Canadian officials, they also realize that the changes happening outside of the WTO, including the work at the BIS, IOSCO, and IAS are equally important.[98]

At the end of the December 1993 WTO negotiations, concerns about the lack of developing country commitments versus what developed countries were offering threatened to collapse any potential agreement in financial services. Canada did however keep its best offer on the table while other countries (Japan, US) were threatening to pull back their commitments and threatening to collapse the financial services agreement. This meant that for the six-month period of extended negotiations after the Uruguay Round, Canada indicated it would allow MFN treatment, but retained the flexibility to put back an MFN exemption if it was not satisfied with the outcome. Several other developed countries, including members of the EC, similarly did not pull back any commitments and provided MFN treatment.

Canada and the 1995 Interim Financial Services Agreement

When negotiations resumed again in 1995, Canada made an important contribution to the negotiations by tabling a new schedule containing a number of improvements. In exchange for the concessions of other countries in the GATS financial services negotiations, Canada agreed to eliminate the foreign ownership and market share limitations in the federal financial regime. These restrictions had already been lifted under the NAFTA for the US and Mexico. More specifically, Canada had eliminated the following restrictions: the "10/25" limitations on foreign ownership, the 25 percent limitation on the foreign ownership of banks, and the 12 percent asset

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[95] NAFTA outlines how institutions are to be treated rather than setting out principles of liberalization. See Wethington, *Financial Market Liberalization: The NAFTA Framework*, 67.

[96] Personal interview, September 2001.

[97] Chant, "Canada's Economy and Financial System: Recent and Prospective Developments and the Policy Issues they Pose", 22.

[98] Personal Interview, October 2001.

ceiling on the size of the foreign bank sector in Canada which applied to non-NAFTA countries. Canada also offered to bind its current open regime with respect to market access and national treatment.[99] Finally, Canada offered MFN treatment by removing the requirement that foreign bank subsidiaries seek Ministerial approval to open additional branches in Canada. This had implications for the reciprocity provisions that then existed in Canadian legislation (through NAFTA) with respect to the entry of foreign financial institutions into its market. The existing Canadian provisions were not consistent with the MFN principle, but Canada had promised to enforce reciprocity over the period of the interim deal in financial services.

The GATS and Financial Services - Towards 1997

[99] Department of Finance Canada, *The GATS: The Financial Services Sector*, (1995), 8.

There were seven rounds of bilateral negotiations in GATS which occurred from April to December 1997. The reason for this duration was that the goals of 'significantly improved market access and broader participation' were difficult to achieve under the interim agreement.[100] In hindsight this was seen to be bad for both general services and financial services because it excluded any cross-sectoral trade-off[101] - a similar problem that was mentioned earlier in this chapter with respect to the 'hard bargaining' in the FTA negotiations.

In the 1997 negotiations, Canada committed in three important areas. First, Canada agreed to maintain its existing open regime for banking, insurance, and securities. Second, it allowed foreign banks to establish in Canada through (limited) branch offices and therefore have the same opportunities as Canadian institutions. Finally, Canada removed the requirement for foreign bank subsidiaries operating in Canada and originating from a non-NAFTA country to seek authorization before opening additional branch offices. These final two points that Canada upheld through both the FTA and NAFTA would bring Canadian policy closer in line with that of other developed countries. Canada would now be giving all WTO members the same access in financial services that it was giving to the United States and Mexico under NAFTA.[102] The fact that Canada was bringing their international commitments in line with those it had already made under NAFTA suggests that this was probably not an extraordinary move. Canada was merely updating its commitments at the international level as part of the negotiations while seeking greater market access abroad.

Other Domestic Issues and Conclusions

Financial Legislative Reform on the Domestic Front

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[100] These were goals set at the WTO's Ministerial Conference in Singapore, Dec.1996.

[101] Dobson, Wendy, and Jacquet, Pierre, *Financial Services Liberalization in the WTO*, (Washington, D.C., Institute for International Economics, 1998), 96.

[102] Department of Finance Canada, "What has Canada committed to in the 1997 agreement?", 3.

In Canada, 1996 marked the end of another 5-year review of financial legislation. In February 1997, just before the beginning of renewed WTO financial services negotiations, the Senate Banking Committee wrote that further liberalization in foreign bank branching should be considered. In December 1996, the Canadian government appointed the Task Force on the Future of the Canadian Financial Services Industry. One of the major themes of the final report (September 1998) was 'enhancing competition and competitiveness'. Echoing the conclusions of the earlier consultation paper released by the Department of Finance (September 1997), and in line with commitments made by Canada in the WTO Agreement on Financial Services (December 1997), the Task force concluded that, in the interests of enhancing domestic competition, 'it is important that the Government move expeditiously to allow foreign banks to operate through branches in Canada, as well as through subsidiaries.'[103] In the meantime Canada maintained restrictions on branching by allowing foreign bank subsidiaries only in the form of "regulated foreign banks".

In the review of the Bank Act that took place in 1997 (Bill C-82), the federal government agreed to allow foreign bank branching, although legislation to bring branching into effect had been postponed due to complexity.[104] New financial legislation was introduced as Bill C-67 in February 1999 and passed into law June 1999.[105] On June 25 1999 the government also released its policy White Paper entitled "*Reforming Canada's Financial Services Sector: A Framework for the Future*". The paper proposed changes to the "widely held rule" so an investor could own up to 20 per cent of voting shares, and 30 per cent of non-voting shares, of a widely held bank,

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[103] Task Force on the Future of the Canadian Financial Services Sector, final report, September 15, 1998, p.99.

[104] The complexity and time constraints were announced by Mr. Bob Hamilton, Assistant Deputy Minister, Financial Sector Policy Branch, Department of Finance Canada to the Standing Senate Committee on Banking, Trade and Commerce, April 17, 1997.

[105] Bill C-67 ("*An Act to Amend the Bank Act, the Winding-Up and Restructuring Act and Other Acts Relating to Financial Institutions ... Acts.")*.

subject to a “fit and proper test”.[106] The changes were designed to allow banks to enter into substantial share exchanges to accommodate alliances and joint ventures and were incorporated into upcoming legislation. The Secretary of State for International Financial Institutions, Jim Peterson, indicated the government’s balanced concerns: “The new foreign bank branching rules were developed through extensive consultations with all interested parties. They are designed to open the door to increased competition from foreign banks without compromising our high standards of protection of depositors,...”[107]

[106] Bill C-8, Part XII, Division 1, Definitions, #8 (“Person is a Major Owner”).

[107] Department of Finance Canada - “Foreign Bank Branching Legislation Comes into Force”, June 28, 1999.

The newest Canadian legislation, Bill C-8 is the culmination of the long process described above.[108] The predecessor to this Bill, Bill C-38, was first given reading on June 13 2000. It died when the November 2000 general election was called. The Act was reintroduced on February 7, 2001 with some minor changes. Canada brought a new form of branching into effect in harmony with the terms of the WTO Financial Services Agreement and the new domestic policy framework. This freed foreign banks from having to establish a "foreign bank subsidiary" (though they still may do so). However, foreign banks will require the approval of both the Minister of Finance and the Superintendent (OSFI) to establish a Canadian branch, so they are still effectively restricted. The principles underpinning the new regime provide flexibility for foreign banks wishing to operate in Canada and to streamline regulatory approvals. They have the option of establishing as an "authorized foreign bank branch" (Schedule III Bank) as either *full service branches*, which are only allowed to take deposits greater than $ 150,000., or *lending branches* which are not allowed to take deposits and may only borrow from other financial institutions.[109] The new regime brings Canada's foreign bank entry policies into line with international practices. All other major industrialized countries currently allow foreign banks to operate through branches. The requirements to establish a full service branch are however still quite onerous. Foreign banks that wish to take retail deposits in Canada will still have the option of doing so by establishing a fully regulated Canadian subsidiary (Schedule II Bank), and operating under the same OSFI regulations as the domestic chartered Canadian banks (Schedule I Banks). As of April 2003, there were 17 Schedule III banks (13 full-service branches and 4 lending branches), 31 Schedule II banks, and 16 Schedule I banks in Canada.[110]

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[108] Bill C-8 ("*Act to Establish the Financial Consumer Agency of Canada and to Amend Certain Acts in Relation to Financial Institutions*")

[109] Note the "Schedule I, II, and III" classifications are being changed to a size-based ownership regime: large banks (equity > $5 billion), medium banks (equity $ 1-5 billion), and small banks (equity <$1 billion). This new distinction clears up some of the national treatment problems foreign banks had complained of earlier.

[110] Canadian Bankers Association, (2003), "Banks in Canada".

Two other amendments to the *Bank Act, Insurance Companies Act, and Trust and Loan Companies Act* are part of the new legislation and stem from commitments taken by Canada in the WTO FSA.[111] The first releases WTO members from the requirement to seek the Minister of Finance's approval before opening additional branches of a foreign bank subsidiary in Canada. The second removes the application of legislated reciprocity provisions. As reciprocity is inconsistent with the most-favored nation (MFN) rule of the WTO Agreement, it can no longer be applied to WTO Members. Under the MFN rule, parties to the agreement must not discriminate among financial institutions from different countries. Therefore, Canadian firms can expect to receive the same treatment as firms from other countries in third markets.

<u>Repeal of the Widely Held Rule</u>[112]

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[111] Finance Canada, News Releases, "Backgrounder on Foreign Bank Entry Bill", p.4.

[112] The widely-held rule was discussed above on p.13. See also footnote #31 same page.

Foreign access to the Canadian financial services sector has improved as a result of the NAFTA and the GATS. The WTO Agreement Implementation Act removed long-standing limitations on non-Canadian ownership of federally regulated financial institutions, lifted a market share limitation on foreign banks, and extended NAFTA thresholds for investment review and control to all WTO members. Under new Canadian financial legislation, the widely held rule has been liberalized, but not eliminated. For financial institutions with $5 billion or more in equity, there is now a new definition of widely held that permits an investor to own up to 20 per cent of any class of voting shares and 30 per cent of any class of non-voting shares. These rules are subject also to a "fit and proper" test designed to evaluate the applicant's character and suitability. This would allow these institutions to enter into substantial share exchanges, including the ability to enter into strategic alliances and joint ventures. The new rules essentially subject banks to different ownership rules based on the size of the institution. The policy reason behind the maintenance of the "widely-held" rule in Canada is that it avoids potential conflict of interest problems and maintains public confidence in the system. Essentially restricting foreign interests from the deposits of Canadians protects them from being subject to risks in non-financial, commercial corporations, and hence, conflicts of interest.[113]

Arguments in favor of repealing the rule suggest that Canadian banks do not need protection from international competition because the domestic Canadian banking market is small, mature, over-banked, with strong customer relationships. Further, foreign financial institutions have found it difficult to establish profitable operations in the retail banking market in Canada. They thus tend to focus on niche markets like credit cards and business lending. Canada's banks are also linked to the natural resources and energy sectors, like the rest of our economy, so economic swings in these sectors affect banking too.[114] Maintaining the widely held rule may enable Canada to hold onto important bargaining leverage for future liberalizing initiatives in financial services and insulate it from the cycles of the resource economy.

Some argue that Canada should shed its institutional approach to regulating foreign financial firms and allow them to operate unregulated with no prudential concerns.[115] Where concerns do exist they argue that regulation should be applied on a purely 'functional' basis in line with their specific financial activity. In my view this is unacceptable because it is unrealistic in any country's financial regulatory regime. Members of the WTO are currently engaging in the Doha Round of services negotiations and no country currently allows FSP's to operate unregulated. Once you open the doors to let FSP's unregulated, de jure, you are bound by law and dispute settlement. You can not retract these obligations. It is currently better to offer de

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[113] Kuchta, Alison, R., "An Overview of the Bank Act", *The Advocate*, 52, 1, January 1994, 29.

[114] Gouvin, Eric, J., "The Political Economy of Canada's "Widely Held" Rule for Large Banks", *Law and Policy in International Business*, 32, 2, (2001), 8.

[115] For example see Owens, Richard, C., and Guthrie, Neil, "Foreign Banks and the Business of Banking: Reforming Canada's Foreign Bank Access Regime for the Global Marketplace", *Banking and Finance Law Review*, 13, 3, (August 1998), 383.

facto access on a case-by-case basis and apply regulation on a functional basis - as is currently the regime in Canada. I agree with Edward Neufeld who argues: “There is every good economic reason to make access to the market by new entrants as easy as prudence permits. But making them too easy simply leads to future bankruptcies and, ... a charge on the public treasury or the deposit insurance fund.”[116]

[116] Neufeld, Edward, P., “What Kind of a Financial System Do Canadians Want?”, *Discussion Paper Series* #1, School of Policy Studies, Queen’s University. (2000), 37.

Most recently, John Chant has argued for a solution which takes the 'middle road' between full competition and protectionism regarding foreign banks in Canada. Chant argues for a mutual reciprocity regime where retail branching is allowed and mutual agreements exist between countries with respect to prudential concerns and home-country regulation.[117] The first problem with this proposal has already been discussed: Canada already has an over-banked retail banking market where foreign banks are not banging down the doors to enter the segment. Furthermore Canadian banks already have the option, and are, expanding abroad as desired. Second, universal reciprocity through most-favored nation treatment is already being developed through the WTO's FSA, currently under negotiation between all Members. The benefit of the WTO system in this respect is that it in fact moves slowly. Governments are choosing to maintain sure control of banking regulations and are proceeding prudentially with respect to liberalization - especially with respect to cross-border banking. Commercial presence is now largely allowable in the commercial banking segment where big banks want to expand, and this seems to be acceptable by most countries from a prudential point of view. In Canada, the uncertainty surrounding the policy framework dealing with foreign financial institutions seems to be a reflection of the lack of vision about how the legislation should meet the challenges of the future.

Conclusions

Efforts to deregulate and liberalize regulations in financial services rest on a number of unique considerations. They can place the social and prudential interests of the government against those of competition-minded industry and other countries. The special treatment given to financial services reflects the need for financial suppliers to have right of establishment rather than just freedom of trade in order to serve customers in other countries. The Canada-US FTA represented an effort to reduce or eliminate obstacles to trade between the two economies to create a single market in which there would be a free flow of goods and services. In the FTA, however, increasing market access in financial services was not a major concern because the close integration of the Canadian and US financial systems meant that most benefits from freedom to trade had already been realized.[118]

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[117] Chant, John, F., "Main Street or Bay Street: The Only Choices?", *Commentary Paper* # 153 ('The Banking Papers'), (Toronto, C.D. Howe Institute, 2001), 22.

[118] Chant, John, *Free Trade in the Financial Sector*, 1.

The FTA's importance was more significant for maintaining existing market access and Canada's longer- term economic interests. If the FTA had not been signed, Canada might have been a divided and heavily indebted country facing the prospect of entering into international trade negotiations on trade in financial services in a weakened state.[119] The current progress of Canada in financial services in the WTO can also be traced back to the success of the FTA negotiations and results. The increased expansion of Canadian firms into the US would not have been possible without the success of the FTA (e.g., TD overtaking Waterhouse). Glass-Steagall has now been repealed and Canadian banks have been expanding their opportunities in the US building on the original success of the FTA. Today Canadian bankers will underestimate the benefits of the FTA financial services agreement, but the reality is that they are now major players in the US and always quote their share of the US market in stating the success of their business.[120]

During the negotiations leading up to the NAFTA, the basic principles surrounding free trade in financial services and services more generally were still just developing. The FTA approach to trade in the financial sector, therefore would have been awkward for any agreement designed to extend beyond two countries to embrace other countries. Hence, NAFTA chapter 14 on financial services went well beyond specific concerns that might have arisen in Canada-US-Mexico negotiations and established a framework for dealing with a range of issues that could arise in future multilateral negotiations. Canada and the US each expressed concerns about the difficulties surrounding their fundamentally different approaches to prudential regulation in the financial sector. While NAFTA was designed to enhance competition, beyond a certain level it could have also resulted in less systemic stability, so much of the existing domestic banking regulation untouched by NAFTA is designed to control competition. Therefore, the NAFTA financial services provisions regulate activities across borders, and in some ways also serve to reinforce the idea of the nation state.[121] In broader terms, the NAFTA was still seen as a significant achievement based on the idea that if it were not for the success of NAFTA, the WTO Uruguay Round itself would not have happened.[122]

While some of the most important issues surrounding the liberalization of trade in services are still being heavily debated, the successful completion of the financial services agreement in the WTO can be viewed as a major success. The most contentious issue still being debated is domestic regulation, one that goes to the heart of the ability of a government to regulate it's economy as it sees fit. For Canada, the WTO financial services agreement meant a

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[119] MacIntosh, R., *Different Drummers: Banking and Politics in Canada*, 283.

[120] Personal interview, March 2002.

[121] Gouvin, Eric, J., "Cross-Border Bank Branching under the NAFTA: Public Choice and the Law of Corporate Groups", *Connecticut Journal of International Law*, 13, 21, (Spring 1999), 302.

[122] In financial services, NAFTA's success fueled a number of other regional efforts in to liberalize banking services. See Schefer, *International Trade in Financial Services: The NAFTA Provisions*, 393.

committing to the liberalization it had made at the domestic level up to that point. This included a relaxation of the widely-held rule on foreign ownership aside from the big banks, the 12 per cent asset ceiling on foreign participation, and Ministerial approvals. The changes brought Canada's policies in these regards more in line with what was found in other advanced countries. The most recent financial sector reforms dealing with foreign financial institutions have gone even farther by allowing foreign bank branching, albeit with conditions applied. Finally, the widely-held rule still applies to foreign ownership of Canada's biggest banks. Critics of the rule argue that such protectionism is no longer appropriate or needed, yet most countries still have rules in place to prevent their largest financial institutions from falling into foreign hands. For now this rule keeps the financial institutions focused on the 'national interest' and represents some bargaining leverage in the ongoing negotiations in services at the WTO.