jei JOURNAL OF ECONOMIC ISSUES
Vol. XXVIII No. 2 June 1994

The Impact of the North American Free Trade Agreement on Commercial Banking

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This paper examines the effect of the North American Free Trade Agreement (NAFTA) on commercial banking by comparing the banking systems of the United States, Canada, and Mexico and the consequences of the NAFTA treaty on these systems. It will also compare the provisions of NAFTA dealing with commercial banking to provisions of the existing U.S.-Canada Free Trade Agreement in this area.

The United States banking industry is diverse and fragmented with side-by-side federal and state chartering and supervision. Two important pieces of legislation that distinguish U.S. banks from those in Canada and Mexico are the McFadden Act, which prohibits interstate branching, and the Glass-Steagall Act of 1933, which separates commercial from investment banking. At the present time, there is a relaxation in the enforcement of provisions of these acts by various regulatory agencies but not outright repeal.

Aside from its regulatory functions, the main duties of the Federal Reserve System (FED) are the control of monetary policy and maintenance of the nationwide check collection system. The FED uses changes in reserve requirements, changes in discount

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rates, and, most importantly, open market operations in order to implement monetary policy.

While not under total control of the Federal Reserve, the Federal Funds market and rate play an important role in U.S. monetary policy. The Federal Reserve uses this rate as a target and an indicator in its open market operations.

Foreign banks in the United States. The International Banking Act (IBA) of 1978 brought the domestic agencies, branches, and commercial lending affiliates of foreign-owned banks under federal supervision and regulation. Foreign banks also have to obey branching prohibitions similar to those of the McFadden Act and have essentially the same privileges and restrictions as do U.S. banks.

The Canadian Commercial Banking System is characterized by a few very large banks and a number of smaller ones. Nationwide branching is permitted, and the federal government has almost complete regulatory control of the commercial banking system. The shares of Schedule A banks (the largest domestic banks) are widely held–no investor can own more than 10 percent, and no group of nonresident investors can own more than 25 percent of the shares. Since 1987, banks have been allowed to underwrite and distribute corporate securities, underwrite and distribute debt issues of Canadian government and Crown corporations, and invest their surplus funds in government and corporate securities.

The Office of the Superintendent of Financial Institutions is responsible for supervising the soundness of *all* federally chartered financial institutions. Because commercial banking regulation is a federal responsibility in Canada, there are fewer regulatory authorities, regulatory coordination is easier to achieve, and banks cannot change their regulatory environment by changing their charters.

The Bank of Canada uses open market operations to influence short-term interest rates and exchange rates [Joyce 1989]. Transfers of government deposits between the Bank of Canada and the chartered banks have become the most important method of changing the reserve position of the chartered banks. The concentrated nature of the banking system means that this method of reserve control can be used rather easily.

The bank rate (the interest rate for advances to banks) is a market-determined penalty rate. At the present time, it is allowed to float at one-quarter of 1 percent above treasury bill rate.

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In June 1992, four new pieces of legislation governing financial institutions were implemented. Commercial banks will now be allowed to enter the trust and insurance business and own a substantial investment in an expanded list of businesses. These acts also immediately eliminated secondary reserves and initiated the phasing out of primary reserves over a two-year period. By 1994, commercial banks will only be required to maintain sufficient amounts on deposit with the Bank of Canada to cover their daily check clearings. When the funds in these accounts are insufficient to cover the daily clearing balances, the additional funds can be raised in the overnight financial market (analogous in the United States to the Federal Funds market) or by an overdraft loan from the Bank of Canada at the prevailing bank rate (U.S. discounts and discount rate). The necessity for a positive daily balance will result in an increase in the importance of the Bank of Canada rate as some banks may have to borrow constantly in order to cover their outstanding checks (this will be especially true right after these changes occur, since banks will be experimenting with how much they need to keep in order to cover their daily clearings).

Political pressures do not seem as important in influencing monetary policy as in the United States [Binhammer 1988]. Since the early 1980s, the Bank of Canada has used a wide variety of economic indicators to aid in the formulation of its monetary policy. One goal that does seem to be more important in Canada than in the United States is foreign exchange stability, especially with respect to the U.S. dollar [Boreham 1987; Joyce 1988].

Foreign banks in Canada. The 1980 Bank Act permitted foreign banks to operate subsidiaries in Canada as a special class of banks (Schedule B banks). These banks can be closely held, but their combined domestic assets cannot exceed 16 percent of the total domestic assets of the Canadian banking system. Their size is controlled through regulatory guaranteed approval of their capital bases, and their right to establish branches is not automatic [*Industry, Science & Technology Canada* 1988].

Summary and Comparison. In general, the Canadian banking industry is characterized by federal control of banking, few banking firms with many branches, and fewer regulatory levels with more coordination than the American banking industry. The U.S. authorities apply the same set of regulation to foreign-controlled banks as they do to domestically controlled ones, but foreign-con-

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trolled banks in Canada are relegated to special status and limited in growth.

The Bank of Canada uses the deposit and withdrawal of government funds, rather than open market operations, as a means of controlling availability of funds in the banking system [Toronto Dominion Bank 1992]. The bank rate is much more a market rate of interest than is the discount rate. Among its policy goals, the Bank of Canada also seems to put a higher priority on exchange rate stabilization than does the Federal Reserve.

The Free Trade Agreement. Under the FTA, the United States will now permit both Canadian and non-Canadian banks to underwrite Canadian governmental securities in the United States. Canadian-controlled institutions will be accorded the same treatment as U.S. institutions with respect to any future amendments to the Glass-Steagall Act.

Canada agreed not to restrict U.S. ownership of various financial institutions. U.S. subsidiaries are to be exempted from the Bank Act provisions that restrict total foreign-controlled bank assets in Canada to 16 percent of total bank assets and other restrictions on Schedule B banks. U.S.-controlled subsidiaries will be able to open branches without having to apply to the Minister of Finance. These banks will also be able, subject to normal prudence, to transfer loans to their parent companies. Canada also agrees not to use its review powers in a manner inconsistent with the agreement.

Both countries agree to continue to provide financial institutions of the other with the rights and privileges they now enjoy subject to normal regulatory considerations. Each country will consult with the other as they continue to liberalize rules governing the banking industry and extending the benefits to the others' institutions [Toronto Dominion Bank 1988].

Basically, the Free Trade Agreement confirms the status quo for Canadian banks in the United States and guarantees their future equal treatment with U.S. banks, while opening the Canadian market for U.S. banks. Since the Canadian financial services industry is less restrictive in many areas, U.S. banks will gain access to a rapidly deregulating market and have a wider range of operations in Canada than in the United States. This could lead to increased pressure for more deregulation in the United States. U.S. banks might be able to use their Canadian subsidiaries to circumvent provisions of Glass-Steagall and other regulatory statues. The

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1992 Canadian banking acts, which continue the liberalization of the regulation of the Canadian banking system and reduce reserve requirements, will make Canada even more attractive to U.S. banks. Contrary to some of the concerns expressed when the FTA was enacted [Peters 1988], Canadian banks are expanding into the United States more than the reverse because they are following their customers to the United States; they have reached expansion limits at home; and they are in better financial condition than U.S. banks [Farnsworth 1992]. This situation could change dramatically when the U.S. economy improves and U.S. banks realize that whole new areas of business will be open to them in Canada under the 1992 banking acts.

Mexican banking industry. The past decade has been one of great change in the Mexican banking industry. In 1982, the banks in Mexico were nationalized. Citibank, the only foreign bank allowed to have commercial operations in Mexico, was not affected by this nationalization. The government was then able to increase the amount of financing supplied by the banking system by increasing the level of required reserves. These required reserves were held in the form of nonmarketable, one-year government bonds that paid below market interest rates. Banks were also subject to interest rate ceilings and forced lending at below market rates [Skiles 1991; Hufbauer and Schott 1992].

By April 1991, interest rate controls and forced lending requirements were lifted on all bank deposits. In addition, banks were to be privatized, and banks, brokerage firms, and insurance companies were given the right to form integrated financial groups.

The growth of off-balance sheet instruments in the 1980s had implications for stability since these instruments were not subject to control by the monetary authorities. The banking reforms of the early 1990s, which led to reintermediation of savings, has allowed the monetary authorities to use open market operations, rather than reserve requirements, as their main monetary instrument [Skiles 1991].

Foreign banks in Mexico. From 1982 to 1989, Citibank was the only foreign bank allowed to operate in Mexico. In 1990, a system that divided bank equity into A, B, and C shares was instituted. Foreigners could only own "C" shares, which were limited to 30 percent of the bank's total equity [Karnin 1992]. In another restriction, similar to that on schedule A, Canadian banks, in-

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dividuals, and single companies, both foreign and Mexican, were limited to owning only 5 percent of any bank [Karnin 1992]. Foreign bank subsidiaries operating in Mexico were prohibited from offering services to Mexican citizens. In light of these restrictions, few foreign banks have entered Mexico.

Proposed Changes under NAFTA

In essence, NAFTA will build on the existing Free Trade Agreement between Canada and the United States. The existing provisions of the FTA will not be changed. NAFTA will allow Mexican banks into the United States (a right they have under existing legislation) and will extend the benefits that U.S. banks obtained from Canadian authorities to Mexican banks. Specifically, Mexican investors will be allowed to establish subsidiary institutions that will be exempt from existing restrictive ownership rules and will not need permission from the Canadian Ministry of Finance to open additional branches. However, banks from non-NAFTA countries with operations in the United States or Mexico cannot use NAFTA to avoid Canadian ownership restrictions [Jordan 1993]. NAFTA would allow U.S. and Canadian investors to own 100 percent of Mexican banks, subject to the restriction that no more than 8 percent of the entire Mexican banking industry is owned by foreigners within the first year after NAFTA is signed. This 8 percent limit would be raised 1 percent per year, each year for seven years, at which time the limit would be completely removed. For the first four years after the limit is removed, Mexico would reserve the right to freeze U.S. and Canadian investment if it reached 25 percent of the Mexican banking industry. This 25 percent freeze could only last three years. Any further restrictions beyond this transition period would require the approval of U.S. and Canadian officials.

Individual investors are limited to only 1.5 percent of the market during the transition period. After the transition period has ended, individual investors would still be limited to 4 percent of the market share if the 4 percent was achieved by acquiring Mexican banks. This stipulation was designed to protect Mexico's largest banks from foreign takeover. Individual investors from Canada and the United States could expand beyond this 4 percent limit, but only through internal growth.

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Under the agreement, U.S. and Canadian subsidiaries in Mexico would receive national treatment and therefore be allowed to provide all the services that Mexican banks provide. U.S. and Canadian banks operating outside Mexico would still be restricted to providing "offshore" services only [Karnin 1992].

Canadian banks are also using NAFTA to press for relaxation of the U.S. prohibition on interstate banking. In Article 1403, Canada will consider permitting direct cross-border branching of commercial banks into Canada (wanted by U.S. banks) only when the United States permits interstate branching.

Prospects and Predictions

The extent of the movement of U.S. and Canadian banks into Mexico will depend on several factors. One is the health of the financial sector in the home country. At the present time, U.S. banks are consolidating operations in response to large outstanding loans and higher capital requirements and are not likely to expand rapidly into the Mexican market. If, however, U.S. and Canadian businesses moved into Mexico, then their banks would probably follow them there. When U.S. and Canadian banks move into Mexico, it is anticipated that they will "offer first world efficiencies to millions of Mexicans" who have been deprived of credit because of the cartel-like operations of the existing Mexican banks [*Wallstreet Journal* 1993, C12].

Cally Jordan [1992] feels that Canadian banks will especially do well in Mexico since they have more experience in a completely federally supervised system. There are also no Glass-Steagall barriers to entry by Canadian bank-owned security dealers, and no McFadden Act limits on nationwide branching and a potential for enormous growth in retail banking.

In the United States, banks will continue to ask for less regulation and broadened powers in order to compete with Canadian banks in Canada and Mexico. It is anticipated that the separation of investment banking from commercial banking provisions of Glass-Steagall will be a target of the banking industry since these prohibitions do not exist in either Mexico or Canada. U.S. and Canadian businesses will benefit since they will be able to continue their existing banking arrangements when they move to Mexico. U.S., Mexican, and Canadian banks will benefit since new markets will open up to them. Last but not least, the Mexican con-

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sumer and small business owner could benefit since the present Mexican banking system has concentrated on making loans to the wealthy or to highly rated corporations.

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