
by

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How Global/Regional Trade Agreements Have Intensified a Competitive Rivalry Among Financial Firms Operating in the Global Economy Based on the Differences Between Domestic Regulatory Frameworks.

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Abstract
I seek to examine the dynamic interconnection between a range of disparate regulatory interventions that influence and/or constrain the strategic positioning of financial firms, which may also possibly give rise to a competitive strategy used by national banks that may be accessory to the creation of anti-competitive practices, albeit justified in the name of macroeconomic prudence and supervision. I illustrate these complexities in the case of Canada. In turn, I concluded that the gains from the liberalisation of national banking sectors are only realised if policy interventions are left untouched. In this sense, the process of liberalisation involves reaching a consensus on where to draw the line between regulations that are barriers to trade and regulations that are necessary for prudential purposes.
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INTRODUCTION

The globalisation of the financial services sector manifested in the trend towards national and cross border mergers and acquisitions in recent decades, has magnified concerns regarding market concentration and intensified the differences among nations in openness to foreign take-overs. Subsequently, the requisite to achieve economies of scope, scale, and learning has altered the historical segmentation of the financial services industry resulting in increased competition between and among financial centres on the basis of synergies of skills and infrastructure, thereby also accelerating an important source of conflict among state and corporate interests.

In the present, financial firms in different countries competing in various markets must match their (national and international) competitors in terms of the cost and access to capital, and the ability to exploit financing bargains. However, the opportunities for such gains are distorted in national market structures by various controls on; credit, exchange market transactions, information disclosure, tax and accounting regimes, limits on forms of foreign commercial presence and scale of

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1 While the jury is still out over whether size brings increased profitability, research conducted by The Banker shows that an increasing number of banks have more of their assets based overseas. In short, more banks are becoming more global. In their list of the top 50 global banks, 17 banks stated they have more than 50% of their assets based abroad; this compares with only 12 banks in their survey last year. Similarly, 42 banks have more than 30% of their assets abroad compared to 37 banks the previous year. The top global banks remain largely the same, Standard Chartered Bank, the United Kingdom (U.K.) institution that has most of its business in Asia and the Middle East (74%), was ousted from top slot this year by American Express Bank (80%). They are just ahead of Credit Suisse Group and the other two big Swiss banks. Meanwhile, two giants, the U.K. based HSBC Holdings and the United States (U.S.) based Citicorp, increased their global ratio to 65% and 63% respectively, while increasing their staff based overseas significantly to 65% and 58%. Also, it is worth noting that 70% of Citicorp's income came from outside the U.S., the highest level of non-domestic income for one of the world's biggest banks. Stephen Timewell "Going Global" The Banker (February 1999) p. 37.

2 Economies achieved by a firm that is large enough to engage efficiently in multi-product production and associated large-scale distribution, advertising, and purchasing.
operations, and via federal ownership restrictions, which in one way or another are all an institutional effort by nation-states to maintain their safeguards on macroeconomic prudence and supervision in the national banking industry. Accordingly, in the context that I have described, particularly in the pursuit of financial stability, central bankers and other regulators must increasingly recognise the international dimension of their efforts which seek to promote the health of financial institutions, financial markets, and the infrastructure (legal, payments systems etc) which supports them. Henceforth, this international dimension affects the nature of the prudential policies adopted as well as the processes through which they are agreed.

In this regard, the premise of this paper is two-fold. First, I seek to examine the contentious dynamic interconnection between a range of disparate regulatory interventions that influence and/or constrain the strategic positioning of financial firms, which may also possibly give rise to a competitive strategy used by national banks that may be accessory to the creation of anti-competitive practices, albeit justified in the name of macroeconomic prudence and supervision. Second, how global/regional trade agreements have intensified the friction between these rationales of national ownership, macroeconomic prudence and supervision, and financial restructuring manifested in

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3 A reduction of average total costs resulting from an expansion in the scale of a firm's operations so that more of all inputs are being used.

4 For example, the lack of progress to dismantle barriers to the free flow of financial services among nations is exemplified in all countries, I attempt to explain that while the linkages between markets are increasing, the changes are by no means uniform – the global financial system exhibits widely varying degrees of integration between various 'sets' of market models. Competition in domestic/local markets served by one or a few financial service firms differs in the degree of competition between financial firms operating in international markets.

5 Internationally integrated capital markets provide new freedom but also new limitations and policy complications. In this light, it should be recognised that monetary policy and financial stability are two sides of the same coin – in which domestic interest rates and asset prices become increasingly determined by international developments, rather than solely by domestic factors. Argued by William R. White in "Evolving International Financial Markets: Some Implications for Central
national banking sectors. And as a result, facilitated a competitive rivalry among financial firms operating in the global economy which seek to escape the boundaries imposed by national regulatory frameworks – thereby also generating a fierce antagonism between national banking regulators (ions).

Consequently, the new era of multilateral negotiations is shifting away from trade instruments and practices (border barriers such as tariffs) to a whole set of microeconomic measures and regulatory practices seen as validating market access barriers, leading to market distortions in global trade and investment flows, and more specifically, consolidating an unlevelled ‘playing field’ among financial corporations functioning in the international/global arena. This interrelationship between diverse renditions of national policies and laws, as having generated manifold 'constructions' of competitiveness, has suggested the need for governments to address differences in approaches to competition, and facilitate broader domestic regulatory reform, as expressed in global and regional trade agreements governing financial services trade.

However, although international trade regulation has historically acknowledged the retraction of market access through substantial policy autonomy in the formulation of domestic prudential regulations and related policies, like competition laws, today's era of; deregulated capital and factor markets, transformation in the structure of domestic/global production facilitating changes in the composition of world trade and investment and in the nature of technological innovation, has exacerbated the problematiques posed by divergent national policy styles regarding prudential concerns, market structure, and corporate conduct in the banking industry.

Henceforth, in the case of Canada, a reconfigured competitive economic rivalry operating simultaneously in both the domestic and global market, has (re) defined the strategic interaction

among the national banking industry and the Canadian government, and among national and foreign financial houses and respective governments', culminating in the restructuring of the conceptual and institutional characteristics which privilege the banking sector to the raison d'être of the Canadian nation-state.

Subsequently, these structural changes in production and organisational capacity, in tandem with, the inclusion of financial services into global trade agreements, have come to problematise Canada's ability to unilaterally administer regulations that are imperative for prudential rationales and financial stability, and policies that advance private barriers to entry. Thus in the present, Canada's intent in formulating laws and policies regarding prudential regulation, market structure, and corporate conduct in the banking industry has increasingly become conditioned by international policy co-ordination. Correspondingly, Canadian chartered banks have begun to (re) define corporate strategies amidst increased domestic and foreign competition and have proceeded to expand their operations on a more global scale.

I delineate my hypothesis in the context of the Canadian banking industry, in which the functional importance of finance has resulted in the justification of restricted market access, impelled by the maintenance of macroeconomic prudence and supervision, providing exemptions for banking conglomerates to wield market power and monopolise domestic competitiveness, legitimated by the effort to retain the industry under national ownership and federal control.  

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6 I delineate my hypothesis specifically to the banking sector in Canada, because it has traditionally faced more restrictions on how it can organise and conduct its activities than most other financial sub-sectors, which may be controlled by provincial charters. Chartered Banks (Schedule I) in Canada are exclusively managed and supervised by a federal regime which maintains the industry under primarily Canadian control through restrictions on ownership, structure, and business powers. In turn, I argue that this sector specifically has been able to abuse its market power through its concentrated economic power and domination in domestic competition. Less regulated sectors, like the insurance industry, naturally have more foreign competitors, and less domestic market share.
I conclude that in an environment where international trade among financial services is managed in a discriminatory manner, in which, market access is contingent upon state provisions that guarantee effective and equitable competitive opportunities to foreign entrants, in return for, reciprocal market access opportunities in foreign markets, middle sized powers like Canada who are dependent on the global market, will be forced to (re) evaluate their prudential regulations in favour of greater regulatory flexibility and transparency, in order to secure their access to foreign capital and penetration in foreign markets. In this light, I project that there will be an inevitable dichotomy between government obligations intended to secure financial stability, and rent-seeking banking interests seeking to exploit the gains from trade in international/global markets, and potentially multiplying their market/asset share. 

Correspondingly, in the 21st century we will witness a tug-of-war between (re) articulated political power and (re) configured economic power. Ubiquitously, at every institutional level of governance, there will be a dialectical interface between 'competitive governments' and 'competitive markets.'

In turn, the dynamics of the global trading system may be implicitly endangered by the problematiques I have posed.

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8 This statement refers to the public sectors' deliberate attempt to encourage the expansion of cross border competition albeit not compromising financial stability and recognising the significance of economic externalities, and conversely, the attempt by private sector agents to facilitate the conduct of cross border financial transactions albeit as shaped by self-interest. How this difference of leadership will be reconciled will be difficult since agreements to facilitate (private) cross border business takes place within the framework of domestic (public) legal systems. Thus, conscious efforts to expand international competition must recognise the transitional costs that may be imposed on domestic financial institutions, and, measures to ensure systemic stability must not do so at the price of excessively constraining competition in the private sector. The process and substance which will
HISTORICAL OVERVIEW

THE POLITICAL ECONOMY OF FINANCIAL RESTRUCTURING

The globalisation of financial markets in the last three decades has brought into being a very different kind of financial order from that planned for at Bretton Woods. The internationalisation of markets has brought about the free movement of capital and factor markets, and subsequently transformed the nature of trade and investment flows. This phenomenon has also re-evaluated relationship dimensions between financial firms and their home nation-states and their interaction with similar players at the global level. There are many ideologically varied explanations for the financial liberalisation trend, but for the purpose of my argument I relate the trend to two interrelated phenomena; first, the growing transnationalisation of business, particularly the internationalisation of production facilitated by the growth of multinational corporations (MNCs), and their subsequent guide these deliberations (within nation-states and between them) will prove crucial to whether they are successful or not.

9 The Bretton Woods conference in 1944 hoped to re-establish an open world economy via extensive capital control regimes which built an international economic order in which finance was the 'servant' not the 'master' of society. Thus Bretton Woods constructed a socially 'embedded' international financial order, that sought to minimise the socially disruptive influence of speculative and 'disequilibrating' capital movements on exchange rates and trading patterns. Equally important, capital controls would help to protect the policy autonomy of the institution which was seen as central in promoting social stability in the post-war world: these were the characteristics of the Keynesian welfare state. In Eric Helleiner "Great Transformations" A Polanyian Perspective on the Contemporary Global Financial Order" Studies in Political Economy A Socialist Review No. 48 (Autumn 1995) p. 152. In 1971, the collapse of the Bretton Woods order, was replaced by a floating rate mechanism in which all currencies were to be priced continually by the market, while economic imbalances would generate corrective pressures on the foreign exchange rate. This mechanism obviated the need for capital market controls that restricted cross border transfers. This meant that users and providers of capital could look overseas for capital market opportunities that were superior to what was available at home. It also meant that interest rate and foreign exchange market volatility would be much greater in the new floating exchange rate environment than in the old fixed rate regime, leading ultimately to a greater expansion in trading activities, and hedging strategies by banks. This triggered the utility of offshore markets for financial services beyond the reach of national authorities, such as Eurocurrency and Eurobond markets which were untaxed and
influential power on political circles to dismantle domestic capital controls, and second, to the rise of multinational banks which became dominant players in the new financial markets by lending to MNCs (and to governments) on a dramatically enhanced scale. \(^{10}\) It is also important to note here that this lending was concentrated among exclusive financial centres (primarily New York, Chicago, and London – later Tokyo) which combined the right mixture of regulatory and fiscal conditions, together with political stability. \(^{11}\) In this light, the international competitiveness of financial firms was, and continues to be, very much contingent on the political power of the nation-state, and the protection it is able to provide to its financial firms amidst integrated financial markets and networks. \(^{12}\)

Respectively, there was a growing convergence between industrial and financial corporations and state institutions, in world markets. As international cross-border activity grew, the circumstance of 'preserved' expansion was inextricably linked to the deregulation of capital controls which became a central importance in international business and provided the conditions for the rapid unregulated. For further inquiry see Roy C. Smith and Ingo Walter *Global Banking* (New York: Oxford University Press 1997) p. 216.


\(^{11}\) Jones, *ibid.*, p. 189.

\(^{12}\) I illuminate this distinction because it is important in so far as it explains the future of financial service trade between the 'buyers' and the 'sellers' of financial products and services. Moreover, there is a powerful correlation between strong political power and influential economic power, both complement each other in a variety of ways. Less of both 'powers' will peg medium and small sized states to succumb to foreign pressures to modify policies in the financial sector towards less regulatory oversight. Most importantly, this power struggle has manifested itself at both levels, among the hierarchy of states and between political and economic interests at the national level, and reflects the polarised nature of global trade negotiations in the financial services sector that takes place in the 1990s. By this time, it is evident that economic and political 'markets' come to rival each other for power and influence, as both no longer possess coinciding interests.
rise of financial service trade. Therefore, the deregulation of capital and factor markets beginning in the early 1970s induced the financial liberalisation trend.  

However, it is important to note that the financial order which I have described has been actively 'made' by states, particularly through their decisions to dismantle the capital controls that had been established under the Bretton Woods order. 14 Once this decision was made among the power circles in the United States (U.S.) and Britain, other countries were prompted to follow their lead to prevent footloose financial business and capital from being lured away to the more attractive British and American market. The process that has come to be called the 'competitive deregulation dynamic' was underway, and was consolidated by the creation of technological developments, market forces, and accompanied ideologies. 15

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13 Throughout my paper I will argue that in the postwar order, a complementary interaction exists between economic power/sovereignty and political power/sovereignty, and thus on these grounds, it is important to note here that the trend towards financial liberalisation was specifically promoted by the U.S. and Britain as each would significantly gain from such a phenomenon. In particular, the U.S. officials recognised that mobile capital would be attractive to help finance the U.S. budget and current account deficits because of America's unique position as a safe haven for global investors, the international prominence of the dollar, and the depth and liquidity of U.S. financial markets. (Eric Helleiner "Great Transformations: A Polanyian Perspective on the Contemporary Global Financial Order" in Studies in Political Economy A Socialist Review No. 48 (Autumn 1995).

14 Helleiner, ibid., p. 152.

15 I would just like to reiterate that the trend towards greater integration of financial markets was and is not universal. Many less developed countries in response to foreign exchange crises brought about by their own external borrowing at attractive interest rates and by the frivolous lending of Western financial firms resulting in a recession, have seen their financial systems cut off from the world system by debt 'overhang.' Donald R. Lessard "Global Competition and Corporate Finance in the 1990s" in Lawrence H. Wortzel Strategic Management in the Global Economy (New York: John Wiley & Sons Inc. 1997) p. 435. Thus, the financial map of the world includes an increasingly integrated core with pockets of local differences due to domestic intervention, particularly the necessity of governments to maintain macroeconomic policies serving as prudential safeguards, and a large periphery of developing countries which, while dependent on the core's international market, are only loosely linked to it. Distinguishing between the 'participants' and the 'observers' in the liberal financial order illuminates the core's comparative advantage in the financial service sector, as institutionalised in the Plurilateral Financial Services Agreement in 1997 under the rubric of the World Trade Organisation.
THE GLOBALISATION OF THE FINANCIAL SERVICES INDUSTRY

Evidence of Growing Financial Integration

One indicator of growing international financial integration has been the sharp expansion in the scale of both gross and net capital flows between developed countries, and between developed and emerging markets. For example, balance-of-payments statistics indicate that net inflows into emerging economies rose from virtually zero in 1989 to reach $307 billion in 1996, before falling to about half that level in 1997 and 1998. Cross border transactions in bonds and equities for the G-7 (excluding the United Kingdom (U.K.)) rose from less than 10 per cent of gross domestic product (GDP) in emerging markets in 1980 to some 140 per cent in 1995. The growing size and scope of international financial markets is also evident in the results of a survey of foreign exchange and derivative markets conducted by twenty-six central banks in April 1995. Daily foreign exchange turnover in a month may amount to U.S. $ 1.2 trillion, while in the global derivatives markets average daily turnover amounts to U.S. $ 900 billion and of these trades more than half were between agents registered in different national jurisdictions.

Accordingly, increased international financial flows have been matched by a growing penetration of domestic markets by foreign financial institutions. There are over seven hundred foreign banks in the U.S. and over five hundred in the U.K., and many emerging economies (particularly in Latin America) are clearly moving to more openness in this regard.

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The globalisation of finance has revolutionised the nature of the financial services industry. The adoption and impact of new technology, and government deregulation in capital and factor markets, has led to an unprecedented amount of financial innovation bringing into existence a new range of financial instruments and products to facilitate international transactions. The culmination and interdependence of these changes have contributed to the growth of the financial services industry in scale, complexity, and importance over the last forty years.

The growth of international trade has stimulated the demand for trade finance products, such as foreign exchange management and borrowing and lending facilities in foreign countries and currencies. These financial instruments have been developed to allow both borrowers and lenders to obtain precisely the combination of return, risk, and liquidity that they desire. In response to these possibilities, the outstanding notional value of exchange-traded derivative instruments rose to $13.5 trillion by end-March 1998 and average daily turnover in foreign currency markets rose to $1.5 trillion by April 1998 according to the latest Bank for International Settlements (BIS) survey. With single firms operating worldwide and books being transferred across time zones, highly interdependent markets in many financial instruments now operate twenty-four hours a day. As a corollary to these developments, the volume of transactions in related systems for payments and settlements now amounts to over $10 trillion a day, with potential implications for systemic stability and thus a new source of concern for central banks.

It is important to note the reasons for this expansion because it is fundamental and not likely to be reversed or easily resisted. While the catalyst for the growth of international capital flows was

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21 ibid.. BIS, November 1998.
not solely the current account imbalances of the 1970s (including those associated with the OPEC (Organisation of Petroleum Exporting Countries) shocks), subsequent developments have been driven in large part by technological advances and reductions in communications costs. The fact that certain kinds of financial transactions have become both possible and cost-efficient has been a powerful engine feeding growth in demand for these products. Deregulation of the financial sector in both developed countries and emerging economies has also played an important role in supporting these trends. In large part, this has been a deliberate attempt to reap the efficiency gains of more open, liberalised financial markets. However, in some instances deregulation has also been a response to the reality that previous regulations were being circumvented in various ways.

**International Agreements**

International banking and finance involves two things: cross border financial transactions and associated payments, and the cross border establishment of premises. The explosion in both these types of activity has led to a need for international agreements on how the business of international finance and banking should be conducted. This internationalisation process has in turn (re) formulated the nature and scope of regulatory oversight with respects to prudential policies. Accordingly, a slew of international supervisory and regulatory regimes were established which worked to minimise the risk of financial crises 22 and the phenomenon of systemic risk within the new global markets. 23 These agreements have been enforced using domestic legislation or other means,

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22 For example, the recent Mexican crisis (1994) has led to a greater appreciation of the need to set *international standards* of best practices in general. While the East Asian crises (1997) has led to a recognition of the particular need for transparency on the part of all economic agents if international financial markets are to function effectively. Finally, and likely a by-product of both crises, there is a growing if still inadequate recognition that agreement on proper standards (including level of transparency) must be followed up by ensuring their proper implementation on a global scale.

23 Cooperation and coordination between home and host country supervisors is to ensure that prudential regulation, which refers to capital and other requirements designed to ensure the safety and
and have been extended to a wider international community only by force of example. This approach is referred to as 'international co-operation based on home country control'. However, an increasingly favoured approach is to foster harmonisation through 'model laws' or 'model statutory provisions' although given the structural differences among nations this has had relatively little success, and thus are only suggested for adoption by national legislators. These model rules are today prepared almost exclusively by permanent bodies or international organisations entrusted with the task.

International agreements in the area of banking and finance are the natural by-product of the dismantling of quantitative restrictions on domestic financial markets and international capital flows. They seem to have one of three purposes. First, they may serve to facilitate the conduct of cross-border business. In this category one finds agreements on technical standards, standardised soundness of financial institutions, and supervision which involves ensuring that such requirements are adhered to by financial institutions operating on an international scale. This is important because the consequences of lax regulation and weak supervision within a particular country can have an impact far beyond that nation's borders. The problems with one bank can be transmitted to unrelated banks, both within and beyond a single country. Systemic risk refers to the chain reaction of problems that could be triggered through imitative runs as depositors lose confidence in a banking system, through default on domestic or international payment systems. Thus, problems in a country's financial sector can also affect the real economy, both domestically and internationally, through declines in output and shifts in trade flows. Sydney J. Key "Trade Liberalisation and Prudential Regulation: The International Framework for Financial Services" International Affairs. Institute for International Affairs, Vol 75 No 1 (January 1999) p. 68.


25 For a full description of initiatives in this area, see Gregor Heinrich "Fund Transfers, Payments and Payment Systems International Initiatives Towards Legal Harmonisation" (1996), obtained from the BIS in Basel, Switzerland June 2, 1999.

26 Technical standards allow the electronic exchange of messages, SWIFT, the Society for Worldwide Interbank Financial Telecommunications, under the umbrella of the International Standards Organisation has developed accepted standards for this in the banking industry.
contracts (master agreements), codes of conduct, harmonised accounting and disclosure standards, arrangements for cross border payment, netting and custodial services, and a wide range of legal conventions and agreements governing financial services in general. Second, international agreements may have as one of their objectives the deliberate expansion of cross-border competition in banking and finance. The General Agreement on Trade in Services (GATS) under the rubric of the World Trade Organisation (WTO), the Organisation for Economic Co-operation and Development (OECD) Codes of Liberalisation of Capital Movements and of Current Invisible Operations, the relevant European Union (EU) legislation, and the financial services clauses of the Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA) provide for the progressive liberalisation of capital flows and the provision of financial services on the basis of 'national treatment', and thus have drastically altered national legislation. Agreements reached by various standing committees which meet at the BIS, under the aegis of the Governors of the Group of Ten, have been particularly important in this regard. The Basle Committee on Banking Supervision is

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27 Instead of formally harmonising laws, contract agreements reduce potential legal conflicts by agreeing in advance to apply common principles, and avoid uncertainty about jurisdictional issues.
28 These codes commonly define 'best practice' in such areas as the financial resources of participants (their adequacy to support the risks being borne), policies and procedures related to transactions (control and compliance, valuation procedures, etc), relationships among participants (fair dealings, etc), the mechanisms of transactions (documentation, settlements of differences, etc) and acceptable standards (manipulation, bribes etc). These codes of conduct are voluntary and have no legal authority. Nevertheless, they establish a set of standards by which participants will be judged in the marketplace, potentially to their significant cost.
29 A complication with respect to international transactions is that the accounting standards used by the counterparty may differ from home country standards. For example, it is contended that the Anglo-American approach focuses on the substance of financial transactions, whereas the European approach puts more emphasis on the legal form of what is taking place. Disclosure of firm-specific information is seen as essential for the overall risk management procedures. More recently, the public sector has begun to encourage greater disclosure of both credit risk and market risk associated with trading activities in general, and off-balance sheet items in particular. Public sector involvement reflected the recognition that such trading might pose certain systemic risks, but it was also a
the best known of these committees. Finally, the Committee on Payment and Settlement Systems has in recent years helped establish policies designed to ensure the continued functioning of such systems even under duress.

(Re) regulation was operationalised through vehicles such as the BIS, The Basle Committee on Banking Supervision, and via diplomatic means by the finance ministers from the G-10 central banks which demanded that national central banks actively intervene in the unregulated financial order to protect businesses from unstable fluctuating business conditions and crises. In turn, the rationale for measures such as uniform capital adequacy regulations on international banks was an effort to create levelled competitive conditions between banks competing in the global market from different countries. However, such measures also indirectly (re) created a political and institutional space for a more extensive form of state intervention in the global financial order, albeit beyond a purely national basis. Thus, the conditions which favour such agreements emanate from a shared recognition of a common problem, some agreements on how the financial system should function, and how problems might be best addressed, and the continuing exercise of state power to make it happen. Regulatory regimes maintained at both the national and international level, became a way of preserving (yet consolidating) a vulnerable and precarious financial order.

response to the fact that there was a hesitancy on the part of individual private sector firms to be the first to disclose relevant information.

30 The recommendations suggested by BIS deal with minimum standards (in the areas of; transparency, use of information, safety nets, dealing with weak institutions, corporate governance, market access, legal framework, deep and liquid markets) and best practices like the Basle Risk-based Capital Accord, and the Code of Good Practice in Transparency in Monetary and Financial Policies, which is in process of being finalised in association with the International Monetary Fund (IMF) and suggests that there should be transparency with respects to the supervisors' mandate, the effectiveness of their powers, and their democratic accountability to other bodies, and the Core Principles for Effective Banking Supervision. However, these are all only informal agreements and do not create any obligations in international law.

31 Helleiner, ibid., p. 156.
These new rules permit banks under supervisory guidance to calculate their market risk capital changes according to one of two methods: a standardised measurement or an approach based on the results of internal models. However, there has been an increasingly growing mismatch between the way complex global firms organise themselves managerially with global risk management, and the legal entity structure through which they engage in business and are supervised.

PRESENT CHALLENGES

TECHNOLOGICAL CHANGES

The 1980s witnessed an unprecedented increase in the use of new technology and especially the widespread use of computers in the financial service sector. Improved information systems have relegated the instantaneous transfers of price sensitive information around the globe. Computers and the use of information technology on distribution channels have enabled the industry to store and analyse masses of information and produce new complex financial products and innovative technology-intensive services. For example, the proliferation of new financial derivative products such as swaps, futures, and options were created for the purpose of more secure risk management increasingly integral to stock market, exchange rate and interest rate volatility, critical to the requisites of integrated financial markets. Moreover, the deregulation of financial transactions and the deepening and diffusion of financial technology have fundamentally affected the relationship

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32 Pilbeam, ibid., p. 5.
33 The increasing volume of international transactions in financial markets has created complex infrastructures in many different areas of the financial industry: global financial information services such as Reuters, which underpin trading in the foreign exchange and international securities markets, which is complemented by the multinational web of banks and other institutions, which are linked by a series of communication networks operated by the financial institutions themselves.
between traditional suppliers of financial services – such as commercial and investment banks – and the users of these services such as industrial corporations and institutional investors.

Technology has also had a dramatic effect on the way in which banks conduct their businesses, in terms of process and dispense payments. For example, Automatic Telling Machines (ATMs) have reduced the need for cashiers, and the increased use of debit cards has dramatically reduced the cost of processing payments. Moreover, the use of sophisticated databases means that a diverse group of financial players not just retail banks, are able to target new services at the customer, particularly through electronic networks, hence requiring no physical presence in the country (ies) of operation.

Furthermore, improved communication capabilities have enabled firms to extend and delocate their products into more distant markets through the development of networks that seek to exploit country-specific productive assets within financial firms or corporate spaces, rather than to purchase key inputs in arms length spot markets. This tendency has altered the structure of world trade patterns (and subsequent investment flows) in that a greater percentage of traded service transactions are taking place within transnational industries and financing corporations than between firms and end users. International trade in the present is increasingly concentrated among production networks than between different domestic production systems.

In this context, technology has created a diversification of functions in the financial services industry among banks, insurance and trust companies, and brokerage/securities firms. Thereafter, creating a new landscape of competition and competitors in the provision and range of financial products and services in both the domestic and global market. However, the diversification of

functions and the increasing importance of technology to the financial services industry as a whole, has mutated the balance between fixed and variable costs and in so doing, made market (and asset) share an increasingly important issue, in both national and global markets. In which case, specifically in the present era, the rationalisation of business techniques are attained through national and cross-border mergers and acquisitions, thereby gradually resulting in the overall consolidation of the financial service industry.

**DEREGULATION**

No analysis of financial markets and institutions can be complete without an examination of the regulatory environment in which they operate. Not only does (de) regulation have an impact upon the performance and development of financial markets, state regulation itself, as I have tried to outline is often revised and adjusted in response to changes in production/organisational structures, technological innovation, market developments, new financial instruments, and the occasional financial crises or scandal. Government policies in the 1980s specifically among the G-10 countries were particularly favourable for the 'global' development of the financial service industry. The progressive expansion of the industry and the increased possibilities of instability have contributed to the formation of multiple international linkages, and networks, designed to maintain integrity and transparency in international financial markets. Deregulation means capital mobility and the increasing infiltration of international financial global networks/and firms on domestic financial systems/and firms, and ensued by privatisation programmes and a range of tax breaks for domestic financial institutions. The U.K. for example, introduced a range of tax breaks, personal equity plans, and privatisation programmes that benefited the financial sector through advice, consulting, and

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underwriting fees - and thus contributing to the relative attractiveness of the sector.\footnote{Pilbeam, \textit{ibid.}, p. 7.} However, this competitive deregulation dynamic primarily within the integrated core, \textit{only} presented the 'option' of entry to foreign banks into regulated domestic markets. A case in point, in spite of the fact that British and Japanese banks purchased several large American banks to expedite their entry into the American market, they remained tightly 'supervised' by national regulatory authorities.\footnote{Host-country regulatory authorities have retained powers under national law to reject applications for entry from a foreign bank for prudential reasons. Hence, although British and Japanese banks gained access to the American market, they were nevertheless subject to the \textit{Foreign Bank Supervision Enhancement Act} (1991), which states that the Federal Reserve Board is required to determine \textit{inter alia}, that a foreign bank seeking to establish an American branch is subject to 'comprehensive consolidated supervision' in the home country. \textit{See International Banking Act of 1978}, as amended in 1991, Section 7, 12 U.S.C 3105.} The penetration of national markets by foreign financial firms, particularly banks, was limited by national regulators who feared that the costs of deregulation would outweigh its benefits, and cause the burden of adjustment emanating from financial expansion and restructuring, to cause harmful spillover effects in the domestic economy.

\section*{CURRENT DILEMMAS}

\subsection*{RATIONALES FOR REGULATORY OVERSIGHT}

The maintenance of effective national regulation was seen as an important means not only to exert some degree of control over financial markets, but also as a means of preserving confidence and stability in the financial order. The interaction between states and financial markets was viewed as an institutional requisite securing prudential management. Such oversight was imperative to the political economy of a nation and to the overall structure of financial markets in terms of; a) financing the economy (domestic and global), b) supervising the role of domestic banks in monetary and payments
systems, c) managing the allocation of financial capital to its most productive use, and d) controlling the phenomenon of systemic risk which operates domestically as well as internationally. Notwithstanding, it is important to remember that the degree of national regulation and control varies greatly between countries due to different historical, cultural, social, economic, and political factors.

In this regard, objections to deregulation and market opening are premised on the fact that finance is special – because of the crucially important services it provides to a domestic economy and hence, should be controlled by domestic interests. More sophisticated foreign entrants, pursuing different objectives, could come to dominate the industry to the detriment of national objectives. In concrete terms, this reluctance is further merited by the experience of countries that have deregulated their financial markets, opened those markets to foreigners, and liberalised their capital accounts in the wrong sequence, and subsequently, have experienced banking and/or financial crises associated with such reforms and internationalisation. 38 One analysis of banking crises worldwide found that, in 18 of 25 cases studied, financial liberalisation had occurred some time in the previous five years. 39 In turn, striking a balance between financial market efficiency and economic stability is and will continue to be difficult. 40 The finale has been the (re) regulation and continuance of a plethora of regulatory controls, which emphasize the importance of domestically owned and controlled financial

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40 As demonstrated by the U.S. savings and loan crisis of the 1980s and its aftermath and by Japan's ongoing struggle to work out the banking crisis that began there in the early 1990s. The Asian economic and financial crisis in 1997-1998 and the associated currency turmoil have stimulated renewed concerns about the trade-off between economic stability and financial reform. Dobson and Jacquet, ibid., p. 9.
institutions. A case in point, few governments tolerate 100 percent foreign ownership of major domestic financial institutions. 41

Government intervention in financial markets is rationalised on the grounds of 'market failure': that is, left to itself, the market would produce a sub-optimal outcome. 42 The means by which governments intervene are classified into three types of interrelated state regulations: structural regulation (covering the different types of activities, products, and geographical boundaries within which a financial service can operate, prudential regulation (e.g. setting ratios to ensure that domestic institutions have sufficient capital to absorb possible losses, and sufficient liquidity to ensure they can meet their obligations), and investor protection (to protect investors, primarily domestic from mismanagement of funds, malpractice and fraud.) Although there are numerous types of regulations that fall under these classifications some of the key regulatory measures include: licensing requirements, disclosure requirements, deposit insurance, restrictions on activities, exposure limits, and various liquidity and capital requirements to ensure solvency. 43

The conclusion is that there is neither a general recipe nor a standard sequence for reform or internationalisation – market access to foreigners. It is evident that macroeconomic preconditions greatly influence the chances of successful adjustment: those economies with stable and realistic prices and prudent fiscal policies do better because the creditworthiness of potential borrowers is superior, and reform of the financial sector – to free up interest rates, reduce subsidisation of credit,

41 New Zealand is an exception; only one of its 18 banks is still domestically owned. All others are foreign owned.
42 Pilbeam, ibid., p. 366.
43 There are four instances of market failure in the financial sector that are frequently cited as requiring government intervention to correct. These four problems are referred to as the externalities problem, the problem of asymmetric information, the problem of moral hazard, and the principle-agent problem. For a more extensive elaboration on regulatory oversight view Pilbeam, ibid., p. 366-373.
and strengthen financial institutions and their supervision - are also necessary preconditions to easing restrictions on capital accounts. Financial firms operating on an international scale in this regard, are not nationless, but are in one form or another influenced by a variety of state policies. On that account, the benefits of foreign participation in the domestic market, in the form of access to foreign savings and technology transfer, may only be realised if macroeconomic preconditions exist, and if foreign participation is judiciously supervised. Illustrating further that there lies a correlation between economic and political power, as the twin tenets to state sovereignty.

A STRUCTURAL ENIGMA

ENDURING NATIONAL FOUNDATIONS
THE 'CONSTRUCTION' OF COMPETITIVENESS

"'Globalism' is an emblem that points at expanding market interconnections in the form of investment, financial networks, and trade." 44 Subsequently, national governments will find themselves constrained with few levers of influence, and pressed by common international market requirements, and thus national institutional structures will eventually converge. In turn, remaining differences between nation-states will be more stylistic than substantive. 45 In contrast to this prevailing discourse, I argue that today's global era should not be conceived as the progressive replacement of 'states' by 'markets', as I argue invariably throughout this paper, but that the two are and remain to be intertwined. Although in the same sense, I do believe that the possibilities for national governments to unilaterally influence the course of economic growth and (political and social) development have been (re) defined. Nevertheless, states have retained a central place in an

ever more interconnected market, but will be more constrained to shape prudent policy safeguards, especially if they serve to deny market access to foreign entrants.

Disparate state institutional forms, specifically in advanced industrialised countries are not collapsing, but are rather undergoing a common transition along distinct trajectories, as they collectively, yet competitively, seek to (re) articulate the objectives of state power as (re) enunciated in their influence on economic power. In a dialectical manner, the internationalisation of markets created by states (but explained as sole causes of innovation and information/communicative technologies) has redistributed their ‘monopoly’ on power, through miscellaneous international linkages and transnational social interactions, – thus structurally changing the political dynamics surrounding domestic regulatory policy-making in a variety of important ways.

First, in traded goods and service sectors, if one or more of a country’s major trading partners have adopted policies that substantially enhance the efficiency and innovative potential of a sector, counterpart sectors in the first country may have little option but to emulate these policies if they are not to lose international competitiveness on either the import or export sides. In this context, there will be a swelling claim by internationally oriented interests to problematise the states' ability to sustain rigid domestic regulatory regimes. In this regard, governments are not so much being squeezed out of the economy; rather their traditional ‘Westphalian’ points of leverage are being undermined, and are in desire of (re) configuration.

Debates concerning the role of the state in general, and its influence on firm competition in particular, have surfaced as a result of the dismantling of protectionist barriers (tariffs), the

45 Zysman, ibid., p. 157.
46 Zysman, ibid., p. 159.
integration of financial markets, and the surge of foreign direct investment (FDI) centered principally on capital and technology flows, bringing about an escalation in service trade, and in turn, unveiling a variety of government tactics that are composed within particular national institutional arrangements and supply bases and pose to constrain and/or direct the choices and decisions that are made in the domestic and or global marketplace. 49

In this context, the new arena of contention in international policy-making circles has moved beyond the border to domestic policies which either directly and/or indirectly protect and influence the competitive dynamics of firms,' thereby generating an unequal footing among MNCs involved in international/global competition. The concern voiced is that while liberal international trade policies remove public impediments (border measures like tariffs, and state subsidies) to foreign competition, such policies will leave unaddressed private restrictions on competition, including foreign competition. 50 In this respect, inadequately framed or enforced domestic competition laws are seen as impediments to the successful insertion of foreign firms into a domestic market, because they shape the nature of the domestic market structure, in terms of market access (vertical/horizontal restraints, quantitative restrictions), and market presence (inward FDI). This friction is further complicated in the banking sector, where a particular national market structure may be the result of a lax competition policy, or an (in) appropriately perceived competition analysis, and/or the creation of government barriers to entry which are disguised as prudentid safeguards. Consequently, in the banking sector it

48 Trebilcock, ibid., p. 57-8.
49 Domestic markets have come to be created through processes of social change and public regulation, and thus a firm's competitive strategy as conditioned by a nation-specific regulatory framework will be determined by the history and ideology embodied in those state institutions. Therefore, the historical/cultural/and ideological legacies in state institutions highlight the cross-national variations in the mix between markets and public planning in domestic resource allocation.
is difficult to identify and make lucid the exact influence of the state on a financial firms' competitiveness and ultimately affecting (positively and/or adversely) its market share.  

As Sylvia Ostry argues, this friction between divergent 'market models' stems from both historical and cultural legacies and domestic policies. Thus, the politics of trade in the 21st century will be about reconciling differently structured political economies that express different values. However, this will be most difficult in service industries in which the 'competitive edge' of firms is not determined by factor endowments, but 'created assets' (primarily in the form of human capital – the stock of knowledge, technology, organisational capacity, infrastructure, and governing policies) chartered by the state. As a result, these 'new issues' which define the 'new protectionism' have effectively replaced the 'invisible hand' of market forces and have come to violate the assumptions of free trade theory.

51 The problem is further complicated by the various modes of supply characteristics of service industries, which may be traded through the movement of money, people, or data.
52 Sylvia Ostry, Governments and Corporations in a Shrinking World: Trade and Innovation Policies in the United States, Europe and Japan (New York: Council on Foreign Relations 1990) p. 2. As I have stated previously, the institutional structure is a function of the country's distinct political and industrial development. For analytical reasons, the character and function of national institutions is evident in their history and social arrangements which shape and determine the form of national markets. It is for this reason that national competition policy objectives, once articulated at the global level, become internationally nuanced and culturally distinctive. These differences which are endemic and generic vary widely in terms of economic rationales, legal forms, principles, and institutional context, which reflects the distinct and conflicting national attitudes towards cartels, mergers, and state monopolies etc.
SEARCHING FOR CONTESTABLE MARKETS: THE CONTENTION WITH COMPETITION POLICY & CURRENT HARMONISATION ATTEMPTS

As I have profiled, domestic policies have become elements to be reckoned with in the pursuit of improved access to markets or, more generally, in the establishment of markets which are truly more contestable. A 'contestable' market by definition is characterised by very low barriers to entry by new sellers. In the present, there has been a growing consensus among the OECD countries that contestability should be a goal in international policy negotiations and represents a deepening in the concept of the 'degree of openness' that is sought for international competition, in order to fully achieve market integration.

Competition policy has come to be prominent in parallel with the rise of economic liberalism in the 1970s. Competition policy is centered on law and the main areas of activity are conventionally reviewed in terms of the targets of legal action. Competition policy consists of those policies and actions of the state intended to prevent certain restraints of trade by private firms — cartels, mergers, monopolies, and restrictive business practices. In each of these areas the extent of legal powers is important, but of at least equal importance is the stringency with which those provisions are enforced. Henceforth, only effective competition laws put a premium on deterrence and seek to encourage uncoerced compliance with the law on the part of business enterprises. By its nature and theory, competition policy provides a regulatory framework within which competition can operate

57 Doern and Wilks, ibid., p. 3.
unconstrained. The tendency is therefore to control potential restrictions on competition rather than actively to encourage competitive behaviour. The purpose of competition policy is intended to promote rivalry among firms, buyers, and sellers and restrict actions that are anti-competitive. Surprisingly, competition is not the objective of competition policy, but efficiency (the distinction between allocative and dynamic efficiency varies across industrial sectors), and fairness are the objectives, and when these conflict, the purpose is to evaluate the trade-offs between them. Under most circumstances, neither objectives can be met without some sacrifice of the other. A conflict between these objectives occurs within and among countries. Also, competition policy concerns differ for an economy as a whole and for multiple economies in regional/global interaction. Inevitably, in a context of internationalised markets, linked to concerns about effective market access once goods and services have crossed borders, competition laws are being made subject to close international scrutiny.

However, defining and measuring contestability is not only a matter of degree, but circumscribing an interpretation has been an impasse of its own. Nevertheless, a growing consensus has evolved and flourishes on the assumption that anti-competitive business practices can – and indeed have – exerted a significant and harmful effect on international trade and investment. The world wide endorsement of the United Nations (U.N.) Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices of 1980 and the coordination of competition policies in the framework of the OECD, reflects an increasing unison on

58 Doern and Wilks, *ibid.*, p.3.
60 See OECD Recommendations concerning Co-operation between Member Countries on Anti-Competitive Practices Affecting International Trade, www.oecd.org/daf/clp/rec8com.htr and a
at least some basic competition wrongs such as, abuses of market power, market concentrations enabling price fixing and/or market sharing, and other market distortions.

Moreover, the rise in the number of mergers and acquisitions and abusive practices with transnational effects, have prompted states to co-ordinate their competition policies to limit the unilateral extraterritorial application of domestic competition laws and to overcome the jurisdictional gap and tensions that have surfaced. Attempts at harmonisation at the global level, continue in the form of Working Parties but have been met with resistance, and through regional agreements (North American Free Trade Agreement), and bilateral agreements (European Union-America Agreement 1991 and Canada-America Mutual Legal Assistance 1990). In general, attempts to harmonise have been tardy due to the complication in conceiving a trade-off between contestability and regulatory diversity. Ultimately, the removal of these barriers would require either harmonisation of domestic regulatory regimes or (as in the European Union) home country regulation, whereby a


62 Home country regulation referred to as Mutual Recognition Agreements (MRAs) can be defined as a contractual norm between governments whereby they agree to the transfer of regulatory authority from the host country (or jurisdiction) where a transaction takes place, to the home country (or jurisdiction) from which a product, a person, a service, or a firm originate. This in turn, embodies the general principle that if a product can be sold lawfully in one jurisdiction, it can be sold freely in any other participating jurisdiction, without having to comply with the regulations of these other jurisdictions. The basis for MRAs constitutes a variation on the broader question of how to reconcile trade and regulatory objectives, that is how to reduce the trade impact of differences in national regulations without sacrificing legitimate regulatory objectives. Kalypso Nicolaidis “Mutual Recognition of Regulatory Regimes: Some Lessons and Prospects” Jean Monnet Working Paper, Harvard Law School 1997.
service provider is given the right to enter a foreign market provided it complies with its home
country's regulatory requirements. 63

In the current era, some argue for maximum harmonisation which seeks to create a level
playing field among financial firms, while others suggest that harmonisation should be kept to a
minimum so individual member states can compete to provide the most efficient trading
environment. On these grounds, should the emphasis be on market regulations or self-regulation by
market practitioners? A review of the Financial Services Agreement indicates that the resolution over
differences in domestic regulatory philosophy is not over, but has only begun.

INSTITUTIONALISING A PARADOX OF NATIONAL ‘RATIONALES’

INTERFACE: LIBERALISATION AND REGULATION: OVERVIEW OF GATS AND
THE FSA

The introduction of services into multilateral trade negotiations under the General Agreement
on Trade in Services (GATS) was one of the central achievements of the Uruguay Round despite a
lack of enthusiasm and indifference on the part of some industrial countries and despite strong
reluctance and even opposition on the part of developing countries, led by Brazil and India. In this
regard, it was also a way of systematically addressing a range of new and important issues stemming
from widespread government intervention, regulation, and policies, other than trade policy at both the
regional and international level. 64

63 Michael J. Trebilcock and Robert Howse The Regulation of International Trade 2nd Edition,
64 How the influence of domestic regulatory regimes will be reconciled at these institutional levels
will be contingent upon the power of the state and the size and attractiveness of its market. A case in
point, in the Free Trade Agreement (FTA) Canadian banks preserved some of their existing rights and
privileges under U.S. law, such as exemptions from restrictions on inter-state branching (1702.2), and
The inclusion of financial services was a recognition of the growing importance of trade in services in the growth and development of the world economy. It rests on the premise that international openness improves the efficiency and institutional development of financial sectors through increased competition, skills and technological transfer, and better risk management and risk diversion across borders, transparency, and information. Subsequently, financial service trade liberalisation which promotes the use of a broad spectrum of financial instruments and allows the presence of foreign financial institutions whilst not unduly restricting their business practices, results in less distorted and less volatile capital flows, and promotes financial sector stability.  

Although, one must recognise that different types of financial service trade can have a differing impact on the level, volatility, and structure of capital flows, and the stability of the financial system. A further dimension to financial services trade is the so-called modes of supply.

the right to deal in government securities (1702.1), as well promised national treatment with respect to future changes to domestic U.S. regulation, including the Glass-Steagall Act (1702.3), but commitments to further liberalise America's regime, which Canada has promised, is premised on further Canadian unilateral liberalisation of regulations (1702.4) in Trebilcock & Howse, ibid., p. 36-7. Moreover, in the North American Free Trade Agreement (NAFTA) the national treatment obligation (Article 1405) is based not upon the notion of facially non-discriminatory treatment, but rather on 'equal competitive opportunities' (Article 1405.5-7). Domestic regulations preventing the Right of Establishment are protected, (Article 1403.2), limits/safeguards are set on the aggregate market share of foreign financial institution (NAFTA and non-NAFTA), and measures to ensure 'the integrity and stability of a Party's financial system' are protected (Article 1410) in Trebilcock and Howse, ibid., p. 38-9.  

A recent study conducted by the WTO Economic Research and Analysis Division found two important policy implications. Firstly, liberalising international trade in financial services can be a market based means to improve the 'quality' of capital flows and to strengthen financial systems. This would complement other policies including financial regulation, as foreign commercial presence can increase the pressure to strengthen the regulatory and supervisory framework. Secondly, even in countries where the financial system is weak, and where immediate, full-fledged financial sector liberalisation is not advisable, certain types of financial services trade could be liberalised, as such trade strengthens the financial system without provoking destabilising capital flows. As argued in the Staff Working Paper ERAD-98-12 WTO November 1998, by Masamichi Kono & Ludger Schuknecht in "Financial Services Trade, Capital Flows, and Financial Stability", received in Geneva, Switzerland by the WTO Secretariat June 3, 1999.
Financial services are provided mainly in two ways: cross border (mode 1) and through the presence of a foreign establishment (mode 3). The GATS encourages progressive liberalisation and allows differential liberalisation commitments across different financial services and modes of supply.  

The framework for analysing financial service trade is the GATS, which provides the multilateral legal framework for over 95 per cent of world trade in financial services. GATS requires only limited liberalisation of capital movements in the context of financial services trade liberalisation. Commitments to cross border trade liberalisation (mode 1) require the liberalisation of capital inflows and outflows, which are an essential part of the liberalised service. Regarding commercial presence, the GATS rules require the liberalisation of capital inflows which are 'related to the supply of the service' without specifying in more detail whether this refers only to capital and equipment to 'set up shop' or whether this also includes capital inflows related to service provision. Capital outflows related to the supply of services by foreign establishments do not have to be liberalised under GATS, which is likely to constrain inflows. This implies that even fully free trade in financial services under GATS does not require full capital account liberalisation. For that matter, liberalisation of services trade is also consistent with the existence of certain restrictions on capital movement.

66 The four modes of supply in GATS are; Cross-Border, Consumption Abroad, Commercial Presence, and Presence of Natural Persons, for a full detailed analysis view Aaditya Mattoo, "National Treatment in the GATS: Corner-stone or Pandora’s Box?" November 1996 Staff Working Paper TISD-96-002, received in Geneva, Switzerland June 4, 1999.

67 See GATS Article XVI, Footnote 8.

68 It must be recognized however, that restrictions on capital movements (such as capital and exchange controls) substantially reduce the users' freedom to purchase services directly from foreign financial institutions and may also discourage entry. Arrangements for delivering financial services across borders without permitting capital flows will be costly. Therefore, opening the capital account, although a distinct issue from that of opening to foreign financial services competition, sooner or later becomes an issue that countries must face. Economically speaking, liberalisation of services
The World Trade Organisations' (WTOs) passing of the Financial Services Agreement (FSA) is an important step towards the liberalisation of financial services trade for four reasons. First, multilateral commitments tie in the degree of liberalisation attained, and in many cases contain ongoing or future liberalisation programs. This makes polices more predictable for both domestic and foreign financial institutions. Second, commitments to further liberalisation can provide an incentive for policy reforms in other areas, including the macroeconomy and the regulatory environment. Third, commitments are a signal of 'good' policy intent and policy stability, which can help keep domestic savings in the country and attract foreign investors. This further reduces the need for other measures (such as subsidies) to promote investment and development. Fourth, the willingness to make commitments in the multilateral context can induce other countries to do likewise. Whilst significant benefits may already arise from unilateral liberalisation, multilateral commitments by many countries can magnify these benefits.

In the industrial countries, services now account for 50 per cent to 60 per cent of Gross National Product (GNP), but account for only about 20 per cent to 25 per cent of world trade. Moreover, world banking deposits amounted to some U.S. $ 40 trillion in 1994 and foreign assets of deposit banks amounted to U.S. $ 8.6 trillion in 1995. Consequently, cross border trade in financial services more than tripled between 1985 and 1995 and now exceeds U.S. $ 50 billion for the most important trading countries. The magnitude of these transactions exemplifies the need to bring trade and capital account liberalisation are closely linked; they are both elements of an efficient, market based economy.

70 View www. wto.org/wto/services/press86.htm
financial services into the realm of international rules. It is through these international rules agreed by all members that business can best gain the certainty needed to plan its future international activity.

The FSA was completed on 13 December 1997 and included market opening commitments by 102 WTO members and will take effect early 1999. For the purpose of my argument I will go into a discussion of the GATS only in so far as it pertains to financial services. The GATS contains two Annexes on financial services as well as an Understanding on Commitments in financial services and a Decision on financial services. These various instruments not only reflect the incompleteness of the negotiations, but also the asymmetries with respect to not only the levels of economic development, but also the degrees of development in service regulations. In this light, the GATS provides a useful multilateral framework for doing so, offering sufficient flexibility for countries to pursue an appropriate financial services liberalisation strategy, and yet take a more prudent approach towards capital account liberalisation when warranted. Such liberalisation also allows for the necessary degree of prudential regulation and supervision, and provides safeguard mechanisms against financial crises.

The Annex on financial services does not contain any specific liberalisation commitments with respect to trade in financial services, but rather concerns the application of the GATS to the financial services sector. The first Annex, Article 2.1. for example, provides an exemption from GATS strictures of measures taken for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial services

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71 The Understanding has been adopted by 31 members for scheduling specific commitments, including 5 members deciding to adopt it as a result of the most recent negotiations.

72 Article 5.1 defines financial services very broadly as including 'any service of a financial nature offered by a financial service supplier of a member,' financial services which fall within this general definition are – insurance, banking (deposit-taking and lending), underwriting of securities and
supplier, or to ensure the integrity and stability of the financial system, — this is what has come to be called the ‘prudential carve-out.’ 

73 Its provisions on domestic regulation are based on the overriding importance of prudential considerations, monetary policies, and the integrity and stability of the financial system. 

74 Although in theory, this carve-out applies purely to prudential measures and not to measures that would disguise limitations to market access or national treatment, the use of it in this manner is a potential concern and thus it is subject to the mechanism of dispute settlement. However, Panels will have a difficult time delineating between regulations that are imposed for prudential concerns and regulations that create barriers to entry, for the strategic reason that finance is important, and thus GATS gives broad freedom to domestic regulatory frameworks. 

There would be little objection in banking to considering that capital adequacy ratios, limits on risk concentration and risk management system requirements, liquidity requirements, prohibitions on insider trading and transactions giving rise to conflicts of interest, rules on the classification of and provisioning for non-performing assets, ‘fit’ and ‘proper’ tests for directors and managers, as well as trading in virtually every existing form of security or negotiable instrument, consulting, and brokering services. In Trebilcock and Howse, *ibid.*, p. 40.

73 Trebilcock and Howse, *ibid.*, p. 40.

74 Article 3 permits either unilateral or mutual recognition of other countries' 'prudential measures' subject to the requirement that any such non-conforming measures not be used to circumvent GATS obligations. With regard to market access limitations applied by WTO Members to commercial presence of financial service suppliers, restrictions on the specific type of legal entity or joint venture and limitations on the participation of foreign capital in local financial institutions are common. Although such measures may be motivated by a policy to develop national financial industries, they may also stem from supervisory concerns, since the supervision of branches would require information on the head office abroad, and this is more difficult than the supervision of locally incorporated subsidiaries, particularly when the regulatory mechanism is not well-developed. In this respect, international cooperation in consolidated supervision of financial institutions is expected to gradually alleviate any supervisory concerns.

75 A Report of the meeting held on October 16, 1998 stated that some Members have expressed in their schedules either the need to establish a regulatory framework before admitting new financial services (E.U., Japan) or that new financial services or products are subject to certain requirements or approval (U.S., Canada).
transparency and disclosure requirements constitute prudential measures. At the margins, however, there may be differences of views as to whether certain measures can be considered as prudential, and therefore, not subject to scheduling under the GATS. A possible means to address concerns arising from differences in prudential regulation between countries is for each Member to recognise the prudential measures of other countries with high standards of prudential regulation and supervision. Such recognition may be based on an agreement or arrangement with the countries concerned, or may be accorded unilaterally. Although the Annex on financial services provides for such recognition, and a notification requirement exists under Article VII: 4 (a) and (c), no notification has been made under these provisions to date. Non-prudential regulatory measures such as lending requirements to certain sectors or geographical regions, restrictions on interest rates or fees and commissions, and requirements to provide certain services may also exist. Services related to the issuance of public debt are often subject to special rules and standards. Some of those measures may be subject to scheduling under the GATS as limitations on market access, or as limitations on national treatment, particularly when they are applied in a discriminatory manner. They may also necessitate Most Favoured-Nation (MFN) exemptions, if applied in a discriminatory manner between trading partners.

76 WTO, Council for Trade in Services December 2, 1998 Financial Services Background Note by the Secretariat p. 11. Received in Geneva, June 4, 1999.
77 Traditional line - of - business restrictions, such as the segregation of banking, securities, and insurance businesses such as those existing in the U.S. and Japan, have prudential objectives, but they can be perceived as having non-prudential elements from the point of view of European countries with a tradition of universal banking. Another example may be portfolio allocation rules for investments of financial institutions, where a shift appears to be occurring towards the adoption of prudent-person rules providing flexibility in investment decisions instead of numerical restrictions traditionally adopted in many European countries. This does not necessarily mean, however, that the traditional rules are trade restrictions limiting market access or national treatment.
78 This does not mean, however, that such recognition is not made in the domestic laws or regulatory practices of countries.
Consequently, both market access (Article XVI) and national treatment (Article XVII) are not general obligations per se only if they are listed by countries in the schedule of commitments (Part 3) and applies only to sector, subsectors, and activities listed. On that account, they are ‘options’ offered by states and not guarantees. Therefore, under the FSA, there has been less emphasis on the introduction of competition through allowing new entry than on allowing (or maintaining) foreign equity participation and protecting the position of incumbents. Even where immediate introduction of competition was not deemed feasible, not much advance has been taken of the GATS to lend credibility to liberalisation programmes by pre-committing to future market access.

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79 It is important to note that Article XVI does not include all measures which could restrict market access. Perhaps most significantly, fiscal measures are not covered, thus, a member could maintain, without being obliged to schedule, a high non-discriminatory tax on a particular service which severely limits market access. In this regard, limitations must be read as ‘minimum guarantees’ rather than ‘maximum quotas’.

80 The interpretation of the national treatment obligation has not been clearly delineated in relation to Article XVI dealing with market access. There is a conflict between the text of Article XVII and the structure of the schedule of commitments which makes it difficult to interpret the scope of the national treatment obligation even for identical services supplied through different modes. The most complex problem arises in establishing the definition of 'like' services and 'like' service suppliers. Thus, uncertainty about the precise meaning of the national treatment commitment may undermine the key GATS objectives of creating a secure, predictable trading environment. Moreover, the extent of liberalisation implied by the commitments under GATS depends on the precise choice of interpretation.

81 The specific commitments on market access and national treatment are the core of the GATS, and the impact of the Agreement depends to a large extent on the commitments made by the members. Article XVI stipulates that measures restrictive of market access which a WTO Member cannot maintain or adopt, unless specified in its schedule, include limitations on: (a) the number of service suppliers; (b) the total value of services transactions or assets; (c) the total number of services operations or the total quantity of service output; (d) the total number of natural persons that may be employed in a particular sector; (e) specific types of legal entity through which a service can be supplied; and (f) foreign equity participation, with the exception of (e), the measures covered by Article XVI all take the form of quantitative restrictions. Information received from the WTO Trade in Services Division, Geneva, Switzerland June 3, 1999.

82 It should, however, be noted that the measures contained in the Schedules and the sectorial classifications required a significant amount of interpretation as the exact scope and content of the commitments are not always clear from the inscriptions in the Schedules.
By virtue of the importance of the sector, the first Annex specifies the conditions under which countries may claim exemptions from the MFN obligation. Exceptions to and exemptions from MFN obligations have been inserted into the GATS provisions particularly for the purpose of compromising conflicting interests between and among the participants. The second Annex allows members a period of sixty days beginning four months after the date of entry into force of the WTO agreement, the right to improve, modify, or withdrawal all or part of the commitments and MFN exemptions on financial services notwithstanding Article XXI on Modification of Schedules and finalise their decisions. However, for the U.S. and the rest of the integrated core, the schedule of commitments were inadequate in terms of market access, and subsequently, they chose to sign the FSA on the basis of 'conditional reciprocity'. In other words, foreign financial institutions operating in the U.S., and more generally, in fellow OECD countries, market access and national treatment will be unaffected (in essence 'grandfathering' their rights), but new foreign entrants will be treated on a reciprocal basis according to how their home countries treat U.S. – OECD based financial institutions.

This no access for no access policy represents the polarisation between the 'participants' and the 'observers' in financial markets as I have defined before. As a result, this has led to the adoption

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83 Other exemptions from MFN include those recognising the possibility that countries might enter bilateral or regional agreements aimed at economic integration (Article V), those relating to public procurement (Article XIII), balance of payments (XII), and those invoked for national security reasons, which include public policy measures (Article XIV and XIV bis). Individual exemptions taken at the time of entry into force of the WTO agreement are valid for a specified period, which 'in principle' should not exceed ten years. Those exceeding five years will be reviewed by the Council for Trade in Services within five years after entry into force, to 'examine whether the conditions which created the need for the exemption still prevail.' Dobson and Jacquet, ibid., p. 74.

of an Understanding, 85 which offers members with more competitive financial services to voluntarily assume more onerous liberalisation obligations. It is also important to note that only the Understanding addresses competition related issue such as the abuse of monopoly power (Article VIII) and the elimination of restrictive business practices (Article IX), elucidating the fact that only those with a comparative advantage in financial services industries accent the need to incorporate binding obligations against market distortions emanating from abuses in market power. 86

In turn, the FSA simply formalises the status quo and does little to further open the market, reflecting the fact that the aforementioned are only measures which urge to limit the adverse effects of such practices, not to remove them. This transparent discrimination will most likely lead to a

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85 The Understanding contains a commitment to guarantee financial service suppliers of any other Member national treatment with respect to such regulatory bodies. (Paragraph C.2)
86 Competition policy was not a primary concern for regulators of the financial sector in the past, when prudential and resource allocation objectives were priorities for the sector. In many countries, the sector was wholly or partly owned and operated by public entities, as mentioned above, and some financial services sectors have been excluded from the coverage of competition law in many countries. (WTO Annual Report 1997 Section II.7.) In many cases, policies were implemented to curtail competition, such as interest rate controls, limits on the number of operations, and restrictions on the services provided such as controls on credit allocation. However, as governments embarked on privatisation and deregulation, hence eliminating those obstacles, they increasingly shifted to the use of market forces to attain efficiency objectives. Therefore, giving rise to a growing need for competition policy to address anti-competitive behaviour of financial service suppliers. Moreover, the recent surge of mergers and acquisitions involving the financial services industries could be a cause for concern in this respect, unless it succeeds in raising the overall degree of competition through transnational activities of the merged financial institutions. Financial regulators have been generally cautious about introducing competition in the financial sector, due primarily to prudential concerns, but also because many countries have adopted policies to develop domestic financial industries and markets. Based on those concerns, licensing and authorization requirements in financial services are often restrictive, and the conditions or requirements sometimes extend beyond prudential objectives such as soundness and competence of applicants. This appears to be the reason why many of the licensing requirements or restrictions on the number of licenses granted were inscribed in the Schedules of Commitments as limitations on market access and national treatment. For example, the Understanding (paragraph B.6.) explicitly allows a Member adopting it to impose terms, conditions, and procedures for authorization of the establishment and expansion of a commercial presence. And as such licensing requirements are liberalised and are made purely
monopolised comparative advantage of financial service industries by the integrated core, or it will lead to a proliferation of foreign financial service entrants to less developed countries who chose to bargain away financial stability and state regulation, in an effort to obtain access to industrialised markets that they are unable to compete in anyway, especially on a co-equal footing. This will not be a wise decision, as an important 1997 study by the WTO Secretariat identified that the importance of appropriate domestic policies and regulations are inescapable, if financial services liberalisation is to be undertaken consistently with financial market stability.

In general, the relationship between liberalisation and regulation for the financial services sector has two very different dimensions. On the one hand, liberalisation requires reducing/removing barriers to trade, and on the other hand, liberalisation also requires increasing the strength and quality of prudential regulation and supervision.\(^7\) Such deregulation and re-regulation are both the cause and the effect of the inter-mingling of various financial service activities and the blurring of the distinctions between different types of financial institutions observed in many industrialised countries. The elimination of the historical segmentation of financial service industries has enhanced competition among financial service suppliers, increasingly enabling one-stop shopping of banking, securities, insurance and asset management services for consumers. Such deregulation, however, needs to be accompanied by appropriate prudential and transparency rules as well as measures to prevent anti-competitive practices, in order to effectively enhance fair competition and innovation in financial service industries and markets. This has become even more of a pressing dilemma as the

global, regional, and bilateral integration of markets has exposed numerous inconsistencies and distortions caused by differences between national regulatory rationales.

Thus, the process of liberalisation involves *inter alia* reaching a consensus on where to draw the line between regulations that are barriers to trade and regulations that are necessary for prudential purposes. Accordingly, the WTO negotiations on freer cross border trade and on foreign entry in financial services needs to be understood in two conflicting and equivocal contexts.

First, the FSA should not be necessarily understood in terms of its contribution to financial market development and growth. The gains that would emanate from such a phenomenon have only partially been realised by a few countries that have thoroughly liberalised and opened their domestic banking sectors to foreigners. For the rest, including many countries in the OECD, like Canada, it remains an empirical façade, not yet realised even if many ‘vested’ interests argue otherwise. Hence, the benefits from domestic financial de-regulation and the opening of the economy to international trade and capital flows only contributes to financial market development (in the form of: inflow of advanced technology - access to better and faster service channels – credit assessment procedures and information gathering, easier access to foreign capital markets through cheaper financing, improving risk management by pooling and diversifying the risks faced by the providers and users of funds, and increasing transparency in supervision and oversight as foreign entrants comply with unfamiliar standards, rules and regulations) 88 if a) countries have wholly opened their banking (financial) centres, and b) macroeconomic preconditions are institutionalised from the onset.

In this regard, and in the context of the FSA, domestic deregulation has never meant the wholesale elimination of prudential regulation, but the withdrawal of government intervention through privatisation (state owned banks), freeing key prices such as interest rates which are to be
determined by the market, and the easing of restrictions on cross-sectoral activities to allow banks, insurance companies, financing companies, and securities firms' to enter each others subsectors. 89

On this account, the gains from liberalisation may only be realised if many standard policy interventions in the financial services sector are untouched. In the FSA, increasing international competition is clearly an important objective, but it still must be weighed against the other important goals of macroeconomic and systemic stability. In this light, a major challenge for the multilateral trading system is to secure the benefits of trade liberalisation without infringing on the freedom of governments to pursue legitimate domestic objectives. The difficulty lies in distinguishing between two types of situations. In one, non-protective governments cannot prevent certain domestic polices from incidentally discriminating against foreign competitors. In the other, a protectionist government uses a legitimate objective as an excuse to design domestic policies, which inhibit foreign competition. The challenge is to devise rules, which are sensitive to the differences between these two situations – exonerating the former while preventing the latter. The approach suggested is to create a presumption in favour of the economically efficient policy measure, with departures inviting justification.

Nevertheless, the WTO Members which signed the FSA committed themselves to making significant improvements, allowing commercial presence of foreign financial service suppliers by eliminating or relaxing: limitations of foreign ownership of local financial institutions, limitations on the juridical form of commercial presence (branches, subsidiaries), and limitations on the expansion of existing operations. Important progress was also made in ‘grandfathering’ existing branches and subsidiaries of foreign financial institutions that are wholly – or majority owned by foreigners.

88 Dobson and Jacquet, ibid. p., 15.
CASE STUDY

THE CASE OF CANADA

Introduction

The economic environment facing Canada is substantially different from that of a decade ago, experiencing major structural adjustment that has impacted the way in which the Canadian government attempts to respond, shape, and control growing international economic interpenetration, and hence altering the interaction between the regulator and the regulated in the financial services sector.\(^9\) The main drivers of structural change in the financial services sector are technology,\(^8\) as expressed by the OECD in "Financial Market Trends" June 1998, p. 4. Received in Paris at the OECD on June 10, 1999.\(^9\)

The pace of change and globalisation have been so rapid and the changes have been so extensive that there is a ‘growing mismatch between how firms run their businesses and how they are supervised’ which has become a major new challenge. Whereas supervisors have traditionally regulated particular types of financial firms, these institutional barriers are breaking down as companies move into new products and markets. Financial institutions are becoming increasingly internationalised with complex organisations and diversified operations spread across the globe and managed along business lines. Technological advances, coupled with the globalisation of financial services, has led to what has been described as an ‘explosion of cross-border financial transactions.’ In this context, today the array of services that can be accessed is by no means limited to those provided from within Canada. While it has always been possible for Canadians to open a bank account or purchase insurance from an institution established in another country, the Canadian consumer today can access financial services offered from almost anywhere in the world without leaving his or her desk, without ever meeting a representative of the provider face to face, and without the provider having any physical presence in Canada. However, this exploding choice of financial services and methods of access does not come without problems. Transactions over the Internet and by mail give rise to uncertainties concerning the applicable law, the question of which country’s courts have jurisdiction, the place where the contract is made, and electronic and digital signatures. The consumer may discover that he or she is subject to the courts and laws of the country of the provider. Additional problems have arisen because regulators of financial institutions and financial services around the world have not been able to keep up with the changes. Regulation remains cemented in a legal regime designed in an era when cross-border financial services could be offered only through the establishment of a physical presence and through paper-based products. Canada is no exception, and the concern is that there is little, if any, protection for the Canadian consumer from pitfalls ranging from misrepresentation to outright fraud. The problem is that the scope of the issues is not yet fully apparent or understood, so it is difficult to formulate enforceable solutions. It is important to understand international developments in regulation because they provide
particularly innovative forms of financial activity (thereby changing the role of competition also magnified by demographic changes which have altered household portfolios), the internationalisation of markets, and the impact of regional and multilateral trade agreements all contributing in one fashion or another to the inclusion of foreign entrants into the domestic market. This interaction makes it difficult to pinpoint a certain factor or change as the cause of a particular development. A factor may have been the necessary condition for a development to occur, but it may not have been sufficient by itself to bring about the outcome. An understanding of the nature of these drivers and the interplay among them is essential to an understanding of other over-arching features and challenges facing the Canadian state and the banking sector in terms of changes in organisational structures and required competencies. These changes raise challenges for the financial services industry, most notably, determining what services and products to offer as well as the best size for providers.

With the evolution in the financial services industry, policymakers and regulators also face challenges: the relative use of disclosure and market discipline versus direct supervision; the potential

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Demographic developments have been largely responsible for the gradual change in the desired asset-liability structure of household portfolios. As the population of the industrialised countries age, and as income levels and wealth increase, there has already been evidence which suggests that there has been a slow but steady shift away from credit products (such as consumer loans and home mortgages) to wealth-management products (such as pension funds and mutual funds). Moreover, the portfolio shift from deposits to mutual funds has been intensified by the movement to a low-inflation, low-interest rate environment that has caused many savers to search for higher rates of return than are typically offered by deposits.
role of functional regulation; the role of non-regulated financial service providers; changes in the current supervisory process; cross-border transactions; and specifically, the impact of new developments on the legislative framework governing financial service providers. How these forces of change that I have outlined affect Canada and progressively (re) shape our banking sector is not at all clear. What is clear is that the commitment made by Canada in the FSA comes into force March 1999 and as a result, Canada has undertaken efforts to modify its Schedules by June 1999 to incorporate results of the implementation of a new foreign bank entry regime which will allow foreign banks to branch directly into Canada. Thus, ultimately eliminating a requirement to gain Ministerial approval for foreign bank subsidiaries to open more than one branch.  

On these grounds, some argue that the globalisation of financial markets offers the promise of better quality service (even though there is no concrete evidence to validate this assumption) and greater choices for consumers, as technology makes it easier for foreign companies to offer financial services in Canada. Conversely, others argue that both the pace and magnitude of change causes serious concerns about the impacts of these forces on the safety and soundness of the financial system, because liberalisation of the sector will induce many financial firms to transfer their capital abroad, thus reducing the annual tax base of this $1.5 billion industry which makes up nearly 1/5 of all federal corporate taxes collected (yields over $9 billion annually in tax revenue to all levels of government).

92 For more information on individual country improvements in their Schedule of Commitments view www.wto.org/wto/services/finsum.htm The U.S. for example, has made binding commitments with respect to new entrants and new activities of foreign suppliers on an MFN basis. Specifically, the U.S. removed some restrictions at the state level in relation to the issuance of licenses to non-residents, and to the issuance of branch licenses to foreign banks as well as some state restrictions on the opening of representative offices by foreign banks, binds national treatment with respects to the costs of Federal Reserve examinations for foreign banks, provides market access and national treatment to foreign firms with respect to interstate banking and interstate branching of banks except in the case of de novo branching, and makes additional commitments binding the major items
government, provides a yearly payroll of over $22 billion, and exports nearly $50 billion of services annually), and employs one million Canadians directly or indirectly, making the sector in many ways the economic lifeblood of Canada, considering it represents five per cent of Canada’s gross domestic product. 93

Consequently, the challenge in the 21st century for the Canadian government will be to find the right balance between these competing objectives while striving for a choice of structure that minimizes the trade off between them.

Exhibit 1.0
**Assets of Domestic Banks**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Total Assets ($ millions 1997)</th>
<th>Assets in Canada ($ millions 1997)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royal Bank of Canada</td>
<td>262,865</td>
<td>188,737</td>
</tr>
<tr>
<td>Canadian Imperial Bank of Commerce</td>
<td>277,677</td>
<td>156,610</td>
</tr>
<tr>
<td>Bank of Montreal</td>
<td>227,752</td>
<td>126,630</td>
</tr>
<tr>
<td>Bank of Nova Scotia</td>
<td>206,016</td>
<td>123,813</td>
</tr>
<tr>
<td>Toronto-Dominion Bank</td>
<td>172,974</td>
<td>117,968</td>
</tr>
<tr>
<td>National Bank</td>
<td>66,981</td>
<td>56,872</td>
</tr>
<tr>
<td>Laurentian Bank of Canada</td>
<td>12,467</td>
<td>12,464</td>
</tr>
<tr>
<td>Canadian Western Bank</td>
<td>2,007</td>
<td>2,022</td>
</tr>
<tr>
<td>Citizens Bank</td>
<td>805</td>
<td>805</td>
</tr>
<tr>
<td>Manulife Bank of Canada</td>
<td>346</td>
<td>346</td>
</tr>
<tr>
<td>First Nations Bank</td>
<td>11</td>
<td>11</td>
</tr>
</tbody>
</table>

Sources: Total assets from Office of the Superintendent of Financial Institutions Web site for December 31, 1997. Assets in Canada for some banks from OSFI individual bank data, used with permission of the institutions. Assets in Canada for others provided by the institution or estimated from October 1997 annual report data.

referred to in the bilateral measures agreed with Japan in insurance, banking and other financial activities.
Exhibit 1.1
Canadian Assets of Financial Institutions, 1997

<table>
<thead>
<tr>
<th></th>
<th>$ billions</th>
<th>Percentage of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chartered Banks (Schedule I and II)</td>
<td>897.5</td>
<td>56.1</td>
</tr>
<tr>
<td>Trusts (excl. bank subsidiaries)</td>
<td>53.6</td>
<td>3.4</td>
</tr>
<tr>
<td>Credit Unions and Caisses Populaires</td>
<td>107.0</td>
<td>6.7</td>
</tr>
<tr>
<td>Life Insurers</td>
<td>178.3</td>
<td>11.2</td>
</tr>
<tr>
<td>Property and Casualty Insurers</td>
<td>53.6</td>
<td>3.4</td>
</tr>
<tr>
<td>Securities Dealers (excl. bank subs.)</td>
<td>28.7</td>
<td>1.8</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>280.8</td>
<td>17.5</td>
</tr>
<tr>
<td>Total</td>
<td>1,599.5</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Statistics Canada, cat. no. 61-008.

TECHNOLOGY, INDUSTRY CONSOLIDATION AND INTERNATIONALISATION

One of the significant catalysts of change in the banking sector in Canada has been technology. Technological developments in recent years, especially those in information processing, management, and delivery, have led to a number of significant changes in the way in which financial service providers operate. Canadian financial institutions have improved the speed, security, volume, and quality of financial information – processing and continue to greatly lower the unit costs of these transactions. 94 Hence, this information-intensive sector has been increasingly reliant on technology in the creation, production, distribution, and regulation of its industry. 95

94 An example is Symcor, the joint venture formed by the Bank of Montreal, the Royal Bank and the Toronto-Dominion Bank in 1996 to combine the high volume processing of cheques, customer statements, credit card sales, drafts and remittances. Also, The Bank of Nova Scotia and the Canadian
In this light, it has been articulated by Canada's banking conglomerates, that the sustenance of their 'monopolised' domestic market share, and their competence to compete in international markets hinges on their capacity to generate economies of scope, scale, and learning which could only be realised through the consolidation of the industry (either domestically and/or internationally between financial firms or among financial (sub) sectors (in-pillar-cross-pillar). For example, international expansion as key to a banks' continued strength is exemplified by the Bank of Montreal's presence in the U.S. through its acquisition of Chicago based Harris Bank, and similarly, by the Canadian Imperial Bank of Commerce (CIBC) which bought Oppenheimer and Company of New York in 1997.

Consequently, there has been a significant increase in the internationalisation of Canada's financial services industry, defined for purposes of this paper as the spread of banks across borders. The internationalisation of banks has involved banks in many countries in a two-way movement.

Imperial Bank of Commerce (CIBC) set up a strategic alliance named Intra to combine certain back-office functions in network support, computing centres, end-user devices, ATM servicing and document processing. These developments allowed banks to manage the sharp increase in the volume of transactions that was underway without a proportionate increase in costs. The Task Force on the Future of the Canadian Financial Services Sector September 1998 ("Competition, Competitiveness and the Public Interest" Background Paper #1 p. 124.) & Brent Sutton, The Canadian Financial Services Industry: The Year in Review, 1996 Edition (Ottawa: The Conference Board of Canada, November 1996) p. 21.

96 For example, since Canada has adopted electronic banking services, 75% of all retail banking transactions are today carried out electronically rather than over the counter at a branch. See Stephen Timewell "Showdown in Toronto" The Banker (November 1998) p. 63.

95 International competition is an important determinant in this regard because the cost of staying abreast of new technological innovations has become a strategic competitive tool and serves to determine who survives and who perishes – for example, the three biggest banks in Canada spent only $1.6 billion (U.S.) on technology, whereas U.S. banks of the same size spent $5 billion (U.S.), see Whittington, ibid., p. 37.

97 It is important to note here that the evidence on mergers and acquisitions remains inconclusive, for instance, although consolidation may maximize market size, evidence suggests that problems may take the form of customer loss (whether merged banks live up to the expectations of delivering
That is, in most major countries, domestic banks have moved into foreign markets at the same time that foreign banks have moved into the domestic markets, increasing competition in both markets. For example, not only have U.S. banks (especially investment banks) been very successful moving into foreign markets, many foreign banks have, at the same time, successfully penetrated U.S. markets.

The historical pattern in the earlier post-war period was for banks to follow their large non-financial customers' abroad. They relied on an information asymmetry (namely, their intimate knowledge of their customers' businesses and needs, based on their domestic relationships) to enable them to provide some financial services to such customers abroad as well. Initially, they were limited even in this type of business by their lack of a solid base in the foreign country. Indigenous banks, because of their long-standing relationships in and knowledge of local markets, still received the lion's share of the financial business of foreign non-financial firms in their countries. In addition, government policies in many countries severely constrained the ability of foreign banks to compete successfully with domestic banks.

Gradually, however, this began to change. Since each banking system had somewhat different forms of expertise and somewhat different weaknesses, foreign banks were able to find opportunities to expand their operations by focusing on their own areas of expertise. This was especially true where the indigenous banks were, for whatever reason, unable or unwilling to compete in certain areas. For example, U.S. investment banks have long been innovators in the development of new instruments. They also have been in the forefront of developments in the merger and acquisition business, and they have been able to offer this expertise successfully to European and Japanese customers. An

element of expertise that foreign banks brought to the U.S., at least in jurisdictions such as California where such activity was permitted, was their experience in branch banking. Similarly, the development of innovative techniques of service delivery in a domestic market can be exported to foreign markets and can cut into the domain of indigenous institutions.

Another factor that has played an important role in the ability of foreign banks to penetrate domestic markets successfully has been their willingness to compete on both price and non-price terms. The entry of foreign banks into domestic markets has often shaken or broken the prevailing cartel-type arrangements, since the foreign banks had to operate at lower margins than those prevailing in the domestic market in order to gain market share. Gradually, over time, the foreign banks were able to establish themselves as low-cost lenders or high-return borrowers of funds.

This is not to say that the indigenous institutions have lost their home markets, as is the case in Canada. They still retain the major share of the business in those markets. But increasingly, foreign banks are gaining market share as well as forcing the indigenous banks to behave more competitively and more efficiently in their previously protected home market. While the principal thrust of internationalisation in the past was in the wholesale or large-value part of the financial services industry, more recently the emerging trend seems to be increased penetration of foreign banks into domestic retail markets. A key obstacle in the past that prevented foreign banks from breaking into the retail market in a major way was the strongly entrenched position of the indigenous banks in an industry that depended largely on brick and mortar branches for service delivery. With the best branch locations already owned by local banks and with explicit or implicit government prohibitions of the take-over of major domestic banks by foreign banks, the indigenous banks in Canada, Europe and Japan were largely immune to retail competition from foreign banks.
However, technological change in the form of remote delivery of certain financial services and products may well provide the means for foreign banks to overcome this obstacle (although this possibility has not yet materialised on a large scale in most countries). The spread of telephone banking and the introduction of computer based delivery of services has made the so-called 'virtual bank' a possibility. Of course, domestic banks are also rushing to offer such services to their customers, both as a way of cutting costs and of holding on to their customer base in the face of the new competitive challenges. Nonetheless, the domestic banks are concerned that their costly investment in brick and mortar branches, which until now were the principal obstacle to entry of foreign banks, will become an albatross for them, with the new virtual banks (themselves perhaps the subsidiaries or branches of brick and mortar banks in other countries) gradually gaining an increasing share of the local retail business. Nevertheless, brand recognition and loyalty to the domestic banks are still formidable obstacles for foreign banks.

While the principal focus of the spread of virtual banking has been on the deposit side, similar developments are occurring (although at a slower pace) on the loan side as well. With the spread of credit-scoring techniques, it has become possible to engage in consumer and even small business lending without having a physical presence in the country or a personal relationship with the borrower. And perhaps, with video telephones and video conferencing, even larger loans might become more common, since 'face to face' discussion and negotiation will be possible even at long distances.

Therefore, resulting from the aforementioned developments, Canadian chartered banks believe that domestic provisions are no longer adequate because they ignore international competition and they do not address the joint issues of 'level playing fields' and 'regulatory competition.' In this regard, individual countries cannot regulate or supervise their domestic institutions and markets
without recognising the implications for international competitiveness. In turn, the actualisation of increasing market share that may result from such organisational restructuring can only be attained through greater substantial regulatory flexibility, and reductions in the artificial restrictions on competition.  

Accordingly, a comprehensive restructuring of legislation and regulatory oversight has occurred from the mid-1980s to the present time. In this light, there has been a reconfiguration of state power in the control over the financial services industry, and in the means by which, economic power/wealth is consummated. Henceforth in the last two decades, financial institutions have been able to expand their range of activities from the elimination of the traditional four pillars - banks, insurance companies, investment dealers, and trust companies - and allowing a cross-ownership of control among and between these financial sectors. Thus, competition is increasingly based on the

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99 Fading regulatory barriers and active risk management have served to blur the distinction between commercial and investment banking. Banks are relying more and more on non-interest income to support their profits. In particular, fees for services together with proprietary trading have for many firms become a significant complement to the traditional lending business. At the same time, other financial institutions have entered into the competition for more traditional banking business. Armed with new technology, investment dealers have now begun to offer ways of unbundling risks inherent in bank loans and to price them in the securities markets. Also, alternative savings instruments to bank deposits are growing rapidly; deposits in mutual funds in Canada are now larger than those in the banking system, although the process of diversifying these assets internationally is only beginning.
function performed or the product and service provided, rather than between types of institutions, resulting in an intensified competition in the provision of financial products and services.

In this light, the forces of change are compelling financial institutions to fundamentally re-assess their business strategies. The responses are varied. In some cases, financial institutions are repositioning their business to focus on key markets and capitalize on core strengths. This might include dropping or selling lines of business in which a financial institution has no real competitive advantage. In other cases, the institutions are looking to grow their market share in specific business lines or locations where they believe they do have a competitive advantage but may, for example, need sufficient scale to keep unit costs down to remain competitive.

As institutions reposition themselves to cope with the forces of change, transformations continue to take place at the organisational level. A firm, which chooses to drop a line of business, may sell some of its operations, as has happened recently with the Canadian operations of several foreign insurance companies. Financial institutions may be encouraged to merge with competitors to achieve cost efficiencies such as by rationalising an existing costly distribution channel. Similarly,

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100 With the recent technological changes, new instruments have been developed that permit the unbundling of functions, the restructuring of financial components into a variety of new products, and the delivery of separate services by different entities.

101 It is important to note here that the relentless pressures from technological change and from domestic and international competition in the provision of financial services and products, has produced distinct and varied changes in each of the financial sub-sectors, and also has come to illuminate their regional differences. For example, foreign entrants into the banking sector have been unable to dominate the industry or acquire a significant market share, while the property and casualty insurance sector has progressively been dominated by foreign institutions. Also, the securities market is now a distinct barbell: almost all the mid-sized players have disappeared as the chartered Canadian banks and American brokerage firms have become niche players. Also, the cooperative sector – (credit unions), have retained their market share as deposit-taking institutions in Quebec and Saskatchewan, while their importance in asset share in Ontario has dropped.
mergers or acquisitions may be pursued in order to expand the scope of products that the financial institution is able to sell to its customers.\(^\text{102}\)

As globalisation continues, national economies (including that of Canada) will find that international trade in financial services will constitute a larger part of the economy. Sales of Canadian services to foreign clients and purchases of financial expertise, products, and services from foreign service providers will become more common. Which way the balance of trade in financial services will turn depends on the competitiveness of the Canadian financial services sector and the strategic initiatives it will undertake. It is not yet confirmed, but the availability of competitively priced Canadian and foreign-based financial products and services may contribute to the efficiency and competitiveness of Canada's economy as a whole, since virtually every sector and individual is a user of financial services.

Exhibit 1.2
Financial Services Sector Overview, 1997

<table>
<thead>
<tr>
<th></th>
<th>No. of Companies</th>
<th>Total Assets ($ millions)</th>
<th>Capital ($ millions)</th>
<th>Total Revenue ($ millions)</th>
<th>Net Income ($ millions)</th>
<th>No. of employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks (includes Subsidiaries)</td>
<td>55</td>
<td>1,322,085</td>
<td>54,699</td>
<td>42,124</td>
<td>7,954</td>
<td>219,977</td>
</tr>
<tr>
<td>Canadian</td>
<td>11</td>
<td>1,229,864</td>
<td>49,767</td>
<td>39,629</td>
<td>7,550</td>
<td>211,398</td>
</tr>
</tbody>
</table>

\(^{102}\) The Canadian banks have implemented a variety of strategies in their international activities, cultivating niches where they have developed advantages and skills. For example, while previous forays by the banks into the Eurobond markets proved disappointing, the continuing upward trend in foreign asset orientation reflects growing international business: The Bank of Nova Scotia has built a banking network in the Caribbean and more recently participated in joint ventures in Latin America. Scotiabank's foreign expansion has continued with the recent opening of branches in New Delhi, and in Guangzhou, China. The Toronto-Dominion Bank has pursued a discount brokerage strategy in the U.S., the U.K., and Australia. And the Royal Bank has done a considerable amount of loan syndication and foreign exchange business in several U.S. centres and has the largest presence in Europe of any Canadian bank. See the Banks, *Annual Reports* 1997-8.
POLICY IMPLICATIONS

The challenge to balance domestic competition, international competitiveness, and safety and soundness grows as the sector struggles to adapt to the forces of change. Trends such as an ageing consumer base, the growth of financial supermarkets in Canada, and the increasing emphasis on technology in the delivery of financial services quickly draw focus to public-interest issues such as access to financial services, privacy, and consumer protection. Demographic and economic trends, plus the government’s response to the pressure placed on Canada’s social safety net, increase the importance of a well-functioning financial services sector in Canada. Governments must also react to industry restructuring, which is itself, a response to these same forces of change. The increasing complexity and changing nature of financial services raise questions about whether regulators will
have the ability to keep up with the changes, and accordingly, what the appropriate supervisory model to ensure safety and soundness of the financial system should be.

As the financial services sector quickly evolves in response to the forces of change, government must act urgently to address the challenge that this transformation poses for setting public policy. Flexible and effective regulatory policies are needed now more than ever in order to offer Canadians greater access to world-class financial services, while providing Canadian institutions with opportunities to compete in both domestic and international markets. Ensuring a flexible, responsive regulatory system, in which change can be managed for the benefit of Canadians, will demand ongoing and focussed attention from policy makers, regulators, industry leaders, and customers alike.

However, the structural challenges resulting from the culmination of these organisational and regulatory changes, which have reconfigured corporate demands, have also brought the controversial promulgation of market power to the forefront of Canadian politics, economics, and consumer life. In this regard, the domain of competition policy has been extended beyond the purview of economics and law - disciplines which have so far dominated the analysis – to the exercise of bureaucratic politics – particularly the political choices made by ministers and officials and how they recognise the linkage that is drawn between political democracy and economic democracy, as the former is empty without a guarantee of the latter. In the present, this inextricable correlation has been blurred.
HISTORICAL OVERVIEW

CREATING A FRICTION BETWEEN REGULATORY OVERSIGHT AND FINANCIAL MANEUVER

Traditionally, regulation in the banking sector in Canada has been formulated in the belief that market forces are insufficient to ensure that financial institutions meet the standards against which they are judged. There has thus been a formal process of re-examining the legislative arrangements approximately once every decade, or once every five years, through the post-war period, leading to significant revisions of the *Bank Act* in 1954, 1967, 1980, 1987, 1992, 1997, and 1999. Only some of these sets of legislative amendments were fundamentally significant for the banking system’s ability to cope with change. However, the opportunity and requirement for government to re-examine periodically the issues affecting the financial industry (and more particularly, the banking sector’s place in that industry) and to make legislative changes to respond to market-driven developments assisted banks in adjusting to an ever-changing environment.

Throughout much of Canada’s post-war history, the issue of bank concentration and the implications for reduced competition have continued to surface. Subsequently, a highly concentrated, bank-dominated financial system shapes the workings of Canada’s economic system and financial regime. Domestic regulations concerning the banking sector in the post-war era were targeted to ensure stability and designed to limit the exploitation of monopoly power, primarily by way of price regulations and ceilings on interest rates that could be charged on loans by banks. However, by the time of the 1967 *Bank Act* review, the concern of cartel-like behaviour by oligopolistic banks who subjected price competition by agreed minimum levels in both lending and deposit taking activities induced sweeping recommendations for more efficient changes in banking, as predicted five years earlier by the Royal Commission on Banking and Finance, otherwise known as the Porter Commission.
Commission which enquired into and reported on the structure and methods of operations of the Canadian financial system.  

Price Competition was induced by the prohibition on interbank agreements to set interest rates or other charges on loans and deposits. At the same time, the 1976 amendments also eliminated restrictions on the banks’ involvement in residential mortgage financing, permitting them to invest in non-insured or conventional mortgages.

Accordingly, changes in the structure of the Canadian economy affected parallel refinements in the allocation of credit which ensured that then Prime Minister Pierre Trudeau could manipulate the allocation and flow of credit to its most valuable uses, and to warrant that the expanding lines of economic activity and financial instruments made available to asset holders on the best possible terms (i.e. offering the most favourable combination of risk, liquidity, and expected yield) would not further polarise the distribution of income in Canada. Subsequently, although restrictions were removed on the foreign ownership of financial institutions, foreign interests could not collectively own more than 25 per cent of the shares of a bank, nor a subsidiary, and no interests can acquire more than 10 per cent of any class of shares in a federally incorporated financial institution. This ‘widely-owned’ policy retained the banking industry under Canadian control because it constrained share values and business strategies by restricting banks in the use of their shares as currency in acquisition of other institutions, primarily foreign banks. Moreover, the Canadian Deposit Insurance Act required that all federally incorporated intermediaries ensure their deposits with the newly established Canadian Deposit Insurance Corporation (CDIC), rendering most other provinces except Quebec to make mandatory that their controlled trust and loan companies also became insured with CDIC.

__103__ Royal Commission on Banking and Finance, Report (Ottawa: Queen’s Printer 1964) p. 569.

However, during the 1970s, the growth of transnational firms created a demand for the linking together of financial markets as companies commanded finance on an international scale, which required the pooling of financial resources and the spreading of risk management across domestic markets. Correspondingly, the rapid growth of foreign banking and foreign currency activity, facilitated by technological innovation and the impact of information technology on distribution channels, allowed much greater access to information between markets so that information from one market is readily communicated to other markets in the global network. These developments in the mode of operation have engendered a collective wave of deregulation and privatisation on the part of the industrialised countries whose interest rates became more flexible, and capital more mobile. In turn, the proliferation created by the necessity to create new types of loans and deposits with diverse conditions and terms led to further changes in the Bank Act in 1980.

The 1980 Bank Act revisions maintained the regime of widely held ownership (with no single person or group of persons allowing to owe more than 10 per cent of the voting shares) for existing chartered banks, now called Schedule I banks. However, it also introduced a new class of banks, Schedule II banks, that could be started and owned on a closely held basis. Schedule II banks that were subsidiaries of foreign banks and, following the 1992 amendments, those that were owned by widely held regulated non-bank financial institutions, would be permitted to be closely held indefinitely. Otherwise, Canadian owned Schedule II banks would have to become widely held ten years after being incorporated. Moreover, these revisions also permitted chartered banks to diversify their functions and participate in leasing and factoring services, including venture capital companies and mortgage loan companies, thereby positioning them to be in direct competition with the newly permitted foreign banking subsidiaries like the Honk Kong Bank of Canada and Citibank Canada, which remained subject to Canada's Ministry of Finance.
Therefore, although there was an influx of foreign entrants which increased competition in the commercial banking market, changes in legislation nevertheless, ensured that Canadian banks would be able to operate in the markets of other countries, and foreign entrants remained subject to the 25 per cent ownership cap which limited their market share in Canada, and they were prohibited to operate through branches of their parent company and instead had to set up subsidiaries in Canada with a separate allocation of capital.

Also, cash reserve requirements were also modified particularly to reflect the increasing importance of foreign currency deposits. In 1980, Parliament also passed the Canadian Payments Association Act. Banks and non-bank deposit-taking institutions took over responsibility for running the cheque clearing system from the Canadian Bankers Association and were given the responsibility for planning the future evolution of the Canadian payments system. 105

However, by the mid-1980s the impact of the debt crisis on macroeconomic conditions; diminished commodity markets, defaults on interests payments and loans, increases in short term interests rates, and the ensuing insolvency of many financial institutions in Canada (primarily the collapse of the Northland Bank and the Canadian Commercial Bank) facilitated by the failure of real-estate linked assets, enabled the Canadian state to implement legislative changes in 1987 initiated by the CDIC in co-operation with the new federal regulator, the Office of the Superintendent of Financial Institutions (OSFI) 106 which began to develop 'Standards of Sound Business and Financial

106 The OSFI Act sets out the objects of OSFI which are 1) to supervise financial institutions to determine whether they are in sound financial condition and in compliance with the law, 2) to advise management if this is not the case and require remedial action to be taken, 3) to promote the adoption by management of risk control policies and procedures and, 4) to monitor events at the industry level that may negatively affect the financial condition of institutions. In carrying out these four objects, OSFI is instructed to strive to protect the interests of depositors, creditors, and policy holders while at
Practices' having the force of law and covering such issues as liquidity management, interest rates, foreign exchange, credit risk management, real estate appraisals, and securities management. This signified the danger of foreign entrants in the domestic market operating without an accompanied national inspection and supervisory system. Similarly, at the international level the Core Principles for Effective Banking Supervision established by the Basle Committee demanded that national banks set capital adequacy regulations to protect businesses from unstable fluctuating economic conditions emanating from such 'international' crises and hence seek to reduce the risk of contagion.

This contradictory mix between equitable market access opportunities albeit preserving prudential, portfolio and ownership restrictions was institutionalised by regional and global trade agreements. The Free Trade Agreement (FTA) signed by the U.S. and Canada in 1989 was the first attempt to develop formal rules and disciplines for financial services in a trade policy setting. In this conceptual sense it was revolutionary, but in practical terms it was less so. The Agreement addressed some long standing grievances about 'access' within the Canadian and U.S. markets, but it did not do so on the basis on any well-articulated and forward-looking set of principles. Moreover, in the aftermath of the treaty, very little of consequence happened. Far from coming to dominate the Canadian financial scene, U.S. financial institutions generally lost market share and a number of them withdrew from the Canadian market entirely. For example, although the FTA eliminated the 25 per cent ownership limit to U.S. residents, the continuation of the national treatment principle by the

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the same time 'having due regard' to the fact that financial institutions must be allowed to 'compete effectively.' See OSFI, Annual Report 1995-6, p. 3; see also OSFI Annual Report 1996-7, inside front cover.


108 The only guiding principle, in addition to that of national treatment, was to preserve 'the access that our respective financial institutions have to each other's markets.' See Canada: Department of External Affairs (1987) p. 249.
U.S. to Canada was contingent upon further Canadian *unilateral* liberalisation of regulations. Accordingly, the Canadian states' decision to retain control over Schedule I banks via ownership restrictions and by way of various federal regulations expressed as necessary prudential safeguards, indirectly affected Canadian chartered banks to compete in the American market. Subsequently, this no access for no access policy influenced Ottawa to allow banks to own up to 100 per cent of Canadian securities dealers, in turn, forcing Ontario and other provinces, to open up their securities market to foreign brokerage firms in 1987-8 providing that Canadian securities firms receive reciprocal rights in those foreign firms home jurisdictions. ¹⁰⁹

By the end of the 1980s, as the traditional bank loan was losing ground to bond, equity, and especially paper market financing, as well as Euro-Canadian dollar and foreign currency issues, the banks were becoming increasingly concerned about their ability to operate profitably and to compete effectively with both domestic securities dealers and foreign banks and securities dealers. Some observers in the 1980s went so far as to argue that there was no future for the traditional bank with its focus on corporate loans, and that the future would belong to institutions that could offer their clients the widest possible range of financing options.

¹⁰⁹ Among the key factors motivating this change in legislation was the increasing use of market borrowing by corporations at the expense of bank lending, the trend to globalisation, and the concern that securities dealers would not be able to generate the larger amounts of capital that would be needed in the future. In addition, banks and securities dealers had been penetrating increasingly into each other's core business areas. For example, the payment of interest on credit balances by dealers brought them into competition with bank deposits, and banks made syndicated loans that competed directly with bond issues. The separation of banking and securities business was coming under increasing pressure as banks were entering the discount brokerage business and a growing share of the short-term financing business of the corporate sector was being done in the form of commercial paper and bankers' acceptances. Indeed, the increasing use of securities markets by corporate borrowers was probably the single most important factor driving the integration of the banking and securities industries. Charles Freedman, "The Canadian Banking System" *Bank of Canada* Technical Report No. 81 March 1998 p. 10.
In a similar vein, it was also argued that considerable synergy results from one institution being able to service all the financing needs of the corporate borrower. The banks also argued that it was essential that they be able to underwrite securities in the domestic market to develop the expertise that would enable them to compete with universal banks and investment banks in a world of increasing securitization, globalisation, and integration of functions.

In turn, the comprehensive reform in legislation in 1992 governing the operation of federal financial institutions, recognised the breadth and scope of changes in the banking sector, and involved a major rewrite of the legislation governing banks, trust companies, and insurance companies. Among other things, it dealt most notably with the powers of the various financial institutions, ownership, and ways of managing self-dealing and conflicts of interest. Likewise recognising that Canada’s continued market access to foreign markets and foreign capital required in the future a reformulated regulatory approach. As a result, financial institutions were wholly allowed to diversify into new lines of financial business through broader in-house business powers and subsidiary operations. The traditional four-pillar distinction was eliminated and banks, insurance companies, and trust companies, were given expanded, overlapping, and almost identical investment and business powers, together with the ability to own all types of financial institutions and subsidiaries. This diversification of function has been underway since the 1980s, and the result has been that chartered banks have come to virtually own all of the large independent trust (except for Canada Trust), loans, and securities firms in the domestic market, further increasing their market

110 Thomas J. Courchene & Edwin H. Neave Reforming the Canadian Financial Sector Canada in Global Perspective (Queen's University, John Deutsch Institute for the Study of Economic Policy No. 34 1997) p. 250.
111 Following the 1992 legislative changes; the Toronto-Dominion Bank bought Central Guaranty Trust in 1993 with assets of $9 billion and 154 branches, the Royal Bank paid $1.6 billion for Royal Trust in 1993, with 150 branches and $20 billion in assets, Scotiabank acquired Montreal Trust in
share. However, certain ‘core’ powers continue to be reserved along institutional lines. This increased competition among financial institutions for asset management on a wide range of products has also clarified Canada’s attempt to harmonise interjurisdictional regulatory standards 112 culminating in amendments to the four Acts which govern the financial sector – The Trust and Loans Act, The Bank Act, The Insurance Company Act, and the Co-operative Credit Association Act.

This strategy has also sought to alleviate interjurisdictional competition for foreign asset management especially among Schedule II financial institutions, which by 1992 were permitted to own 100 per cent of a deposit institution. However, portfolio regulation was preserved in the case of loan and insurance companies - if shareholders’ equity exceeds more than $750 million it is subject to a 35 per cent public shareholding requirement. As shown, these reforms began a movement from legislation to regulation for restricting the activities of financial firms.

In contrast to the FSA, the North American Free Trade Agreement (NAFTA) was based on a forward-looking set of principles designed more to enhance access than to simply preserve it. The search for principles was in part due to the desire to extend the NAFTA over time; transparent principles would ease such an extension. Beyond this, the U.S., Canadian, and Mexican participants all hoped that these principles might serve as a model for trade agreements in other fora. Most importantly, at the time NAFTA was being negotiated, the future shape of the GATS, and in

1994 with 150 branches and $12 billion in assets, and National Trust in 1997 for $1.25 billion with 175 branches and $14.6 billion in assets. The latest acquisition was put forth by the Toronto-Dominion Bank in August 1999 to buy Canada Trust for $8 billion. See Rob Ferguson, Toronto Star "Your Business" Section August 4, 1999.

112 Duplicative regulation of financial institutions stems in large measure from the division of federal and provincial jurisdiction over financial institutions. It has been expressed by the private sector that conflicting regulations, together with the long and cumbersome approval processes, has led to higher compliance costs and has discouraged new entrants. Also, in today’s financial service marketplace, with increasing competition from monoline providers, the cost of regulation has become a serious competitive disadvantage.
particular financial services, was still to be determined. Moreover, it was felt that successful implementation of a principles-based agreement, to which an important emerging economy was party, might provide an important precedent for regional trade agreements elsewhere. If so, shared principles underlying such regional agreements might lessen the danger that they could get in the way of forging more global agreements. 113

The broadest principle of all in NAFTA recognises that all firms providing financial services should have equal access to all customers in all participant countries, either through cross-border trading or rights of establishment, and that there should be no discriminatory legislation. The treaty also recognises the need for transparency in all government decisions in this area; the need to recognise that national treatment must be de facto and not just de jure; 114 and it lays down specific procedures for dispute resolution. The treaty also lays out certain provisions with respect to supervision. Most importantly, supervision will continue to be host rather than home-based, though regulators can negotiate bilateral agreements providing for regulatory or supervisory harmonisation. While NAFTA left in place the existing differences between the structures of the Canadian/Mexican and U.S. banking systems (differences related primarily to multi-branching and universal banking), its principles explicitly espouse universal banking, multi-state branch banking and international

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113 There was also less altruistic reasons for the Canadian and U.S. governments to pursue this principles based approach. Canada feared that, without clear principles in place, the U.S. would use regulatory change to the disadvantage of Canadian financial institutions. The U.S. administration apparently felt much the same about the Mexican government, and wished as well to anchor trade liberalising principles in a legally binding treaty so as to condition future domestic legislation. For further inquiry view William R. White "The Implications of the FTA and NAFTA for Canada and Mexico" Bank of Canada, Technical Report No. 70, 1994.

114 It is now widely recognised that an absolutely identical application of regulations may disadvantage foreign firms. De facto national treatment is sometimes referred to as 'reciprocity in the sense of equal competitive opportunities' as opposed to 'mirror image reciprocity.' See OECD, Market Access for Foreign Financial Institutions, 1993 p. 22. Received in Paris from the OECD June 10, 1999.
branch banking. The upshot is that the repeal by the U.S. of the McFadden and Glass-Steagall Acts, would oblige Canada and Mexico to alter domestic legislation to bring these principles fully into play. In this altered world, it would not be inconceivable for the harmonisation of regulations to proceed a very long way. Should this happen, it would also be more likely that host supervisors would come to rely more heavily on input from home supervisors. This would also be helpful for global developments since, a home-based approach to supervision is more or less the norm elsewhere in the world.

By 1994 under NAFTA, domestic competition with foreign entrants increased by virtue of the fact that Canadian banks began to directly compete with American banks for capital, resulting from an integrated regional economic formation. However, although regional trade among financial firms was based theoretically on the notion of the provision to 'equally competitive opportunities', domestic regulations prevented the right of establishment, and stringent ownership restrictions such as the 10 per cent rule, in tandem with prudential measures ensured financial integrity and stability, under the oversight of the Canadian government. Although, the 25 per cent aggregate restriction was removed for Mexican residents, and altogether for fellow WTO members pursuant to Canada's commitment under the Uruguay Round of trade negotiations, despite the fact that, the scriptures of the WTO obligations like national treatment and MFN status continue to be obscured as are equally competitive opportunities by the broad freedom that is given to domestic regulations and prudential concerns in the NAFTA and the FSA, which limits for example in the American market, the market share of foreign financial institutions to 8 per cent rising to 15 per cent by 2000 and thereafter, market share limits will be predicated upon temporary safeguards and policies like the Glass-Steagall and McFadden Acts and subject to the Foreign Bank Supervision Enhancement Act amended in 1991.

Accordingly, in response a year later after NAFTA, the Canadian government released a Discussion Paper entitled 'Enhancing the Safety and Soundness of the Canadian Financial System' which proposed refinements to strengthen the supervisory/regulatory framework for Schedule I banks, the federal deposit insurance system, and federal oversight of clearing and settlement arrangements. Subsequently, legislative proposals flowing from this 1995 Discussion Paper have been introduced under 'An Act to amend, enact, and repeal certain laws relating to financial institutions.' On these grounds, chartered banks are retained under Canadian control as no individual, domestic or foreign, can own more than 10 per cent of any class of shares and certain requirements in the Bank Act ensure that the management and principal location of economic activity remains in Canada. Moreover, non-NAFTA Schedule II banks continue to face restrictions in the number of branches they are permitted to operate and in the percentage of total Canadian deposits (generally defined as deposits under $150 000) for which they can account.

The 1997 amendments include a number of changes to up-date and fine-tune the 1992 legislation and are in part a response to minor problems that became apparent after it entered into effect. The amendments also deal with such issues as consumer privacy and the ability of banks not engaged in retail deposit-taking to opt out of membership in the deposit insurance agency. At the same time, the government announced that foreign banks, which have been required to establish a separately capitalized subsidiary to operate in Canada, will be allowed to establish branches directly in Canada, subject to certain conditions. Therefore, although the federal government undertook to relax the restrictions on foreign bank entry in 1997, foreign banks must continue to a) have $25 billion in assets worldwide, b) be widely held, c) have international banking experience, d) have the

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consent of the regulator in their home jurisdiction, e) demonstrate 'favourable performance' in the last five years, and f) be regulated and supervised in a suitable manner by the bank's home jurisdiction.

The most recent set of reforms concerning the financial services sector were implemented in June 1999 and seek to give banks further flexibility in their ownership and structural framework. As of June 28, 1999 — under Bill C-67, An Act to amend The Bank Act, The Winding-Up and Restructuring Act and other Acts relating to financial institutions and to make consequential amendments to other Acts, banks will benefit from greater flexibility to adapt to the changing business environment. \(^{116}\) Under the new revisions, Canadian banks have been given more freedom to make strategic deals in the U.S. and elsewhere, and will face stiffer competition in the Canadian market. The government now allows an investor to hold up to 20 per cent of any class of voting shares, and up to 30 per cent of any class of non-voting shares, of a widely held bank, although subject to 'fit and proper' \(^{117}\) tests. Subsequently, enabling banks to sign joint venture agreements involving more share swaps — a move that may possibly result in de facto American ownership and/or be used to create alliances between banks and such companies as grocery stores, information-technology companies, and business service providers.

The government has also allowed banks for the first time to restructure their operations through holding companies. The holding company option will provide financial service providers with greater choice and flexibility with respect to how they structure their operations. It will also


\(^{117}\) Generally, 'fit and proper' tests are used to assess the suitability of prospective owners. These tests include an examination of the applicant's past record as a business person, the soundness of their business plan and the reasons why they wish to get into the particular lines of business. They also
allow them to compete more effectively in the global market by giving them new latitude for raising capital and embarking on strategic alliances. The holding company regime seeks to enhance domestic competition by providing a structure for institutions to come together under a common ownership structure without having to enter into a parent-subsidiary relationship. This will allow banks to maintain their separate identities to an extent not possible under an acquisition or merger. For example, a bank, an insurance company and a mutual fund company might find that there are economies of scale and scope if they were to work together within a corporate group. Banks will have the choice of moving certain activities that are currently conducted in-house, or in a subsidiary of the bank, to an affiliate outside of the bank – that will be subject to lighter regulation than the bank, which will allow for tailored and flexible supervision based on the particular activities of the group. This will enhance the flexibility of banks to meet the increased technological and competitive challenges from sources such as unregulated and ‘monoline’ firms specializing in a single line of business. Moreover, these legislative revisions will enable bankers to set up separate business lines such as brokerage services, credit cards, or mortgage divisions that would not be subject to the same level of scrutiny by federal watchdogs as other bank operations, although the banks were denied the right to sell insurance from their branches or lease automobiles.

Also, the government is acting to increase the degree of competition in the domestic marketplace by encouraging new entrants under liberalised ownership rules and lower minimum capital requirements - which have been lowered from $10 million to $5 million. The new ownership regime will be based on size – as measured by equity, 118 with the widely held requirement applying seek to assess that applicants have the necessary integrity and fitness of character. These tests help ensure that key shareholders are not a source of weakness to the regulated institution.

118 Canada’s large banks – whose equity is greater than $5 billion – will continue to be widely held, under the new definition of widely held (20% of voting shares). Medium banks with equity between
only to the largest banks, where the concerns regarding the impact of failure on depositors and the wider economy are greatest. Small and medium sized banks will have the added flexibility on being able to be closely held indefinitely.

In addition, domestic competition will increase for the provision of financial products and services by allowing credit unions to band together on their services, and by opening up the Canadian payments system to other institutions with the result that money market mutual funds, brokerages, and insurance companies will be able to offer chequing accounts.

Legislation has also removed an unnecessary regulatory barrier to increased competition by allowing foreign banks to offer specified services in Canada through branches, rather than requiring them to set up separate Canadian subsidiaries. For many foreign banks, this will be more cost-effective. This measure seeks to encourage a healthy foreign bank presence, which should in turn lead to a wider range of financing sources for both large and small Canadian businesses, as well as greater choice for some types of consumer lending, such as credit cards or personal lines of credit. 119

Moreover, in addition to making the financial services sector more competitive, the new legislation also focuses on enhancing protection for consumers. A new consumer protection office will open along with a package of measures meant to help customers do business with banks. The

$1 billion and $5 billion will be allowed to be closely held, but will be required to have a 35% public float of voting shares — thus increasing the threshold from $750 million to $1 billion. And small banks with equity of under $1 billion will have unrestricted choice in ownership structure. 119 A foreign bank now has the option of establishing one of two types of branches: either a full-service branch or a lending branch. This allows the level of regulatory requirements to be tailored to the foreign bank's activities in Canada. Neither type of branch is permitted to take retail deposits, defined as deposits under $150,000 (foreign banks that want to take retail deposits in Canada still have the option of doing so through a subsidiary). Full service branches are permitted to take deposits greater than $150,000 while lending branches are not permitted to take any deposits. In addition, lending branches are restricted to borrowing only from other financial institutions. Since this puts no individual Canadian's funds at risk, lending branches face fewer regulatory requirements than full-service branches.
government requires that banks make their contracts easier to understand and give the consumers greater opportunity to restrict the use by banks of their personal financial data. Therefore, this new legislation includes extensive consumer protection measures including a financial consumer agency to scrutinize industry practices, an independent bank ombudsman to handle complaints from the public, requirements that banks provide four months' notice of bank closures, and new rules to reduce coercive tied selling of financial products.

With respects to improving the regulatory environment, the government is acting to make sure that the regulatory structure responds to the evolution of the sector by streamlining OSFI’s regulatory approval process, in which case, regulation will be adjusted to adapt to an environment in which the importance of competition has increased and regulatory bodies will share information and enhance their co-ordination in order to abbreviate the reporting burden on financial institutions.

THE SIGNIFICANCE OF CANADIAN CONTROL AND THE IMPORTANCE OF REGULATORY SAFEGUARDS vs THE FINANCIAL IMPERATIVES OF INTERNATIONAL COMPETITION

Implications for Policies Directed to Financial Stability

Anecdotal and survey evidence indicates that most central banks in countries with well-developed financial systems feel that they have a significant responsibility for ensuring domestic financial stability, even if the precise meaning of this mandate remains somewhat elusive. In most countries, central banks are now devoting far more resources to the issue of financial stability than was the case twenty years ago. The fundamental reason for this has been the growth of liberalised financial markets, responding to both technological developments, the search for efficiency, and the associated increase in the risk of financial instability. In recent years, financial crises have erupted with increasing regularity in both industrial and emerging markets, indicating that the concerns of
central bankers in this area are fully justified even if their endeavours have not yet been wholly successful.

Recognising these interdependencies, central banks can take measures at both the micro\textsuperscript{120} and the macro\textsuperscript{121} levels to foster financial stability. Underpinning all these policies, whether at the micro or macro levels, is the recognition that market processes are increasingly the dominant force in financial markets. The implication of this fundamental insight is that public policies should be primarily directed to redressing market failures, and that such policies should rely on market-compatible incentives to prudent financial behaviour. In addition, the important point to note is that, while final decisions must still be taken at the national level where sovereignty continues to reside, these national decisions are increasingly the final act in a long process of international negotiation.

\textsuperscript{120}Micro measures to promote financial stability involve regulation and oversight of individual parts of the system with a view to influencing behaviour or gathering information which can be of use either in preventing crises or managing them better. At the micro level, policies to foster financial stability have focused on each of the three pillars supporting the international financial system: institutions, markets, and infrastructure, (which have become internationalised thus affecting ownership on the part of Canadian market authorities). The overriding objective is a 'systemic' one, to ensure that whatever the source of disturbance might be, it does not feed through to exacerbate weaknesses elsewhere in the system with possibly non-linear effects. Thus, central banks, (often in association with other bodies) play a regulatory role with respect to financial institutions, conduct market surveillance, and oversee the functioning of payment and settlement systems.

\textsuperscript{121}Macro measures conducted by central banks traditionally include the provision of liquidity to the system through an expansion of the balance sheet of the central bank. However, as the interdependencies between macro stability and financial stability have become more recognised, two other considerations have more recently come to the fore. One issue is the extent to which concerns about financial fragility should influence the conduct of monetary policy and the pursuit of domestic price stability. The second issue is whether prudential norms should be designed and implemented so as to reflect their potential macroeconomic implications. For example, a traditional role of central banks is to provide adequate domestic liquidity through the lender of last resort function. However, as financial markets have become increasingly interdependent, and different kinds of financial institutions have entered into alliances of various sorts, it has become harder to balance off short-term exigencies against the longer-term need to reduce moral hazard and to limit the application of the social safety net. A case in point, financial institutions with international operations, receive liquidity support from the 'home' regulator who is primarily responsible for prudential supervision, however, the possibility remains that the 'host' central bank will be drawn into the affair.
and agreement among national experts. Therefore, while national sovereignty remains in an internationally integrated financial world, it does so in a form that is materially constrained.

Canada's Regulatory Framework

Chartered banks are important to the stability and integrity of the Canadian financial system by virtue of their size and geographic spread of their operations, and most importantly, that they collectively represent the largest concentration of assets in any regulatory category of financial institutions. 122 With the onset of the regulatory changes that I have outlined in the preceding paragraphs, which progressively have permitted chartered banks to diversify their functions and increase their total assets through the acquisition of securities firms, has enabled banks to play an even more dominant role in Canada's monetary and payment system. Consequently, because monetary policy is one of the instruments used by the Canadian government to pursue macroeconomic objectives, it can only achieve such an integral role by taking specific action through the Central Bank that affects the money issuing of financial institutions and induces a predictable monetary adjustment on chartered banks. Henceforth, national ownership and federal control of chartered banks allows the Canadian government to manage the money supply because it sets the amount of cash available as reserve requirements which must be met by the banks. In turn, the integrity and stability of the financial system is ensured by the Bank of Canada which controls the cost and availability of credit and maintains certain other powers that enable it to influence appropriate lending decisions by chartered banks.

Under the constitution, the federal government is responsible for 'banking', the incorporation of banks, and the issuing of paper money. As well, the federal government has the authority to

122 Bond, Chant, and Shearer ibid., p. 295.
incorporate companies and to regulate their corporate affairs. In addition to banks, trust, loan, and insurance companies, and non-banking financial institutions which are federally incorporated are also regulated by the federal government, while provincial charters govern all aspects of the financial service industry, other than the banking sector.

In this light, Canadian control is desirable because of the benefits and associated economic advantages of having a domestic financial centre, taxation revenue, and sensitivity to domestic market conditions amidst integrated financial markets. Also, it must not be forgotten that 7.5 million Canadians have directly or indirectly $75 billion of their life savings invested in bank shares. In Canada, as in other industrialised countries, market access to foreigners is relatively denied to preserve these objectives, and by the necessity to secure prudential regulation and supervisory oversight realised only through Canadian ownership, not just governance, of financial institutions. However, these regulations in the banking industry have also constructed an incontestable market, albeit one that is 'secured' from global financial volatility through monopolised domestic competitiveness.

Exhibit 1.3
Canadian Financial Sector Global Competitiveness Rankings

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<tr>
<th>Characteristic</th>
<th>Canada's rank</th>
<th>U.S. rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Degree of overall sophistication</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Supply of venture capital</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>Degree of competition from foreign banks</td>
<td>41</td>
<td>10</td>
</tr>
</tbody>
</table>

124 Whittington, ibid., p. 208.
125 A case in point, Canada was ranked 1st in terms of prudential regulation by the World Competitiveness Survey in 1997, but ranked 41st out of 53 countries surveyed with respects to the degree of competition from foreign banks. Institute for International Management Development, The World Competitiveness Yearbook 1997, June 1997. As can be observed from Exhibit 1.3
Competitive Strains

However, amidst cross border business and increased competition, coupled with the progress with respect to the financial markets, the pace of change continues to accelerate as international agreements, increased trade, technological progress, and domestic deregulation interact to promote the process of change. In this context, the banking sector now opposes stringent regulations, which they see as hindering their ability to compete in international markets.\(^{126}\)

A Canadian controlled financial services sector that is internationally competitive may contribute to the achievement of these goals, and a diversified mix of international business will enable Canadian financial firms to weather the difficulties that may arise in domestic financial markets from time to time. In adopting a public policy of Canadian control, it is important to have Canadian firms that are internationally competitive. They must be able to defend their positions in the Canadian market \textit{vis a vis} foreign competitors, as well as compete effectively in international

\(^{126}\) Closely related to this fact is that profits in the financial system will be under increasing pressure from enhanced competition. If the past provides any guide to the future, there will be an increased tendency for firms to try to enhance profits by taking more risks. The implication is that Canadian
markets. From this perspective, there is really no trade-off between international competitiveness and Canadian control. International competitiveness of Canadian firms is a sound and efficient means of promoting Canadian control without the costs to consumers that protection would entail.

Therefore, the equivocal notion of 'equitable competitive opportunities' has just solidified and intensified this power struggle between the state's obligation to regulate for prudential reasons, and the economic interests who wish to expand their rents beyond the domestic market. The manifestation and resolution of this dialectic will (re) shape Canada's rendition of sovereignty, and direction of democracy, in the 21st century.

**HOW IMPORTANT IS SIZE?**

Current conventional wisdom suggests that a financial institution must be large to prosper in the future environment. This view is based on some or all of the following propositions. First, given technological requirements, it will be extremely expensive in the future to maintain a competitive infrastructure for delivering financial services efficiently and only large institutions can manage these costs. Second, economies of scale in some parts of the operation can be realised only by very large entities. Third, a successful financial institution will have to be large enough to provide all or most types of services to its customers in a sort of financial supermarket, either because of demand or to take advantage of economies of scope (or synergies). Fourth, an international presence is essential for success, and only large institutions can compete outside the domestic market. Fifth, large amounts of capital will be necessary to handle the kinds of transactions and provide the kinds of services demanded by some customers in the future. These propositions imply that the successful financial supervisors, in industrial countries at least, will come to rely more on disclosure, internal models, and market discipline as a complement to more traditional techniques of oversight.
institution of the future will be a very large conglomerate, operating in an international context, and providing all or most types of services to its customers in a technologically advanced way.

These propositions are plausible on the surface but can be challenged to some degree. It appears true that technological changes associated with product delivery will be quite expensive in some cases. However, investment in these new technologies need not necessarily come only from one provider or, for that matter, only from financial service providers. The infrastructure for the delivery of some products could be developed jointly with other service providers, or with other entities such as telephone or cable companies. Also, not all delivery mechanisms will require large investments; telephone banking is an example.

Economies of scale clearly exist in certain parts of the operation of financial service providers. However, empirical work thus far has provided no evidence that a bank has to be a mega-institution, rather than just large, to exploit most economies of scale. And, of course, some economies of scale can be exploited by outsourcing or by purchasing certain types of services from specialist institutions, as has happened in a number of industries and in the back room operations of banks.

More broadly, one can raise the issue of how universal a bank has to be in both services and geography. The conglomeration movement, in financial services as in other industries, is largely based on the importance of economies of scope, or synergies, among its various components. Here too, there is little evidence thus far that such economies are very large or very important. While some customers of a financial services provider may want to do all their financial shopping in a single supermarket, others may prefer to shop in separate institutions for different kinds of services. Indeed, some customers may feel more comfortable seeking advice and purchasing services from different firms precisely because they want to avoid relying on a single supplier. Moreover, large institutions are often thought to be less nimble in their responses to change than smaller institutions, raising the
issue of how innovative, flexible and responsive mega-sized, multiple-line institutions would be. The analogy with the non-financial industries, which have gone through waves of conglomeration and divestiture over the years, must at least give one pause before arguing that the future lies with the one stop shopping supermarket. What appears to have been the case in some industrial conglomerates was that the diseconomies of scale and scope (or the difficulties of managing and operating a mega-operation with many diverse arms) led to a loss of focus and increased costs. The response was divestiture, with a return to more specialized enterprises and a focus on core business activities.  

Another major element in the argument for the mega-bank is the need for a major international presence. The general consensus is that there will be at most only a small number of banks offering the full range of services in virtually all major markets. One might speculate that the current renewed enthusiasm for global mega-institutions is a reflection of the very benign economic environment, with very low credit losses in a number of countries during the most favourable phase of the business cycle. In the end, however, what counts is profitability, not size. It is far from clear that the global mega-institutions will be best at providing the efficient, innovative, and flexible service environment necessary to maintain high profitability.

In summary, while there are many advantages to size, there are some disadvantages. This suggests that the mega-institutions will co-exist with niche players in the future financial system. The conventional wisdom that has mid-sized players disappearing may be correct, since they have neither the strength of the very large nor the flexibility of the small. But even here, if mid-sized institutions can become focused, specialized institutions rather than attempting to be mini-supermarkets, there

127 Of course, part of the perceived synergistic value of the financial supermarket will depend on the regulatory arrangements in place. In Canada, the legal prohibitions preventing banks and other deposit-taking institutions from selling most kinds of insurance on their premises and from sharing
may well be a positive future in store for them. Thus, the key issue may not be so much the size of financial service providers, but rather the nature of the activities they undertake.

**CONTEMPORARY PROBLEMATIQUES**

**THE INTERCONNECTION BETWEEN REGULATORY OVERSIGHT AND MARKET STRUCTURE**

In the present, policy concerns in Canada which drive regulation primarily deal with issues that relate to prudential risk, market conduct, and corporate conduct. In the contemporary era of technological developments and deregulation, economic barriers have been reduced and have rendered the sector to flows of fierce competition from abroad. However, regulatory barriers have been maintained to protect the domestic economy from destabilising risks and asserted in the form of restrictions to ownership, minimum capital requirements, 'fit' and 'proper' management tests, high capital taxes (provincial and federal), and through stringent accounting procedures, thus successfully restraining the range of 'qualified' foreign rivals.

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128 The government has recognised that taxes on capital are an important element in determining the competitiveness of our banks. Although, capital taxes are an important component of taxes paid by financial institutions, banks have expressed concern that the existing capital tax burden has placed them at a competitive disadvantage vis a vis their non-regulated and foreign competitors. Therefore, the June 1999 legislative changes seek to begin discussions between the federal government and the provinces concerning the 'negative' effects of capital taxation on competitiveness. For further detail view [www.fin.gc.ca/finserv/docs/finserv2e.html](http://www.fin.gc.ca/finserv/docs/finserv2e.html)

129 Likewise, it is generally acknowledged that the Canadian accounting standards in this area can result in lower reported income than the rules that apply in the U.S., which can put Canadian firms at a competitive disadvantage relative to their U.S. counterparts in making strategic acquisitions. Thus, accounting standards bodies in Canada and the U.S. are working towards new harmonised standards for business combinations by the end of the year 2000. The government supports this initiative and encourages these bodies to make the necessary changes as soon as possible, and to consider bringing forward an interim solution in Canada to level the playing field.
In turn, this regulatory adjunct has concentrated the banking sector in terms of market share, capital employed, and profitability, as eleven Canadian controlled banks possess 90 per cent of their banking assets in Canada, while the five largest banks account for 85 per cent of the banking sectors’ profits and 76 per cent of its domestic market share. In this light, the market is dominated by oligopolistic banking houses who have benefited from federal regulation by virtue of dominating domestic competition vis a vis foreign entrants, as illuminated by the fact that there are forty-four established foreign financial institutions in Canada, but collectively only account for 8 per cent of the domestic market share.

Subsequently, the nature of Canada’s market structure and the magnitude of market power held by domestic chartered banks, has surfaced amidst merger attempts to further consolidate the industry. The Canadian Competition Bureau has declined the merger proposal put forth by Canada’s four largest banks, because as gathered from this overview it would be seen as not only being

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130 Total profits for 1997 for the big six chartered banks - Royal Bank, CIBC, Bank of Montreal, Bank of Nova Scotia, Toronto-Dominion Bank, and the National Bank- hit $17.5 billion (43% higher than the $5.2 billion in profits recorded only two years earlier). Whittington, ibid., p. 11. Thus, profitability (measured net income divided by total revenue) rose from 9.7% in 1992 to 19.5% in 1996.


132 However, this situation may be altered by the foregoing changes in regulatory policies and innovations in information technology which have reduced the competitive significance of branch networks in the provision of financial services, as exemplified in the new competitors which are niche players in various segments of the financial services market, including credit cards, small business lending, consumer loans, mortgages, and deposit accounts. Historically, foreign entrants have proved to be unsuccessful in large scale commercial banking, unless they were allowed to takeover an existing Canadian bank. However, it will be interesting to see if the recent reformulation of the 10% rule to 20% will increase competition or reduce concentration, or simply raise concerns about the accepted level of foreign ownership in the Canadian banking industry and the continuing viability of national regulations in the Canadian financial regime.

133 Market power is the ability to profitably maintain prices, quality, service and or product variety for a significant period of time at levels that are less favourable to consumers that would exist in
detrimental to Canadian interests, but to the overall interests of safeguarding the federal governments’ ability to pursue macroeconomic prudence. In 1998, mergers proposals were put forth by the Bank of Montreal and the Royal Bank and the Canadian Imperial Bank of Commerce and the Toronto-Dominion Bank. The merger review process decided that the mergers would have a negative impact on ordinary people and small and medium sized businesses and lead to a substantial lessening of competition, thereby negate the twin principles of competition policy; as allocative efficiency would not be realised because higher prices would be charged, and fairness would not be achieved because there would be lower levels of service from branch closings which would ultimately hurt consumer welfare. Moreover, the mergers were declined for prudential considerations because currently when Canadian financial institutions face difficulty, one possibility would be to sell their operations to other stronger Canadian competitors. However, after such a merger given the size of the banks, a merger between the four largest banks would result in the sale of assets to a foreign institution. (Rob Ferguson, *Toronto Star* December 15, 1998 Cover Story in Section D "Your Business.") However, concerns went beyond the issue of competition, it

MARKET STRUCTURE: PROBLEMatisING COMPETITION ANALYSIS IN THE FINANCIAL SERVICES INDUSTRY

Competition laws in Canada exist for the purpose of preventing individual firms or groups of firms from engaging in activities, which will seriously harm competition. In the financial services sector, the main focus of competition policy in not upon industries *per se* but rather on markets. In competition analysis, it is important to think in terms of function (type of product or service) rather than institution (type of firm). For example, in the financial services industry, similar institutions such as banks, do not compete in all product lines. Conversely, in any given product line or service, such as term deposits, competitors are not restricted to any one type of institution, such as credit unions. In this approach, the level of competition for a product or service is a function of a number of variables, including the number of firms offering competitive choices for that particular product or service (number of competitors) and the ease with which new competitors can enter the (product) market competitive markets. (Competition Bureau, *The Merger Enforcement Guidelines as applied to a Bank Merger* Ottawa July 1998) p. 3.
In this light, the oligopolistic market structure which characterises Canada's financial service industry becomes somewhat irrelevant for competition analysis because a plethora of financial products and services are nevertheless still being offered, thus the market for financial products and services seems contestable because of the wide variety of competitive choices offered to customers. However, what has become a problem in the banking sector specifically with reference to the proposed bank mergers, is that with an oligopolistic market characterised by high barriers to entry, banking conglomerates have the impetus to behave in a way that results in their charging higher prices, and offering lower levels of service or quality.

On these grounds, policy concerns relating to corporate conduct have surfaced because of the information asymmetry between financial institutions and their customers. In concrete terms, the variety in and among product features, fee structures, and insurance contracts makes it difficult for customers to assess the nature of each transaction and the accompanied stipulations of each arrangement. In this context, financial markets cannot function effectively unless participants act with integrity and there is adequate disclosure to facilitate informed judgements. Correspondingly, this phenomenon has sparked a considerable debate over the practice of coercive tied selling. In 1997 there was a proclamation to amend the Bank Act Section 459.1(1) and embody to make it an offence to 'impose undue pressure, or coerce, a person to obtain a product or service from...the bank and any

was also stated that the planned mergers would leave decisions on credit allocation—which is so crucial to the effective functioning of the economy— in the hands of fewer, even larger institutions. In addition to what I have outlined, financial services pose a number of particular challenges to competition analysis in terms of product complexity (defining a market is complicated because of the way in which financial services are packaged and purchased), product range (the sector has very distinct product markets), price (it is difficult to measure the price of loans, and service fees), and delivery channels (the ways in which financial services are delivered poses a challenge of identifying markets).

of its affiliates, as a condition for obtaining a loan from the bank. Further, as convergence continues to occur in the financial services sector and as institutions and intermediaries offer a broader range of products, they will wish to present them to consumers in attractive packages, therefore, tied selling is likely to increase. Currently, Canada is unequipped to deal with these practices because competition policy focuses on the restraints on trade and lessening of competition in the market, rather than in the abuse of customers.

In conclusion, following the Canadian governments' veto of the proposed bank mergers, the banks will have to rethink their strategies in several business areas. Under the newly formed Merger Review Process, Canadian banks will have to indicate their intention to merge and must cover the costs and benefits of the proposed merger transaction on Public Interest Impact Assessment (PIIA) forms. For example, according to the 1999 legislative amendments, all merger participants must include the impacts on sources of financing for individual consumers and small and medium sized enterprises, they must cover the regional impacts including bank closures and changes to service delivery, as well as the impact of the merger on international competitiveness, employment and technology. Also, the PIIAs must explain what impact the merger would have on the structure of the financial sector overall. Accordingly, OSFI and the Competition Bureau will conduct their respective reviews of the merger as proposed from the perspective of market competition and the safety and soundness of the merged bank and the financial system. A mechanism will be created to bring together a full set of remedies to address competition, prudential, and other public interest concerns. Legislative changes will also be introduced in the near future to ensure that a financial institution complies with the terms and conditions attached to the approval of mergers and acquisitions and to provide the Minister of Finance with appropriate powers of sanction.
As a result, Canadian banks will very likely offer all the traditional banking services in Canada, but may choose quite different strategic paths in providing non-banking financial services. Externally, they may also choose to specialize in a niche or niches which they perceive that they have a comparative advantage, in part for historical reasons, and in part because of their strengths in the domestic market. In the domestic market, Canadian banks will face increased competition from major global banks, from other international banks that see a niche for themselves in the Canadian market (for example, International Nederlanden Groupe (ING) in virtual banking, and Wells Fargo in small business-lending), and from non-regulated entities like GE Capital and Newcourt that have developed specialized expertise in certain areas of lending. They will also face potential competition from non-regulated entities in attracting funds and in the delivery of payments services. Their decision on which lines of business to concentrate may implicitly involve a decision whether to focus on customized or commoditized types of products, or, as until now, both. All this will be done in the context of what is perceived by many to be over capacity in the financial services industry in both international and domestic markets, with considerable uncertainty as to how important size in itself really is (in relation to the need to access economies of scale and scope).  

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137 The evidence on size, scope and economies of scale does not strongly support the idea that mergers of large institutions necessarily provide business benefits. However, there are enough changes going on in the business environment that one cannot formulate a definitive conclusion. The evidence deals with size itself and not the potential savings stemming from particular mergers which raise different considerations than size alone. Although there are numerous studies of the efficiency effects of mergers, most pertain to the U.S. experience in a period when smaller banks were consolidating on a regional basis. These early studies typically found limited evidence of efficiency gains. A recent study dealing with ‘megamergers’ finds that mergers did improve profitability, albeit not through increased market power and lower costs, but through changes to improve the mix of product and services offered after the merger. See J. Akhvein, A. Berger and D. Humphrey, “The Effects of Megamergers on Efficiency and Prices: Evidence from a Bank Profit Function”, Working Paper 1997-09 (Washington D.C. Board of Governors of the Federal Reserve System, 1997). Thus, each business combination has unique aspects that must be evaluated as part of the decision to merge: rationalising particular business lines, introducing alternative technologies, building a stronger
CONCLUSION

In the present era, national regulations governing the banking sector have become intertwined and penetrated by a variety of market forces, which increasingly adhere to a greater reliance on the requisites of market innovation and dynamism. As a result, shifting political and economic dynamics have authenticated a challenge of reconstruction and reinstitution, for not only economic interests, but equally for political authority. This is exemplified by the fact that there have been ongoing attempts by corporate interests at the national level, to free themselves from the constraints of government policy, regulation, and restrictions, as they strive to grow bigger possibly at the expense of Canadian jobs, communities and the national economy. In response, the Canadian government must weigh the costs and benefits of this strategy, which is predicted to harm the long-term interests of Canadian consumers and workers, not to mention Canada’s economic and cultural interests.

On these grounds, today’s multi-level form of governance is conceived of a weakened state from above (the power of suprastate economic networks and regional economic arrangements with binding obligations have changed the scope of state action as decisions/actions transpire outside the boundaries of states - reflected in the 1980 decision by the Canadian government to open up the financial services industry to foreigners, in order for Canadian banks to continue to operate in the markets of other countries), and below (the ascent of provincial/municipal manifestations of discontent and fragmentation, vis a vis the federal government in the area of jurisdictional control over the leverage of financial institutions funnelled by an integrated financial capital power bloc, like the one that resides in Toronto, whose networks also operate through other world financial cities).
However, this friction between delegated power and authority is still managed by the Canadian state which determines the sectors' ability to pro-actively exploit new markets and opportunities generated by mergers and acquisitions, a business strategy contingent upon Ottawa's (re)articulation of regulatory control. Notwithstanding, it is important to note that the recent adoption of the FSA by the WTO in 1997 has increased pressure on Ottawa from foreign governments and financial firms who demand reciprocal market access opportunities in the Canadian domestic market. The effects of this global agreement have resulted in (re)conceptualised federal regulations implemented in June 1999. For example, foreign banks are now permitted to set up branches without being required to incorporate separate subsidiaries; and limits on single shareholdings in a Canadian bank have been raised from 10 per cent to 20 per cent. Consequently, with the dismantling of existing bank regulations, Canada might well end up with a small number of very large banks controlling all the facets of the financial industry, resulting in less, not more, competition, as well, these financial institutions could be principally owned by foreigners, not Canadians.

Nonetheless, given the strategic importance of the sector and its effects on a myriad of other important realms, the Canadian state has refused to abdicate its hold on the mode of regulation and influence on corporate conduct, and has (re)created a multi-level platform of control and legitimacy in an effort to maintain the sector under Canadian possession which will help to secure the domestic economy from the volatility of integrated financial markets. A case in point, at a G7/8 meeting in May 1998, Finance Minister Paul Martin put forth a plan for the creation of an international body for financial surveillance which would inter alia, 'provide a mechanism for peer review of financial sector supervisory and regulatory regimes,' and 'form part of the crisis response team in responding to
Asian style crises.' In this case, the federal government has sought to (re) legitimate the *raison d'être* of domestic regulatory control over prudential concerns through, and in tandem with, international policy co-ordination, primarily for the sole reason that mid-sized and open economies like Canada's are dependent on a rules based system to be able to compete on a level playing field. As stated by Paul Martin in a speech recently given at Cambridge University, "there is no greater threat to national sovereignty than the threat of financial crisis.... Canada's goal is to defend not only its own sovereignty, but also that of other nations so that all countries will be better placed to offer their citizens protection and stability." This is perfectly exemplified in the June 1999 legislative changes which seek to strike a balance between increased competition and the counterpart potential for greater risk by reducing the administrative powers of OSFI yet granting the supervisory body additional powers to deal with the potential for increased risk in the financial system, specifically with increased domestic competition by domestic and foreign players.

In the present, the Canadian government is attempting to deal with the contradiction between easing the regulatory burden of financial institutions and keeping legislative currents in line with evolving needs primarily modifying entry/ownership policy coinciding with the no access for no access policy on the one hand, and in parallel formulating a policy which ensures the safety and soundness of the financial sector and safeguarding consumer protection on the other. On these grounds, the recent legislative amendments throw off the regulatory strictures governing financial services with recommendations for a tough new strategy to enhance consumer protection, in tandem

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with, extensive suggestions for creating more competition in the sector. These included allowing life insurance companies, mutual fund companies, and investment firms access to the national payments system used by the banks to process financial transactions, making it easier to start new banks, encouraging more activity in Canada by foreign banks, and streamlining regulations to create a national credit union network that could better compete with big banks. Moreover, merger participants will be forced to undergo a detailed Public Interest Review Process, which would examine the implications for employment, costs, and benefits to consumers, and other factors.

However, on a more global level, the contention between disparate domestic regulatory frameworks in general, and the friction between national rationales for prudential regulations that indirectly assemble a market structure conducive to anti-competitive practices must be analysed through a broader lens that takes into account historical, cultural, and ideological variations within the hierarchy of nations. In turn, I am very sceptical of the possibility of a global competition policy, and moreover of national regulatory harmonisation attempts in the financial services sector. Despite the fact that, as capital markets become more global and the Canadian economy becomes integrated into a North American regional bloc, and as part of a broader multilateral liberal trading order, all Schedule I banks in response have reconfigured their capital base by raising capital in foreign markets and listing their shares in U.S. stock exchanges.

Subsequently, these structural changes have sparked a heated debate between political power and economic power around what constitutes prudential regulatory oversight as expressed in a national ownership policy. The banks see the Canadian market as only part of a much larger market, and argue that restrictions on equity investments lowers their demand for bank shares, thus raising their banks' cost of capital, and creating an environment that is not conducive to market efficiency and innovation. However, the fact that the latest regulatory changes do not lift insurance networking
restrictions upon banks nor permit banks to broaden their reach into auto leasing and/or merge even though the 1992 legislation contains no prohibitions for mergers between Schedule I banks, demonstrates to some extent not only the continuing concern that banks are already too big and too concentrated, but the necessity for the federal regime to manage these institutions in the best interests of Canada.

There is no doubt that the developments at every multi-level arena of governance suggest that Canada must realign its domestic regulations in order to benefit from continued market access abroad. However, it seems that this can only be achieved by denying the benefits that emanate from a Canadian controlled and dominated financial centre such as: domestic market sensitivity, taxation revenue, the contribution of banks to Canadian communities, and our ability to diminish the extraterritorial application of laws.

Conclusively, my research has sought to imperil a twin interface that may potentially undermine the dynamics of the global trading system. The power of the state, like the economic power of banking interests is being simultaneously (re) articulated in an unprecedented and precarious manner. Legally binding trade regulations governing trade and investment flows between and among countries, regions, and cities have intensified government and private barriers to entry by rendering differences in the competitive dynamics of countries and firms as legitimate, yet unequal. Hence, today the problems of the international community of nations are two-fold. First, to collectively, yet competitively control externalities originating either in the supply of international public goods or in international interjurisdictional spillover, or in both. And second, to ensure that the competitive forces that arrange and govern international relations remain stable and efficient. 140

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In this regard, the 21st century will dawn a new era that will peg 'competitive governments' against 'competitive markets' a duo soliciting for (re)conceptualisation in the transformation of national financial systems. The globalisation of the financial services industry and integration of domestic financial systems across borders and across product markets has created irreversible changes in the way risks are managed, and thus has brought the need for banks and their regulators to adapt their controls to an international, rather than purely domestic environment.