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Banking in North America: The Triumph of Public Choice over Public Policy

Eric J. Gouvin*

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Introduction

As late as 1985, in *Northeast Bancorp, Inc. v. Board of Governors of the Federal Reserve System*,¹ the U.S. Supreme Court observed that “banking and

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1. 472 U.S. 159 (1985).

related financial activities are of profound local concern.”² Such an assessment, however, has been rendered obsolete by recent trends in world banking. Today, we participate in an increasingly global financial services marketplace. In North America, some leading U.S. banks report that a majority of their productive assets are located outside the United States.³ The Canadian Bankers Association touts international banking as the ideal export.⁴ Mexico is seriously considering removing restrictions on foreign ownership of its largest banks.⁵ North American banking concerns are moving to form the first truly continental banking organizations. The Bank of Montreal leads the way in that endeavor, with its commanding presence in Canada, its ownership of Harris Trust in the United States, and its major investment in Bancomer in Mexico.⁶ However, many major U.S., Mexican, and other Canadian banks also have substantial operations throughout North America.⁷

Continent-wide banking in North America emerged as a direct response to the financial demands of the North American Free Trade Act (NAFTA).⁸ In simple terms, increased cross-border trade required the creation and support of cross-border financial institutions. The need for a cross-border, North American banking establishment was anticipated by NAFTA trade negotiators. NAFTA broke new ground by setting out a principles-based approach to liberalized trade in financial services as well as trade in goods.⁹ Yet, while the agreement on trade in financial services was

2. *Id.* at 177 (quoting *Lewis v. B.T. Investment Managers, Inc.*, 447 U.S. 27, 38 (1980)).

3. See William H. Lash, III, *The Decline of the Nation State in International Trade and Investment*, 18 *CARDOZO L. REV.* 1011, 1017 (1996) (citing the fact that Bankers Trust reports that 52% of its productive assets are offshore, while Citicorp reports 51% of its assets fall into that category).

4. See *Reforms Needed for Financial Services to Flourish Says CBA*, *CANADA NEWSWIRE*, Oct. 29, 1997 (noting that Canadian banks are major exporters, generating 40% of their earnings abroad while having 90% of their workforce located in Canada).

5. See Jonathan Friedland, *Mexico's Zedillo Predicts Passage of Reforms, But Warns of Possible Further Cuts in Spending*, *WALL ST. J.*, June 10, 1998, at A13 (describing the banking reform package proposed by the Zedillo administration).

6. See Drew Clark, *Harris Marketers Look to a Mouse That Roars*, *AM. BANKER*, Jan. 7, 1998, at 14 (describing Bank of Montreal's plan to be the first true North American bank through its operations in Canada, Mexico and the United States).

7. See, e.g., Jonathan Friedland, *Citibank Buys Confia of Mexico*, *WALL ST. J.*, May 12, 1998, at A14 (noting the acquisition by Citibank of the troubled Confia banking organization from the Mexican bank-savings protection agency, Fobaproa, thereby stepping into a well-established branch system; also noting Bank of America's informal discussion with Grupo Financiero Banorte SA). See also Stephen L. Fluckiger, *The Mexican Banking Crisis: Remedies and Opportunities*, 50 *CONS. FIN. L.Q.* 76, 82 (1996) (describing the Mexican operations of Bank of Nova Scotia, Bank of Montreal, Wells Fargo, and NationsBank). See generally John P. Cogan, Jr., *Privatization of the Mexican Banking System: Quetzalcoatl and the Bankers*, 23 *ST. MARY'S L.J.* 753, 770 (1992) (noting the presence of Mexican banking subsidiaries in the United States since 1978).

8. North American Free Trade Agreement, Dec. 17, 1992, U.S.-Can.-Mex., 32 *I.L.M.* 289 [hereinafter NAFTA].

9. See Cally Jordan, *Financial Services Under NAFTA: The View From Canada*, 9 *REV. OF BANKING AND FIN. SERVICES* 45, 51 n.39 (Mar. 24, 1993) (noting that NAFTA marks the “first ever principles-based approach to trade liberalization” in financial services, as

innovative, it was incomplete. Although NAFTA liberalized access of member countries to one another's banking markets, it failed to eliminate all of the obstacles to free and unfettered cross-border banking.

One of the largest obstacles to cross-border banking involves the drastically divergent banking environments found in the signatory member countries.¹⁰ While the United States and Canada have well-established banks and stable currencies, Mexico's banking industry is still evolving and the peso remains volatile. On the other hand, while Canada and Mexico both have relatively concentrated banking markets in which banking organizations are free to offer a broad range of financial services, the U.S. market shares neither of these attributes.¹¹ NAFTA trade negotiators also had to take into account the unique banking regulatory scheme in each of the member countries. For example, they had to recognize that U.S. banking law separates commercial and investment banking and, at the time of negotiation, placed significant restrictions on geographic expansion. They also had to accommodate both Canadian and Mexican laws designed to ensure domestic ownership of their largest banking institutions and to prevent U.S. encroachment into their home markets through branching.

Given these realities, NAFTA gave the signatory countries a somewhat more liberal trading regime than had existed previously. However, it did not resolve the question of how well-integrated a North American banking organization should be. More specifically, it did not resolve whether there would be a requirement to force member countries to permit banks from the other member countries to branch across national borders without having to charter a new bank. Therefore, NAFTA left the issue of cross border branching for future resolution, and memorialized that compromise in section 1403(3), which states:

[A]t such time as the United States permits commercial banks of another Party located in its territory to expand through subsidiaries or direct branches into substantially all of the United States market, the Parties shall review and assess market access provided by each Party . . . with a view to adopting arrangements permitting investors of another Party to choose the juridical form of establishment of commercial banks.¹²

opposed to the "à la carte approach pursued under the FTA [U.S.-Canada Free Trade Act]"); see also WILLIAM R. WHITE, *THE IMPLICATIONS OF THE FTA AND NAFTA FOR CANADA AND MEXICO* 9 (1994) ("The FTA was a path-breaking agreement in that it explicitly treated the issue of trade in financial services and accepted the principle of national treatment instead of reciprocity.").

10. See Stephen Zamora, *Comments on the Regulation of Financial and Legal Services in Mexico Under NAFTA*, 1 U.S.-MEXICO L.J. 77 (1993) [hereinafter Zamora, *Comments*] (noting the disparities between the U.S. and Mexican banking industries).

11. The U.S. market is served by thousands of banks and thrifts, and stands almost alone among Western countries in its division between commercial and investment banking. See William Jackson, *Glass-Steagall Act/Financial Modernization Issues in the 105th Congress* (Congressional Research Serv. No. 16, 1997). In most countries banking organizations may engage in securities activities either directly through the bank itself, or, as in Canada, through a securities affiliate in a holding company organization. *Id.*

12. NAFTA, *supra* note 8, art. 1403(3), 32 I.L.M. at 657.

Under the terms of § 1403(3), the time is now at hand to re-examine the issue of cross-border branching. Recent U.S. banking law reforms permit Mexican and Canadian banks located in U.S. territory to branch into substantially all of the U.S. market.¹³ Of course, the trade negotiators do not have the power to unilaterally change the domestic laws of their home countries. Therefore, the requirement to “review and assess” cross-border branching contained in § 1403(3) is by no means a guarantee that cross-border branching will become a reality any time soon. Assuming, however, that the cross-border branching issue will at least be “reviewed and assessed” as required by the agreement, this paper considers the possibilities for true cross-border branching in the NAFTA countries.

The paper begins by considering several possible models for the decisionmaking process that will resolve the branching question: the “Expert” model, the “National Interest” model, and the “Public Choice” model. Of these three, the Public Choice model is seen as the most useful. Part II recognizes that the larger bargaining process that will produce an outcome on the cross-border branching issue is actually composed of a group of embedded games that are being played out in the regulatory arena and in the financial services industry. Part II then explores the stakes in the several subgames and the incentives for the key rent-seeking groups to affect the development of North American banking policy. Part III makes predictions about what may happen in the future, concluding that the United States is unlikely to liberalize foreign branching unless a significant change in some other area of financial services, such as insurance, makes departure from the status quo worthwhile. Canada is likely to move toward the appearance of freer branching without actually making any meaningful concessions on foreign access to the Canadian retail market. Finally, Mexico is unlikely to allow branching since it is concerned with creating incentives for foreign investment in the existing banking structure rather than risking any developments that may hinder the precarious recovery of the Mexican banking system.

I. Models of Analysis

Since the issue of cross-border branching is currently before the NAFTA member countries, one might imagine how the issue will be decided. Three different decisionmaking models exist. First is the “Expert” model, in which a hypothetical disinterested expert versed in international banking and corporate law makes the objectively “right” decision based on public policy considerations. A second approach, the “National Interest” model, recognizes that even if the countries aspired to achieve the “expert” result, their national interests might nevertheless require them to try to establish an international regime that produces a different outcome designed to maximize their perceived national interest. The third

13. Nationwide branching was made possible by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (1994) (codified throughout 12 U.S.C.).

approach, the “Public Choice” model, analyzes the process as a competition of various rent-seeking groups – not “nations” with “interests” – to obtain the maximum benefits from their own point of view.

A. Expert Decisionmaker Model

If we lived in Plato’s Republic, the decision about cross border branching would be an easy one because we would trust our public guardians to make the wisest decision based on all the facts available.¹⁴ In that world, a disinterested expert would be entrusted to make the “right” decision. Our hypothetical expert decisionmaker, not constrained by political realities, would: (1) identify the problem, (2) define and rank the goals for solving the problem, (3) specify all the relevant options for meeting the defined goals, (4) collect data relevant to each option, (5) predict the consequences of each option on the basis of the data collected, and (6) select the option that best achieves the goals.¹⁵ To carry out this analysis, the decisionmaker would employ the wisdom of macroeconomic theory, which promotes free trade as a good thing that will increase all participants’ wealth,¹⁶ and holds that a country should eliminate its tariffs even if its trading partners do not eliminate theirs.¹⁷ Liberalizing cross border trade in financial services should increase competition (or at least the threat of competition) which could, in turn, reduce prices, help eliminate inefficient regulation and otherwise improve the market for financial services.¹⁸

The decisionmaker would be familiar with the barriers that prevent countries from achieving truly free trade. The most obvious barriers are tariffs, and NAFTA took steps to eliminate tariff barriers on virtually all goods traded among the NAFTA member countries.¹⁹ Our hypothetical expert, however, would also be aware of the more pernicious problem of

14. PLATO, *THE REPUBLIC OF PLATO* (Allan Bloom trans., 1968) (Plato articulates a vision of the Republic in which an elite group of philosophers are specially groomed to govern).

15. See CARL PATTON & DAVID SAWICKI, *THE POLICY ANALYSIS PROCESS: BASIC METHODS OF POLICY ANALYSIS AND PLANNING* 26-38 (1986) (articulating the traditional approach to public policy analysis); see also JOHN SPANIER & ERIC M. USLANDER, *HOW AMERICAN FOREIGN POLICY IS MADE* 103 (2d ed. 1978) (describing a similar process in the “rational actor” model of decision making).

16. See N. GREGORY MANKIWI, *MACROECONOMICS* 202-04 (3d ed. 1997) (setting forth the widely accepted view that protectionist trade policies have no effect on the trade balance even though they do affect the amount of trade and noting that trade benefits all countries whereas protectionism makes everyone worse off even if it produces some winners within a society).

17. See DAVID FRIEDMAN, *HIDDEN ORDER* 282-87 (1996) (providing a simple mathematical proof of why elimination of tariffs, even on a unilateral basis, is wealth maximizing).

18. See Ernesto Aguirre, *International Economic Integration and Trade in Financial Services: Analysis from a Latin American Perspective*, 27 L. & POL’Y IN INT’L BUS. 1057, 1060 (1996) (stating that “liberalization may raise the average efficiency of industry, and this should be reflected in lower prices for financial services and products”).

19. NAFTA, *supra* note 8, art. 302(2) (describing five different categories of goods and tariff phase-out schedules for each, with the last tariffs to be eliminated by January 1, 2008).

non-tariff barriers to trade.²⁰

In the case of cross-border banking, non-tariff barriers generally involve regulation in the host country to which the firm is not subject in its home country. Because of the difficulties with the burdens of host country regulation, some firms will decide not to do business "in" the host country, but will only do business "with" trading partners located in the host country on terms designed to consider the transaction as having occurred in the firm's home country territory.²¹ In the banking area, for example, foreign banks may use the "representative office" device to solicit business with firms in the host country without actually doing business in the host country.²²

This strategy can be risky because it is difficult at times for a foreign firm to know whether it is engaging in trade "in" the country instead of merely "with" the country.²³ Our hypothetical expert would cringe at such a situation.

Ideally, the location of the trade should not factor in the trading parties' decision. The hypothetical expert would likely reach the conclusion that all member states should have the same regulations affecting banking and therefore should all commit to harmonizing their respective regulatory schemes to relieve firms from having the incentive to avoid doing business in one country or another. Unfortunately for our hypothetical expert, under NAFTA ground rules, large scale harmonization of legal regimes is not on the table.²⁴

20. See JOAN EDELMAN SPERO, *THE POLITICS OF INTERNATIONAL ECONOMIC RELATIONS* 82-83 (2d ed. 1981) (describing and discussing the general problem of non-tariff barriers to trade).

21. Doing business in a country frequently requires complying with more onerous licensing and regulatory obligations. See Guillermo Marrero, *What Foreigners Should Know About the Mexican Market*, in *NAFTA: WHAT YOU NEED TO KNOW NOW* 119, 125 (Practising Law Institute ed., 1994) (describing the distinction between doing business with and doing business in Mexico).

22. Typically, a "representative office" does not solicit loans or take deposits, but instead acts as a liaison to make it easier for potential borrowers or depositors in the host country to transact business with the foreign bank in the bank's home country. See HAL S. SCOTT AND PHILIP A. WELLONS, *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION* 135 (4th ed. 1997). For example, even though Mexico has traditionally closed its banking market to foreign firms, foreign banks have nevertheless been permitted to maintain representative offices in the country. See Ghislain Gouraige, Jr., *Recent Development*, 24 *HARV. INT'L L.J.* 212, 214 n.19 (1983) (noting that at the time Mexico nationalized the Mexican banks there were over 100 representative offices of foreign banks in Mexico).

23. See Marrero, *supra* note 21 (noting that in Mexico, a business will be considered doing business in the country if it regularly or continuously executes commercial transactions there).

24. See Joel P. Trachtman, *Trade in Financial Services Under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis*, 34 *COLUM. J. TRANSNAT'L L.* 37, 94 (1995) (noting that NAFTA does not require financial regulation harmonization); but see Stephen Zamora, *NAFTA and the Harmonization of Domestic Legal Systems: The Side Effects of Free Trade*, 12 *ARIZ. J. INT'L & COMP. L.* 401 (1995) [hereinafter Zamora, *Harmonization*] (arguing that increased cross-border contact between businesspeople, bureaucrats, lawyers, academics and others will inevitably lead to a beneficial exchange of ideas in each of the three countries); and Alfred C. Aman, Jr., *A Global Perspective on Current Regula-*

With that in mind, the expert would instead have to consider which of the three primary methods of engaging in cross-border banking is "best" for all the players involved. The three methods of cross-border business are the following: (1) having no legal presence in the host country, (2) having a limited presence in the host country, and (3) being fully present in the host country.

The first method calls for banking firms to remain in their home countries and do business with customers in the host country without actually having a legal presence there. In general, there are two ways to pursue this strategy: by doing business "with" instead of "in" the country; or by staying in the home country while accepting the fact that transactions are occurring "in" the host country, and complying with host country rules as a cost of doing business. With regard to the first strategy, foreign banks must be especially careful about the volume and frequency of their transactions.²⁵ As a result, firms that attempt to employ this strategy as a method of entering the foreign market do not participate in the foreign market to the full extent that a true competitor in that market would. This may be a good strategy for the foreign firm. In the foreign market, however, limited participation does not provide the benefits of competition that economists predict.

With regard to the second strategy, it may be possible for some financial service providers, such as cash managers, mortgage servicers and data processors, to comply fully with host country regulation while engaging in the activity from their home country location.²⁶ This may be a profitable approach for firms pursuing certain lines of business, but for most financial service providers a physical presence in the host country will be either necessary or convenient to their business operations.

A second method to cross-border banking would be for the banking firm to have a limited presence in the host country, thereby allowing limited participation in the banking business. Variations on this approach include the "correspondent bank" approach and the "consortium" approach, whereby a foreign bank establishes an affiliation with a local bank and the ultimate customer does business with the foreign bank through the offices of the local bank or a joint venture.²⁷ A common U.S.

tory Reforms: Rejection, Relocation, or Reinvention?, 2 GLOBAL LEGAL STUD. J. 429 (1995) (arguing that global political and economic forces push national policies towards deregulation and privatization).

25. See Marrero, *supra* note 21.

26. For example, some aspects of the Mexican market could be exploited without an actual physical presence in Mexico. Of course, large loans to major borrowers and government units can be arranged that way, while consumer banking services like credit cards could be offered in Mexico and serviced in the United States. See Karen MacAllister, Note, *NAFTA: How the Banks in the United States and Mexico Will Respond*, 17 HOUS. J. INT'L L. 273, 295 (1994) (suggesting that credit cards, ATM networks and residential mortgages may be a lucrative and easily penetrated market for U.S. banks desiring to do business with Mexico).

27. See MICHAEL P. MALLOY, *THE REGULATION OF BANKING* 859-60 (1992) (quoting Haley & Seligman, *The Development of International Banking in the United States* for a description of the correspondent banking and consortium approaches).

variant on the limited access strategy is to use the “agency” device that foreign banks typically employ in the United States. Agencies are essentially special purpose banks that are permitted to engage in certain aspects of the banking business, but are generally prohibited from accepting deposits.²⁸ These limited entries into the host country market suffer from potential shortcomings. Similar to the problems of not physically entering the host market at all, entering on a limited basis also leaves foreign banks poorly situated to participate in the broad financial services market so the benefits of increased competition might not be fully realized.

Assuming a foreign banking organization wants to participate fully in the host country banking market, our enlightened expert would have to consider the best way for foreign banks to have a physical presence in the host country. As a practical matter that decision comes down to a choice between a regime requiring the establishment of banking subsidiaries or one permitting cross-border branching from the home country.

1. *Subsidiaries*

The subsidiary approach to expansion has its strengths and weaknesses. Commentators have long recognized that the greatest strength of the subsidiary device is to insulate the parent from liabilities arising out of the subsidiary’s activities.²⁹ There are some widely accepted public policy benefits of allowing limited liability for corporations generally, such as: permitting absentee investors to avoid exposure to risk, permitting large-scale enterprise, allowing diversification of portfolios, avoiding increased agency costs, avoiding impairment of the efficient capital market, avoiding increased collection costs for creditors, avoiding the costs of contracting around liability, and encouraging risk-taking.³⁰ It has been noted, however, that in the subsidiary context, many of these traditional justifications for limited liability may become irrelevant.³¹

Nevertheless, the subsidiary form offers additional benefits that may appropriately be considered by business planners when establishing the structure of the firm. Some of the benefits include: avoiding restrictions in the parent’s charter or restrictions arising under law, limiting tax implications, avoiding complications arising from “foreign corporation” status, increasing the morale of the subsidiary’s management, settling shareholder disputes, helping public relations, complying with regulatory ownership requirements, or establishing certain procedural benefits, such as venue and jurisdiction.³²

28. See MICHAEL GRUSON & RALPH REISNER, REGULATION OF FOREIGN BANKS 1-26 to 1-28 (2d ed. 1995) (describing the agency device).

29. See CHESTER ROHLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 10.02 (5th ed. 1975).

30. See PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS — SUBSTANTIVE LAW 66-86 (1987); see also FRANK H. EASTERBROOK & DANIEL R. FISCHER, THE ECONOMIC STRUCTURE OF CORPORATE LAW 40-62 (1991).

31. See BLUMBERG, *supra* note 30, at 93-99.

32. See ROHLICH, *supra* note 29 (noting various legal reasons for subsidiary formation); LARRY A. SODERQUIST & A.A. SOMMER, JR., UNDERSTANDING CORPORATE LAW 238-41

On the other hand, some commentators have argued that any theoretical advantages are outweighed by the disadvantages of limited liability in the corporate group context. Specifically, these include: unfairness and inefficiency for tort and other involuntary creditors, unfairness and inefficiency for labor claimants, the encouragement of excessive risk taking, increased information and monitoring costs, impairment of the efficiency of the market, and the possibility of misrepresentation.³³ Others have argued that the limited liability aspect of subsidiaries is economically inefficient and therefore undesirable.³⁴ Despite these criticisms, the limited liability feature of corporate subsidiaries is an essential aspect of that device.

As a practical matter, however, the greatest drawback to the subsidiary form may be the cost of establishing and maintaining a separate legal entity. A subsidiary bank must comply with all licensing and regulatory requirements. A free-standing subsidiary bank must have a complete internal infrastructure, capital base, and management team. All of these requirements cost money. Even after overcoming the burdens of establishing the subsidiary, the newly formed bank will suffer from a somewhat limited lending capacity because loan limits are typically a function of the subsidiary's capital. Because of the expense of establishing and operating subsidiaries, subsidiaries seem to be less attractive than branches.³⁵

From a public policy perspective, another drawback to the subsidiary form in the financial services industry is that the use of banking subsidiaries tends to aggravate the moral hazard problem.³⁶ In the subsidiary context, one risk is that a holding company might not run the bank prudently due to the limited risk of loss and the limited liability of the parent for the bank's obligations.³⁷ In the United States, the moral hazard problem in the bank holding company/bank subsidiary context has resulted in an ongoing effort by regulators to invent new and better ways of imposing liability on holding companies for the failure of their bank subsidiaries. Federal

(1990) (citing use of subsidiaries in corporate acquisitions); and Joseph H. Sommer, *The Subsidiary: Doctrine Without a Cause?*, 59 *FORDHAM L. REV.* 227, 259-73 (1990) (citing use of subsidiary as an effective method for controlling choice of law and venue).

33. See BLUMBERG, *supra* note 30, at 74-83; see generally EASTERBROOK & FISCHEL, *supra* note 30.

34. See Sommer, *supra* note 32, at 231-42.

35. See Hal Scott, *Supervision of International Banking Post-BCCI*, 8 *GA. ST. U. L. REV.* 487, 491 (1992) ("The competitive superiority of branches is reflected in the fact that of the \$800 billion total of foreign bank assets in the United States, \$626 billion is in branches and agencies of foreign banks — only \$174 billion is in subsidiaries.").

36. The idea of moral hazard is present in any situation where the existence of some kind of insurance or cost-shifting is perceived to reduce the incentives to reduce or minimize loss. See Tom Baker, *On the Genealogy of Moral Hazard*, 75 *TEX. L. REV.* 237, 238 (1996) (providing a history of the term "moral hazard" and criticizing its use in the debate over the reform of various government programs on the ground that the conditions necessary to give the concept force in economic theory do not exist in the real world).

37. See William A. Lovett, *Moral Hazard, Bank Supervision and Risk-Based Capital Requirements*, 49 *OHIO ST. L.J.* 1365, 1365-77 (1989) (describing the moral hazard problem in the banking context).

banking regulators have devised a host of legal techniques designed to impose liability on bank holding companies in the event of bank failure.³⁸ Although the federal efforts have been criticized as over-zealous in some situations,³⁹ there are times when a holding company should bear some responsibility for the failure of its subsidiary.⁴⁰ The subsidiary arrangement makes the imposition of that liability somewhat problematic.

2. Branching

Presently, all three NAFTA countries permit banks from other member countries to expand into their territory by establishing separately chartered subsidiaries in the host country. In contrast, Mexico and Canada currently do not permit foreign bank branching into their respective territories.⁴¹ From the point of view of the parent banking organization, branching should be more economically attractive than setting up an independent subsidiary because capital, accounting, and legal costs can be shared more easily.⁴² In the United States, operations may be more easily integrated because §§ 23A and 23B of the Federal Reserve Act do not apply to transactions between branches, whereas they do restrict transactions between commonly controlled subsidiaries.⁴³ In addition, loans generated

38. These regulatory mechanisms include the so-called source of strength doctrine, 12 C.F.R. § 225.4(a) (1996), cross guarantee provisions, 12 U.S.C. § 1815(e) (Supp. 1994), capital restoration plans, 12 U.S.C. § 1831 o(e)(2)(C)(ii) (1996), regulatory agreements, the elaboration of a general fiduciary duty to regulators, equitable subordination, preferences, and fraudulent conveyances. See Eric J. Gouvin, *Shareholder Enforced Market Discipline: How Much is Too Much?*, 16 ANN. REV. BANKING L. 311, 333-45 (1997) [hereinafter Gouvin, *Market Discipline*] (describing the various regulatory methods in light of a pervasive scheme to impose liability on holding companies).

39. See Gouvin, *Market Discipline*, *supra* note 38, at 345-54 (arguing that the federal response to the moral hazard problem is an example of regulatory overkill that results in unanticipated negative consequences).

40. See Eric J. Gouvin, *Of Hungry Wolves and Horizontal Conflicts: Rethinking the Justifications for Bank Holding Company Liability* 51-78 (Nov. 12, 1997) (unpublished manuscript on file with author) (arguing that holding companies should be liable to third parties for bank failure only to the extent the directors of the subsidiary owed a duty to non-shareholders (including the bank as an entity) and failed to carry out those duties).

41. See Larry M. Greenberg, *Canada's Banks Question Their Cocoon*, WALL ST. J., Apr. 16, 1998, at A17 (noting that of the world's 50 largest economies, only Canada and Mexico do not allow foreign banks to branch into their territory, although Canada has indicated that it will introduce legislation designed to permit wholesale banking through branches).

42. See Zamora, *Comments*, *supra* note 10, at 79 (noting economies achieved through branching).

43. Sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c-371c-1 (1994) impose significant restrictions on transactions among affiliates within a holding company organization. Section 23A restricts transactions such as loans or extensions of credit, purchase of securities or other assets, and the issuance of various kinds of accommodation between a bank and an affiliate unless they meet certain quantitative and qualitative limits. *Id.* Section 23B extends the restrictions in 23A by prohibiting certain transactions outright and subjecting additional transactions to the constraint that they be on terms comparable to those that they would obtain in an arm's length transaction. See JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION*, 398-401 (2d ed. 1997).

by a branch can be made based on the capital of the home bank in the home country instead of on the branch's capital.⁴⁴ This typically permits much higher loan limits. On the other hand, liabilities of the branch will be imposed on the home office more readily than the obligations of a separately organized subsidiary would be.⁴⁵ Although local regulators are likely to have less control over a branch because the regulator in the home country will have primary responsibility, the branch is likely to be more stable because of the bank's greater worldwide capital.⁴⁶

Corporate law offers two insights regarding the question of whether subsidiaries or branches are preferable from a public policy point of view. In the first view, branches are preferable to subsidiaries because, from a moral hazard perspective, the home bank should clearly be responsible for the branch's obligations. The second view argues that international banking law should permit both methods of expansion so corporate planners can exercise their own judgment about which form makes the most sense for a particular bank in a particular situation. NAFTA adopted the second approach.⁴⁷ Section 1403(1) states that investors of a Party should be free to establish financial institutions in the other countries "in the juridical form chosen by such investor."⁴⁸ The import of that provision is that banks should be able to expand across borders by establishing either branches or subsidiaries as dictated by their business plan rather than by banking law.

This, of course, is the "best" decision from a public policy point of view.⁴⁹ It allows private parties to make decisions that order their preferences without regard to the law. From the perspective of free trade, it allows parties to eliminate the non-tariff barrier that otherwise would accompany the required subsidiary form. From the banking law perspec-

44. See GRUSON & REISNER, *supra* note 28, at I-26 (noting that branch lending limits are based on the capital of the foreign parent).

45. See *Wells Fargo Asia, Ltd. v. Citibank, N.A.*, 936 F.2d 723 (2d Cir, 1991), *cert. denied*, 505 U.S. 1204 (1992) (holding that absent a contractual restriction on the place of collection, a customer of a foreign branch may recover from the bank's home office in the United States the amount of the obligation). The risk of foreign sovereign actions that make meeting obligations impossible was addressed somewhat by amendments in 1994 to the Federal Reserve Act and the Federal Deposit Insurance Act. Those acts changed the law to hold the U.S. home offices liable for such obligations only if agreed to in writing. See Eric Palace, Comment, *International Banking—Foreign Banks Operating in the United States*, 14 ANN. REV. BANKING L. 154, 169 (1995) (describing the amendments).

46. See Scott, *supra* note 35, at 491 (noting that local deposits of branch are backed by home office capital).

47. See NAFTA, *supra* note 8, art. 1403(1), 32 I.L.M. at 657 (recognizing the principle that investors should be able to choose the juridical form to use for cross-border banking).

48. See *id.*

49. See George J. Benston, *International Regulatory Coordination of Banking*, in *THE INTERNATIONALISATION OF CAPITAL MARKETS AND THE REGULATORY RESPONSE* 197, 206-07 (John Fingleton ed., 1992) (noting that "it is well known that competitive markets are promoted when entry (including branching) is not constrained . . ." and concluding that unless an important policy weighs against free entry, protectionist barriers should be eliminated).

tive, it allows the parties to employ the method of expansion that best suits their strategic needs, whether those needs are protection from liability afforded by the subsidiary or integration of operation provided by the branching mechanism. From the perspective of corporate law, it allows the parties to decide if the host country activities will be liabilities of the home country bank in all cases or only in special cases. Thus, the drafters of NAFTA arrived at the same conclusion that our hypothetical expert would have reached. Of course, the actual decision on cross-border branching will not be decided by the expert because no such decision-maker exists. The idea of an all-knowing expert who can objectively perform a rational assessment and produce an objectively "right" answer seems somewhat naive.⁵⁰

B. National Interest Model

A more realistic way of thinking about trade agreements is to assume that in an international environment characterized by extensive economic interdependence, each trade negotiator will advocate for the implementation of the "international regime" that best serves the interests of the negotiator's own country.⁵¹ The country's national interest may be informed by a public-spirited inquiry into the "best" approach to the problem, or it may be more nefarious, recognizing that sometimes nations choose to take action that is not theoretically ideal because it will enhance interests within the nation at the expense of other parties. With every negotiator urging his or her "national interest," an agreement develops that is informed by rational self-interest, but which may give rise to conflict upon implementation.⁵²

This approach, while better than the expert decisionmaker model, nevertheless suffers from some shortcomings. Most importantly, to the extent the model rests on nations advancing national interests through the propagation of international regimes, it may be misleading. In the real world, nations do not have "interests." Because groups do not speak with one voice, attempts to determine a particular interest or purpose must fail.⁵³ Although some scholars have argued that in some situations government

50. See THOMAS O. MCGARITY, *REINVENTING RATIONALITY: THE ROLE OF REGULATORY ANALYSIS IN THE FEDERAL BUREAUCRACY* xvi (1991) (observing that "data analysis is expensive, cost and benefit assessment models are inaccurate, biases can subtly creep into 'objective' analyses, and the uncertainties are sometimes so huge and pervasive as to render the idea of objectivity virtually meaningless").

51. See ROBERT O. KEOHANE & JOSEPH S. NYE, *POWER AND INTERDEPENDENCE* 5 (1977) ("By creating or accepting procedures, rules or institutions for certain kinds of activity, governments regulate and control transnational and interstate relations. We refer to these governing arrangements as "international regimes.").

52. See Enrico Colombaro & Jonathan R. Macey, *A Public Choice Model of International Economic Cooperation and the Decline of the Nation State*, 18 *CARDOZO L. REV.* 925, 930-32 (1996) (describing the national interest view as "regime theory" in which negotiators seek to advance the interests of states).

53. See, e.g., Frank H. Easterbrook, *Statutes' Domains*, 50 *U. CHI. L. REV.* 533, 547-48 (1983); see also EDITH STOKEY & RICHARD ZECKHAUSER, *A PRIMER FOR POLICY ANALYSIS* 257-86 (1978) (discussing the difficulties of articulating a meaningful standard for social welfare).

actors are capable of acting (or at least of aspiring to act) for the common good,⁵⁴ the more convincing view is that the challenge of aggregating individual preference makes determination of a group (or national) preference extremely difficult if not impossible.⁵⁵ As public choice scholars have amply demonstrated, voting procedures employed in a group decision making process can determine the outcome.⁵⁶

Another flaw in the National Interest approach is that it fails to recognize that government actors in the various countries have their own agendas to pursue and are in fact players in their own right in the political/economic power struggle.⁵⁷ Regulators' interests are pivotal in the development of North American banking policy. Therefore, although the National Interest model may be useful in some situations,⁵⁸ it does not work as well as a model that takes into account the interests of individual economic actors and regulators.

C. Public Choice Model

A government often takes a position because interest groups within the nation have successfully compelled government action.⁵⁹ The public

54. The neo-republican model of politics views the political process as a method of solving problems for the common good. See Richard H. Fallon, Jr., *What is Republicanism, and is it Worth Reviving?* 102 HARV. L. REV. 1695, 1698 (1987); Frank Michelman, *Law's Republic*, 97 YALE L. J. 1493, 1503-04 (1988). The neo-republican model holds that at least some problems can be addressed with substantively "right" answers for the public good without regard to political ideology or individual preferences. See Cass R. Sunstein, *Beyond the Republican Revival*, 97 YALE L.J. 1539, 1541 (1988).

55. This key insight owes much to the work of Kenneth Arrow, who developed the famous theorem that bears his name. Arrow's Impossibility Theorem holds that under certain conditions it is impossible to aggregate the preferences of a given group because the way in which voting is conducted could result in an infinite cycling of choices. For a useful summary of Arrow's Theorem and its larger implications, see SHAUN HARGREAVES HEAP ET AL., *THE THEORY OF CHOICE: A CRITICAL GUIDE*, 209-15 (1992).

56. See, e.g., DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION* 38-42 (1991). If the agenda develops through an open process where each legislator can propose an alternative, then the outcome of majority rule may wander anywhere because of preference cycling problems. See Kenneth A. Shepsle, *Prospects for Formal Models of Legislatures*, 10 LEGIS. STUD. Q. 5, 10 (1985). For an example of the cycling problem, see Eric J. Gouvin, *Truth in Savings and the Failure of Legislative Methodology*, 62 U. CIN. L. REV. 1281, 1346-47 n.233 (1994) [hereinafter Gouvin, *Truth in Savings*] (illustrating the cycling problem with a hypothetical committee vote).

57. See Edward J. Kane, *Tension Between Competition and Coordination in International Financial Regulation*, in *GOVERNING BANKING'S FUTURE: MARKETS VS. REGULATION* 33, 34 (Catherine England ed., 1991), [hereinafter Kane, *Tension*] (describing the need of regulators to maximize the value of their enterprise within the confines of what he terms the "microeconomic analysis of regulation," which is consistent with the public choice view).

58. The model gives a creditable, though not perfect, account of U.S.-Canadian relations, for instance. See KEOHANE & NYE, *supra* note 51, at 165-218 (employing regime theory to explain the outcomes of several U.S./Canada cross-border conflicts during the twentieth century).

59. From the point of view of public choice theorists, government action, especially in the form of legislation and regulation, is nothing more than a product that effects a wealth transfer from one group to another. For a general discussion, see Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339 (1988). The idea of government

choice⁶⁰ perspective on international agreements suggests that countries will not agree to terms in a treaty unless the key interest groups in the country agree and the regulators who deal with the matter find it in their own best interests.⁶¹

Therefore, in light of the many demands of the constituents they deal with, we would expect trade negotiators to make agreements that maximize their own interest groups' competitive positions, even if the theoretically optimal position would be somewhat different. Any attempt at regional integration will succeed only if the self-interests of key actors and interest groups within the region coincide.⁶² In the case of NAFTA, the interest groups concerned about cross-border financial services include, most obviously, the financial services industry and the regulators who oversee those firms.

The interest groups in each of the member nations are likely to have different perspectives on the attractiveness of cross-border branching. After the necessary bargaining for government action, we can reasonably expect that the trade representatives of the member countries will not compromise the positions of their clients for their trading partners. Of course, the representatives should remember the basic lesson of Economics 101, that liberal trade is good for everyone. They are also likely to understand that they could easily fall into a prisoner's dilemma if they pursue their own economic self-interest too vigorously.⁶³ The parties will try to balance these concerns while simultaneously pressing for private advantage. Unfortunately, when all is said and done, an examination of the relative

action as a bargained for exchange can readily be applied to the international trade situation by considering that the government's action in negotiating the trade agreement is the action for which competing groups are bargaining. See Colombatto & Macey, *supra* note 52 (examining the difference between regime theory and public choice theory).

60. Public choice scholars draw heavily on economics, game theory, organizational behavior and political science. See generally FARBER & FRICKEY, *supra* note 56, at 21-33; Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873, 878-79, 883, 901-06 (1987) (arguing that a general theory of "public choice" is impossible because there are many variations on the set of core principles that have inspired many scholars); HEAP, *supra* note 55, at 209-15 (1992) (giving a useful overview of the topic, especially the theoretical problems of aggregating preferences, which tend to make the output of collective bodies incoherent).

61. See Colombatto & Macey, *supra* note 52, at 932 ("Public choice theory . . . posits that international institutions are vehicles through which politicians, bureaucrats, and interest groups reflect their own interests.").

62. See Frederick M. Abbott, *Foundation-Building for Western Hemispheric Integration*, 17 NW. J. INT'L L. & BUS. 900, 902 (1996-97) (discussing various interest groups, such as business groups, labor groups, environmental groups, citizen groups and government actors, whose interests would have to coincide in order to expand NAFTA into the Free Trade Area of the Americas, and noting that "the success of a regional integration effort may well depend on the presence of a sufficient confluence of self-interest among key actors and interest groups throughout economically-important countries in a region.").

63. See Jeffrey Simser, *GATS and Financial Services: Redefining Borders*, 3 BUFF. J. INT'L L. 33, 40 (1996) (noting the propensity for states negotiating a trade pact to become subject to a prisoner's dilemma).

interests of the affected regulators and industry participants reveals that cross-border branching is a deadlocked issue.

II. Public Choice Model Examined

The resolution of the cross-border branching issue under NAFTA can be seen as a complicated game among the trade negotiators of the three member countries. Any attempt to map out the strategies of the parties will quickly stall on the realization that the three players' strategies are part of a much larger and more complicated game that includes several embedded games played by other rent-seekers in their respective home countries.⁶⁴ The rent-seeking interests that compete for favorable treatment from the trade negotiators are complex and emanate from two key sources: regulators and financial services providers. The concerns of these two groups have both national and international aspects.

A. Rent-Seeking Behavior of Regulators

In all three NAFTA countries, financial services policymakers must balance the inevitable economic pressures to move toward a more open marketplace against demands for protectionist measures to counteract the dislocations brought about by market forces.⁶⁵ In addition, regulators must be careful to protect their own interests and to ensure implementation of a regulatory regime that maximizes the value of their respective regulatory enterprises.⁶⁶ The regulators must also compete to maximize their interests in both the domestic and the international arenas. It is likely that this complex game will play out differently in each of the several NAFTA countries. The outcome of the domestic games may have an international effect.

1. Domestic Rent-Seeking by Regulators

a. The United States

In the United States, the number of players in the financial services regulatory area is bewildering. Government actors involved in one way or another include state bank regulators, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of Currency (OCC), the Office of Thrift Supervision, the Department of the Treasury, and the Federal Reserve Board (Fed). All of these actors share a complicated and redundant regulatory scheme governing U.S. banks.⁶⁷ In addition, there

64. For a general discussion of embedded games and the structure of large games, see DOUGLAS G. BAIRD ET AL., *GAME THEORY AND THE LAW* 188-202 (1994) (providing an overview of the problems of modeling large games).

65. Cf. Arthur J. Cockfield, *Tax Integration Under NAFTA: Resolving the Conflict Between Economic and Sovereignty Interests*, 34 *STAN. J. INT'L L.* 39 n.2 (1998) (noting this conflict in the tax area).

66. See Kane, *Tension*, *supra* note 57, at 34.

67. See GENERAL ACCOUNTING OFFICE, *BANK OVERSIGHT STRUCTURE: U.S. AND FOREIGN EXPERIENCE MAY OFFER LESSONS FOR MODERNIZING U.S. STRUCTURE* 36-56 (1996) [hereinafter *GAO OVERSIGHT STRUCTURE*] (describing the redundant function of the federal banking regulators).

are state level regulators for insurance and securities activities, and the Securities and Exchange Commission covers the securities market at the federal level. None of these actors will voluntarily give up their regulatory power without good reason. Predictably, on the several occasions when Congress considered reforming the financial services regulatory scheme, the regulators mobilized political opposition to protect the existing "turf" controlled by each agency.⁶⁸

The most notorious of these turf wars has been the ongoing struggle between the Federal Reserve and the Comptroller of the Currency over the appropriate corporate structure for groups of banks and related financial services providers. The conflict between these two key regulators appears to be the path dependent⁶⁹ result of historical policy decisions affecting branching in the United States.⁷⁰ The historical adoption of restrictive rules for branching resulted in the bank holding company becoming the dominant form of organization for the U.S. banking industry. This kind of consequence may be an example of what S.J. Liebowitz and Stephen Margolis call "second degree path dependence."⁷¹ This term refers to a situation in which an initial decision is made and "the inferiority of the chosen path is unknowable at the time the choice was made, but it is later recognized that some alternative path would have yielded greater wealth."⁷² Today policy makers are debating whether the holding company is a more or less efficient structure for the banking industry than the operating subsidiary model.

The complex product line barriers that pepper U.S. banking law, reinforced by the holding company form with its many regulatory "firewalls," are increasingly viewed by banks, insurance companies, and securities

68. See John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 *BUS. LAW.* 447, 447-48 (1995) (chronicling the turf wars that erupt whenever serious proposals to reform U.S. making law are advanced); see also Edward J. Kane, *The Evolving U.S. Legislative Agenda in Banking and Finance*, in *REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN THE NAFTA COUNTRIES AND BEYOND* 180, 186-88 (George M. von Furstenberg ed., 1997) [hereinafter Kane, *Legislative Agenda*] (describing one round in the on-going battle between the Fed and the OCC over the structure of bank activities).

69. Path dependency occurs in situations where subsequent developments in a particular phenomenon are dependent to a great extent on initial conditions. Once those initial conditions are set, the developments that follow tend to be "locked in" to the original condition. The classic example of historical lock in is the "QWERTY" keyboard used on typewriters and computers. See Paul David, *Clio and the Economics of QWERTY*, 75 *AM. ECON. REV.* 332 (1985).

70. For a brief discussion of the evolution of U.S. branching policy, see Eric J. Gouvin, *Cross-Border Bank Branching Under the NAFTA: Public Choice and the Law of Corporate Groups*, 13 *CONN. J. OF INT'L L.* (forthcoming, 1998).

71. See S.J. Liebowitz & Stephen E. Margolis, *Path Dependence, Lock-In and History*, 11 *J.L. ECON. & ORG.* 205, 207 (1995) (describing the idea of "second degree" path dependence).

72. *Id.* at 207 (noting that in the case of second degree path dependence, "sensitive dependence on initial conditions leads to outcomes that are regrettable and costly to change. They are not, however, inefficient in any meaningful sense, given the assumed limitations of knowledge.").

firms as obstacles to business.⁷³ Industry desires to be free of the restrictive provisions of existing banking law, and the requirements that non-banking activities be carried out through a holding company structure, obtained some relief in 1997. At that time, the Comptroller of the Currency promulgated regulations permitting national banks to engage in activities incidental to banking through so-called operating subsidiaries of the bank itself, without the need for a bank holding company structure.⁷⁴ Although the Federal Reserve, at about the same time, also liberalized its treatment of bank holding companies,⁷⁵ the OCC operating subsidiary regulation set off a major debate in Washington over what the ownership structure of financial services providers should look like.

Not surprisingly, the Federal Reserve, as the prime regulator of bank holding companies, insists that the bank holding company form is the best way to proceed, while the OCC, the chief regulator of national banks, favors a system comprised of bank operating subsidiaries.⁷⁶ Although many observers see this long-running battle as little more than territorial positioning,⁷⁷ the debate ostensibly turns on the question of whether the banking industry enjoys a subsidy from the federal government,⁷⁸ and, if

73. See J. Virgil Mattingly & Keiran J. Fallon, *Understanding the Issues Raised by Financial Modernization*, 2 N.C. BANKING INST. 25, 26-27 (1998) (reporting the frustrations of industry participants).

74. See 12 C.F.R. § 5.34(f) (1997). The Comptroller of the Currency has promulgated a regulation that permits national banks to form operating subsidiaries that may engage in several new activities, such as equipment leasing, insurance, real estate brokerage, real estate development, and securities underwriting. *Id.* Given that most states have parity or "wild card" statutes, which by law grant their state-chartered institutions powers at least as liberal as the powers given to national banks, the extent of liberalized banking powers in the banking system as a whole is quite extensive. CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 156-58 (1996). For a discussion of the new provisions, see James R. Smoot, *Bank Operating Subsidiaries: Free At Last or More of The Same?*, 46 DEPAUL L. REV. 651 (1997) (analyzing the OCC operating subsidiary regulations).

75. The Federal Reserve Board has loosened the restrictions between banks and their securities affiliates within the holding company structure. See Review of Restrictions on Director and Employee Interlocks, Cross-Marketing Activities and Purchase and Sale of Financial Assets, 61 Fed. Reg. 57,679 (1996) (easing or eliminating restrictions on personnel interlocks, marketing activities, and financial transactions between a bank and a securities affiliate); Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (1996) (increasing from 10% to 25% the amount of total revenue that a nonbank subsidiary of a bank holding company may derive from underwriting and dealing in securities in which the bank is prohibited from dealing). In addition, the Federal Reserve has completely overhauled Regulation Y, the regulation that covers bank holding companies, to loosen existing restrictions and add new activities to the list of those approved as being "closely related to banking." See Melanie L. Fein, *Fed's Proposed Overhaul of Regulation Y Goes Far, But Could Be Bolder*, 15 BANKING POL'Y. REP. 4 (Oct. 21, 1996) (describing the proposed changes to Regulation Y).

76. See Michael Schroeder, *Greenspan, Rubin Duel Over Banking Overhaul*, WALL ST. J., June 3, 1998, at A20; Alan Yonan, Jr., *Fed's Greenspan Backs Bill Rubin Opposes*, WALL ST. J., Mar. 18, 1998, at A6.

77. See Kane, *Legislative Agenda*, *supra* note 68, at 186-88 (noting the ongoing turf battle between the Fed and the OCC).

78. See David G. Oedel, *Puzzling Banking Law: Its Effects and Purposes*, 67 U. COLO. L. REV. 477, 479 (1996) ("banking law enshrines fundamental economic inefficiencies

so, whether the law should attempt to confine the benefit of that subsidy to the bank itself. The Federal Reserve Board clearly believes that the safety net created to protect federal banks provides the banking industry with a subsidy vis-a-vis other financial services providers.⁷⁹ Although Chairman Greenspan sees the creation of a banking subsidy as an “undesirable but unavoidable consequence of creating a safety net,”⁸⁰ he believes that the subsidy should be contained within the bank in order to prevent the transfer of the sovereign credit subsidy for non-banking purposes. Such a transfer might result in a “subsidized competitive advantage” to the bank affiliate.⁸¹

Others, most notably the Office of the Comptroller of the Currency, question whether a net subsidy to the U.S. banking industry exists.⁸² Of course, bankers do not believe they receive a subsidy and they point to deposit insurance premiums, capital requirements, and regulatory costs as evidence that they pay for whatever benefit they receive from the safety net.⁸³ Officials from the FDIC and the Department of Treasury have also raised questions about the existence of a subsidy, especially in light of regulation costs.⁸⁴

in banking that are tolerable for banks because of breathtaking anti-competitive protections and financial subsidies — protections and subsidies that are not always apparent to outsiders nor admitted publicly by banking savants.”).

79. See generally MYRON L. KWAST & S. WAYNE PASSMORE, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *THE SUBSIDY PROVIDED BY THE FEDERAL SAFETY NET: THEORY, MEASUREMENT AND CONTAINMENT* (1997) (articulating a theory that the government’s commitment to the prevention of a systematic banking crisis provides a subsidy to banks); see also Alan Greenspan, Chairman, Board of Governors of Federal Reserve System, Statement Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services (Feb. 13, 1997), in 83 FED. RES. BULL. 249 (1997) [hereinafter Greenspan Statement] (stating “In this century the Congress has delegated the use of sovereign credit — the power to create money and borrow unlimited funds at the lowest possible rate — to support the banking system. It has done so indirectly as a consequence of deposit insurance, Federal Reserve discount window access, and final riskless payment system transactions [As a result of the government’s major role in protecting the banking system, banks get an unfair advantage over other financial services providers because banks] determine the level of risk-taking and receive gains therefrom, but do not bear the full costs of that risk. The remainder of the risk is transferred to the government.”).

80. Greenspan Statement, *supra* note 79, at 250.

81. *Id.*

82. See GARY WHALEN, OFFICE OF THE COMPTROLLER OF THE CURRENCY, *THE COMPETITIVE IMPLICATIONS OF SAFETY NET-RELATED SUBSIDIES* (1997) (examining the existing empirical evidence that addresses the subsidy question and concluding that even if some evidence points to a small gross subsidy, the evidence cannot be taken at face value because the studies fail to take the costs of regulation into account).

83. See Janet Seiberg, *Banks’ Plea To Fed: Stop Saying We’re Subsidized*, AM. BANKER, Nov. 5, 1997, at 1 (noting the banking industry’s arguments); Bert Ely, *Comment: Greenspan’s Deposit Insurance Subsidy Argument Is Nonsense*, AM. BANKER, June 6, 1997, at 3 (stating that deposit insurance has never cost taxpayers a cent, while loans from the discount window must be collateralized, and the small risk of intraday overdraft risk can be minimized by proper management; concluding there is no meaningful subsidy).

84. See Olaf de Senerpont Domis, *Helper, Ludwig Insist Deposit Insurance Doesn’t Give Banks an Unfair Advantage*, AM. BANKER, Mar. 6, 1997, at 2 (recounting the testimony of Comptroller of the Currency Eugene Ludwig and Federal Deposit Insurance Corporation Chairman Ricki Helfer asserting that the Fed’s subsidy argument is incorrect

Congress has complicated regulatory matters by grappling with various aspects of financial reform for well over a decade. Again, some amount of path dependency has complicated Congress' predicament: once the Glass-Steagall product line distinctions were cast in stone, it was only a matter of time before the various artificially created industries became invested in the system and resisted change. Over the years, the interest groups affected by Glass-Steagall have made so many conflicting demands for "reform" that Congress has become paralyzed on the matter.⁸⁵ A more cynical perspective is that Congress has no incentive to change the law because it knows that key players in the financial services industry will make generous campaign contributions to influence the course of "reform."⁸⁶ Indeed, some have suggested that the harsh economic realities of the ongoing quest for re-election prevent Congress from repealing Glass-Steagall.⁸⁷

The behavior of Congress and regulators fits nicely with public choice theory. Assuming governmental actors will attempt to maximize the value of their enterprises, Congressmen will act to ensure their re-election while attracting large campaign contributions. Regulators, on the other hand, will try to attract new regulatees while keeping current regulatees under their auspices.⁸⁸ We have recently witnessed major changes initiated by regulators to maximize their positions in the regulatory scheme, while Congress has been silent. This may result from either the expected "regulatory capture phenomenon" or the deadlocked Congress, created by too many competitors for financial services legislation.

The discussion so far has not addressed the turf wars that are bound to emerge if securities and insurance activities regulation are bundled together in a single federal regulator.⁸⁹ The most easily observable conflict

because it does not take regulatory compliance costs into account); John D. Hawke, Jr., Under Secretary of the Treasury for Domestic Finance, What is the Governmental Role in Finance, Anyway?, Panel Discussion Remarks at AALS Annual Meeting, San Francisco (Jan. 8, 1998) (manuscript at 3, on file with author) (expressing skepticism with regard to the existence of a net subsidy).

85. See Michael Schroeder, *Why Glass-Steagall, Reviled for Decades, Just Won't Go Away*, WALL ST. J., Apr. 10, 1998, at A1 (providing a concise history of the Glass-Steagall Act and the efforts over the years to change the law) [hereinafter Schroeder, *Glass-Steagall*].

86. *Id.* (reporting that, in 1997, while banking reform was being seriously considered, Democratic and Republican lawmakers and their national committees received \$7.4 million from securities firms, \$6.8 from insurers, and \$5.5 million from banks).

87. See Howard Gleckman & Dean Foust, *Why Congress Can't Afford to Shatter Glass-Steagall*, BUS. WK., Mar. 30, 1998, at 38 (commenting that financial services modernization comes up in Congress about every two years, just in time for massive fundraising from affected industries, and drawing the conclusion that Congress will never change the status quo because it needs the biennial source of campaign funds).

88. See Kane, *Tension*, *supra* note 57, at 34 (noting that "managers of individual regulatory entities seek to maximize something broadly equivalent to the value of their enterprises, subject to technological, market, and statutory restraints and principal-agent difficulties . . .").

89. The insurance industry has been fighting this battle for years and has raised this concern in the current round of congressional deliberations. See Mattingly & Fallon, *supra* note 73, at 49-50 (describing the explicit regulatory competition issue).

to date has centered on banking industry regulation. Nevertheless, even with a single bank regulator with authority over organizations engaging in a wide range of activities, there will almost certainly be a clash between regulators of the different industries. The inter-industry turf wars will inevitably be tied up with politically charged federalism issues and will further complicate our interest group analysis. The issue is sufficiently complex to limit our discussion to the rent-seeking behavior of banking regulators.

b. Canada

Unlike the U.S. regulatory scheme, plagued by ossification that reinforces the path dependent problems discussed above, Canada's banking law is subject to periodic systematic reconsideration. As a result, major revisions take place about once every ten years.⁹⁰ The use of "sunset provisions,"⁹¹ coupled with the different political dynamic of the parliamentary system,⁹² has allowed Canada to modernize its financial system much more quickly than the United States.

The highly concentrated banking industry in Canada⁹³ ensures that banking policy-makers get a clear picture of what the industry wants. These conditions also may have fostered the development and maintenance of a coherent and straightforward bank regulatory scheme. In Canada, a federal banking supervising agency is the chief banking regulator.⁹⁴ The head of the agency is appointed by the Cabinet and reports directly to the Minister of Finance. The federal supervisor is responsible for all federally chartered financial institutions. These include banks, insurance companies, and trust companies. The supervisor shares responsibility with the provinces for oversight of securities firms.⁹⁵ The Canadian federal deposit insurer plays a secondary role in bank oversight, while the Bank of Canada

90. See CHARLES FREEDMAN, *THE CANADIAN BANKING SYSTEM I* (1998) (noting the periodic reexamination of Canadian banking legislation).

91. For a discussion of sunset provisions generally, see Gouvin, *Truth in Savings*, *supra* note 56, at 1366-67 (noting the checkered experience of sunset provisions in the United States).

92. See John F. Chant, *Canada's Economy and Financial System: Recent and Prospective Developments and the Policy Issues They Pose*, in *THE BANKING AND FINANCIAL STRUCTURE IN THE NAFTA COUNTRIES AND CHILE* 3, 36-7 (George M. von Furstenberg ed., 1997) (noting the difference between the U.S. and Canadian political systems).

93. Unlike the United States, which has thousands of independent banks, Canada is dominated by six large institutions with nationwide branching networks: the Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, Royal Bank of Canada, and Toronto Dominion Bank. Collectively, these six banks control 98.5% of the assets held by banks in Canada. See James R. Kraus, *Canadian Government's Fears of Concentration Seen Threat to Megadeal*, *AM. BANKER*, Feb. 12, 1998, at 20. The banking industry will become even more concentrated if the two pending mergers between Bank of Montreal and Royal Bank of Canada and between Canadian Imperial Bank of Commerce and Toronto Dominion Bank are consummated. See John Urquhart, *Canada Banks May Get Boost in Merger Plans*, *WALL ST. J.*, Sept. 14, 1998, at B2. These are so-called Schedule I banks, subject to the "widely-held" rule: no person or group may control more than ten percent of the voting stock of a Schedule I bank. See *id.*; Bank Act, R.S.C., ch. B-1.01, § 370(2) (1996) (Canada) (defining "widely held").

94. See GAO OVERSIGHT STRUCTURE, *supra* note 67, at 57.

95. See *id.* at 62.

maintains data on the financial system's condition and on individual banks.⁹⁶

The regular sunset reviews may also be a factor in minimizing the regulatory burden faced by Canadian banks. Apparently, a significant difference exists between the weight of the regulatory burden shouldered by U.S. and Canadian banks. Although an imprecise measure, the differing volume of banking law in the two countries speaks to the difference in regulatory attitudes. During the early 1990s in the United States, an estimated 220,000 pages of banking law and regulation existed at just the federal level, while in Canada the entire Bank Act and associated regulations amounted to only 530 pages.⁹⁷

Because all banks are federally chartered, there is no regulatory competition between the provinces and the federal government. However, the provincial regulators of near-banks might be tempted to engage in some enterprise maximizing actions designed to reduce the hegemony of the banks. On the federal level, although there is a hint of turf war between the primary banking regulator and the bank insurance fund; the chance that it will erupt into the type of agency rivalry found in the United States is remote.

c. Mexico

Mexico's banking regulatory system is still evolving. Financial instability since the peso crisis of 1994 left Mexico searching for the appropriate model of governmental regulation. Mexico's banks and securities firms currently are regulated by Mexico's central bank, the Ministry of Finance and Public Credit, and the primary regulator, the National Banking and Securities Commission (CNBV).⁹⁸ However, this scheme may change if the banking reform package should make its way through Congress. The states of Mexico are not active in the regulation of financial institutions.

The interest groups that are likely to influence Mexico's domestic banking policy include its banks⁹⁹ and its financial groups generally.¹⁰⁰

96. *See id.* at 57.

97. *See* John C. Pattison, *Trade in Financial Services In NAFTA: A Public Choice Approach*, in *REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN THE NAFTA COUNTRIES AND BEYOND*, *supra* note 68, at 145, 148-49. Another explanation for the difference is the willingness of Canada's banks to adopt voluntary guidelines to prevent the need for legislated solutions to perceived problems. *See* GAO OVERSIGHT STRUCTURE, *supra* note 67, at 72 (noting the voluntary adoption by Canadian banks of consumer and small business lending guidelines to prevent legislative solutions.).

98. *See* Roy A. Karaoglan & Mike Lubrano, *Mexico's Banks After the December 1994 Devaluation – A Chronology of the Government's Response*, 16 *Nw. J. INT'L L. & BUS.* 24, 28-29 (1995) (describing the Mexican bank regulatory system).

99. At the time of NAFTA's negotiation, Mexico's banking market was dominated by six large nationwide institutions, with seven smaller regional banks playing a secondary role. *See* Carlos M. Nalda, Note, *NAFTA, Foreign Investment, and The Mexican Banking System*, 26 *GEO. WASH. J. INT'L L. & ECON.* 379, 388 (1992) (noting the existence of six national and seven multiregional banks).

100. Banks may be owned by financial groups that own other financial services firms such as securities and insurance companies. *See* Ramón Bravo H., *Mexican Legal Framework Applicable to Operations Involving Financial Services*, 25 *ST. MARY'S L.J.* 1239, 1243

In light of the economic crises since 1994, however, populist elements will also influence banking policy.¹⁰¹ Unlike Canada with its parliamentary system, but similar to the United States, the process for adopting political change in Mexico requires the executive office to deal with the Congress to create an acceptable package of legislation.¹⁰² Therefore, in Mexico, interest groups have incentives to seek influence not only with the President, but also with the Congress.

President Zedillo recently proposed a broad package of reforms that would give autonomy to banking regulators, eliminate the remaining limits on foreign ownership of Mexican banks, reform the deposit insurance system, dismantle the existing bank resolution agency (known as Fobaproa), and recognize the cost of the bank bailout as public debt.¹⁰³ Prospects for the success of the reform package are difficult to assess, but as of this writing, the stock market is taking a dim view of the situation by heavily discounting the value of Mexico's major banks.¹⁰⁴

2. *International Rent-Seeking by Regulators*

While banking regulators face "market pressures" in their home countries to differing degrees, they also must contend with the more difficult problem of international regulatory competition.¹⁰⁵ Cross-border banking regulation is always awkward because regulators in both the home and host countries have legitimate claims to full and accurate information about banks operating in or from their jurisdiction.¹⁰⁶ Moreover, both regulators share legitimate concerns about prevention of systemic risks brought about

(1994) (reporting that Mexican financial groups may consist of general deposit warehouses, financial lessors, factoring companies, limited scope financial entities, exchange houses, bonding companies, insurance companies, brokerage firms and banks).

101. There is a widespread perception in Mexico that the rescue of the Mexican banking system benefitted a few wealthy bank owners at the expense of the rest of the country. See Roberto Salinas-León, *Mexico's Bank Bailout Quarrel Misses a Key Point*, WALL ST. J., June 26, 1998, at A15 (reporting the misperception); Geri Smith, *A Torpedo That Could Cripple The Economy*, BUS. WK., June 22, 1998, at 62 (discussing the political aspects of Mexico's banking crisis and reform legislation); Jonathan Friedland, *Mexican Congress Balks at Zedillo Bank Bailout*, WALL ST. J., June 3, 1998, at A11 (reporting public opinion on proposed bank reforms).

102. See Jonathan Friedland, *Mexican Officials Land in the Hot Seat*, WALL ST. J., July 31, 1998, at A9 (noting congressional involvement in the deliberations over the pending bank reform proposal marks a departure from 70 years of domination by the Institutional Revolutionary Party, which previously presented legislation as a *fait accompli*).

103. See Friedland, *supra* note 5 (summarizing the proposal).

104. See Jonathan Friedland, *Mexico Is Hit Despite Belt-Tightening*, WALL ST. J., Sept. 14, 1998, at A27 (noting that Mexico's two largest financial groups were both trading at less than one half of their book value). Part of the discount must be attributable to the difficulty of getting timely and accurate information about what is going on in Mexico. See Jonathan Friedland, *Mum's the Word: Mexico Isn't Free With Information*, WALL ST. J., Sept. 10, 1998, at A1 (reporting on the pervasive secrecy and scarcity of reliable information in Mexico).

105. See Kane, *Tension*, *supra* note 57, at 34 ("individual regulatory enterprises are in competition with each other for whatever it is they maximize").

106. Apparently, at least one lesson from the LDC debt crisis is that more information is always preferable. See William A. Lovett, *Conflicts in American Banking Regulation: Renewed Prudence, Retrenchment, and Struggles Over Growth Potential*, 12 ANN.

by bank failure.¹⁰⁷ Ideally, bank regulators in different countries would be confident that a fellow regulator in another country applied rigorous standards when supervising an international bank's operations. But in reality, North American regulators cannot adopt the joint regulation strategy because they face a commitment problem.¹⁰⁸ It is unclear whether the regulators in the three NAFTA countries have enough mutual respect to implement a successful cooperative regulation effort. For example, Canadians resent what they consider to be the propensity of U.S. regulators to seek extraterritorial application of U.S. law.¹⁰⁹ Simultaneously, U.S. regulators worry that the Mexican banking regulators are not capable of supervising a modern banking system.¹¹⁰

Given the lack of harmonization and mutual respect, the NAFTA banking structure will most likely default to a system requiring subsidiaries, rather than one permitting branching. Not surprisingly, the laws of all three NAFTA countries permit expansion by establishment of subsidiaries, but only the United States permits foreign banks, including Canadian and Mexican banks,¹¹¹ to expand into its market through branching.¹¹² The fact that U.S. law technically permits branching, however, is somewhat illusory. Foreign banks seeking to establish a presence in the United States must comply with a labyrinth of federal regulations that treat foreign banks less favorably than U.S. banks.¹¹³

REV. BANKING L. 443, 449 (1993) (noting that enforceable mutual disclosure laws should exist to prevent unsustainable debt loads from getting out of hand again).

107. See generally Mico Loretan, *Systemic Risk in Banking: Concept and Models*, in REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN THE NAFTA COUNTRIES AND BEYOND, *supra* note 68, at 38-42 (discussing the concept of systemic risk).

108. See FRIEDMAN, *supra* note 17, at 148-52 (discussing the problems of commitment in strategic games).

109. See Jordan, *supra* note 9, at 48 (noting that "Canadian regulators do not indulge in the extraterritorial application of Canadian banking laws").

110. As evidence of this, consider that to have access to the U.S. market, Mexican (but not Canadian) banks must demonstrate to the Federal Reserve that Mexican regulators can adequately supervise the home bank. See Ross Levine, *Foreign Banks, Financial Development, and Economic Growth*, in INTERNATIONAL FINANCIAL MARKETS: HARMONIZATION VERSUS COMPETITION 224, 243 (Claude E. Barfield, ed., 1996) (noting the requirement).

111. Branches are the most important mechanism for giving Canadian and Mexican banks access to the U.S. market. See Michael G. Martinson, *Consolidated Supervision of Cross-Border Banking Activities: Principles and Practice in the NAFTA Context*, in REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN THE NAFTA COUNTRIES AND BEYOND, *supra* note 68, at 217, 225.

112. Canada is considering legislation to permit cross-border branching. See Joseph Weber, *Just Over the Horizon: North American Banks, A Few Rule Changes Would Bring a Wave of Cross-Border Mergers*, Bus. Wk., Feb. 23, 1998, at 100.

113. See Charles W. Hultman, *Foreign Banks and the U.S. Regulatory Environment*, 114 BANKING L.J. 452, 452 (1997) (noting that the Foreign Bank Supervision Enhancement Act of 1991 resulted in less favorable treatment for foreign banks). The Foreign Bank Supervision Enhancement Act of 1991 tightened U.S. supervision of foreign branches and agencies operating in the United States. See generally Daniel B. Gail, Joseph J. Norton & Michael K. O'Neal, *The Foreign Bank Supervision Act of 1991: Expanding the Umbrella of "Supervisory Regulation,"* 26 INT'L LAW. 993, 993 (1992) (discussing changes in foreign bank supervision brought on by the BCCI scandal). The law provides for increased sharing of information between home and host country regulators,

For example, U.S. regulations require foreign banks to declare whether they intend to engage in wholesale or retail banking through their branches. If they plan to engage in retail banking and take deposits of less than \$100,000, then the U.S. operation must be organized as an insured subsidiary rather than as a branch of the foreign bank.¹¹⁴ The comprehensive supervision and information requirements of the law have dampened foreign interest in the U.S. banking market.¹¹⁵ The increasingly difficult process of branching into the United States may explain the NAFTA provision that imposes a freeze on any further restrictions on cross-border banking.¹¹⁶

Canadian regulators fare no better on the international turf protection front. Like their U.S. counterparts, Canadian regulators are not willing to give up their regulatory power without a fight. For example, it was understood during the negotiation of both the FTA and NAFTA that Canada opposed cross-border branching. This was due, in part, to Canadian banking regulators' desire for a Canadian bank that they could regulate.¹¹⁷ We should expect Mexican regulators to behave like their U.S. and Canadian counterparts, especially in light of the fact that Mexico does not permit foreign branching and explicitly negotiated for bank ownership protections in NAFTA.¹¹⁸

The turf war mentality is entirely consistent with a public choice view of the world, which sees regulators as managers who seek to maximize the

requires deposit insurance for all deposits under \$100,000, requires the Federal Reserve to approve all applications for any branch, agency or representative office, and permits the Federal Reserve to examine and close all such international banking facilities. *Id.* at 993-94.

114. 12 U.S.C. § 3105 (1994); see Scott, *supra* note 35 (discussing the change from previous policy).

115. See Hultman, *supra* note 113, at 453 (commenting that comprehensive supervision and extensive information requirements have contributed to waning foreign interest in the U.S. banking market).

116. See NAFTA, *supra* note 8, at art. 1404(1), 32 I.L.M. at 658.

117. See Jordan, *supra* note 9, at 48 (voicing the opinion that the Canadian trade negotiators did not yield to the pressures to permit U.S. branches because "Canadian regulators . . . wished to ensure that there was a Canadian entity to be regulated.").

118. When foreign banking was first permitted in 1994, foreign subsidiaries' aggregate capital share of the Mexican domestic market was limited to eight percent. The Mexican plan called for an increasingly liberal scheme of foreign ownership over a six year transition period until the last year if the transition foreign banks could control an aggregate of 15% of the capital in the commercial banking market. NAFTA, *supra* note 8, at Annex VII(B)(9), 32 I.L.M. at 774. At the end of the transition period the aggregate capital limits are supposed to lapse, subject only to Mexico's reserved right to impose additional limitations on banking competition if foreign banks control 25% of the Mexican banking market before January 1, 2004. See Bravo, *supra* note 100, at 1249-51 (setting out the restrictions on foreign ownership of various Mexican financial institutions). In the years since negotiating NAFTA, Mexico has had to reconsider the wisdom of foreign ownership requirements, and make adjustments in the foreign ownership scheme to attract needed capital to the Mexican banking system. See Jonathan Friedland, *Mexico's Big Banks Can't Lure Investors*, WALL ST. J., July 16, 1998, at A13; Michael Tangeman, *Caps Off to Foreign Investment*, LATIN FIN., May 1998, at 40 (summarizing the changes in foreign bank ownership rules since NAFTA's enactment).

value of their enterprises.¹¹⁹ Because branches are primarily regulated by the bank's home country regulator rather than the host country regulator, a scheme of cross-border branching will necessarily require paring down the current regulatory load of the host country regulators who are primarily responsible for the banking subsidiaries that operate within their territory.¹²⁰ Banking regulators who have a vested interest in the current system will not give up their authority willingly. Putting the public choice perspective aside, the legitimate public policy problems facing banking regulators (such as protecting bank customers and investors from asymmetric information problems, guarding against systemic failure, and working toward fair trade) indicate that regulators should retain the right to fashion their own domestic regulatory scheme.¹²¹

On the other hand, there is a dynamic tension between the regulators and the regulated that causes regulators to be sensitive to industry concerns. Corporate structure allows banking organizations some leeway in selecting their regulators. Since the costs of regulation can be quite high, banking firms often prefer to choose the regulator that will cover them. Because regulators act to increase their jurisdiction and different countries govern different aspects of international banking organizations, regulators may act as catalysts to alter banking regulation to attract more regulatees to their jurisdiction. This competition may lead to better and more efficient regulation, or it could instead turn into a "race to the bottom." By attracting firms from other countries, international regulators can increase their market share, their power, and the value of their regulatory enterprise.¹²²

In the NAFTA countries, regulatory competition seems to favor Canada and Mexico over the United States. Canada is probably best positioned because of its relatively light regulatory load. Mexico's banking regulation, although more liberal in many respects than U.S. law, still suffers from the stigma of being perceived as unstable. Banks in Canada and Mexico, however, are freer to engage in a broader range of activities over a wider geographic area than those chartered in the United States. In light of this, U.S.

119. See Kane, *Tension*, *supra* note 57, at 34 (describing the need of regulators to maximize the value of their enterprise within the confines of what he calls the "microeconomic analysis of financial regulation" that is consistent with the public choice view).

120. Subsidiaries are regulated primarily in the jurisdiction in which they are chartered. The regulation of branches is more complicated: for prudential matters, such as capital levels and management competence, the home country regulator has priority, but for market matters, the host country regulates. See Martinson, *supra* note 111, at 217 (applying general concepts of home and host country regulation to the NAFTA situation).

121. See Jean Dermine, *International Trade in Banking*, in INTERNATIONAL FINANCIAL MARKETS: HARMONIZATION VERSUS COMPETITION, *supra* note 110, at 49, 70-71 (reaching the conclusion that some autonomy in domestic regulation is necessary to address problems of asymmetric information, systemic failure and fair trade problems, but going on to consider whether the best approach in the international context should be national treatment or reciprocity).

122. See Kane, *Tension*, *supra* note 57, at 35-36 (noting that banking regulators must be aware of competition from banking regulators in other countries).

regulators may recognize their competitive disadvantage and delay cross border branching until the U.S. regulatory scheme can be made more compatible with international norms.

Of course, the regulators may recognize that they are engaged in a game that could maximize joint pay-offs if they co-operate with each other.¹²³ Although NAFTA itself does not require the signatory countries to take any meaningful steps toward harmonization of their respective domestic laws regulating financial services,¹²⁴ when viewed through a public choice lens, harmonization may be acceptable to regulators. While acting to maximize the values of their respective regulatory enterprises, North American bank regulators could attempt to standardize their regulation by forming a cartel. Harmonization would reduce much of the regulatory competition that erodes regulators' market share. By standardizing the regulatory product, the regulators could control the supply of regulation and protect the status quo to lock in their respective positions.¹²⁵ Of course, cartels can be unstable. Also, it would be difficult for regulators to craft an agreement that could not be broken by an innovative regulatory scheme in one country designed to increase the power and prestige of that country's regulator.¹²⁶

Even without the motivation to form a cartel, NAFTA banking regulators may find themselves pushed in the direction of increased harmonization. One important reason for increased harmonization is that North America is generally characterized by "regulatory emulation."¹²⁷ That is, Canada and Mexico tend to change their policies to be at least as liberal as the United States to make sure that they have not erected obstacles to the flow of international resources that would favor investment in the United States over either Canada or Mexico.¹²⁸

The NAFTA countries also face pressure to liberalize trade and gain access to non-NAFTA markets.¹²⁹ Indeed the regional trade blocks may

123. For a discussion of cooperative non-zero sum games, see R. DUNCAN LUCE AND HOWARD RAIFFA, *GAMES AND DECISIONS: INTRODUCTION AND CRITICAL SURVEY* 88-96 (1957) (providing mathematical discussion and examples).

124. See Trachtman, *supra* note 24, at 94 (noting that NAFTA does not require financial regulation harmonization).

125. See Kane, *Tension*, *supra* note 57, at 34 (discussing the concept of regulatory cartels).

126. See ROBERT S. PINDYCK & DANIEL L. RUBINFELD, *MICROECONOMICS* 454-60 (4th ed. 1995) (describing the factors affecting the stability of cartels).

127. See Cockfield, *supra* note 65, at 45-46 (describing the idea of regulatory emulation in North America in the tax context).

128. *Id.* This may explain why the Task Force on the Future of the Canadian Financial Services Sector has proposed that Canada permit foreign bank branching for purposes of engaging in wholesale banking but continue to require a Canadian subsidiary in order to engage in retail banking. See TASK FORCE ON THE FUTURE OF THE CANADIAN FINANCIAL SERVICES SECTOR, *CHANGE, CHALLENGE, OPPORTUNITY: REPORT OF THE TASK FORCE* 195 (Sept., 1998). This approach to foreign banking is notably similar to the U.S. approach.

129. For example, Canada (1996) and Mexico (1991) have already negotiated free trade agreements with Chile. See George M. von Furstenberg, *Preface to THE BANKING AND FINANCIAL STRUCTURE IN THE NAFTA COUNTRIES AND CHILE*, *supra* note 92, at xiii

end up in competition with each other, which in turn could lead to significant reductions in trade barriers.¹³⁰ As trade in financial services plays an increasingly important role in these trade pacts, the obstacles to unfettered cross-border activity should disappear.

Even if none of the reasons for harmonization discussed above come to pass, the North American banking industry inevitably will find itself subject to an increasing number of international agreements affecting the trade of services and the regulation of banking in particular.¹³¹ Although multinational trade agreements covering industries as complicated as the financial services industry take a long time to evolve, banking regulators have begun a movement toward greater cooperation.¹³²

The public choice perspective predicts the mere existence of cross-border commerce, combined with increased contact between policy-makers and business people, will hopefully lead to the adoption of the "best" policies.¹³³ Indeed, in the securities area, U.S. and Canadian regulators have already achieved a considerable degree of harmonization of federal, state, and provincial securities regulation.¹³⁴

Conversely, given the effects of path dependence and the disparate initial conditions of the NAFTA nations, even if liberalization and competition create some pressure for the convergence of the banking regulatory scheme in the three countries, that convergence is unlikely to ever be complete. As Lucian Bebchuk and Mark Roe have argued, in a context of international corporate governance structures where key decision makers also receive rent and can block change, the existing system will tend to persist.¹³⁵

(noting the existence of free trade agreements between Canada and Chile and Mexico and Chile).

130. One way to look at NAFTA is as a competitive response by the North American countries to the increased unification of the European Union.

131. For example, the General Agreement on Trade in Services ("GATS") has already begun to have some effect on the international provision of banking services. *See generally*, Simser, *supra* note 63 (describing the structure of the GATS and its implications for trade in financial services).

132. *See* Joseph J. Norton, *Trends in International Bank Supervision and the Basle Committee on Banking Supervision*, 48 *CONS. FIN. L.Q.* 415 (1995) (summarizing some of the issues confronting the Basle Committee on Banking Supervision).

133. *See* Zamora, *Harmonization*, *supra* note 24 (arguing that increased cross-border contact between businesspeople, bureaucrats, lawyers, academics and others will inevitably lead to an exchange of ideas and accommodation in each of the three countries of the cultural differences of the others); and Aman, *supra* note 24 (arguing that global political and economic forces push national policies towards various forms of deregulation and privatization).

134. *See* Jordan, *supra* note 9, at 53 (noting that the Canadian scheme of securities regulation is modeled on the U.S. scheme and that regulators have achieved considerable integration).

135. *See* Lucian Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, in *CORPORATE GOVERNANCE TODAY* 575, 585-96 (1998) (describing the view that difference in corporate governance might persist provided that the costs of a Coasian bargain are not trivial); *but see* J. Mark Ramseyer, *Are Corporate Governance Systems Converging?*, in *CORPORATE GOVERNANCE TODAY*, *supra*, at 537 (arguing that systems of successful firms are shaped by economic logic and, over time, differ-

B. Rent-Seeking Behavior of Financial Services Industry Interests

Of course, in addition to regulators, participants in the financial services industry will try to influence the actions of trade negotiators. There can be little doubt that the banking, securities, and insurance industries in NAFTA countries have the necessary resources to translate their economic power into political action when desired.

1. United States

The United States has a highly fragmented financial services industry. Identifiable industry segments include money center banks, regional banks, community banks, investment banks, asset-based lenders, consumer finance firms, thrifts, credit unions, insurance companies, mutual funds, and securities brokers, among others. Each of these participants has its own perspective on optimal financial services modernization. Thus, to date, no one group or coalition of groups has mobilized enough political support to change the structure of the financial services industry in the United States.¹³⁶ In addition, the political process relating to financial services regulation is complex and fragmented, such that altering financial services policy in the United States requires lobbying in the legislative, executive, and administrative branches of government at both the state and federal levels. While it is easy to observe rent-seeking behavior by both industry participants and various political actors, rarely does the critical mass of industry interest align with the critical mass of political weight, enabling change in the regulatory scheme.

Consequently, the current configuration of U.S. banking regulation seems likely to persist, in part because the current regulations produce winners and losers, and while the benefits to the winners tend to be concentrated, the costs to the losers tend to be diffuse.¹³⁷ The stakes for the losers (such as individual consumers of financial services who pay marginally higher prices than they might under a different regulatory scheme) will never coalesce into an effective counterweight to the loot for the winners. Given the incentives created by our own regulatory scheme for the existing set of winners and losers in our financial system, it seems unlikely that the United States will lead the charge to bring cross-border branching to the NAFTA countries.

One group of winners under the current scheme is the banking industry. U.S. bankers will oppose change in cross-border banking because they benefit from the current structure that permits U.S. access to Mexico or

ent systems will tend to converge). See also Lawrence J. White, *Competition Versus Harmonization – An Overview of International Regulation of Financial Services*, in INTERNATIONAL FINANCIAL MARKETS: HARMONIZATION VERSUS COMPETITION, *supra* note 110, at 5 (providing an overview of the competition versus harmonization debate).

136. See Schroeder, *Glass-Steagall*, *supra* note 85 (providing a concise political history of Glass-Steagall reform).

137. See Randall S. Kroszner, *The Political Economy of Banking and Financial Regulation in the United States*, in THE BANKING AND FINANCIAL STRUCTURE IN THE NAFTA COUNTRIES AND CHILE, *supra* note 92, at 201, 202 (noting the disparity in costs and benefits of preferential regulation).

Canada through subsidiaries while permitting access to the United States through highly regulated branches. Under this scheme, the United States has better access to both Canada and Mexico than the rest of the world's major banking powers, while Canada and Mexico have access to the United States on essentially the same terms as every other country. The United States can honestly state that it permits branching already and maintain that it will not liberalize its branching regime until Mexico and Canada permit true branching.

Although U.S. law permits nationwide branching for banks located in the United States, U.S. banks will be reluctant to permit Canadian and Mexican banks the right to unfettered branching from their home offices, regardless of the sentiment contained in NAFTA Section 1403. Even though nationwide branching is now possible, only two mega-mergers, announced earlier this year, have made coast-to-coast branching a reality.¹³⁸ U.S. banks need time to establish their own nationwide branching systems and will not permit U.S. trade representatives to allow Canadian and Mexican banks to get in on the ground floor of U.S. nationwide branching. On their home territories, both Mexican and Canadian banks have long established branched national networks that give them a big head start on any U.S. attempts to enter their respective markets.

In addition, strong evidence suggests that foreign banks in the United States are less profitable than their U.S. competitors.¹³⁹ Because a branch network should be cheaper and thus more profitable than a subsidiary network, permitting true branches will only serve to make foreign banks more competitive in the United States. The banking lobby will use its political clout to prevent that from occurring. On the other hand, branching will permit U.S. banks to access the Canadian and Mexican markets more efficiently. However, the big U.S. banks have already incurred the expense and inconvenience of establishing Mexican subsidiaries¹⁴⁰ and can be expected to oppose unfettered branching which would permit late-comers to branch into Mexico at a lower cost. As for Canada, the banking market there is already saturated, and free branching would not make the profit picture there much brighter.

138. See Steven Lipin & Gordon Fairclough, *Mergers of NationsBank, BankAmerica and Banc One, First Chicago Unveiled*, WALL ST. J., Apr. 14, 1998, at A3 (discussing two banking mergers that if approved will result in two organizations with retail locations that literally reach from coast to coast). Earlier attempts to provide "coast-to-coast banking have not been successful. See Matt Murray, *KeyCorp Fails to Prove It Can Unlock Promise of a Merger of Equals*, WALL ST. J., Aug. 25, 1998, at A1 (describing the failure of KeyCorp to achieve success on its northern tier strategy).

139. See Hultman, *supra* note 113, at 453 (providing statistics showing that the average return on assets of foreign banks operating in the United States is significantly lower than that of U.S. banks generally and lower than a cohort group of internationally active U.S. banks); SCOTT & WELLONS, *supra* note 22, at 138 (noting that foreign banks appear to be less efficient and more dependent on wholesale funding, thereby making their cost of funds higher).

140. See Palace, *supra* note 45, at 162 (describing the flurry of application approved by U.S. banking organizations to engage in a range of activities in Mexico).

2. Canada

Canada's banking market is not very hospitable to foreign entrants, and its banks still enjoy some protectionist measures.¹⁴¹ In addition, because the Canadian market is already overbanked, the major Canadian banks have come to recognize that the opportunities for growth are outside Canada.¹⁴² While NAFTA's provisions allow U.S. and Mexican banks slightly easier access to a mature market where well-established firms have long customer relationships and efficient operations,¹⁴³ foreign entrants are largely left to exploit niche businesses.¹⁴⁴

Foreign financial service providers have found it very difficult to establish profitable operations in Canada.¹⁴⁵ Although many U.S. banks maintain a presence in Canada, it is clear that they will never be major players there.¹⁴⁶ Therefore, Canadian banking interests probably do not care whether NAFTA member countries are permitted to branch into Canada, as long as the other markets, especially Mexico, are opened to Canadian banks in return.

The Canadian banking industry is able to easily communicate its interests to the Canadian trade representative since the industry is concentrated and therefore can speak with one voice. In addition, the Canadian parliamentary form of government means the industry needs only to seek rents from the party in power to implement the policy it desires.¹⁴⁷ These facts, coupled with the national policy of reviewing the banking laws every five years or so, ensure that Canada will respond quickly to the political demands of its financial services industry.¹⁴⁸

141. As a practical matter, the Schedule I banks will never be taken over by foreign interests as long as the "widely held" rule remains in place. See Bank Act, R.S.C. ch. B-1.01 § 370(2) (1996) (Canada) (defining "widely held"). The Task Force's proposals for modifying the widely held rule fall far short of eliminating it. See TASK FORCE REPORT, *supra* note 128, at 200-01 (describing proposed modifications to the widely held rule).

142. See Weber, *supra* note 112 (noting that Canadian banks are looking south for growth).

143. See James R. Kraus, *Canada Plan Would Permit Cross-Border Branches*, AM. BANKER, May 22, 1997, at 22 (quoting Canadian banking experts who remark that Canada has a technology and cost efficiency edge on U.S. banks resulting in lower spreads and the need for high volume to cover costs).

144. See CHARLES FREEDMAN & CLYDE GOODLET, *THE FINANCIAL SERVICES SECTOR: PAST CHANGES AND FUTURE PROSPECTS* 25 (Mar. 1998) (noting that the dominant position of Canada's banks will be challenged by "global" banks and niche players).

145. See WHITE, *supra* note 9, at 10 (noting that foreign banks in Canada have failed to achieve rates of return on equity that even equal the return available from Canadian treasury bills).

146. *Id.* (noting that Canada has been a "tough nut to crack" for U.S. banks and pointing out that in the seventeen years since U.S. banks have been permitted in Canada they have a very limited presence, with Citicorp, the largest, having merely \$4.8 billion in assets, which amounts to about one half of one percent of total Canadian banking assets).

147. See Chant, *supra* note 92, at 36-7 (noting the difference between the U.S. and Canadian political systems).

148. As the recent Report of the Task Force demonstrates, however, the banking industry is not the only rent-seeking group that is accommodated through the review process. The report contains payoffs for consumer groups, regulators and other service

Given the state of the Canadian political marketplace, it comes as no surprise that the Task Force on the Future of the Canadian Financial Services Sector has recommended that Canada permit foreign banks to branch into Canada to engage in wholesale banking, but to continue to require a Canadian subsidiary to engage in retail banking.¹⁴⁹ By making this change, Canada responds to international pressure to permit branching, but does so within the restrictive U.S. model, so that neither the banking industry nor the Canadian regulators give up very much by way of this modest change. Additionally, as expected, the Task Force did not recommend the elimination of the "widely held" rule, but rather only suggested modifications to it.¹⁵⁰ The modest modifications seem designed to guarantee that the largest Canadian banks will continue to be Canadian owned.

3. Mexico

Mexico represents a very attractive market for U.S. and Canadian banks,¹⁵¹ despite Mexican banks' competitive edge because of their extensive branch networks (which gives them a diverse geographic and customer base), and their expertise on the Mexican market, legal system, and political institutions.¹⁵² Whereas the U.S. and Canadian markets are well supplied with banking services, Mexico is dramatically undersupplied.¹⁵³ The average interest rate on a Mexican loan is thirty-two percent.¹⁵⁴ Consequently,

providers such as insurance companies and credit unions. See TASK FORCE REPORT, *supra* note 128.

149. See *id.* at 195 (noting that foreign banks that want to attract deposits of less than \$150,000 (Canadian) would have to establish a Canadian subsidiary).

150. See *id.* at 200-01 (noting that for most institutions no party may own 10% of any class of shares except upon prior approval of the Minister of Finance, while ownership restriction on banks of over \$5 billion are even more restrictive).

151. See Zamora, *Comments, supra* note 10, at 78 (noting attractiveness of Mexican banking market).

152. See Thomas Heather, *Comments on Financial Services, Other Services, and Temporary Entry Rules*, 1 U.S.-MEX. L.J. 73, 75 (1993) (listing advantages held by Mexican firms in the post-NAFTA Mexican banking market); MacAllister *supra* note 26, at 303-04 (noting many potential competitive advantages for Mexican banks in the retail and commercial banking markets, including the ability of customers of Mexican banks to pay their utility bills at the bank).

153. See Jordan, *supra* note 9, at 52, n.43 (noting that at the time of NAFTA's negotiation only eight percent of Mexicans had a checking account and there were an average of 18,500 people per banking branch in Mexico as opposed to approximately 2,000 people per branch in the United States and Canada); see also WHITE, *supra* note 9, at 16 (giving the branching information as 19,000 people per branch in Mexico versus 2,000 people per branch in the United States and Canada); and MacAllister, *supra* note 26, at 297 (noting that Mexico is a large, untapped market).

154. See Bronwen Davis, *Comment, Mexico's Commercial Banking Industry: Can Mexico's Recently Privatized Banks Compete With the United States Banking Industry After Enactment of the North American Free Trade Agreement?*, 10 ARIZ. J. OF INT'L & COMP. L. 77, 101 (1993) (noting the high Mexican interest rate compared to similar U.S. loans). Nominal Mexican interest rates fluctuate between 30% and 40%, more than double the inflation rate of 13%. Although such rates may reflect a market where demand for banking exceeds the supply, the high rates may also merely reflect risk premiums that compensate lenders against the default risk. See Salinas-León, *supra* note 101 (noting the perverse incentives created by Mexico's deposit insurance and bankruptcy laws that have the effect of increasing the risk of default).

U.S. banks have been eyeing the potential of the Mexican banking market for some time.¹⁵⁵

The easiest way for U.S. and Canadian banks to gain access to the Mexican market would be for NAFTA to provide unfettered, routine cross-border branching. But cross-border banking may be prevented because of events that occurred after the enactment of NAFTA. Mexico's banking system is in dire need of massive amounts of new capital. Allowing U.S. and Canadian branching will defeat efforts to find foreign investors for Mexico's ailing banks. Industry interests and political operators know that Mexico does not really have the option of allowing branching at this time. On top of that, some members of Congress are suspicious of foreign involvement in banking and would want to maintain barriers to foreign entry. In addition, branching will be only a minor issue for the U.S. and Canadian banks already present in Mexico. The large U.S. and Canadian banks have already expanded into Mexico through the subsidiary device, and branching from home will not be a significant advantage to them.¹⁵⁶

Mexican negotiators may be willing to make some concessions on branching to obtain access to the U.S. banking market. Mexican banks may desire to provide banking services to the substantial Hispanic populations in the southern tier of the United States.¹⁵⁷ U.S. banking interests are likely to oppose these prospects with vigor.¹⁵⁸ Nevertheless, Mexican banks with existing subsidiaries in the southwestern United States¹⁵⁹ would also probably prefer to service that market through a branch network. Therefore, depending on how attractive Mexican banks find the U.S. market, Mexican negotiators may be willing to make some concessions on branching.

155. See Karen Epper, *Crowded at Home, U.S. Firms Look to Mexico*, AM. BANKER, Jan. 19, 1994, at 2. With rates of return on equity in Mexican banks at 27%, compared to 13% for U.S. banks and 10% for Canadian banks, the Mexican banking industry seems to show signs of weak competition. See WHITE, *supra* note 9, at 16 (providing return on equity figures).

156. See Clark, *supra* note 6 (describing Bank of Montreal's plan to be the first true North American bank through its operations in Canada, Mexico and the United States); James R. Kraus, *Commercia Near Decision on Opening Bank in Canada*, AM. BANKER, July 2, 1997, at 5 (describing Commercia's North American strategy); Fluckiger, *supra* note 7, at 82 (describing the Mexican operations of Bank of Nova Scotia, Bank of Montreal, Wells Fargo, and NationsBank); and Weber, *supra* note 112 (noting that Canadian bankers are looking south for growth).

157. See Davis, *supra* note 154, at 99 (noting that Mexican banks are especially interested in cultivating the southwestern border region of the United States); but see Andrea Gerlini, *In This Texas Town, Their Favorite Bank is Mattress Savings*, WALL ST. J., Oct. 31, 1996, at A1 (noting market research showing that Hispanics are reluctant to use banking services).

158. Loans made in Mexico frequently are denominated in US dollars. U.S. banks know this and will be very cautious about providing easy branching to Mexican banks and thereby permitting access to low cost funds through a deposit gathering network.

159. See Cogan, *supra* note 7, at 770 (noting the presence of Mexican banking subsidiaries in the United States since 1978).

4. *International Aspects*

In addition to the country specific matters discussed above, several considerations affecting industry's desire for branching (or lack thereof) cut across national borders. The first major issue is the exploitation of government safety subsidies bestowed on banks in the NAFTA countries.

a. *Exploiting the Safety Net Subsidy*

While the debate over the existence and extent of the safety net subsidy in the context of domestic banking policy drags on,¹⁶⁰ the issue has a different dimension in the international context. If U.S. banks receive a safety net subsidy but "firewalls" make it difficult to transfer the benefit of the subsidy upstream to the holding company, then banks should clamor for cross-border branching in order to exploit the subsidy from within the bank itself. Intuitively, U.S. bankers would, if such a subsidy exists, insist on engaging in cross-border branching as soon as possible so that U.S. banks could exploit the subsidy in our neighboring countries.

But in the international setting, such an argument is off the mark because all important banking countries bestow a safety net through some kind of systemic default guarantee that acts to protect depositors and subsidize banks.¹⁶¹ The mere existence of such a subsidy does not explain one country's competitive success in the banking market vis-a-vis banks from other countries. Rather, success is more likely determined by a combination of "comparative advantage, the fundamentals of each economy,¹⁶² and governmental support in the form of safety net policies."¹⁶³ So while the safety net subsidy is part of the picture, it is only part. On the international level, the important question to ask is not "does a subsidy exist," but rather "how big is one subsidy compared to the subsidies provided by the other countries?"

Canada's banks enjoy safety-net benefits from their deposit insurance system and central bank similar to the benefits bestowed upon U.S. banks by the FDIC and the Federal Reserve.¹⁶⁴ One might surmise from the difference in the regulatory burden between the United States and Canada, and the much lower failure rate of Canadian banks, that the net subsidy to

160. See *supra* notes 79-82 and accompanying text.

161. See Colombaro & Macey, *supra* note 52, at 941.

162. On the point of the strength and stability of the domestic economies in each country, the United States is clearly head and shoulders above its two partners. The U.S. economy is mature, diverse and immense. Mexico's and Canada's economies are each less than 10% the size of the U.S. economy, and both countries are also both making the transition from being primarily natural resources based economies to being centered more on manufacturing and services. A strong U.S. economy means strong U.S. banks, which should translate into a comparative advantage.

163. HAL S. SCOTT & IWAHARA SHINSAKU, *IN SEARCH OF A LEVEL PLAYING FIELD: THE IMPLEMENTATION OF THE BASLE CAPITAL ACCORD IN JAPAN AND THE UNITED STATES I* (1994).

164. See *Reforms Needed for Financial Services to Flourish Says CBA*, CANADA NEWSWIRE, Oct. 29, 1997 (reporting on a Canadian Bankers Association report that urges reevaluation of the "special privileges" accorded to Canadian banks, such as deposit insurance, liquidity support from the Bank of Canada, and access to the payment system).

Canadian banks exceeds the U.S. subsidy. Mexico's commitment to its banking system, although recently tested by the peso crisis, probably does not translate into a sizeable subsidy for Mexican banks (especially with the memory of nationalization still relatively fresh in the collective consciousness of the industry). In sum, Canada would appear to have the edge on the size of safety net subsidy and would therefore desire to branch directly across national borders to capitalize on that subsidy. U.S. and Mexican banks would therefore be expected to resist.

b. Realizing Economies of Scope

Financial services firms have been combining over the past few years in an effort to offer customers a wide range of products and services.¹⁶⁵ The firms theorize that joint production of a wide range of products and services will result in an economy of scope.¹⁶⁶ An economy of scope occurs when one firm can more cheaply produce two products together than any two separate firms can produce the separate products independently.¹⁶⁷ Oddly, this strategy has disappointed financial service firms in the past.¹⁶⁸ Even with the recent liberalization of bank powers, the artificial compartmentalization of the U.S. financial services market effectively prevents banking organizations from realizing meaningful economies of scope.

Studies examining the issue have found that there is no consistent evidence of global economies of scope in banking, although there is some evidence of product specific economies of scope in production.¹⁶⁹ The lack of academic literature supporting the existence of economies of scope in banking has been offered as an argument against breaking down the artificial barriers that define U.S. commercial banking.¹⁷⁰ The weakness of the literature, however, is that it focuses on the U.S. banking industry as it currently exists. Eliminating the barriers between commercial and investment banking would make the production of securities underwriting,

165. See, e.g., *With Rules Eased, Banks Flock to Securities Underwriting*, AM. BANKER, Aug. 18, 1997, at 1 (noting the acquisition of securities firms by large banks and the strategic changes in regional banks' plans.).

166. See PINDYCK & RUBINFELD, *supra* note 126, at 220-23 (discussing economies of scope).

167. See Loretta J. Mester, *Efficient Production of Financial Services: Scale and Scope of Economies*, FED. RESERVE BANK OF PHILA. BUS. REV., Jan./Feb. 1987, at 15, 16.

168. See Steve Swartz & Steve Weiner, *Many Firms Back Off From Offering Arrays of Financial Services*, WALL ST. J., Nov. 12, 1986, at A29 (discussing the disappointing results of full service financial service providers such as Merrill Lynch, American Express, and Sears Roebuck).

169. See Jeffery A. Clark, *Economies of Scale and Scope at Depository Financial Institutions: A Review of the Literature*, 73 FED. RESERVE BANK OF KANSAS CITY ECON. REV., Sept./Oct. 1988, at 26 (reviewing the literature and finding little evidence of meaningful overall economies of scope, but finding support for the idea that cost complementarity may exist for some pairs of products); see also William Curt Hunter and Stephen G. Timme, *Does Multi-product Production in Large Banks Reduce Costs?*, 74 ECON. REV. FED. RESERVE BANK OF ATLANTA, May/June 1989, at 2 (finding that multiproduct production does not necessarily result in lower costs of production).

170. See *Leach Circulates GAO Study Criticizing Mixing of Banking and Commerce*, 16 BANKING POL'Y REP. 10, 12 (1997) (stating "the virtually unanimous finding in the literature is that economies of scope are insignificant in banking").

banking, insurance and other financial services much easier. One would be able to take advantage of combined facilities, personnel, knowledge, information, brand name, and customer base, all within one firm rather than dealing with separate firms.¹⁷¹ Many observers of the banking business believe economies of scope would be significant.¹⁷² Therefore, the ability of U.S. banks to achieve meaningful economies of scope likely depends on repeal of the Glass-Steagall Act. This, in turn, will be a multifaceted political question. Glass-Steagall has essentially provided the U.S. securities industry with a generous subsidy, and the industry is unlikely to give up the advantages of the law without a fight.¹⁷³

To the extent U.S. banks are unable to exploit economies of scope, they are at a competitive disadvantage with respect to their Canadian and Mexican competitors. Canada once imposed restrictions along product lines similar to Glass-Steagall, but did away with most of those restrictions in the 1987 and 1992 banking act revisions.¹⁷⁴ At the anecdotal level, because Canada has permitted banks to acquire securities dealers as subsidiaries, all of the major Canadian securities dealers are now owned by banks.¹⁷⁵ Even though cause and effect are difficult to prove, all three U.S. brokerage firms with a presence in Canada in 1987 had withdrawn from the market by 1994.¹⁷⁶ Mexico, like Canada, permits common ownership of securities firms and banks, along with other financial services providers. Glass-Steagall is currently acting as a major non-tariff barrier to trade to keep the North American competitors from realizing economies of scope from their integrated financial services businesses. Banks in the United States are

171. See Bernard Shull & Lawrence J. White, *The Right Corporate Structure for Expended Bank Activities*, 115 *BANKING L. J.* 446, 464 (1998) (describing potential economies of scope).

172. See David M. Eaton, *The Commercial Banking-Related Activities of Investment Banks and Other Nonbanks*, 44 *EMORY L.J.* 1187, 1206 n.127 (1995) (citing ROBERT E. LITAN, *WHAT SHOULD BANKS DO?* 60 (1987) for the proposition that combining financial products will result in economies of scope); Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan and the United States*, 48 *STAN. L. REV.* 73, 110 (1995) (noting economies of scope between banks and their securities affiliates); Joseph J. Norton & Christopher D. Olive, *The Ongoing Process of International Bank Regulatory and Supervisory Convergence: A New Regulatory-Market "Partnership,"* 16 *ANN. REV. BANKING L.* 227, 276 n.170 (1997) (stating that economies of scope could arise by combining commercial and investment banking because information gathering is an important function of both businesses); and George A. Walker, *The Law of Financial Conglomerates: The Next Generation*, 30 *INT'L LAW.* 57, 63 (1996) (noting that one advantage of conglomeration is the presence of economies of scope).

173. See Donna L. Lance, Note, *Can the Glass-Steagall Act be Justified Under the Global Free Trade Market Policies of the NAFTA?*, 34 *WASHBURN L.J.* 297, 298 (1995) (observing that Glass-Steagall has shielded the U.S. securities industry from domestic competition from commercial banks and thereby bestowed a subsidy to the securities industry).

174. See Edward P. Neufeld & Harry Hassanwalia, *Challenges for the Further Restructuring of the Financial Services Industry in Canada*, in *THE BANKING AND FINANCIAL STRUCTURE IN THE NAFTA COUNTRIES AND CHILE*, *supra* note 92, at 45, 57-59 (describing the rise and fall of the "four pillars" of the Canadian financial services industry — banking, insurance, trust and investment activities).

175. See WHITE, *supra* note 9, at 10.

176. *Id.*

likely to cling to this current scenario until they can compete with Canadian and Mexican firms on an equal footing.

c. Realizing Economies of Scale

When a firm can increase its level of output and decrease the average cost of production, economies of scale exist, since it costs proportionately less to produce at a larger scale.¹⁷⁷ Although researchers have long studied the existence of economies of scale in the banking industry, results of those studies do not paint a clear picture.¹⁷⁸ Studies in the 1970s and 1980s evaluating the existence of overall economies of scale in the banking industry almost unanimously concluded that economies of scale either did not exist or were substantially exhausted by the time banks reached the asset size range of \$25 million to \$100 million.¹⁷⁹ However, there may have been some methodological problems with those studies.¹⁸⁰ Other studies prepared during the period have tended to show that some product-specific economies of scale do exist.¹⁸¹ Intuitively, it seems obvious that economies of scale, at least on the product-specific level, should exist in banking.

177. See Mester, *supra* note 167.

178. The earliest empirical studies of economies of scale tended to show that scale economies in banking were relatively unimportant. See Richard W. Nelson, *Economies of Scale v. Regulation as Determinants of U.S. Banking Structure*, in PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 462 (1983). Studies during the 1960's, however, found significant economies of scale in the banking industry. See FREDERICK W. BELL & NEIL B. MURPHY, *ECONOMIES OF SCALE IN COMMERCIAL BANKING* 8-9 (1967) (analyzing data obtained in 1965 and showing that unit costs declined significantly as banks expanded operations); George J. Benston *Economies of Scale and Marginal Costs in Banking Operations* 2 NAT'L BANKING REV. 507, 541 (June 1965) (using data from the early 1960s, concluded that economies of scale were observed in each of several different banking services).

179. See Clark, *supra* note 169, at 26 (reviewing 13 empirical studies and finding that, overall, economies of scale appear to exist only at low levels of output, while diseconomies of scale appear at large output levels); George J. Benston et al., *Economies of Scale and Scope in Banking*, in PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION, *supra* note 178, at 432, 452 (concluding that there are no overall scales of economy below low output levels); see also A. Sinan Cebenoyan, *Multi-Product Cost Functions and Scale Economies in Banking*, 23 FIN. REV. 499 (Nov. 1988); Thomas Gilligan & Michael Smirlock, *An Empirical Study of Joint Production and Scale Economies in Commercial Banking*, 8 J. BANKING & FIN. 67-77 (1984) (finding scale economies in small banks, but diseconomies in large banks).

180. The studies are subject to the following criticisms: a) they all relied on the translog cost function which may contain deficiencies that cause it to invariably find a U-shaped cost curve. See James E. McNulty, *Economies of Scale: Discussion*, in PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION, *supra* note 178, at 456, 457; b) the data sample came from the Federal Reserve's functional cost analysis system, which consists of only 700-800 banks and is not a random sample but rather is a voluntary reporting scheme, and likely contains information from a disproportionate number of banks merely concerned about their costs, *id.*; c) the studies do not include banks with over a billion dollars in assets, see, e.g., Benston et al., *supra* note 179, at 433.

181. See Peter Maloney, *Merging Trust Operations*, 98 U.S. BANKER, June 1, 1989, at 37-38 (finding that banks can capitalize on significant economies of scale by combining trust departments into one operational unit); John P. Mara, *The New Economics of Mortgage*, 49 MORTGAGE BANKING, Mar. 1989, at 89-94 (suggesting that technologically induced economies of scale exist in mortgage banking and servicing and do not diminish until volumes reach about \$2.5 billion).

For example, banks must invest in a certain amount of legal work, form preparation, training, record keeping and other start-up costs to produce consumer loans. Banks incur these costs irrespective of the number of loans actually made. Because there is a large fixed-cost start-up expense, the average cost per loan should decrease as a function of the number of loans made because the start up cost will be spread over a larger number of loans. Therefore, all things being equal, the bank that produces more consumer loans should, on average, be able to produce those loans at a lower average cost than its less productive competitor.¹⁸²

Another study found significant economies of scale in compliance cost for Regulation Z and B for commercial banks at levels of output of up to 375,000 consumer credit accounts, beyond which there are small diseconomies of scale.¹⁸³ The study concluded that "at the lowest output levels, large, unexploited scale economies exist but that scale economies decrease rapidly as output increases and are exhausted at a moderate level of output."¹⁸⁴ Subsequent studies, however, have reached results tending to show moderate to substantial economies of scale.¹⁸⁵ While the scale economy debate continues, the studies to date seem to point to three salient conclusions: (1) within banking organizations, economies of scale may be modest; (2) with regard to specific high volume products such as credit cards and checking accounts, the economies of scale may be significant; and (3) large money center banks do appear to enjoy a cost economy because they can attract capital at a lower cost than their competitors.¹⁸⁶

182. More recent studies have specifically investigated whether the production of consumer loans, which have high regulatory compliance costs, display scale economies. One study found substantial economies of scale in compliance with Regulation B. Larger banks spent more on compliance than smaller banks, but a 5.7% change in the cost of compliance was accompanied by a 10% change in the amount of credit extended. See Neil B. Murphy, *Economies of Scale in the Cost of Compliance with Consumer Credit Protection Laws: The Case of the Implementation of the Equal Credit Opportunity Act of 1974*, 10 J. BANK RES., 248, 250 (1980). This study, however, was based on a very small sample of banks, and also evaluated the costs of compliance at the outset of Regulation B's existence. This data may not reflect long run compliance costs because the survey was conducted less than one year after the original Regulation B became effective. See GREGORY ELLIEHAUSEN & ROBERT D. KURTZ, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *SCALE ECONOMIES AND COMPLIANCE COSTS FOR CONSUMER CREDIT REGULATION: TRUTH-IN-LENDING AND EQUAL CREDIT OPPORTUNITY LAWS*, Staff Study number 144, 1, n.3 (1985).

183. ELLIEHAUSEN & KURTZ, *supra* note 182, at 10.

184. *Id.*

185. See, e.g., Joseph P. Hughes et al., *Efficient Banking Under Interstate Branching*, 28 J. MONEY, CREDIT & BANKING 1045 (1996) (finding relatively large scales of economy that increase with size and geographic diversity); Joseph P. Hughes & Loretta J. Mester, *Bank Capitalization and Cost: Evidence of Scale Economies in Risk Management and Signaling*, 80 REV. ECON. & STAT. 314 (1998) (finding substantial scale economies); Stravos Peristiani, *Do Mergers Improve the X-Efficiency of U.S. Banks? Evidence From the 1980s*, 29 J. MONEY, CREDIT & BANKING 326 (1997) (acquiring banks experienced moderate improvements in scale efficiency relative to a control group).

186. See PETER S. ROSE, *BANKING ACROSS STATE LINES: PUBLIC AND PRIVATE CONSEQUENCES* 106-07 (1997) (discussing economy of scale studies). See also Patrick H. McAllister & Douglas McManus, *Resolving the Scale Efficiency Puzzle in Banking*, 17 J. BANKING & FIN. 389 (1993) (examining returns to scale generally, and finding significant scale

In the NAFTA context, some North American bankers may harbor the concern that the production of banking products and services could have such economies of scale that large banking organizations will inevitably come to dominate the market.¹⁸⁷ The economic studies do not consistently support such a conclusion, and experience with the consolidating banking industry of the 1980s and 1990s has yet to show such a trend. Even if the threat of large banks is unfounded, however, the perception of a threat is just as damaging politically, so community banks in the United States will rail against cross-border branching on the theory that U.S. money center banks and their huge Canadian and Mexican counterparts will squeeze small community banks out of the competitive picture entirely.

III. Possible Resolutions of the Dilemma

If NAFTA'S bank branching provisions are considered in isolation, without some countervailing bargaining chip to even out the tradeoffs, there will not be a departure from the status quo. It seems likely that the cross-border branching issue will not be resolved until there is some exogenous shock to the status quo that realigns the interests of the players and regulators in the current regime.

One possible source of change might be the resolution of one or more of the sub-games that influence the strategies of national trade negotiators. For instance, the turf war in the U.S. federal banking scheme could end with either the Federal Reserve or the Comptroller of the Currency emerging as the clear victor.¹⁸⁸ Such a reform could result in a single federal banking regulator that could influence the NAFTA negotiation without fear of giving up too much domestic regulatory power. Given the poor track record of recent attempts by Congress to rebalance the power of the various federal banking regulators, however, this event may never come to pass.¹⁸⁹

economies for banks below \$500 million in assets, but also finding significant cost advantages for big banks over smaller banks for financial capital, thereby negating any diseconomies of scale in pure operating costs).

187. The data do not clearly support the contention that large banks enjoy economies of scale. Hence, the predictions of the demise of the small community bank appear to be greatly exaggerated. See generally DONALD R. FRASER & JAMES W. KOLARI, *THE FUTURE OF SMALL BANKS IN A DEREGULATED ENVIRONMENT* (1985); Paul Nadler, *Lending Strategies: Why the Community Bank Thrives*, 1 COMM. LENDING REV. 71 (1986).

188. There has been a clamor for a more rational system of banking regulation for several years. In a recent Congress, the testimony sounded more like a bureaucratic turf battle than a genuine articulation of the best route for public policy. Although the immediate prospects for a single federal regulator have passed, the idea retains its attractiveness. See GAO OVERSIGHT STRUCTURE, *supra* note 67, at 78 (calling for a reduction in the number of federal agencies with primary responsibilities for bank oversight).

189. See Kane, *Legislative Agenda*, *supra* note 68, at 186-88 (noting the turf battle between the Federal Reserve Board and the Office of the Comptroller of the Currency over authorization and oversight of new banking powers); see also Yonan, *supra* note 76 (describing an incipient turf battle between the Treasury Department and the Federal Reserve Board over the structure of the banking industry).

Alternatively, regulators in the North American countries could bow to international pressure to make their banking markets more open, especially with regard to branching. Currently, Canada and Mexico are the only countries of the top 50 economies that do not permit foreign branching.¹⁹⁰ In addition, the United States is sometimes criticized for not being a sufficiently open banking market. However, it is hard to imagine that this will come to pass without some other event to make it worthwhile, since the United States has refused to sign on to the GATS on the ground that other countries' banking schemes are not as liberal as the existing U.S. scheme. The United States did not want to be locked into the requirement of national treatment unless U.S. financial services providers would have access to foreign markets on terms at least as liberal as those provided to foreign firms by the United States.¹⁹¹ On the other hand, the United States does want to expand NAFTA into the Free Trade Agreement of the Americas,¹⁹² and if Canada and Mexico want to be part of that arrangement they may have to make their banking markets more accessible.

Nevertheless, as discussed above,¹⁹³ there may be some pressure for the three North American bank regulatory schemes to converge naturally, thereby making concerns over branching and subsidiary operation less important. Even unilateral liberalization may be possible. In Canada, for example, industry players seem to be chafing at the protectionist bent of existing law,¹⁹⁴ and that sentiment may presage a change in policy.¹⁹⁵

The greatest incentive for harmonization and regulatory cooperation, however, may be the desire held by both banking regulators and the financial services industry to foster a stable macroeconomic climate in North America. Recent experiences with the Asian monetary crisis remind us that our domestic economy is inextricably entwined with the global economy. In North America, the peso crisis of 1994 spilled over into other Latin American countries, especially the leading markets of Brazil, Peru,

190. See Greenberg, *supra* note 41.

191. See Trachtman, *supra* note 24, at 51-57 (providing an overview of issues affecting financial services under the GATS).

192. *But cf.* Bernard K. Gordon, *The Natural Market Fallacy*, 77 FOREIGN AFF. 13, 15 (1998) (criticizing the drive toward expanding NAFTA to the rest of Latin America on the ground that it will undermine the world trading regime by promoting regionalism).

193. See *supra* notes 123-35 and accompanying text.

194. See Greenberg, *supra* note 41 (noting that "most bank chiefs themselves say the costs of preferential treatment outweigh the benefits").

195. Unfortunately, despite the rising impatience with protective legislation, the Act introduced to the Canadian Parliament for revising foreign bank branching stipulated that foreign branches not take retail deposits, that only foreign banks with assets of \$35 billion be permitted to branch, that the regulator be empowered to require maintenance of assets in Canada to cover branch liabilities, that they maintain at least five percent of branch liabilities with a Canadian depository institution, that the home bank meet certain standards of supervisory review, that the branch be subject to Canadian reporting, auditing and taxation requirements and that the Canadian bank regulator have the power to seize all assets of the foreign bank to satisfy the liabilities of a branch. These requirements go a long way toward completely eliminating the benefit of the branch form of expansion. See Robert E. Elliott, *The 1997 Federal Financial Institutions Legislative Review and Beyond*, 16 NAT'L BANKING L. REV. 1, 24-25 (1997) (discussing the proposed branching requirements).

Chile, and Argentina.¹⁹⁶ When instability of global dimensions shakes the world's financial markets, everyone worries. Both regulators and bankers may find some value in rationalizing the international regulatory scheme to enhance stability.¹⁹⁷ A harmonized structure could pave the way for greater regulatory cooperation, which could result in regulators feeling confident enough to allow branching even though it would mean allowing the primary regulator to be in the home country. If harmonization does proceed, the negotiators will need to grapple with the issue of what role, if any, is left for local control over those matters that are of local importance, such as lending policies, the availability of credit, and market-related matters.¹⁹⁸

The other sub-game that may eventually lead to a determinate outcome is the battle in the United States over banking powers. One of the factors that has paralyzed U.S. banking policy is the existence of too many industry participants seeking rents from too many political actors. This results in no one interest group or coalition achieving the critical mass to move their position forward. If U.S. law moves toward broader product lines, the traditional battle lines between banks, insurance companies and securities firms may fall and those former political enemies may begin to think of themselves as "financial services providers" with a common interest in access to other countries.

Insurance is one product category where this convergence of industry interests may come to pass. NAFTA contains a provision that requires renegotiation of insurance powers before January 1, 2000.¹⁹⁹ Between the United States and Canada, there are not many issues relating to insurance worth fighting about,²⁰⁰ but the Mexican insurance market remains largely closed to foreign investment. Given recent U.S. case law allowing banks easier access to the insurance business²⁰¹ and possible explicit authority in a new banking law, the banking lobby may send the message to our trade negotiators that Mexican bank branching into the United States will be an acceptable trade-off in exchange for greater access to Mexico's insurance market.

More importantly, perhaps, will be the realization by regulators and industry participants that the business of financial intermediation is changing rapidly and the traditional notion of banking may be supplanted

196. See SCOTT & WELLONS, *supra* note 22, at 1294.

197. *But see* WHITE, *supra* note 9, at 32-37 (arguing that international systemic risk is not a pressing enough concern, in light of sufficient domestic systemic protection regimes, to warrant a move toward harmonization).

198. See Dermine, *supra* note 121, at 70 (noting that some local regulation makes sense).

199. See NAFTA, *supra* note 8, at Annex 1404.4, 32 I.L.M. at 662.

200. See Jordan, *supra* note 9, at 51 (noting that few restrictions on U.S.-Canada insurance activity existed before or after the FTA).

201. See *Barnett Bank v. Nelson*, 517 U.S. 25 (1996) (allowing national banks to conduct insurance brokerage activities despite state law prohibition on affiliations between banks and insurance firms); *NationsBank v. Variable Annuity Life Ins. Co.*, 513 U.S. 251 (1995) (giving the Comptroller of the Currency discretion for determining what products constitute "insurance" for purposes of the National Bank Act).

by other service providers that are not subject to the regulations saddling the banking industry.²⁰² Technology could shock the system as well, with regulators realizing that in the fast changing technological world borders are increasingly irrelevant to the transaction of banking business. Some “banking” transactions conducted over the Internet, for example, may escape effective regulation by “falling through the cracks” of national borders.²⁰³ Perhaps through cooperation, international regulators could divide the pie of non-bank and internet transactions in a way to preserve their relative market positions.

If no dramatic shock materializes, though, it seems unlikely that the deadlock will end. National trade negotiators are not going to give up a trade provision and its related political support without getting something in return.²⁰⁴ Although this conclusion seems bleak, it must be so in a world governed by principles of public choice.

Conclusion

If trade decisions were left to philosopher kings, the NAFTA countries would permit unfettered cross-border branching. That result would appear to be the substantively “correct” result as a matter of trade policy, banking law and corporate law. In trade negotiations, however, countries often negotiate for outcomes that are not theoretically optimal, but which are nevertheless politically expedient. One way to think about this departure from the optimal outcome is to posit that negotiators attempt to maximize their respective “national interests.” The problem with that approach is that nations do not have “interests” in any meaningful sense. It is more appropriate to consider government action as being the result of interest group bargaining.

In the case of trade agreements, it is important to consider domestic regulators of the financial services industry as players in the rent-seeking calculus. As discussed above, banking regulators in each NAFTA country have built-in incentives to prefer the subsidiary device over branching. Industry groups also should prefer the subsidiary approach because the current North American market is already well-served by big banks that have a presence in all three countries through the subsidiary device. They have little to gain by switching to the branch structure at this point, and much to lose because a change to allow branching will permit late participants to get into Mexico and Canada on a low cost basis.

202. See Peter Coy, *Doing Business*, *Bus. Wk.*, Aug. 31, 1998, at 98, 101 (suggesting that in the financial services market of the 21st Century, intermediation may be carried out by non-bank, non-insurance firms such as rating agencies).

203. See FRIEDMAN & GOODLET, *supra* note 144, at 38 (noting difficulties of regulating financial services on the internet); Richard Blackwell, *Under Siege: So What?*, *FIN. POST*, Oct. 4, 1997, at 12 (noting the concern of Canadian regulators that they may be losing regulatory authority over “Canadian” banking transactions conducted over the internet).

204. See FRIEDMAN, *supra* note 17, at 293 (noting the need for compensating trade in negotiation).

The deadlock in favor of subsidiaries is likely to persist until an exogenous shock to the North American banking system shakes up the current order. That shock could take the form of changes in the domestic regulatory schemes that change the international dynamic, or concerns about macroeconomic stability, or marketplace developments in the delivery of financial services that threaten to make banking obsolete. In any event, the players involved in shaping North American banking policy will not act until pushed to do so.