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Evelina Moreyra
Lehigh University

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THE EFFECTS OF NAFTA ON FINANCIAL SERVICES

Evelina Moreyra



Introduction

Over the past eight years, Mexico has gone from being a country with a closed economy, where investors faced inhibiting ownership limitations, to one where barriers and restrictions have been reduced to increase foreign investment. The reforms of President Salinas, most importantly the deregulation of the financial services sector, have facilitated this change in the Mexican economy.

Although many reforms have taken place, Mexico remains isolated from foreign competition in the financial services sector. The North American Free Trade Agreement (NAFTA) will bring many new foreign investors with a great number of financial service needs. The question is will Mexico, with its unskilled labor force and lack of technology, be able to meet these needs? New technology and services tailored to individual needs must be rapidly developed and implemented. Although both Canada and the United States are able to provide the services needed, they are not treated fairly in Mexico. For example, ownership and market share limits continue to exist, and cross border transac-

tions are restricted. The North American Free Trade Agreement will include further deregulation of the financial services sector that is indispensable for a more efficient financial service system and non-discriminatory treatment of foreign financial firms in Mexico.

In order to understand the effects of NAFTA, it is important to understand the changes that have occurred in Mexico. In this paper I review the general principles of NAFTA as well as the reforms that have already taken place in the banking and insurance sectors. I further describe Mexico's potential to compete with Canadian and U.S. financial firms, and how U.S. financial firms will benefit from NAFTA.

Principles of NAFTA

NAFTA contains three general principles for regulating financial services among Canada, Mexico and the United States. These principles concern commercial presence and cross-border services, non-discriminatory treatment, and procedures for entry. It is important to note that the provisions affect *both* the banking sector and the insurance sector.

The first principle, commercial presence and cross border services, will allow consumers in NAFTA countries to have a greater number and a greater variety of financial services available. According to the agreement each NAFTA country must permit financial service providers of another NAFTA country to establish financial services in that country. Furthermore, each country must allow its residents to purchase financial services from another NAFTA country. (The Governments of Canada, The United Mexican States..., p. 33)

The second principle, non-discriminatory treatment, requires that all three NAFTA countries provide national treatment and most-favored-nation treatment to all NAFTA financial service providers operating in its territory. National treatment demands that each NAFTA country will grant to investors and financial institutions of another NAFTA country treatment no less favorable than that which it grants to its own investors and financial institutions. This provision will enable U.S. banks to have the same powers in Mexico that Mexican banks have. Mexican banks are currently afforded national treatment in the U.S.; however, they do not have national access to the U.S. market. National access would allow Mexican banks to operate in all fifty U.S. states. However, the Glass-Steagall Act, which prohibits U.S. banks from stepping over state lines, also limits the number of states in which Mexican banks can operate.

The third principle, procedures for entry, sets forth specific guidelines for the processing of applications for entry into the financial services market. Under NAFTA, each country will:

- inform all interested investors and firms of its requirements for completing applications;
- provide adequate information on the present state of an application;
- make a decision on a completed application within 120 days if possible;
- publish guidelines of general application no later than their effective date and allow interested parties the opportunity to comment on those proposed guidelines; and
- provide one or more inquiry points to answer questions about its financial

services guidelines. (The Governments of Canada, The United Mexican States..., p. 34)

Attractiveness of Mexico's Financial Service Sector

Mexico's financial service sector is relatively small. Many have argued that the impact of U.S. investment on Mexico's financial services sector will be negligible to U.S. investors because of the relatively small size of Mexico's market. Mexico accounts for only approximately three percent of U.S. sales worldwide. However, the recent changes implemented by President Salinas are allowing the financial services market to grow. The Mexican market presents a good prospect for growth and many opportunities for new business. This contrasts with both the Canadian and United States markets which have reached maturity and are highly competitive.

The United States has the potential to benefit from providing financial services to Mexico for three reasons: Mexico's services in the financial sector are poor; Mexico is still in the process of learning about financial services; and the United States has the knowledge and capacity to provide these services.

Banking

Reforms

Throughout Mexico's history, the banking system had been strongly regulated by the government. For instance, the Mexican government was allowed control of loan rates and interest rates. In 1982 Mexico's eighteen commercial banks were nationalized, and U.S. and foreign banks were allowed to maintain only representational offices in Mexico. This restriction prohibited foreign banks from taking deposits or making loans in Mexico. In essence these foreign banks could not competitively provide a full range of financial services and products directly to Mexican individuals. (USITC, p. 4-41) Even more regulations were imposed with the May 1989 Regulations to the Foreign Investment Law. The reform placed restrictions on 141 business activities, which

were broken down into six categories. (Canadian Embassy, p. 27) Among the restricted activities was banking. Banking was classified in category 1, activities reserved exclusively for the state.

Mexican customers had been earning interest rates below inflation rates. Consequently, money was withdrawn from the Mexican banking system throughout the 1980s, and the government realized that deregulation must occur. And so in July 1990, the Mexican Congress passed the Law on Credit Institutions which re-established the framework for private ownership of commercial banks in Mexico. The new law aimed for the complete privatization of commercial banks. In fact, as of 1992 all the commercial banks have now been privatized, with Banamex, Mexico's largest bank, being sold in 1991 for an outstanding 2.6 times its book value.

The Law on Credit Institutions provides for three types of bank common stock shares: type A, B, and C shares. Type A shares, which have a majority interest of 51 percent, can be purchased by state development banks, the development trust funds, financial holding companies, and the Bank Fund for Savings Protection. The remaining shares are B shares and may be purchased by A shareholders, Mexican companies, institutional investors, and investment funds. (Hufbauer and Schott, 1992, p. 310)

Type A and type B shareholders may issue type C shares. Type C shares are the only shares that foreign investors can purchase, and issuance is subject to approval by the Minister of Finance and Public Credit. Although the owners of this stock have voting rights, type C shares are limited to thirty percent of the total shares. Thus C shares provide an avenue for foreign commercial banks to participate in the Mexican financial system, but few foreign investors are interested in taking a small minority stake in a Mexican bank. (Hufbauer and Schott, 1992, p. 311) The thirty percent limit is critical because it effectively closes the Mexican banking system to foreign control.

The Law on Credit Institutions also makes provisions for individual participation in commercial banks and foreign interest in holding companies. With respect to individual partici-

pation in commercial banks, no single Mexican or foreign shareholder can generally hold more than five percent of the capital stock. However, an individual may hold ten percent in special cases. With respect to holding companies, foreign banks may hold a minority interest in holding companies of financial groups.

Can Mexico Compete?

Mexican banks have one overwhelming disadvantage relative to banks in the United States and Canada: technology. Many new services, such as electronic payment systems, will need to be developed and offered to large corporations. This will require substantial investment in information technology systems in order to achieve the needed distribution and processing power while maintaining low transaction costs. (Dias et al., 1992) New financial groups offering services of banks, insurance companies and fund managers will also find information technology of great importance to their success. In 1990 the National Bank of Mexico (Banamex) had approximately fifteen percent of its capital investment go towards technology. This number should have been closer to forty-five percent in order for Banamex to be competitive with banks in Canada and the U.S. However, the last two years have seen an increase in spending for information technology, representing approximately thirty percent of the banking sector's capital investment. (Dias et al., 1992)

Notwithstanding the lack of technology, the banks of Mexico have one outstanding advantage which will help them be competitive with banks in the U.S. and Canada. This advantage is the loyalty of Mexican firms to Mexican banks. Most members of the boards of directors of the Mexican banks are often also the owners of large Mexican firms. This guarantees the Mexican banks business with these firms. Most Mexican firms and customers will stay with their domestic banks simply because they are familiar with them.

Benefits from NAFTA for U.S. Banks

Although U.S. banks, with their technol-

ogy and expertise, are in a strong position to enter the Mexican market, they face competition from more than just Mexico. U.S. banks are also faced with strong competition from Japanese and European banks. In a recent annual survey conducted by the *Wall Street Journal*, twenty-seven of the world's one hundred largest banks are Japanese, with seven Japanese banks placing in the top ten. ("The Global Giants," p. R25) Moreover, Germany, France and Italy each have at least eight banks among the hundred largest banks. However, the United States has only seven on the list, with its top bank ranking only number twenty-six. The implementation of NAFTA will give a clear advantage to U.S. and Canadian banks. Foreign banks will not be permitted to enter Mexico on the same terms as Canadian and U.S. banks.

In addition to the general principles previously discussed in this paper, NAFTA describes country-specific commitments which will benefit United States banks. Country-specific commitments are guarantees that one NAFTA country provides to another NAFTA country. In essence, the agreement will finally enable U.S. banks to effectively compete in both the Canadian and Mexican banking sectors. The most significant benefit for U.S. banking is that Mexico will permit U.S. banks to establish wholly owned subsidiaries in Mexico. Almost all market share restrictions placed on U.S. banks in Mexico will be eliminated during a transition period. U.S. banks will be allowed a gradual expansion in their aggregate share of the Mexican banking market: an eight percent aggregate market share in 1993 rising to fifteen percent in 1999. Finally, all restrictions will be eliminated by January 2000. Furthermore, Mexico's ability to place future constraints on foreign-owned banks will be limited.

However, as previously stated, NAFTA will have a limited effect on the total international operations of U.S. banks. Even if U.S. banks invest heavily in the Mexican banking system, U.S. banking revenues from these investments will be negligible given the relatively small size of the Mexican market. Nonetheless, NAFTA may help to expand U.S. banking services to other Latin American countries through their Mexican operations. Many South American

countries, such as Argentina and Chile, have growing economies and have the need for U.S. expertise in banking. NAFTA may be the doorway to these countries.

Nonetheless, NAFTA will have *some* impact on both commercial banking and retail banking. With respect to commercial banking, U.S. banks will most likely concentrate on expanding their presence in Mexico by developing commercial banking relations with privatized Mexican banks and corporate entities. (USITC, p. 4-42) Given the fact that commercial banking requires less capital investment and smaller staffs than retail banking, the expansion of commercial banks will be relatively easier than that of retail banks.

The need for retail banking services in Mexico is expected to rise dramatically. Both exports and imports of the NAFTA countries are expected to grow due to the current reforms of President Salinas and NAFTA. As trade among Canada, Mexico and the United States grows, so will the need for banking instruments and banking expertise in foreign trade by retail banks. Furthermore, the Mexican economy is expected to grow at a real annual rate of 5.2 percent with NAFTA. As Mexico's economy progresses and the number of middle-class and affluent Mexicans increases, the demand for retail banking services will grow. (Orr, p. 80)

Insurance Firms

Reforms

Although Mexico's insurance industry is relatively small, insurance industry experts estimate that Mexico could become one of the world's top ten insurance markets by the next century. (Hufbauer and Schott, 1993, p. 63) Currently there are forty-three insurance firms in Mexico; thirty-eight are equity companies, two are mutual companies, and three are state-owned institutions. (Hufbauer and Schott, 1992, p. 314) Until 1990, insurance was also a tightly regulated industry in Mexico. New foreign investment in the insurance sector had been prohibited since 1935. Those foreign companies which were already established in the sector at the time were allowed to remain, but they were required to reduce their participation to

below fifty percent of market share. (Canadian Embassy, p. 31) This maximum investment was later reduced even further to fifteen percent. As with the banking sector, the May 1989 Regulations to the Foreign Investment Law included the insurance sector as an activity which would continue to be restricted. Insurance was classified in category 2, activities reserved for Mexican nationals. However, deregulation did appear in the following year.

The reforms of 1990 eliminated the restrictions on foreign insurance firms by raising the maximum permissible level of foreign investment to forty-nine percent. However, the acquisition by foreign investors of ten percent or more of an insurance firm requires the permission of the Secretariat of Finance and Public Credit.

Notwithstanding the easing of foreign investment restrictions, Mexican national insurance firms remain largely protected from foreign competition. For example, premiums paid by business firms for certain types of insurance policies are tax deductible only if the insurance is purchased from a Mexican firm. (Hufbauer and Schott, 1992, p. 317) Moreover, many insurance services are reserved exclusively for national firms. Examples of such services include motor vehicle insurance for any motor vehicle which has Mexican license plates or that is owned by a Mexican resident, and insurance of imported or exported goods if a Mexican is liable for the risk. (Hufbauer and Schott, 1992, p. 317)

Investment in Technology and Training

Mexican insurance firms appear to be unable to provide adequate services in three areas: insuring large risks, managing pension plans, and insuring professional risks. (Hufbauer and Schott, 1992, p. 315) As in the case of banking, these weaknesses and inefficiencies are largely due to less-than-adequate investment in technology and training. Because the insurance industry was so highly protected from outside competition, it became undercapitalized, inefficient and technologically weak. These three factors provide a perfect avenue for foreign companies to apply their

resources and skills to areas where Mexican insurance firms are deficient. Greater investment is needed in both technology and training employees in order for Mexican insurance firms to become competitive with firms in Canada and the United States.

Benefits from NAFTA for U.S. Insurance Firms

Under NAFTA many of the restrictions that hindered U.S. ownership and services in the Mexican insurance market will be eliminated. Specifically, when the agreement goes into effect, U.S. insurance companies will be able to sell cargo insurance and reinsurance on a cross-border basis in Mexico. Reinsurance takes place when one insurance firm allocates a portion of its return and risk to another insurance firm. (Madura, p. 709) Furthermore, U.S. insurance firms will be allowed to sell health, life, and travel insurance to Mexican residents who come to the United States.

In addition, *new* U.S. entrants will be able to enter the Mexican market. U.S. insurance firms that acquire interest in an existing Mexican firm to form joint ventures may increase their ownership in such ventures. They will be allowed to become thirty-percent owners in 1994, fifty-one percent (majority) owners in 1998, and finally one-hundred percent owners by 2000. U.S. insurance firms with *existing* joint ventures in Mexico will be permitted to increase their equity participation to one hundred percent by January 1, 1996. Those entrants that wish to start their own wholly owned subsidiaries in Mexico will still be subject to certain size limitations, but the current limitation of six percent of market share will increase to twelve percent in 1999, and will be eliminated on January 1, 2000.

Mexico's insurance industry has great potential for growth, and NAFTA will benefit both Mexican and U.S. insurance firms. Once NAFTA reforms are fully implemented, it is estimated that the Mexican insurance industry can generate fifty billion dollars in life and casualty insurance premiums annually. (Hufbauer and Schott, 1993, pp. 63-64) Furthermore, NAFTA will stimulate competition in Mexico and will make for a stronger and more effective

Mexican insurance industry. Mexican insurers will become more service oriented and will gain access to new expertise and skills. On the other hand, U.S. insurers will profit from Mexico's immature market. The clear superiority of U.S. insurers is likely to increase demand for U.S. insurance services.

Conclusion

Many have argued that NAFTA should have taken an immediate liberalization approach for the Mexican financial services sector. This would have fostered an atmosphere of high competition and rapid change among the NAFTA countries. However, the culture and pride of the Mexican people must be taken into consideration. The immediate entrance of huge foreign banks and insurance firms in Mexico would have been overwhelming to Mexico's

financial services sector and would have struck at the heart of Mexican financial sovereignty. (Hufbauer and Schott, 1992, p. 324)

Instead NAFTA has chosen a slower and gradual opening of the Mexican financial services sector to United States and Canadian financial firms. Although NAFTA reforms do establish some immediate new opportunities for these firms, the majority of the reforms will be phased in through a transition period ending in the year 2000. NAFTA will ultimately allow foreign majority ownership in the financial services sector, and will require non-discriminatory treatment. In turn, foreign investment and trade in financial services will eventually increase above the present levels. In the long term, it is anticipated that both Mexico and the United States will benefit from the deregulation of the financial services sector in Mexico.

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