WPS 1153

Policy Research
WORKING PAPERS
Financial Sector Development

Financial Sector Development Department
The World Bank
July 1993
WPS 1153

North American Free Trade Agreement

Issues on Trade in Financial Services for Mexico

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Implementation of the North American Free Trade Agreement (NAFTA) will generate substantial efficiency gains for Mexico's financial system and economy. The key to NAFTA's success in the financial sector will be effective prudential regulation and supervision. But Mexican financial institutions will need a reasonable transition period to modernize operations and rise to the challenge of their Canadian and U.S. counterparts.

This paper — a product of the Financial Sector Development Department — is based on a report produced for the Mexican authorities in March 1991. It updates the earlier report in relevant areas. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Priscilla Infante, room N9-003, extension 37664 (July 1993, 58 pages).

To maximize the efficiency gains from NAFTA, the regulatory environment for Mexican banking, insurance, and securities markets should be further harmonized with those of the more advanced and efficient Canadian and U.S. markets.

Musalem, Vittas, and Demirgüç-Kunt argue that a prerequisite for NAFTA's success is to remove regulatory distortions and to eliminate opportunities for regulatory arbitrage. Moreover, eliminating or reducing disparities between the NAFTA countries' tax rates and ways of levying taxes would help prevent distortions, tax evasion, and tax avoidance.

Complete harmonization may not be feasible or even desirable, given the way the three countries' financial systems have evolved and the differences between their industrial structures and stages of economic development.

In banking, insurance, and securities markets, the main free trade issues are the convergence of authorization criteria and the removal of most of the obstacles to freedom of establishment. It is also important to harmonize guarantee schemes and to create well-defined Mexican schemes to protect small, unsophisticated investors rather than mismanaged institutions. The key to NAFTA's success in the financial sector will be effective prudential regulation and supervision — particularly because of the heavy financial pressures on the newly privatized banks and the financial groups that own them. Without effective supervision, the new owners of the banks may take excessive risks to recoup the substantial element of goodwill in the privatization price, before the protection from foreign competition and new entrants is phased out.

An integrated market will presuppose greater cooperation and information exchange among the national regulatory authorities to ensure, for instance, that weak banks do not undermine credit standards and that weak insurers do not offer deceptively low-priced policies. In these areas, Mexico needs intensive training and cooperation with the Canadian and U.S. regulatory authorities.

To increase the contestability of the financial markets and benefit from the transfer of financial technology, the Mexican financial system should be opened to foreign entry. But Mexico needs to modernize its financial institutions and Musalem, Vittas, and Demirgüç-Kunt conclude that the proposed NAFTA should allow for a gradual approach to foreign entry. A reasonable transition period, extending up to the year 2000, will give Mexican institutions ample time to achieve the efficiency gains that motivated the quest for the agreement in the first place.

NORTH AMERICAN FREE TRADE AGREEMENT:

ISSUES ON TRADE IN FINANCIAL SERVICES FOR MEXICO

Alberto Musalem, Dimitri Vittas, Aslı Demirgüç-Kunt

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I. INTRODUCTION[1]

If everything goes well, a North American free trade agreement (NAFTA) between Canada, Mexico and the United States will become effective in January 1994.[2] The primary objective of NAFTA will be to reduce yet further any remaining tariffs collected on cross-border trade within North America, allowing each country to concentrate its production more in those sectors in which it has a comparative advantage. In addition, NAFTA will likely reduce regulations currently restricting the degree to which firms can shift their operations across borders, allowing firms to take better advantage of economies of scale and scope.

One sector that has been of particular concern in NAFTA negotiations is financial services. While the financial sector in Mexico is still developing to attain the most advanced international standards of efficiency, it has reached maturity in the United States and Canada a long time ago. However, the financial systems of all three countries have been undergoing fundamental change. Mexico has recently dealt with the privatization of commercial banks, the restructuring of the development banking sector, the promotion of contractual savings institutions, and the review of regulation and supervision of financial intermediaries. In the United States there are the problems of regulation of banking and insurance at the state level and restrictions on universal banking activities, and also the problems with the Savings and Loan insolvencies and the possible reform of deposit insurance. Canada has gone a long way towards domestic deregulation, having authorized universal banking and financial conglomerates. These issues may raise important questions concerning efficiency, transitional arrangements and the pace of integration. This paper aims at identifying regulatory and tax issues that may constrain Mexico from deriving the maximum benefits from the implementation of NAFTA.

The paper analyzes the implications of NAFTA for the Mexican financial sector from differences in sector development, in regulations on banking, insurance and securities markets, in constraints to capital mobility involving direct foreign investment (DFI) regulations and in the tax treatment of financial assets. It is organized in seven sections. The next section provides a brief sector background and discusses the main issues involved in free trade in financial services. Sections 3, 4 and 5 focus on subsector issues involving banking, insurance and securities markets. In each case, existing regulations are compared and contrasted, transitional problems are discussed, and recommendations are made. Section 6 analyzes issues arising from differences in tax treatment. The last section provides a brief summary and conclusions. Appendix A reviews the treatment of financial services in free trade negotiations, while Appendix B summarizes the provisions covering financial services in the proposed NAFTA that was signed in December 1992.

II. ISSUES IN FREE TRADE IN FINANCIAL SERVICES

The Mexican financial services sector (including commercial banks, development banks, securities markets, and insurance) still represents a comparatively small fraction of aggregate output (3.5% of GDP compared to 6.5% in the European Community, EC), numbers employed (1.5% of total employment versus 3% in the EC), and compensation of employees (5.5% of total compensation versus 6.2% in the EC). These figures suggest that compensation is rather excessive in Mexico. In 1989, M3 represented 79% of GDP in the USA, 71% in Canada and only 29% in Mexico. Hence, by increasing income, and improving income distribution and sector efficiency, NAFTA will pave the path for an increased role of financial services in Mexico's GDP.

Financial Market Integration: The Efficiency-Ownership Trade-off

Efficiency. By integrating financial markets across North American borders NAFTA is likely to have a particularly important impact on efficiency. It will not only have significant effects on the efficiency of the sector itself but also on the efficiency of resource allocation in sectors using financial markets.[3] In addition, NAFTA will influence macroeconomic policy management, especially if it were to include exchange rate commitments. Because financial services are inputs in the production of goods,[4] estimation of the effects of NAFTA on financial services should take into account economy wide effects rather than just following a narrow sector focus. Therefore, some degree of synchronization in the pace of integration among participating markets will be required.

An inefficient financial sector will not only increase production cost to final users, but it will also induce suboptimal use of these services in the production of final goods or services. Since Mexican financial assets are near perfect substitutes with U.S. financial assets, cross-border after tax deposit rates are equalized on equally liquid and risky securities. On the other hand, not all Mexican firms can issue international tradeable liabilities. Those that can are able to consider international lending rates as their opportunity cost of capital; but Mexican firms which do not have the same access to international financial markets will bear the full cost of domestic intermediation. This implies that competitiveness in the goods markets for the second group of firms will be negatively affected if prevailing conditions in financial markets generate intermediation costs that are over and above international standards. Moreover, for those firms that rely on domestic intermediation the effects on production costs will not be uniform, those that are relatively financial services intensive will suffer the most.

NAFTA will bring additional pressure to improve efficiency due to increased cross border competition and easing of entry barriers. Foreign banks and non-banks regularly operate and compete informally in Mexico's financial markets. Also Mexican depositors, investors, insured (mainly life and health) and borrowers widely use foreign financial intermediaries. Therefore, opening up the sector would provide greater scope for domestic intermediation, since regulators have virtually no control over either foreign entities or Mexican residents performing cross border financial transactions. In addition, it would offer greater protection to investors, would add competitiveness to the economy as a whole, and should increase financial deepening.

The main benefits of foreign participation are the increase in competition and efficiency, the transfer of technology and skilled management, the introduction of new products and services, the employment and training of local staff, and greater access to international markets. These are likely to bring about a higher quality of service and a lower level of prices.

Ownership. In the financial services area, although the benefits of privatization have gained wide acceptance, the authorities of most countries, both developed and developing, are reluctant to see their banking and financial systems dominated by foreign institutions. Thus, even if they allow DFI in the financial system, most countries impose explicit or implicit limits on the level and scope of activities of foreign institutions.

One of the key questions regarding the liberalization of DFI in financial services is whether national authorities are justified to be worried about the ownership and control of financial institutions. Unfortunately, mainstream economic theory highlights the gains in efficiency and welfare that may result from greater competition but has little to say on the distribution of these gains and on the importance of ownership and control issues.

An important concern in many countries is the fear that foreign institutions may acquire dominant positions in domestic markets and may drive out of business local institutions that are less efficient and have fewer capital and management resources. Restrictions on foreign entry are often justified on "infant industry" arguments. A related criticism is that foreign institutions will not provide services to local firms. Although local institutions may be created to fill such a gap, this argument implies that such institutions will not be able to survive either because they will be taken over by the large and capital-rich foreign institutions or because they will be prevented from achieving a minimum combination of economies of scale and scope by the foreign domination of the wholesale and international segments of the market.

A parallel argument against allowing foreign institutions to dominate local markets relates to the strength of their local commitment. If institutions are assumed to retreat from distant markets when they are faced with difficulties, then their level of commitment to local markets would be lower than that of local institutions. Foreign institutions would tend to retreat from a local market in response to two separate events: when they faced problems in the local market (for instance foreign institutions could pull back operations from a local market facing an economic slowdown) and when they faced problems in their home market. Local institutions faced with difficulties in their home market cannot retreat from that market, unless the difficulties are so serious that they are forced to go out of business. The impact of a pullout would be larger the greater the share of a national market held by foreign institutions.

Moreover, the authorities of many countries claim that foreign institutions often confine themselves to serving the most profitable segments of the market (cream skimming) and capturing economic rents that may result from existing regulations or the inefficiency of domestic institutions. Foreign institutions fail to lower prices, although they may provide more efficient services and they also fail to extend their services to the retail segments of the market. In addition, foreign institutions may stimulate capital flight and thus aggravate pressures on the exchange rate at times of external crisis.

The experience of foreign institutions in different countries is not well documented. Anecdotal evidence from various countries suggests that foreign institutions, especially foreign banks, have been instrumental in enhancing the quality and lowering the cost of services to large corporations, particularly in countries where the latter have been discouraged by restrictions on cross-border transactions from accessing the international markets. Foreign institutions have played an important role in stimulating product innovation and introducing new types of services, such as leasing and factoring. They have also contributed to a reversal of the brain drain by attracting foreign-educated nationals and have trained local executives who have later assumed the management of domestic institutions.

In most countries, however, foreign institutions have not extended their services to the retail segments of the market. The main factors explaining this reticence have been the imposition of restrictive regulations, the high cost of entry, and political sensitivity to domestic concerns about acquiring an unduly large share of domestic business. Many countries criticize foreign institutions for failing to extend their services to retail customers, but the fact is that if they did, foreign institutions would be criticized even more for acquiring a dominant position in the domestic financial system.

Another important factor that may explain the failure of foreign institutions to serve small firms and the consumer market may be the high information costs that characterize retail operations. Foreign institutions may have a comparative advantage over domestic institutions in providing financial services to large corporations and wealthy individuals but the reverse is likely to be the case in dealing with small and medium-size firms and retail consumers.[5] Thus, the alleged tendency of foreign institutions to specialize in some segments of the market may be explained by regulatory and economic factors.

The criticism that they engage in cream skimming is based on the observation that foreign institutions often report high profits from their local operations. This may, however, reflect their higher efficiency compared to domestic institutions. In countries where domestic institutions have been able to respond to their challenge, foreign institutions have been unable to build a significant market share in any segment of the market, while their profits on even the most wholesale or specialized types of operations have been low. The profitability of foreign institutions depends very much on the ability of domestic institutions to modernize their operations and meet the challenge of increased competition.

As regards their alleged role in stimulating capital flight, the role of foreign institutions is little different from that of domestic institutions in countries with an open capital account. Both have the means to facilitate capital flight if there are strong incentives to do so (e.g., expectations of an imminent devaluation, unfavorable interest rate differential, political instability). In countries with a closed capital account, foreign institutions may contribute to capital flight by providing contacts to their parent institutions in foreign financial centers and by facilitating arrangements for the maintenance of bank accounts and other investments in overseas markets. But even in such countries, the main reason for capital flight is the pursuit of unsustainable financial policies and adverse political environment. Foreign institutions may exacerbate but they do not cause the flight of capital. Even in the absence of foreign institutions, capital controls have to be particularly effective and watertight to prevent a flight of capital in the presence of adverse macroeconomic conditions. Experience in this area indicates that controls on capital mobility have been quite ineffective.

Finally, as regards the question of local commitment, there is no empirical study documenting the response of international financial institutions to difficulties in their home and foreign markets. Both the extensive retrenchment of American banks from European and Asian markets in the late 1980s and the behavior of Japanese banks in the eurocurrency markets over the 1970s and 1980s provide some support to this argument. The risk for a national system that is dominated by foreign institutions is that it might be susceptible to greater instability than a system where national institutions are the dominant players.

Efficiency/Ownership Trade-off. Maximizing the benefits of free entry of foreign institutions requires the deregulation of domestic financial institutions and markets and the establishment of a competitive environment. Artificially low interest rates, directed credit programs, barriers to entry, and other impediments make it likely that foreign institutions will simply capture regulatory rents rather than promote competition and efficiency. Foreign participation may be beneficial even if markets are not fully liberalized but some restrictions may be necessary to grant domestic institutions enough time to adjust to the new environment, modernize their operations and meet the challenge of their foreign competitors.

Because of their location, cross-border financial transactions between Mexico and the U.S. and possibly Canada are already quite integrated. The capital flight argument is, therefore, less important for the North American market case. Local market commitment may still be an issue, and the Mexican authorities may have to assess the trade-off between efficiency and ownership.

Components of Financial Integration

Financial integration involves three distinct but interrelated components: monetary and exchange rate policies, capital movements and financial services. Capital movements and financial services can hardly be conceived independently: without capital mobility, the placing power of financial intermediaries has limited scope; conversely, regulatory barriers that prevent operators from supplying services to non-residents threaten to undermine capital mobility itself.

In turn, capital movements and financial services forge a direct link between the balance of payments and domestic monetary policy. Capital moves across borders in response to changing (after tax risk-adjusted) rates of return. Equilibrium is maintained through variations in exchange rates or adjustments in relative monetary aggregates. Therefore, full capital mobility under a fixed exchange rate system is only consistent with passive monetary policy.

The linkages between the three components underscore the need for a coordinated effort in freeing capital movements and financial services. Moreover, while capital mobility and freedom to provide financial services might both be integral parts of the long run objective of the FTA, there does not seem to be an operational plan for integrating monetary policy.

Monetary and Exchange Rate Policies. The theory of optimal currency areas indicates that a fixed exchange rate system -- implying a passive monetary policy -- is the preferred solution for an FTA with a high degree of economic and financial integration and perfect mobility of factors of production. On the contrary, in a situation where there is immobility of labor across borders, as it may happen under NAFTA, the same theory suggests a flexible foreign exchange rate system, which would enable the government to pursue employment objectives through active monetary policy. Hence, the Mexican authorities will have to decide on maintaining the existing generalized fixed exchange rate system or to adopt a flexible exchange rate system as Canada has. These are very complex issues that are beyond the scope of this paper, although they will need to be addressed in the context of NAFTA. Moreover, other objectives such as stabilization and credibility may overrule the optimal currency areas policy suggestions.

Capital Movements under NAFTA. Issues in the liberalization of capital movements within an FTA may require a review of DFI regulations. FTA should reduce the screening of foreign investments by member countries, eliminate most trade-distorting performance requirements, and provide security and guarantees for investors in member countries. Investors are assured that new discriminatory barriers to investment will not be erected and that the rules of the game will not be changed unfairly. In short an FTA provides a business environment conducive to further investment and free trade.

The US has traditionally held the first rank among countries investing in Mexico (65% of the accumulated total DFI into Mexico originates in the US, a value of about $15 billion) while Canada has held an insignificant proportion of total DFI in Mexico (1.5% or an accumulated value of about $300 million).

NAFTA could build on Mexico's substantial liberalization of its treatment of DFI but it would have to incorporate the principles developed in the US-Canada FTA's investment chapter. The Reglamento (Implementing Rules) to the DFI Law passed in mid 1989 contains measures: (i) allowing automatic 100% DFI participation in activities comprising about 60% of GDP and only requiring the registration of the investment with the National Registrar for Foreign Investment (NRFI) (this procedure applies if minimum requirements concerning exports, regional development, technology and investment size are met); (ii) increasing participation of the private sector (domestic and foreign) in areas subject to specific regimes; (iii) increasing transparency and speed of decision making by the National Commission for Foreign Investment (NCFI); and (iv) simplifying and deregulating registration procedures in the NRFI.

While the Law defines the activities reserved for the Government and for Mexican investors and maximum DFI participation in petrochemicals, auto-parts and mining, the Reglamento clearly defines concepts that were rather obscure in the Law. These reduce discretionality and define precisely the scope of DFI. This goes a long way towards eliminating the case by case approach to DFI approval and registration in a significant number of activities. Another objective of the Reglamento was to simplify procedures for those cases for which authorization is still required. The time elapsed between application, approval and registration was reduced from about 1 1/2 years, before, to about 2 months now. Therefore, for the first time clear, transparent and automatic rules have been established.

Sector deregulations also facilitated DFI. New Implementing Rules issued for mining and technology transfer, new Decrees for auto-parts and petrochemicals, and new rules for pharmaceuticals and microcomputers, have all opened up DFI in a significant way. New financial sector laws passed in mid 1990 opened up the sector to DFI. Banks, brokerage houses, and insurance houses are allowed to have up to 30% foreign ownership.[6] In addition, DFI in trust funds is unlimited but these investments do not provide control.

Under NAFTA, national treatment would grant expanded access to US and Canadian investors to all sectors where the Mexican private sector is allowed to operate. Also performance indicators and investment conditionalities may have to be relinquished. Under NAFTA, investors from partner countries would be treated equally as domestic investors. Also, national treatment may require phasing out screening of investment originated from member countries. Finally, Mexico would need to adjust portfolio investment in listed securities originated from the US and Canada to incorporate national treatment. However, some exceptions might be granted for strategic, political, environmental or cultural reasons; while many cases may be subject to a phase-out strategy given the disparities in economic development of the associating country members.

Any foreign investors in Mexico will also have to forecast carefully the risk they face of future adverse policy changes, i.e., political risks. The nationalizations of the banks in 1982, as well as Mexico's restructuring of its international debt, are both recent events, forcing investors to take these risks very seriously. In general, investors will enter Mexico only if they can earn an after-tax rate of return as high as they can get elsewhere. To the extent the existing policy regime leads investors to rationally anticipate some chance of adverse policy changes, foreign (and Mexican) investors will cut back their investments in Mexico until the ex ante return is again comparable to that available elsewhere, after taking account of these risks.

The types of policy changes investors may fear are many and diverse. For one, Mexico may increase its corporate or withholding taxes in the future, to try to earn more from the investment that has taken place in Mexico. More simply, it could again nationalize some firms, providing only partial compensation, or again default on interest payments to foreign creditors. Domestic investors would also fear higher personal taxes in the future on assets they make visible to the tax authorities through investing them in Mexico. Foreign investors could also fear fiscal, trade, financial and monetary policy changes leading to a depreciation of the exchange rate. Other types of policy risks could include restrictions on the repatriation of profits, requirements that profits be exchanged into dollars at an unfavorable exchange rate, etc.

Mexico's inability to credibly commit itself to its present policy reduces capital investment in Mexico without reducing the ex ante rate of return earned by rational investors, whether foreign or domestic. As a result, it lowers the country's growth rate and wage rate. Any credible commitment not to change policy adversely would be a welfare gain for Mexico.

Since firms and individuals decide on the location of their investments based not only on current government policies but also on expectations of future policies, it is important to reassure investors concerning the stability of these policies. NAFTA offers the best possible opportunity to assure investors on Mexico's commitment to stay on the course of the sound policies already implemented.

Financial Services. The third component of financial integration is the liberalization of financial services involving banks and securities firms, stock exchanges and insurance companies. For these three sectors the FTA should envisage measures that are expected to provide market access under the national treatment principle and a minimum degree of convergence in regulations and supervision. General issues involved in integration of financial services are discussed below. As background information Appendix A contains a discussion of how financial services were treated under the GATT negotiations, the EC single market approach and the US-Canada FTA.

The liberalization of trade in financial services covers two areas: cross-border transactions and DFI. Cross-border transactions occur when the customer and supplier of services reside in different countries. Cross-border transactions may be restricted by controls on foreign travel or by controls that prohibit residents from purchasing financial services in overseas markets.

Controls on cross-border transactions are often justified on balance-of-payments grounds and aim to limit capital flight. Many countries, however, support cross-border transactions that result in capital inflows, such as borrowing in overseas markets by large corporations. Cross-border transactions may also be restricted to protect local financial institutions.

The liberalization of controls on foreign travel and capital movements that has characterized the economic policies of most developed and many developing countries in recent years has reduced the importance of cross-border transactions in trade negotiations. However, many countries that continue to apply controls on cross-border transactions are concerned that relinquishing control of foreign exchange and capital flows may have serious implications for their balance of payments and may undermine their control over monetary policy. There is also concern that freeing cross-border transactions may encourage tax evasion.

DFI involves the presence of foreign institutions in the domestic market. This may be affected by restrictions on the right of establishment and scope of operations of foreign firms. Restrictions on DFI are more likely to be motivated by strategic and protectionist considerations than by concerns about the balance of payments.

Much of the recent debate regarding the liberalization of trade in services has been about the rules of DFI rather than cross-border transactions. Financial services, telecommunications and utilities are the main service sectors where DFI has been discouraged for strategic and protectionist purposes. These sectors have traditionally been seen as occupying a central position in the national infrastructure for promoting economic development and they have been reserved not only for national but often also for public ownership and control.*

In recent years, the emphasis on public ownership and control of utilities has given way in many countries to an acceptance of the benefits not only of private but also of foreign ownership. This has been facilitated by the strengthening of the administrative powers and effectiveness of regulatory agencies, which has mitigated fears about the possible abuse of monopoly power by foreign suppliers of public utility services.

The pace of financial integration under NAFTA depends on the existing level of integration already present among the member countries, and Mexico's pace of progress in developing prudential regulations and strengthening its supervisory process. There is a great deal of financial integration between the US and Canada. In contrast, Mexican banks have some small activities in the US and none in Canada, while US and Canadian banks have not been able to provide a full range of banking services in Mexico since 1982. They are just now entering the insurance industry through acquisitions of minority interest in existing firms. However, cross border financial transactions between Mexico and the US are thought to be important. While progress in regulations may encourage a quick financial integration, the differences in stages of development, implementation of supervisory standards and deposit insurance schemes may provide some justification for a slower pace under a NAFTA than under the US-Canada FTA.

III. SUBSECTOR ISSUES: COMMERCIAL BANKING

Regulatory Considerations

With the implementation of NAFTA, differences in regulatory systems between Mexico, the United States and Canada will gain importance. There are fundamental structural changes underway in all countries. Canadians are the most advanced in their reform process towards achieving universal banking. The government reform proposal, which was announced in September 1990 (enacted December 1991 and became effective June 1992), has three main goals: to expand the powers and functions of financial institutions; to establish new rules governing ownership and capitalization; and to strengthen regulatory controls and prudential safeguards[8]. In 1990 the United States also considered a reform package which aimed to abolish branching restrictions and the separation between banking and commerce, reform the deposit insurance system, strengthen the supervisory system, and reduce regulatory and supervisory duplication[9]. However, the reform bill failed to pass the Congress.

The Mexican banking system has also been going through major restructuring and reform. Following successive regulatory reform in October 1988 and April 1989, the banking system has been freed from the restrictive controls that inhibited competition. A privatization plan for commercial banks was announced in May 1990, proceeded quickly, and was successfully completed by July 1992[10]. In August 1990, the banking law was also amended to relax restrictions on bank ownership. Restrictions on financial conglomerates have also been relaxed and the formation of financial groups that might include banks, insurance companies, securities brokers, leasing and factoring companies, etc. has been permitted. Mexico has also been simultaneously dealing with the restructuring of the development banking system, and with improvements in prudential regulation and supervision.

The financial systems of all three countries are thus in a process of fundamental structural change. There appears to be a common trend in the development of all three financial systems towards regulatory reform that aims to extend the powers and activities of various institutions and allow common ownership of firms within the financial sector. This trend towards universal banking is also coupled with an increased emphasis on improving prudential regulation and supervision. Still, each country is moving along this path at its own pace. For Mexico it is important to keep abreast of these developments in order not to adopt or continue regulations that might impede the competitiveness of Mexican institutions.

The following discussion groups issues that merit attention in evaluating the Mexican banking regulations under four headings: (i) market structure and barriers to entry and exit, (ii) FONAPRE and the banks savings protection fund, (iii) other regulatory issues, and (iv) supervision.

Market Structure and Barriers to Entry and Exit

Maximizing the benefits of foreign entry requires the deregulation of domestic financial institutions and the establishment of a competitive environment. If impediments to competition exist in the domestic economy, it is likely that foreign financial institutions will simply capture monopoly rents rather than promote competition and efficiency. The greater the extent of liberalization of the markets, the greater will be the benefits of foreign participation.

Although most of the impediments to competition, such as interest rate ceilings, directed credit controls, and other constraints, have been removed with the recent deregulations, there are still barriers to entry and exit in the Mexican banking system. The Mexican banking system is a highly concentrated one. Out of the 18 domestic banks, the six largest account for around 75% of the assets of the entire banking sector. However, concentration in itself does not necessarily imply inefficiency. For example, the Canadian banking system is also a highly concentrated one, dominated by six large banks.[11] Nevertheless, studies of Canadian banking have found it to be highly competitive.[12]

One key factor in being able to foster competition within a concentrated banking environment is market structure. Levels of competition approaching perfect competition are possible in contestable markets where entry and exit to the market is costless. By eliminating or minimizing barriers to entry and exit bank regulators can induce competition among existing banks since market discipline will be imposed by not only the number of actual competitors, but also by potential competitors.

Leaving the issue of foreign bank entry aside, the Mexican Banking Law does not seem to encourage the chartering of new banks. To charter a new bank the minimum capital requirement is determined by 0.5% of the paid capital and reserves of the whole banking system at the 31st day of December of the preceding year. An estimate of this requirement is around US$20 million based on 1990 year-end capital of the banking system, obtained from the Banco de Mexico. Conditioning initial entry requirements on the total capital of the banking system increases entry barriers as the value of the banking system increases. Therefore, as the Mexican banking system continues to capitalize, new banks will face stricter barriers to entry. Furthermore, issuance of bank charters is at the discretion of the Federal Government and there are no clear rules or procedures.

In the US and Canada, obtaining a banking charter requires lower initial capital and is relatively straightforward. For example, in the United States charters and initial capital requirements of national and state banks are handled by the Office of the Comptroller of the Currency (OCC) and the state banking authorities, respectively. The OCC's regulations stipulate that the initial capital of a national bank must be in excess of US$1 million. Although there is variation among states, the New York Banking Board sets the minimum initial capital of state-chartered banks at US$1.2 million. Only banks in large metropolitan centers, such as New York City, Los Angeles, and San Francisco may be required to have an initial capital of US$5 million.[13] The application for a charter becomes the part of a publicly available file, and generally within approximately four to six months a new national bank can commence operations in a key commercial state.

In Canada, initial capital requirements are higher, yet rules for obtaining a banking charter are less cumbersome. The capital requirement which was Can$5 million (US$4.3 million) has recently been increased to Can$10 million (US$8.7 million). However, given that the volume of financial operations is much higher in the United States and Canada than in Mexico, the Mexican initial capital requirement appears to be unduly restrictive.

Another issue that is related to entry restrictions regards the limits imposed on the participation of foreign banks. Until recently, Mexico did not allow foreign banks to establish branches or subsidiaries. Following the privatization of banks, foreign banks (and other investors) are allowed to hold up to a cumulative 30% of the capital of a commercial bank (or of a financial holding company). Individual holdings of either Mexican or foreign investors cannot exceed 5%, although the Ministry of Finance may authorize a greater percentage up to a maximum of 10%.[14] This rule does not apply to the Federal Government, institutional investors (whose individual participation may amount to as much as 15%), the Bank Savings Protection Fund and financial holding companies. However, it is debatable whether this 10% rule can be enforced effectively given the complex relationships among international institutions. In addition, foreign tax credit in the US is only allowed to entities having at least 10% ownership control (see Section 6).

The United States do not have such restrictions; foreign banks can own state or national banks or operate wholly-owned branches and subsidiaries. But the acquisition of management control in insured banks, which is deemed to occur if more than 25% of bank capital (or in the case of individual shareholders more than 10% of bank capital) is subject to approval by the regulatory authorities[15]. Moreover, differences in regulations for different states are cumbersome and banks are subject to interstate branching restrictions.

In Canada, banks have a variety of ownership structures; chartered banks can be widely-held, or closely-held for a temporary period. Schedule I banks, which include the largest six Canadian banks, have to be widely-held with no one person or group owning more than 10% of their shares. Schedule II banks can be started and owned on a closely-held basis for the first 10 years, or directly-owned by widely-held regulated financial institutions that are not banks. Foreign banks can establish subsidiaries in Canada, designated as Schedule II banks, subject to restrictions on market share, asset growth, transfer of loans to their parent banks, branch approval, and capital expansion. Schedule II banks whose capital exceeds Can$750 million are required to have at least 35% of the total voting rights attached to shares that are widely-held. After the US-Canada Free Trade Agreement, US banks are no longer subject to foreign bank restrictions and are treated as Canadian banks, except that Canadian branches of US banks are considered independent Schedule II banks.[16]

As discussed above, for developing countries allowing foreign bank entry has trade-offs between maximizing benefits from foreign entry and retaining control of domestic institutions. Foreign ownership of banking institutions is a politically sensitive topic. The role of banks in implementing monetary policy and financing government out of seigniorage makes the banking industry a very important policy instrument whose control cannot be relinquished.

For Mexico, the 30% ownership restriction in already existing institutions, coupled with future free entry of wholly-owned subsidiaries, may be adequate to retaining control, while reaping the benefits of foreign participation. To ensure that Mexicans retain control of large intermediaries, the Canadian system of Schedule I and II banks can be adopted. Schedule I banks would be the existing large Mexican banks that are widely-held and Mexican-controlled, with maximum single ownership of 10%. Subsidiaries of foreign banks and new domestic banks could be established as closely-held Schedule II banks, and if their capital increases over a certain threshold, they would be required to go public.

Opening up a domestic market to foreign competition can also be accomplished by permitting the cross-border provision of banking services. This requires the protection of nonresident depositors by extending insurance coverage of deposits to nonresidents (see below), as well as closer cooperation and coordination of information sharing across the borders to minimize possible fraudulent activities.

Branching restrictions are another way of restricting entry that lead to market segmentation. In Mexico branching is no longer subject to specific authorization. Banks are required to submit an annual plan of their branching policy to the authorities but are otherwise free to open and close branches. But banks should also have the right to buy and sell branches to each other as this would facilitate their expansion in areas where they may be underrepresented or where business is more profitable. This would allow banks to mobilize funds from the cheapest sources.

Canada does not have branching restrictions. In the US, the ban on interstate branching (McFadden Act, 1927) and the curb on affiliation between banks in different states [Section 3(d) of the Bank Holding Company Act of 1956] are still in force, although the constraints on the geographic expansion of banks and bank holding companies are being steadily eased by reciprocity agreements between states. Unless US restrictions of interstate branching are amended, at some stage Mexico may have to enter into the same kind of arrangements with every state.

Exit in the Mexican banking system is equally difficult. Banks with financial difficulties are financed and restructured by FONAPRE, the Mexican insurance fund. Deposit insurance is another issue that deserves special attention for the newly-privatized Mexican banking system and the implementation of NAFTA. If properly designed and implemented, and coupled with effective risk management and supervision, a deposit insurance system can also enhance the competitive ability of Mexican banks with respect to foreign banks.

FONAPRE and the Bank Savings Protection Fund

Mexican banks that have liquidity or solvency problems are financed by the FONAPRE. Banks pay fixed premiums to FONAPRE. Those receiving support are regulated more closely till they reachieve financial stability. Before the privatization, since the banks were also publicly owned, moral hazard problems were minimal and insolvent banks could be pressured to curb their unsound management practices.

With the privatization of the banking system, a Banking Savings Protection Fund (BSPF) is envisaged to take over the functions of the FONAPRE. The purpose of this fund will be to provide preventive support for banks that are likely to encounter financial problems. For a newly-privatized and relatively inexperienced banking system, having a vaguely-defined insurance fund may create more problems than it can solve. Timely exit of insolvent institutions is important to foster healthy competition. Preventing individual institution insolvencies may destabilize the financial system by distorting risk-taking incentives and undermining market discipline.[17] The experience of the US savings and loan industry exemplifies the importance of allowing timely exit. The BSPF should have very well-defined powers and its purpose should be to protect small, unsophisticated (resident and non-resident) investors rather than mismanaged institutions. Such a deposit insurance scheme, coupled with strong and effective supervision can establish public trust in the newly-privatized banking system and allow Mexican banks to compete with foreign banks on equal ground.

In the United States, the Federal Deposit Insurance Corporation (FDIC) was established in 1933, after the massive bank failures that occurred during the Great Depression of 1930-33. The original role of deposit insurance was to protect the nation's payment and credit systems from system-wide disruption and to shelter small deposit holders from losses. Through time, the FDIC's preference for keeping insolvent banks afloat and handling inescapable failures through mergers or assisted transactions has taken the US deposit insurance to a system of de facto 100% coverage.

By providing insurance coverage to most bank depositors, FDIC destroyed an important external discipline on bank risk-taking. Without insurance, large depositors have strong incentives to monitor the financial condition of their banks. The possibility that depositors may withdraw their funds gives banks an incentive to avoid excessive concentrations in risky and illiquid assets and to stay well capitalized. Without such market discipline it is difficult for regulators to ensure safe and sound banking practices. The US needs a deposit insurance reform that would reinstate market discipline. The reform should include improved accounting and insolvency-resolution procedures, risk-rated insurance premiums, decreased coverage, and expanded powers for deposit-insurance regulators that would increase transparency and allow sophisticated investors to play an important role in disciplining banks. To a certain extent some of these issues were addressed by the Federal Deposit Insurance Improvement Act of 1991 (FDICIA).

The Canadian Deposit Insurance Corporation (CDIC) was established only in 1967 in response to the failure of several trust companies, again to protect small depositors. However, the decision of the banking authorities to protect uninsured depositors in 11 of the 18 loan and trust companies, and all three of the banks that failed during the 1980s, sparked a debate about whether the government has created incentives for depository institutions to take excessive risks. For a number of years, the banking industry has been advocating some minimal level of market discipline through deposit co-insurance by individual depositors on deposits exceeding a certain limit. No major changes in bank failure resolution procedures are currently under consideration in Canada.

Other Regulatory Issues

The following specific points also deserve consideration in eliminating impediments to competition.

Liquidity requirements. Both in US and Canada reserve requirements are seen as an instrument of monetary policy. However, it has been shown that the imposition of formal, legally enforced reserve requirements is not essential for monetary control.[18] In fact, the Bank of England executes its monetary control without such formal requirements. Banks are required to maintain minuscule reserves that on average should not be less than 0.5% of eligible liabilities. Solvent banks, when allowed to pay market rates on their liabilities, are expected to handle liquidity requirements in normal circumstances. During crises, the central bank is trusted to handle runs on the banking system.

Reserve requirements in US were simplified by the Depository Institutions Deregulation and Monetary Control Act of 1980. They now vary from zero to 12% of deposits based on the type and size of the account. Reserves do not earn interest. Canada also has cash reserve requirements that vary from one to 10% based on the type and size of the account. Canadian banks also have a secondary reserve requirement of 4%. In Canada there is a proposal to phase out the cash reserves within two years.

With the April 1989 deregulation, Mexican reserve requirements were eliminated. Instead, banks were required to hold 30% of their deposits in qualified tradable paper. Only CETES (Mexican treasury bill) was eligible. This liquidity requirement allowed banks to earn market interest rates and was justified on prudential grounds. However, this requirement imposed a tax on banks since more profitable uses were available for these funds. Furthermore, having only one government paper as qualified tradable paper was an unjustified restriction.

Generally, continuing liquidity problems are considered to be an indication of the institution's underlying insolvency which is better controlled by capital requirements. Elimination of liquidity requirements would be feasible if institutions are sound and well-capitalized and a strong bank supervisory system is in place. In the case of Mexico, liquidity requirements were justified as a transitional regulation. In fact, as steps were taken to improve bank capitalization and supervision, in mid-1991 liquidity requirements on additional deposits were eliminated, and a phase-out plan for the already existing limits was put in place.

Capital requirements. The Mexican Banking Law requires banks to have a net capital of at least 6% of their assets, contingent liabilities, and any other operations that are subject to significant risks, taking into account the international capital adequacy standards. The US and Canadian banks are subject to international risk-adjusted capital adequacy rules which state total capital must be 8% of risk-adjusted assets. Of the total capital, at least 50% must represent core capital (common equity) and the remainder can be supplementary capital (preferred shares and debentures). Mexican banks are expected to reach the international standards of capitalization to ensure that they have adequate equity cushion for competition.

Supervision of the Banking System

Deregulation of the financial system without adequate prudential regulation and supervision is dangerous. This is especially true if the institutions are not well-capitalized, or if they are newly-privatized as in the case of Mexico. Moreover, since the privatization price for some Mexican banks was much higher than their book value of capital, these banks will be under additional pressure to recoup their expenses before the negotiations are completed and their protection is phased out. Thus, improving bank supervision is as crucial as deregulation of the banking industry.

Mexican banks are supervised by the Comision Nacional Bancaria (CNB). Supervision is performed through off-site monitoring of bank performance and visits to the banks to review their financial condition. The supervisory system is currently being computerized. Efforts are being made to improve the loan classification system and monitoring of the bank portfolios. Although after these developments, the Mexican off-site monitoring facilities will be quite sophisticated, it is difficult to evaluate the effectiveness and accuracy of on-site inspections which are crucial in bank supervision.

Both US and Canada have well-established supervisory systems. In the US sound banks with assets of US$300 million and above are examined annually. Supervision responsibilities are shared among national and state authorities. Canadians also conduct annual inspections. The Superintendent of Financial Institutions is the main supervisory authority. In both countries on-site and off-site methods are used in order to obtain information about the economic condition of the institutions. Off-site monitoring consists of analyzing quarterly income and balance sheet statements filed with the authorities. To a limited extent off-site monitoring also makes use of market data (such as growth rates, deposit rates, and stock prices), public disclosures, and credit ratings assigned by private analysts. On-site examinations consist of a team of inspectors that visit the head office of the bank. Examiners rate the bank based on the detailed CAMEL criteria. The criteria used by both countries consist of Capital adequacy, Asset quality, Management quality, Earnings, and Liquidity. The team of examiners carries on discussions with senior management and prepares a formal report pointing out strengths and weaknesses in the bank's operation.

Given the importance of supervision for a newly-privatized banking system operating in a deregulated environment, Mexican bank-supervision reform should receive the attention it deserves. A good supervisory system requires a well-defined supervisory framework, adequate resources and technology for the supervisors to obtain and monitor information in a timely fashion, and sufficient authority for supervisors to enforce their decisions.

The Mexican supervisory system should be evaluated within the context of Mexico's banking environment. The banking environment has been changing from a controlled and highly regulated market to one with many free market characteristics. The private sector has started gaining an increasingly greater access to commercial bank credit and services. The privatization of the banks also presents additional challenges to both banks and supervisors.

With increased competition and private banking, institutions will make an effort to maximize their profits. One outcome of this process will be the need to reduce operating costs and increase efficiency. However, banks may also be inclined to increase their credit, interest, and liquidity risks. Credit risk will inevitably increase as banks increase their lending activities to the private sector, especially into new and profitable areas with which they are unfamiliar. As banks compete for customers, decreasing margins will make higher risk borrowers attractive. Banks may also be subject to interest rate risk, given the liberalized interest rates, and the possibility of mismatching the durations of assets and liabilities. Liquidity risk would also increase as increases in default risk and duration gaps would hamper the bank's ability to meet its maturing obligations. Therefore, for Mexican regulators it will be quite a challenge to maintain the safety and soundness of the banking system without placing an unnecessary regulatory burden on the industry.

A well-defined supervisory framework requires many components. **Loan classification** and **provisioning rules** based on risk of default are important in monitoring asset quality and early detection of deteriorating bank portfolios. As mentioned above, CNB is already in the process of improving its loan classification and provisioning rules.

Capital adequacy rules should be based on the riskiness of bank operations and should grow parallel to the expansion of these operations. Initial capital requirements should be low enough to allow entry to the system but at the same time adequate to enable safe start-up of operations. Although initial capital requirements need to be reexamined, Mexican capital adequacy requirements are expected to be in line with international standards within the next few years.

Loan concentration should be monitored carefully and rollover practices and interest accrual policies should be judged based on the repayment capacity of the borrowers. Mexican bank supervisors may have to be especially strict about placing controls on the capitalization of delinquent and unpaid interest.

In addition, improving **disclosure rules**, using internationally comparable accounting techniques would increase transparency and make supervision easier not only for the regulators but also for the general public. Encouraging development of private rating agencies would also improve information dissemination and help establish market discipline. Audits of bank statements by independent auditors may be required to provide independent checks.

To be able to obtain timely information on the banks, supervisors should have adequate resources. They should be able to hire, train, and retain a sufficient number of employees, as well as acquire appropriate technology. For example, CNB has already computerized its off-site monitoring. Statistical early-detection models can be utilized to improve monitoring and make maximum use of this computerized data base. Frequency of on-site inspections can be increased or priority can be determined based on such models.

Supervisors should also be able to have sufficient authority to deal with mismanaged institutions. They should be able to discontinue insurance coverage, issue cease and desist orders, force write-offs or provisions, and demand capital increases.

Even if supervisory regulations are adequate, and the above conditions are met, lack of an appropriate incentive structure may prevent financial institution regulators from doing their job properly and may thus jeopardize enforcement.[19] Therefore, it is also important to protect supervisors from political and bureaucratic pressures. For example, in the US deposit-institution regulators face pressures from politicians, their regulatory clientele, and lobbyists. As appointed officials, regulators face pressure from politicians to leave problems unsolved since tackling them openly would cause conflict with various constituencies and adversely affect the chances of winning a reelection. Following a cover-up strategy keeps involved constituencies and political action committees willing to pay tribute to politicians. Regulators also face oversight controls from their regulatory clientele, that is, from the institutions they regulate. If regulators can successfully complete their term in government service, they can generally expect higher wages in postgovernment employment. Their success is determined by the "perceived" quality of their performance, which makes them very sensitive to the opinions of the institutions they regulate, as well as to those of the trade associations and lobbying groups connected with these institutions. These career-oriented incentives and political and bureaucratic constraints lead regulators to be influenced by their constituencies, avoiding solutions unfavorable to them, or promoting solutions that they find particularly desirable.

One of the most challenging features of financial reform in the US is improving the incentive structures for regulators and politicians. For regulators this entails additional obligations imposed in the form of requiring improved accounting practices and strictly enforcing capital requirements and tough insolvency-resolution procedures. Additional market checks and balances on the exercise of governmental powers through private insurance agencies are envisaged. Greater powers for regulators are also deemed necessary for successful enforcement of regulations. To better motivate politicians, the option of covering up problems by focusing on only acknowledged expenditures and failures must be eliminated. This may be achieved through greater transparency. In addition, independent hearings held by budget committees can be used to assess the adequacy of regulators' compliance with the procedures.

For Mexico, it is important to learn from international experience in structuring its supervisory system. Bank regulators and supervisors should have the necessary incentives to avoid conflicts of interest. This is again possible through very well-defined supervisory rules, transparency, necessary mandate for the regulators to perform their duties, and periodic independent checks on regulatory activities.

Operating Efficiency

One of the potential benefits from NAFTA for the Mexican financial sector is the likely increase in operating efficiency of the Mexican banks. After a long consolidation process, the number of banks has been reduced in Mexico from around 200 in 1975 to 18 state-owned banks and 2 private banks (Obrero and Citibank) by the mid-1980s. Concentration is quite high with 6 banks holding about 75% of total assets. As already discussed, concentration in itself is not necessarily a problem. It is the combination of high concentration with extensive state-ownership and restrictive regulations that usually result in high inefficiency reflected in high staffing levels and wide bank margins.

Analyzing bank efficiency is a difficult and complicated process. The main problem is the lack of a satisfactory definition of bank output. Most accounting ratios that relate revenue and expense items to total assets, gross income and equity suffer from the effects of differences in capital structure, product mix, and accounting conventions (with regard to the treatment of inflation, asset valuation and amortization, loan loss provisioning, and hidden reserves) among banks, across countries and over time[20].

Although detailed data for Mexican banks that are comparable to those of Canadian and US banks are not readily available, it is generally held that Mexican banks exhibit much higher operating asset and equity ratios than their counterparts in their northern neighbors[21]. For instance, in the United States and Canada, the return on bank assets averaged around 1% during the second half of the 1980s, while in Mexico it has been well over 2%. Gross income margins were less than 3.75% in Canada, between 4.5% and 5% in the United States, but well over 7% in Mexico. At around 70%-75% the cost/income ratio of Mexican banks was not particularly high by international standards, but staffing levels at 40 employees per branch were significantly higher than the average of 26 staff per branch prevailing in Canada and the United States. This partly reflects the lower branch density in Mexico, where there are about 50 bank branches per million people as against between 250 and 500 in the other two countries. The return on equity of Mexican banks is high in nominal terms, but in view of the very high level of inflation in the 1980s and the unsatisfactory accounting treatment of gains from the revaluation of assets, it is very difficult to compare the real profitability of Mexican banks with that of their northern counterparts.

Despite the difficulty of comparing the operating efficiency of Mexican banks with that of US and Canadian banks, it is generally expected that opening the Mexican banking market to greater competition will result in greater efficiency. This will be reflected in lower operating costs and lower margins that will benefit all users of banking services.

The Transition Process

With the implementation of NAFTA, there will be welfare gains for the users of financial services due to increased competition and availability of a wider range of financial instruments at more favorable terms. However, at the same time, commercial banks may have to suffer adjustment costs due to the changes brought by privatization and increased competition. The evaluation of the impact of NAFTA should be based on "net" welfare gains, also taking into account the costs of the adjustment process.

Clearly the most important issue to be addressed during the transition is how to handle the bad-loan portfolio and unfunded bank labor liabilities. Two extreme transition paths can be visualized. On the one hand, the transition may take place quickly with minimum impact on the financial institutions and maximum benefits for the users of financial services. However on the other hand, transition can also be relatively more difficult and be very costly for the government.

Although not likely, if many banks are expected to emerge undercapitalized after the privatization, the government may consider a very gradual transition period during which barriers to entry remain.[22] In this way, newly-privatized banks and their foreign minority shareholders will be able to keep their margins high, and slowly write-off their bad loans, fund their labor liabilities and recapitalize. Only after the financial health of the banks are restored, an opening up will be considered. However, there are two serious drawbacks to recapitalizing through rent instead of equity:

A Multisector Approach. As already discussed, financial services provided by financial institutions are basically intermediate goods. Therefore, protection of financial institutions is similar to protecting industries of intermediate goods. In protecting financial intermediaries, gradual transition policies will prevent domestic producers from accessing cheaper credit and an expanded set of financial services. Furthermore, if the real sector is at a more advanced stage of liberalization, as in the case of Mexico, protecting the financial sector or allowing its gradual transition, taxes the real sector which faces international competition in pricing its output. This tax is also disproportionally born by smaller producers as explained in Section 2. In order to avoid this undesirable outcome, liberalization in the real and financial sectors should be synchronized.

The Political Economy Arguments Against Gradualism. Financial liberalization involves transfers of wealth and income from the financial institutions to the users of financial services. An abrupt transition exaggerates and makes these transfers more visible. Naturally, adversely affected groups oppose the reform process. In the case of Mexico, since the large proportion of financial institutions were state-owned, these problems were minimal. However, if the government were to keep barriers to entry in order to allow slow recapitalization of the newly-privatized banks, political economy considerations would start to become important. Gradualism may allow extensive lobbying opportunities for the now private banks, which in turn endanger continuation of the reform. This may explain why governments that appear to be committed to reforms have difficulty abolishing temporary controls. If the issue of financial liberalization is not dealt with at the time of privatization, efforts to abolish entry restrictions would surely face opposition. Clearly these concerns favor a relatively faster liberalization to gradualism.

Conclusions and Recommendations

To maximize the efficiency gains from liberalization, the regulatory environment of the banks can be further reformed through deregulation and better defining and implementing prudential supervision. Establishing an effective supervisory system is crucial and will determine the pace of liberalization. Improving transparency through greater disclosure is very important in enforcing regulations and establishing market discipline. Further deregulations are necessary to remove barriers to entry and exit. The deposit insurance system should have well-defined purpose and powers. Also discrepancies between different financial institution regulations should be eliminated.

Opening up the Mexican banking sector to new entry is likely to reduce the value of existing Mexican banks. To the extent privatization prices paid included a premium for remaining entry barriers (the average price was three times the book value and 14 times the expected earnings), the institutions may have expected to collect "protection" rents for an extended period of transition during which they can recapitalize through these rents. This is not a desirable solution since it would impose a specific tax on the real sector and may weaken the commitment of the government to financial reform due to opposition from the newly privatized banks.

Having concluded the privatization, Mexico still needs to remove remaining uncertainties and strengthen its supervisory systems. Improving systems of prudential supervision and regulation are crucial given the newly privatized, relatively inexperienced banking system. Ensuring transparency, and clarifying rules for new domestic as well as foreign entry and exit will help remove uncertainties about expected future rents. In addition, adoption of the Canadian system of Schedule I and II banks would allow wholly-owned foreign institutions without jeopardizing Mexican control of large intermediaries.

IV. SUBSECTOR ISSUES: INSURANCE

Regulatory Considerations

Since the extensive deregulation of the Mexican insurance industry in 1990, the regulatory differences between US, Canada and Mexico have been reduced substantially.

In terms of financial conglomerates, Mexico has already enacted legislation that permits the creation of financial holding companies able to own banks, insurance companies and securities firms (as well as other financial companies specializing in leasing, factoring, data processing, etc.).

In Canada, new legislation enacted in December 1991 has permitted the desegregation of banking and insurance by allowing the creation of financial groups that own subsidiaries in both sectors. Canadian banks and insurance companies have earlier been allowed to own securities firms through holding companies.

In the United States, insurance companies can be organized either as independent entities or as controlled subsidiaries of holding companies. Insurance holding companies are not subject to direct insurance regulatory supervision and are permitted to own subsidiaries engaging in virtually any other sector, except banking. However, the United States continue to impose a legal separation between commercial and investment banking, between banking and insurance, and between banking and commerce.

The discussion of issues on Mexican insurance regulations is organized under four headings: (i) market structure and barriers to entry, (ii) insurance guarantee funds (iii) other regulatory issues, and (iv) supervision of insurance.

Market Structure and Barriers to Entry

The Mexican insurance sector comprises 45 companies, two of which are state-owned, 37 are private primary insurers, 4 are mutual insurers and two are private reinsurers. No branch or local subsidiary of foreign companies is authorized to operate in Mexico, although there are over 260 registered foreign reinsurers that are authorized to reinsure Mexican risks. Mexican companies operate in both life and nonlife business and are not required to segregate their capital accounts, although they maintain separate technical reserves. Market concentration is very high, with 80% of premiums accounted for by the largest 8 companies. The level of concentration is much higher than in either Canada or the United States.

Until the deregulation of 1990, insurance companies were authorized to operate by means of concessions that were granted by the government. Insurance business was effectively treated as a public service. There were strict limits on individual shareholdings (10% but up to 15% with government permission), while no foreign insurer could sell insurance in Mexico and no increase in foreign ownership of insurance companies was allowed. However, several grandfathered firms had a higher concentration of domestic and foreign ownership.

Following the extensive financial deregulation of the past two years or so, the new authorization system treats insurance as a commercial activity. 100% ownership through a financial holding company is allowed, while foreign participation is permitted up to 30%.[23] However, individual shareholdings in independent insurance companies are still limited to 15%. The state continues to have discretionary powers in authorizing new companies and no new licenses have been issued. But most insurance companies now have 49% participation from large foreign insurers that include such companies as AIG and Cigna from the United States, Allianz from Germany, Mafpre and Banco Santander from Spain, and Generali and RAS (the Italian subsidiary of Allianz) from Italy. In some cases, foreign companies are reported to have effective control through friendly shareholdings from individual investors.

In contrast to banking where the minimum capital requirement is set in relation to the total capital of the sector, in insurance the minimum capital requirements have been set by regulation at a fixed level. This reflects the need for healthy competition and balanced growth of the sector but does not directly depend on the total capital of the industry (capital requirements can be changed by future regulations). The current requirements specify a minimum of Mex$2 billion for life insurance and Mex$1.5 billion for one line of general business, rising to Mex$2 billion for two lines and Mex$2.5 billion for three lines or more. These limits (which range from US$0.5 million to less than US$1 million) are considered to be quite reasonable and unlikely to act as a barrier to entry.

Although the minimum capital requirements are quite reasonable, the discretionary powers that the authorities continue to enjoy may act as a barrier to entry if they are not applied objectively. Ideally, the authorization process should allow all insurers that are deemed "fit and proper" and can show proof of solvency to enter the market. Moreover, a procedure for appealing denials and revocations of license should also be established. The threat of potential competition from new entry is a necessary ingredient of a contestable market. Developing countries may have some reservations about granting automatic market access to foreign insurers but such reservations do not apply to the case of more liberal domestic entry.

In Canada, insurance companies can be authorized at either the federal or the provincial level. The minimum capital requirements for federally-licensed insurance companies are Can$1.5 million for nonlife companies and Can$2 million for life insurers (between US$1.2 and 1.6 million). Federally-licensed companies must also be authorized by the provinces in which they operate. There is a large number of foreign companies that are authorized at the federal level.

The Canadian insurance market comprises over 500 companies, of which 14 are composite insurers, 175 are life insurers and over 250 are nonlife insurers. Foreign presence is very extensive - over 80% of all companies are either local branches and agencies of foreign companies or foreign controlled local companies. Foreign companies account for 32% of premiums in life and 61% in nonlife insurance (1988). These are the highest among OECD countries for which data are reported.[24] Foreign companies also generally have a much higher share of reinsurance business.

In the United States, insurance companies are authorized only at the state level. There are no federal or national companies. As in banking, home state authorization is not yet accepted but, unlike banking, interstate expansion of operations has long been permitted. Companies from other states (which are described as "foreign" in most state regulations) and companies from other countries (which are described as "alien") are allowed to expand their operations in particular states through the establishment of local subsidiaries or through branches. Local subsidiaries must meet the minimum capital requirements of state companies, while branches are also generally required to place deposits that are secured by trust agreements and are equivalent to the minimum capital requirements imposed on local subsidiaries. Several states do not allow companies owned or controlled by foreign governments to establish operations in their states. Such prohibitions reflect concerns about unfairly subsidized competition, location of assets, quality of regulation and management, and uncertainty of contract enforcement in the case of diplomatic disputes.

Minimum capital requirements vary across states but in general they range between US$0.5 and US$2 million. Both out-of-state firms and firms from other countries that wish to operate nationwide have to incur the additional administrative costs of dealing with over 50 sets of criteria, while some states also impose special requirements that discriminate against "foreign" and "alien" firms, such as higher minimum capital requirements, higher premium taxes, US citizenship or state residency for board directors or managers, local maintenance of records, and frequent periodic renewal of licenses. For instance, in New York, alien insurers must make a deposit of 150% of the amount required from domestic insurers, while in Texas premium taxes, which are levied on gross premiums, are higher for companies that maintain less than 90% of their investments in Texas.

The US insurance industry comprises about 3,800 property and casualty companies and 2,300 life and health insurance. Most of these companies are small and market concentration is not much different from that prevailing in Canada or European countries, although it is much less than Japan.[25] A relatively small number (less than 200) of generally larger companies are "alien", i.e. they are owned or controlled by foreign residents. "Alien" companies account for about 5% of life premiums, 10% of nonlife premiums and 33% of reinsurance premiums (US Treasury, 1990).

Despite the increase in competition that has resulted from the deregulation of the industry, the Mexican market is still characterized by high concentration. Although a concentrated market may exhibit a high degree of competition, allowing more liberal domestic entry would increase pressure for competitive behavior. Thus, the Mexican authorities need to limit discretion in applying the new authorization criteria to ensuring the fulfillment of "fit and proper" and "adequacy solvency" criteria. To ensure more liberal entry a procedure for appealing denials and revocations of license should also be established.

Insurance Guarantee Funds

As in banking, guarantee or compensation funds raise many issues. They are created in order to protect small policyholders from insurance company insolvencies but they give rise to problems of moral hazard. Policyholders have no incentive to choose sound companies and may prefer companies offering cheaper policies or promising higher returns and disregard the higher risks that may be involved. Guarantee funds also provide strong incentives to directors and owners of companies that are near insolvency to invest in highly risky assets and effectively "bet" their companies. Regulatory authorities must develop their supervisory capabilities and must be empowered to take timely action to prevent weak institutions from magnifying potential losses.

Guarantee funds are of greater importance in systems that comprise large numbers of small institutions. In the United States, there are separate guarantee funds in most states for life and nonlife companies. These are funded by assessments on covered companies that depend on the required payouts. However, assessments are subject to limits and although losses from insolvencies of insurance companies have not been large, there have been cases when state guarantee funds have come very close to running out of headroom. Major coordinating and loss allocation problems also arise if insolvent firms have multi-state operations. To cope with these problems, there are proposals to create national guarantee funds. However, these would imply federal regulation of insurance and any progress is likely to be slow. Other proposals include the removal of coverage from sophisticated corporate buyers of insurance and the assessment of risk-related premiums that would depend on the degree of riskiness of operations and investment portfolios.

Canada has a privately-run guarantee fund for life and health insurance - known as CompCorp. This is mutually owned by its member companies, is funded with assessments levied on its members and covers policies issued for residents and up to clearly specified limits per policyholder per member company. CompCorp covers both life and annuity policies and both individual and group business.

There do not appear to be any guarantee funds for nonlife insurance in Canada, while insurance guarantee funds for either life or nonlife business have yet to established in Mexico. However, to ensure a level playing field and protect the competitive position of the Mexican market, prompt action may need to be taken in establishing appropriate guarantee funds.

Other Regulatory Issues

The following specific points also deserve consideration in eliminating impediments to competition.

Premium Regulation. Insurance regulation has traditionally followed two approaches. One approach has emphasized the fixing of premiums at levels that are adequate to pay future claims and avoid insolvencies, while the alternative approach has relied on solvency monitoring.

Erring on the side of caution, price controls tend to fix premiums at high levels. Insurance companies then tend to return some of the excess prices in premium rebates and/or to engage in nonprice competition, especially by mounting more aggressive and lavish marketing campaigns and paying higher commissions to selling agents. The main rationale for controlling prices, an approach that has long been followed in Germany and other European countries with large and generally quite efficient markets, is to discourage the offer of deceptively low-priced contracts.

Prior to 1990, Mexican insurance companies were subject to a wide array of price and product controls. Tariffs required the prior approval of the regulatory agency and, although some differentiation was allowed between life companies, there was in general little room for competition and innovation. In property and casualty business, a single tariff for all companies was in force and no discounts or rebates were permitted. Moreover, approvals of tariff changes were often subject to long delays that affected the performance of the industry in the face of the accelerating inflation of the mid-1980s. Because of these delays, prices were sometimes increased without authorization.

Since the reform of regulations, insurance companies are free to fix their prices and develop new products, but they are required to file any changes with the regulatory agency at least 30 days prior to their use (except for large risks where no filing is required). Market sources indicate dramatic reductions in the prices of some lines of business, although without hard price data it is difficult to document these claims.

Data compiled by insurance brokers BMZ, the local affiliate of Marsh & McLennan, show that the premiums for home insurance (fire and extended coverage for building and contents) fell from 1.4 per mil to 1.1 per mil (a reduction of 22%). In commercial fire and theft insurance, the reduction in premiums was nearly 30%, while even greater reductions occurred in industrial risks. However, motor insurance became more expensive in view of the big increase in loss ratios. In fact, rates for motor insurance more than doubled between 1989 and 1991. Market practitioners from US brokers and companies with active involvement in the Mexican market compare the recent changes to those that occurred in the Chilean market after the insurance reform of 1981.[26]

In Canada, insurance companies have long enjoyed freedom in setting their prices and developing their products. The regulatory tradition has been similar to that prevailing in Britain, which grants insurance companies "freedom with responsibility and disclosure".

In the United States, most state regulators allow price freedom and product innovation to insurance companies, although some states impose limits on increases in premium rates for some lines of business, such as in particular motor insurance.[27] Alternatively, insurance regulators may impose rate-of-return limits. In many cases, such intervention is prompted by consumer pressure as in the well known "Proposition 103" in California.[28]

To allow greater scope for competition and product innovation in the Mexican market, the authorities should eliminate the filing and approval requirement. The law should also clearly recognize the primacy of solvency monitoring, which can be used for discouraging irresponsible competition and the offer of deceptive policies.

Solvency Regulation. The alternative approach to insurance regulation, which is now finding greater favor with regulatory authorities around the world, is based on solvency monitoring, whereby insurance companies are required to maintain adequate technical reserves and solvency margins that are based both on premiums and on claims. In this way, insurance companies that engage in too aggressive price competition and offer deceptive packages are caught by the claims-based solvency margins that depend on the loss experience of the lines they write.

Mexican insurance regulation is now firmly based on solvency monitoring. Again, US market practitioners consider the regulation setting out the minimum solvency margins as a model regulation, combining the use of both premium-based and claims-based solvency margins. For instance, the required minimum ratios stipulate that solvency margins for property and casualty insurance should be the highest of either 22.8% of retained premiums or 35% of retained losses. For motor insurance, the corresponding ratios are 32.5% and 45.8%.

In Canada, solvency regulation is well established although solvency margins are mostly set by provincial authorities. US state regulators also place increasing emphasis on solvency monitoring. Under the aegis of the National Association of Insurance Commissioners (NAIC), model laws and regulations have been developed that include IRIS (Insurance Regulatory Information System), a computer-based system of solvency monitoring that is based on an array of financial and solvency ratios that are reported regularly to both NAIC and the respective state regulators. IRIS calculates financial ratios for each insurance company that measure solvency, liquidity, profitability and other aspects of insurance operations. They serve as preliminary tests of financial condition and identify companies whose ratios are not within acceptable ranges and thus require further regulatory attention.

Although the new solvency margins appear to satisfy the basic requirements of a solvency-based system of regulation, the Mexican authorities should elaborate further their methodologies for valuing assets and assessing risks. Moreover, the solvency margins should be kept under review to ensure that they reflect changes in loss experience and do not impose an unnecessary burden on Mexican insurers. Assets and liabilities, including technical reserves and capital, should be valued at market prices to the maximum extent possible.

Investment Regulations. The regulation of investments is an integral part of solvency monitoring that aims to ensure the soundness of insurance companies and safeguard the interests of policyholders. However, in many countries investment controls have been used to make insurance companies a captive source of funds to finance large public deficits or to direct their funds into high priority sectors, such as export industries and housing.

The main objective of investment regulations should not be the subsidization of particular activities with low-cost funds but the prudent diversification of risks. To this end, investment regulations should place maximum limits on investment assets by broad category of risk. Minimum requirements should not be used.

Prior to 1990, investment regulations in Mexico were unclear and restrictive. Although they were supposed to protect the real value of assets to back both the technical reserves and the equity capital of insurers, in practice they imposed limits that had the opposite effect. For instance, insurance companies were required to invest 30% of their reserves in nonmarketable government securities yielding below market rates of return. When inflation took off in the 1980s, these holdings yielded highly negative real rates of return. The investment regulations were modified after 1985 when insurance companies were allowed to place any increase in their mandatory investments at market rates of interest. In 1989, insurance companies were further allowed to place all their mandatory investments in marketable securities yielding market rates of interest that were highly positive in real terms.

Mexican insurance companies are now subject to investment regulations that broadly reflect a proposal put forward by AMIS, the Mexican insurance association, regarding the use of risk-based capital requirements for investment assets. This is also considered as a model regulation by US market practitioners.

The regulations impose maximum limits by type of asset, except for a continuing minimum 30% requirement for government securities. However, a minimum ratio is not fully compatible with an effective solvency monitoring approach. This is likely to affect the investment yield of Mexican insurance companies and to weaken their competitive position in the integrated insurance market that is likely to emerge from the implementation of NAFTA. Moreover, as discussed in Section 6, these minimum requirements have important tax implications.

Another issue in investment rules is the limit on foreign assets. Currently, insurance companies are not allowed to invest in overseas markets. However, consideration should be given to allowing investment in foreign assets, especially default-free and liquid securities in US and Canadian markets. This would allow a better diversification of risks and could also lead to a higher overall return, although the latter would depend on the differentials in real rates of return.

In Canada, insurance companies are subject to investment regulations for prudential purposes. The approach adopted in Canada is more restrictive than that followed in Britain. A major difference is the imposition of restrictions on investments in overseas markets. In Britain, insurance companies are free to diversify their assets by instrument, sector and country, subject to a general requirement to satisfy regulators about the prudent valuation of assets and the adequacy of reserves. In Canada, strict ratios are imposed that limit investments in foreign markets, real estate, equities, etc. For instance, Canadian life insurance companies are not allowed to invest more than 25% of their funds in equities or more than 10% in directly owned real estate. They are also required to hold domestic assets to match their domestic liabilities.

In the United States, investment regulations differ between states. The insurance department of New York state, which is generally considered to impose very tough prudential controls, imposes limits on holdings of foreign assets and foreign equities. The approach favored by NAIC applies risk-based weights on different assets and requires higher coverage by capital and reserves of more risky assets. Under the NAIC approach, life insurance companies must maintain mandatory securities valuation reserves (MSVR) that range from 1% for high quality bonds to 20% for low quality bonds and for equities.

The investment regulations should impose maximum limits to ensure adequate diversification of risks. The Mexican authorities should consider abolishing the minimum requirement for investment in government securities. They should also consider introducing valuation and risk-based investment reserves that are more in line with those applied in Canada and the United States as well as permitting investment in default-free and liquid US and Canadian securities to start with, and later on expanding to other well reputed markets.

Reinsurance. The regulation of reinsurance is one of the most controversial issues in the international regulation of insurance. The main purpose of reinsurance is to spread the insured risks. This can take place either through domestic reinsurance or through foreign reinsurance. The latter is very important for covering catastrophic risks, such as earthquakes and other natural disasters. In large countries, such as the United States, domestic reinsurance can be very effective for most types of risks and in fact, there is a considerable exchange of insurance portfolios among domestic reinsurance groups in the United States.

In countries with smaller or less developed markets, the ability of the local reinsurance market to spread risks is more limited and this calls for greater reliance on foreign reinsurance. However, many countries that have a much smaller market than the United States impose minimum local retention ratios and require primary insurers to reinsure with state-owned reinsurance companies or with reinsurance companies that are collectively owned by domestic insurance companies. The purpose of such restrictions is twofold: to reduce the outflow of foreign currency and to promote the development of the local market. Although many countries allow domestic insurers to seek coverage in the foreign reinsurance market if local reinsurance is unavailable, the strong bias in favor of local reinsurance often results in large losses and inadequate coverage of risks.

Foreign reinsurers are usually required to be registered and authorized to accept reinsurance for domestic risks. In the United States and Canada, domestic insurers are allowed to reinsure with unauthorized foreign reinsurers, but they are not allowed to take credit in their solvency ratios for such business.

In Mexico, reinsuring with unauthorized foreign reinsurers is not allowed. But following the losses suffered in the aftermath of the 1985 earthquake, the Mexican authorities have relaxed the previously tight restrictions on foreign reinsurance. Minimum retention ratios have been removed, although primary insurers are expected to have a local bias in their reinsurance programs.

One issue that concerns the Mexican authorities as well as the authorities of other countries is the practice of "fronting". This involves the use of local subsidiaries of foreign insurance companies as generators of local insurance policies that are then automatically reinsured with the parent company overseas. One way to tackle these problems is to introduce regulations that require a diversification of reinsurance so that no local subsidiary of a foreign insurer would be allowed to place all its reinsurance business with its parent company.

Another concern, which is more pronounced in the United States, is the possible use of brokers both in primary insurance and in reinsurance as a means of placing substandard business, delaying the reporting of premiums and losses, and failing to establish adequate loss reserves. Because such improprieties have played a prominent part in recent insolvencies in the United States, the NAIC has created two Model Acts, the Reinsurance Intermediaries Model Act and the Managing General Agents Model Act, that aim to establish minimum requirements for the relationship between primary insurers, intermediaries and reinsurers.

To improve the efficiency of the market, the Mexican authorities should remove any bias in favor of local reinsurance. To discourage the practice of "fronting", a requirement for a diversification of reinsurance could be imposed. Moreover, as in the case of primary insurers, greater cooperation and exchange of information with regulatory authorities in other countries, and especially Canada and the United States, would be required.

Distribution Systems. Distribution plays a very important part in the insurance sector, mainly because insurance, especially life insurance, is a service that is sold rather than bought. In all three countries, insurance brokers and intermediaries need to be registered with regulatory authorities, which in the United States and Canada means the state or provincial departments of insurance. Regulation of brokers may include proof of professional qualification (by examination or experience), minimum working capital and solvency margins, professional indemnity insurance and an adequate system of client accounting.

In general, there are four types of distribution systems: independent multiple agents who sell the products of many companies; exclusive or tied agents who sell the products of only one company; salaried employees (also known as direct writers); and mail order insurers. Independent brokers are presumed to sell to consumers the best products for their needs and to offer best advice, although in practice the advice of brokers may be influenced by the commission they earn on different products. In the other three systems, the products of only one company or group of related companies are sold.

The organization of the distribution system has important implications for the functioning of insurance markets. There is growing evidence that direct mailers incur lower costs than direct writers who, in turn, incur lower costs than agency companies. The main difference is the level of commissions, although this is partly offset by the higher overhead costs incurred by direct mailers and direct writers. For the United States, market estimates suggest that the cost of selling whole-life policies through agents may be one-third to two-thirds more expensive than selling through stockbrokers, and up to twice as expensive as selling directly to the customer. For annuities, the cost of selling through life insurance agents is 6-6.5%, about 5% through stockbrokers, 4% through banks and perhaps 2.5-3% through a direct-mail mutual fund.[29]

These differences in selling costs, which imply some important economies of scale and scope, explain the strong interest of banks to expand into insurance operations and sell insurance products through their branches and by direct mail. However, in both Canada and the United States, there is strong resistance by independent insurance brokers to allowing banks to enter the insurance broking business. For instance, in Canada, banks are allowed to expand into insurance through separate subsidiaries of financial holding companies, but they are barred from selling insurance products through their branches. In the United States, state-chartered banks are allowed in several states to sell insurance products either by direct mail or through their branches and also to engage in insurance underwriting through subsidiaries but national banks are not yet authorized to do so.

In both Canada and the United States, direct writers and direct mail insurers have been gaining market share at the expense of agency companies. In Mexico, independent brokers are still the most important distribution system. Many of the leading insurance brokers are affiliates of large international groups, such as

Marsh & McLennan. However, exclusive agencies as well as direct writing are on the increase and are likely to become more important in the future.

The independent agency system has been criticized as inefficient and expensive because agents have an incentive to sell the insurance policy with the highest commissions.[30] Because of this, many countries impose limits on commissions although such limits have adverse effects on competition. In recent years, insurance companies have been allowed to set their commissions but insurance agents are required to disclose to policyholders the commission they earn on different policies. In Britain, insurance agents must also indicate clearly whether they operate as exclusive agents selling the products of a single group or whether they act as independent multiple agents. In the latter case, they are expected to offer best advice and to disclose their commissions. In Mexico, commissions used to be regulated but an efficient market should only provide for full disclosure.

The structure of the distribution system has important implications for the prospects of international trade in insurance. A market that is dominated by exclusive agents and direct writers is more difficult to penetrate than one where there is a substantial independent broking network. New foreign insurers will be able to gain market access more cheaply and quickly if they sell through existing multiple agents than if they have to set up their own distribution network of exclusive agents. However, insurance regulations should favor the most efficient distribution system and this would call for permitting exclusive agencies and direct writing even if such a system puts foreign companies at a cost disadvantage.

In Mexico, the distribution system is not yet fully developed. The regulatory framework should not discriminate between different systems. Limits on commissions should be removed, but a requirement should be imposed on all types of systems (including direct writers and direct mailers) to disclose to policyholders all commissions and other distribution costs.

Other Regulatory Issues. Another regulatory issue concerns limitations on public sector procurement of insurance. In Mexico, state-owned firms currently enjoy sizable captive markets in the public sector. A level playing field between state and private insurers would require elimination of these captive arrangements. Permitting private Mexican firms to compete for public sector business would allow them to reap greater economies of scale and thus become more efficient and able to meet the challenge of foreign competition.

Private insurers business opportunities in Mexico are also constrained by the Social Security System (SSS). By providing comprehensive health and disability insurance it competes with private providers. The contractual savings study suggests reforming the SSS.[31] It recommends restricting the SSS at providing basic coverage to comply with the minimum requirements of a safety net program, while supplementary health and disability coverage should be provided by private insurers. In addition, the study suggests introducing compulsory complementary term life insurance for workers and issuing secondary regulations on insurance company competence on providing pension plans. Adopting these reforms would expand market opportunities for insurance companies allowing them to exploit further economies of scale.

Supervision of Insurance

The supervision of insurance operations is based in all three countries on off-site surveillance through detailed computerized analysis of financial reports that are submitted on a regular basis. Detailed on-site inspection of accounting and other records is effected at infrequent intervals, ranging from 3 to 5 years, unless a company is revealed to be in financial trouble by the analysis of its solvency ratios, when detailed examinations and close regulatory action are undertaken.

In Mexico, the supervision of insurance companies is entrusted with the Comision Nacional de Seguros y Fianzas (CNSF). CNSF has already developed a sophisticated computer model that analyses in great detail the financial performance and solvency margins of insurance companies. CNSF is also empowered to take drastic action against companies that do not meet the specified minimum requirements. Already, one company has been ordered to increase its reserves to comply with the solvency margin regulations.

In Canada, insurance supervision is shared between the provincial and federal governments. In 1987, the Office of the Inspector General of Banks and the Federal Department of Insurance were consolidated into a new Office of the Superintendent of Financial Institutions (OSFI). OSFI has full supervisory responsibilities for all chartered banks and for federally incorporated nonbank financial intermediaries, including insurance companies, trust and loan companies, and cooperative credit associations. However, responsibility for supervising insurance companies is shared with the provincial authorities. The role of CompCorp in the supervisory arrangements is unclear.

In the United States, NAIC plays a central part in analyzing the financial performance of companies with multi-state operations. However, NAIC is a voluntary association of state commissioners and has no statutory power to intervene. NAIC relies on moral suasion in trying to improve solvency monitoring and supervisory standards. In recent years, it has tried to develop an accreditation system that rates state insurance departments by the effectiveness of their regulatory standards. NAIC granted accreditation to the insurance departments of New York (traditionally the toughest in the country) and Florida in December 1990.

Strengthening the effectiveness of supervision is of paramount importance for the functioning of a system of regulation based on solvency monitoring. Greater cooperation and exchange of information with the supervisory authorities of Canada and the United States would also be essential. The Mexican authorities should also consider the need for establishing guarantee funds to safeguard the interests of small policyholders and protect the competitive position of the Mexican market.

Operating Efficiency

The measurement and comparison of efficiency in insurance are as difficult as in banking. International comparisons are complicated by differences in accounting conventions, market structure, business mix and data coverage. A basic problem, as in banking, is the lack of a satisfactory definition of output. Traditional definitions of insurance output are based on premium income, but this is a revenue rather than an output measure and depends as much on changes in prices as on changes in quantities.

General insurance companies use four main ratios as measures of efficiency and performance. The loss ratio, which relates losses to earned premiums, shows the percentage of premiums that are paid back to the insured in the form of claims for losses. Because payments for losses may be spread over a number of years, insurance companies make transfers to loss reserves to cover future payments. The loss ratio also includes the loss adjustment expenses. Differences in reserving policies and manipulation of reserves for tax and other purposes reduce the usefulness of this index of efficiency. The expense ratio is computed as administration costs plus commissions paid on sales less commissions received from reinsurers as a percentage of direct premiums. This provides a measure of the acquisition costs of insurance business. The combined ratio, which is often used as a measure of insurance profitability, is the sum of the two ratios.

Finally, the operating ratio takes account of the investment income earned on loss reserves by deducting the investment income ratio from the combined ratio.

Traditionally, insurance companies aimed to earn a 5% profit on their premiums without taking account of investment income. With an average leverage of premiums over equity of 3, this resulted in a satisfactory return on equity of 15%. This approach made sense when loss reserves were low in relation to total equity and when inflation and nominal rates of return on investment assets were also low. But over the years the growing complexity of general insurance business has led to the building of larger loss reserves[32], while the high inflation experience of the 1970s forced insurance companies to take into account the investment income on their assets and to charge lower premiums on their policies. The practice of cashflow underwriting has resulted in companies incurring underwriting losses which were more than made up by investment income.

Available data show substantial differences in the loss ratios and financial performance of insurance companies in the United States, Canada and Mexico, although great caution is needed in interpreting these data because of the differences in accounting conventions and business mix mentioned above.

The loss ratio for all nonlife lines of US companies was 83% over the five year-period 1984-88, while the expense ratio reached 27%.[33] The combined ratio was 110%, implying an underwriting loss of 10%. Insurance companies earned net investment income equal to 17% of premiums so that the net result before taxes amounted to 7% of premiums. With a ratio of premiums to equity of 1.75, the average return on equity was 11%.[34] But the ROE fluctuated widely over this period, ranging from 2% in 1984 to 19% in 1987.

In Canada, general insurance companies operated with an average loss ratio over the 3-year period 1987-89 of 76%. Their expense ratio was 31%, giving a combined ratio of 107% and an underwriting loss of 7%. Investment income amounted to 18% of premiums so that net income before taxes was equal to 11% of premiums. However, the ratio of premiums to equity amounted to only 1.35 in Canada, resulting in a ROE of 15%.

In Mexico, the average loss ratio for all nonlife lines between 1985 and 1989 was 80% of earned premiums. The expense ratio was a very high 43%[35], giving a combined ratio of 123% and an underwriting loss of 23%. But investment income corresponded to 61% of premiums, a result of the very high nominal rates of return prevailing in Mexico during a period of very high inflation. Nonlife business generated a net income before taxes of 38% of earned premiums. However, the reported net income before taxes was 23%, because insurance companies have been allowed to set aside tax-free precautionary reserves equal to 10% of retained premiums. Mexican companies are not required to segregate their capital accounts and thus it is not possible to calculate separately the ROE on nonlife insurance operations.

In all countries, substantial differences exist in the performance ratios of different lines of business. There are various reasons for this. Some lines incur high loss ratios but have relatively few underwriting costs. Professional lines, such as medical malpractice, fall under this category. Other lines, especially motor insurance, have both high loss and expense ratios, mainly because they involve compulsory insurance and there is consumer resistance to higher premium rates. Finally, some lines involve weaker consumer resistance to high costs and low loss ratios. Fire insurance and homeowners multiple perils fall under this category. Loss ratios varied in the United States from 56% for fire and 72% for homeowners multiple perils to 93% for motor insurance and 128% for medical malpractice. In Canada, loss ratios varied from 63% for personal lines to 91% for motor insurance. In Mexico, the average loss ratio for fire insurance was 49% against 93% for motor insurance. The fire loss ratio fluctuated widely. It was 99% in 1985, the year of the earthquake, against less than 40% in all other years.

Performance in life insurance is generally more stable than in nonlife business. But because life insurance is based on long-term contracts, it is affected more by the accumulation of reserves. In the United States, investment income over the five-year period 1985-89 corresponded to 47% of premiums. Benefits and dividends paid to policyholders and additions to technical reserves, which over the long run represent the premiums paid back to policyholders, amounted to 119% of premiums. Expenses and commissions absorbed 23% of premiums, leaving a net income before taxes of 5% of premiums. With a ratio of premiums to equity of 2.9, life insurance companies achieved a ROE of 13.8%.

Canadian life insurance companies had an even greater investment income of 67% of premiums. Total benefits to policyholders, including additions to reserves, corresponded to 128% of premiums, while underwriting expenses were equal to 31%, leaving a net income before taxes of 9%. Canadian life insurance companies have a very low ratio of premiums to equity of only 0.9 and as a result their pre-tax ROE was only 7.7%.

In Mexico, life insurance achieved a pay-back ratio of 78% over the 5-year period 1985-89. This includes benefits paid to policyholders and additions to technical reserves. The expense ratio was 44% of retained premiums. The investment income of life companies was on average 38% of premiums, a level that was in fact substantially lower than that of property and casualty lines. The net income before taxes as a proportion of net retained premiums was 16%.

The results of the combined life and nonlife business of Mexican insurance companies show investment income of 50%, a total loss ratio of 80%, an expense ratio of 43% and a net income ratio of 27%. With a ratio of premiums to average total equity (reported equity capital plus precautionary reserves) of 1.7, the nominal return on average equity was 44.4%. This is considerably greater than the rates of return achieved by US and Canadian companies. However, annual inflation in Mexico averaged 55% between 1985 and 1989, so that their effective real ROE before asset revaluation gains was substantially negative. The nominal revaluation gains amounted on average to 28%, so that the real ROE was 17%. This figure is not comparable to the return rates shown for US and Canadian companies, which are expressed in nominal terms and do not take account of both inflation and asset revaluation gains.

The above data show that Mexican firms exhibited both higher expense and profit ratios, a result that can be attributed partly to the very high rate of inflation that prevailed in Mexico in the mid-1980s, partly to the real rates of interest in 1988 and 1989 and partly to the protection afforded Mexican firms by the regulatory framework that prevailed until 1989. As inflation and real interest rates come down to more moderate levels and deregulation opens the market to greater competition, Mexican insurance companies will have to improve their performance and achieve operating ratios that are more in line with those of their counterparts in Canada and the United States.

This will bring considerable benefits to the customers of insurance companies, will lower the costs of insurance for industrial and commercial companies, and will increase the welfare of consumers both by lowering the cost of insurance and by encouraging an expansion of the insurance habit. Like banking, insurance services are intermediate goods for producers and final goods for consumers. Any reduction in their cost will enhance efficiency in industry and commerce and increase consumer welfare.

The Transition Process

In general, the authorities of different countries can adopt various policies to ensure that the benefits of foreign participation exceed the costs, such as requiring a diversification of reinsurance and increasing the exchange of relevant information with supervisors in other countries. As already discussed in earlier chapters, realization of the potential net benefits depends on the regulatory environment. A competitive but properly supervised system is more likely to produce net benefits than a system that is oppressed by detailed controls on products, prices and market shares. In the latter case, the most likely outcome is that foreign companies will simply grab a big share of the economic rents enjoyed by domestic companies.

Most developed and developing countries have adopted a more liberal attitude to foreign insurance companies than to foreign banks. In part, this may be explained by the greater concern to maintain control over monetary and credit policy and over the functioning of the payment system. But in part it may also be explained by the complexity of insurance business and by the fact that a relatively small number of people had any dealings with insurance companies.

Technology transfer is very important in general insurance where business is quite complex and risks are often difficult to assess. In life insurance, where contracts are long-term and may generate substantial long-term savings, there has been greater concern about control over the utilization of such funds and less willingness to allow foreign companies to play a big part in this market. It is likely that a substantial expansion of long-term savings and personal pension plans will accentuate concern about ensuring adequate control over the utilization and safety of long-term funds. Although the need for greater risk diversification will call for allowing investments in foreign assets, national authorities will be reluctant to permit foreign companies to play a big part in the life insurance and pension business without adequate safeguards about the solvency and integrity of the institutions involved. This will require greater international cooperation among regulatory and supervisory authorities.

The more liberal attitude of national authorities towards entry of foreign insurance companies is shown by the share of foreign companies in the generation of insurance premiums. Among OECD countries, in life business, this ranges from 10% in Germany and Spain to 16% in Australia, 21% in the Netherlands, 29% in Austria and 51% in Portugal. In nonlife business, foreign companies generally controlled a bigger share of the market, ranging from 14% in Germany to 23% in Portugal, 24% in the Netherlands, 27% in New Zealand, 37% in Spain, 46% in Austria and 54% in Australia (1988).[36] These shares are generally much greater than those found in banking markets.

Opening up a domestic market to foreign competition can take many different forms. The first form is to permit the cross-border provision of insurance services. As already noted, this requires adequate protection of nonresident policyholders by the authorities of foreign markets by supervising closely companies that may specialize in selling insurance in less developed insurance markets and by extending coverage of guarantee funds to policies issued to nonresident policyholders.

A second form is to allow joint ventures and minority participation in domestic companies. Allowing minority participation of between 30% and 49% is likely to produce many of the potential benefits of foreign entry, especially if the sector is free from product and price controls, is subject to a market-based and effective system of prudential regulation and supervision, and allows liberal domestic entry. Mexico has already authorized 49% foreign participation and has made considerable progress in reforming the regulation of insurance business. The benefits of foreign participation -

greater competition, lower prices, better products - are already evident in the market.

However, large companies in Canada and the United States have a strong cultural preference for total ownership and control over their foreign operations. Denying either 100% foreign ownership or local presence through branch operations will deprive the Mexican market of the potential benefits of a more closely integrated North American insurance market.

A possible solution could be to allow foreign companies to establish fully-owned local subsidiaries but to require them to sell to the public a minority participation once they reach a certain size (expressed in terms of total assets, total equity or total revenues). In addition, limits on maximum individual shareholdings in very large companies could be imposed. Shareholding restrictions may dissuade some firms from seeking further growth once they reached a certain size. Although these restrictions may prevent companies from exploiting economies of scale and may discourage them from transferring the technology that is adequate for handling a larger volume of transactions, competition and contestability would be unlikely to suffer much in a market with liberal entry and good prudential regulation and supervision.

Conclusions and Recommendations

The US-Canada FTA has adopted the principle of national treatment in the insurance sector, which is covered under Chapter 13 that deals with services generally rather than Chapter 17 that deals with the financial sector. But because insurance regulation is primarily the responsibility of state and provincial authorities, insurance companies will face many impediments due to the restrictions imposed by political subdivisions. These restrictions will not limit market access, but will cause additional costs to be incurred by companies that wish to operate in many states or provinces. The US and Canadian insurance markets are already at a broadly similar level of development and their closer integration is not likely to create major problems.

For Mexico, market integration through NAFTA will pose a greater challenge. The Mexican authorities need to take various measures to enhance the ability of the local market to compete effectively with the US and Canadian markets. These include the following:

1. Complete the reform of regulatory framework and emphasize the primacy of solvency regulation and monitoring. This would involve the effective elimination of any bias in favor of domestic reinsurance and the adoption of a more liberal policy on domestic entry.

2. Strengthen the supervisory capabilities of regulatory agencies by hiring and training qualified staff, improving regulatory incentives and granting regulators necessary powers for successful intervention. Swift action to require the recapitalization of insurers with inadequate solvency margins will be needed to prevent insolvencies and losses for policyholders. Effective mechanisms to facilitate the exit of failing companies, through either merger or closure, must also be developed.

3. To safeguard the interests of small policyholders and protect the competitive position of the Mexican market, consideration should be given to the case for establishing guarantee funds.

4. In addition to encouraging domestic entry by applying the authorization criteria in a consistent and transparent way, the authorities would be expected, as part of NAFTA, to allow a further opening of the market by authorizing the establishment of fully-owned local subsidiaries and branches of US and Canadian firms. This will stimulate a greater integration of the North American insurance markets. But greater integration will also require progress in resolving issues in the taxation of insurance companies in different countries, the cross-

border provision of insurance and the protection of nonresident policyholders. Supervision of the institutions also have to be coordinated internationally.

5. An integrated market will presuppose greater cooperation and exchange of information among the respective regulatory authorities to ensure that individual insurers are prevented from exploiting loopholes in prudential regulations and engaging in deceptive and unsound business practices. Consideration should also be given to the case for organizing joint training programs to enhance staff expertise and achieve greater consistency in regulatory approach.

6. The Mexican authorities may wish to impose restrictions on shareholding on firms above a clearly specified size. These may involve the compulsory sale to the public of a minimum part of their capital, while for very large companies specific limits on individual shareholdings could also be introduced. However, in accordance with the principle of national treatment enshrined in NAFTA, such shareholding restrictions should not discriminate against US and Canadian residents. But these restrictions may prevent companies from exploiting economies of scale and from transferring the technology that is adequate for handling a larger volume of transactions.

7. One of the most difficult and sensitive issues is the timing of the further opening of the market to Canadian and US companies. The timing should be determined in connection with the period needed to improve further the effectiveness of supervision. Given the progress already made, a relatively short adjustment period would probably suffice.

V. SUBSECTOR ISSUES: SECURITIES MARKET

Regulatory Considerations

The securities market as a subsector of the Mexican financial system will inevitably be affected by whatever changes in regulations will be carried out in other parts of the system. Mexico stands to gain substantially from a closer link with the more developed markets, especially because the basic precondition for a flourishing securities market is credibility and stability.

The National Securities Commission (Comision Nacional de Valores, CNV) has already established a close consultative relationship with the US SEC. A Memorandum of Understanding has been signed formalizing bilateral cooperation on enforcement, information exchange and technical assistance. Further substantial topics currently under discussion between the two agencies include recognition by the US of INDEVAL as a designated custodian for US institutional investors; simplified procedures for listing of Mexican securities on US stock exchanges; procedures for simultaneous public offerings in the two jurisdictions; simplified procedures for recognition of Mexican brokerage house subsidiaries in the US; and criteria that would permit US brokerage houses to participate in the financial groups that are likely to be formed in Mexico as a result of the changes to the securities law enacted in July 1990.

This pattern of negotiated agreements between the relevant agencies is similar to that between the USA and Canada.[37] It is a process which allows careful consideration of the interplay between the complex regulatory regimes in each jurisdiction. It enables well thought-out adjustments to be made to each regime which will bring desired efficiency gains without compromising investor protection and system stability. And it diminishes the likelihood that negotiated liberalization in other sectors of the economy will be traded off against changes in the financial sector.

The regulation of securities markets and brokerage houses is generally mare restrictive in Mexico than in the other North American countries. The emphasis is on restricting the introduction of new instruments, regulating mutual funds' portfolios and limiting the scope of brokerage houses' activities. However, in recent years the authorities have moved to a more liberal approach, at the same time trying to strengthen supervision. Major changes in the respective regulations are currently being discussed. In the following paragraphs only those issues that affect international securities market transactions are addressed. The discussion focuses on (i) market structure and barriers to entry, (ii) other regulatory issues, (iii) establishing guarantee funds, and (iv) supervision of securities markets.

Market Structure and Barriers to Entry

The present Mexican securities market is quite small compared to the USA and Canada (Mexican market capitalization is approximately equal to .5 percent of U.S. and 7 percent of Canadian market capitalization). In Mexico the principal providers of securities market services are brokerage houses, the stock exchange and the clearing house. But the main occupation and source of income for each of these providers is in fact the conduct of the money market, not the long-term securities market. The former accounts for nearly 90% of trades by volume and value. This distinguishes Mexico from the USA and Canada, where money market activities are generally conducted off-exchange by counter-parties or by banks as intermediaries.

The general opinion in the Mexican securities industry is that the securities market will become increasingly important and that the money market will take a relatively less important position in the medium term. Certainly interest rate and inflation rate trends currently support such a shift, and Ministry of Finance and CNV policy is to expand the securities market, especially the corporate equities market.

These trends may be accelerated by the opening up of the real economy to foreign competition, the formation of financial groups which will lead to brokerage house operations being split into discrete subsidiary operations and by the development of the role of institutional investors in the market.

The positive side of the existing Mexican situation is that brokerage houses are generally well-capitalized and profitable and both the stock exchange and clearing-house are efficient and forward-looking. The negative side is that none of these parties is greatly experienced in the growing area of high value sophisticated securities market operations, especially in long-term debt instruments and equities.

In addition to existing restrictions in licensing new brokerage houses, foreigners are prohibited from owning more than 30% of a Mexican brokerage house and from having control of the board irrespective of percentage holding. Brokerage houses are one of the very few industries so protected. The CNV is considering increasing the number of new brokerage houses (there are 25 operating), but the rules are not yet transparent and refusal of admission seems to be left to the discretion of CNV.

The Mexican government is rightly concerned that the prudential and conduct supervision of brokers operating under its jurisdiction is sufficient to ensure investor protection and system stability. But these aims can be met through domestic regulatory requirements on new entrants irrespective of the source of investment capital in the brokerage house so long as the regulatory regime is equipped to ensure compliance.

Brokerage houses are at present key market intermediaries and market makers in government paper, although they are not long-term holders of the paper. There may be concern that foreign ownership of brokers may leave the Government vulnerable to artificially created distortions in its market-based financial management operations. This is not true for the same reason as given above -- domestic regulation should ensure proper prudential and conduct compliance regardless of the source of ownership. And growth in the long-term end of the government paper market has added to the Government's protection from short-term market movements.

Free capital movement and openness to foreign investment are key elements of the Government's implementation of the 1988-1994 National Development Plan and should be proscribed only where national interest is clearly at risk. Foreign participation in ownership of brokerage houses does not of itself bring such risks. The Government could remove entry and ownership barriers, perhaps gradually and conditionally, and ensure that the national interest is protected.

At the federal level the USA and Canada allow free entry to the securities industry of foreign-owned brokerage houses and investment banks. Foreigners may hold shares in local brokerage houses without limit. But these freedoms are proscribed under laws operating in the States and Provinces. This is not as serious in the case of Canada as it is in the case of the USA.

In the USA, securities offered or sold within a state usually must be registered in that state, as must broker-dealers, investment advisers and other persons in the securities business. At the least this provides an unnecessary duplication of registration at the Federal level and at worst can act as a barrier to entry by foreign brokerage houses, either explicitly or implicitly. In practice these barriers have worked to the disadvantage of Mexican brokerage houses, especially those wishing to operate in the border states of the USA.

This matter should be raised with the USA Federal Government and the relevant states in order to achieve simplicity, uniformity and compliance with the l deral Government's national treatment approach. It is probably however that only minor improvements will be obtained because of the constitutional power of the states in this area.

The same topic should be examined in relation to Canada. The Provincial-Federal differences there are less than in the USA but still may disadvantage Mexican brokerage houses.

Other Regulatory Issues

Product, Client and Location Restrictions. The source of investment capital in a brokerage house should not of itself determine the products or clients the broker may deal with: domestic regulation can ensure adequate protection. Restriction on foreign access to clients or products unnecessarily limits the innovation potential inherent in opening the market to foreign access.

At the Federal level the USA substantially prohibits commercial banks from participating in the securities business, whereas Canada does not.

At the state level in the USA, product, client and location restrictions are a significant barrier to operations by Mexican brokerage houses. This should be raised with the USA Federal Government and the relevant states. It is probable however that only minor improvements will be obtained.

No significant product, client and location barriers have been identified at the Provincial level in Canada.

Instruments Offered and Traded. Articles 11 and 13 of the Securities Market Act prohibit the public offer and secondary market trading of securities not listed in the National Registry of Securities and Intermediaries. Article 14 sets out the general requirements for registration. The CNV develops and applies the specific requirements which derive from these general principles.

Securities registered, offered and traded in foreign jurisdictions may be also registered in the National Register for offer and trading in Mexico. To obtain registration the issues must comply with all the requirements of the CNV.

Because the Mexican market is relatively small, the cost of complying with the requirements tends to discourage foreign issuers from seeking Mexican registration. As a consequence, Mexican investment and trade in those securities is conducted off-shore. The Mexican market would benefit from having as much of that business as possible brought home.

Domestic trading of securities issued abroad and unrestricted foreign placement of Mexican securities would be a precondition for a full integration of securities markets. Under these conditions mutual fund shares would also be available in all FTA countries. This in particular could substantially improve resource mobilization and promote equity financing. However, it would also imply that Mexican mutual fund companies must be free to determine their portfolios as it is the case in the US and Canada.

There are a number of difficult problems to be resolved before the requirements for re-registration in Mexico can be modified. These relate primarily to differences in accounting and disclosure requirements. And there may be benefit in placing some general limit on access to automatic Mexican registration, for example on the basis of a well-established record of market liquidity and business history.

This topic should be examined in regard to establishing some form of reciprocal or common prospectus agreement between Mexico, the USA and Canada. It would be to Mexico's advantage to negotiate an agreement on multijurisdictional offerings with both the USA and Canada.

Voting Rights. At present foreign holders of most Mexican corporate equities are precluded from exercising attached voting rights. This is achieved either through allowing foreigners to hold only non-voting shares or requiring that voting shares be held in trust by NAFINSA with all benefits except voting rights flowing through to the foreign holder.

One benefit of having substantial institutional holdings of corporate equities is that such investors can monitor the performance of company management and exercise some influence over management decisions. Because foreign investors are precluded from exercising that influence by way of voting rights they are left with only the decision to buy and sell as an expression of their assessment. This is a spur to greater market volatility and may therefore not be desirable.

Consideration should be given to allowing foreigners to hold and exercise voting rights attached to equities. This would be in line with the principle of national treatment.

Trading for Own Account. Mexican brokerage houses may hold and trade for their own account only those securities allowed by the CNV. In Circulars 10-126 and 10-118 the CNV prohibits the direct holding and trading of variable rate securities such as corporate equities and places a strict time limit on the holding of fixed rate securities.

The CNV places these restrictions on brokerage houses in order to ensure that:

- brokers do not trade against the interests of their own clients.
- trade in a way which may distort the market; and
- brokers do not carry a large, variable and inadequately monitored portfolio risk.

These three objectives -- protection of the fiduciary relationship between broker and client, protection against market manipulation, and maintenance of strict prudential control, can be achieved in other ways. The USA and Canada achieve the objectives but they do not place the time period, counterparty or holding limitations of Mexico. Instead, the USA and Canada require brokerage houses to accurately value their securities holdings on a daily basis (mark to market) and to adjust their capital position to maintain the prescribed prudential ratios. These valuations are independently audited and are monitored by the regulatory authorities. With regard to trading, the authorities require a brokerage house to disclose to its client when the client's order is traded from the brokerage house's own account and to disclose to the stock exchange when a large tranche from the broker's own account is traded.

There may be some value in Mexico adopting a regime similar to the USA/Canada one. This would be in line with the market liberalization policies of the Government. It could allow Mexican brokers to better compete with their foreign counterparts. Foreign brokers operating in Mexico would of course be subject to whatever rules apply in Mexico, but it could be argued that their ability to trade in their home market, without the Mexican limits, unnecessarily diminishes the competitive power of Mexican domestic brokers.

Before removing the present limits the CNV would need to be assured that:

- effective portfolio valuation mechanisms are in place;
- prudential regulations are effective in accounting for changing portfolio values;
- there are effective reporting and monitoring procedures;
- market manipulation is not facilitated by the use of brokerage house account trading; and
- brokerage house clients are fully aware of the fact when their broker takes the other side of any transaction with them and that the broker's fiduciary responsibility to the client is not compromised.

Brokerage Commissions. The fixed brokerage requirements for secondary market trading that used to exist in Mexico contrasted with the negotiated brokerage rates which apply in the USA and Canada. Retaining fixed commissions would have acted as a brake to competitive pressures for lowering commissions on large trades. The introduction of negotiated commissions has removed this obstacle to the integration of the Mexican market with its North American counterparts. Although the levels of commissions have remained the same, there is little doubt that with growing foreign participation, they will be adjusted downwards.

Establishing Guarantee Funds

To protect small unsophisticated market participants consideration may be given to the establishment of guarantee funds. These funds generally cover losses incurred due to the failure of brokerage institutions.

Supervision of Securities Markets

In the US and Canada regulation attempts to minimize interference with contractual freedom. Instead the emphasis is on close supervision of market activities and strict rules on accounting and disclosure. Self regulation plays an important role in ensuring proper and transparent market procedures. However, serious restrictions towards the freedom to provide services result from political federalism and, in the case of the US, from the separation of investment and commercial banking. These restrictions also affect international securities market transactions.

With the implementation of NAFTA Mexico should improve its prudential regulation and monitoring of brokerage houses in the light of more complex cross-border, intra-group, term-related and exchange rate risks which are likely to arise.

The Transition Process

Mexico is likely to reap benefits from continuing with the process of liberalization it has begun. But the balance of benefit will be determined to a considerable degree by the effectiveness of domestic regulation in Mexico and by the extent to which efficiencies and innovations are transferred to Mexico.

In order to ensure that Mexico receives the maximum benefit from the liberalization it may be appropriate to implement the necessary reforms in stages over time and to place some conditions on implementation of some reforms. The advantage of such an approach is that the domestic financial sector may adjust and position itself to compete with the foreign entrants. The Government may consider that this is an important objective. If so, freer domestic entry could come almost immediately together with the definition of a short time period to allow adjustment prior to complete opening of the market to foreign participation, which could be economically justified because delay in implementation denies the cost saving and other benefits which will accrue to the real goods sector.

In any case the Government may wish to impose some conditions on the authorization of new foreign entrants to ensure a diffusion of the technical and other skills which they can bring to Mexico. Such conditions would not be in line with the principle of national treatment. They could be justified, however, on the grounds that they are temporary and will be superseded at the time that complete openness is achieved. A second important justification is Mexico's considerable relative disadvantage in the finance area which should be acknowledged and accounted for by way of a structured developmental effort.

Conclusions and Recommendations

In light of the above Mexico should make a commitment in NAFTA to remove, in stages, all barriers to entry by some agreed upon date, subject to satisfactory performance of foreign entrants during the transition period. An important advantage of a commitment to staged implementation of reforms is that it will allow Mexico to pursue the co-operation and technical assistance initiatives already underway between the relevant regulatory agencies and to add new areas as they become relevant. In this way Mexico may assure itself that its regulatory regime is fully equipped to deal with the new entrants. Grant or loan funded technical assistance from the USA and Canada may further this process. Some key regulatory areas to be considered include:

- improved prudential regulation and monitoring of brokerage houses in the light of more complex cross-border, intra-group, term-related and exchange rate risks which are likely to arise.

- improved prudential regulation and disclosure requirements to replace the present restrictions on brokers trading their own account.

- improved arrangements for cooperative monitoring investigation and enforcement activities across borders, including information exchange, proceeds of crime sequestration, and methods for acting in one jurisdiction to prohibit a cross border activity conducted there which is unlawful in the country across the border.

- more detailed, consistent and effective rules of conduct for brokers who are members of the Mexican Stock Exchange to minimize regulatory arbitrage across borders by USA and Canadian brokers who may face stricter regulation at home.

- free domestic entry and deregulation of brokerage fees to allow the maximum competitive price benefit to arise from opening the market to foreign participation.

VI. TAX ISSUES

This section analyzes issues arising from differences in the tax treatment of trade in financial services. How will the existing tax structures in the three countries affect the relative competitiveness of financial intermediaries with different ownership structures? Existing tax laws distort in many ways the location of financial activity, the pattern of ownership of financial firms, and their financial structure. Each country's tax system can have substantial effects on the resulting structure of the industry. The chosen tax treatment for the financial sector will not only affect the relative competitiveness of domestically owned vs. foreign firms, but will also affect the cost of financial transactions for domestic residents, most importantly including the cost of funds to domestic investors. What beneficial tax changes can Mexico make on its own, taking as given the tax structures in the other two countries?

Financial institutions doing business in Mexico in principle can be located in the US, Canada, or other countries, as well as in Mexico. US banks, for example, can accept deposits from Mexican investors and can make loans to Mexican firms. In addition, financial institutions located in any given country can in principle be owned by investors located elsewhere. Taxes can have substantial effects on the relative competitiveness of firms in different locations, or firms with owners residing in different locations. In addition, taxes affect the prices charged for financial services to both individuals and firms. To what degree does the existing Mexican tax system affect the ownership structure, location, and costs, of financial institutions, or corporations more broadly, doing business in Mexico? What changes in the Mexican tax system might be appropriate, in light of the increased international competition that will likely result from a NAFTA?

The principal conclusions reached in this section involve recommendations for both long-term tax reform and more specific short-term tax changes. The recommended long-term reforms are as follows:

1) **Mexico may consider reducing restrictions on the fraction of foreign ownership in firms located in Mexico.** Foreign subsidiaries in Mexico qualify for a tax credit against their home-country corporate taxes for any corporate taxes paid in Mexico only if the parent firm owns at least 10% of the voting shares of the subsidiary. There are further tax advantages in the home country from having the parent own a majority of the shares. Allowing firms these tax advantages in their home country would increase investment in Mexico. Of course, allowing a higher ownership share gives foreign investors more than just tax advantages. Their incentive to transfer technology, or simply invest effort in improving the performance of the subsidiary, depends critically on the share of the resulting increased profits that they receive.

2) **Financial services should be exempt from value-added taxes.** At present transactions in the Mexican securities markets pay VAT. This tax discriminates against this form of intermediation. In addition, a VAT on financial services transacted in Mexico simply induces Mexicans to conduct their financial transactions abroad. While in principle, this distortion could be avoided by imposing a VAT on all financial transactions conducted by Mexicans, regardless of location, such a broad-based tax would be administratively infeasible.

3) **Requirements to invest in tax exempt government bonds should be removed.** Currently insurance companies have to invest 30% of their portfolio in government tax-exempt bonds (this requirement has been phased out for banks). While their interest income is

tax-exempt under Mexican law, it is not tax-exempt under the US or Canadian tax law, so that this provision discourages investment by these foreign firms in Mexico and foreigners in domestically issued public debt. There are three alternative solutions to this issue. **First,** eliminate the tax-exempt status of government bonds. This will increase the interest rates on these bonds by the amount of the tax (the after tax yields are equalized across borders and thus will remain unchanged, since Mexico is a "small" country). This solution would also promote pension plans and life insurance by rebating this tax on interest income earned on the assets held by these programs, and will encourage holdings of domestically issued government debt by foreigners in general and not only foreign owned financial intermediaries. **Second,** eliminate the 30% requirement. Although there is no problem for implementing it immediately, insurance companies (and financial intermediaries in general) would like to maintain government bonds as a part of their liquid portfolio. **Third,** have the previous two solutions simultaneously implemented.

4) **Profit-sharing payments should be tax deductible for corporations.** If profit-sharing payments, unlike other forms of labor compensation, are not tax deductible for corporations, then the corporate tax discourages use of labor by profitable corporations, and more so the more profitable the corporation. This provision also tends to put firms located in Mexico at a competitive disadvantage.

5) **Adopt better tax policies for insurance companies.** Contributions to build up precautionary reserves should not be tax deductible. On the other hand, the yield of the technical reserves from life and disability insurance policies should be tax exempt to avoid double taxation of saving (i.e., ensure consumption tax treatment for this form of contractual savings instrument).

6) **Harmonize sourcing rules for income/deductions.** The US rules for allocating interest and overhead expenses among a parent and its branches can induce a firm to shift its overhead activity and its borrowing to its branches, thereby reducing foreign tax payments while leaving the firm's total tax liabilities unchanged. Mexico should try to undo these distortions, for example by adopting the US sourcing rules.

7) **National tax treatment of dividend income.** For firms holding internationally diversified portfolios of equity, dividends received from domestic firms are normally exempt from tax, but dividends received from foreign firms are normally fully taxable. Given the frequent gains from the international diversification of portfolios, this tax distortion penalizing corporate holdings of foreign equity may be very costly, particularly for financial intermediaries, and requires rethinking. One alternative would be to allow such firms a credit for foreign corporate taxes even when they own less than 10% of any given foreign firm (i.e., granting national tax treatment under NAFTA). Another alternative, adopted by the Canadians with respect to life insurance companies, would be to exempt these firms from domestic taxes on their foreign operations.

8) **National tax treatment for foreign life-insurance in the US.** The US has different tax treatment to domestic branches of foreign life-insurance companies. Canadian firms are also subject to this treatment in spite of national treatment under the US-Canada FTA. In order to prevent such companies from shifting their taxable income abroad, the US government has set their minimum net investment income equal to the product of their required US assets multiplied by the domestic investment yield. Since other insurance firms operating in the US do not face this restriction, they may be put at a competitive advantage.

9) **Allow loss-offset provision to holding companies.** If firms are likely to end up with unused tax losses, then they have an incentive to engage in potentially costly rearrangements of

their financial portfolios or their form of ownership in order to make use of these tax losses. Also, it discourages financial holding companies, thereby preventing the exploitation of economies of scope derived from universal banking practices. These distortions should be avoided, either by allowing groups of firms with common ownership to file consolidated tax returns, or by indexing carry-overs by the nominal interest rate.

10) Correct loophole in personal income tax treatment of group insurance. Group insurance premiums are tax deductible if such insurance is regarded by the tax law as a fringe benefit for employees. A loophole arises, however, since the premium is not part of workers' taxable income, and the insurance payments are untaxed up to nine times the annual minimum salary. Unless the tax sharing information is capable of detecting cross-border arbitrage transactions, this could result in considerable revenue losses for the Mexican Treasury.

Group insurance should lead to the same tax treatment of final beneficiaries as individual insurance does, that is, if workers are not taxed on the basis of the premiums paid by firms on their behalf, they should be taxed on the basis of the benefits they receive (i.e., insurance payments).

VII. SUMMARY AND CONCLUSIONS

In summary, to maximize the efficiency gains from liberalization of the financial sector, the regulatory environment of banking, insurance, and securities markets can be further reformed through deregulation and better defining and implementing prudential supervision. Harmonization of regulatory and supervisory rules is a key issue in liberalization. An integrated market will presuppose greater cooperation and exchange of information among the respective regulatory authorities to ensure that individual insurers are prevented from exploiting loopholes in prudential regulations and engaging in deceptive and unsound business practices. Discrepancies between different financial institution regulations should be eliminated so as to create a level playing field for all participants, domestic as well as international, between member countries. For each subsector, establishing an effective supervisory system is crucial and will determine the pace of liberalization. International cooperation between regulators and examiners should be ensured. Improving transparency through greater disclosure is very important in enforcing regulations and establishing market discipline. Finally, guarantee funds should have well-defined objectives and powers to avoid moral hazard problems.

In addition to harmonizing regulation and supervision, eliminating or reducing the disparities between NAFTA countries in both tax rates and the way taxes are levied would help prevent distortions, tax evasion and tax avoidance linked to the diversity of national systems. Although the harmonization of taxation of income from capital may not be a legally binding prerequisite for full capital mobility, proposals designed to eliminate these distortions should also be evaluated. Related issues are the development of a common system for the transmission of information to tax authorities by intermediaries and cooperation among national tax administrations.

In banking the issues are the convergence of general criteria for authorizing firms to engage in banking business and to remove many of the obstacles to freedom of establishment. Other provisions may prove useful in the present phase of integration, such as the creation of a Banking Advisory Committee to assist in the preparation of banking measures aiming at greater convergence in regulations and supervision.

There is the issue of branching and interstate banking, i.e., the territorial segmentation of the market. Because of the US restrictions on interstate banking Mexico may have to enter into separate arrangements with each state.

Strengthening supervision still remains a priority issue. This is especially true since the banking system is being newly privatized. Given that the privatization price for some Mexican banks was much higher than their book value of capital, these banks will be under additional pressure to recoup their expenses before their protection is phased out.

Also, the issue of harmonizing deposit guarantee schemes deserves considerable analysis. The Mexican deposit insurance system should have very well-defined powers and its purpose should be to protect small, unsophisticated investors rather than mismanaged institutions.

Turning from the legislative to the executive aspect of supervision, it should be emphasized that the FTA design will not foresee a central body with responsibility for the day-to-day supervision of banks: this function will be left to the authorities of individual member countries. Bilateral contacts between national authorities should be encouraged and strengthened in dealing with individual cases. But there will clearly also be a need for a permanent forum for the coordination of practices and policies among all the national authorities with banking supervision responsibilities.

In **insurance**, convergence in regulations and supervision is again the central issue. Consideration should be given to the case for organizing joint training programs to enhance staff expertise and achieve greater consistency in regulatory approach.

In Mexico cross-border insurance business is relatively less developed but foreign participation in local establishments is more developed. However, domestic entry is restricted and the establishment of fully-owned foreign subsidiaries is not allowed. A more liberal entry policy for both domestic and foreign-owned institutions is necessary. Mexico also needs to remove any biases that exist in favor of domestic reinsurance.

Also to safeguard the interests of small policyholders and protect the competitive position of the Mexican market, consideration should be given to the case for establishing limited guarantee funds.

In **securities markets** there will also be a need to harmonize essential prudential regulations. NAFTA will have to pursue an appropriate balance between investor protection, market efficiency and the regulation of risk management.

A first set of problems concerns the internal rules that investment firms will need to adopt on prudential grounds and with the aim of minimizing conflicts of interest. One possibility that could be considered is mutual recognition of home-country disclosure requirements. Moreover, any agreements in this area, in contrast to banking and investment services, would involve primarily issues of investor protection rather than prudential concerns.

A second set of more general problems concerns the importance the rules should attribute, in promoting the supply of services in a regime of mutual recognition, to whether or not investment firms are part of an organized market. Finally, minimum capital requirements and the regulation of market risks (chiefly, interest rate and exchange rate risk) will have to achieve equality of treatment and neutrality with respect to both credit institutions and investment firms.

The issue is whether the aim of NAFTA is to develop a truly unified capital market by both increasing transparency and ensuring access for issuers to stock exchanges throughout the area. If so, there will be a need to harmonize the rules on listing particulars, on the information to be published on a regular basis by listed companies, on the information to be published when major holdings are acquired in a listed company, on the mutual recognition of listing particulars, on the prospectus to be published when transferable securities are first offered to the public, on rules and procedures for takeover bids, and on inside trading. On the last one, the rules should define inside information, identify the persons with access to such information and establish their obligations.

In conclusion, implementation of NAFTA will pose a major challenge to the Mexican financial system and the Mexican supervisory authorities to modernize their operations, enhance their efficiency and strengthen their effectiveness. In some areas, there will be a strong need for intensive training and cooperation with the regulatory authorities of Canada and the United States. The inclusion in NAFTA of a reasonable transition period, which extends up to the year 2000, provides a reassurance that Mexican institutions will be able to rise to the challenge and achieve the efficiency gains that have motivated the quest for the agreement in the first place.

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APPENDIX A

TREATMENT OF FINANCIAL SERVICES IN FREE TRADE NEGOTIATIONS

This appendix reviews the treatment of financial services in the GATT negotiations, the European Community single market, and the US-Canada free trade agreement.

Financial Services in the GATT Negotiations

Financial services are one of the most controversial sectors in the GATT negotiations regarding the liberalization of trade in services. There are two main reasons for this. First, there are very large differences in the level of development, efficiency and sophistication of the financial systems of different countries. And, second, there are substantial differences in financial structure and practice that reflect different philosophies about the role of banks and other financial institutions, their permissible scope of activities and their links with other financial institutions and nonfinancial corporations.

The GATT negotiations aim to establish a framework of principles and rules that should govern the liberalization of trade in services. The main issues under discussion include: the modes of delivery of financial services (i.e. through cross-border transactions or through local commercial presence); market access; reciprocity; national treatment; equality of competitive opportunity; the right to regulate;[38] the transparency of regulations; the pace of liberalization; the resolution of disputes; and the question of cross-linkage.

As regards modes of delivery, the prevailing view is that cross-border transactions raise complex issues in connection with the liberalization of capital and foreign exchange controls. There is concern that liberalizing cross-border services might hamper the stability of developing countries' financial systems and have adverse implications for the balance of payments. But there is also agreement that the scope for cross-border transactions is limited to large corporations and wealthy individuals who can overcome the high information and transaction costs of obtaining financial services from institutions established in foreign countries. However, some cross-border services, such as marine insurance, reinsurance, and financial advisory services, are suitable for inclusion in an agreement on multilateral liberalization.

The discussion of modes of delivery is focussed on the local commercial presence and the right of establishment of foreign institutions. On this issue, a distinction is drawn between market access and national treatment. Market access refers to the right of local commercial presence which can take many different forms such as a local branch, local subsidiary, joint venture, minority participation or acquisition of local institution. There is general agreement that market access will not be an automatic obligation under the framework agreement, but there is considerable debate on whether it should be a general obligation against which countries have the right to enter reservations or whether it should be treated as a qualified right under the framework that would be granted only through negotiations and an exchange of concessions. Moreover, there is some debate as to whether some forms of market access (such as local branch or acquisition of local institution) may be subject to tighter restrictions to ensure that domestic control is maintained over the core of the banking and financial system. Linked with the issue of market access is the question of temporary entry of essential foreign personnel. There is general agreement that entry of essential personnel is necessary but opinions differ on how "essential" personnel should be defined.

Historically, DFI in financial services has been permitted either on a unilateral basis or through reciprocity. Reciprocity can involve unduly tight restrictions on the operations of foreign institutions. These may affect the number of foreign institutions that are granted market access, their individual or total share of domestic business, and their range of activities. A particularly restrictive type of reciprocal arrangements is the so-called "mirror image" reciprocity. This implies that foreign institutions are allowed to engage in identical activities in two or more countries, irrespective of the permissible range of activities of national institutions in each market.

Because of the highly uncertain outcome, a strategy based on the use of reciprocity as a bargaining tool could be very risky. If a reciprocity policy is in fact used to bar entry by some foreign financial institutions, the ultimate effect of the policy could be to close rather than to open markets. Moreover, if any reciprocity policy is adopted and a review procedure is set up, a bureaucratic structure will have been created that, once in place, has the potential for being used in an increasingly restrictive manner.

A reciprocity policy, depending on its definition and implementation, could result in a complex regulatory structure for operations of banks from different countries outside the FTA. Such a structure could involve discrimination not only between foreign and FTA members-owned financial institutions but also among foreign financial institutions from different countries. Moreover, a reciprocity review procedure could delay applications by non-members banks to establish or acquire banks within the FTA countries. Such delays could be particularly burdensome if reciprocity were to be determined on a case-by-case basis rather than by an established rule for each non-member country.

Insisting on a reciprocity policy will not earn the support of the US, since it will undermine its efforts pursued in various international fora to achieve national treatment for foreign financial institutions in a host country. In general, a policy of national treatment is the US policy toward foreign banks and other DFI in the US. The overall US policy of national treatment is based on the belief that open and competitive markets facilitate a more efficient, a more innovative and dynamic, and a more financially sound banking system.

Use of a financial service reciprocity concept as a bargaining tool in the general context of trade negotiations could also create problems because of differences between trade in financial services and trade in other services and goods. As has been emphasized above, financial services involve issues of prudential regulation, monetary policy, and stability of financial markets. Thus it may be inappropriate for financial services to be the subject of "reciprocal" concessions for goods or for nonfinancial services in a global trade negotiation context. Moreover, it is conceptually and practically difficult to measure trade in financial services in a meaningful way. In part to avoid these kinds of trade-offs and measurement issues, the US Treasury has always urged that trade in financial services be viewed in terms of equality of competitive opportunity in a national market for foreign and domestic financial institutions, that is, in terms of national treatment.

Because of the restrictive effects of reciprocal agreements and the danger of retaliatory action in response to grievances and disputes, there is now widespread consensus that once market access is granted, the principle of national treatment should apply, whereby foreign institutions receive the same treatment as domestic institutions in like circumstances. There is some uncertainty as to the exact meaning of the term "like circumstances" as well as to the implications of the principle of national treatment for different modes of delivery, and especially for local subsidiaries and local branches. Under national treatment, a local subsidiary of a foreign institution should receive identical treatment as a domestic institution but in the case of local branches, national treatment may confer regulatory advantages to foreign institutions. The principle of equivalent treatment may then be applied, whereby foreign branches may be treated less favorably than domestic branches but the effect would be to achieve equivalent treatment between domestic institutions and the local operations of a branch of a foreign institution.

There is also considerable debate regarding the concepts of *de jure* and *de facto* national treatment. *De facto* national treatment is associated with the concept of equality of competitive opportunity. The latter refers to the prevention of various practices and regulations that have the effect of discriminating against foreign institutions. Thus, *de facto* national treatment and equality of competitive opportunity imply that foreign institutions are not impeded by regulations or the use of discretionary authorizations from obtaining local currency funding from the money and capital markets, having equal access to refinancing and other central bank facilities, and participating in preferential domestic credit programs. A sharper interpretation of the principle of equality of competitive opportunity requires that foreign institutions should not be prevented from introducing new instruments or services by delays in authorization procedures that discriminate in favor of domestic institutions.

The principle of national treatment is part of the non-discrimination principle of trade negotiations that covers both the "most favored nation (MFN)" clause and national treatment. MFN requires that imports from all sources should face identical barriers, while national treatment requires that, once through customs, foreign goods should not be subject to taxes and regulations that are more onerous than those on equivalent domestic goods. But with regard to DFI in financial services, application of the national treatment principle is complicated by the role of political subdivisions in regulating financial institutions. In those countries where political subdivisions impose restrictions on foreign participation, including participation from other subdivisions, national treatment may impose considerable limits on market access on foreign institutions.[39] In addition, restrictions at the level of political subdivisions may even deny national treatment to foreign institutions.

Effective market access (which the EC sometimes refers to as the "broad definition of national treatment") appears to encompass two different concepts: national treatment and "progressive liberalization" of laws and regulations relating to banking and other financial services. In other words, national treatment in the context of a restrictive, highly regulated banking system might not be considered to provide effective market access. The concept of effective market access appears to be based on the arguments that (a) a highly regulated host-country environment may have a differential impact on foreign and domestic institutions and (b) host-country treatment may be so restrictive in comparison with the regulatory framework for banking services in other countries, that market distortion is created.

The first argument implies that in a highly regulated environment it is much more difficult to achieve national treatment for foreign banking organizations than it is to achieve such treatment in a more open system. But it does not necessarily follow that is impossible to achieve national treatment under such circumstances. If, however, it is assumed that national treatment cannot be defined or achieved in a restrictive environment, liberalization of the regulatory structure is necessary to achieve meaningful access to domestic markets.

The second argument, because it is based on a more global comparison of regulatory structures, raises the issue of harmonization. At least for the industrial countries, "progressive liberalization" could be viewed as a somewhat less formal and less structured GATT equivalent of one aspect of the EC process of harmonization of essential laws, regulations, and practices. Because the degree of liberalization is measured against that existing in other major industrial countries, trying to achieve progressive liberalization in countries with restrictive structures amounts to an attempt to bring those structures into rough conformity with the more liberal structures in other countries.

The next issue in the GATT negotiations concerns the right to regulate and the transparency of regulations. There is general agreement that the liberalization of trade in services should not put into question the right of national authorities to regulate the financial system for prudential and other purposes. There is a legitimate need to ensure the safety and soundness of financial institutions and the stability of the financial system, to maintain fair and orderly market conditions, to preserve the integrity of the national payment system and to protect the interests of consumers and investors. Moreover, there is widespread concern, especially among developing countries, that liberalization of trade in financial services should not prevent developing countries from using their banking systems to promote national development objectives and should not leave them with inadequate powers to control money and credit growth and foreign exchange flows.

Although the right to regulate is widely accepted, strong emphasis is placed on the need for regulations to be transparent and non-discriminatory against foreign institutions. Regulations should be taken for legitimate reasons and not for the purpose of circumventing a liberalization agreement. However, the broad scope of regulations, the legitimate concerns of many countries to maintain domestic control over the core of their banking and financial system, and the difficulty of devising effective settlement dispute procedures would make a universally acceptable multilateral agreement rather difficult to reach.

A crucial issue in the GATT negotiations concerns the pace of liberalization. There is widespread agreement in favor of gradual or progressive liberalization. The pace should depend on progress made in implementing domestic financial reform and deregulation, restructuring domestic institutions and modernizing their operations, and strengthening national regulatory and supervisory agencies. The pace of liberalization is relevant not only with regard to the question of market access and the allowable mode of delivery, but also with regard to the permissible new instruments. Authorization of new financial instruments and services must be linked to the ability of regulators to assess their implications for the stability of the financial system and control possible abuses that might negate their benefits. New products need to be monitored and supervised to ensure the protection of depositors, policy holders and investors.

Two additional issues in the GATT negotiations are the establishment of an effective mechanism for the resolution of disputes and the question of cross-linkage between different sectors. These two issues are interrelated since if there is cross-linkage, countries may threaten to retaliate in the financial services area for disputes arising in a nonfinancial sector. It is generally agreed that financial markets should not be exposed to such de-stabilizing threats but it is rather difficult to avoid any cross-linkage. Establishing an effective dispute resolution mechanism is also a very sensitive issue because disputes in the financial services area may challenge the transparency of regulations and the discretionary powers of national authorities.

In a world of complete convergence, the policies of national treatment, reciprocal national treatment, mirror-image reciprocity, and effective market access would produce identical results. Pending such convergence, however, the differences among these concepts are still important. And some of the most difficult problems are presented by the lack of agreement among the major industrial countries regarding the permissible activities of banks, in particular, whether to separate commercial and investment banking.

In the banking, investment services, and insurance sectors, national treatment, as embodied in the OECD Codes of Liberalization and the National Treatment Instrument, is in general the currently accepted approach. Whether national treatment or effective market access might become the accepted approach if any agreement is reached on trade in financial services in connection with the current Uruguay Round of GATT negotiations remains to be seen.

To sum up this brief review of the GATT negotiations, financial services raise many difficult and sensitive issues and it is unclear whether they will be included in any agreement that might eventually result from this round of negotiations. In fact, there are many officials and practitioners who express the view that financial services should be the subject of separate negotiations and should not be part of a general agreement on trade and services. However, it is now too late to change this approach without undermining the momentum for agreeing a general framework for trade in services.

Financial Services in the European Community Single Market

The proposals for the creation of a single market in financial services in the EC is based on the three principles of home country authorization and control, mutual recognition of national supervisory authorities and an approximation of rules and regulations that include such items as the permissible range of activities (a universal financial services approach has been adopted) and solvency controls.

The approach of the EC differs from that of traditional bilateral and multilateral FTAs because it envisages a progressive economic and, ultimately even political, integration of member countries with the ultimate objective of creating institutions with EC-wide operations and ownership.

The EC base the completion of integration on the principle of **mutual recognition**, whereby each member state recognizes the validity of the laws and regulations in force in each of the other, and agrees not to exploit the differences between regulatory systems to protect its national market. The traditional approach, by contrast, saw integration as involving the detailed harmonization of the entire corpus of laws and regulations applicable to each sector.

The principle of mutual recognition implies that every member countries sets of national rules, which differ in significant respects, will all be in force and co-exist in the same large market. This is bound to trigger arbitrage. Thus, the convergence of national regulatory systems, which would have been reached through the traditional approach of complete top-down harmonization, should be brought about by market forces instead or, to be more precise, by the interaction between market forces and national regulators.

In principle, the outcome will not necessarily be complete convergence since different market segments may place different values on regulatory standards and product prices. In the financial sphere, for instance, some customers may be ready to pay more for the services of an intermediary that is subject to the stricter prudential controls of a particular member state. However, the internationalization of financial services is already creating market pressure for greater **convergence of prudential standards** on a world wide basis. A single market may accelerate this process further.

The danger inherent in mutual recognition is that relying exclusively on market forces to determine regulatory standards may lead to a sub-optimal outcome, with excessive or inappropriate deregulation. This is why, both on financial services, the principle of mutual recognition has been tempered by that of **minimal harmonization.** To avoid leap-frogging by member states seeking to offer the most favorable regulatory conditions, the EC should make the application of mutual recognition conditional on the introduction of common regulations to safeguard fundamental public interests.

The crucial question is, of course, how "minimal" minimal harmonization can be while still ensuring an acceptable level of regulatory standards. In the financial sector, the definition of what is necessary to harmonize has already been found not to be a once-and-for-all process. On the contrary, it calls for continuous evaluation and is likely to require more common legislation than originally thought.

In the financial field, a corollary of the two key principles of mutual recognition and minimal harmonization is the principle of **home-country control,** which assigns supervisory responsibility to the authorities of the member state in which the financial institution was originally authorized to operate. An important aspect of home country control is how deposits of branches overseas are protected. In the EC countries, they are covered by the national deposit protection system of the home country.

However, despite the objectives of a single market and even economic and political integration (which, if implemented, should remove concerns about national ownership of financial institutions), there is currently considerable apprehension in some countries about the likelihood of national institutions coming under the control of institutions from other member countries. At present, the right of regulatory authorities to approve controlling stakes in individual institutions, coupled with the widely dispersed ownership of most institutions of national importance, allows member countries to influence the ownership of national financial institutions. Member countries can still introduce regulations similar to those used in Canada, whereby no individual shareholdings of large banks are allowed to exceed 10% of share capital. However, any such requirements would have to grant equal treatment to all citizens of member countries with no discrimination against nationals of other member countries.

Financial Services in the US-Canada FTA

The US-Canada FTA went into effect in January 1989. It is based on the principles of national treatment, the right to sell across borders, the right of establishment, and transparency in regulations. The US-Canada FTA contains a chapter on services that grants national treatment to insurance companies but banking is covered in a separate chapter that does not grant national treatment to banks from the two countries. It does not cover securities markets *per se*. However, the agreement removes several restrictions on market access and scope of operations, e.g. expands the scope of banking into securities transactions.

National treatment assures that any new Canadian (US) law or regulation must treat US (Canadian) financial service providers no less favorably than Canadian (US) providers. This will provide stability and predictability for US (Canadian) businesses in the Canadian (US) market.

However, this does not mean that Canada and the US must always give identical treatment. Differential treatment may occur between domestic and foreign service providers for prudential, fiduciary, consumer protection, or other valid reasons.

For example, with respect to insurance, new provincial (state) requirements which are higher for a foreign insurer than a domestic insurer in Canada (US) would not necessarily be inconsistent with the FTA. However, any differences in treatment must not be disguised barriers to trade and must be justifiable.

The FTA assures US and Canadian service providers of the **right to sell** across the border. This is important when it is more economical for a business to provide the service from the home-country, rather than establish itself in the host-country. This right is especially important for many high-technology services, such as credit reporting services, where the normal means of delivery is over telephone lines to all customers from one central computer installation. Conversely, when a local presence is the preferred (or only) method to provide a service in the host-country, the FTA guarantees **the right of establishment.**

The two countries have agreed to make publicly available (to make transparent) all laws and regulations relating to services trade so that persons and firms who may be affected will have an opportunity to make their views known. Transparency also includes clear criteria in exercising discretionary powers. Such **transparency** will enable US (Canadian) services providers to participate with Canadian (US) firms in the Canadian (US) regulating process. It is essential to know the rules of the game.

APPENDIX B

Financial Services in the Proposed NAFTA

This appendix summarizes the main provisions regarding financial services in the proposed NAFTA that was signed in December 1992 and, subject to the completion of domestic approval procedures, will enter into force on January 1, 1994.

Each NAFTA country must grant "national treatment" and "most-favored-nation" treatment to participants from other NAFTA countries. Market access is limited to individuals or companies that already engage in their country of origin in financial services. It may also be limited to subsidiaries rather than direct branches.

Mexico is allowed to impose on US and Canadian participants individual and aggregate market share limits. These will be stated as a proportion of the total capital in each sector and will be phased out by the year 2000. The whole issue will, however, be revisited if US and Canadian participants acquire a combined market share in excess of 25%.

In **banking**, the aggregate limit will rise from 8% in 1994 to 15% by 1999. The single-institution limit will be 1.5% throughout the transition period. Both during and after the transition period, acquisitions of Mexican banks will be subject to an individual, per institution limit of 4%.

In the **securities** industry, the aggregate limit will increase from 10% in 1994 to 20% by 1999. The single-institution limit will be 4% throughout the transition period. Within two years of entry into force, Mexico will decide whether to authorize new types of limited-scope securities firms that would be subject to lower capital requirements.

In the **insurance** sector, the aggregate limit will rise from 6% in 1994 to 12% by 1999. The single-institution market limit will remain 1.5% throughout the transition period. US and Canadian insurance companies that enter into joint ventures with Mexican firms will be permitted to expand their equity participation on an accelerated schedule, reaching 51% in 1998 and 100% in 2000. Moreover, these investments will not be subject to either individual or aggregate limits.

The provision of cross-border financial services includes both the concept of the "mobility of provider" and the concept of the "mobility of consumer". Each NAFTA country must permit its citizens and residents to purchase financial services from providers located in other NAFTA countries. Except for insurance companies, Mexico may require that a Mexican subsidiary must be wholly owned by the US or Canadian parent institution. Mexico may also deny access to Canadian or US banks or securities firms that are affiliated with industrial or commercial corporations.

There are various provisions for the creation of limited-scope financial institutions that would be subject to less onerous capital requirements and less restrictive market share limits. Warehousing, bonding, foreign exchange and mutual fund management will not be subject to market share limitations.

The right to provide new financial services and to transfer information for data processing is also covered in the proposed agreement. No requirement to employ nationals in key positions will be allowed.

Finally, the proposed NAFTA does not constrain the right of each country to impose regulatory or restrictive measures for prudential reasons, in pursuit of monetary, credit or exchange rate policies, for balance of payments reasons or for taxation and social security purposes.

NOTES

1. This paper is based on a report produced by a World Bank mission to Mexico in which Roger Gordon and Robert Pardy also participated. The report was completed in March 1991. The paper includes a limited amount of updating, mainly to note some main recent developments in financial regulation.

2. This follows the free trade agreement between Canada and the U.S. that has already been in place for a number of years.

3. To give an overall quantitative perspective, the average price reduction in the cost of financial services for the EC as a whole was estimated, in a study conducted by Price Waterhouse, at 0.7% of GDP (1.5% for Spain alone).

4. In the EC, excluding interest payments or capital raised, credit and insurance services accounted in total for about 6% of intermediate inputs into industry.

5. Some of these arguments may explain, for example, the co-existence of small and large intermediaries in California, New York and other states with state-wide branching.

6. Before the new law, insurance companies were allowed 49% foreign ownership. These companies are now grandfathered.

7. To some extent this attitude may be explained by the fact that these sectors provide services to the majority of the local population and generate little foreign exchange earnings. It is worth noting that DFI in the hotel industry, which deals with foreign tourists, has been positively encouraged, in part, because it contributes to improve the current account of the balance of payments.

8. For a review of Canadian developments, see Friedman (1992).

9. For an official study supporting the proposed reforms, see U.S. Treasury (1991).

10. A succinct review of bank privatization in Mexico is provided in Barnes (1992).

11. For a review of bank structure in Canada see Kryzanowski and Roberts (1990).

12. For empirical tests of competition in Canadian banking see Nathan and Neave (1989) and Shaffer (1990).

13. Low initial capital requirements in small cities is one of the causes for the large number of commercial banks in the United States. There is now growing consensus that the fragmentation of the banking industry may have contributed to the widespread problems of nonperforming loans and insolvency that have afflicted the US banking system in recent years.

14. Allowing less than 10% equity holdings per foreign entity raises some tax issues (discussed in Section 6) so that consideration should be given to increasing the limit to 10% for all foreign participations.

15. The OCC is responsible for approving changes in control of national banks, the Federal Reserve Board for bank holding companies and state-chartered member banks, and the Federal Deposit Insurance Corporation (FDIC) for insured state-chartered banks that are not members of the Federal Reserve System.

16. See Appendix for a discussion of financial integration under the Canada-US FTA.

17. The distorted incentive effects of mispriced insurance schemes are widely discussed in the literature. See, for example Kareken and Wallace (1978), Sharpe (1978), Pyle (1983, 1984), and Kane (1985, 1989).

18. See Kaminow (1977) and Kanatas and Greenbaum (1982).

19. This section draws on Kane (1989), which contains a detailed discussion of the incentive structure of the US deposit-institution regulators and a reform proposal.

20. For a detailed discussion of these issues, see Vittas (1991).

21. A main reason for the lack of comparable data is the impact of the very high rates of inflation that prevailed in the mid-1980s. These led among other things to the introduction of new products that evaded the restrictive banking regulations but created difficult accounting issues.

22. Indeed, the Wall Street Journal reported that "privatized Mexican banks found many undisclosed problem loans" (5/15/1992).

23. This limit was set for a couple of years at 49%. These companies are now grandfathered.

24. OECD (1991).

25. The ten largest US companies account for almost 40% of premiums in the life sector and for nearly 50% in nonlife business. In Canada (as in most European countries) the concentration ratio of the largest ten companies is well over 55% in life and, with few exceptions, less than 50% in nonlife insurance (Economist, 1990).

26. Comments made at a meeting of the International Insurance Council in New York on February 28, 1991 to review insurance developments in Latin American countries.

27. Premium regulation in the United States used to emphasize minimum tariffs to prevent deceptive policies and insolvencies. But since the mid-1970s, regulators have allowed greater price competition among insurance companies. In recent years, regulators in several states have shown increasing concern about "excessive" increases in premiums. For an excellent review of insurance regulation in the United States, see Meier (1988).

28. Proposition 103 was voted by Californian residents in November 1988. It mandated a rollback of 20% in most property and casualty rates, including motor insurance, and established tougher rules for rate setting. However, the impact of Proposition 103 has been watered down by court decisions, following appeals by insurance companies.

29. Market estimates quoted in Economist (1990).

30. See Joskow (1973).

31. World Bank (1990).

32. For US property and casualty companies, loss reserves increased from 30% of equity in 1940 to almost 180% of equity in 1988 (Bath, 1990).

33. The expense ratio is not expressed in this paper as a percentage of direct premiums (as is the customary practice) but as a percentage of earned premiums. This tends to overstate the ratio because earned premiums are equal to direct premiums less net premiums ceded to reinsurance less transfers to unearned premium reserves. The overstatement is greater, the larger the net reinsurance ceded and the lower the retention ratio.

34. These ratios are unweighted averages of annual ratios and differ slightly from those published in Best Aggregates and Averages.

35. The high level of the ratio may be explained by the use of earned premiums as the denominator. Expressed as percentage of direct premiums, the expense ratio was 33.4%.

36. OECD (1991).

37. In addition, mutual recognition of home-country disclosure requirements has been the basis of discussions among the US, Canada, and the UK for several years.

38. It includes prudential regulation and supervision.

39. In this respect, it is somewhat ironic that liberalization in international trade and DFI in financial services is actively promoted, while restrictions continue to be applied on domestic trade and direct investment between political subdivisions of individual countries. One would have thought that gains in efficiency and welfare would be as likely to result from freer international trade as from freer domestic trade.

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