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Cross-Border Bank Branching Under the NAFTA: Public Choice and the Law of Corporate Groups

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I. INTRODUCTION

When representatives of the United States, Canada, and Mexico signed the North American Free Trade Agreement[1] (NAFTA) in 1992, they created the largest free trade zone in the world.[2] On items ranging from automobile parts to water, from saw logs to beer, the negotiators crafted a workable document that represented compromises by all parties, but which was nevertheless minimally acceptable to all. As might be expected, on the specific issue of trade in financial services the NAFTA fashioned an acceptable, but incomplete compromise.

The promise of increased cross-border trade brings with it the need for cross-border financial services. In 1988, the United States-Canada Free Trade Agreement took the historic step of addressing trade in financial services in addition to trade in merchandise, and the NAFTA followed suit.[3] The willingness of the North American negotiators to address issues of trade in services marked a significant departure from typical trade negotiations where the focus is on the trade of goods rather than the trade of services.[4]

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1. North American Free Trade Agreement, Dec. 17, 1992, U.S.-Can.-Mex., 32 I.L.M. 289.

2. *See* Linda Powers, *NAFTA and the Regulation of Financial and Other Services*, 1 U.S.-MEX. L.J. 65, 66 (1993) (noting that the NAFTA is a free trade area only, not a common market).

3. *See* WILLIAM R. WHITE, THE IMPLICATIONS OF THE FTA AND NAFTA FOR CANADA AND MEXICO 9 (1994) ("The FTA was a path-breaking agreement in that it explicitly treated the issue of trade in financial services and accepted the principle of national treatment rather than reciprocity."); *see also* Cally Jordan, *Financial Services Under NAFTA: The View From Canada*, 9 REV. OF BANKING AND FIN. SERVICES, Mar. 24, 1993, at 45, 51 n.39 (noting that NAFTA marks the "first ever principles-based approach to trade liberalization" in financial services, as opposed to the "à la carte approach pursued under the FTA").

4. Of course, by the time the FTA and the NAFTA were negotiated, all of the North American economies were solidly based on the provision of services rather than the trading of goods, so all the

Drafting trade agreements that cover services is always difficult because of issues such as defining what constitutes a service, figuring out where it is performed, and finding equitable treatment for labor-intensive as opposed to capital-intensive services.[5] The challenge of drafting an acceptable document covering trade in financial services in North America was made even more daunting by the very different banking markets in the three signatory countries.[6] The United States and Canada have solid, well-established banks and stable currencies, while Mexico's modern banking industry is still in its infancy and the peso is somewhat volatile. Canada and Mexico both have relatively concentrated banking markets in which banking organizations are free to offer a broad range of financial services, while the United States banking industry shares neither of those attributes.[7]

Despite these serious obstacles, the NAFTA negotiators were able to agree on a framework for trade in financial services in the North American free trade zone. Although the NAFTA potentially covers all providers of financial services, this article focuses specifically on the banking industry. The NAFTA gives banks from each of the member nations access to the banking markets of the other member nations. At present, U.S. access to the Mexican and Canadian markets can be accomplished only through the establishment of a new subsidiary. Of course, Mexican and Canadian banks may also expand into the United States by establishing a *de novo* bank or by acquiring an existing institution. In addition to these methods, however, Mexican and Canadian banks are permitted to branch into the United States, although like all foreign banks they are subject to an extensive system of U.S. regulation as part of the price of expansion through branching. In practice, the foreign branching regulations are so onerous that it often makes more sense for foreign banks to establish a

countries recognized that they needed to address the issue. *See* Valerie J. McNevin, *Policy Implications of the NAFTA for the Financial Services Industry*, 5 COLO. J. INT'L ENVTL. L. & POL'Y 369, 377 n.37 (1994) (noting that services are the dominant U.S. export and that services account for 60% of Mexican GDP).

5. For a general discussion of the difficulty in negotiating agreements regarding trade in services, see Jeffrey Simser, *GATS and Financial Services: Redefining Borders*, 3 BUFF. J. INT'L L. 33 (1996) (relating some of the historic, economic and political forces that shaped the development of the General Agreement on Trade in Services).

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

7. The United States market is served by thousands of banks and thrifts, and stands almost alone among the Western countries in its division between commercial and investment banking. *See* WILLIAM JACKSON, CONGRESSIONAL RESEARCH SERVICE, GLASS-STEAGALL ACT/FINANCIAL MODERNIZATION ISSUES IN THE 105TH CONGRESS, CRS-16 (1997). In most countries, banking organizations may engage in securities activities either directly through the bank itself, or, as in Canada, through a securities affiliate in a holding company organization. *See id.*

subsidiary rather than a branch.[8] A question left open by the NAFTA, therefore, is whether the banks of the member nations should be permitted to expand across national borders through a true branch as opposed to a subsidiary network or the currently burdensome U.S. branching regulations.[9]

This article examines the issue of cross-border branching. It starts with a brief overview of the banking markets and regulatory approaches in the three countries, then it turns to a discussion of how the NAFTA changed the regulatory landscape. It proceeds to examine the branching question in light of the theoretical considerations of enterprise liability, the moral hazard problem, and public choice. It concludes that in a perfect world, a scheme of cross-border branching would be the preferred approach to bank expansion in North America. However, in the real world the banking regulators of the member countries will be reluctant to give up any authority and the financial services providers in the member countries will do what they can to preserve the non-tariff barriers to trade that already exist, one of which is the restriction on branching. As a result, nothing will change on the NAFTA branching issue until other concessions, perhaps involving securities or insurance, tip the balance.

II. THE BANKING MARKETS AND APPROACHES TO REGULATION IN THE NAFTA COUNTRIES

The three NAFTA countries have three very different banking markets. These markets have been shaped by each country's unique history and politics. The regulatory schemes of the three countries have also molded the banking markets within their respective borders. This section provides a brief summary of the banking markets and the regulatory schemes in the three NAFTA countries.

A. *The United States*

The banking market in the United States is unusual by international standards. The two most distinctive features of the U.S. market are the large number of financial institutions and the existence of barriers between commercial and investment banking. To serve the twin goals of promoting the development of a dispersed and locally-controlled banking system while at the same time insulating the business of banking from

8. *See infra* text accompanying notes 128-35.

9. NAFTA, *supra* note 1, art. 1403(1), 32 I.L.M. at 657 (stating that access to banking markets should be through the choice of juridical form chosen by the investor); NAFTA, *supra* note 1, art. 1403(3) (agreeing to review branching restrictions after the United States provides for nationwide branching).

other commercial activities, the U.S. federal banking regulators have focused a significant amount of energy on the regulation of bank holding companies.[10] Bank holding companies evolved in the United States for a number of reasons, but most importantly to overcome restrictions on branching or interstate ownership of banks or as a way to circumvent restrictions on permissible bank activities.[11] I will discuss these two aspects of the U.S. banking system in turn.

We have almost 12,000 banks and thrifts in this country[12]—an extraordinarily large number by comparison to other developed countries. Recent consolidation in the banking industry notwithstanding, the United States is not home to the world's largest banks and that is in part a choice shaped by regulatory policy. There are many possible explanations for the multitude of banks, such as the ongoing constitutional struggle between the central government and the states, or the ingrained American distrust of concentrated economic power.[13] These historical and political factors certainly contributed to the most easily identifiable cause of having many banks in the United States: prohibitions on bank branching. Until quite recently, the United States had a patchwork quilt of branching schemes. Some states essentially prohibited branching and instead required that every banking location be a free standing, individually chartered and capitalized bank. The goals of this approach, called "unit banking" were two-fold: first, to lend stability to the banking system; and second, to provide insulation to country banks from the potential state-wide domination of city banks.[14]

The unit banking idea, however, was relatively easy to circumvent. By using a holding company, one banking organization could exercise

10. The hallmark of U.S. federal banking regulation is the Bank Holding Company Act (the "BHCA"). *See* 12 U.S.C. §§ 1841-1848 (1997).

11. *See* Robert Charles Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 787, 816-17, 822-23 (1979) (noting that bank holding companies have been employed as a means to achieve branching where states had restrictive branching laws, interstate ownership when that was not permitted by law, and entry into businesses "closely related" to banking).

12. *See* General Accounting Office, Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U.S. Structure, 21 (1996) [hereinafter GAO Oversight Structure].

13. *See* PETER S. ROSE, BANKING ACROSS STATE LINES: PUBLIC AND PRIVATE CONSEQUENCES 1-2 (1997) (expressing the view that the regulatory scheme and the fear of concentrated economic power combined to produce the atomized U.S. banking industry). By lucky coincidence, the fact that banks do not dominate our national financial scheme may be at least partially responsible for the strong securities markets and venture capital firms in the United States that permit new companies to take root, prosper, and ultimately be sold off to the investing public. *See* Bernard S. Black and Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. (forthcoming, 1998).

14. This scheme is referred to as "unit banking" and the two states most closely associated with this approach were Texas and Illinois, but it once was the predominant approach to branching in the United States. *See* JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION, 12-15 (2d ed. 1997).

control over a large group of separately chartered institutions.[15] During the Great Depression, states began to liberalize their branching statutes to permit state banks to branch within the state, and federal law was amended to give national banks the same branching privileges as state banks.[16] In general, however, even as branching laws became more permissive, banks were not permitted to branch across state lines. Even as interstate banking began to take hold in the late 1970s and 1980s, the only method available for banking organizations to enter a new state was to either form a *de novo* bank in the state or to acquire an existing bank there.[17] Of course, banking organizations that desired to engage in the business of banking in more than one state could form holding companies to own separately chartered institutions in different states.[18]

Today, the branching picture is very different. On the state level, virtually all states now permit state-wide branching.[19] On the interstate level, the Riegle-Neal Interstate Banking and Branching Efficiency Act,[20] which went into effect on June 1, 1997, has essentially superseded the old McFadden Act and Douglas Amendment provisions. The Riegle-Neal law permits nationwide interstate branching, thereby negating the requirement that holding companies operating in several states have a bank chartered in each of those states.[21] Therefore, in the current regulatory environment, the holding company structure is much less important for the purposes of overcoming branching and interstate banking restrictions.[22]

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15. *See* Clark, *supra* note 11, at 816-17 (noting that bank holding companies have been employed as a means to achieve branching where states had restrictive branching laws).

16. *See* MACEY & MILLER, *supra* note 14, at 23, 25-26. Under the McFadden Act, 12 U.S.C. § 36 (1988), national banks were permitted to branch only to the extent of state-chartered banks located in their home state.

17. This was the result of the so-called Douglas Amendment to the Bank Holding Company Act, 12 U.S.C. § 1842(d) (1988), which permitted interstate acquisitions only if expressly provided for in the banking law of the target state. *See* ROSE, *supra* note 13, at 33-35.

18. *See* Clark, *supra* note 11, at 18 (noting the use of the holding company device as a way to get around interstate banking restrictions).

19. As of the end of 1994, there were no more unit banking states and only two states that did not permit branching on a state-wide basis. *See* Dean F. Amel, *Trends in the Structure of Federally Insured Depository Institutions, 1984-94*, Fed. Res. Bull. 3 (Jan. 1996).

20. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (1994) (codified throughout Title 12 United States Code).

21. Only Texas and Montana have opted to delay implementation of the Riegle-Neal branching provisions. Texas has delayed interstate branching until September 1999 and Montana has postponed it until October 2001. *See* Bill McConnell, *Interstate Starts Sunday; Impact Will Take Longer*, AM. BANKER, May 30, 1997, at 2 (noting the decision to delay in Texas and Montana).

22. Indeed, several banking organizations have already combined their numerous state-chartered bank subsidiaries into one bank to take advantage of the benefits afforded by the Riegle-Neal law. Many large banking firms have decided to consolidate all of their bank charters into one institution, thereby in essence becoming single bank holding companies, or alternatively, shedding the holding company structure altogether to operate as a bank with subsidiaries. *See* Brett Chase, *As Milestone Nears, Banks Prepare to Centralize*, AM. BANKER, May 15, 1997, at 4. For example, Minneapolis-

The other great distinguishing feature of the U.S. banking system is the scheme of product differentiation embodied in various state and federal statutes, the most notorious of which is the so-called Glass-Steagall wall.[23] Although this law was designed to separate commercial banking and investment banking, in the past few years observers of the U.S. banking scene have witnessed significant erosion of that distinction.[24]

While the role of the holding company as a component of geographic expansion regulation is falling away, its role in the regulation of permissible activities continues. The Bank Holding Company Act reinforces the Glass Steagall act by erecting a barrier between a bank and the other affiliates owned by the same corporate group.[25] Transactions between members of the holding company group are subject to special restrictions.[26] The goal of the "firewalls" constructed between the bank and the other affiliates in the holding company is to insulate the bank financially and operationally from the other activities being carried on in

based First Bank System, Inc. will combine most of its nine banks into one charter. *See id.* KeyCorp, headquartered in Cleveland, will merge its twelve bank subsidiaries into one. *See id.* Other banks taking advantage of consolidation include Wells Fargo & Co., BankAmerica Corp., and First Union Corp. of Charlotte. *See id.*

23. The "Glass-Steagall wall" essentially consists of four key provisions, referred to by the section numbers the provisions had in the original Glass-Steagall Act, namely §§ 16, 20, 21 and 32. Section 16 limits the involvement of national banks and state banks that are members of the Federal Reserve System in the "dealing of stock and securities," and prohibits them from purchasing securities for their own account (except those approved by the Comptroller of the Currency), and from underwriting any issue of securities or stock. 12 U.S.C. § 24 (1988 & Supp. 1996). Section 20 prohibits the affiliation of any member of the Federal Reserve System with any business "engaged principally" in the issuance, floatation, underwriting, public sale or distribution of securities. 12 U.S.C. § 377 (1988). Section 21 is essentially the mirror image of § 16, prohibiting persons "engaged in the business of issuing, underwriting, selling or distributing securities" from engaging in the "business of receiving deposits . . . ." 12 U.S.C. § 378(a)(1)(1988). Section 32 prohibits persons "engaged in the business of issuing, floating, underwriting, selling or distributing securities from serving as officers, directors or employees of Federal Reserve System member banks." 12 U.S.C. § 78 (1988).

24. *See generally* THE NEW BUSINESS OF BANKING: WHAT BANKS CAN DO NOW (Julie L. Williams, et al. eds, 1996) (giving an in-depth description of the various securities and insurance powers permitted to commercial banks).

25. *See* Board of Governors of the Fed. Reserve Sys. v. Investment Co. Inst. (ICI II), 430 U.S. 46, 71 (1981) (stating that one of the purposes of the Bank Holding Company Act was to sever the connection between bank holding companies and affiliates principally engaged in securities activities).

26. Sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c to c-1 (1994), impose significant restrictions on transactions among affiliates within a holding company organization. Section 23A restricts transactions such as loans or extensions of credit, purchase of securities or other assets, and the issuance of various kinds of accommodation between a bank and an affiliate unless they meet certain quantitative and qualitative limits. *Id.* Section 23B extends the restrictions in 23A by prohibiting certain transactions outright and subjecting additional transactions to a test that they be on terms comparable to those that would obtain in an arm's length transaction. *See* MACEY & MILLER, *supra* note 14, at 398-401.

the holding company organization.[27] By providing that insulation, the law aims to avoid the "subtle hazards" and conflicts of interest that may arise when one organization controls a bank and other businesses that might be tempted to exploit the banks resources.[28]

Yet even with the restrictions contained in the BHCA, U.S. commercial banks already participate in a range of businesses outside of the traditional lending and deposit-taking activities that constitute the core of the commercial banking business. By statute, bank holding companies are allowed to participate in activities "closely related" to banking provided those activities produce public benefits.[29] The Federal Reserve Board has promulgated Regulation Y to specify that "closely related" activities include such things as acting as investment advisor to mutual funds, leasing property, providing data processing services, providing courier services, performing real estate appraisals, providing investment advice on financial futures and options, and providing tax preparation services.[30] Bank holding companies are now permitted, among other things, to provide discount brokerage services,[31] and to underwrite (on a limited basis) mortgage-backed securities,[32] municipal revenue bonds,[33] and corporate securities.[34] Recently, the Federal Reserve Board has loosened the restrictions between banks and their securities affiliates

27. *See* ROBERT A. EISENBEIS, *Commentary*, *in* RESTRUCTURING BANKING AND FINANCIAL SERVICES IN AMERICA 203, 206 (William S. Haraf & Rose Marie Kushmeider eds. 1988) (describing the two types of insulation).

28. *See* Investment Co. Inst. v. Camp, 401 U.S. 617 (1971). Possible subtle hazards that have been identified in the scholarly treatment of the subject include: the potential for biased advice to clients designed to benefit the holding company's non-banking operations; uneconomical transfers, such as bank loans to troubled holding company subsidiaries; bank trust department securities transactions designed to bolster the offerings of an investment bank affiliate; predatory practices and collusion between the bank and other affiliates designed to injure other competitors of the affiliates; and the possibility of tying arrangements by which bank services and products would only be available in conjunction with the purchase of affiliates' products and services, perhaps at an above-market price. *See* Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 323-30 (1987) (discussing the "subtle hazards" suggested by the Camp decision); *see also* James R. Smoot, *Striking Camp and Moving to Higher Ground: The Hazardous Subtleties of "Subtle Hazards" in Bank Regulation*, 4 GEO. MASON L. REV. 1, 38-40 (1995) (discussing "subtle hazards" in light of the Camp decision and the history of the Glass-Steagall Act).

29. 12 U.S.C. § 1843(c)(8) (1996).

30. 12 C.F.R. § 225.25 (1996).

31. *See* Securities Industry Ass'n v. Board of Governors of the Federal Reserve System (Schwab), 468 U.S. 207 (1984); 12 C.F.R. § 225.125(h) (1997).

32. *See* Citibank, 73 Fed. Res. Bull. 473 (1987), *aff'd sub nom.* Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 839 F.2d 47 (2d Cir. 1988).

33. *See* Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988).

34. *See* J.P. Morgan, 75 Fed. Res. Bull. 192, 195 (1989).

within the holding company structure.[35] In addition, the Federal Reserve has completely overhauled Regulation Y, the regulation that covers bank holding companies, with an eye toward loosening existing restrictions and adding new activities to the list of those approved as being "closely related to banking."[36]

Seeking to go further than the Federal Reserve, the Office of the Comptroller of the Currency recently blessed the use of operating subsidiaries for national banks,[37] thereby making the holding company structure less important as a way to get around restrictions on bank activities.[38] In light of these revolutionary changes, there is talk in Washington of abandoning the traditional product market distinctions altogether and developing the idea of "Financial Institution Holding Companies."[39]

If recent experiences with banking reform are any guide, the success of the new proposals will depend in significant part on how well they balance the interests of the myriad state and federal regulators that have a

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35. *See* Review of Restrictions on Director and Employee Interlocks, Cross-Marketing Activities and Purchase and Sale of Financial Assets, 61 Fed. Reg. 57,679 (1996) (easing or eliminating: (1) the prohibition on personnel interlocks between a bank and a securities affiliate of a bank holding company; (2) the restrictions on joint marketing activities between a bank and a securities affiliate; and (3) the restrictions on the purchase and sale of financial assets between a bank and a securities affiliate.); Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750 (1996) (increasing from 10% to 25% the amount of total revenue that a nonbank subsidiary of a bank holding company may derive from underwriting and dealing in securities that the bank is prohibited from dealing in).

36. Melanie L. Fein, *Fed's Proposed Overhaul of Regulation Y Goes Far, But Could Be Bolder*, 15 BANKING POL'Y. REP. 4 (Oct. 21, 1996) (describing the proposed changes to Regulation Y). The Fed's initiative seems to be influencing the expansion plans of players in the banking industry. *See With Rules Eased, Banks Flock to Securities Underwriting*, AM. BANKER, Aug. 18. 1997, at 1 (noting the acquisition of securities firms by large banks and the strategic changes in regional banks' plans).

37. *See* 61 Fed. Reg. 60,342 to 60,387 (1996). The Comptroller of the Currency has promulgated a regulation that permits national banks to form operating subsidiaries that may engage in several new activities, such as equipment leasing, insurance, real estate brokerage, real estate development, and securities underwriting. *See id.* Given that most states have parity or "wild card" statutes which by law grant their state-chartered institutions powers at least as liberal as the powers given to national banks, *see* CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 156-58 (1996), the extent of liberalized banking powers in the banking system as a whole is quite extensive.

38. *See* McConnell, *supra* note 21 (noting that some banks plan to convert to a national charter, establish operating subsidiaries, and shed their holding company structure).

39. As of this writing, the House of Representatives appeared to be making progress on a financial services modernization bill that accommodates all the necessary parties. *See* Jeffrey Taylor, *House Is Close to Deal on Leveling Walls Among Banks, Securities Firms, Insurers*, WALL ST. J., Mar. 5, 1998, at A2. It is unlikely that the House bill will be considered by the Senate in this session. *See id.* Earlier in the 105th Congress, the Financial Services Competitiveness Act of 1997, H.R. 10, 105th Cong. (1997), the Depository Institutions and Thrift Charter Conversion Act, H.R. 268, 105th Cong. (1997), and the Depository Affiliation Act, H.R. 669 & S. 298, 105th Cong. (1997) were all proposals that would have restructured the regulation of banking to permit closer affiliations between banks and securities firms.

stake in the financial services market. At the federal level there are four important bank regulators, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).[40] In addition to the federal banking regulators, every state has a state-level banking regulator as well. In the securities industry, the picture is similar. Federal regulation is primarily the responsibility of the Securities and Exchange Commission (SEC), but each state has a securities regulator to carry out the state "blue sky" law. In insurance, there is no federal regulation, just state level insurance regulators. From a political perspective, the changing role of bank holding companies raises interesting turf battles among the major federal banking regulators.[41] Because the Federal Reserve Board is charged with supervision of bank holding companies while the OCC, OTS, and FDIC are focused on banking institutions, the Federal Reserve Board feels quite threatened by the declining importance of the holding company structure. The regulatory competition picture is more complicated, however. Because the banking regulatory adjustments are being made at the same time changes to Glass-Steagall are under consideration, the turf battles will necessarily include the various state and federal regulators who have some involvement in the securities and insurance industries. The political melee may come to resemble the war of all against all.

B. *Canada*

Canada's banking industry presents a radical contrast to the U.S. banking scene. All banks are federally chartered and fall into one of two categories: "Schedule I" or "Schedule II" banks.[42] So-called Schedule I banks are subject to the "widely-held" rule: no person or group may control more than ten percent of the voting stock of a Schedule I bank.[43] Instead of the thousands of independent banks found in the United States, Canada is dominated by six large Schedule I institutions with nationwide

40. To this list some would add the Treasury Department generally. *See* GAO Oversight Structure, *supra* note 12, at 27.

41. *See* John C. Coffee, Jr., *Competition versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447, 447-48 (1995) (chronicling the turf wars that erupt whenever serious proposals to reform U.S. banking law are advanced).

42. *See* Bank Act, R.S.C., ch. B-1.01, § 14 (1996) (Can.); *see also* Jordan, *supra* note 3, at 46 (noting that when a bank is chartered in Canada, the bank's name must be added to either Schedule I or Schedule II of the Bank Act).

43. *See* Bank Act, R.S.C., ch. B-1.01, § 370(2) (1996) (Can.) (defining "widely held").

branching networks.[44] Schedule II banks, on the other hand, may be closely held and owned by non-Canadians.[45]

In addition, unlike American banks but similar to their Mexican counterparts, Canadian banking organizations are not constrained by the artificial product line distinctions found in the Glass-Steagall Act. Under present Canadian law, banks, insurance companies, and securities firms are permitted to own one another and to provide services to the public through separate subsidiaries in a holding company structure.[46] While the separate subsidiary requirement provides some financial insulation for the bank, the operational insulation required by U.S. law is lacking.

The lines of command in the Canadian bank regulatory scheme are much clearer than in the American regulatory system. In Canada, a federal banking supervising agency whose head is appointed by the cabinet and who reports directly to the Minister of Finance, is the chief banking regulator.[47] The federal supervisor is responsible for all federally chartered financial institutions including banks, insurance companies and trust companies, while sharing responsibility with the provinces for oversight of securities firms.[48] The Canadian federal deposit insurer plays a secondary role in bank oversight, while the Bank of Canada maintains data on the financial system generally and on banks individually.[49]

Another big difference between U.S. banks and their Canadian competitors is the weight of the regulatory burden shouldered by each. Although it is an imprecise measure, the differing volume of banking legislation in the two countries speaks to the difference in regulatory attitudes. In the early 1990s, U.S. federal banking laws and regulations totaled approximately 220,000 pages, while in Canada the entire Bank Act and associated regulations amounted to no more than 530 pages.[50] This might not be surprising in light of the deep concern in U.S. banking policy

44. These six institutions are the Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, Royal Bank of Canada, and Toronto Dominion Bank. *See* James R. Kraus, *Canadian Government's Fears of Concentration Seen Threat to Megadeal*, AM. BANKER, Feb. 12, 1998, at 20.

45. *See* Jordan, *supra* note 3, at 48 (observing that virtually all Schedule II banks are foreign-controlled bank subsidiaries).

46. *See id.* at 50 (noting the "Canadian model" of universal banking as securities and banking activities being conducted through a parent-subsidiary structure).

47. *See* GAO Oversight Structure, *supra* note 12, at 57.

48. *See id.* at 62.

49. *See id.* at 57.

50. *See* John C. Pattison, *Trade in Financial Services In NAFTA: A Public Choice Approach, in* REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN THE NAFTA COUNTRIES AND BEYOND 145, 148-49 (George M. von Furstenberg ed., 1997).

over branching and activities, both of which are not important issues in Canada.[51]

C. *Mexico*

The Mexican banking system is perhaps best described as a work in progress. Years of political and economic turmoil in Mexico from its colonial past, through the tumultuous nineteenth century, and into the present time have stacked the odds against a stable banking system.[52] Throughout its history, Mexico has been dependent on foreign capital for economic development. Perhaps in an effort to reclaim Mexico from foreign influence, the Mexican Constitution of 1917 established substantial restrictions on foreign investment in Mexico, basically setting aside such major industries as petroleum, railways, and electricity for either the Mexican government or Mexican nationals.[53]

Although the constitution and subsequent foreign investment laws did not set aside banking as a Mexican-only activity, as a practical matter the banking industry in Mexico was concentrated in the hands of a few powerful families.[54] In 1973, Mexico passed the Law for the Promotion of Mexican Investment and the Regulation of Foreign Investment (FIL), which contained a provision essentially requiring all economic enterprises doing business in Mexico to have 51% Mexican ownership.[55]

During the oil boom of the 1970s, Mexico incurred a huge foreign debt. When oil prices slid and interest rates rose in the early 1980s, Mexico's public and private borrowers were unable to make their payments.[56] In a surprise move, on September 1, 1982, Mexico

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51. Another explanation for the difference is the willingness of Canada's banks to adopt voluntary guidelines in order to prevent the need for legislated solutions to perceived problems. *See* GAO Oversight Structure, *supra* note 12, at 72 (noting the voluntary adoption by Canadian banks of consumer and small business lending guidelines to prevent legislative solutions).

52. Mexico won its independence from Spain in 1821, after three centuries of Spanish exploitation that did little to establish an independent economy in Mexico. *See* Carlos M. Nalda, Note, *NAFTA, Foreign Investment, and The Mexican Banking System*, 26 GEO. WASH. J. INT'L L. & ECON. 379, 380-81 (1992). In the 1800s Mexico resisted an invasion from Spain, two invasions from France and significant border battles and outright war with the United States. *See id.*

53. *See* Jorge Camil, *Mexico's 1989 Foreign Investment Regulations: The Cornerstone of a New Economic Model*, 12 HOUS. J. INT'L L. 1, 6 (1989).

54. *See* Ewell E. Murphy, Jr., *Expropriation and Aftermath: The Prospects of Foreign Enterprise in the Mexico of Miguel de la Madrid*, 18 TEX. INT'L L.J. 431, 440-41 (1983).

55. *See* Nalda, *supra* note 52, at 382-83.

56. *See* Bronwen Davis, Comment, *Mexico's Commercial Banking Industry: Can Mexico's Recently Privatized Banks Compete With the United States Banking Industry After Enactment of the North American Free Trade Agreement?*, 10 ARIZ. J. OF INT'L & COMP. L. 77, 78-79 (1993) (noting the boom and bust cycle).

nationalized the banking system.[57] Over the next eight years, the Mexican government made significant economic reforms and reduced state ownership of industries and state control of banking. Beginning in 1990, Mexico reprivatized the eighteen state controlled banks, finishing the process in 1992 with a generous profit for the Mexican government.[58]

After reprivatization, Mexican banks grew at a furious rate.[59] Most banks were owned by financial groups dominated by securities firms with high risk tolerances. Bank managers likely felt pressure to recover the rich premiums paid to acquire the banks.[60] Consequently, loan quality dropped while loan growth soared. Once the bubble-nature of the bank growth became clear, however, banks significantly increased their loan loss reserves.[61] The devaluation of the peso in late 1994, together with the credit quality problem, sent Mexico's banks into crisis. In response to the crisis, international and Mexican banking concerns took action that stabilized the Mexican banking system.[62] The repercussions of the 1994 crisis are still being felt, although Mexican banks have shown a revival and demand for peso-denominated loans has been increasing.[63]

At the time of the NAFTA's negotiation, Mexico's banking market was dominated by six large nationwide institutions, with seven smaller regional banks playing a secondary role.[64] Mexican banks may branch anywhere in the country. Banks may be owned by financial groups that

57. *See* John P. Cogan, Jr., *Privatization of the Mexican Banking System: Quetzalcoatl and the Bankers*, 23 ST. MARY'S L.J. 753, 754 (1992).

58. *See* Davis, *supra* note 56, at 87-89 (chronicling the privatization process and noting that the Mexican government earned $12.9 billion on the sale of the banks).

59. *See* Roy A. Karaoglan & Mike Lubrano, *Mexico's Banks After the December 1994 Devaluation—A Chronology of the Government's Response*, 16 NW. J. INT'L L. & BUS. 24, 25-26 (1995) (reporting that during the period 1991-94 assets of Mexican banks grew 111.3% in nominal terms, and 64.6% in real terms, equal to a real annual growth rate of 18.1%).

60. *See* Stephen L. Fluckiger, *The Mexican Banking Crisis: Remedies and Opportunities*, 50 CONSUMER FIN. L.Q. 76 (1996) (reporting the dominance of the securities firms and pressure on bank management).

61. *See* Karaoglan & Lubrano, *supra* note 59, at 27.

62. *See generally* Javier Gavito et al., *Mexico's Banking Crisis: Origins, Consequences and Countermeasures, in* REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN THE NAFTA COUNTRIES AND BEYOND (George M. von Furstenberg ed., 1997) (providing a detailed history of the peso crisis and the response thereto); Leslie M. Norwood, Note, *International Banking—U.S. Banks Operating Abroad*, 15 ANN. REV. BANKING L. 169, 173-174 (1996) (describing the peso devaluation and the subsequent international intervention to address it); Karaoglan & Lubrano, *supra* note 59 (describing the government's response to the peso devaluation); *see also* Fluckiger, *supra* note 60 (outlining the regulatory changes brought about by the crisis).

63. *See* Craig Torres, *Mexico's Banking System Is Having A Revival—Loan Demand Rises Among Businesses*, WALL ST. J., Jan. 28, 1998, at A12.

64. *See* Nalda, *supra* note 52, at 388 (noting the existence of six national and seven multi-regional banks).

own other financial services firms such as securities and insurance companies.[65]

Mexico's banks and securities firms are regulated by Mexico's central bank, the Ministry of Finance and Public Credit and the primary regulator, the National Banking and Securities Commission (CNBV).[66] The states of Mexico do not play an active role in the regulation of financial institutions.

III. HOW THE NAFTA CHANGED THE LANDSCAPE

In many ways it seems that the NAFTA banking provisions have been *much ado about nothing*. Despite the exaggerated claims, both positive and negative, that accompanied the passage of the NAFTA,[67] the empirical data since the passage of the Agreement suggests that the North American financial services market is not radically different.[68]

The NAFTA was intended to give the member nations broad access to each other's markets. The banking provisions of the NAFTA are based in large part on the banking provisions of United States-Canada Free Trade Agreement (FTA).[69] The foundational ideas of both treaties are national treatment[70] and most favored nation status.[71] As between the United States and Canada, the NAFTA added little to the existing relationship memorialized in the FTA, but it did add important provisions framing the relationship of the two countries with the Mexican banking system. What

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65. *See* Ramon Bravo, *Mexican Legal Framework Applicable to Operations Involving Financial Services*, 25 ST. MARY'S L.J. 1239, 1243 (1994) (reporting that Mexican financial groups may consist of general deposit warehouses, financial lessors, factoring companies, limited scope financial entities, exchange houses, bonding companies, insurance companies, brokerage firms and banks).

66. *See* Karaoglan & Lubrano, *supra* note 59, at 28-29 (describing the Mexican bank regulatory system).

67. *See* McNevin, *supra* note 4, at 382 (noting the "exaggerated and extravagant expectations regarding the possible negative and positive effects of the NAFTA").

68. *See* Daniel E. Nolle, *Integration and Globalization of the Canadian and U.S. Banking Industries: A Modest Role for NAFTA? in* REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN THE NAFTA COUNTRIES AND BEYOND 159, 160-64 (George M. von Furstenberg ed., 1997) (showing that there has been no significant change in the amount of U.S. banking activity in Canada or Canadian banking activity in the U.S. since the passage of the NAFTA).

69. United States-Canada Free Trade Agreement, Jan. 2, 1988, U.S.-Can., 27 I.L.M. 281. In fact, several provisions of the FTA were incorporated into the NAFTA by reference. *See* NAFTA, *supra* note 1, art. 1401(4), annex 1401.4.

70. *See* NAFTA, *supra* note 1, arts. 1405, 1406. In a nutshell, national treatment means that the people and companies of one country will be treated in the same way and be subject only to the same restrictions as citizens or companies of the host country. *See* Kenneth L. Bachman et al., *Financial Services Under the North American Free Trade Agreement: An Overview*, 28 INT'L LAW. 291, 294 (1994).

71. *See* NAFTA, *supra* note 1, art. 1406(1). Most favored nation status insures that where the host country confers favorable treatment to a non-NAFTA country, the NAFTA member countries will also receive the same favorable treatment. *See* Bachman et al., *supra* note 70, at 295.

follows is a summary of the changes the NAFTA brought about within the confines of the existing banking regimes in the three signatory countries.

A. *The United States*

Under the NAFTA, Canada and Mexico's access to the United States banking market did not change in any material way. The United States already extended national treatment to all foreign banking organizations doing business in the United States.[72] Before the treaty both Canadian and Mexican banks had access to the U.S. market on terms similar to those available to all other countries. Under the FTA, however, the United States granted Canada a concession under the Glass-Steagall act to treat Canadian government securities as "bank eligible" securities.[73] Under the NAFTA, however, the United States did not extend that same treatment to Mexican government securities.[74]

On the other hand, Mexican financial holding companies that, as of January 1, 1992, owned a Mexican bank with U.S. operations and also owned a Mexican securities firm that owned or controlled a U.S. securities firm were grand-fathered to offer both brokerage and banking in the United States for five years without being a violation of Glass-Steagall.[75] Otherwise, Mexican banks entering the U.S. market are treated as any other foreign bank doing business in the United States.

B. *Canada*

Under the FTA, U.S. banks gained preferential access to the Canadian banking market. Although the FTA did not make any meaningful changes in the access of Canadian banks to the U.S. market,[76] it did provide U.S. banks with rights not shared by non-Canadian banks generally. In effect, it provided national treatment in Canada for U.S. banks that were established there. As a result of the FTA changes, U.S. banks were no longer subject to the foreign ownership restrictions of the Bank Act.[77] The

72. Although national treatment is the official view, the United States has sometimes articulated a policy of reciprocal national treatment. *See* Eric Palace, *International Banking—Foreign Banks Operating in the United States*, 14 ANN. REV. BANKING L. 154, 164 (1995).

73. *See* U.S.-Canada Free Trade Act, *supra* note 69, art. 1702.

74. *See* Bachman et al., *supra* note 70, at 311.

75. *See id.* at 311-12 (noting that the NAFTA grandfathers some Mexican firms that already had both banking and securities operations prior to the enactment of the NAFTA).

76. In fairness, by comparison to the Canadian banking market, the U.S. banking market was already quite open to foreign bank participation. For instance, as of 1995, banks owned by foreign countries controlled 20.8% of the total assets in the United States banking system, as opposed to just 7.8% of the assets in the Canadian banking system. *See* Nolle, *supra* note 68, at 162.

77. Those restrictions were formerly found at Bank Act, R.S.C., ch. B-1.01, § 399(1) (Can.), but were repealed by Ann. Stat. Can., 1994, ch. 47, § 20.

Bank Act now makes special provision for "NAFTA country residents."[78] The policy of national treatment as embodied in the NAFTA also liberalized the treatment of U.S.-owned Schedule II banks. Specifically, U.S. Schedule II banks are permitted to branch across Canada in the same streamlined fashion that Canadian banks may.[79]

Canada has not, however, become the 51st state. For many purposes, U.S. and Mexican banks are still foreign banks. For example, they may not branch directly into Canada, but may operate in Canada only through a Canadian-chartered Schedule II subsidiary.[80] Canadian bank regulators apparently insisted on requiring a Canadian-chartered subsidiary in order to ensure that Canadian law would apply.[81]

Relating to Canada-Mexico relations, the NAFTA extended to Mexico the same treatment that Canada extended to the United States under the FTA. Most importantly, Mexican residents qualify for the special treatment afforded to "NAFTA country residents" under the Bank Act.[82] Therefore, the same benefits accorded to U.S.-controlled Canadian banks will apply to Mexican controlled Canadian banks as well.

C. *Mexico*

Prior to the NAFTA, Mexico's banking market essentially was closed to American banks.[83] The NAFTA changed that by permitting U.S. and Canadian banks to establish wholly-owned banking subsidiaries in Mexico.[84] Given the relative weakness of Mexico's banking system compared to its two imposing northern neighbors, however, Mexico negotiated for some protections in the NAFTA to prevent foreign domination of the Mexican banking industry. Specifically, Mexico set out aggregate capital limits for foreign subsidiaries.[85] In the wake of the 1994

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78. Bank Act, R.S.C., ch. B-1.01, § 11.1 (Can.).

79. *See* Bank Act, R.S.C., ch. B-1.01, § 422.2 (Can.).

80. Canada may soon consider legislation that would permit cross-border branching. *See* Joseph Weber, *Just Over the Horizon: North American Banks, A Few Rule Changes would Bring a Wave of Cross-Border Mergers*, BUS. WK., Feb. 23, 1998, at 100 (noting the expectation that the Chretien government will introduce branching legislation).

81. *See* Jordan, *supra* note 3, at 48 (explaining that Canadian regulators continued to insist on foreign banks employing a Schedule II subsidiary in Canada in order to be assured they would have a Canadian entity to regulate).

82. Bank Act, R.S.C., ch. B-1.01, § 11.1 (Can.).

83. *See* Norwood, *supra* note 62, at 174.

84. *See* Palace, *supra* note 72, at 161-62.

85. When foreign banking was first permitted in 1994, foreign subsidiaries' aggregate capital share of the Mexican domestic market was limited to 8%. The Mexican plan called for an increasingly liberal scheme of foreign ownership over a six year transition period until in the last year if the transition foreign banks could control an aggregate of 15% of the capital in the commercial banking market. NAFTA, *supra* note 1, Annex VII(B)(9), 32 I.L.M. at 774. At the end of the transition period

peso crisis, Mexico modified, but did not abandon, its foreign ownership rules to permit greater foreign influence in the banking system.[86]

After the transition period, U.S. and Canadian institutions will be permitted to acquire outright existing Mexican banks, subject to the limitation that the sum of the capital of the acquired bank and any affiliate of the foreign acquirer not exceed four percent of the aggregate capital of all commercial banks in Mexico.[87] Barring unforeseen circumstances, this restriction will prevent the unfriendly acquisition of Mexico's six largest banks since they all exceed the capital limit.[88]

IV. CROSS-BORDER BRANCHING: PUBLIC POLICY AND LEGAL THEORY

International banking is now a fact of life. Some U.S. banking organizations now report that a majority of their productive assets are located abroad.[89] As the North American market for goods and services becomes more integrated, there will be increasing pressure on the NAFTA countries to rationalize cross-border banking. Under the terms of the NAFTA, the time is now at hand to re-examine the issue of cross-border branching. Section 1403(3) of the NAFTA states:

> at such time as the United States permits commercial banks of another Party located in its territory to expand through subsidiaries or direct branches into substantially all of the United States market, the parties shall review and assess market access provided by each party . . . with a view to adopting arrangements permitting investors of another Party to choose the juridical form of establishment of commercial banks.[90]

Section 1403(1) stipulates that investors of a Party should be free to establish financial institutions in the other countries "in the juridical form chosen by such investor."[91] The import of that provision is that banks

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the aggregate capital limits will lapse subject only to Mexico's reserved right to impose additional limitations on banking competition if foreign banks control 25% of the Mexican banking market before January 1, 2004. *See* Bravo, *supra* note 65, at 1249-51 (setting out the restrictions on foreign ownership of various Mexican financial institutions).

86. *See* Fluckiger, *supra* note 60, at 79 (describing changes in Mexican law that expand but do not eliminate the NAFTA foreign ownership limits).

87. *See* NAFTA, *supra* note 1, Annex VII(B)(3), 32 I.L.M. at 775.

88. *See* Nalda, *supra* note 52, at 407.

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

90. NAFTA, *supra* note 1, § 1403(3), 32 I.L.M. at 657.

91. NAFTA, *supra* note 1, § 1403(1), 32 I.L.M. at 657.

should be able to expand across borders by establishing either branches or subsidiaries as dictated by their business plan rather than by banking law.

Of course, branching is not the only way to cross borders. There are several ways in which banks located in one country may gain access to foreign markets. Using one approach instead of another may in part depend on whether the bank wants to do business "with" the foreign country as opposed to "in" the foreign country. In general, it is easier to do business with a foreign country because the legal requirements are relatively modest. Doing business in a foreign country frequently requires complying with more onerous licensing and regulatory obligations.[92] Of course, the distinction sometimes is not clear.[93] With that in mind, there are four major alternatives for foreign banks to deliver financial services across national borders.

A. *Methods of Engaging in Cross-Border Banking*

1. Subsidiaries

All three NAFTA countries permit banks from the other NAFTA countries to expand into their territory by establishing separately chartered subsidiaries in the host country. The subsidiary must comply with all licensing and regulatory requirements, including capital requirements. The subsidiary approach to expansion suffers from several weaknesses. The costs of establishing a subsidiary can be considerable. A free standing bank must have a complete internal infrastructure, capital base and management team. In addition, subsidiaries are limited somewhat in their lending capacity, since loan limits are typically a function of the amount of the bank's capital. The problem of a low lending limit can often be avoided through the use of loan participation agreements. Perhaps owing to the expense of establishing and operating subsidiaries, it appears that subsidiaries are less attractive than branches.[94]

On the other hand, if subsidiaries are respected as legal persons separate and distinct from their corporate parents, they may be an effective

92. *See* Guillermo Marrero, *What Foreigners Should Know About the Mexican Market, in* PRACTICING LAW INSTITUTE, NAFTA: WHAT YOU NEED TO KNOW NOW 119, 125 (PLI Comm. Law & Practice Course Handbook Series No. 669, 1994) (describing the distinction between doing business with and doing business in Mexico).

93. *See id.* (noting that, in Mexico, a business will be considered doing business in the country if it regularly or continuously executes commercial transactions there).

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

method for insulating the parent from liabilities arising out of the subsidiary's banking activities.[95] Indeed, the limitation of the parent's liability is frequently the most important reason for forming subsidiaries.[96] Of course, limited liability is a central tenet of modern corporation law. Professor Blumberg has summarized the various advantages of limited liability in the corporate context as: permitting absentee investors to avoid exposure to risk; permitting large-scale enterprise; permitting diversification of portfolios; avoiding increased agency costs; avoiding impairment of the efficient capital market; avoiding increased collection costs for creditors; avoiding the costs of contracting around liability, and the encouragement of risk-taking.[97] Professor Blumberg also has concluded, however, that many of the traditional theoretical factors justifying limited liability for corporations become irrelevant in the context of subsidiary corporations;[98] and may as a matter of public policy be outweighed by the disadvantages of limited liability including: unfairness and inefficiency for tort and other involuntary creditors; unfairness and inefficiency for labor claimants; the encouragement of excessive risk taking; increased information and monitoring costs; impairment of the efficiency of the market; and the possibility of misrepresentation.[99] Others have argued that the limited liability aspect of the subsidiary is economically inefficient and therefore undesirable.[100]

Nevertheless, in modern practice, corporations form subsidiaries for any number of reasons, including, in addition to the desire to limit liability, the need to comply with regulatory ownership requirements, a desire to establish certain procedural benefits, such as venue and jurisdic-

95. The idea of subsidiaries as independent legal persons is tied up in nineteenth century ideas about corporate personality. There have been several excellent treatments of corporate theory that examine the evolution of the idea of the corporation from a concession granted by the sovereign to an artificial person to a natural person to an aggregate of contractual interests. For general background on this topic, see Morton J. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV 173 (1985); HERBERT HOVENCAMP, ENTERPRISE AND AMERICAN LAW, 1836-1937, at 12 (1991); JAMES W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970, at 4 (1970); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201 (1990); and Phillip I. Blumberg, *The Corporate Entity in an Era of Multinational Corporations*, 15 DEL. J. CORP. L. 283 (1990).

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

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

98. *See* BLUMBERG, *supra* note 97, § 5.01.

99. *See id.*; *see also* EASTERBROOK & FISCHEL, *supra* note 97.

100. Joseph H. Sommer, *The Subsidiary: Doctrine Without a Cause?*, 59 FORDHAM L. REV. 227, 231-42 (1990).

tion,[101] or in the case of banking in the NAFTA countries because present law does not permit cross-border branching. Regardless of the reasons for the use of subsidiaries, it may be said that despite their separate legal existence they form a cohesive economic unit with their parent and related corporations.

In the banking context, the ability of the parent to avoid or deflect liability through the use of a banking subsidiary gives rise to an especially pernicious moral hazard problem.[102] Holding companies might not run a subsidiary bank as prudently as they otherwise might because the risk of loss is limited to the capital invested in the subsidiary and not backed by the full faith and credit of the parent. In the United States, the moral hazard problem in the bank holding company/bank subsidiary context has resulted in an ongoing effort by regulators to invent new and better ways of imposing liability on holding companies for the failure of bank subsidiaries. Federal banking regulators have devised a host of legal techniques designed to impose liability on bank holding companies in the event of bank failure.[103]

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101. *See* ROHLICH, *supra* note 96 (citing various legal reasons for subsidiary formation such as to limit liability, to avoid restrictions in the parent's charter or restrictions arising under law, for tax reasons and for purposes of avoiding complications arising from "foreign corporation" status; also citing non-legal reasons such as increasing the morale of the subsidiary's management, to settle shareholder disputes and public relations purposes); LARRY A. SODERQUIST & A.A. SOMMER, JR., UNDERSTANDING CORPORATE LAW 238-41 (1990) (citing use of subsidiaries in corporate acquisitions); Sommer, *supra* note 100, at 259-73 (citing use as an effective method for controlling choice of law and venue).

102. *See* Eric J. Gouvin, *Shareholder Enforced Market Discipline: How Much is Too Much?*, 16 ANN. REV. BANKING L. 311, 312-17 (1997) [hereinafter Gouvin, *Market Discipline*] (providing a general overview of the moral hazard problem in the banking context). Of course, the moral hazard problem is not unique to the bank holding company situation. In fact, "moral hazard" may be present in any number of situations from products liability and workers' compensation to bankruptcy and health care. The idea of moral hazard is present in any situation where the existence of some kind of insurance or cost-shifting is perceived to reduce the incentives to reduce or minimize loss. *See* Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 238 (1996) (providing a history of the term "moral hazard" and criticizing its use in the debate over the reform of various government programs on the ground that the conditions necessary to give the concept force in economic theory do not exist in the real world). In general, a moral hazard results whenever one actor or class of actors in a transaction can undertake risky behavior without fear of loss because the loss from the risky activity falls on a different actor or group of actors by contract or other arrangement. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 150 (3rd ed. 1986). Moral hazards are present in all transactions in which an actor may be shielded from liability by insurance or by limited liability business forms. *See* Frank H. Easterbrook and Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 103-04 (1985). All corporations entail some moral risk, for example, because the limited liability form always presents opportunities to shift losses from the equity holders to creditors and other claimants. *See id.*

103. These regulatory mechanisms include, among other things: the so-called source of strength doctrine, 12 C.F.R. §225.4(a) (1996), cross guarantee provisions, 12 U.S.C. § 1815(e) (Supp. 1994), capital restoration plans, 12 U.S.C. § 1831*o*(e)(2)(C)(ii) (1996), regulatory agreements, the elaboration of a general fiduciary duty to regulators, equitable subordination, preferences, and fraudulent

The most powerful tool currently available to U.S. banking regulators to indirectly shift the costs of bank failure to holding companies is the cross-guarantee device contained in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).[104] The cross guarantee provisions allow the receiver of a failed insured bank to make claims against other commonly controlled insured depositary institutions for the loss that the receiver incurs or anticipates that it will incur in disposing of or assisting the failed institution.[105] This approach will not be useful in the international context because it only applies to insured depositary institutions. Assuming the cross guarantee provisions are not effective in the international context, and also assuming banking regulators will still seek to protect the deposit insurance fund by looking for other parties to share the pain of bank failure, we may find the Federal Reserve Board resurrecting the "source of strength" doctrine.

Under the source of strength doctrine, bank holding companies are required to assist bank subsidiaries in difficult financial times by providing financial assistance to them.[106] Although the validity of the source of strength is an open question,[107] the Federal Reserve Board continues to employ the source of strength idea in its decisions.[108] A return to the source of strength doctrine could mean that bank holding companies will essentially become unlimitedly liable for the losses that may occur when an insured bank fails. Obtaining these payments from foreign bank holding companies will also be problematic. Establishing the source of strength may be something that the Federal Reserve Board will seek to do through contractual arrangement at the time the foreign banking organization seeks to establish its U.S. operations, or perhaps through aggressive use of the "prompt corrective action" provisions of U.S. law.[109]

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conveyances. *See* Gouvin, *Market Discipline, supra* note 102, at 333-45 (describing the various regulatory methods in light of a pervasive scheme to impose liability on holding companies).

104. Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified in various sections of 12 U.S.C. and 27 U.S.C.). The cross guarantee provisions are codified at 12 U.S.C.A. § 1815(e) (West Supp. 1996).

105. *See id.*

106. *See* Policy Statement; Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, Federal Reserve System, 52 Fed. Reg. 15,707 (1987).

107. For a brief discussion of the evolution of the source of strength doctrine and its current status, see Gouvin, *Market Discipline, supra* note 102, at 333-36; Leonard Bierman & Donald R. Fraser, *The "Source of Strength" Doctrine: Formulating the Future of America's Financial Markets*, 12 ANN. REV. BANKING L. 269 (1993).

108. *See, e.g.*, Deutsche Bank AG, 79 Fed. Res. Bull. 133, 137 (1993); Banc One Corp., 78 Fed. Res. Bull. 159, 161 (1992).

109. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Pub. L. No. 102-242, 105 Stat. 2236, commonly referred to as FDICIA (codified as various sections of 12 U.S.C.), requires institutions defined as "undercapitalized" to submit a Capital Restoration Plan to the institution's federal banking agency. 12 U.S.C.A. § 1831*o*(e)(2)(D)(I)-(ii) (West Supp. 1996). If a bank holding company controls the financial institution, FDICIA prohibits the banking agency from

Under the prompt corrective action provisions, a troubled institution must submit a capital restoration plan to its regulator. If a troubled financial institution fails to submit a capital restoration plan or to implement a plan that has been submitted and approved, the regulators have a number of sanctions at their disposal, including the power to seize the institution.[110] It should be noted, however, that no provision of U.S. banking law expressly requires a holding company to guarantee compliance with a subsidiary's Capital Restoration Plan.[111] The optional aspect of these plans may have been designed to facilitate early resolution of the insured institutions by requiring the holding company to either make a financial commitment to the subsidiary's continued survival, or, alternatively to decline such a commitment and in doing so indicate to the regulators that the holding company is willing to let the subsidiary fail.[112]

Although the moral hazard problem is a serious public policy problem that should be addressed with innovative countermeasures, I have argued elsewhere that the current regulatory scheme goes too far in imposing liability on bank holding companies for bank failure, resulting in negative consequences.[113] I believe the move toward increased liability for bank holding companies is misplaced, and should be reassessed in order to give more respect to the separate legal existence of well capitalized banks and the holding companies that own them. Nevertheless, there are times when a holding company should bear some responsibility for the failure of its subsidiary.[114] The subsidiary arrangement makes the imposition of that liability somewhat problematic.

2. Branching

In general, from the point of view of the parent banking organization, branching should be more economically attractive than setting up an independent subsidiary since capital, accounting, and legal costs can be

approving the Capital Restoration Plan unless the holding company guarantees compliance with the CRP for one year and provides adequate assurances of compliance. 12 U.S.C.A. § 1831*o*(e)(2)(C)(ii)(I) (West Supp. 1996).

110. *See* 12 U.S.C. § 1831*o*(g)(3) (1994).

111. *See* Cassandra Jones Havard, *Back to the Parent: Holding Company Liability for Subsidiary Banks—A Discussion of the Net Worth Maintenance Agreement, The Source of Strength Doctrine, and the Prompt Corrective Action Provision*, 16 CARDOZO L. REV. 2353, 2388 (1995).

112. *See* Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 339 (1993).

113. *See* Gouvin, *Market Discipline*, *supra* note 102, at 345-354.

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

shared more easily.[115] In the United States, operations would be more easily integrated because the prohibitions of §§23A and 23B will not apply to transactions between branches, but they would restrict transactions between commonly controlled subsidiaries.[116] In addition, loans generated by a branch can be made based on the capital of the home bank in the home country instead of on the branch's capital. On the other hand, liabilities of the branch will likely be imposed on the home office more readily than the obligations of a separately organized subsidiary would be.[117] Although local regulators are likely to have less control over a branch because the regulator in the home country will have primary responsibility, the branch is likely to be more stable because of the greater worldwide capital of the bank.[118]

3. Other Ways of Accessing Foreign Markets

Another way to do business with a foreign country is through a "representative office" which does not solicit loans or take deposits, but which acts as a liaison to make it easier for potential borrowers or depositors in the host country to transact business with the foreign bank in the bank's home country.[119] In addition to these three common approaches, the United States permits banking activities to be carried out through "agencies" chartered by a state or the federal government, which are in effect special purpose banks.[120]

Finally, for some financial service providers, such as cash managers, mortgage servicers and data processors, it would appear that many aspects of international business may be undertaken from home. It seems likely that some aspects of the Mexican market, for instance, can be exploited

115. *See* Zamora, *Comments, supra* note 6, at 79 (noting economies achieved through branching).

116. *See supra* note 26 and accompanying text (describing §§ 23A and 23B).

117. *See* Wells Fargo Asia, Ltd. v. Citibank, N.A., 936 F.2d 723 (2d Cir. 1991), *cert. denied*, 505 U.S. 1204 (1992) (holding that absent a contractual restriction on the place of collection, a customer of a foreign branch may recover from the bank's home U.S. office the amount of the obligation). The risk of foreign sovereign actions that make meeting obligations impossible was addressed somewhat by amendments in 1994 to the Federal Reserve Act and the Federal Deposit Insurance Act, which changed the law to hold the home U.S. offices liable for such obligations only if agreed in writing. *See* Palace, *supra* note 72, at 169 (describing the amendments).

118. *See* Scott, *supra* note 94, at 491 (noting that local deposits of branch are backed by home office capital).

119. *See* HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 135 (4th ed. 1997). When Mexico was closed to foreign bank ownership, foreign banks were nevertheless permitted to maintain representative offices in the country. *See* Ghislain Gouraige, Jr., *Recent Development*, 24 HARV. INT'L L.J. 212, 214 n.19 (1983) (noting that at the time Mexico nationalized the Mexican banks there were over 100 representative offices of foreign banks in Mexico).

120. *See* SCOTT & WELLONS, *supra* note 119, at 135.

from the United States without a physical presence in Mexico.[121] Although for some companies, these alternative methods will make the most sense, this article focuses on the choice of subsidiaries as opposed to branches.

On the question of whether subsidiaries or branches are preferable from a public policy point of view, corporate law would offer two possible insights: first, in order to avoid the moral hazard problem branches are preferable to subsidiaries because it is clearer that the home bank should be responsible for the branch's obligations; or, second, international banking law should permit both methods of expansion in order to let corporate planners exercise their own judgment about which form makes the most sense for a particular bank in a particular situation.[122]

B. *Problems of Cross-Border Regulation*

Regulation is an inescapable fact of modern banking. Cross-border regulation, however, is awkward. Both the home and host countries have legitimate claims to full and accurate information on banks operating in or from their jurisdiction,[123] and both regulators have a legitimate concern to prevent the threat of systemic risk brought about by bank failure.[124] In an ideal world, bank regulators in different countries would be comfortable if they knew that a fellow regulator in another country was supervising the other aspects of an international bank's operations by applying rigorous standards. Such an ideal scheme would require at least two preconditions: (1) regulators would have to agree on acceptable standards that would pass international muster, and (2) regulators would have to have confidence in the competence and integrity of the regulators in other countries. Unfortunately, the NAFTA countries do not meet these conditions. It will

121. Of course, large loans to major borrowers and government units can be arranged that way, but perhaps consumer banking services like credit cards can be offered in Mexico but serviced in the United States. *See* Karen MacAllister, Note, *NAFTA: How the Banks in the United States and Mexico Will Respond*, 17 HOUS. J. INT'L L. 273, 295 (1994) (suggesting that credit cards, ATM networks and residential mortgages may be lucrative and easily penetrated market for U.S. banks desiring to do business with Mexico).

122. This is the approach adopted by the NAFTA. NAFTA, *supra* note 1, art. 1403(1), 32 I.L.M. at 657 (recognizing the principle that investors should be able to choose the juridical form to use for cross-border banking).

123. The lesson from the LDC debt crisis seems to be that more information is always preferable. *See* William A. Lovett, *Conflicts in American Banking Regulation: Renewed Prudence, Retrenchment, and Struggles Over Growth Potential*, 12 ANN. REV. BANKING L. 44, 49 (1993) (noting that there should be enforceable mutual disclosure laws so unsustainable debt loads do not get out of hand again).

124. *See generally* Mico Loretan, *Systemic Risk in Banking: Concept and Models*, *in* REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN THE NAFTA COUNTRIES AND BEYOND 37, 38-42 (George M. von Furstenberg ed., 1997) (discussing the concept of systemic risk generally).

be extraordinarily difficult for trade negotiators to make agreements about cross-border branching without also making a commitment to harmonize North American banking law. For example, the United States would legitimately want to know whether the source of strength doctrine would allow the Federal Reserve Board to pursue the holding companies of Mexican and Canadian banks operating in this country. Canada and Mexico would legitimately want to know whether Glass-Steagall will prohibit their banks from operating freely in the United States while also being part of an organization that owns a securities company. But the NAFTA does not contain any meaningful commitment to harmonization of the banking regulatory schemes of the three countries.[125]

On the second point, it is not at all clear that the regulators in the three countries have the mutual respect necessary for a successful cooperative regulation effort. For example, Canadians resent what they consider to be the propensity of U.S. regulators to seek extraterritorial application of U.S. law.[126] During the negotiation of the FTA and the NAFTA, it was understood that a significant part of Canada's opposition to cross-border branching was based on Canadian banking regulators' desire that there be a Canadian bank doing business in the country that they could regulate.[127] Similarly, there was some concern in the United States that the Mexican banking regulators were not up to the task of supervising a modern banking system.

Given the lack of harmonization and the lack of mutual respect, it was inevitable that the NAFTA banking structure would default to a system requiring subsidiaries instead of one that permitted branching. Therefore, under current law, all three NAFTA countries permit expansion by establishment of subsidiaries, but only the United States permits foreign banks, including Canadian and Mexican banks,[128] to expand into our

125. *See* Joel P. Trachtman, *Trade in Financial Services Under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis*, 34 COLUM. J. TRANSNAT'L L. 37, 94 (1995) (noting that the NAFTA does not require financial regulation harmonization). *But see* Stephen Zamora, *NAFTA and the Harmonization of Domestic Legal Systems: The Side Effects of Free Trade*, 12 ARIZ. J. OF INT'L & COMP. L. 401 (1995) [hereinafter Zamora, *Harmonization*] (arguing that increased cross-border contact between businesspeople, bureaucrats, lawyers, academics and others will inevitably lead to an exchange of ideas and accommodation in each of the three countries of the cultural differences of the others); Alfred C. Aman, Jr., *A Global Perspective on Current Regulatory Reforms: Rejection, Relocation, or Reinvention?*, 2 GLOBAL LEGAL STUD. J. 429 (1995) (arguing that global political and economic forces push national policies towards various forms of deregulation and privatization).

126. *See* Jordan, *supra* note 3, at 48 (noting that "Canadian regulators do not indulge in the extraterritorial application of Canadian banking laws").

127. *See id.* (voicing the opinion that the Canadian trade negotiators did not yield to the pressures to permit U.S. branches because "Canadian regulators . . . wished to ensure that there was a Canadian entity to be regulated.").

128. In fact, branches are the most important mechanism for giving Canadian and Mexican banks access to the U.S. market. *See* Michael G. Martinson, *Consolidated Supervision of Cross-Border*

market through branching.[129] The fact that the U.S. law permits branching, however, is not the end of the story. Foreign banks seeking to establish a presence in the United States must comply with a labyrinth of federal regulations which seem to treat foreign banks less favorably than U.S. banks.[130] The Foreign Bank Supervision Act of 1991 tightened U.S. supervision of foreign branches and agencies operating in the United States.[131] The law provides for increased sharing of information between home and host country regulators; mandates deposit insurance for all deposits under $100,000; requires the Federal Reserve to approve all applications for any branch, agency or representative office; and permits the Federal Reserve Board to examine and close all such international banking facilities.[132]

One of the most significant aspects of the new regulation is that foreign banks must decide if they intend to engage in wholesale or retail banking through their branches. If they plan to engage in retail banking, in which they will take deposits of less than $100,000, then the U.S. operation must be set up as an insured subsidiary rather than as a branch of the foreign bank.[133] The comprehensive supervision and information requirements of the law have dampened foreign interest in the U.S. banking market.[134] The increasingly difficult process of branching into the United States may explain the provision in the NAFTA that imposes a freeze on any further restrictions on cross-border banking.[135]

From a regulator's point of view, in a modern world where one banking organization might act across the country and around the world through dozens of wholly owned subsidiaries, the fiction of separate corporate personality for each subsidiary in a corporate group does not reflect reality. Because in the real world there is little practical difference

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Banking Activities: Principles and Practice in the NAFTA Context, in REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN THE NAFTA COUNTRIES AND BEYOND 217, 225 (George M. von Furstenberg ed., 1997).

129. Canada may soon propose legislation that would permit cross-border branching. *See* Weber, *supra* note 80.

130. *See* Charles W. Hultman, *Foreign Banks and the U.S. Regulatory Environment*, 114 BANKING L.J. 452 (1997) (noting that the Foreign Bank Supervision Enhancement Act of 1991 resulted in less favorable treatment for foreign banks).

131. *See generally* Daniel B. Gail et al., *The Foreign Bank Supervision Act of 1991: "Expanding the Umbrella of Supervisory Regulation,"* 26 INT'L LAW. 993 (1992) (discussing changes in foreign bank supervision brought on by the BCCI scandal).

132. *See id.*

133. *See* 12 U.S.C. § 3105 (1994); Scott, *supra* note 94 (discussing the change from previous policy).

134. *See* Hultman, *supra* note 130, at 453 (commenting that comprehensive supervision and extensive information requirements have contributed to waning foreign interest in the U.S. banking market).

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

between a wholly owned subsidiary and a traditional branch, it seems overly formalistic that the legal treatment of one should differ from the other.[136] In order to accommodate complex corporate groups, international law will have to jettison traditional ideas about corporate personality, but when the corporate actors operate across national borders the challenge of harmonizing concepts of enterprise liability is a daunting one.[137]

If a workable solution to the moral hazard can be devised, and if home and host country regulators can coordinate their efforts in a mutually agreeable manner, there should be no real difference between a subsidiary and a branch, and financial services providers should be free to set up their corporate structures as they see fit. Therefore, if one were writing on a clean slate to devise the optimal North American legal framework for structuring the financial services industry one would probably enact a plan that permits the individual players in the market to determine the corporate structure they prefer, be it branching or holding company form. Unfortunately, the NAFTA negotiators are not writing on a clean slate. They have political, historical, and economic factors unique to their individual countries that they need to pay attention to. These factors make the public choice perspective on trade agreements a more useful tool for understanding the cross-border branching issue than the arguments based on the law of corporate groups.

V. CROSS-BORDER BRANCHING: THE PUBLIC CHOICE PERSPECTIVE

The traditional way of thinking about trade agreements is to assume that each trade negotiator will advocate for those results that are in his or her own country's best interest. By every negotiator doing so, they eventually reach an agreement that is informed by rational self-interest, but which may give rise to conflict upon implementation.[138] In the real world, however, it is misleading to suggest that nations have "interests." It is much more appropriate to recognize that to the extent a government

136. *See* MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION 303 (1976) (discussing that lack of a practical difference between wholly owned subsidiaries and traditional corporate divisions). For a traditional view of the rather inconsequential managerial aspects of the subsidiary/division distinction, see Robert W. Murphy, *Corporate Divisions v. Subsidiaries*, 34 HARV. BUS. REV. 83 (Nov.-Dec. 1956).

137. *See generally,* PHILLIP I. BLUMBERG, THE MULTINATIONAL CHALLENGE TO CORPORATION LAW: THE SEARCH FOR A NEW CORPORATE PERSONALITY (1993) (describing the evolution of enterprise principles around the world and articulating a jurisprudence of corporate groups).

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

takes a position it does so because competing interest groups within the nation have competed for, and won, government action.[139] The public choice[140] perspective on international agreements suggests that countries will not agree to terms in a treaty unless the key interest groups in the country agree and the regulators who deal with the matter find it in their own best interests to do so.[141]

In light of the many demands of the constituents they represent, we would expect trade negotiators to make agreements that maximize their own interest groups' competitive positions, even if the theoretically optimal position would be somewhat different. Any attempt at regional integration will succeed only if the self-interests of key actors and interest groups within the region coincide.[142] In the case of the NAFTA, the interest groups concerned about cross-border financial services include, most obviously, the financial services providers of the member countries and the banking regulators who oversee those businesses.

Each of the member nations has a different perspective on the attractiveness of cross-border branching, and we can reasonably expect the member countries not to sacrifice perceived advantages to their trading partners. Of course, it is difficult to negotiate multilateral trade agreements where the parties too vigorously pursue their own economic self-interest. While in a theoretical world they would all be better off under a system of completely free trade unencumbered by legal constructions, in the real world a prisoners' dilemma opens up by which cooperation and trust take a back seat to the pursuit of self-interest.[143] An

139. *See id.* (examining the difference between regime theory and public choice theory).

140. The scholars who make up the public choice camp are a somewhat loosely knit group. Their perspectives on the law draw heavily on economics, game theory, organizational behavior and political science. *See generally* DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION 21-33 (1991). *See also* Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873, 878-79, 883, 901-06 (1987) (stating a general theory of "public choice" is impossible, since there are many variations on the set of core principles that have inspired many of the scholars); SHAUN H. HEAP ET AL., THE THEORY OF CHOICE: A CRITICAL GUIDE 209-15 (1992) (giving a useful overview of the topic, especially of the theoretical problems of aggregating preferences, which tends to make the output of collective bodies incoherent).

141. *See* Colombatto & Macey, *supra* note 138, at 932 ("Public choice theory . . . posits that international institutions are vehicles through which politicians, bureaucrats, and interest groups reflect their own interests.").

142. *See* Frederick M. Abbott, *Foundation-Building for Western Hemispheric Integration*, 17 NW. J. INT'L L. & BUS. 900, 902 (1996-97) (discussing various interest groups, such as business groups, labor groups, environmental groups, citizen groups and government actors, whose interests would have to coincide in order to expand the NAFTA into the Free Trade Area of the Americas, and stating that "[t]he success of a regional integration effort may well depend on the presence of a sufficient confluence of self-interest among key actors and interest groups throughout economically-important countries in a region.").

143. *See* Simser, *supra* note 5, at 40 (noting the propensity for states negotiating a trade pact to become subject to a prisoner's dilemma).

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

A. *The Interest of Regulators in the Status Quo*

One rent-seeking group informing the public choice perspective is the cadre of regulators who exercise authority over the various aspects of the financial services industry. In the United States, the picture is bewilderingly complex and includes state bank examiners, the FDIC, the Office of the Comptroller of Currency, the Office of Thrift Supervision, the Department of the Treasury, and the Federal Reserve Board who share a complicated and redundant regulatory scheme governing U.S. banks.[144] Each of these government actors has some influence and control over the U.S. banking system and to a greater or lesser extent over foreign branches doing business in the United States. None of them will willingly give up their regulatory power without a good reason. Predictably, in the several occasions when Congress has considered reforming the banking regulatory scheme, the regulators have mobilized political opposition designed to protect the existing "turf" controlled by each agency.[145]

Canadian regulators fare no better on the turf protection front. Even though the domestic chain of command in Canada is clearer, on the international level Canadian regulators are not willing to give up their regulatory power without a fight. For example, it was understood during the negotiation of both the FTA and the NAFTA that Canada opposed cross-border branching in part due to the desire of the Canadian banking regulators that there be a Canadian bank doing business in the country that they could regulate.[146] We should expect Mexican regulators to behave like their American and Canadian counterparts.

The observed turf war mentality is entirely consistent with a public choice view of the world, which sees regulators as managers who seek to maximize the value of their enterprises.[147] Because any scheme of cross-

144. *See* GAO Oversight Structure, *supra* note 12, at 36-56 (describing the redundant function of the federal banking regulators).

145. *See* Coffee, *supra* note 41 (describing the recurrent turf battles); *see also* Edward J. Kane, *The Evolving U.S. Legislative Agenda in Banking and Finance, in* REGULATION AND SUPERVISION OF FINANCIAL INSTITUTIONS IN THE NAFTA COUNTRIES AND BEYOND 186-88 (George M. von Furstenberg ed., 1997) [hereinafter Kane, *Legislative Agenda*] (describing one round in the on-going battle between the Fed and the OCC over the structure of bank activities).

146. *See* Jordan, *supra* note 3, at 48 (voicing the opinion that the Canadian trade negotiators did not yield to the pressures to permit U.S. branches because "Canadian regulators . . . wished to ensure that there was a Canadian entity to be regulated.").

147. *See* Edward J. Kane, *Tension Between Competition and Coordination in International Financial Regulation, in* GOVERNING BANKING'S FUTURE: MARKETS VS. REGULATION 33, 34 (Catherine England ed., 1991) [hereinafter Kane, *Tension*] (describing the need of regulators to

border branching that makes sense for the NAFTA member countries will necessarily require paring away some of the current regulatory load, the existing regulators who have a vested interest in the current system will not give up their authority willingly.

The banking regulators of the three countries can be expected to defend their turf. The NAFTA is based primarily on the idea of host country regulation. If the treaty leads to greater harmonization, the members may consider a European style home country regulatory approach.[148] The home country approach would probably be acceptable to U.S. and Canadian regulators since banks from their countries are likely to have the most extensive North American operations. Until that time, however, the first impulse of the regulators will be to jealously stake out their territory.

On the other hand, there is a dynamic tension between the regulators and the regulated that makes regulators sensitive to industry concerns. The costs of regulation can be quite high, and banking firms to some extent prefer to choose the regulator they will be covered by. Corporate structure allows banking organizations some leeway in selecting their regulators. Subsidiaries are regulated primarily in the jurisdiction in which they are chartered. The regulation of branches is more complicated: for prudential matters, such as capital levels and management competence, the home country regulator has priority, but for market matters, the host country regulates. Because different countries govern different aspects of international banking organizations and because regulators act to increase their jurisdiction, regulators may act as catalysts to change banking regulation in order to attract more regulatees to their jurisdiction. By acting to attract banking firms, international regulators compete with one another for "market share."[149] By attracting firms from other countries, regulators can increase their power and the value of their regulatory enterprise.

In the NAFTA countries, regulatory competition seems to favor Canada and Mexico over the United States. Banks in both of those countries are freer to engage in a wider range of activities over a wider geographic area with less bureaucratic interference than are banks chartered in the United States. In light of this, U.S. regulators may recognize their competitive disadvantage and may wish to delay cross-

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maximize the value of their enterprise within the confines of something he calls the "microeconomic analysis of financial regulation," which is consistent with the public choice view).

148. *See* WHITE, *supra* note 3, at 18 (discussing the home country versus the host country approach to regulation).

149. *See* Kane, *Tension*, *supra*, note 147, at 35 (noting that banking regulators must be aware of competition from banking regulators in other countries).

border branching until the U.S. regulatory scheme can be made more compatible with international norms.

B. *Interests of the Financial Services Industry in the Status Quo*

Of course, the structure of the banking industry is not driven solely by the actions of regulators. The market participants in the financial services industry also influence the way in which the North American market is structured. Frequently, the industry's desires must be translated into political action before they bear fruit. In Mexico and Canada, the financial services sector is relatively concentrated. The key players in those countries may be able to mobilize political power to press for their positions. In the United States, however, the financial services industry is balkanized. I have already discussed the Glass-Steagall distinction between commercial and investment banking, but the industry also includes the insurance industry, thrifts, credit unions, finance companies and other non-banks engaged in the financial services sector. Even within the banking industry there are separate camps of common interest ranging from the money center banks, to the regional banks, to the community banks. Each of these participants has its own perspective on the wisdom of financial services modernization, and to date no one group or coalition of groups has mobilized enough political support to change the structure of the financial services industry in the United States.[150] Nevertheless, there are some observations that can be made about the three countries on the cross-border branching issue.

1. The United States

Ironically, though the United States has been a leading proponent of extending formal international trade agreements to cover trade in services,[151] it seems unlikely that the United States will lead the charge to

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

151. *See* Simser, *supra* note 5, at 44-45 (noting that the United States pushed to expand GATT during the Tokyo round to include trade in services, but the idea turned out to be quite contentious because: (1) trade in services was already being addressed by the United Nations Conference on Trade and Development (UNCTAD); (2) developing countries feared that existing open issues in GATT such as agriculture and textiles would be linked to concession on trade in services; (3) developing countries feared any negotiated regime would merely be a way for developed countries to perpetuate their dominance in the services sector; and (4) the proposals did not deal with the full range of services very well, but instead focused on capital and technology intensive services and paid scant attention to labor-intensive services).

bring cross-border branching to the NAFTA countries. The current structure of cross-border banking via subsidiaries serves U.S. banks very well. The United States has access to both Canada and Mexico on better terms than the rest of the world's major banking powers, while Canada and Mexico have access to the United States on essentially the same terms as every other country.

Now that U.S. law permits nationwide branching, U.S. banks should be very reluctant to permit our North American neighbors unfettered access to our national market, § 1403 of the NAFTA notwithstanding. American banks need time to establish their own nationwide branching systems and should not permit our trade representatives to allow Canadian and Mexican banks to get in on the ground floor of U.S. nationwide branching. On their home territories both Mexican and Canadian banks have long established national branch networks that give them a big head start on any U.S. attempts to enter their respective markets. Besides, there is significant evidence suggesting that foreign banks in the United States are less profitable that their U.S. competitors.[152] Because a branch network should be cheaper and therefore more profitable than a subsidiary network, permitting true branches will only serve to make foreign banks more competitive in the United States. The banking lobby will use its political clout to prevent that from occurring.

2. Canada

The banking provisions of the NAFTA, as currently written, make very little difference in the Canadian banking market. As a practical matter, the Schedule I banks will never be taken over by foreign interests as long as the "widely held" rule remains in place.[153] In any event, the Canadian market is already over-banked. The major Canadian banks dominate the Canadian market and have come to recognize that opportunities for growth are outside Canada.[154] For American and Mexican banks, the NAFTA's relatively benign provisions allow slightly easier access to a mature market where well-established firms have long customer relationships and efficient operations.[155]

152. *See* Hultman, *supra* note 130, at 453 (providing statistics showing that the average return on assets of foreign banks operating in the United States is significantly lower than that of U.S. banks generally and lower than a cohort group of internationally active U.S. banks); SCOTT & WELLONS, *supra* note 119, at 138 (noting that foreign banks appear to be less efficient and more dependent on wholesale funding, thereby making their cost of funds higher).

153. *See* Bank Act, R.S.C., ch. B-1.01, § 370(2) (1996) (Can.) (defining "widely held").

154. *See* Weber, *supra* note 80 (noting that Canadian banks are looking south for growth).

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

Foreign financial service providers have found it very difficult to establish profitable operations in Canada.[156] Although many U.S. banks maintain a presence in Canada, it is clear they will never be major players there.[157] Therefore, Canadian banking interests probably do not care whether the NAFTA member countries are permitted to branch into Canada, as long as the other markets, especially Mexico, are opened to Canadian banks in return.

3. Mexico

Mexico represents a very attractive market for U.S. and Canadian banks.[158] While the markets in the United States and Canada are fairly well saturated with banking services, Mexico is dramatically under banked.[159] With the average interest rate on a Mexican loan at 32%,[160] U.S. banks have been eyeing the potential of the Mexican banking market for some time.[161] The easiest way for the United States and Canada to get access to Mexico would be for the NAFTA to provide unfettered, routine cross-border branching, but based on how events have unfolded since the enactment of the NAFTA, it is unlikely to receive support from the big U.S. banks.

Branching will only be a minor issue for the U.S. banks already present in Mexico. The large U.S. and Canadian banks have already expanded into Mexico through the subsidiary device.[162] Even in a world

156. *See* WHITE, *supra* note 3, at 10 (noting that foreign banks in Canada have failed to achieve rates of return on equity that even equal the return available from Canadian treasury bills).

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

158. *See* Zamora, *Comments, supra* note 6, at 78 (noting attractiveness of Mexican banking market).

159. *See* Jordan, *supra* note 3, at 52 n.43 (noting that at the time of the NAFTA's negotiation only 8% of Mexicans had a checking account and there were an average of 18,500 people per banking branch in Mexico as opposed to approximately 2,000 people per branch in the United States and Canada); *see also* WHITE, *supra* note 3, at 16 (giving the branching information as 19,000 people per branch in Mexico versus 2,000 people per branch in the United States and Canada); MacAllister, *supra* note 121, at 297 (noting that Mexico is a large, untapped market).

160. *See* Davis, *supra* note 56, at 101 (noting the high Mexican interest rate compared to similar U.S. loans).

161. *See* Karen Epper, *Crowded at Home, U.S. Firms Look to Mexico*, AM. BANKER, Jan. 19, 1994, at 11. With rates of return on equity in Mexican banks at 27% compared to 13% for U.S. banks and 10% for Canadian banks, the Mexican banking industry seems to show signs of weak competition. *See* WHITE, *supra* note 3, at 16 (providing return on equity figures).

162. *See* Drew Clark, *Harris Marketers Look to a Mouse That Roars*, AM. BANKER, Jan. 7, 1998, at 14 (describing Bank of Montreal's plan to be the first true North American bank through its operations in Canada, Mexico and the United States); James R. Kraus, *Commercia Near Decision on Opening Bank in Canada*, AM. BANKER, July 2, 1997, at 5 (describing Commercia's North American

where branches were permitted in Mexico, a banking organization might decide to expand through a subsidiary to control liability exposure, especially political risk. Because they have already incurred the expense and inconvenience of establishing Mexican subsidiaries,[163] it strikes me as improbable that U.S. banks will become champions of unfettered branching which would permit late-comers to expand into Mexico at a lower cost.

There is tremendous room for growth in the Mexican banking market.[164] Over time the newly created foreign subsidiaries may take a leadership role in the market. Even with American and other foreign competition, however, existing Mexican banks have an edge because of their extensive branch networks (which gives them a diverse geographic and customer base), solid capital structure, knowledge of their market, knowledge of the Mexican legal system, and political connections.[165] Even with all these advantages, Mexico has legal protections in place to prevent its banking system from falling into foreign hands.

Perhaps aware that its banking market was ripe for picking under the NAFTA, Mexico has reserved a degree of state-supported protection for its banking industry during a six-year period following the enactment of the treaty. After the transition period however, foreign investors will be limited to acquiring institutions that control less than four percent of the

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strategy); Fluckiger, *supra* note 60, at 82 (describing the Mexican operations of Bank of Nova Scotia, Bank of Montreal, Wells Fargo, and NationsBank); Weber, *supra* note 80 (noting that Canadian bankers are looking south for growth).

163. *See* Palace, *supra* note 72, at 162 (describing the flurry of application approved by U.S. banking organizations to engage in a range of activities in Mexico).

164. Somewhat surprisingly, given that the United States has had relatively easy access to the Canadian market for a much longer time than it has been able to do business freely in Mexico, total U.S. bank exposure to the two countries is almost equal. *See* FED. FIN. INST. EXAM. COUNCIL STATISTICAL RELEASE, Jan. 14, 1998, at 1-2 (showing total exposure of all reporting banks to Canada to be $21.302 billion and to Mexico to be $17.978 billion; of that amount exposure by money center banks—defined as Bank of America, Bankers Trust, Chase Manhattan, Citicorp, First Chicago and J.P. Morgan—was $12.743 billion to Canada and $14.385 billion to Mexico, *id.* at 17-18; other large banks—defined as BankBoston Corp., Bank of New York Co., Corestates Financial Corp., First Union Corp., Nationsbank Corp., Republic NY Corp., and State Street Corp.—had exposure of $6.354 billion to Canada and $1.227 billion to Mexico, *id.* at 33-34; finally, all other reporting banks had exposure of $2.205 billion to Canada and $2.366 billion to Mexico). These numbers perhaps reflect the relative size of the Mexican and Canadian economies. Using 1993 conversion rates, Canada's GNP was 8.7% of the U.S. GNP, while using 1992 conversion rates Mexican GNP was 5.5% of U.S. GNP. *See* WHITE, *supra* note 3, at 1 n.1 (providing figures). The different growth rates of the two economies may have produced a different result in 1997.

165. *See* Thomas Heather, *Comments on Financial Services, Other Services, and Temporary Entry Rules*, 1 U.S.-MEXICO L.J. 73, 75 (1993) (listing advantages held by Mexican firms in the post-NAFTA Mexican banking market); MacAllister, *supra* note 121, at 303-04 (noting many potential competitive advantages of Mexican banks in the retail and commercial banking markets, including the ability of customers of Mexican banks to pay their utility bills at the bank).

capital in the banking system.[166] This limitation should effectively place the most important Mexican banks beyond the reach of any foreign acquirer. So Mexico, like Canada, has essentially protected its leading banking firms from foreign takeover.

While Mexico has obtained a degree of protection at home, they may also desire to cross the border into the southern tier of the United States to provide banking services to the substantial Hispanic populations in those states.[167] Mexican banks were already doing business in the southwestern United States, primarily through subsidiaries, prior to the enactment of the NAFTA.[168] Mexican banks would probably prefer to service that market through a branch network; therefore, depending on how attractive the U.S. market is deemed to be, the Mexican negotiators may be willing to make some concessions on branching.

C. *Specific Aspects of Comparative Advantage Among the NAFTA Countries*

In addition to the general considerations discussed above, several specific aspects of comparative advantage in the three countries deserve attention: the safety net subsidy, economies of scope, and economies of scale. This section discusses those items and ends with a brief overview of some other comparative advantage matters that may be significant for further NAFTA negotiations.

1. The Safety Net Subsidy Question

A matter that could weigh heavily in deciding whether branching is to be preferred to expansion by subsidiary is whether U.S. banks enjoy a subsidy from the federal government.[169] If our banks do receive such a subsidy, and existing firewalls make it difficult to pass the benefit of the subsidy upstream to the holding company, banks should be clamoring for branching rights since that would permit them to exploit the benefit of the subsidy in addition to all the other benefits of branching.

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166. *See* NAFTA, *supra* note 1, Annex VII(B)(13), 32 I.L.M. at 775.

167. *See* Davis, *supra* note 56, at 99 (noting that Mexican banks are especially interested in cultivating the southwestern border region of the United States). *But see* Andrea Gerlini, *In This Texas Town, Their Favorite Bank is Mattress Savings*, WALL ST. J., Oct. 31, 1996, at A1 (noting market research showing that Hispanics are reluctant to use banking services).

168. *See* Cogan, *supra* note 57, at 770 (noting the presence of Mexican banking subsidiaries in the United States since 1978).

169. *See* David G. Oedel, *Puzzling Banking Law: Its Effects and Purposes*, 67 U. COLO. L. REV. 477, 479 (1996) ("banking law enshrines fundamental economic inefficiencies in banking that are tolerable for banks because of breathtaking anti-competitive protections and financial subsidies—protections and subsidies that are not always apparent to outsiders nor admitted publicly by banking savants.").

The Federal Reserve Board clearly believes that the federal banking safety net provides the U.S. banking industry with a subsidy vis-à-vis other financial services providers.[170] Although Chairman Greenspan sees the creation of a subsidy to banking as an "undesirable but unavoidable consequence of creating a safety net,"[171] he believes that the subsidy should be contained within the bank to the extent possible in order to prevent the transfer of the sovereign credit subsidy for non-banking purposes which might result in a "subsidized competitive advantage" to the bank affiliate.[172]

Others, most notably the Office of the Comptroller of the Currency, question whether a net subsidy to the U.S. banking industry exists.[173] Of course, bankers do not believe they receive a subsidy - pointing to the deposit insurance premiums, capital requirements, and regulatory costs as evidence that they pay for whatever benefit they receive from the safety net.[174] Officials from the FDIC and the Department of Treasury have also

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170. *See generally* Myron L. Kwast & S. Wayne Passmore, Board of Governors of the Federal Reserve System, The Subsidy Provided by the Federal Safety Net: Theory, Measurement and Containment (1997) (articulating a theory that the government's commitment to the prevention of a systematic banking crisis provides a subsidy to banks). *See also* Statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services, U.S. House of Representatives, Feb. 13, 1997, *reprinted in* 83 Fed. Res. Bull. 249 (Apr. 1997) [hereinafter Greenspan Statement] (stating "In this century the Congress has delegated the use of sovereign credit—the power to create money and borrow unlimited funds at the lowest possible rate—to support the banking system. It has done so indirectly as a consequence of deposit insurance, Federal Reserve discount window access, and final riskless payment system transactions . . . [As a result of the government's major role in protecting the banking system, banks get an unfair advantage over other financial services providers because banks] determine the level of risk-taking and receive gains therefrom, but do not bear the full costs of that risk. The remainder of the risk is transferred to the government.").

171. Greenspan Statement, *supra* note 170, at 250.

172. *Id.*

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

174. *See* Janet Seiberg, *Banks' Plea To Fed: Stop Saying We're Subsidized*, AM. BANKER, Nov. 5, 1997, at 1 (noting the banking industry's arguments). The Fed's subsidies generated a flurry of pointed comments in AMERICAN BANKER, the newspaper of record for the U.S. banking industry. *See* Bert Ely, *Comment: Greenspan's Deposit Insurance Subsidy Argument Is Nonsense*, AM. BANKER, June 6, 1997, at 3 (stating that deposit insurance has never cost taxpayers a cent, loans from the discount window must be collateralized and the small risk of intraday overdraft risk can be minimized by proper management and concluding there is no meaningful subsidy); Warren G. Heller, *To The Editor: It Sure Looks Like a Subsidy to Me*, AM. BANKER, June 17, 1997, at 7 (arguing that if one considers the historical support of the banking system, there is a net subsidy); Bert Ely, *Letter to the Editor: Congress Has Largely Ended Deposit Insurance Subsidy*, AM. BANKER, July 2, 1997, at 9 (responding to criticism and noting that historical problems have been remedied by congressional action).

raised questions about the existence of a subsidy, especially in light of regulation costs.[175]

While the debate over the existence and extent of the safety net subsidy in the context of domestic banking policy drags on, the issue has a different dimension in the international context. Intuitively, U.S. bankers would, if such a subsidy exists, insist on engaging in cross-border branching as soon as possible so that the U.S. banks could exploit the subsidy in our neighboring countries. But in the international setting, such an argument is off the mark because all important banking countries bestow some kind of systemic default guarantee that acts to protect depositors and subsidize banks.[176] The mere existence of such a subsidy does not explain one country's competitive success in the banking market vis-à-vis banks from other countries, but rather success is more likely determined by a combination of "comparative advantage, the fundamentals of each economy, and governmental support in the form of safety net policies."[177] So while the safety net subsidy is part of the picture, it is only part. On the international level the important question to ask in not "does a subsidy exist", but rather "how big is one subsidy compared to the subsidies provided by the other countries?"

It appears from the available evidence, for example, that the safety net subsidy enjoyed by European and Japanese banks is greater than the subsidy bestowed upon U.S. banks.[178] Canada's banks enjoy safety-net benefits from their deposit insurance system and central bank similar to the benefits bestowed upon U.S. banks by the FDIC and the Fed.[179] One might surmise from the difference in the regulatory burden between the United States and Canada that the net subsidy to Canadian banks exceeds

175. *See* Olaf de Senerpont Domis, *Helfer, Ludwig Insist Deposit Insurance Doesn't Give Banks an Unfair Advantage*, AM. BANKER, Mar. 6, 1997, at 2 (recounting the testimony of Comptroller of the Currency Eugene Ludwig and Federal Deposit Insurance Corporation Chairman Ricki Helfer that the Fed's subsidy argument is incorrect because it does not take regulatory compliance costs into account); Remarks of John D. Hawke, Jr., Under Secretary of the Treasury for Domestic Finance, AALS Annual Meeting, San Francisco, Jan. 8, 1998, Panel Discussion on *What is the Governmental Role in Finance, Anyway?*, 3 (manuscript on file with author) (expressing skepticism of the existence of a net subsidy).

176. *See* Colombatto & Macey, *supra* note 138, at 941.

177. HAL S. SCOTT & SHINSAKU IWAHARA, IN SEARCH OF A LEVEL PLAYING FIELD: THE IMPLEMENTATION OF THE BASLE CAPITAL ACCORD IN JAPAN AND THE UNITED STATES 1 (1994).

178. *See* Hal S. Scott, *The Competitive Implications of the Basle Capital Accord*, 39 ST. LOUIS U. L.J. 885, 887 (1995) (noting the relative stability of European and Japanese banks generally compared to U.S. banks and noting that creditors will demand higher interest rates from United States banks because the overall risk of lending to United States banks is higher).

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

the U.S. subsidy. As to Mexican banks, the overall quality of the country's commitment to its banking system, although recently tested by the peso crisis, probably does not translate into a very big subsidy for Mexican banks (especially with the memory of nationalization still relatively fresh in the collective consciousness of the industry). On the matter of safety net subsidy, therefore, Canada would appear to have the edge and would therefore desire to branch directly across national borders to capitalize on the subsidy. American and Mexican banks would be expected to resist.

2. Economies of Scope

An economy of scope occurs when it is cheaper for one firm to produce two products together than it would be for two separate firms to produce the separate products independently.[180] The artificial compartmentalization of the U.S. financial services market effectively prevents banking organizations from realizing meaningful economies of scope. Studies examining the issue have found that there is no consistent evidence of global economies of scope in banking, although there is some evidence of product specific economies of scope in production.[181] The lack of academic literature supporting the existence of economies of scope in banking has been offered as an argument against breaking down the artificial barriers that define U.S. commercial banking.[182]

The weakness of the literature, however, is that is focuses on the banking industry as it currently exists. If the barriers between commercial and investment banking were eliminated, many observers of the banking business believe economies of scope would be significant.[183] Therefore,

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

181. *See* Jeffery A. Clark, *Economies of Scale and Scope at Depositary Financial Institutions: A Review of the Literature*, 73 FED. RESERVE BANK KAN. CITY ECON. REV. 16, 26 (Sept./Oct. 1988) (reviewing the literature and finding little evidence of meaningful overall economies of scope, but finding support for the idea that there may exist cost complementarity for some pairs of products); *see also* William Curt Hunter & Stephen G. Timme, *Does Multi-product Production in Large Banks Reduce Costs?*, 74 ECON. REV. FED. RESERVE BANK ATLANTA 2 (May/June 1989) (finding that multi-product production does not necessarily result in lower costs of production).

182. *See Leach Circulates GAO Study Criticizing Mixing of Banking and Commerce*, 16 No. 7 BANKING POL'Y REP. 10, 12 (Apr. 1997) (quoting House Republican Conference Chair John Boehner (R-Ohio) stating "the virtually unanimous finding in the literature is that economies of scope are insignificant in banking").

183. *See* David M. Eaton, *The Commercial Banking-Related Activities of Investment Banks and Other Nonbanks*, 44 EMORY L.J. 1187, 1206 n.127 (1995) (citing ROBERT E. LITAN, WHAT SHOULD BANKS DO? 60 (1987) for the proposition that combining financial products will result in economies of scope); Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan and the United States*, 48 STAN. L. REV. 73, 110 (1995) (noting economies of scope between banks and their securities affiliates); Joseph J. Norton

the ability of U.S. banks to achieve meaningful economies of scope likely depends on repeal of the Glass-Steagall Act. This, in turn, will be a multifaceted U.S. domestic political question. Glass-Steagall has essentially provided the U.S. securities industry with a generous subsidy and the industry is unlikely to give up the advantages of the law without a fight.[184]

To the extent U.S. banks are unable to exploit economies of scope, they are at a competitive disadvantage to their Canadian and Mexican competitors. At the anecdotal level, since Canada has permitted banks to acquire securities dealers as subsidiaries, all of the major Canadian securities dealers are now owned by banks.[185] Although cause and effect are difficult to prove, all three U.S. brokerage firms with a presence in Canada in 1987 had withdrawn from the market by 1994.[186]

3. Economies of Scale

When a firm can increase its level of output and experience a decline in the average cost of production, economies of scale exist, since it costs proportionately less to produce at a larger scale.[187] Although researchers have long studied the existence of economies of scale in the banking industry, results of those studies do not paint a clear picture.[188] Although not all of the studies make the distinction explicitly, some studies have examined the question of whether *overall* economies of scale exist in the

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& Christopher D. Olive, *The Ongoing Process of International Bank Regulatory and Supervisory Convergence: A New Regulatory-Market "Partnership,"* 16 ANN. REV. BANKING L. 227, 276 n.170 (1997) (explaining that economies of scope could arise in combining commercial and investment banking because information gathering function is an important part of both businesses); George A. Walker, *The Law of Financial Conglomerates: The Next Generation*, 30 INT'L LAW. 57, 63 (1996) (noting that one advantage of conglomeration is the presence of economies of scope).

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

185. *See* WHITE, *supra* note 3, at 10.

186. *See id.*

187. *See* Mester, *supra* note 180.

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

industry, while other studies have examined whether *product-specific* economies of scale exist.[189]

Studies in the 1970s and 1980s, evaluating the existence of overall economies of scale in the banking industry, almost unanimously concluded that economies of scale either did not exist or were exhausted for the most part by the time banks had accumulated assets ranging from $25 million to $100 million.[190] Because of problems in the methodology and data,[191] however, it is probably safe to say that the final word on overall economies of scale has not yet been written, especially since studies at the product-specific level have reached significantly different conclusions.

While studies during the 1970s and 1980s consistently concluded that overall economies of scale in the banking industry either do not exist or disappear after relatively low output levels, other studies prepared during the period have tended to show that some product-specific economies of scale do exist.[192] Intuitively, it seems obvious that economies of scale, at least on the product-specific level, should exist in banking. As an example, in order to produce consumer loans, banks must invest in a certain amount of legal work, form preparation, training, record keeping,

189. The difference appears to be crucial. Because banks are multi-product firms, the cost structure can be analyzed either as a function of the entire product mix or as a function of each individual product. Only recently have economists developed the mathematical tools to meaningfully explore overall economies of scale in a multi-product firm as a function of the entire product mix.

190. *See* Clark, *supra* note 181, at 26 (noting 13 empirical studies finding that overall economies of scale appear to exist only at low levels of output, while diseconomies of scale appear at large output levels); George J. Benston et al., *Economies of Scale and Scope in Banking, in* PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 432, 452 (1983) (concluding that there are no overall scales of economy below low output levels); *see also* A. Sinan Cebenoyan, *Multi-Product Cost Functions and Scale Economies in Banking*, 23 FIN. REV. 499 (Nov. 1988); Thomas Gilligan & Michael Smirlock, *An Empirical Study of Joint Production and Scale Economies in Commercial Banking*, 8 J. BANKING & FIN. 67, 67-77 (1984) (finding scale economies in small banks, but diseconomies in large banks).

191. The conclusions of the studies are subject to the following caveats: a) they all relied on an evaluative technique known as the translog cost function, but that function may contain deficiencies causing it to invariably find a U-shaped cost curve, *see* James E. McNulty, *Economies of Scale: Discussion, in* PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 456, 457 (1983); b) the data sample analyzed by various researchers came from the Federal Reserve's functional cost analysis system (FCA), which consists of only approximately 700-800 banks, is not a random sample, is a voluntary reporting scheme and likely contains information from a disproportionate number of banks that are concerned about their costs for some reason or another, *id.*; c) the studies do not include banks with over a billion dollars in assets, *see e.g.* Benston et al., *Economies of Scale and Scope in Banking, supra* note 190, at 433. Very large banks could display the kinds of scale economies that would challenge the existing findings. In today's market, a billion dollar bank is not all that large. This is a serious shortcoming in the data.

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

and other start up costs. Banks incur these costs irrespective of the number of loans actually made. Because there is a large fixed-cost start-up expense, the average cost per loan should decrease as a function of the number of loans made since the start up cost will be spread over a larger number of loans. Therefore, the bank that produces more consumer loans should, on average, be able to produce those loans at a lower average cost than its less productive competitor, all things being equal.

More recent studies have specifically investigated whether the production of consumer loans, which have high regulatory compliance costs, display scale economies. One study found substantial economies of scale in compliance with Regulation B. Larger banks spent more on compliance than smaller banks, but a 5.7% change in compliance cost was accompanied by a 10% change in the amount of credit extended.[193]

A later study found significant economies of scale in compliance costs for Regulations Z and B for commercial banks at levels of output of up to 375,000 consumer credit accounts, beyond which there are small diseconomies of scale.[194] The study concluded that "at the lowest output levels, large, unexploited scale economies exist, suggesting that Regulations Z and B impose a competitive disadvantage on banks with small consumer credit portfolios. Scale economies, however, decrease rapidly as output increases and are exhausted at a moderate level of output."[195] As of this writing, the scale economy question is still unresolved. The studies to date do, however, seem to point to a few salient conclusions: (1) within banking organizations scales of economy are modest; (2) with regard to specific high volume products such as credit cards and checking accounts, the scales of economy may be significant; and (3) large money center banks do appear to enjoy a cost economy in that they can attract capital at a lower cost than their competitors.[196]

In the NAFTA context, some North American bankers may harbor the concern that the production of banking products and services could have such economies of scale that large banking organizations inevitably will

193. *See* Neil B. Murphy, *Economies of Scale in the Cost of Compliance with Consumer Credit Protection Laws: The Case of the Implementation of the Equal Credit Opportunity Act of 1974*, 10 J. BANK RESERVES 248, 250 (Winter 1980). The study, however, was based on a very small sample of banks, and also evaluated the costs of compliance at the very outset of Regulation B's existence. This data may not reflect long run compliance costs because the survey was conducted less than one year after the original Regulation B became effective. *See* GREGORY ELLIEHAUSEN & ROBERT D. KURTZ, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, SCALE ECONOMIES AND COMPLIANCE COSTS FOR CONSUMER CREDIT REGULATION: TRUTH-IN-LENDING AND EQUAL CREDIT OPPORTUNITY LAWS, Staff Study number 144, 1 n. 3 (1985).

194. *See* ELLIEHAUSEN & KURTZ, *supra* note 193, at 10.

195. *Id.*

196. *See* ROSE, *supra* note 13, at 106-07 (discussing economy of scale studies).

come to dominate the market.[197] The data does not support that conclusion. Even if the threat of large banks may be unfounded, however, the perception of a threat is as good as a threat for political purposes, so community banks in the United States will rail against cross-border branching on the theory that U.S. money center banks and their huge Canadian and Mexican counterparts will squeeze small community banks out of the competitive picture entirely.

4. Other Aspects of Comparative Advantage

There certainly are many other factors in the complex web of economic forces that tip the balances one way or another in favor of one country or the next. One point that cannot be ignored is the strength and stability of the home economies in each country. On this point, the United States is clearly "head and shoulders" above its two partners. The U.S. economy is mature, diverse, and immense. Mexico's and Canada's economies are each about ten percent the size of the U.S. economy. Canada and Mexico are also both making the transition from being primarily natural resources-based economies to being centered more on manufacturing and services. A strong U.S. economy means strong U.S. banks, which should translate into a comparative advantage.

Another aspect of comparative advantage is the relative strengths of the banking industries as they currently exist. Canadian banks excel at retail banking delivered through a wide ranging branch network.[198] With nationwide branching in the United States now enacted, the U.S. subsidiaries of Canadian banks should be able to exploit this expertise, but not as efficiently as they would if they could merely branch from home. Canada enjoys an advantage in the Mexican market, which is quite under-banked and would seem to favor an organization skilled in delivering retail banking services.[199] American banks are probably most skilled at complying with regulations and, therefore, they should be accorded some merit in recognition of this characteristic.

Another economic fact that will affect the parties' perspectives on the branching issue is the cost of funds. Loans made in Mexico frequently are

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

198. *See* Jordan, *supra* note 3, at 54 (noting that Canadian banks are arguably more competitive than U.S. banks in retail banking).

199. *See* WHITE, *supra* note 3, at 17 (opining that Canadian banks have an initial advantage under a straight-forward branching scheme).

denominated in U.S. dollars. American banks know this, and will be very wary about providing easy branching to Mexican banks that will permit access to low cost funds through a deposit gathering network.

Of course, as the only developing country in the NAFTA group, Mexico faces some special challenges on the monetary front. Banking restrictions on foreign denominated liabilities will prevent Mexican banks from becoming too much engaged in the collection of U.S. dollar deposits.[200] Eliminating the foreign currency restrictions may destabilize the peso and will certainly increase the foreign currency exchange risk of Mexican banks. Therefore, to the extent Mexican borrowers need U.S. dollar-denominated loans, American banks enjoy an advantage.

VI. WHERE DO WE GO FROM HERE?

If the cross-border branching issue is considered in isolation, it seems unlikely that the status quo will be altered. An optimist would argue that at least unanimous Pareto optimal transactions, that is, actions where at least one party is made better off and no other party is made worse off, should be made.[201] But on closer inspection, it seems that any departure from the status quo will have winners and losers (at least in terms of comparative advantage), so the universe of potential Pareto optimal moves is an empty set.[202] Because changes to the NAFTA require unanimous agreement, if the branching provisions are considered in isolation, without some countervailing bargaining chip to even out the tradeoffs, a departure from the status quo will not occur. It seems likely that the cross-border branching issue will not be resolved until there is some exogenous shock to the status quo that realigns the interests of the players and regulators in the current regime.

An event on the horizon that could supply that shock is the agreed upon renegotiation of insurance powers that must take place before January 1, 2000.[203] As between the United States and Canada, there are not many issues relating to insurance worth fighting about,[204] but the Mexican insurance market is still largely closed to foreign investment. Given recent changes in the U.S. bank regulatory scheme permitting banks

200. *See* Karaoglan & Lubrano, *supra* note 59, at 31 (noting the regulatory restrictions on Mexican banks' exposure to foreign currency risk).

201. *See* Maxwell L. Stearns, *The Point of Pareto, Dueling Edgeworths, and Assessing Institutional Comparative Advantage, in* PUBLIC CHOICE AND PUBLIC LAW: READINGS AND COMMENTARY 362 (Maxwell L. Stearns ed., 1997).

202. *See* Guido Calebresi, *The Pointlessness of Pareto: Carrying Coase Further,* 100 YALE L.J. 1211, 1216 (1991) (noting that objectors to change believe they will lose something from the change).

203. *See* NAFTA, *supra* note 1, Annex 1404.4, 32 I.L.M. at 662.

204. *See* Jordan, *supra* note 3, at 51 (noting that few restrictions on U.S.-Canada insurance activity existed before or after the FTA).

easier access to the insurance business, the banking lobby may send the message to our trade negotiators that Mexican bank branching into the U.S. market will be acceptable in exchange for greater access to Mexico's insurance market.

Another possible exogenous shock to the system could be the reform of the U.S. federal banking scheme. Such a reform could result in a single federal banking regulator[205] - secure in its own position – that could enter into a NAFTA negotiation without fear of giving up too much domestic regulatory power. Recent attempts by Congress to rebalance the power of the various federal banking regulators, however, have resulted in protracted turf battles without any real progress toward reform,[206] so this event may never come to pass.

Perhaps the shock to the system will result from regulators realizing that in the fast changing technological world, borders are increasingly irrelevant to the transaction of banking business. Some "banking" transactions conducted over the Internet, for example, may escape effective regulation by "falling through the cracks" of national borders.[207] Perhaps through cooperation, international regulators could divide the pie of Internet transactions in a way that preserves their relative market positions.

If no dramatic shock materializes, it seems unlikely that the deadlock will end. It seems a pity, however, to perpetuate the problematic approach to bank expansion currently in place merely because banks perceive disadvantages to change. It may be possible, with the appropriate leadership, for the various players in the North American financial services market to seek out common ground instead of merely defending their current turf. From the industry's perspective, some kind of harmonization across North America would be highly desirable. It could lower compliance costs and make planning much more reliable. When viewed through a public choice lens, harmonization may also be

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205. There has been a clamor for a more rational system of banking regulation for several years. In a recent Congress the testimony sounded more like a bureaucratic turf battle than a genuine articulation of the best route for public policy. Although the immediate prospects for a single federal regulator have passed, the idea retains its attractiveness. *See* GAO Oversight Structure, *supra* note 12, at 78 (calling for a reduction in the number of federal agencies with primary responsibilities for bank oversight).

206. *See* Kane, *Legislative Agenda*, *supra* 145, at 186-88 (noting the turf battle between the Federal Reserve Board and the Office of the Comptroller of the Currency over authorization and oversight of new banking powers); *see also* Alan Yonan, Jr., *Fed's Greenspan Backs Bank Bill Rubin Opposes*, WALL ST. J., Mar. 18, 1998, at A6 (describing an incipient turf battle between the Treasury Department and the Fed over the structure of the banking industry).

207. *See* Richard Blackwell, *Under Siege: So What?*, FIN. POST, Oct. 4, 1997, at 12, *available in* LEXIS, Canada Library, Finspt File (noting the concern of Canadian regulators that they may be losing regulatory authority over "Canadian" banking transactions conducted over the Internet).

acceptable to regulators. Harmonization would reduce much of the regulatory competition that erodes regulators' market share. By standardizing the regulatory product, the regulators could form a cartel to control the supply of regulation.[208] To proceed in this direction, the parties would first need to identify the goals of the NAFTA. It seems the foremost goal is to promote the regional development and to facilitate trade. This goal, while admirable, is too broad to have any meaning for specific industry participants.

A second goal of the NAFTA is to enhance competition. Liberalizing cross-border trade in financial services should increase competition (or at least the threat of competition), which could, in turn, reduce prices, help eliminate inefficient regulation, and otherwise improve the market for financial services.[209] Of course, even if increased competition would be a legitimate national goal in a perfect world, it is clearly not something that the existing players in the market would welcome. In addition, the positive effects of increased competition are not limitless. Much of existing banking regulation is intended to rein in competition rather than to foster it. In the United States, we have made a public policy choice to trade off the benefits of competition for the benefits of a more stable banking system.[210] A moment's reflection makes clear that perfect competition in the financial market is not only unattainable, it is probably undesirable as well, because increased competition tends to result in less systemic stability.[211]

Finally, the NAFTA promotes stability. This goal may be the common ground that all the parties can subscribe to. As recently as 1985, in *Northeast Bancorp, Inc. v. Board of Governors of the Federal Reserve System*,[212] the United States Supreme Court stated that "banking and related financial activities are of profound local concern."[213] Yet, recent

208. *See* Kane, *Tension, supra* note 147, at 34 (articulating the cartel idea).

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

210. *See* NICHOLAS A. LASH, BANKING LAWS AND REGULATIONS: AN ECONOMIC PERSPECTIVE 23 (1987) (noting the value our system places on stability in the banking system).

211. The U.S. experience with "free banking" during the nineteenth century illustrates the pros and cons of unfettered competition. On the good side, the free banking era was marked by almost pure competition: barriers to entry were low, there were many participants in the banking market, and government interference was kept to a minimum. On the bad side, the era was marked by frequent bank failures, unstable money, and widespread fraud. *See* John Steele Gordon, *Understanding the S&L Mess*, AM. HERITAGE, Feb./Mar. 1991, at 49, 56-58; KERRY COOPER & DONALD R. FRASER, BANKING DEREGULATION AND THE NEW COMPETITION IN FINANCIAL SERVICES 46 (1984) (providing details about the free banking era).

212. 472 U.S. 159 (1985).

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

experiences with the Asian monetary crisis remind us that our domestic economy is inextricably entwined with the global economy. In North America, the peso crisis of 1994 spilled over into other Latin American countries, especially the leading markets of Brazil, Peru, Chile, and Argentina.[214] When instability of global dimensions shakes the world's financial markets, everyone worries. Bankers may find some value in rationalizing the international regulatory scheme to enhance stability.

Inevitably, the banking industry will find itself subject to an increasing number of international agreements affecting the trade of services generally,[215] and the regulation of banking in particular. Although multinational trading agreements covering industries as complicated as the financial services industry take a long time to evolve, on the regulation front banking regulators have begun a movement toward greater cooperation.[216] The NAFTA itself does not require the signatory countries to take any meaningful steps toward harmonization of their respective domestic laws regulating financial services,[217] although in the securities area, U.S. and Canadian regulators already have worked toward and achieved a considerable degree of harmonization of federal, state, and provincial securities regulation.[218]

If harmonization does proceed, the negotiators will need to grapple with the issue of what role, if any, is left for local control over those matters which are of local importance such as lending policies, the availability of credit and market-related matters. In North America, this question is still very much an open one, exacerbated as it is by the differences in economic power and political systems among the three countries of the region. We have not yet devised a process that allows balancing of all the public and private, local, state, federal, and

214. *See* SCOTT & WELLONS, *supra* note 119, at 1294.

215. For example, the General Agreement on Trade in Services ("GATS") has already begun to have some effect on the international provision of banking services. *See generally* Simser, *supra* note 5 (describing the structure of the GATS and its implications for the trade in financial services).

216. *See* Joseph J. Norton, *Trends in International Bank Supervision and the Basle Committee on Banking Supervision*, 48 CONSUMER FIN. L.Q. REP. 415, 415-19 (1995) (summarizing some of the issues confronting the Basle Committee on Banking Supervision).

217. *See* Trachtman, *supra* note 125, at 94 (noting that the NAFTA does not require financial regulation harmonization). *But see* Zamora, *Harmonization, supra* note 125, at 414-15 (arguing that increased cross-border contact between businesspeople, bureaucrats, lawyers, academics and others will inevitably lead to an exchange of ideas and accommodation in each of the three countries of the cultural differences of the others); Aman, *supra* note 125 (arguing that global political and economic forces push national policies towards various forms of deregulation and privatization).

218. *See* Jordan, *supra* note 3, at 53 (noting that the Canadian scheme of securities regulation is modeled after the U.S. scheme and that the regulators have achieved considerable integration).

international interests that are affected in cross-border policy-making.[219] Although the NAFTA reaches across borders, it in some ways only serves to reinforce the idea of the nation state,[220] in a world informed by the public choice perspective it must be so. That perspective aside, however, if the governments of the three NAFTA countries truly aspire toward improving the lot of their citizens, they must find a way to move beyond national politics in order to implement the best practice approaches that will benefit everyone in North America.[221] In the end, perhaps one of the benefits of trade will be that we begin to think of ourselves more as "North Americans" and less as Mexicans, Americans, and Canadians. When we begin to forge that common link, the political will to permit trade across national borders with no more formality that we now require for interstate trade may gain ground and even overcome the resistance of particular groups who oppose change because of their own short-term economic interests.

VII. CONCLUSION

In a perfect world, form follows function. In that world, banking organizations that profit from the activities of subsidiaries would bear responsibility for their subsidiaries' business, at least to some extent. Alternatively, in a world where freedom of choice is highly valued, firms would be free to choose whether to organize their operations as subsidiaries, branches, or agencies based on the dictates of their own business plan rather than the dictates of the regulatory scheme. In the world we live in, however, choices are constrained by the parties who have an interest in the outcome of the process. In the cross-border banking context, that means the regulators who will have to give up power under a new system, and market participants who may have to sacrifice perceived market advantages embedded in the status quo. For any real change to occur, the regulators and the industry participants will have to see that change is in their own best interests. Such a change may occur through an exogenous shock to the current status quo that forces a realignment of interest or through the process of international regulation of

219. *See generally* Stephen Zamora, *Allocating Legislative Competence in the Americas: The Early Experience Under NAFTA and the Challenge of Hemispheric Integration*, 19 HOUS. J. INT'L L. 615 (1997) (discussing the problem of balancing legislative power in international policy-making).

220. *See generally* Lash, *supra* note 89 (discussing generally how multinational agreements change the nation states, but how they ultimately remain the most important political unit even in a multinational world).

221. *See* Ruth Buchanan, *Border Crossings: NAFTA, Regulatory Restructuring, and the Politics of Place*, 2 IND J. GLOBAL LEGAL STUD. 371 (1995) (arguing that the NAFTA exacerbated differences between localities, industries and labor markets and ignored the complex interaction of labor, capital and regulation in the borderlands).

financial services designed to lend stability to the world's financial markets.