Is the North American Free Trade Agreement (NAFTA) the Trojan Horse for the US Insurance Industry?

by
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Introduction

North American Free Trade Agreement (NAFTA) is an unprecedented treaty. It opened the markets for goods between the United States, Canada and Mexico. On January 1, 2000, the "services" component of the treaty kicked in. This new phase will bring in a sea of changes in insurance business practiced across borders. Here, we look at the exact nature of NAFTA by analyzing how it came about (with an emphasis on financial services). We show how some national laws can easily contradict NAFTA. We discuss NAFTA financial services provisions in the light of the recently passed Gram-Leach-Blily Act. We pinpoint some examples where mismatch of legal provisions has given rise to disputes. Finally, we show that NAFTA dispute resolution mechanism is inadequate to handle these problems.

NAFTA and the US in Global Perspective

The US insurance market is the largest in the world (see Table 1). To understand the NAFTA market for insurance, we have listed the top ten markets in the world in Table 1. Mexico does not feature there though Canada does. Thus, in global scheme of things, NAFTA represents a small extension of the US market (see below). However, in regulatory reform, NAFTA represents in giant leap. It has brought together three countries: a large developed market (US), a small, developed market (Canada) and a small but potentially large developing market (Mexico).

Table 1: Ten largest countries in terms of insurance premiums

1	United States	$747,984	6	South Korea	$62,470
2	Japan	$519,589	7	Italy	$43,911
3	Germany	$152,218	8	Canada	$36,196
4	United Kingdom	$137,061	9	Netherlands	$36,139
5	France	$136,841	10	Australia	$33,103

Premium volumes are in millions of US dollars. Data are for 1996. Source: Sigma 4/1998 and NAIC database.

The following table (Table 2) compares three large regions of insurance markets in the world: NAFTA, European Union (EU), and East Asia. EU has little restriction on expansion within the EU zone. Thus, for example, insurance companies from Italy can expand almost freely in Spain. There have been years of regulatory harmonization among the EU countries. The Third Directive is a big move in that direction. In addition, the EU has also taken steps to move towards a common currency (Euro), although not all EU members have joined (notably the United Kingdom). It has also taken steps to integrate labor markets across countries.

NAFTA is a half way house. It has ensured (almost) free flow of goods between the three countries. On January 1, 2000, it has also opened the financial services sector for all the three countries. We shall show below that NAFTA provisions for goods were very different from the provisions for services. Specifically, insurance provision under NAFTA will severely test regulators in all the three countries.

Table 2: Markets by regions

NAFTA		EU	
United States	747984	Germany	152,218
Canada	36196	United Kingdom	137,061
Mexico	4097	France	136,841
Total	$788,277	Italy	43,911
		Netherlands	36,139
		Spain	30,200
East Asia		Belgium	15,323
Japan	519,589	Austria	13,608
South Korea	62,470	Sweden	13,057
Taiwan	15,827	Denmark	11,118
China	9,622	Finland	10,105
Malaysia	4,631	Ireland	6,946
Thailand	4,586	Portugal	6,048
Total	$616,725	Luxembourg	3,914
		Greece	2,082
		Total	$618,571

Premium volumes are in millions of US dollars. Data are for 1996. Source: Sigma 4/1998 and NAIC database.

Table 3 shows that North America, Europe and Asia have insurance markets with similar order of magnitude. These three are twenty times bigger than the markets for Oceania, Latin America and Africa.

Table 3: Regional Markets and their sizes

1	North America*	$784,179	4	Oceania	$37,187
2	Europe	$674,737	5	Latin America+	$32,913
3	Asia	$647,060	6	Africa	$24,755

Premium volumes are in millions of US dollars. Data are for 1996. Source: Sigma 4/1998 and NAIC database. * North America includes US and Canada but not Mexico. +Latin America includes Mexico.

It is probably unfair to think of the insurance market as one single market. Given that the state insurance commissioners have strong influence on the policy making in each of the fifty states, it might be instructive to think of each state as a separate market. Table 4 shows the results of this exercise. Among the top ten markets in the world, four states of the US come in (New York, California, Texas and Florida). Among the top 20, another five states join in. Among the top 50, 30 states of the US find place. Thus, by global standards, each state of the United States represents an important piece of the insurance market.

Table 4: How big are world insurance markets compared with States of the US

1	Japan	$519,589	26	Virginia	$16,020
2	Germany	$152,218	27	Taiwan	$15,827
3	United Kingdom	$137,061	28	Washington	$15,822
4	France	$136,841	29	Wisconsin	$15,365
5	New York	$71,390	30	Belgium	$15,323
6	California	$66,702	31	Brazil	$15,029
7	South Korea	$62,470	32	Missouri	$14,742
8	Texas	$48,685	33	Connecticut	$14,621
9	Florida	$44,079	34	Maryland	$14,234
10	Italy	$43,911	35	Minnesota	$14,129
11	Illinois	$39,923	36	Austria	$13,608
12	Canada	$36,196	37	Tennessee	$13,536
13	Netherlands	$36,139	38	Sweden	$13,057
14	Australia	$33,103	39	Colorado	$12,379
15	Switzerland	$32,994	40	Arizona	$11,721
16	Michigan	$30,502	41	Denmark	$11,118
17	Spain	$30,200	42	Alabama	$10,579
18	New Jersey	$29,959	43	Louisiana	$10,106
19	Ohio	$29,487	44	Finland	$10,105
20	Pennsylvania*	$28,016	45	China	$9,622
21	Massachusetts	$26,389	46	Oregon	$9,315
22	Georgia	$19,951	47	Iowa	$8,289
23	South Africa	$19,578	48	Kentucky	$8,188
24	North Carolina	$17,769	49	South Carolina	$7,807
25	Indiana	$16,199	50	Kansas	$6,615

Premium volumes are in millions of US dollars. Data are for 1996. Source: Sigma 4/1998 and NAIC database. *Pennsylvania data does not include HMO and HMDI premiums.

The Insurance Market in Mexico

From 1990 to 1999 the number of insurance premiums issued in Mexico doubled. During the same period the number of companies operating in the country rose from 44 to 64, while 41 of these involve foreign participation, either as subsidiaries or through joint investment. The participation of foreign companies in the industry brought with it new technology, new markets and a new insurance culture. In 1999 there were 37.9 million insurance contracts worth $6 billion in premiums. The size of each company in the market is given in Table 5.

Table 5: Size and share of insurance market in Mexico 1998

Company	Premium	Share
Comercial America	13,596,392	23.62
Grupo Nacional Provincial	10,505,415	18.25
Monterrey Aetna	4,042,230	7.02
Inbursa	3,948,257	6.86
Pensiones Bancomer	2,219,876	3.86
Tepeyac	1,755,921	3.05
Genesis	1,705,674	2.96
Banamex Aegon	1,398,445	2.43
Porvenir GNP	1,371,605	2.38
Bancomer	1,318,952	2.29
Aba/Seguros	988,815	1.72
AIG Mexico	933,734	1.62
Atlas	812,194	1.41
BBV Probursa	730,178	1.27
Allianz Mexico	714,472	1.24
General de Seguros	556,344	0.97
Pensiones Comercial America	515,015	0.84
La Territorial	511,958	0.89
Serfin	505,727	0.88
Interacciones	496,219	0.86
Total Private	53,161,849	92.35
Total Government	4,405,270	7.65
Hidalgo	4,006,317	6.96
Agroasemex	398,952	0.69
Total Market	57,567,119	100.00

Premium in thousands of Mexican pesos (9.5 pesos=1 USD, July 2000)

Foreign Participation in the Insurance Market

Of the 64 companies competing in the insurance industry in Mexico more than 41 have major foreign participation with more than 30 percent (InfoLatina, 16 June 2000). In April 2000, Dutch financial group, ING, confirmed its intention to expand on the Mexican market. The group announced that it would acquire 39.7 percent of stock in the largest insurance group in Mexico, Seguros Comercial America. Monterrey Aetna, the third largest insurance company is Mexico has been acquired by New York Life of the US in December 1999 (see, Sinha, 1999).

Table 6: Mexican Insurance Companies as Foreign Subsidiaries

Subsidiary	*Institution*
AIG Mexico, Seg. Interamericana	American International Group Inc.
Allianz Mexico	Allianz of America, Inc.
Allianz Rentas Vitalicias	Allianz of America, Inc.
Aseguradora Inverlincoln	Santander Investments
BBV Probursa	BBV International Investment Corp.
Chubb de Mexico	Federal Insurance Co.
Colonial Penn de Mexico	Colonial Penn Insurnace Company
Combined Seguros Mexico	Combined Insurance Co. of America
El Aguila Cia. de Seguros	Windsor Insurance Co.
Generali	Transocean Holding Corp.
Geo New York Life, S.A.	New York Life International Inc.
Gerling De Mexico	Gerling America Insurance Co.
ING Seguros	ING US Insurance Holding
Liberty Mexico	Liberty Mutual
Principal Mexico	Principal International Inc.
Reaseguradora Alianza	Swiss Reinsurance Co.
Seguros Renamex, S.A.	Reliance National Insurance Co.
Skandia Vida American	Skandia Life Assurance Company
Seguros Cigna	Cigna International Holdings Ltd.
Seguros del Centro	General Electric Assurance Company
Seguros Genesis	Metropolitan Life Insurance Company
Seguros St. Paul de Mexico, S.A. de C.V.	St. Paul Multinational Holdings Inc.
Tokio Marine, Cia de Seguros	Tokio Marine Delaware Corp.
Yasuda Kasai Mexico	Yasuda FMI Co. of America
Zurich, Cia. de Seguros	Zurmex Canada Holding, Ltd.
Zurich Vida, Cia. de Seguros	Zurmex Canada Holding, Ltd.

Source: CNSF

Privatization Setback

Hidalgo, the largest government owned insurance company was to sell 49% of its shares to the market. This process was slated for March 2000. On May 8, 2000, the Federal Competition Commission canceled this privatization. The Commission denied authorization to the four interested companies in the sale to participate, resulting in the abandonment of the process. The company will therefore remain 100 percent state owned at least for what remains of the current administration. With the change of the government that takes office on December 1, 2000, this will surely change.

Bank Participation in Insurance Sector

Mexico had private banking for 140 years. For a short period of time (1982-1991) banks were nationalized. They were re-privatized in 1991. New laws allowed banks to provide investment services and insurance within the banks. Banks have been offering insurance, pension and other financial services under the same roof. For instance, we see the largest bank in Mexico (Bancomer) operating the largest pension fund in Mexico. Ever since the privatization of banks, bancassurance has not only become a fact of life; it has been encouraged in the tradition of Continental Europe. Therefore, banks have acquired expertise on how to sell related products (see, Sinha, 1998).

The participation of Mexican banks in the insurance sector is rising (though still low) because banks can offer lower prices taking advantage of their distribution system. Bank participation in this sector rose to 7.7 percent in 1999. Seven banks participate in the sector, including Bancomer, Banorte, Generali and Banamex-Aegon. Banks are able to reduce insurance sales costs by making direct sales to clients instead of using agents.

Insurance Selling in the Other Direction

Some of the subsidiaries of international companies have already obtained licenses to operate in the US. For example, AIG Mexico, a subsidiary of AIG International, already has license to sell insurance policies in three key border states: California, Arizona and Texas.

Some medical insurers from Mexico have also started business in the US. For example, in March 2000, Mexican HMO called Sistemas Medicos Nacionales SA de CV was given a license to provide services as health maintenance organization in California. The main reason for seeking such a license is to provide health care insurance for Mexican workers in the US.

Understanding Market Penetration in Mexico

In Tables 7-9 we present market penetration data for Mexico in relative terms. It shows that insurance density (premium per capita) in Mexico remains under $65 in 1998. The numbers are 40 times as large in other the developed Western nations. This presents an opportunity. As a country develops, the insurance density rises at a rate faster than the per capita income (in economic terms, income elasticity of insurance demand is greater than unity). This can be clearly seen in the case of Argentina, Chile and Venezuela (Table 8). In Venezuela, per capita income has steadily fallen as has the insurance penetration. Exactly the opposite holds for Argentina and Chile.

Table 7: Insurance market share, density and premium

Item	*Mexico*	*US*	*UK*	*G7*	*EU*	*NAFTA*
Share of World	0.29	34.17	8.40	80.04	31.22	36.46
Insurance Density (US$)	62.90	2,722.70	2,858.90	2,497.70	1,651.30	1,959.90
Insurance Penetration (%)	1.52	8.65	12.09	8.93	7.35	8.25

Insurance Density (premium per capita) is the premiums written divided by total population. Insurance penetration (premiums as a share of GDP) measures the significance of the insurance industry relative to the country's entire economic production. Life Insurance penetration typically increases in line with personal income (Source: Sigma, 1998).

Table 8: Insurance Premium as a percentage of GDP

Country	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
US	8.60	8.70	8.90	8.60	8.60	8.60	8.49	8.65
Canada	5.80	5.40	6.50	6.20	6.60	6.00	7.37	7.14
Chile	2.89	2.92	3.26	3.30	3.17	3.34	3.46	3.39
Brazil	n.a.	n.a.	1.63	1.93	1.89	1.78	2.12	2.15
Argentina	1.54	1.55	1.58	1.60	2.25	1.47	1.59	2.09
Venezuela	2.03	2.19	2.53	1.97	1.77	1.52	1.63	1.89
Mexico	1.30	1.40	1.43	1.43	1.30	1.23	1.30	1.52

Sources: various.

Table 9: Premium per capita in US (current) dollars

Country	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
US	1,927	2,068	2,192	2,280	2,372	2,460	2,571	2,723
Canada	1,225	1,255	1,240	1,168	1,255	1,210	1,544	1,425
Argentina	89	105	112	127	145	127	143	172
Chile	70	88	102	128	146	162	182	162
Brazil	n.a.	34	46	70	85	88	104	103
Venezuela	54	65	50	47	37	40	63	76
Mexico	45	70	70	70	42	45	56	63

Sources: various

Free Trade Agreements in Services

On a global basis, exports of services account for some 19% of total trade (1998). Between 1990 and 1997, global trade in goods rose at the rate of 7% a year whereas global trade in services grew at the rate of 8% a year. Financial services did not grow in terms of exports. Financial services stand out for two specific reasons. (1) Regulation of financial services is more extensive than other services. (2) Regulation of financial services is almost always couched in national terms.

Canada United States Free Trade Agreement (CUSFTA)

CUSFTA provided the pioneering step in financial services agreements. Both countries already had low tariff fences. Thus, tariff phase-outs were not central to CUSFTA. Non-tariff measures, trade remedy laws, and structural and regulatory impediments were the largest source of bilateral trade disputes. In setting out the agenda, the negotiators had to walk through the minefield of regulations of financial services. Canada had long feared US domination of its market. Hence, it chose to allow foreign banks to operate in Canada only in limited areas. Foreign banks were allowed to operate under "Schedule II". They were basically barred from branching, deposit taking and many other critical retail activities. Only Canadian banks were allowed unrestricted access (so called Schedule I banks). In the US, the dominant regulation was the *Glass-Steagall Act* of 1933. It prevented banks from dealing with securities directly or to enter insurance business. It also prevented interstate banking.

US sought full-scale entry into the Canadian market. Canada wanted complete exemption from the *Glass Steagall Act* under CUSFTA. In the end, the CUSFTA Agreement Chapter 17 (for financial services) ended up with a list of things that either party was permitted to operate in the other country. This is the so-called positive list approach. If some activity is specifically listed, it is allowed. Everything else is automatically excluded. Specifically, US banks were still excluded under Schedule I.

North American Free Trade Agreement (NAFTA)

In some ways NAFTA is an extension of CUSFTA. It trilateralizes the bilateral agreement. However, it added a developing country into the equation: Mexico. In the early 1990s, Mexican financial sector has gone through the most dramatic changes in a century. Foreign investment was not only permitted but also welcome. In June 1990, the government passed *La Ley de Grupos Financieros* that permitted establishment of universal banks. This law allowed cross-ownership of banks, insurance companies and security firms. The government stipulated a maximum total foreign participation of 30% of equity capital. Ownership of shares by a single foreign individual was limited to 10%. Institutional investor of foreign origin had a limit of 15%. Until 1990-1, foreign companies were effectively prohibited from ownership of banks in Mexico (the only exception was granted to Citibank).

When Mexico came to the negotiating table for NAFTA, it wanted to add financial services at a later date. Therefore, NAFTA negotiations forced the creation of a separate chapter (Chapter 14, discussed below). This chapter departed from CUSFTA in one fundamental way. CUSFTA specified a positive list: parties can only work in other party's territory in areas of the positive list. NAFTA negotiations created a negative list (Annex VII). The parties could operate in any area *not* specified in that list. In addition, the negative list excluded only a few items. Thus, in principle, NAFTA expanded the scope of financial operations vastly over CUSFTA. The Mexican approach to NAFTA was to put restrictions during a transitional period of 1994-1999. From the Mexican side, liberalization of financial services was "locked in". For example, it would be extremely difficult to re-nationalize banks in the future without paying huge compensation. This was not the case when Mexico nationalized the oil industry in the 1930s or banking industry in the 1980s.

The NAFTA Financial Services Chapter is a historical document because it marks the first event in history where two developed countries with stable financial systems have linked themselves to a developing country with a history of financial instability. By including financial services under NAFTA, the US and Canada have cast an implicit vote of confidence in the success and durability of Mexican financial reform process. With the December 1994 devaluation of Mexican peso and the ensuing financial crisis in Mexico, the durability of NAFTA was severely tested. Most observers agree that without NAFTA it would have been extremely difficult to put together the "rescue package" (Exchange Stabilization Fund) that was in place swiftly.

Legal Standing of the NAFTA in the US and Mexico

Two main issues determine NAFTA's legal standing: whether the agreement is self-executing or not, and what authority it has within the national legal framework, vis-à-vis other federal laws and state laws. A self-executing treaty is one that is automatically binding within the national legal system at the moment it is signed. In general, treaties are not self-executing in dualist legal systems such as that of the U.S. International law is considered a separate legal system, so that a violation of international law alone cannot give rise to a claim under national law. Moreover, individuals and firms are not subjects of international law, so no legal claim against them can be made under that legal system. The state in which the violation takes place can be sued by another state under international law, and may be made to compensate the harmed state(s), but this liability cannot extend to any individual or firm. Hence, for a treaty to become binding under national law, an "act of transformation" such as an implementation act must be passed by the legislative branch of the national government.

In addition, treaties in the U.S. need only be ratified by two thirds of the Senate. If the House disapproves of the treaty it may then block the passage of any implementation act, thus invalidating the treaty's effects. The Johnson administration found itself in this situation after negotiating a Canada-U.S. auto pact eliminating many tariffs on vehicles, auto parts, and accessories. Congress delayed passage of the implementation act until Canada threatened to sue the U.S. for breach of its international obligations under the pact. The implementation act finally passed by Congress strictly limited the president's future ability to enter into trade accords without previously consulting Congress. Eventually, this legislation led to the fast-track mechanism (Trade Acts of 1974 and 1979; Trade and Tariff Act of 1984; Omnibus Trade and Competitiveness Act of 1988). In this mechanism, the president obtains Congressional approval prior to beginning trade negotiations. Permission is given for the negotiation of executive agreements (not treaties) to attain specific trade goals, and Congress commits to expedite the discussion and passage of the corresponding implementation act once the trade agreement is signed by the president.

NAFTA and the Uruguay Round of GATT were both negotiated and implemented in the U.S. through the fast-track process. Regarding both the agreements, the U.S. has explicitly stated: "No provision of this Agreement, nor the application of any such provision to any person or circumstance, which is inconsistent with any law of the United

States shall have any effect." (NAFTA, P.L. 103-361, Section 102(a); Uruguay Round Agreements Act Pub. L. No.103-564, Section 102(a)(1)).

Regarding their position in the hierarchy of the national legal system, these agreements constitute federal laws within the U.S. As between federal laws, the law enacted last in time prevails. This means that any act passed after 1993 that violates the original NAFTA implementation act will prevail over that act within the U.S. legal system. For conflicts between NAFTA provisions and state laws, the implementation act states: "No State law may be declared invalid on the ground that the provision or application is inconsistent with the Agreement, except in an action brought by the United States for the purpose of declaring such law or application invalid." (Sec. 102(b)(3)). In other words, states have no direct obligations under NAFTA, and any state law in violation of U.S. obligations under NAFTA can only be challenged by the U.S. federal government, and must be decided under U.S. conflict of law rules.

Mexico, on the other hand, has a monist legal system, in which international treaties (like the NAFTA) are automatically incorporated into the national legal system and are self-executing. In terms of hierarchy, Article 133 of the Mexican Constitution places treaties at the same level as ordinary federal legislation, in which case the law last enacted would bind. However, several leading scholars of Mexican law consider treaties to be above ordinary federal legislation, and only below the Constitution itself. As yet, no occasion has arisen to test the strength of the NAFTA treaty against conflicting federal legislation. In addition, federal-state conflicts affecting the application of the NAFTA are very unlikely in the Mexican framework. Commercial law does not exist at the state level in Mexico, so all commercial questions, including financial investments and contracts, fall under federal jurisdiction. Also, regulation of the financial sector is exclusive to the federal government. Therefore, although Mexican states have no legal obligations under the NAFTA treaty, they also can do virtually nothing to impede its application in the financial services area.

NAFTA's Financial Services Section:

NAFTA chapter 14 incorporates provisions from the investment chapter that relate to the ease of transfers from the investment in the host country to the investor in the home country. This would include all dividends, interest, fees, contract obligations, proceeds from sales of assets. In other words, the NAFTA countries promise not to restrict in any way the accrual of profits from financial sector investments to the home country investors. For example, any exchange and currency controls of the sort that Mexico used extensively in the 60s and 70s would be precluded. Also, chapter 14 incorporates the strict expropriation controls of chapter 11: expropriation may only be done for a public purpose, in a non discriminatory manner, and must provide prompt market value compensation – including "going concern value" – in a G7 currency, with interest provisions in case of any delay. The NAFTA parties reserve the right, in both chapters 11 and 14, to regulate investment in such as way as to protect the environment or public health. Nevertheless such regulations would have to be applied on a nondiscriminatory basis to home country and NAFTA party investors. Finally, chapter 14 imports chapter

11's quasi-rules of origin. A NAFTA party need not extend the agreement's benefits to a financial services enterprise incorporated under another NAFTA party's law but owned or controlled by a non-party who is either excluded from financial investments in the host country or has substantial business dealings with that party. This provision indicates that the basic rule of origin for financial services is corporate control. An institution controlled by U.S., Canadian, or Mexican investors would thus qualify for all treaty benefits.

Concerning the establishment of financial institutions, the parties to the NAFTA agree to the principle that each foreign investor in the financial services sector should be free to choose the most convenient form of incorporation. In practice, however, each party is allowed to require the other party's investors to incorporate subsidiaries under the laws of the host country in order to take advantage Ch. 14's benefits. The only party that gives NAFTA treatment to branches is the US. (footnote here – in fact the situation is more complicated because branching rules within the US are state based, so that financial services companies expanding into the US may want to establish subsidiaries in any case). According to Article 1403, when the US permits interstate branching, the parties to the NAFTA are to renegotiate the branch/subsidiary issue so as to allow investors in the financial sector to choose any form of incorporation. To date, there is no evidence that these consultations have taken place.

Cross border service provision is allowed in the sense that a resident of one country can purchase financial services from a company located in another party's territory. However, companies may not solicit or do business within another party's territory without establishing a branch or subsidiary in that territory. In short, cross border provision of financial services is frozen at its pre-NAFTA level. Revision of this freeze is supposed to begin before January 1, 2000.

National treatment means that no NAFTA party can discriminate against a financial service company established in its territory on the basis of ownership or control by another NAFTA party's investors. Discrimination could take the form of prohibiting the sale of certain services, additional regulations that raise the costs of the foreign affiliate, limitations on expansion or acquisitions, and so on. Each NAFTA party commits to treat such companies "no less favorably" than it treats domestically owned firms. This commitment extends to the treatment given by state and provincial regulations and regulators to NAFTA-owned financial service providers. An important caveat distinguishes "no discrimination" from "identical treatment". A federal, state, or provincial regulator may impose additional requirements on a NAFTA firm establishing in its territory, as long as these requirements do not put the company at a competitive disadvantage. Since competitive advantage is difficult to measure or prove, this refinement of the "national treatment" concept seems to allow the host country's regulators to engage in some discrimination. Additionally, "national treatment" applies to services and products that are produced within the host country by its own domestic firms. In other words, this provision does not commit the NAFTA parties to open their financial markets to new products.

Most favored nation treatment extends the principle of "no less favorable" treatment by guaranteeing that the host country will treat the NAFTA financial services firm as well as it treats any other foreign firm. In general, national treatment is better than most favored nation status; NAFTA parties are entitled to the better of the two. MFN would become important where the host country places more entry restrictions on NAFTA firm than it requires of a non-NAFTA foreign affiliate.

The transparency article (1411) makes two commitments. First, each NAFTA party must notify the others of proposed or planned measures that relate to financial services, and must provide an opportunity for each of its partners to comment on the measure. Second, each party's regulatory authorities must provide potential entrants into their market with a complete list of requirements to apply for entry. Once these requirements have been completed, the regulator should make a decision on the application within 120 days. Note that a complete application may require hearings and extensive information exchange, so that entry could easily be delayed beyond 6 months. Also, if the regulator cannot decide within 120 days, it may inform the applicant of the delay, and make its decision "within a reasonable time".

Finally, the financial services section creates a committee, formed by the parties' finance or treasury ministers. The Committee plays a role in the dispute resolution process discussed below and reports to the Free Trade Commission (trade ministers) on an annual basis regarding the performance of the financial service provisions.

Exceptions:

Articles 1409 and 1410 and each country's schedule to Annex VII set out the exceptions taken by each country to this part of the agreement. The general exceptions include all reasonable regulatory measures taken for prudential purposes. This means protection of investors or depositors or other financial market participants, as well as maintaining the soundness of each country's financial system or implementing monetary or exchange rate policy. Each country's specific exceptions essentially contain a "negative list" of financial services that will remain restricted either indefinitely or for some transition period. This means that all financial services not subject to restrictions should get full NAFTA benefits.

Part A of Mexico's schedule details exceptions of definite duration, but most of these do not apply to foreign financial affiliates incorporated under Mexican law, i.e. subsidiaries of NAFTA companies. Part B contains the transitional provisions, which allow progressively larger levels of investment of NAFTA party companies in financial institutions established in Mexico. Since the transition period ended on January 1, 2000, only the permanent exceptions in Part B still have effect. A limit on the acquisition by a foreign financial service provider of a Mexican commercial bank constituting more than 4% of aggregate commercial bank capital was extended to 6% in 1995 and eliminated in 1999. Thus, at the moment U.S. or Canadian financial service companies could acquire any of Mexico's 6 largest banks. In fact, the elimination of such acquisition restrictions for commercial banks appears to have been extended to European Union countries – two

Spanish banks have recently acquired Mexican commercial banks. Two major exceptions will continue to hold. First, Mexico may stipulate that the foreign financial service company wholly own a non-insurance foreign affiliate. The idea behind this restriction may be that wholly owned subsidiaries represent more "commitment" on the side of the foreign company, including sufficient capitalization and liability for the subsidiary's legal obligations or wrong-doing. Second, Mexico may prevent the financial subsidiary established in its territory from setting up its own branches or subsidiaries in other countries. In other words, a financial subsidiary of a New York insurance company in Mexico may not be able to establish a subsidiary in Texas.

On the U.S. side, the NAFTA provisions taken together with its exceptions imply no real concessions to Mexico and Canada. In other words, all foreign owned financial service companies are entitled to the same treatment under U.S. law[1]. The main benefit of the NAFTA for the Canadian and Mexican financial services companies is the assurance that no new restrictions will be places on investment and financial activities. In its schedule to Annex VII, the U.S. first provides that all current non-conforming federal laws are grandfathered. In addition, it lists state laws or regulations that could preclude the entrance of a foreign bank into a given state, notwithstanding the relevant federal law. Under the International Banking Act of 1978, foreign banks branching into the U.S. must choose a "home state" as their base of operations in the U.S. National treatment implies that state B must evaluate an application for branching or acquisition by the foreign bank just as it would evaluate an application by a U.S. bank incorporated in state A. However, the U.S. states clearly in Part A of its schedule that this may not hold for some states. In particular, some states have explicit prohibitions on foreign banks being considered "regional holding companies", that are entitled to almost automatic access to state markets. Also, some states require that a majority of the parent bank's deposits be located in the U.S. or in a particular region of the U.S. In such cases, the U.S. exception indicates clearly that state law will prevail.

Dispute Resolution

In general, consultations and negotiations are encouraged, though not mandatory, before a dispute resolution process is triggered. The requirement that a complaining party inform the defending party of its intention to pursue a formal dispute at least 90 days before the formal initiation of the process makes consultation and negotiation almost inevitable. For financial services, the Committee oversees consultations and negotiations, and when negotiations lead to resolution of the conflict, the Committee must report on the conflict and its resolution in its annual report to the Federal Trade Commission.

The NAFTA has three basic dispute settlement procedures. Chapter 11 deals with investment disputes, Chapter 19 deals with dumping and countervailing duties, and Chapter 20 is the main default settlement mechanism. Disputes in the financial services area are divided into investment and non-investment disputes. The former follow Chapter

[1] Gouvin, 1999.

11 procedures, and the latter follow Chapter 20, with some special provisions for financial sector disputes.

Article 1415 sends investment related (acquisition, transfer, and expropriation) disputes to the chapter 11 procedures. While the rest of the NAFTA's dispute resolution mechanisms involve the formation of a national panel, followed by a possible appeals process, investment disputes are sent directly to international arbitration, following international procedures from the ICSID and UNCITRAL treaties. The parties are to appoint three arbitrators, and if they cannot agree, the Secretary General of ICSID appoints the arbitrators. When the defense of a party to the dispute involves a reservation or exception taken by that party in the relevant annex, the panel must refer the interpretation of such reservations to the Federal Trade Commission, which issues an interpretation in no more than 60 days. The arbitral tribunal may order an interim measure of protection to safeguard the rights of the parties. Essentially this could be an injunction on all or some of the behavior under dispute. (This is particularly important because the Mexican legal system does not in general allow injunctions, so investment disputes heard under Mexican law must come to a conclusion before any sanctions are imposed). In its final award the panel can provide for restitution of property, or equivalent monetary damages with interest.

For non-investment disputes, Chapter 14 provides for the formation of a special financial services dispute panel. Each party is supposed to keep and publish a roster of 30 individuals to be chosen for general dispute resolution panels, and 15 that may be appointed to financial services panels. The advantage of the special financial dispute resolution panel is that parties can appoint individuals with special expertise in the financial sector. However, a panel formed exclusively from the Chapter 14 roster may only hear financial sector disputes, and may only impose sanctions within the financial services sector. Otherwise, its procedures, powers, and sanctions are similar to those of chapter 20 and chapter 11. There are specific deadlines for the presentation of briefs, the hearing of oral arguments, and the panel's final decision. If deadlines are binding at almost every step, a given dispute resolution process can easily take one year from the time of the formal complaint.

In fact, to date the NAFTA countries have not kept the required rosters, and the choice of panelists has been time consuming and problematic, with parties to the disputes repeatedly exercising their veto rights regarding specific panel appointments by the other party. (In general, vetoes can be exercised when an individual is either not qualified, which rarely happens, or when there is some apparent conflict of interest, because the individual has worked for the government or for domestic corporations that have a vested interest in the dispute. Hence, law professors and other academics have been over-represented in dispute resolution panels thus far.) This leads some international commercial law scholars to believe that a permanent tribunal for disputes would make the dispute resolution process faster, less subject to hold up problems, and more professional[2].

[2] Picker, 1997.

Except for chapter 19 anti-dumping and countervailing duty disputes, the decision of arbitration or dispute resoluation panels is binding on the parties to the dispute. Thus far, compliance has taken place although it has been slow in some instances. To date, 4 Chapter 20 disputes have reached the panel resolution stage and 11 issues, ranging from corn brooms to uranium and bus transport, have reached the chapter 20 consultation stage. Chapter 11 claims have focused on challenges to environmental law. As yet, no financial services formal dispute has been filed. Given that it is very similar to other proven NAFTA dispute resolution processes, financial services dispute resolution should function well. However, delays in the appointment of panelists and problems of interpretation of national laws by the panels will plague the resolution of financial disputes much as they have interfered in other disputes. In addition, the time cost involved in concluding a dispute could be more important in the financial services sector where technological change is rapid and the creation of new services frequent.

National Laws and Regulations Relevant to Financial Services

National laws have important effects on trade in financial services between the NAFTA countries for several reasons. The NAFTA provisions for financial services, as noted above, consist of an incomplete negative list. For any services or financial products not in the list, NAFTA principles of national treatment and most favored nation status should govern. However, in practice these principles will have to "compete" with national laws that deal specifically with such new services. When it comes to services not envisaged by the NAFTA, it is not clear that the NAFTA provisions will take precedence over specific national legislation. Also, within the NAFTA framework, U.S. and Canadian exceptions defer to state or provincial law in certain areas, such as interstate branching. More importantly, NAFTA contains resolution processes for conflicts between nations and for conflicts between companies and states only for the case of investment disputes. However, all standard commercial disputes between companies must be resolved under the law of one of the NAFTA countries. Hence, the jurisdictional rules, procedure, substantive law, and general legal environment in each of these countries is of paramount importance to financial service companies entering its market.

In general, relevant national laws can be divided into two types: laws regarding entry, such as licensing, and regulations of activities once entry has occurred. In a sense, we could consider that entry related laws raise the cost of entry by imposing direct fees, mandating compulsory reports, or forcing the adoption of new accounting standards. On the other hand, regulating ongoing activities could raise the marginal cost of doing business if the regulation requires extensive information collection, complicated documentation, or higher bonds posted as assets or deposits increase. Thus both types of laws can discourage entry, by placing an explicit barrier or by making entry undesirable due to stifling regulation of activities.

A financial service company planning an acquisition or expansion into a NAFTA country worries that the state or country's regulations will put it at a competitive disadvantage with respect to domestic companies of that country. Laws could "discriminate" in an explicit or an implicit way. NAFTA's national treatment obligations make it difficult for national laws to discriminate explicitly against foreign companies without either prudential reasons or a showing that the discrimination does not amount to a competitive disadvantage for foreign companies. However, even laws that are blind to the company's origin can subtly discriminate against foreign entities. For example, some regulations could require a certain number of years of domestic experience, or a large amount of domestic assets or deposits, in order to enter certain markets in the host country. Also, regulations tend to disregard the oversight that foreign companies are already subject to in their state of incorporation. These companies could find themselves forced to comply with different sets of regulations that have similar goals but use orthogonal or even conflicting means. In addition to "origin blind" laws, there are several federal and state level banking and insurance laws that apply only to foreign financial services companies. In general, state regulators of banking or insurance may propose and enforce such laws.[3]

In what follows, we will consider US and Mexican laws and regulatory structure relevant to the financial services sector. We discuss laws pertinent to the whole financial services area, as well as specific insurance and bank regulation. We also discuss any special laws applicable to foreign banking or insurance entrants to each market. Given recent financial reform in the U.S. that permits insurance sale and underwriting by banks under certain circumstances, it is very likely that entrants into the U.S. market will want to provide banking and insurance services jointly. In Mexico, bancassurance is the very common, so US companies entering the market will probably also want to provide both types of services.

US financial, insurance, and banking regulation

Recent General Financial Sector Reforms

Recent financial reform in the US has lowered the barriers between various segments of the financial services sector. The Banking Act of 1933 (known as the Glass-Steagall Act), passed in the wake of the Great Depression, erected barriers between banking, insurance, and securities markets. For many years these restrictions held without any exception, but in the 80's and 90's there has been significant erosion of Glass-Steagall's barriers. For example, in 1987 the Federal Reserve Board allowed bank holding companies to engage in underwriting and selling securities through a subsidiary. In 1997, the Office of the Controller of the Currency began to allow national banks to engage in a range of "impermissible" activities through subsidiaries. In 1998, Citicorp, the nation's largest bank holding company, was allowed to affiliate with Traveler's Group, which deals mainly in securities and insurance.

The Gramm-Leach-Bliley (GLB) Act of 1999 formalizes the gradual lowering of Glass-Steagall's barriers and goes further to create a comprehensive scheme of permissible overlap between securities, banking, and insurance markets. The Act's main innovation is the introduction of financial holding companies. Any bank holding company may

[3] See for example Tex. Finance Code § 204.006 (2000).

choose to become a financial holding company as of March 1, 2000. Certain conditions are required of the company, such as well capitalized depository institutions and a rating of "Satisfactory" or better under the Community Reinvestment. The financial holding company can then engage in any activity that is "financial in nature" through a non-bank subsidiary. Permissible activities for the non-bank subsidiaries include underwriting or dealing in securities, mutual fund organization and distribution, merchant banking investments, insurance sale and underwriting, and issuing annuities. For financial holding companies that were not bank holding companies before November 12, 1999, restricted non-financial activities are also permissible through non-bank subsidiaries. Note that bank holding may not opt to become financial holding companies, and new bank holding companies may be formed. Bank holding companies continue to operate under the same restriction of performing "activities closely related to banking", which do not include insurance and securities underwriting, mutual fund operations, merchant banking, and issuance of annuities.

The GLB Act also expands the scope of activities of national bank subsidiaries. A national bank can own a "financial subsidiary", which can engage in all activities that are financial in nature, except underwriting insurance, issuing annuities, investing in real estate and engaging in merchant banking. Well-capitalized national banks can own subsidiaries that underwrite municipal bonds. A national bank is limited to total transactions with all its non-bank subsidiaries amounting to 20% of the bank's capital and surplus. As far as federal law is concerned, all state-chartered banks may own financial subsidiaries according to the same rules. However, state law prevails where a state's banking law prohibits banks chartered in its jurisdiction from owning financial subsidiaries.

As relates to insurance, the non-bank (insurance) subsidiary of a financial holding company is the only new entity that can underwrite insurance under the GLB Act. Bank holding companies, banks, and their financial subsidiaries may not engage in underwriting. The Act confirms state insurance authorities as the primary regulators of insurance activities, even when they are engaged in by subsidiaries of nationally incorporated banks or financial holding companies. The only restriction placed on state law is that it may not discriminate in its regulation between insurers on the basis of corporate form, that is, depending on whether they are national bank financial subsidiaries, non-bank subsidiaries of financial holding companies, or insurance companies unrelated to the banking industry. In case state laws do discriminate, they would be pre-empted by the GLB Act.

The Community Reinvestment Act, which comprises one of the requirements to form and financial holding company, is a potential source of discrimination complaints by NAFTA financial service companies entering the U.S. market. This act requires depository institutions, whether they are separate banks, subsidiaries, or branches) to serve the local community by offering loans to middle and low-income customers. Each bank must keep a geographic record of its loan activity in order to show compliance with the CRA. In a yearly examination performed by the Federal Reserve Board, the bank must obtain a classification of Satisfactory or better in order to form a financial holding company that may engage in both banking and insurance activities. In addition to loan records, the Board considers investment in local companies owned or managed by women or minorities, as well as joint ventures in cooperation with low-income credit unions. Up to 1994, foreign bank branches with no insured deposits did not have to comply with the CRA. Under the Riegle-Neal Interstate Banking Efficiency Act of 1994, all foreign bank branches are subject to the CRA. As we shall argue below, conflicts between the CRA and the "no restriction on transfers" commitment made by the U.S. in chapter 11 of NAFTA are likely to occur.

Specific Regulation of Foreign Banks

Until 1991, the International Bank Act (IBA) of 1978 governed the entrance of foreign banks to the U.S. market. This law was based on the principle of national treatment. Each foreign bank was to choose a "home state" within the U.S., and any federal or state restrictions on interstate branching would treat foreign banks as if they were incorporated in the home state. However, as mentioned under U.S. exceptions to NAFTA's chapter 14, federal law does not prevail over state law in case the latter prohibits the entry of foreign banks into certain segments of the market. The IBA applied to subsidiaries and branches of foreign banks alike.

The most recent innovation in federal regulation of foreign banks is the 1991 Foreign Bank Supervision Enhancement Act (FBSEA)[4]. This legislation is directed towards branches established by foreign banks, rather than subsidiaries. The main benefit of incorporating a subsidiary is avoidance of liability by the parent company. In general courts are less likely to find parent companies liable for claims against subsidiaries, than for claims against branches. On the other hand, subsidiaries are considerably more expensive to operate, and could be more unstable because they tend to have a much smaller capital base than the parent company. The majority of foreign banks entering the U.S. market have opted to establish branches. In 1994, there were 559 branches of foreign banks in the U.S., as opposed to only 97 subsidiaries[5]. Hence, the FBSEA's exclusive regulation of branches affects most foreign banks operating in the U.S.

Under the FBSEA, the Federal Reserve Board must approve the establishment of a branch by any foreign bank, whether the bank applies for a federal charter under the Office of the Comptroller of the Currency or for a state charter under the state's regulatory authorities. To obtain this approval, the foreign bank must meet three standards. It must be engaged in the business of banking, which means it must be active in its home country in retail banking. It must also demonstrate that it is subject to "comprehensive supervision" by regulators in its home country. Finally the Board may apply other "discretional standards" which usually include a judgment as to whether the foreign bank has "the experience and capacity to engage in international banking".

To meet the requirement of home country regulatory control, the foreign bank must provide information regarding systemic regulation in the home country, as well as a

[4] 12 U.S.C. § 3105(d)-(h), signed December 1991.
[5] GAO/GGD-96-26, February 1996.

record of regulation of the specific bank or financial holding company. Among other elements, the adoption by the home country of the Basle risk-based capital adequacy guidelines is used to determine eligibility under this requirement. Since the Basle accord requires that country risk be included in the risk reported for each category of capital, financial institutions in countries like Mexico find compliance with the accord difficult. This implies that firms from countries with high systemic risk can expect delays and obstacles in the process of obtaining Board approval for the establishment of a U.S. branch[6]. Thus, the FBSEA has placed additional obstacles to the chartering of foreign bank branches in the U.S., and has lengthened the approval process considerably. In particular, the home country regulatory control test has increased the average approval time from 6 months to between 18 and 24 months[7].

In addition to entry restrictions for branches of foreign banks, the FBSEA includes provisions regulating the activities of such branches and offices. An on-site examination of the branch's operations by the Federal Reserve Board is scheduled at least once a year. The Board must approve the acquisition of more than 5% of the voting shares of any bank or bank holding company by a foreign bank and must receive notification of certain types of large loans. The most important outright limitation of the activities of foreign bank branches involves retail banking. As of the passage of the FBSEA, new foreign branches may not join the FDIC system, and thus may not offer retail banking (deposit account of less than $100,000). Although the majority of foreign banks are most interested in offering commercial banking services, it is very likely that NAFTA country banks entering the U.S. will want to offer retail services in areas near the border. Hence, although the U.S. is the only NAFTA country that allows the other NAFTA countries' financial service companies to establish branches in its territory, in fact Canada and Mexico must establish subsidiaries in the U.S. in order to offer retail banking services.

Insurance Regulation

As mentioned above, the Gramm-Leach-Bliley Act confirms that state authorities have priority as regulators of the insurance industry. State regulation has been the norm since Paul v. Virginia[8], in which a New York insurance company was forced by the Supreme Court to comply with Virginia regulations requiring foreign insurance companies to deposit a licensing bond that was not required of Virginia based companies. In 1871, state commissioners formed the National Association of Insurance Commissioners (NAIC). Since its inception, the NAIC has had two main goals: keeping insurance regulation in the hands of the states, and harmonizing insurance laws across states. Besides the evident conflict between these goals, the NAIC has suffered from regulatory capture, lack of any enforcement capability, and an identity crisis as to whether it is a trade commission or a quasi-public regulatory body[9].

[6] Hultman, 1997.
[7] Schefer, 2000, p.74.
[8] 75 U.S. 168; 1868.
[9] Randall, 1999.

Although regulatory capture is a common phenomenon, it is even more likely that usual in the case of the NAIC because it is a private body directly funded by the industry. Randall (1999) cites industry experts, insurance commissioners, and NAIC officials stating that the NAIC "represents" the industry and "cannot be distinguished from the industry". Thus, although the members are insurance commissioners, the NAIC can be expected to act more like a trade association than a regulatory body. This also causes conflicts with anti-trust laws. For example, private trade associations are not allowed to fix rates, while the NAIC's members are. In *United States v. South-Eastern Underwriters' Association*[10] the Supreme Court found that a 198-company cooperative rating bureau operating under the NAIC's supervision was guilty of conspiracy to fix rates and to monopolize a regional fire insurance industry.

The NAIC's lack of enforcement authority is illustrated by the recent attempts at a comprehensive accreditation program. After some large scale insurance insolvencies in the 1980s, the organization instituted an accreditation program for the state regulators of insurance. The program was based on extensive oversight by the NAIC, including many new "model laws" that states would have to enact in order to maintain their accreditation. New York lost its accreditation in 1993 because it did not pass two new model laws. Opponents of the NAIC claimed that the accreditation program usurped state sovereignty in insurance matters by mandating legislative action by the state. Similar conflicts arose with the state regulators and state insurance companies of Vermont, Michigan and Florida. This eventually caused the NAIC to back down and significantly reduce the sanctions for non-compliance with the accreditation program.

Non U.S. insurers entering a particular state are asked to a post a licensing bond. Licenses are granted at the discretion of the state commissioner, and the state regulatory authorities may enforce laws relating to the day to day operations of a foreign insurer, even if such laws are only applicable to the alien company. In addition, the International Insurers Department (IID) of the NAIC tracks non-U.S. insurers wanting to do business in the U.S. surplus or excess lines market. In 14 states, placement on IID's list is the only way that insurers can enter the surplus lines market. Other states consider appearance on the list among the factors necessary for admission to that market. Inclusion is based partly on the NAIC's confidence in the home country regulatory system, especially when the foreign insurer seeks to establish a branch in the U.S. state. As noted above, certification and accreditation of state regulatory authorities within the U.S. has been problematic. Clearly, the NAIC's evaluation of foreign countries' regulatory authorities is much more problematic.

Financial Service Regulation in Mexico

The legal picture on the Mexican side of the border appears to be simpler. As with the country's economy, the legal system is less developed and less complicated than the U.S: system. Below we mention a few basic features of the legal and regulatory system that affect financial services provision. We should bear in mind that despite their relative

[10] 322 U.S. 533; 1944.

simplicity and consistency, the Mexican legal and financial systems continue to suffer from low enforcement standards due to corruption, excessive centralization of power, a general lack of professional civil service career models, and relatively low levels of human devoted to enforcement.

The Mexican legal system, and the financial services sector in particular, have undergone drastic legal changes in the past two presidential administrations. The general provisions affecting foreign financial service companies are the laws governing foreign investment and financial groups and their affiliates. The *Ley de Inversion Extranjera* follows very closely the exceptions taken in Mexico's Part B of Schedule VII to the financial services chapter of NAFTA. Limits on aggregate foreign ownership of financial service companies have been phased out between 1994 and January 1, 2000. Part B also takes a permanent exception as to aggregate foreign ownership limits with respect to net capital of commercial banks and limited scope financial institutions. As mentioned above, this exception for the case of commercial banks was removed by the financial sector reforms signed in early 1999 by President Zedillo.

Three federal regulatory bodies oversee the Mexican financial system: Banco de Mexico, the Comision Nacional Bancaria de Valores, and the Comision Nacional de Seguros y Fianzas. The first two bodies are concerned with banking services and the third specializes in regulating insurance services. These services are generally offered by the same financial institutions, since there is no regulatory barrier between banks, insurance companies, and pension funds, except for standard separate account and capitalization requirements.

The *Ley de Grupos Financieros* governs Mexico's equivalent to a U.S. financial holding company. The holding company is formed by two or more financial institutions such as multiple banking institutions, brokerage firms, insurance companies, exchange houses, general deposit warehouses, bonding companies, and companies operating investment funds. Foreign institutional investors may acquire up to 20% of the voting shares of such institutions, or may form a financial holding company that is a wholly owned subsidiary, by acquiring two or more financial institutions as set forth by the law. Acquisitions are subject to approval by the Ministry of Finance. Priority in regulatory authority is given to the relevant Mexican regulator. Provisions are made for scheduled inspections of foreign owned financial services companies by their domestic regulatory authorities.

The law regulating foreign financial affiliates clearly states that Mexican regulatory authorities must comply with the NAFTA agreement[11]. Since regulators are all part of the federal executive branch, this guarantee written into federal law is probably more credible than similar statements in U.S. state-level laws and regulations. In addition, since commercial law exists only at the federal level in Mexico, state authorities are very unlikely to play a role in the financial services sector.

[11] Ley de Grupos Financieros, Chapter 2, Article 27-C.

A crucial provision of the law regulating financial groups relates to secrecy. Commonly called the law of "secreto bancario"[12] (although it applies to all financial groups, not only banks), the rule prohibits a financial holding company to disclose information relating to its operations or to the operations of any member of its group, other than to the legally empowered government agencies. This prohibition includes board members, officers of the company, and any company agent or employee. *The* legally empowered agency means the relevant Mexican federal regulator. The main concerns raised so far by this secrecy law are related to money laundering. As we will show below, a more mundane but no less important concern is that secrecy law could exclude revelation of information to an adversary in a lawsuit as part of the standard U.S. process of discovery. Also, it is not clear that a U.S. regulatory agency inspecting or evaluating the operations of a U.S. subsidiary in Mexico would be able to obtain the information it requires in spite of this provision.

Possible Conflicts

As trade in financial services grows, conflicts involving financial service providers from the NAFTA countries are likely to increase considerably. Based on the likely expansion plans in the industry, the NAFTA provisions, and the national laws and regulations we have reviewed, we pinpoint some likely disputes.

Banks

In the schedule of the negative list of the United States (Annex VII of Chapter 14 of NAFTA Agreement), it states:

"Federal authorities also may not approve the establishment of, or acquisition of an interest in, a bank subsidiary within a state ("the target state") by a bank holding company, including a foreign bank, that maintains its principal place of banking operations in another state, as defined under the Bank Holding Company Act, unless the measures of the target state expressly permit the establishment and acquisition by bank holding companies from the state of the company's or bank's principal place of banking operations."

On July 16, after the merger of the second largest bank in Mexico (Bancomer) and one of the largest Spanish banks (Banco Bilbao Vizcaya Argentaria or BBVA), the new company declared that they are going to expand their operation in the United States as a first floor bank. That means they will offer full customer service such as deposits, bank loans and money transfer. Bancomer already offers money transfer services. However, the accounts are very restrictive. The new BBVA-Bancomer will be to open a consumer bank in Texas, targeting Hispanic customers. The plan of BBVA-Bancomer is to open 170 full service branches in the border states of Arizona, California and Texas within the next five years. Eventually, they want to open 600 branches (Houston Chronicle, June 17, 2000).

[12] Ley de Grupos Financieros, Chapter 2, Article 35, Rule 18(IV).

This plan would definitely test the provision above of NAFTA negative list. Once this new bank establishes itself in Texas and then tries to expand into Arizona or California, it is not clear that those states will allow it. Even if the states do, there are bound to be challenges in the courts by banks already residing in those states.

The stakes are high for existing banks and for Bancomer-BBVA. All three states have at least 30% native Spanish speakers. Hispanic customers tend to be more comfortable doing business with Spanish speaking banks (that is the motivation for this planned expansion in the first place). In addition, it is estimated that Mexicans residing in the United States (legal or illegal) send some $7 billion to their relatives in Mexico every year. In the process, they lose some 20-25% in "bank fees". If customers can have accounts on both sides of the border with the same bank, they would be able to save much of this transaction costs. Since Bancomer-BBVA already has a customer base of 9 million in Mexico, this scenario is quite possible.

Banks selling insurance

Bancomer-BBVA may also plan to offer insurance and banking services jointly in the US market. As a company incorporated under US law, the only way this can be done, while including insurance underwriting, would be as a financial holding company within the US. To be a financial services holding company, the company must demonstrate that its depository institutions within the U.S. are well-capitalized and have received a Community Reinvestment Act rating of Satisfactory or better in their most recent examination. This implicitly requires some experience in the U.S. retail banking market. However, given the restrictions on retail banking by foreign bank branches, Bancomer-BBVA would have to set up or acquire a U.S. retail banking subsidiary in order to meet the financial holding company requirements.

The CRA rating presents a separate problem. As noted above, satisfactory ratings can depend on local investments made by the foreign bank. This could be construed as a restriction on transfer, which is prohibited by Article 1109 in the investment chapter of NAFTA. Thus, Mexican companies taking this route could end up initiating dispute resolution processes against the US government.

Alternatively, the Federal Reserve Board could consider Mexican financial groups to be financial holding companies within the US context, without asking them to incorporate within the US as such. They would then be able to have insurance and banking subsidiaries in the US, and could underwrite insurance just as a financial holding company would. This route is certain to displease US financial holding companies and banks, and could be considered some sort of “reverse discrimination”. Some US companies might prefer to establish Mexican subsidiaries and then come back to the US markets using the special deal given to Mexican-based financial groups. This would not sit well with US regulators, as they would lose a lot of power over such companies’ operations.

Drugs and health insurance

One of the unanswered questions about a negative list is that the lawmakers need to see all possible contingencies at the time the agreement is signed. If not, new products will test the boundaries of the law. For example, US health insurers, conscious of costs, may allow their patients to seek expensive operations on the Mexican side of the border. Nothing in NAFTA prohibits it. This will save money simply because it is much cheaper to have surgery on the Mexican side of the border. Some hospitals have already set up facilities in Mexico (for example, in Tijuana) solely for servicing their US clients using doctors from the US.

As internet became popular medium for finding information about (legal but prescription) drugs, US consumers discovered that they can buy the same prescription drugs in Canada and Mexico at a fraction of what they pay at home (for example, through drugstore.com). Many started getting their prescriptions filled in the US but had the drugs mailed to them across the border. The HMOs encouraged it by agreeing to co-payment. Immediately, the drug companies took up this issue in the US Congress. It was cutting into the profits of the $120 billion industry. Laws were passed to prohibit mailing of prescription drugs. It was still possible to drive over across the border and buy them personally.

Recently, the US House of Congress and the Senate voted overwhelmingly to make such import illegal (National Journal, July 15, 2000). However, at the same time, it voted to allow wholesalers to import drugs into the United States. The measure's fate will be decided in a House-Senate conference committee, where opponents are expected to try to kill it (USA Today, July 20, 2000).

Ordinary Commercial Insurance Conflicts

An ongoing case in both Mexican and US courts illustrates another likely conflict scenario[13]. Seguros La Republica, now known as Interacciones (see Table 5 above) made a reinsurance agreement with British International Insurance Company (BIIC), a New York based insurer. La Republica then refused to pay over $11 million in claims. Before BIIC initiated legal action in New York federal courts, La Republica sued in Mexico to declare a number of the reinsurance agreements null and void. In the New York district court, BIIC was awarded compensatory damages, and filed a motion to compel post-judgment discovery. Discovery of assets in Mexico is essential in such a case because insurance companies operating in the US may not have sufficient US-based assets to cover their liability. So far, La Republica has used the financial group secrecy law to claim that it cannot respond to the US court's discovery order.

[13] British National Insurance Company vs. Seguros La Republica, 2000 U.S. Dist. Lexis 7509, decided June 1, 2000.

Such standard insurance non-payment cases will arise ever as financial markets are more integrated. Cases tried in the US often result in extensive discovery between the two adversarial parties, and Mexican companies or groups are very likely to invoke secrecy law. The US trade representative may be persuaded to initiate a dispute settlement process to force a change or modification in this law. However, it is not clear what NAFTA provisions the US could use in such a claim. Technically, the financial groups secrecy law meets national treatment standards since it is applied to all financial service companies in Mexico. However, in practice, successful Mexican-owned companies have found ways to deal with the secrecy problem, through repeated interaction, reputation, and the formation of industrial groups that include financial service companies. These informal, experience based methods of contract enforcement clearly disadvantage newcomers to the Mexican financial sector.

Federal-State Conflicts in US Insurance Regulation

For Mexican entrants into the US insurance industry, the lack of homogeneity among state insurance regulations and the confused status of the NAIC could result in a competitive disadvantage. Mexican companies could run into discriminatory provisions against alien insurers, and may find it costly to prove that there is no concrete prudential reason behind the discrimination. In addition, if state insurance commissioners and the NAIC can be "captured" by the industry than a federal regulator would be, foreign companies that lack experience and connections in the US market will face a lobbying disadvantage. If Mexican companies pursue a dispute settlement process that finds against the US, it could be very difficult for the federal government to implement changes at the state regulatory level, because federal legislation expressly leaves this regulatory area to the states. This could increase pressure to federalize insurance regulation or to transform the NAIC into a public institution.

Conclusions

For American companies in legal dispute with a Mexican financial institution, *La Ley de Secreto Bancario* will pose a challenge in Mexico. American regulators will (especially state based insurance regulators) find La Ley de Grupos Financieros in Mexico to be very different from the kinds of legislation they are used to. Mexican financial groups will see any denial of market access in the US as a hostile move. This could lead to a big dispute between US and Mexican government given that state laws takes precedence in the US. NAFTA dispute resolution system is not well equipped to deal with such problems at present. Perhaps the resolution mechanism of the World Trade Organization (WTO) would be sought as an alternative system.

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