For release on delivery
10:00 am, EDT
September 28, 1993

Statement by

John P. LaWare

Member, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

U. S. House of Representatives

September 28, 1993

Mr. Chairman, I am pleased to appear before the Committee this morning to discuss the implications of the proposed North American Free Trade Agreement for the financial services industry and banking in particular.

Before I begin, let me state that the Federal Reserve supports the NAFTA without qualification. Its implementation will provide overall benefits to the people and the economy of the United States that will grow over time. The agreement will promote the economic and financial integration of the North American continent, a process already in progress. The NAFTA will solidify U.S. access to Canadian markets and provide significantly improved access for many U.S. firms to the substantial Mexican markets that will expand rapidly as the Mexican economy capitalizes on reforms instituted over the past decade. Moreover, the long-term beneficial effects for the United States of a stable, growing economy on our southern border are hard to overstate and may be more meaningful than any of the specific provisions in the Agreement.

At this point, I'll summarize briefly the provisions of the Agreement as they relate to banking and other financial services. I will then turn to the other issues raised in your letter of invitation.

The financial services chapter establishes the rules governing treatment by each NAFTA country of the other countries' financial firms, investments in the financial sector, and cross-border service providers. The obligations set out in the financial services chapter, however, do not require any change in U.S. law or regulatory practice because the United States already follows its basic principles: market access, national treatment, and the right to non-discriminatory or "most-favored-nation" (MFN) treatment.

With respect to market access, each country agrees to allow financial institutions of the other countries to establish and operate in its market through subsidiaries. In doing so, each country must grant to the financial firms of the other countries treatment that is no less favorable than what is granted to comparable domestic financial institutions. Thus, a Mexican or Canadian bank in the United States would be treated as a U.S. banking organization and any nonbanking activities of affiliates of the banks will continue to be subject to the provisions of the Bank Holding Company Act. Treatment is considered no less favorable if it grants to the foreign firm equal competitive opportunities, that is, it does not disadvantage the foreign firm in its ability to provide financial services as compared with the ability of similar firms to provide the services. The financial services chapter also requires each country to provide MFN treatment for the firms of the other NAFTA countries, assuring that no NAFTA country may grant better treatment to firms from countries outside the NAFTA. U.S. banks and bank holding companies already operate subsidiary banks in Canada under these general principles. The main benefit to U.S. banks will be in their ability to establish subsidiaries in

Mexico, a market essentially closed to all but one U.S. institution. Although Mexico will open its banking market only gradually, keeping market share limits at least until the year 2000, the NAFTA will allow a number of U.S. banks to form subsidiary banks and other financial firms and compete on a national treatment basis with banks and financial groups in Mexico.

The Agreement will also allow each country to grandfather, or in the language of trade agreements "to reserve," certain provisions of existing law that do not conform to national treatment or MFN principles. Under this provision, the United States has reserved a number of provisions of federal law that limit the national treatment available to foreign banks or individuals. However, the degree of discrimination in these laws cannot be increased and any future measures must conform to the national treatment and MFN principles.

In addition to these basic requirements, the financial services chapter also requires each country to abide by the principle of "transparency" in its regulation of financial services. This requires that each country allow an opportunity for public comment on proposed measures in the financial services area and make available all requirements necessary for engaging in financial services activities in the country. The chapter also contemplates that any country may request consultations with another, including consultations with regulators, on any matter affected by the financial services chapter. In the Federal Reserve's view, this simply codifies existing practice.

From a supervisory standpoint, an essential feature of the NAFTA is that it provides a substantial "prudential carveout," that is, nothing in the services provisions of the NAFTA shall be construed to prevent a country from adopting or maintaining reasonable measures for prudential reasons. The chapter gives a non-exhaustive list of areas for prudential regulation, including the protection of consumers of financial services; the maintenance of the safety, soundness, integrity or financial responsibility of financial market participants; and ensuring the integrity and stability of the financial system. We believe that prudential regulation as implemented in the United States is reasonable and could withstand scrutiny under this provision. In addition, the NAFTA provisions on services do not apply to a country's monetary and related credit policies or to exchange rate policies.

Under the NAFTA, a country would have the right to a hearing on whether another country is abiding by its obligations under the agreement. This so-called dispute settlement mechanism provides that panels, with participants usually drawn from standing rosters, would hear the dispute and render a final opinion on whether the measure at issue conforms to the NAFTA. If the panel finds that a country's law or regulation violates the NAFTA, the country may change the offending measure. If it does not, the complaining country has the right to suspend benefits to firms of the offending country that are commensurate with the harm suffered by the firms of the complaining country.

The financial services chapter contemplates that experts in financial services will be included on the roster of persons who hear disputes in the financial services area. Moreover, the financial services chapter also contemplates establishment of a Financial Services Committee to supervise the implementation of the NAFTA, to consider issues on financial services that are referred to it by another NAFTA country and to participate in disputes in the investment area where a country claims the prudential or monetary policy carveout as a defense to the action at issue. In these cases, the decision of the Financial Services Committee will be final. Unlike other chapters of the NAFTA that allow a private party, such as an individual person or firm, to bring a dispute against another country, a dispute in financial services may only be brought by a government of a country.

In summary, the financial services chapter of the NAFTA incorporates the principles of MFN and national treatment that have long been applied in the United States with respect to foreign investment. The chapter establishes a government-to-government dispute settlement system that allows for the participation of persons knowledgeable about financial services. Significantly, the financial services chapter recognizes the importance of supervision and regulation of financial services and provides protections for prudential actions of regulators.

Let me now turn to the specific questions raised in your letter of invitation. The principles of national treatment and better access to all markets for all firms have been long supported by the Federal Reserve. When multilateral trade agreements began to be negotiated in the 1980s that would, for the first time, establish these principles as enforceable obligations to govern the provision of banking and other financial services, the Federal Reserve sought to assure that these negotiated obligations did not interfere with the legitimate objectives of prudential supervision and regulation. These views were shared with the Treasury Department as the U.S. negotiator for banking and securities services in the NAFTA process. At the Treasury's invitation, the Federal Reserve and other regulators provided technical assistance during the course of the negotiations on how proposed provisions of the NAFTA would affect U.S. banking and other laws. There was ongoing informal contact between Treasury and Federal Reserve officials about supervisory issues over the course of the NAFTA negotiations and a member of the Board's staff attended many of the negotiating sessions.

The Federal Reserve's principal objective has been to assure that any agreement that might be negotiated contain a strong protection for the prudential actions of regulators, with respect to both individual institutions and the stability of the financial system itself. In addition, the Board believed that it was important that any system set up to review disputes in financial services should include the active participation of financial experts. The presence of financial experts in the dispute resolution process assures that persons with an understanding of the basis of financial services regulation will generally decide issues involving regulated financial entities. Finally, the Board believes that it is important that the financial services sector be protected from retaliatory measures resulting from disputes in other sectors. Because of the potential spillover effect into other areas, financial services, and the banking system in particular, should not be disrupted by potentially ill-considered actions resulting from disputes in other sectors.

The NAFTA contains provisions that satisfy the concerns of the Federal Reserve. There is a strong provision that protects the actions of regulators. Financial experts will generally participate in settling disputes in financial services and must be included where prudential or monetary policy reasons are cited as the basis for the dispute. A Financial Services Committee will assist in implementation of the financial services chapter and retaliation across sectoral lines is limited. In sum, the NAFTA appears to protect the interests of prudential supervision in the U.S. market and of financial institutions while creating opportunities for U.S. banks and other financial firms in the Mexican market.

U.S. banks and bank holding companies have a long history of following their U.S. customers to foreign markets.

When U.S. businesses began their substantial foreign expansion in the 1950s and 1960s, U.S. banks increased their foreign presence to continue to provide banking services to American commerce. As the Mexican economy opens under the NAFTA, there will be an increased demand for U.S. goods. American banks and securities companies will have opportunities to provide sophisticated financial services to U.S. companies, as well as to the Mexican firms that will increasingly need the types of innovative services at which U.S. financial services companies excel.

Of course, U.S. banks and bank holding companies will be subject to the same regulation of their Mexican operations by the Federal Reserve as currently apply to all of their other foreign operations, as well as the same supervision of their foreign operations through the regular reporting and examination process.

The NAFTA does not change in any way either the manner in which U.S. banks may make investments in foreign companies or the way that banks are regulated with respect to their activities outside the United States. As you know, the Board's Regulation K governs the international operations of member banks, bank holding companies and Edge corporations. Permissible activities of foreign subsidiaries of these investors are listed in Regulation K and include banking, leasing, fiduciary activities, and securities and insurance activities within certain limits. Regulation K also requires that a U.S. bank or holding company must provide 45 days' prior notice to the Board before investing in any foreign company in an amount that exceeds the lesser of $25 million or 5 percent of its capital. The Board analyzes such proposals in light of the financial condition of the bank or holding company and for compliance with U.S. law. In this regard, the investing U.S. banking organization must provide relevant documentation on the investment. If there are issues raised by the proposal, the Board may suspend the prior notice or deny the investment. All of these measures will be in effect with respect to investments in banks and other companies in Mexico.

After an investment is made, the U.S. bank or bank holding company must provide detailed financial reports to the Federal Reserve for analysis to determine the condition of the foreign entity. This analysis is included in the ongoing performance monitoring of the bank or bank holding company. In addition, the Federal Reserve often conducts on-site examination of foreign subsidiaries of U.S. banks and bank holding companies. Of course, neither the NAFTA nor the Mexican and U.S. legislation to implement it have been passed. Nevertheless, the Federal Reserve has held discussions with regulators in Mexico concerning sharing of information, including possible on-site examinations of subsidiaries of U.S. banks. In this regard, I note that the Mexican authorities conduct on-site examinations of Mexican banks on a regular basis. In most of the large Mexican banks, the National Banking Commission has established and staffed permanent on-site examination offices for constant surveillance. We believe that we will be able to work cooperatively with the Mexican regulators to obtain necessary information on Mexican subsidiaries of U.S. banks through examinations or other mechanisms to assure that these investments would not pose any undue risk to the safety and soundness of the U.S. banks.

The subsidiaries in Mexico will be subject to the same restrictions that are currently in place with respect to any foreign subsidiary under Regulation K. Foreign companies owned by U.S. banks and bank holding companies are generally prohibited from engaging in any activities in the United States. Foreign subsidiaries of U.S. banks are not permitted to underwrite or deal in securities in the United States. Similarly, foreign subsidiaries are prohibited from underwriting insurance in the United States. Consequently, foreign affiliates of U.S. banks cannot be used to evade the nonbanking restrictions of U.S. law. These restrictions are monitored in the ongoing review of each banking organization. If a banking organization were to ignore such restrictions and conduct impermissible activities in the United States through a foreign company, the Board has enforcement authority to deal with such violations.

The NAFTA provision regarding cross-border services provides that no new restrictions shall be placed on cross-border activities that are permitted on the date the NAFTA may enter into force. With respect to banking in the United States, this provision relates primarily to cross-border lending and deposit-taking. Currently, there are no restrictions in federal law preventing a foreign bank from advertising in the United States the services that the bank offers outside the United States. U.S. residents may place deposits with the foreign offices of foreign banks, and also may and do borrow from the non-U.S. offices of foreign banks and other firms. Similarly, U.S. banks could lend cross-border to Mexican or Canadian residents or accept deposits from such residents. Of course, this provision is also subject to the prudential carveout, which allows reasonable measures to be taken to protect depositors or other users of financial services, even with respect to cross-border services.

The provision does not require that the cross-border service providers of the other countries be allowed to "do business" or "solicit" business, such as by advertising or setting up an office, in the country. Each country retains the right to define what is meant by "doing business" or "soliciting" under this provision. The cross-border provision also explicitly recognizes, without prejudicing any other type of prudential regulation, that registration requirements for instruments sold cross-border and for the cross-border providers themselves are reasonable prudential measures. Finally, the NAFTA countries have agreed that further consultations should be held no later than January 1, 2000, on further liberalizations in the cross-border area.

With respect to the Foreign Bank Supervision Enhancement Act of 1991, under which a foreign bank may not establish a branch, agency, or commercial lending company unless the Board finds that the foreign bank is subject to comprehensive supervision or regulation by home country authorities on a consolidated basis, you have asked whether Mexican banks are subject to comprehensive supervision and on what basis the Board made such determination. There are several applications by Mexican banks that are pending at the Board and it would not be appropriate to comment on specifics before the applications have been presented for Board action. I can say that there have been very useful and informative discussions with the supervisory authorities in Mexico on the programs that have been put in place in Mexico since the banks were reprivatized starting in 1991 and that these discussions are continuing in order to allow us to complete the record on the applications.

Let me also say that, as a general matter in determining whether a particular foreign bank is subject to consolidated supervision, the Board considers a broad range of information. We study the structure of the supervisory system; how it applies to the particular bank applicant; the extent of the information on the operations of the bank and its dealings with affiliates that are available to the supervisors, including the nature and frequency of reporting by the bank to its supervisors; whether there are audits required of or commissioned by the bank; the nature and scope of any examinations or inspections by the supervisors; the supervisory practices of the authorities with respect to the bank's operations; and any enforcement authority the supervisor may have. This is the type of information under review in connection with the applications by Mexican banks. These standards would not be changed if the NAFTA were to be adopted.

As can be seen from this brief review, the NAFTA would not in any way diminish the ability of the United States to apply sound prudential standards to financial institutions from Mexico or Canada operating in the United States. Nor would it in any way affect the requirements imposed on U.S. banks in their operations outside the United States. The NAFTA provides no additional scope for a U.S. bank to underwrite securities or insurance in the United States; it cannot be used as a back door to engage in impermissible activities in the United States.

In sum, the NAFTA would provide substantial benefits to U.S. banks and other financial firms that are currently precluded from operating in Mexico. It could also stabilize and strengthen the Mexican economy while allowing the United States and U.S. firms to participate in the benefits to be reaped from such progress. Finally, because the entire regulatory scheme applicable to all foreign subsidiaries of U.S. banking organizations will also apply to any Mexican subsidiaries, we believe the NAFTA will do no harm to the safety and soundness of the U.S. financial system or its institutions.