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Nobody's Poster Child

Why the "Canadian Model" Cannot Be Used to Promote Financial Liberalization at the World Trade Organization

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Introduction

Along with other industrialized countries, in 2008 Canada experienced an economic crisis. However, unlike in the US and UK where century-old institutions did not survive, in Canada all of the dominant banks emerged from the crisis intact. Canadian banks are effectively protected from foreign competition and takeover by exemptions Canada has taken in trade agreements.

Canada has been placed at centre stage of international debates over financial liberalization and regulatory reform, despite its relatively small significance in the global economy. World Trade Organization (WTO) Director General Pascal Lamy points to Canada as an example of a country that supposedly liberalized its financial sector yet was able to keep high standards of financial regulation. Canada is co-ordinating the effort to get more financial liberalization through expanded WTO rules.

Knowing how Canada was able to weather the financial crisis better than other countries is useful for those engaging in the debate over financial liberalization. The following provides a reality check on some of the claims being made about Canada's financial system and its degree of liberalization.

The Threat to Financial Liberalization from the Crisis

One aspect of the current Doha Round of negotiations to expand the WTO involves getting countries to further liberalize their financial sectors. Canada heads the group of countries, including the world's dominant financial powers, that are making a collective push for financial services liberalization. Canadian banks are active internationally, and are working to expand their overseas operations.[1] The countries targeted by the financial services negotiating demands are in the developing world.[2] A key negotiating objective is to have developing countries give foreign interests "rights to establish new and acquire existing companies"[3]. Governments would guarantee these rights by making binding commitments under the General Agreement (GATS). These rights would be enforceable through the WTO dispute system.

However, the global financial meltdown has caused advocates of liberalization to worry about the fate of such negotiations. Media reports on the scale of the crisis included such superlatives as "the most dramatic extension of state ownership in the British economy since the war" (the nationalization of the Royal Bank of Scotland),[4] "the largest loss in United States history," (AIG's March 2009 disclosure of losses)[5]and "the biggest U.S. bank failure in history" (Washington Mutual's).[6] Financial Times columnist Martin Wolf wrote at the height of the crisis that it would reduce willingness to liberalize, with people questioning "If even the US and Europe cannot manage liberalized

financial markets, can emerging economies hope to do so?"[7]

Arguments have been made in the past that financial liberalization should be pursued even when it appeared to produce catastrophic results. Southeast Asian countries were told at the end of the 1990's that their financial crash was not caused by having recently opened their financial systems to foreign hedge funds and banks but instead by a failure to have the right regulations in place to accommodate liberalization.[8] In 1998, despite the financial crisis unfolding in Southeast Asia, WTO members signed a major new agreement to liberalize financial services.[9]

However, to quote Martin Wolf, the 2008 financial meltdown was "no crisis of backwardness, but one of sophistication." Although developed countries supposedly had the world's most advanced regulations, these regulations did not prevent the bankruptcy of Lehman Brothers and the ensuing collapse of inter-bank lending in the fall of 2008. The US Treasury and Federal Reserve took unprecedented actions, including the effective nationalization of financial giants Citigroup and AIG.

Post-crisis, adopting the regulatory frameworks of developed countries could no longer be presented as an answer to concerns about the destabilizing effects of financial liberalization. In addition, developed countries faced a credibility problem in pushing free market policies after they had bailed out their financial institutions.[10] It became too obvious a case of "do as I say, not as I do".

Another problem for supporters of financial liberalization is that the main corporate sponsors of this agenda were seriously weakened by the crisis. At the October 2009 summit of the Coalition of Services Industries, a World Bank official noted that in the Uruguay Round and subsequent negotiations, it was financial institutions like AIG which were at the vanguard in pushing for greater openness. He asked: "In this new world where these giants are teetering between oblivion and socialization, who is going to lead the charge?"[11]

Some countries began to push back against demands for financial liberalization, citing the crisis as a reason. In trade talks with the US in the waning months of the Bush administration, China said it had something to learn from US failures as well as US successes in the financial sector. Alan Holmer, head of the US delegation, advised China not to stop deregulating its financial markets or opening them up to foreign investment, warning "there would be significant costs to China if they were to slow down with respect to their financial sector liberalization."[12]

Organizations that monitor trade negotiations pointedly asked in the wake of the financial crisis how governments could reconcile their push for financial regulatory reform with their demands for further liberalization of the financial sector. The U.S.-based group Public Citizen criticized the G20 for calling for completion of the Doha Round "given one of the three core pillars of the agreement is further service sector deregulation and liberalization, including financial services."[13] Third World Network, a development research organization, recommended that the Doha Round's negotiations on financial services be discontinued. In their view, the types of demands being made of developing countries in the Doha negotiations would make them "more susceptible to financial vulnerability."[14]

The opposite argument was also made—that regulators should be paying more attention to the limits imposed by trade rules in their work on financial system reform. Supporters of expanding the GATS have expressed concern about the impacts of international efforts to reregulate the financial industry. Masamichi Kono, a Japanese finance official and a former counselor in the WTO's Trade in Services Division, raised this issue at the Coalition of Service Industries' October 2009 summit. Kono stated:

"There still needs to be a balance struck between the call for strengthening prudential regulation and the benefits we still expect to derive from deregulation, and well maybe I shouldn't call it deregulation, but liberalization of financial services in a GATS context. There seems to be a certain gap between those calling for stronger regulation on the prudential side and those pursuing financial services negotiations in Geneva. Care should be taken not to over-regulate, and suppress market activity and competition."[15]

At the same summit, Tiff Macklem, Canada's Associate Deputy Minister of Finance and Chair of the international Financial Stability Board's Standing

Committee on Standards Implementation, said sensible financial regulatory reforms were needed but there was also a need to “ensure the health of the industry and prevent regulatory overreaction.”[16]

Protecting the Doha Round

WTO Director Pascal Lamy has attempted to address the threat the financial crisis posed to the Doha Round by claiming there is a hard and fast distinction between financial deregulation and liberalizing financial services under the WTO’s General Agreement on Trade in Services (GATS). In a speech to a business lobby group, Lamy claimed: “As you all know, in the world of the GATS, ‘liberalization’ is essentially about opening specified sectors to competition on a non-discriminatory basis. It does not mean deregulation… If you open your market, you are saying you are regulating foreign and domestic in the same way.”[17]

Given the consequences of a financial crisis, it is important for policymakers to be aware that making full GATS commitments can require deregulation and that it is not enough to regulate “foreign and domestic in the same way.” GATS market access rules prohibit governments from imposing limits on, or outright bans of, a service. In the US Gambling case, the panel ruled that a government violates its GATS commitments “if it does not allow market access to the whole or part of a scheduled sector or sub-sector.”[18] For example, if full GATS market access is granted for trade in derivatives, governments cannot maintain regulations that ban any form of this service. The WTO Secretariat has stated that WTO members can be confused about the meaning of market access under the GATS, thinking that it only prohibits governments from discriminating against foreign suppliers, but “this is not the case.”[19]

Pascal Lamy, though, has used Canada to make his argument that countries can maintain high regulatory standards even when they liberalize under the GATS. In an April 29, 2009 letter to Public Citizen, Lamy said that Canada had made WTO financial services commitments just like the US and UK had done, but Canada had not experienced the same financial crisis.

In an April 2010 speech, Lamy again cast Canada in a favourable light as a country that had embraced liberalization without making the regulatory mistakes the US had. Lamy said that even though the US and Canada had both opened up cross-border financial trade under the North American Free Trade Agreement (NAFTA) Canadian banks were “hardly touched” by the financial crisis. According to Lamy, it was lax regulation of the US mortgage sector that contributed to the crisis, but tighter standards on the other side of the border meant sub-prime loans were not as big of a problem.[20]

Jeffrey Shafer, Vice Chairman for Global Banking for Citigroup, has made the identical argument about Canada. At the Coalition of Service Industries summit, Shafer warned that “open markets are at risk, sometimes because of the unintended consequences of regulatory responses, and sometimes because of a desire to cut off from the outside.” He said the financial crisis was due to “homegrown mistakes in the US” and could not be attributed to globalization because countries like Canada had held up well even though they had open markets.[21] Shafer helped draft the GATS financial services agreement as a US government negotiator before he joined Citigroup.

Yet the reality of Canada’s financial system actually makes it a very poor model for liberalization. Canada has been sharply criticized by liberalization advocates for *not* opening its banking system to foreign entry. Under both NAFTA and the GATS, Canada lodged reservations that have had the effect of curtailing competition from foreign banks. The Canadian banking system is overwhelmingly dominated by Canadian-owned banks. The following section provides additional background on this point.

Canada’s Key Limitation on Foreign Bank Entry

One of the key restraints Canada has placed on liberalization of its banking system is what is termed the “widely held rule”, a regulation in the Bank Act that prevents ownership of the country’s largest banks from being concentrated in the hands of one person or company. Under NAFTA, Canada relaxed its foreign ownership restrictions to some extent, but retained the widely held rule. In comparing Mexican and Canadian financial liberalization, law professor Eric Gouvin argues that Mexico liberalized its banking system under NAFTA whereas Canada did not. Gouvin focuses his criticism on Canada’s decision not to give up its widely held rule, describing it as “a statutory poison pill that makes acquisition of a Schedule I[22] bank impossible.”[23] Gouvin

claims that since the widely held rule was first enacted in 1967, Canada's largest banks have been able to operate free from concern about foreign takeovers.

When Canada made its financial commitments under the GATS, it again exempted the widely held rule from its liberalization commitments. A limitation on Canada's GATS financial commitments states: "No one person (Canadian or foreign) may own more than 10 per cent of any class of shares of a Schedule I bank". [24] Canada's offer in the current round of financial services negotiations retains this limitation, with the change that "Schedule I bank" now reads "a Canadian bank with over $1 billion in equity."[25]

The public interest reasons for requiring Canadian banks to be widely held are to avoid concentration of ownership and control in the banking system as well as to prevent "self-dealing".[26] The World Bank defines self-dealing as "the practice of transferring money or assets from the company to a dominant corporate owner, manager, or director."[27] Self-dealing can cause banking crises, as it did with the collapse of US savings-and-loans financial institutions in the 1980's.[28]

In response to criticism about its ownership restrictions at the WTO, Canadian officials have said that "Canada's size-based ownership regime does not distinguish between foreign and domestic investors, and that its purpose is to enhance the safety and soundness of the largest financial institutions, where concerns regarding the impact of failure on depositors, policyholders, and the wider economy are greatest, while also providing the flexibility to encourage market entry."[29]

Arguably a regulation to prevent excessive concentration and self-dealing in the banking system could be considered a prudential one. The GATS has a provision that says "Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons…"[30] According to the guidelines for making GATS commitments[31], governments are not supposed to list any prudential regulations as limitations on their commitments because these are already exempted by the prudential provision of the GATS.

However, the meaning of "prudential" is not defined in the GATS and governments can be challenged if they use prudential regulations as a way to get around their liberalization commitments. Given the uncertainty surrounding the prudential exception, Canadian officials may have listed the widely held rule as a limitation on Canada's banking commitments to ensure it would not be the target of a WTO complaint.

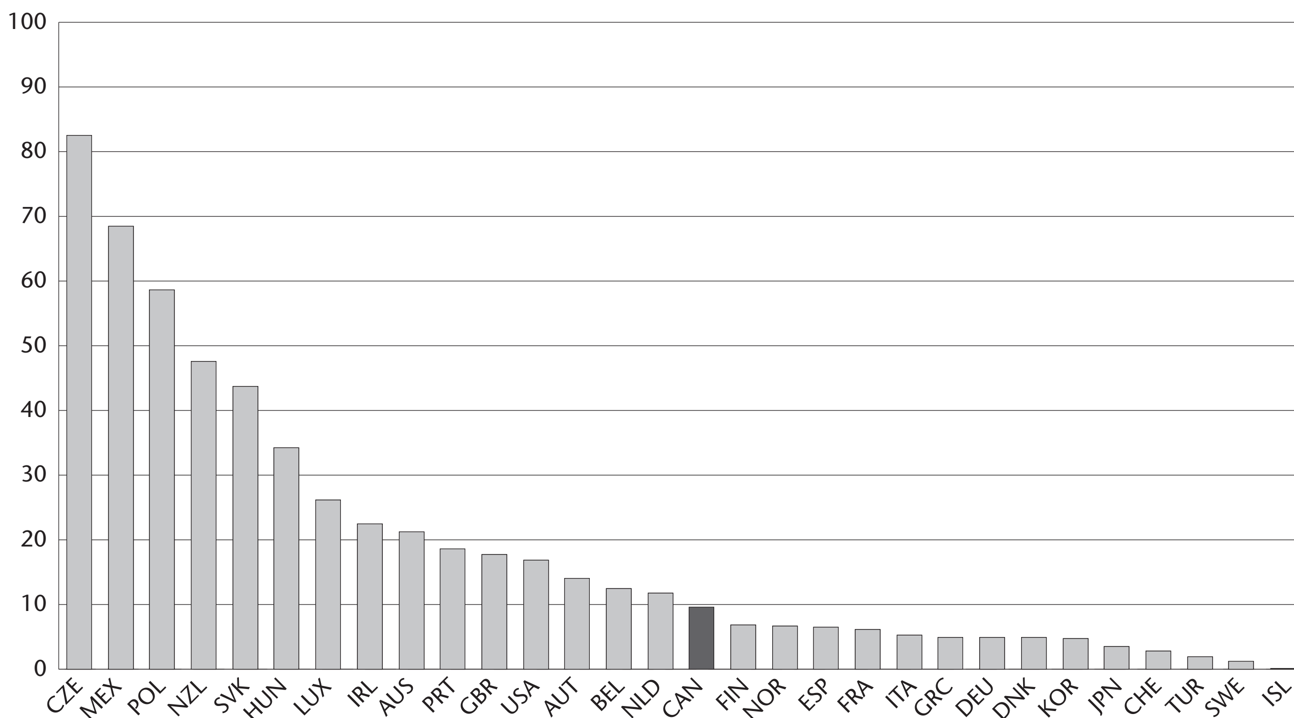
The widely held rule is an example of a "non-discriminatory" requirement, meaning it does not—at least not overtly—impose tougher conditions on foreign-owned companies than it does on local ones. But although Canadian GATS commitments opened the banking system to "competition on a non-discriminatory basis", to quote WTO Director Pascal Lamy, Canada still had to place a limitation on its GATS market access commitments in order to avoid WTO disputes.[32] GATS market access rules prohibit restrictions on access to markets even when the same regulations are applied equally to foreign and local suppliers.

When governments fully commit a service under GATS market access, they have to eliminate non-discriminatory regulations that impose any of six different types of restrictions on access to the market for this service. In other words, full GATS commitments can require a government to deregulate and not simply to eliminate discrimination against foreign suppliers.

Canada's GATS limitation for the widely held rule also protects it from WTO dispute challenges that it is *indirectly* discriminating against foreign entrants.[33] Despite its non-discriminatory wording—"No one person (*Canadian or foreign*) may own more than 10 per cent…"(emphasis added)—the widely held requirement has been repeatedly criticized as a form of protectionism.

The argument is made that while foreign banks can enter Canada and start to build their operations from scratch, it would be far easier to become a significant competitor to Canada's six dominant banks by taking over one of them. That way the foreign bank would not have to commit the time and effort to create a nationwide network of branches and loyal clients.[34] Canadian banks dominate the banking sector, holding 90% of all bank assets.[35] Currently, only one foreign-owned bank, HSBC, is attempting to set up a network of branches in Canada. A foreign buyout of a large Canadian bank would provide the foreign entity with a ready-made branch network, but buying a controlling interest in a large Canadian bank would violate the widely held rule.

Foreign banks' penetration of domestic loan market *(Local claims in local currency only)*



Benefits to Canada from Limiting Liberalization of Banks

In their analysis of the connection between trade agreements and the financial crisis, economists Eugenia Correa and Mario Seccareccia dispute the idea that some innately conservative national culture accounts for the less risky practices of Canada's large banks. They argue instead that "It relates to the fact that the country has a deeply rooted and highly concentrated national multi-purpose system of branch banking with a captive deposit base and less leakage to other financial institutions that could siphon off deposits from the chartered banks."[36]

A 2009 IMF study[37] came to the same conclusion. The study examined why Canada's banks fared better during the financial crisis and identified their extensive retail deposit networks as the main factor. The IMF found that Canada's six largest banks rely primarily for funding on retail deposits obtained through their highly profitable branch networks and that they tend to avoid excessive risk in order not to damage their brand franchise. Global banks that experienced the worst problems during the crisis depended on other kinds of funding that proved to be unreliable during times of financial instability. The IMF study also reported that Canadian banks were more resilient because "Limited external competition reduces pressures to defend or expand market share, again reducing incentives to take risks."[38]

That limited external competition can be a good thing, reducing risk-taking by banks, is not what Canada is accustomed to hearing. Although it may be commonplace currently for the Canadian banking system to be extolled as a model for the world, Canada has come under increasing pressure over the past two decades to open its banking system to more foreign competition. The OECD has repeatedly lectured Canada about doing more to facilitate foreign bank entry, noting in 2006 that "compared with the rest of the OECD, the share of cross-border loans in total domestic borrowing is relatively low, while foreign banks have made very modest inroads into the Canadian banking market."[39] The OECD has told Canada it should focus its banking regulation on allowing domestic bank mergers and "ensuring effective competition from foreign bank entry."[40]

The above chart, taken from the OECD report, shows Canada's rate of foreign bank penetration compared to that of other OECD countries.

The pressure to promote foreign bank entry comes from domestic sources as well as foreign ones. A 2007 report[41] by the C.D. Howe Institute claimed there was an "urgent need" to transform the Canadian banking system. The report compared Canadian banks negatively to the largest global banks, and warned about a decline in Canadian banks' international importance. Its main recommendations were that Canada should lift its restrictions on bank mergers, enable domestic banks to merge with foreign banks, and facilitate the entry of foreign banks.

The C.D. Howe report faulted Canada's liberalization efforts, singling out its ownership regulations for particular criticism: "(R)equiring large banks to be widely held with stocks quoted on a Canadian exchange and leaving foreign banks operating under the 'branch model' (Schedule III banks) out of the deposit insurance system seems to significantly reduce the competitive threat to Canadian banks from foreign entry into the Canadian marketplace. Ownership rules all but eliminate the possibility of a foreign bank takeover of a large Canadian bank."[42]

For the authors of the C.D. Howe report, regulations limiting the size of Canadian banks are a problem because the banks are prevented from copying the strategies the world's largest banks use to manage risk. Some of these strategies that receive favourable mention in the C.D. Howe report include "credit risk derivatives, loan syndication and especially securitizing assets."[43]

The financial crisis though casts doubt on risk management as a rationale for liberalization and increased bank size. It has demonstrated that from a risk perspective, bigger is not necessarily better. Some of the world's largest financial institutions have been exposed as having shockingly flawed internal systems of risk management.[44] Deregulating to enable foreign takeovers and domestic mergers also raises the problem of creating banks that have to be bailed out by governments because they become too big to fail.

Largely unregulated global trading in derivatives and securitized products helped precipitate the financial crisis. According to Robert Herz, chair of the US Financial Accounting Standards Board, "There were important aspects of our entire financial system that were operating like a Wild West show—huge unregulated opaque markets."[45]

While Canadian banks' secure retail deposit base may have made them relatively less inclined to engage in risky behaviour, they have not avoided it entirely. For example, the Canadian Imperial Bank of Commerce ended up paying out more than any US bank to settle suits launched by Enron shareholders over the bank's role in the collapse of that company.[46] CIBC at one point was facing a criminal indictment from the US Department of Justice over its involvement with Enron.[47] In 2008, CIBC was again being sued, this time by its own shareholders for losses related to $11 billion the bank put in investments related to US subprime mortgages.[48]

Some foreign clients have reason to dispute the notion that Canadian banks are by nature conservative. Wisconsin school districts have sued a subsidiary of the Royal Bank of Canada over a $115 million dollar RBC-designed product that may have lost all its value. In a typical story from the financial crisis, the Milwaukee Journal Sentinel reported that: "The investments, which involved a series of complex transactions that included collateralized debt obligations and credit default swaps, were sold to the school districts as a relatively safe and sure way to raise money to help pay for nonpension retirement benefits, such as health insurance, according to district officials."[49]

Prudential Regulation and Trade Conflicts

The IMF report on Canada's banking system found that "ample retail depository funding was the key factor behind the relative resilience of Canadian banks during the turmoil. Sufficient capital and liquidity were also important but played a less distinctive role."[50] In terms of capital requirements, Canada maintains higher standards than the ones recommended by the Basel Committee on Banking Supervision.[51]

However, even without explicit trade requirements to do so, liberalization can create pressures to harmonize regulations. The C.D. Howe report on the Canadian banking system drew a connection between liberalization and harmonization, predicting that "Once mergers allow large Canadian banks to play a bigger international role and further entry of foreign banks into the Canadian market is facilitated, the Office of

the Superintendent of Financial Institutions (OSFI) will be forced to harmonize and coordinate its regulatory oversight with other national regulators."[52] This turns out to be a strong argument against liberalization of the Canadian banking system, since Canada's stronger regulations are credited with its comparatively better performance during the crisis.

According to the WTO Secretariat, capital adequacy ratios and liquidity requirements fit within the GATS "prudential exception". On the other hand, the Secretariat has cautioned that "At the margins... there may be differences of views as to whether certain measures can be considered as prudential, and therefore, not subject to scheduling under the GATS."[53]

At the October 2009 summit of the Coalition of Service Industries, the potential conflict between the GATS and financial system regulatory reform was discussed. Mickey Kantor, a corporate lobbyist and former lead US trade negotiator, said there was a need for the private sector to ensure the GATS negotiations dealt with regulation. He commented:

"Regulation is interesting: you can regulate for good intentions in order to strengthen a financial sector, and you can regulate or not regulate with bad intentions. Market access alone is not enough… The G-20 leaders are going to have to be prepared to say, when they open up and insist on others opening up, they get rid of those regulations which inhibit access… All of us in the private sector who understand these restrictions have to be the quarterbacks and coaches in order to make sure the negotiations are effective."[54]

Masamichi Kono said at this summit that the WTO might play a role in the reform of financial regulations by clarifying what the prudential language in the GATS means. He recommended that the rules adopted by international regulatory bodies such as the Basel Committee be understood to be 'prudential' under the GATS, but that "you're not going to allow any other disguised form of protectionism under the name of the prudential carve out."

However, if prudential had been defined in this way before the financial crisis, Canada could not have maintained its capital requirements because they were stricter than international standards. The Basel II guidelines are now being revised in light of the crisis.

The WTO Secretariat suggested in its 1998 financial services paper that development of international standards would reduce the possibility that financial regulations would be viewed as "overly burdensome" or that they "effectively constitute barriers to trade." However, that leaves the potential for challenges against countries that choose to exceed international banking standards, as Canada has done.

Along with the recommendations proposed to harmonize regulations under the GATS by equating "prudential" with "international standards", an additional deregulatory threat comes from a little-known aspect of the GATS negotiations. An amendment to the agreement is being drafted[55] that would impose new "disciplines" on non-discriminatory regulations. Some delegations are arguing for a rule that would require regulations not to be "more burdensome than necessary." This could mean that if Canada's strict capital requirements were considered too high, even though they are applied without discriminating between foreign and local financial institutions, they could be successfully challenged as unnecessarily burdensome.

Another proposal is to discipline regulatory requirements if they are not "objective", which could mean reliance on international standards to determine what an objective requirement is.[56] Again, the risk is that this would create grounds to challenge regulations that are higher than the international norm.

GATS negotiators are also proposing to limit standards and licensing requirements only to what is "pre-established", a proposal that might present a threat to financial regulatory reform. Since "pre-established" has been left undefined, one extreme interpretation of this GATS rule could be that no new regulations could be imposed on a financial institution that was already licensed to operate.

Conclusion

Canada is no poster child for financial liberalization. Canada never fully embraced liberalization of its banking sector. Despite persistent pressure to do so, Canada maintained measures such as the widely held rule that, in effect, protect its banking system from foreign takeover. The Canadian government explicitly reserved its ability to do this by exempting the widely

held rule from the GATS and other trade treaties. Canada had to rely on exemptions because full GATS commitments can require a government to deregulate and not simply to eliminate discrimination against foreign suppliers.

Limits on liberalization of the banking sector benefitted Canada during the crisis because domestic banks were able to rely on a secure funding base—their retail deposits. Canada's stringent banking regulations served it well during the crisis. However, proposed GATS disciplines will create pressures to weaken regulations in all sectors including financial services.

Developing countries skeptical of full liberalization of financial services could point to the Canadian experience as evidence that protecting national banks from foreign take-over and competition can lessen their vulnerability to contagion from global financial crises. If anything, the Canadian experience seems to support the opposite of what the advocates of financial liberalization contend.

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28 John Chant, "Foreign Direct Investment in Canadian Banking: Is there a Case for Special Treatment?" The IUP Journal of International Business Law, Vol. IX, Nos. 1 & 2, 2010, p. 76.

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30 GATS Annex on Financial Services, Article 2.(a)

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32 Although the Canadian government's rationale for scheduling a limitation for the widely held rule is not public, this rule appears to conflict with the GATS Article XVI 1.(b) prohibition on "limitations on the total value of…assets in the form of numerical quotas."

33 When governments list limitations on their GATS market access commitments for a service, the limitations also apply to national treatment commitments. GATS Article XX.2 states: "Measures inconsistent with both Articles XVI [Market Access] and XVII [National Treatment] shall be inscribed in the column relating to Article XVI. In this case the inscription will be considered to provide a condition or qualificationto Article XVII as well."

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51 The IMF reports the technical difference as: "The Basel Accord requires internationally active banks to hold tier 1 capital of at least 4 percent and total capital of at least 8 percent of riskweighted assets. Canada imposes capital requirement targets that are higher than the Basel minima: tier 1 capital of 7 percent and total capital of 10 percent."

52 Thorsten V. Koeppl and James MacGee, "Branching Out: The Urgent Need to Transform Canada's Financial Landscape and How to Do It," C.D. Howe Institute Commentary, No. 251, June 2007, p. 2.

53 WTO Secretariat, "Background Note — Financial Services", WTO document S/C/W72, 2 December 1998.

54 Mickey Kantor, Panelist at the session "Financial Services and the Global Economic Crisis: the Road to Global Recovery," 9:30 AM October 14, 2009 at the Global Services Summit, October 13–14, 2009.

55 WTO, "Disciplines on Domestic Regulation Pursuant to GATS Article VI:4 — Second Revision," March 20, 2009. Available at:

http://www.tradeobservatory.org/library.cfm?RefID=106851. Accessed June 2, 2010.

56 Professor Robert Stumberg has analyzed the draft disciplines, and concluded that when "objectivity" is read in conjunction with another draft discipline, it "might influence the meaning of 'objectivity' to require use of international standards in certain situations." February 2007 Memo from Robert Stumberg and Jonathan Allen to Kay Wilkie, Chair, Intergovernmental Policy Advisory Committee.

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