

**CAPITAL BLIGHT?: THE REGULATION OF
FINANCIAL INSTITUTIONS IN THE EUROPEAN
COMMUNITY AND CANADA**

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The threat of capital flight is one felt by governments at all levels and every political stripe. The fear of losing the confidence of the investment community - leading to a boycott by potential investors and flight of existing capital - has led most governments to play close attention to the rhetoric and policies that ensure economic competitiveness of national economies. The collapse of Bretton Woods, technological changes, and innovations in financial instruments are just a few of the factors that have led to an unprecedented mobility for capital. It has led some to speculate about the end of geography and that the mobility of capital has rendered borders - and the political authorities that govern their territories - meaningless.¹

Governments are made all too aware of the competitive conditions they must foster to attract private investment that will promote economic growth, and increasingly, to finance public debts. Failure to do so will lead to capital searching for some other shore. The mobility of capital, and goods and services, means that individual countries are competing with each other to attract inward investment, often resulting in the lowest, slowest, common denominators shaping economic and social policies.

Discussion about "capital flight" has generated a debate about "capital blight". The concern with "capital" here is not with an economic means of production but the symbolic, and possibly actual, centre of political power within a national state. The "blight" of, or challenges to, the state manifests itself in two ways. First, as the mobility of capital means that it will more likely than not seek conditions that involve less state intervention, the result would be a diminished role for the state in economic life. Markets assume a more prominent role in regulating economic activity as the state retreats and pursues policies that emphasise "privatisation" and "deregulation".

A second manifestation of "capital blight" is that the increased mobility of capital, in transcending territorial boundaries, tends to favour sub-national and/or supranational (or transnational) forms of government over the national state structures. All levels of government, within legal and constitutional constraints, engage in a form of competition to enhance investment opportunities. Moreover, it is argued that subnational or transnational structures provide greater symmetry between political authority and economic activity. We then have the simultaneous shift in political authority from national governments to transnational bodies such as the European Community; and power shifting from national governments to regional and local authorities.

There have emerged, then, questions about what is to be the role of the state in the global economy. Can governments respond to demands being placed on them when the instruments at their disposal do not match the scale of the issues before them? Does globalization mean market considerations will dictate government policies and signals an irreversible retreat of the state from the organisation of social and political life? What forms of government will allow the state to provide more timely, effective responses to the new challenges being presented to it?² These are just some of the questions that policy-makers, citizens and communities are struggling with, and will be at the top of the political agenda in most advanced industrialised countries.

1. Richard O'Brien, The End of Geography (London: Frances Pinter, 1992); Joseph Camilleri and Jim Falk, The End of Sovereignty: The Politics of a Shrinking and Fragmenting World (Aldershot, Edward Elgar, 1992)..

2. Richard Simeon sets out these questions for Canada in his "Globalization and the Nation-State," in G. Bruce Doern and Bryne B. Purchase, eds. Canada at Risk?: Canadian Public Policy in the 1990s (Toronto: C.D. Howe Institute, 1991), p.205

This paper aims to examine whether institutional arrangements and the division of powers affects the policy responses to the pressures of "capital flight"; and whether the outcome is "capital blight". It will compare the regulation of financial institutions in the European Community, with a particular emphasis on Italy, and in Canada. There are a number of reasons for choosing financial institutions. As one observer notes, "There is no sector of the economy that has become more liberalized, more global in its orientation, and less constrained by national borders than this one."³ Few industries are as sensitive to regulatory changes in different markets, and are as flexible and mobile to exploit the most favourable conditions. This is the result of technical and product innovations that began to make their mark in the 1960s and 1970s and which have constrained the ability of the state to control the flow of capital in and out of its borders.⁴

In addition, financial services are one of the few industries that involves both spenders and savers. The state is expected to ensure that depositors and consumers retain a high degree in the solvency of the system. It can do this by imposing a number of preventive or prudential measures such as separating commercial and industrial interests from financial services. Governments may impose limits on price competition and barriers to market entry to ensure that risk is minimised. When these measures fail, governments are expected to ensure that depositors and consumers are protected, and in many cases, compensated. The contrasts are quite stark, then, between developments in international markets causing pressures to reduce the role of the state and favouring free markets, and the expectation that governments must guarantee the solvency of firms and maintain confidence in the system.⁵

The paper will argue that the pressures of "capital flight" do not necessarily result in the retreat of the state as a regulatory authority. Moreover, it will claim that "capital blight" is not inevitable and that the transfer of political authority from national states to transnational or subnational levels is not a foregone conclusion.

The paper will be divided into three main sections. The first will provide a conceptual framework for understanding various types of regulatory regimes of financial services that cross territorial boundaries. It will focus on the question of the division of powers and how they may affect policy responses. The second section will look at the attempt to create a single market for financial services in the EC, and Italy's response. The emphasis will be on banking as this is the area that the most progress has been made.⁶ The third section will look at the regulation of financial services in Canada, examining briefly recent reforms. The essay will conclude by drawing some

³. William Coleman, "Financial Services and Government Intervention," in Doern and Purchase, *op.cit.* p.205

⁴. For a discussion of some of these developments and responses by governments, see: Richard Dale, The Regulation of International Banking (Cambridge: Woodhead-Faulkner, 1984). David Gowland, The Regulation of Financial Markets in the 1990s (Aldershot: Edward Elgar, 1990).

⁵. The deputy governor of the Bank of England was quoted as saying that, "Society is coming to expect an awful lot, including all the benefits of free markets on the one hand, and increasing high standards of protection against a widening range of financial risks on the other...There has to be a balance but that balance is difficult to pin down", "High price for regulation, warns Bank," The Financial Times, 19 May 1992, p.20.

⁶. The emphasis is on banking but, as we will see shortly, the segmentation of financial services is collapsing and is one of the pressures for regulatory changes.

conclusions from the European and Canadian experiences; and exploring why we may not have had "capital blight" in the former but have in the latter.

REGULATORY REGIMES AND THE DIVISION OF POWERS

As economic activity increasingly ignores territorial boundaries and focuses attention on the relationship between states and markets, its regulation has taken on a growing importance. William Coleman outlines a useful classification of regulatory regimes for financial services that may provide some insight into the regulation of financial services in the EC, and for comparison with Canada.⁷ A "wholly consistent regime" is one with a single regulatory authority supervising the entire market for financial services, even when it crosses territorial boundaries. This implies, for instance, that if a bank wishes to establish a branch in a neighbouring member state or province, it will be subject to the same rules and authorities as it would in its "home" territory. A "wholly consistent regime" would mean that constituent units have transferred a large part of the supervisory and legislative functions to a central authority and a single set of rules.⁸ The constituent units have little scope to shape regulatory regimes to pursue their own objectives. They may gain from the greater coordination and perhaps coherence from a single authority, but at the cost of a loss of a degree of autonomy.

A "partially consistent regime" describes a market where the territorial segments retain their own rules and authorities, but agree to mutual recognition of their partners' regimes. Some attempt is made at minimal harmonization of standards so as to provide prudential safeguards for depositors and borrowers. In such a regime, if a bank is licensed to conduct its business in its home country, it may establish a branch in a partner territory on the basis of the original licence. If, for instance, it is allowed to sell insurance at home, then it will be permitted to do the same in its branches regardless of host country rules.

A "partially consistent" regime implies a minor role for central authorities both in setting a legislative framework and in supervision. The emphasis is on the rules and authorities in the component territorial segments. Recognition of each others' regimes creates pressures for coordination amongst the constituent units and for a degree of harmonization. Although we may not have a single set of rules, it is much easier for a single market to be created once the decision for mutual recognition has been taken.

A third type of regulation may be described as "national treatment". Common to many international trade agreements, it affords similar treatment to both domestic and "foreign" institutions. A bank would be required to meet the same requirements to be granted a licence as would an institution from the home country. There are no formal legal barriers to entry but other obstacles may prevent banks from establishing branches in other territories. A bank would have to apply for a separate licence for each territory in which it wanted to conduct business. If each authority had its own capital reserve requirements, then a bank would have to generate a capital base for each licence.⁹ There is only a limited role, if any, for central authorities. Unlike the

7. William Coleman, "Financial Services Reform in Canada: The Evolution of Policy Dissension," *Canadian Public Policy*, 18:2 (June 1992), 139-52.

8. *Ibid.*, p.141.

9. Coleman also describes two other types of regulation that are not central to our discussion. An "extraterritorial" regime is one where institutions, as with

"partially consistent regime", however, the constituent units have limited scope for coordination, and every incentive to compete.

The various types of regulatory structures and rules that may be adopted raise the question of the relationship between authorities in different territorial units, and about the division of powers between them. The balance between larger units of government that ensured effectiveness and smaller units that secured legitimacy and autonomy, was resolved by the national state through most of the nineteenth and twentieth centuries. However, in the postwar period, the widespread consensus that the nation-state, and more specifically, the unitary state, was the optimal organization of government has been challenged. More complex arrangements, of which federalism is one, have emerged as one response to the pressures for greater powers to larger units - for example, the EC - and for smaller units such as regions or provinces.

However, it is argued that federalism may not be the optimal form of government for economic policy-making. As Gordon Robertson, a senior civil servant who played a prominent role in many Canadian constitutional battles, notes, "If one were designing a system of government today to meet the challenges posed by the imperative of world competition, one would not opt for a federal system. Federalism has many virtues, but maximum economic or operational efficiency is not one of them."¹⁰ The general concern is that the dispersal of power does not provide an adequate basis for coherent responses to policy problems. The constituent units are seen as too small to deal with the pressures and consequences of increasing economic interdependence; but they have enough power to prevent coordinated, coherent policies.¹¹

The dispersal of policy-making authority does not necessarily lead to fragmented, incoherent policy-making, and therefore, weak governments. An important factor is not so much that more complex arrangements are replacing the unitary nation-state, but the relationships and division of powers between different levels of government, and across territorial boundaries. There is an increasing concern that shared decision-making responsibility can lead to immobility and indecisiveness.¹² Governments at each level will seek to make the most of the powers they have available to them; and the simple fact that they share responsibility will mean they will face demands for positive action.¹³

Our concern, then, is with whether certain types of regulatory regimes and the division of powers will lead to a shift in responsibility from national governments to other levels of government. We will argue that it is the factors behind that determine the division of powers that will affect the extent to which national states will give way to either subnational or transnational governments. Some of the criteria that are

national treatment, must apply for separate licences. But in this instance, host authorities require that institutions comply with their rules in all jurisdictions where they conduct business. A final regime is a protectionist one which is self-explanatory: Ibid.

10. Gordon Robertson, "The global challenge and Canadian federalism," Canadian Public Administration, 32:1 (Spring 1989), p.124.
11. This was a view expressed by a Canadian royal commission that examined the economy. See: Royal Commission on the Economic Union, Report (Ottawa: Minister of Supplies and Services, 1985), p.147.
12. See: William Chandler and Herman Bakvis, "Federalism and the Strong-State/Weak-State Conundrum: Canadian Economic Policymaking in Comparative Perspective," Publius, 19 (Winter 1989), pp.59-64.
13. Fritz W. Scharpf, "The Joint-Decision Trap; Lessons from German Federalism and European Integration", Public Administration, 66 (Autumn 1988), p. 255.

normally assigned in determination the division of powers include: avoidance of externalities; capacity to act effectively; simplicity and accountability; spatial distribution of policy preferences; concern for subnational communities.¹⁴ The last two factors reflect the extent to which there is a commitment and the conditions for a coordinated response to common problems.

We will examine financial institutions in the European Community and Canada in an attempt to examine the extent to which the functioning of a single market has been shaped by the type of regulatory regime that governs it, and by the division of powers between different authorities.

TOWARDS A EUROPEAN MARKET FOR BANKING?

Building a Community Regulatory Framework

The objective of a single market for financial services - especially banking, insurance and stock exchanges - has been part of the process of economic integration since the Treaty of Rome. Article 61(2) states that barriers to banking and insurance should be removed along with the progressive liberalization of the movement of capital. However, progress on this front has been slow in coming. It is only with the projected completion of the internal market that significant efforts began to emerge to create a single financial area.

In initial concrete step was taken with the First Banking Coordination Directive, approved by the Council on 12 December 1977 was a tentative attempt towards the creation of a single market for banks. A primary obstacle was finding a common definition for financial institutions. A credit institution was recognized as one that received funds and granted credit within the same undertaking. It also set out market entry requirements for institutions to be authorized in member states, including attempts to set adequate capital requirements.¹⁵

The First Banking Directive tried to move a great deal in the direction of the harmonization of rules for market entry, but it did very little with respect to the coordination of regulatory regimes for the pursuit of business activity. There were requirements for the exchange of information between supervisory authorities and an attempt to approximate similar prudential ratios. However, simply easing market entry requirements did not ensure that a single market for banks would emerge. Banks were relatively free to set up branches in other member states as they would be subject to the same rules for establishment as domestic firms. Barriers could be placed through supervision of institutions by different regulatory regimes. The main obstacle was that banks could still be required to comply with host country minimum capital requirements.¹⁶ For instance, if each member state required a capital requirement of 10 million ecu, then any bank wanting to set up branches in five member states would

14. See: Garth Stevenson, "The Division of Powers," in Richard Simeon, ed. Division of Powers and Public Policy (Toronto: University of Toronto Press, 1985), p.83.

15. For a discussion of the First Banking Directive, see: Paolo Clarotti, "Progress and Future Development of Establishment and Services in Relation to Banking," Journal of Common Market Studies, 22:3 March (1984), p.213.

16. Ibid., p.200.

need 50 million ecu; it could not simply extend its network of branches into other member states.

The objective of creating a single market for financial institutions, then, continued to be elusive. One obstacle was the fact that the unrestricted movement of capital in and out of many member states was still not possible as the EC entered the mid-1980s. Any further attempts at creating a single market for banking would be limited if capital markets were not liberalized. The Council approval of measures to lift most restrictions opened the way for further integration in the banking sector.¹⁷ The important step was the approval by the Council of the Second Banking Coordination Directive in December 1989.¹⁸ While the First Banking Directive aimed to ease market entry requirements its successor looked to ways to provide a common framework for the conduct of business activity.

There were three elements to the creation of single market for banking in the Second Directive.¹⁹ First, consistent with attempts to create an internal market in other sectors, the Directive emphasises mutual recognition by member states of each other's legislation and supervision of financial institutions.²⁰ Second, it aims at minimal harmonization of prudential rules and standards so as to provide some level of protection for depositors; and to avoid the lowest common denominator becoming the standard for prudential safeguards. Third, the Directive will give ultimate supervisory powers to the authorities in the institution's "home" country, regardless of whether it conducts most of its activity elsewhere in the Community.

Mutual recognition in the Second Banking Directive was secured through the creation of a "single licence" (also known as the "single passport") for banks. A credit institution that is authorized as such in one member state can automatically set up branches in another EC country without having to obtain further authorization from the host country.²¹ Furthermore, a bank is able to conduct the same activities throughout its branches permitted to it under its home country licence.

The Directive provided a list of services that banks could extend to all their branches provided they were allowed to do so in their home countries. The list included deposit-taking and lending, leasing, selling securities, and participation in share issues. Banks are allowed to provide those services in host countries even if banks there are prohibited to do so by their bank licences. The result is that, "In those countries which persist in maintaining tight restrictions on the range of activities their banks can carry out, domestic institutions will find themselves at a disadvantage compared to institutions based in countries without restrictions."²² Mutual recognition is also extended to endowment capital, so that banks are not required to maintain a minimum capital requirement in each member state where they have branches or provide cross-border services.

¹⁷. See: OJ L 332, 26.11.1986; and Directive 88/361/EEC, OJ L 178, 8.7.1988.

¹⁸. Directive 89/649/EEC.

¹⁹. Dominique Servais, The Single Financial Market 2nd Ed. (Brussels: Commission of the European Communities Document Series, 1991), p.49.

²⁰. Renaud Dehousse, "Integration versus Regulation? On the Dynamics of Regulation in the European Community," Journal of Common Market Studies, 30:4 (December 1992), pp.384-389.

²¹. Peter Vipond, "Financial Services and the Internal Market," in Leon Hurwitz and Christian Lequesne, eds. The State of the European Community: Policies, Institutions and Debates in the Transition Years (Boulder, CO: Lynne Rienner, 1991).

The aim of the Directive was to encourage the creation of all-inclusive financial institutions: a credit "boutique". It is expected that the wide range of services will provide economies of scale and eventually price reductions for consumers. Member states may still be allowed to keep in place regulations that lead to greater specialization, but these may come under pressure from banks who can provide a greater variety of services at possibly a lower cost.

The Second Directive did not abandon completely attempts at harmonizing rules throughout the Community. The minimum capital base for credit institutions has been set at 5 million ECU.²³ In addition, similar rules will be adopted for disclosure and annual reports of major shareholders of credit institutions. The Directive also adopted standards for the relationship between banks and non-financial firms. Two prudential limits were set. First, a credit institution cannot commit more than 15 per cent of its own funds in one non-financial firm. Second, the total value of such activities cannot exceed sixty per cent of the institutions own funds.²⁴ The prudential limits were to ensure that member states would not compete amongst themselves to attract commercial firms seeking to gain a presence in financial services; and granting them a "single banking passport".

Finally, the Directive gives a prominent role to home country supervision of credit institutions. Article 9 focuses on the ownership of credit institutions and the control of shareholders. One regulatory issue that causes some concern is the ownership of banks by industry, and the potential for conflicts of interest and solvency problems if there is a degree of cross-dealing. The Directive deals with this by stating that credit institutions must provide full disclosure of shareholders to their home authorities. The latter can continue to apply their own rules as to who may own or control credit institutions. The United Kingdom, which does not allow for industry to control banks, can continue this policy while France and Germany can maintain the close links the two sectors.²⁵ The host country authorities will ensure the solvency and liquidity of branches within their territories; and banks will be required to provide them with the same information that they would to their home regulators.²⁶

The Second Directive has taken a major step towards creating a single market for banking. Progress in other sectors of the finance industry - insurance and stock exchanges - has been much slower. Moreover, it remains to be seen what impact the Directive has on authorities and firms in member states. For instance, Italy did not provide the enabling legislation to implement the First Banking Directive until 1985, almost eight years after it was approved by the Council.

It may be argued that the EC has seen a significant shift in the type of regulatory regime for banking. The Second Banking Directive has given the EC a "partially consistent regime" whereas the First Directive emphasized national treatment. We do not have a single set of rules or authority; rather, the regulatory authorities in the

22. Rob Dixon, Banking in Europe: The Single Market (London: Routledge, 1991), pp. 59-60.

23. Directive 89/649/EEC.

24. Jean Dermine, "The Specialization of Financial Institutions: The EC Model," Journal of Common Market Studies, 28:3 (March 1990), p.224.

25. Ibid.

26. There are two other parallel directives that are important for the development of a single financial market. The Own Funds directive, approved in May 1989, provided a common definition of assets that make up the firm's own funds. This gave a fair measure of equivalence for definition of capital that was applied in the Solvency Ratio Directive, approved in December 1989. This set at 8 per cent the amount of assets that a bank must set aside.

member states have not only remained, they have assumed an even more important role. We do not have a single set of rules but regulations in member states that are, as the Italian case will illustrate, under pressure to become more similar.

Banking has moved from a regime that emphasised "national treatment" in the First Banking Directive; with some attempts at creating a "wholly consistent" regime. The key point is that the attempt to create an internal market for banking with a partially consistent regime has not meant a diminished role for authorities of member states, and an increase in the role of the Community structures: there are less than 100 officials in the Commission that deal with regulatory matters for financial institutions. Indeed, this type of regulation requires that the constituent parts provide effective responses if they want their own firms to compete in a wider market.

Banking in Italy

Italy should provide an attractive venue for banks. Italians have had a high savings rate in the postwar period, providing a potential source of deposits.²⁷ The private sector savings rate has been second only to Japan amongst OECD countries in the last thirty years. Italians have a large number of banks in which to place their savings: in 1990, there were over 1100 banks. These included the three large "banks of national interest" - Banca Commerciale Italiana (Comit), Credito Italiano (Credit) and Banco di Roma. In addition, there were six other large state-held banks, 150 or so private banks, 83 savings banks (most of them publicly-owned), 145 co-operative banks and 720 rural banks, of which only one had more than ten branches.²⁸

The banking industry, despite the large number of institutions, is characterised by a great deal of concentration and a significant state presence. For instance, the sixteen largest banks controlled over 50 per cent of deposits in 1990; and state-held banks controlled over 80 per cent of assets. Paradoxically, even though Italy has a high number of banks, it is recognised as not having enough branches to tap into the large reservoir of savings. For instance, in 1989 France and the former West Germany had 6.5 branches per 10,000 inhabitants, the United Kingdom 4.3 and Italy only 2.4 branches. Even the largest asset-holding banks have small branch networks. One of the consequences is that Italian banks have often been short of deposits to finance their loan portfolios and have been forced to look to more expensive sources.²⁹

One thing that Italian banks do not lack is employees. The average number of employees per branch in 1989 was 23; the figure for the UK was 12, for Germany 14 and 17 in France. There are two points here that are relevant for our discussion. First, labour legislation makes it extremely difficult and prohibitively expensive to impose redundancies in banks. This means that efficiency gains that may result from mergers, rationalizations and technological innovations are limited. Second, the high degree of over-staffing is largely the result of the fact that state-held banks have become an important source of patronage and clientelism for the political parties. Positions within the banks, from executive officers and board members to tellers, are part of the spoils of power for the political parties. Management positions within banks were left vacant,

²⁷. Centro Einaudi, Rapporto sul risparmio e sui risparmiatori in Italia (Roma, 1989).

²⁸. "The Italian guide to banking," The Economist, 30 June 1990, p.73.

²⁹. Ibid.

or occupied by directors whose mandates had expired, for years as the parties - mostly those in government - fought over the division of the spoils.³⁰

This raises the more general point that any attempt to change the rules and standards by which banks operate in Italy will touch an important source of power for the political parties. For instance, mergers aimed at creating more competitive firms in the European market will mean negotiations between parties and factions within parties. The pressures for a single market for banks will have an impact not simply on the regulatory regime but also on the more sensitive political relations. Simple arguments about efficiency gains and economies of scale must contend with negotiations and bargaining between political forces.

Historical and Legal Background

Italian banks developed during the country's period of industrialization at the end of the nineteenth century. There was a large German presence in the industry which helped account for the fact that they were based on the German "mixed bank" model. This implied that banks were large holders of equity in industry, forging a close relationship between industry and finance. These close links began to run into trouble in the 1930s. Fascism and the depression kept away foreign investment on which the banks relied so heavily. Both finance and industry faced a serious capital shortages; the large equity holdings in industry pushed banks - and their deposits - to point of collapse.³¹

The Bank of Italy moved to rescue the banks and industry in 1931. The industrial holdings of the Banca Commerciale Italiana (Comit) and Credito Italiano (Credit) were sold to a new institution called Istituto Mobiliare Italiano (IMI). A parallel development was the creation of the Istituto per la Ricostruzione Industriale (IRI) in 1933.³² It was established as a holding company to liquidate the assets that the state had acquired from Comit and Credit and had placed with IMI. A year later, IRI took over complete control of Comit, Credit and Banco di Roma. The three banks were classified as "banks of national interest" and continued to be state held until the early 1990s.

The gradual increase in state intervention in banking was to continue into the postwar era. It was not part of an ideological or economic programme, but a reactive policy to a perceived crisis in the industry.³³ A significant state presence did mean that one of the key regulatory issues for banks in postwar industrialised economies - the question of ownership and the links between industry and finance - was essentially resolved. IRI became the principal shareholder in the major banks, thus ensuring that private sector industrial holdings were limited. The separation of finance and industry also was facilitated by the creation of specialised credit institutions, a form of

30. "Casse frigorifero," *Panorama*, 26 April 1992, p.217. The recent referenda in Italy included one that would no longer require parliamentary or Treasury approval for all managing positions in banks. Italians voted overwhelmingly to take this power away from the parties, and hopefully, give it to shareholders and non-political boards of directors.

31. Paul Furlong, "State, Finance and Industry in Italy," in Andrew Cox, ed. *The State, Finance and Industry* (New York: St. Martin's Press, 1986) pp.145-146.

32. Patrizio Bianchi, "The IRI in Italy: Strategic Role and Political Constraints," *West European Politics*, 10:2 (1986), pp.269-290.

33. F. Belli, ed. *Banche in crisi, 1960-1985* (Bari: Laterza, 1987).

investment or merchant banking, that was to serve high-risk credit needs. IMI was to emerge as the most prominent public sector investment bank, and Mediobanca was to be its private sector rival.

The most important piece of legislation governing banks in the postwar era was the Banking Law of 1936.³⁴ It established the Bank of Italy as the supervisory body for the industry, as well as the sole issuer of currency. The central bank would set reserve requirements, deposit ratios, loan quotas and rules for currency dealings that applied to banks. In addition, it was to authorize the opening of any new branches on the basis of "economic need". This was a means of ensuring controlling the entry of "foreign" banks, and that balances between regional savings banks would be maintained.

The Italian regulatory regime also ensured functional segmentation of the financial services. Banks had limited holdings in insurance companies while the securities industry has been left almost entirely to stock brokers. Moreover, segmentation meant that the activities carried out by each have been limited so that banks have been primarily short-term deposit-takers and have not provided a wide range of services such as leasing, retailing insurance and selling securities.

Italy and the Single Market for Banks

Italian banks face a number of competitive pressures in the single market. For instance, the Cecchini Report on the impact of 1992 found that Italy was second only to Spain in terms of price reductions for most financial services.³⁵ Italian banks have a limited presence in foreign markets, and they remain relatively small in comparison to some of their European competitors. For instance, in 1987 Italy had no banks among the top 25 in the world, while France had four and Germany and the UK had two each; it placed only one bank amongst the world's top 50 banks while France had five, Germany had seven and the UK had four.³⁶ Their competitive position is also seen as weakened by the fact that they are relatively over-staffed.

There emerged widespread concern that Italy did not have firms in the finance sector that could compete on the European level.³⁷ Solutions were sought in reforming two areas: ownership and functional segmentation. Officials in the Treasury and in many banking circles began to argue that the industry required a great deal of restructuring and rationalization in order for its firms to become competitive.³⁸ The

34. For a broader discussion of the legal and regulatory framework for Italian banking, see: Renzo Costi, L'Ordinamento Bancario (Bologna: Il Mulino, 1989) Gianni Manghetti, Le Banche Italiane (Milan: Feltrinelli, 1979)..

35. Commission of the European Communities, European Economy (The Economics of 1992), 35 (March 1988), pp.86-93.

36. Franco Bruni, "Banking and Financial Regulation Towards 1992: The Italian Case," in Jean Dermine, ed. European Banking in the 1990s (Oxford: Basil Blackwell, 1990), p.245.

37. For an overview of Italy's position with respect to an integrated financial market, see: G. Vaciago, "L'integrazione finanziaria in Europa: costi e benefici per l'Italia," in G. Amato and M.L. Salvadori, eds. Europa Conviene? (Bari:Laterza, 1990).

38. For a review of the factors that have led to recent reforms, see the account by the junior Treasury Minister responsible for financial institutions from 1987

first step was to change the ownership structure of banks, especially those controlled by the state. The key piece of legislation was the Amato Law of July 1990 (legge 218/90) named after its chief architect, Giuliano Amato.³⁹ It contained two main provisions. First, it would allow any state-owned bank to become a joint-stock company, and to float 49 per cent of its stock on the stock market. Banks have been quite receptive to the possibility of changing their status to joint stock companies. By June 1992, 80 of the 142 banks that could become publicly quoted companies had changed their status.⁴⁰ Some banks - such as the Banco di Napoli and the San Paolo - had already floated shares or were in the process of doing so by late 1992.⁴¹

The Amato Law also provided over 2 billion dollars - in the form of tax breaks and credits - over a five-year period to encourage mergers and fusions in the banking sector. By June 1992, the Bank of Italy had registered 24 mergers involving banks controlling close to one-fifth of banking assets.⁴² This was to address two perceived problems: fragmentation amongst the regional savings banks and the need for large financial institutions to compete in international markets. The number of banks has decreased to about 1400 while the number of branches continues to grow at a rapid pace.⁴³

The other major programme that aims to change the ownership structure of banks is an ambitious plan to completely privatise the "banks of national interest" along with other state-held banks. The Amato government struggled through economic and political turmoil during the second part 1992 but still managed to put forward a plan to have IRI sell all of its shares in the three major banks as well as reduce its holding in other banks.⁴⁴ More importantly, the plan did not rule out foreign ownership nor industrial holdings for the privatised banks. In doing so, it accepted the recommendations of a report by the Governor of the Bank of Italy, Carlo Azeglio Ciampi, issued in June 1992. The Governor strongly urged close ties between industry and finance along the lines set out by the Second Banking Directive.⁴⁵ The Amato government accepted this recommendation and made it an integral part of its privatisation plan. Scandals and referenda brought an end to the Amato government

to 1992: Maurizio Sacconi, La Finanza e La Regola (Milano: Longanesi & Co., 1992).

39. Sandro Amoroso, ed. La Ristrutturazione Delle Banche Pubbliche: L'attuazione della legge n.218/90 (Milano: Giuffre Editore, 1991); Giuliano Amato, Due Anni al Tesoro. Bologna: Il Mulino, 1990.; Cesare Vento, "The Amato Bill Spearheads Banking Reform," International Financial Law Review, 9:9 (September 1990), 19.
40. "E ora Ciampi scopre la banca alla tedesca," La Repubblica, 2 June 1992, p.46.
41. "The pecking order will be overturned," The Financial Times, 9 December 1991, p.15; "New word in the language," The Financial Times, 15 December 1992, p.25; "San Paolo formato Spa naviga a gonfie vele," La Repubblica, 2 February 1993, p.53.
42. "E ora Ciampi scopre la banca alla tedesca," La Repubblica, 2 June 1992, p.46.
43. There were just under 15,600 branches with over 1100 banks at the end of 1989; two years later, with about sixty less banks, there were over 20,000 branches with another 1400 projected for 1992: "Boom with no end in sight," The Financial Times, 15 December 1992, p.26.
44. "All'asta lo Stato padrone," La Repubblica, 15-16 November 1992, p.2.
45. "E ora Ciampi scopre la banca alla tedesca," La Repubblica, 2 June 1992, p.46.

and created some uncertainty as to the future of the privatisation plans, but it seems unlikely that future governments will retreat significantly.⁴⁶

The second area of change has been an end to functional segmentation. The Italian Parliament has approved the Second Banking Directive, and the Bank of Italy has been preparing the implementing regulations. The most important of these will allow Italian banks to carry out the activities listed in the list of services attached to the Second Directive. It means that Italian banks will be allowed to provide the same services as their German counterparts and to become all-inclusive financial institutions with a wider capital and asset base. The hope is that this will put the Italian institutions in a better position to compete with banks such as the Germans which have always been allowed to provide a wide range of services; and would be allowed to do so in Italy while Italian banks would have been prohibited under the old rules.

The reaction to changes in the last few years has been swift and could lead to a significantly different Italian banking sector. The Banco di Roma has already been part of a major restructuring as it was acquired by the Cassa di Risparmio di Roma which had previously bought the Banco di Santo Spirito. The new venture is called the Banca di Roma and will constitute the "Roman" pole in the Italian banking system.⁴⁷ A second pole has been centred around the "Gruppo Bancario San Paolo", a holding company created to accommodate the acquisition of Crediop, a merchant bank, by the Istituto San Paolo. The aim was to create a diversified banking group that brought together the San Paolo's access to deposits with the merchant banking experience of Crediop.⁴⁸ The larger capital base of the holding company will grant greater opportunities to engage in activities such as underwriting share issues; and access to customers in branches may provide customers for services such as the buying and selling of shares.

There has been widespread speculation since 1991 that IMI, the largest state-held merchant bank, would be involved in a major restructuring. Most rumours have centred around a merger between IMI and Cariplo, the country's largest savings bank. It was a marriage that was difficult to consummate, and by early 1993, new suitors were being suggested for IMI. It emerged that the Banca Nazionale di Lavoro (BNL) was interested in acquiring the merchant bank.⁴⁹ In either case, the merger would involve a fusion between a deposit-taking institution concentrating on short-term credit with a merchant bank. It reflects a general trend that was at the heart of the spirit if not the letter of the Amato Law: that is, to encourage the creation of larger groups that bring together short and long-term credit institutions, combining savings and merchant banking.

Another important change that has affected banking has been reforms to Italy's securities trading. Italy's version of London's Big Bang came in the form of the *Legge n.1/91*, enacted on 2 January 1991. It establishes Società di Intermediazione Mobiliare (SIM - Securities Intermediation Companies) that has ended the monopoly held by stock brokers. The new institutions, in addition to performing stock brokerage functions, will also be able to deal securities on their own account, participate in the

46. "A story of private ambitions," *The Banker*, April 1993, pp.12-13.

47. "Too big a mouthful?," *The Banker*, (April 1992), p.10.

48. "Lo Sportello dei Matrimonio in Bianco," *La Repubblica - Affari e Finanza*, 27 March 1992, p.2.

49. "Ora sull'Imi esce allo scoperto la Bnl," *La Repubblica*, 23 January 1993, p.43.

placement of securities, and offer investment advice and asset management.⁵⁰ They must be either joint stock companies or joint stock partnerships, and they must respect strict stock capital requirements.

The SIMs have been an attractive business for the large banks. The major banks, such as Banca Commerciale Italiana, the San Paolo and Cariplo, were among the first to embark in the securities business; most have followed suit. Many of the SIMs set up by the banks have included significant participation by former stock brokers.⁵¹ The banks bring their capital base and access to customers with savings to the securities business while the brokers can offer specialised services.

The changes to Italian banking in the early 1990s reflect a strategy to create two different classes of banks.⁵² The first focuses on banks in one or more regions that concentrate in their activities in a clearly defined territory. The emphasis here has been on mergers between regional savings banks such as the acquisition of the Banca di Friuli by the Credito Romagnolo or the fusion of Banco Ambrosiano and the Cattolica del Veneto into Ambroveneto.⁵³ The second track has been to create large scale institutions that can compete in international markets and provide a full range of financial services. The process of restructuring has begun with the mergers and the plans to privatise many of the state-held banks. It is also reflected in the development of strategic alliances with banks in other member states.

The strategy has been a response to developments in international banking. It is also a result of the single market and the Second Banking Directive.⁵⁴ Clearly, if Italian banks were to be competitive in other member states, the rules that applied to their "single passport" needed to be changed. The prospect of the single market led a policy-making process that is notorious for its ability to delay and confuse to produce rather timely and coherent responses. A partially consistent regulatory regime would punish Italian policy-makers and banks if they had resorted to their usual ways.

The case of Italian banking and the response by policy-makers to the pressures off the single market reflects a more general point about the affect of 1992 on Italian politics and institutions. The question of institutional reform has been on the political agenda since the early 1980s, but it is only at the beginning of the 1990s that significant changes began to develop; and the need to respond to challenges of a single market has been partly responsible.

One of the major problems faced by policy-making in Italy is the fact that the government has no control over the parliamentary time-table; and weak governing coalitions have had fragile parliamentary majorities. An attempt was made to overcome this obstacle with respect to adapting national laws to EC legislation.⁵⁵ The *legge comunitaria* is a special procedure in Parliament that gives priority to government legislation implementing Italy's European obligations. The procedure was seen as responsible for Italy improving its record of approving directives for the creation of the

50. 'Counting the cost of technological change,' The Financial Times, 9 October 1991, p.26.

51. "Big Bang in Milan," The Banker, February 1992), p.6.

52. "Banche a fette," Panorama, 4 October 1992, p.230.

53. "A story of little change," The Financial Times, 15 December 1992, p.29.

54. "Rischio Europa," Il Mondo - Le Classifiche del Mondo, July 1992, pp.7-8.

55. David Hine, Governing Italy (Oxford: Clarendon Press, 1993), chapter 10.

single market approved. Italy lagged far behind the other member states but the parliamentary procedure allowed it to race ahead.⁵⁶

It may be argued that the single market has created pressures for more general institutional changes. The framers of the Italian Constitution were primarily concerned with creating an institutional framework that favoured a more consensual approach to policy-making rather than effective, coherent policy. Ensuring the stability of democratic institutions was seen as an overriding concern so long as the main opposition party, the Communist Party, was marginalised from governing coalitions. The lack of a perceived democratic alternative allowed policy-makers to act irresponsibly. By the time the Berlin Wall collapsed, it was clear that democratic institutions were firmly entrenched in Italy. Pressure began to mount to shift the emphasis away from consensual decision-making to coherent, timely policy-making. Italy's commitment to the single market served to strengthen these demands.⁵⁷ It was possible for new political forces such as the Northern League to exploit fears of those who felt most vulnerable to greater competition within a single market. They could argue Italy's policy-making processes and institutions were inadequate in a more integrated Europe, and required reforms that could guarantee stable, cohesive and timely policy-making.

The case of banking within the EC highlights the continued importance of national regulatory rules and authorities; and represent a "partially consistent regime". It does not illustrate a case of "capital blight" in that a great deal of financial services will still be subject to some sort of government intervention. Moreover, as the case of Italy illustrates, an increasingly integrated financial market does not mean a shift in policy-making power from the national state to the Community. In fact, it has meant that attempts to create policy-making procedures and structures that can lead to purposive action by government are closer to being realised than at any other point in the history of the Republic. The success of the single market, at least in the case of banking in Italy, has rested on the rising political demands for more coherent, timely policy-making.

THE REGULATION OF FINANCIAL INSTITUTIONS IN CANADA

The Canadian Regulatory Regime

The regulation of Canada's financial institutions throughout most of the postwar period was characterized by two main features. First, the distribution of powers, as defined by constitutional practice and the BNA Act, between the provinces and the federal government resulted in the two levels of government sharing, and often competing for, responsibility. Second, ownership of institutions and the activities they carried out were separated into what became known as the "four pillars": banks, trusts (equivalent to savings banks and building societies), insurance companies and securities. This included placing strict limits on market entry, especially for non-

⁵⁶. A survey of directives approved by member states in February 1993 found that Italy had approved 87%, making it second to Denmark with 92%. "Italia promossa in dogana," *La Repubblica*, 9 February 1993, p.48.

⁵⁷. For instance, see: Carlo de Benedetti, "Europe 1992 Is a Necessity for Italy," *Europe*, 285 (April 1989), 38-39.

financial interests. As we will see, the recent reforms have largely dismantled the "four pillars" but have not resolved the federal-provincial tension.

The constitutional dimension

The constitutional basis for the federal government's regulatory role is found in section 91 (15) of the Constitution Act, 1867. However, this is the only clear sign we get from the Constitution Act as to who has jurisdiction in financial services. For instance, insurance and trust companies fall under either federal or provincial regulation depending on their operations and/or incorporation. The supervision of securities trading has fallen largely to the provinces but this has been through convention rather than a solid legal basis. Provinces assumed jurisdiction in this area pointing to the constitutional provision that gave them responsibility for the protection of property rights. However, the federal government could equally claim regulatory powers as the Constitution Act allows it to interfere with provincial initiatives if they affect residents in more than one province. Securities trading increasingly does not recognise national boundaries let alone provincial divisions. However, provincial authorities - particularly in Ontario and Quebec - have set the policy agenda for the whole country.

The constitutional ambiguity has meant that both the provinces and the federal government have put regulatory structures in place. Provinces have made full use of the regulatory and legislative powers at their disposal. For instance, most provinces have a minister for financial institutions, corresponding to the federal minister of state. All provinces and the federal government have a minister for consumer and corporate affairs that citizens may turn to for protection. Provinces can control the activities of financial institutions, especially trusts and insurance companies, that choose provincial charters. It is possible, then, for there to be eleven sets of rules and authorities. Consumers, financial institutions and policy-makers looking for some sort of clarity from the Constitution as to who has power over whom, when and how, have found only ambiguity; and, as we will see shortly, competition between different jurisdictions.

The "four pillars"

Throughout most the postwar period, federal policy has been to separate both the ownership and operation of financial institutions; and to limit commercial and industrial links with financial services. The approach, known as the "four pillars", had widespread political support, and it was not until the 1980s that governments began to give serious consideration to dismantling the regime.

The main piece of legislation governing the operation of banks since Confederation has been the Bank Act which has been in place since 1871. The first feature of the Bank Act was the question of widely-held versus closely-held ownership. Canadian banks in the early nineteenth century had begun largely with capital from wealthy commercial and industrial families, many of which were American. Some attempts were made to limit the influence of both commercial and foreign interests,

especially in the period after World War II.⁵⁸ Banks has been the fact that they have been widely-held since 1967, with no one share-holder entitled to more than 10% of stock in one of the chartered banks. Moreover, since 1964 total foreign ownership of a bank could not exceed 25%. This ensured both that links between commercial interests and banks would be minimized, and that control would remain in Canadian hands.

It was not until the 1980 revision of the Bank Act that foreign banks could carry out their activities in Canada. Two sets of banks were created, known as Schedule A and Schedule B banks. The former included the domestically-owned charter banks, while the latter was a new category created specifically for foreign-controlled firms. They could engage in full banking activities. They were to be licensed by the federal Minister of Finance who also had powers of review and renewal. One of the factors that the Minister would take into account when considering approval for foreign banks was the nature of non-bank operations of its owners. The restrictions on their activities included being limited to two offices within Canada. More importantly, overall foreign bank assets were limited to 8% of total bank assets (this was raised to 16% in 1984). Despite these restrictions, foreign banks became an important presence in the 1980s.

Banks were limited in the services they were permitted to deliver. They could not engage in fiduciary activities nor could they provide portfolio or investment management. There was some ambiguity as to whether banks could engage in the secondary buying and selling of securities. This was resolved in the 1980 review of the Bank Act which prohibited banks from underwriting stocks for secondary distribution. Banks were prohibited from retailing financial products such as life or casualty insurance to ensure that the "pillars" remained firmly rooted and exclusive.

The emphasis on separating functions was extended to areas such as mortgage lending and car loans. It was not until 1954, as a result of a building boom, that banks were allowed to grant mortgages. Governments did not abandon caution completely, and limited mortgage lending to no more than 10% of a bank's liabilities. Finally, banks were prevented from owning or controlling other financial firms; and their stake in any company could not exceed ten percent. For instance, they could not own, or have as subsidiaries, securities traders. The fact that they were widely held meant that other financial institutions could not own banks.

The responsibility for supervising the banks at the federal level rested with the Minister of Finance. The principal regulatory agency was the Inspector General of Banks (IGB), created in 1925 in the wake of the Home Bank collapse, who reported directly to the Minister. The IGB's main responsibilities were to ensure that the ownership restrictions were respected, and that the "four pillars" remained intact, especially as they applied to banks. However, the size of the IGB's office did not keep pace with its growing responsibilities. For instance, in 1978 it had a staff of only 14. It was merged with the Department of Insurance in 1987 and the Office of the Superintendent of Financial Institutions (OSFI) was created with a staff of over 200 officials.⁵⁹ This was a recognition of the fact that financial activity involved more than just the banks, and was in anticipation of the day when the "four pillars" would be dismantled. In addition, the Canada Deposit Insurance Corporation (CDIC), the compulsory scheme to protect depositors, also had an important supervisory role to ensure solvency.

Trust companies emerged as major competitors to banks in the 1980s, both in terms of attracting deposits and in non-commercial borrowing. The initial activities of

⁵⁸. For a detailed discussion of Canadian Banking see: E.H. Neave, Canada's Financial System (Toronto: Wiley, 1981)

⁵⁹. Coleman, "Financial Services and Government Intervention," p.207.

trust companies were limited to the fiduciary sphere. They were not meant to compete with banks as deposit-taking institutions but to complement banking activities. The trust companies main area of business was in mortgage lending; prior to the recent reforms, 75% of a trust company's loan portfolio had to be mortgage lending. Strict limits were placed on their commercial lending in an attempt to limit their competition with banks in this area.

An important difference between trusts and banks was that the former could be closely-held. The ownership question was addressed by the Royal Commission on Banking and Finance (Porter Commission) in 1964 and by the nationalist Finance Minister at the time, Walter Gordon. It had become apparent that the banks had a large stake in the trusts, both in terms of ownership and interlocking directorships. The banks were forced to scale down their holdings in trust companies to 10% in the mid-1960s, and to end interlocking corporate directorships.

However, the ownership question remained unresolved. The changes introduced to the trust company legislation in the 1964-1966 period imposed something known as the "10/25 clause". This applied to foreign ownership, and restricted non-residents to a stake not larger than 10% of a trust company and aggregate foreign ownership of a trust to no more than 25%. But the ten percent threshold was seen to apply to non-residents, and did not prevent the trusts from being closely-held by Canadian interests. For instance, Royal Trust, with assets of close to \$40 billion (1990) was owned by the holding company Brascan, which is part of Edgar and Peter Bronfman's conglomerate, Edper.⁶⁰ Brascan bought Royal Trust from the Olympia and York, owned and controlled by the Reichman family. Canadian Pacific sold its stake in Montreal Trust, assets of \$11 billion in 1989, to Paul Desmarais and Power Corporation in 1967, who in turn ceded the company to Bell Canada Enterprises in 1989. The problem remained that some provinces, especially Quebec, were willing to accept closely-held ownership of trusts; and companies could threaten the federal government by saying that they would choose a provincial charter.

The trusts were limited in the activities they could engage in, but were free from regulatory control with respect to ownership and were not required to keep cash reserves with the Bank of Canada. They benefited from the shared responsibility between federal and provincial governments. They could choose to be incorporated at either level of government; with the restrictions on their activities being one factor in their decision on which level to choose incorporation. It meant that although there were no formal barriers to the movement of capital within Canada, it was not entirely a "single market" as different rules and authorities still operated.

Pressures for Change

The four pillars did not suddenly come crashing down with the 1990-1991 reforms. Rather, they collapsed after having their foundations eroded throughout the previous decade. The general arguments for deregulation or reregulation in industrialised countries are well-documented.⁶¹ These did not escape Canada's

⁶⁰. The Economist, 9 November 1991.

⁶¹. For example see: Michael Moran, The Politics of the Financial Services Revolution (London: Macmillan, 1991); Geoffrey Underhill, "Markets Beyond Politics?: The State and the Internationalisation of Financial Markets," European Journal of Political Research, 19 (1991), pp.197-225;

financial services industry, and they reflect both international and domestic sets of pressures for change.

An important source of change was the Free Trade Agreement (FTA) with the United States. The Agreement assures "national treatment" for American firms, exempting them from restrictions like the 10/25 formula for foreign ownership of trusts. The significance of the FTA was that it illustrated both the opportunities and the problems posed by more liberalised trade. These gained greater prominence when it was revealed that American Express had been granted a Schedule B licence. American Express had sought the licence as a way of getting access to the extensive network of automatic teller machines (ATM) established by the Canadian banks.⁶² The case for granting Amex a banking licence was a weak one because it failed to meet a number of criteria: most importantly, it was not regulated as a bank in its home country. Canadian banks were deeply troubled by the event because it was quite clear that Amex's prime interest was to use the ATM network for its one million credit-card customers in Canada; and, more importantly, there was a concern that it would use its position to market its commercial activities such as travel insurance.⁶³

Another tension undermining the four pillar regime came from domestic conditions: in particular, the fact that provinces also could regulate financial services. Regulation of institutions with provincial charters meant that many different regimes could be established to challenge the federal system. For instance, Quebec allowed trust companies and "caisses populaires" (a popular cooperative bank) to retail insurance on its premises. Moreover, the Quebec government pursued a policy that sought to create large financial institutions that could compete in the rest of Canada and internationally. This led to dismantling the "four pillars" and forging close links between finance and industry through cross-ownership.

An important provincial challenge to the federal regulatory structure came in 1986 and involved the ownership of securities dealers. The regulation of securities

K.J. Botton and D. Swann, eds. The Age of Regulatory Reform (Oxford: Oxford University Press, 1988); Giandomenico Majone, ed. Deregulation or Reregulation? Regulatory Reform in Europe and the United States (New York: St. Martin's Press, 1990); Ann Cotterrell, "Regulation in Banking: Canada in Comparative Perspective," British Journal of Canadian Studies, 5:2 (1990), pp. 331-346; Jill Bodkin, "Deregulation of Canada's Financial Sector," in J.J. Richardson, ed., Privatisation and Deregulation in Canada and Britain (Aldershot: Dartmouth, 1990); K. Botton, and D. Swann, eds. The Age of Regulatory Reform. (Oxford: Oxford University Press, 1988).

62. Harry Freeman, American Express executive vice-president, was quoted as saying to the Brookings Institution in 1987 that: "In consumer finance, linkages with automatic teller machine networks and points of sales networks are crucial for financial services companies." Cited in: Linda McQuaig, The Quick and the Dead (Toronto: Viking, 1991), p. 177.
63. Opponents of the Free Trade Agreement saw something more sinister in the granting of a licence to Amex. Jim Robinson, Amex CEO, was a leading figure in supporting the FTA in the American corporate community, and has been quite persistent in putting the issue of free trade in service onto the international trade agenda. Suspicion was fuelled even further when it was revealed in that the Order-in-council granting the licence was signed on 21 November 1988. This was the day of the federal election that was fought almost exclusively on the issue of the Agreement. Even supporters of the FTA claimed that the timing would lead to suspicion the Amex was granted a licence by the federal government because of Robinson's support for the Agreement. For a discussion of the Amex affair see: McQuaig, op.cit., chapter 6.

trading had been undergoing change throughout the 1980s, especially with the introduction of discount brokerage fees. In 1983, the Toronto-Dominion Bank began to offer the service to its customers by taking their orders and relaying them to brokerage firms.⁶⁴ The TD Bank was challenged by the securities industry but its case was upheld by the Ontario Securities Commission. The issue of discount brokerage fees was important because it undermined the securities dealers' cartel (namely the Investment Dealers Association), and threatened small firms that benefited by the limits to price competition.

It also led eventually to questions about ownership of securities firms. In the period from 1982-1986, both Ontario and Quebec considered proposals for some form of outside ownership of securities dealers, and to remove barriers for other financial institutions. In June 1986, the Ontario government decided to allow foreign and domestic ownership levels of securities firms up to 30 percent. This was in reaction to pressure from New York investment dealers who wanted to enter the Toronto market, and to developments in Quebec which was moving in the same direction. The catalyst for the Ontario decision was the federal government plan to designate Montreal and Vancouver as international banking centres.⁶⁵ In November of the same year, the Quebec Securities Commission granted a licence to the Bank of Nova Scotia to create a provincially-chartered company called Scotia Securities, a full service dealer.

The federal government could only react to these developments, and regulation would now be dictated by the lowest (or slowest) common denominator. This led to a provision in a document released in December 1986 by the Minister of State (Finance), Tom Hockin, called *New Direction for the Financial Sector*, which permitted banks, trusts, and insurance companies to own investment dealers and brokers, and for foreign ownership. This led to federal legislation in 1987 that created the first "little big bang" in Canada. The major banks moved quickly into the securities business, and there was a major restructuring of the industry.

The pillars, then, began to crumble throughout the 1980s. Federal policy was dictated both by international developments and by provincial regulation. Policy-makers were faced with difficult issues as to the sort of financial services industry they wanted to create, and what was to be done to create it. There was a growing perception that creating strong, competitive Canadian firms that had the confidence of depositors and consumers would require a relaxing of regulations that restrained market entry and cross-ownership. Canada had caught "big bang" fever but it was up to federal as well as provincial policy-makers that were searching for a response.

Recent Reforms

The process of bringing about major change in the governance of Canada's financial institutions was long and complex. The election of the Conservative Party, committed to decreasing the role of government, in 1984 led to the expectation that the

⁶⁴. For a discussion of discount brokerage fees see: Robert MacIntosh. Different Drummers: Banking and Politics in Canada (Toronto: Macmillan, 1991), pp. 269-279.

⁶⁵. Monte Kwinter, the Ontario Minister for Financial Institutions, was asked how long it had taken his government to decide to allow banks, trusts, insurance companies and foreign institutions to own 30 % in a broker or investment dealer, is reported to have said: "About as much as took place when they decided to make Vancouver and Montreal international banking centres." Cited in Ibid., p.269.

deregulation wave was hitting Canada. However, despite Green and White papers and endless parliamentary committee reports, it was not until 1990 that the Mulroney government presented its blueprint for a new framework for financial institutions.⁶⁶ The first piece of legislation was the Trust and Loan Companies Act (C-4), followed by the Bank Act (C-19), the Insurance Companies Act (C-28) and the Co-operative Credit Associations Act (C-34).⁶⁷ The reforms were extensive, and affected nearly every aspect of the financial services industry.

Ownership

Restrictions with respect to most forms of cross-ownership of financial institutions have been lifted. This means that banks can now own trust and loan, and insurance, companies; and that trusts can own insurance companies or vice versa. Insurance companies had been previously limited to only 30 percent of shares in a trust company.⁶⁸ Unlike the previous regulatory regime, financial institutions are now allowed to enter into joint ventures with each other. The recent reforms have continued the process begun in 1987 when banks were permitted to own securities firms; and they open up the way for the creation of financial conglomerates

All financial institutions have been given the power to own firms that offer specialized financial products; and restrictions such as those that barred banks from portfolio and investment management, have been lifted. More importantly, they could "network", or retail on their premises, the financial services of their affiliates or partners. An important exception was made for the retailing of life and casualty insurance by banks and trusts. However, they could promote insurance, along with any another financial products or services, to their credit card holders.

There still remains the difference between chartered banks and other banks, designated as Schedule I and Schedule II banks respectively. The latter may now be owned by widely-held financial institutions. The 10 per cent threshold for Schedule I banks still applies. It also did not touch the provision that allowed Canadians to set up a closely-held Schedule II bank for a period of ten years, after which it would have to be widely-held. An important change introduced in 1991 allowed Schedule II banks to be owned by Canadian or foreign widely-held firms that were not themselves banks. This was a post facto formalization of the granting of a banking licence to American Express. It also opened the way for the financial conglomerates owned by General Motors or Sears to set up shop in Canada. In addition, a change in ownership of a Schedule II bank that results from a takeover of its parent firm by an unregulated firm will require that the bank be widely-held within ten years. It can choose to become a federally regulated trust company if it wishes to remain closely-held.

One of the most contentious issues in the recent reforms was the decision not to prohibit federal trust and loan companies from being closely-held. Bill C-4 allowed trust companies to be entirely closely-held until they reached a capital base of \$750

⁶⁶. The federal reports in the 1980s include: Federal Trust and Loan Discussion Paper (1982); Wyman Report on CDIC (1985); Green Paper on Regulation of Federal Institutions (1985); Report of the House Committee on Finance (1986); Senate Committee on Banking (1985); Senate Committee Report on a More Competitive Financial Environment (1986); "New Directions in the Financial Sector" (December 1986). In addition, there were a series of provincial reports released in Quebec and Ontario. See: Bodkin, *op.cit.*

⁶⁷. The number given to the legislative bills are those for the Third Session of the Thirty-fourth Parliament. The legislation was introduced in the previous session but died on the Order Paper when Parliament was prorogued.

⁶⁸. However, the limit that stock insurance companies can invest in non-financial companies has been reduced to 10% from 30%.

million. Companies larger than this would be required to make 35% of outstanding shares widely-held within five years. Critics of this part of the reforms, ranging from the New Democratic Party on the Left to the Canadian Bankers Association, claim that there is no reason for different ownership restrictions for banks and trusts if they are now competing in the same markets. The government and the trust companies argued that the provision would make it easier for competitors to enter the market.

The reforms also will allow financial institutions to provide a wider range of services. Trusts will, for all intents and purposes, have all the same powers as banks in consumer lending; and they will have full commercial lending powers as long as they satisfy certain conditions such as a capital base of at least \$25 million. The trusts, originally intended to complement banks, are now in direct competition with them in most areas. This is the culmination of a process that began when trusts became deposit-taking institutions in the 1920s, through to the 1950s and 1960s when banks were allowed into the mortgage and car loan business.

The banks will face competition from other sources as well. For instance, insurance companies will be permitted to make consumer and commercial loans. This extends the powers they had assumed when they entered the mortgage business, and when they began to manage savings schemes such as registered retirement savings plans (RRSPs). The banks have gained new powers, especially with respect to marketing travel insurance and selling securities. The federal changes reflect developments in some provinces, especially Quebec, where consumers have been able to conduct many of their financial transactions in one institution.

Prudential Regulations

The recent reforms removed restrictions to business activities and ownership of financial institutions. They also exposed the system to greater risks, and raised questions about abuse and conflicts-of-interest. The federal government, therefore, introduced a series of measures to counter these concerns, and to deal with some of the possible consequences of the new regime. First, a series of provisions were introduced to govern against self-dealing.⁶⁹ The changes will ban most activities that are not at arm's-length; the ban can be lifted if the transactions are cleared by a special committee of the board of directors. This committee, known as the Conduct Review Committee, would be composed of a majority of directors independent of the institution. Alternatively, the transactions may be permitted after being vetted by the Superintendent of Financial Institutions.

The rules on self-dealing indicate that the board of directors are expected to play a greater role in the supervision of federally regulated institutions. This leads to the second set of prudential rules: those designed to strengthen the role of the board of directors. The new regime proposes that one-third of the board be composed of directors that are not affiliated with the institution. Audit committees and "conduct review committees" will be set up to supervise the activities of the institution; these will have a majority of unaffiliated directors, and officers and employees of the institution could not serve as the other directors on these committees. "Affiliated" directors include not only officers or employees of the institution but also anyone that is a significant borrower or is a director or employee of any company that is a significant borrower. In addition, affiliated directors includes anyone who provides an amount of goods and services, either directly or as an officer or director of a company, to the

⁶⁹. Department of Finance, Reform of the Financial Institutions Legislations, (Fall 1990), p.10.

institution that exceeds 10 percent of their annual billing. Finally, these restrictions apply to the spouses of anyone deemed as "affiliated" with the institution.

Assessing the Reforms: Capital Blight?

There is little doubt that one of the driving forces of the recent changes has been the perception that greater competition and easier market access were vital for maintaining Canada's financial services industry and capital markets. The risks were not only that Canadian firms would move elsewhere, but also that domestic capital markets would suffer by not being more accessible to new entrants, both domestic and foreign. It was argued that the recent reforms would provide the right competitive environment for Canadian firms to grow in size and expertise to compete in international markets. This was a sentiment expressed by a number of Canadian firms in the wake of Royal Assent being granted to the financial legislation. All the major firms in banking, trust and insurance have all stated their desire to expand and diversify their operations.⁷⁰

However, the recent reforms have not meant that we have had "capital blight" in the sense of a retreat of the state. In Canada, as elsewhere, recent changes to the regulation of financial institutions has led to a redefinition of the role of the state; and they have not led a decrease in the expectation that government is to maintain confidence in the system. There are many ways in which the federal government still intervenes in the industry. First, there are still a number of prudential safeguards that will guide the activities of institutions. For instance, the reforms dictate that one-third one of members of boards be "unaffiliated" or independent directors. It is an intrusion into the boardrooms of major corporations that has caused more than a little uneasiness amongst executive officers.⁷¹

Second, the supervisory powers of the OSFI and the Minister have been enhanced. There are more provisions in place that will provide these bodies with early warnings of abuses and institutions in trouble, and with more powers to intervene. More importantly, the legislation states quite clearly that the Minister of Finance must approve all major changes in ownership of financial institutions. This may not seem so intrusive with a Conservative government in power but one can imagine the concern amongst the corporate community if there was an NDP Minister of Finance.

Third, barriers to market entry and ownership have not been removed completely. Banks must continue to be widely-held, and there remain limits on the amount of voting shares they can own in non-financial corporations. The same applies for insurance companies, which have actually seen the limit drop from 30 to 10 percent. The federal government did not abandon completely the rules governing what it called "prudent portfolio" management.

There is, then, a less visible role for federal regulations in the present regime but the state's presence is still central in the industry. There is a greater reliance on self-regulation of firms and industries, but these are countered by greater supervisory and discretionary powers given to OSFI and the Minister of Finance. In addition, the Canadian government is involved with its counter-parts elsewhere in developing regulatory frameworks at the supranational level. This includes agreements such as

⁷⁰. "Canada starts race to deregulation," *Financial Times* (4 December 1991), p.31.

⁷¹. For example, see the testimony of the officers of the Trust Company Association and the CBA in House of Commons, *op.cit.*

those with the Securities and Exchange Commission and through the Bank of International Settlements.

If the term capital blight may not accurately describe the role of the federal government in the new regime, it is still very relevant to the tension between federal and provincial regulations. We saw that provincial rules led the way in undermining the four pillars in the area of securities. It also was instrumental in the area of closely-held ownership for trust companies. The federal government stated quite clearly that one of the aims of the reforms was to "lay the groundwork for discussions with the provinces on harmonization."⁷² This meant that many federal regulations had to fall into line with provincial rules that had gone furthest in lifting barriers to competition and market entry.

However, this framework has been one that has been accepted because of a sensitivity to provincial policy preferences and to a concern in Quebec that it needed to develop its own provincially-based financial services industry and competitors. The price for trying to impose a more uniform regime would have been to cause further instability within Canadian federalism. It is an issue that the federal government raised in its recent constitutional proposals. In its document setting out changes to the "economic union", the government pledges to work towards harmonizing federal and provincial regulations in financial services.⁷³ Given the resistance to any increase in federal powers, it is difficult to see how the federal government will impose federal standards. If harmonization will take place, the federal rules will be only one of a possible eleven sets of regulations that will form the basis of a uniform system.

The relationship between federal and provincial governments has been one of tension and competition since the 1970s. The provinces have administrative to shape and respond to the policy agenda, and have been aggressive in asserting the legal and constitutional powers at their disposal. The partially consistent regime for financial institutions suited the needs of provincial governments in Quebec, Ontario and British Columbia as they tried to develop a firms that could compete in the international markets. Quebec was particularly concerned with ensuring a financial sector that could serve the nationalist aspirations of both its economic and political communities.

Regulation of financial institutions in Canada, then, demonstrates a number of features that may be described as part of a "national treatment" regime. Financial institutions must apply for separate licences or charters, and must abide by different sets of rules. Although it often does not mean eleven different authorities, it quite often means having to operate according to separate rules in Quebec.

CONCLUSION

The European Community and Canada provide a number of interesting contrasts. The former is trying to arrive at some sort of closer union while the latter is in the midst of a difficult debate over whether it should continue as a political community. The EC has emerged as one response to capital flight and increasing economic interdependence. Canada, on the other hand, has seen its provinces assert their

⁷². This is a line that was used in nearly every Department of Finance document. For example, see: Department of Finance, *op.cit.*, p1.

⁷³. Government of Canada, Canadian Federalism and Economic Union: Partnership for Prosperity (Ottawa, Minister of Supply and Services, 1991), p.25.

economic policy-making powers. However, the two share a number of important similarities. They must both deal with the challenges of capital flight, questions over the division of powers and sharing powers, and the functioning of a single market. Moreover, they both raise questions about the role national states in an era of capital flight.

We have looked at banking in the European Community and Canada in an attempt to discover whether increasing mobility of capital has meant a diminished role for national states. We found that government intervention in the economy, although much different than in previous regulatory regimes, is still prominent. We have not had a complete deregulation of financial institutions, but rather, a redefinition of activities permitted to them. Governments, whether at the provincial, national or Community levels, still play an important role in ensuring solvency and maintaining prudential safe-guards.

Both the European and Canadian experiences suggest, then, that we have not had "capital blight" with respect to state intervention giving way to market forces. The two cases differ, however, when it comes to the role of national governments when it comes to regulating economic activity in an increasingly complex and interdependent economy. The creation of a single market for financial services in Europe provided a good basis for a claim that it would lead to a significant shift in power away from the national member states to the Community. This would seem like a particularly likely development in a country like Italy which has not had strong governments capable of taking purposive action.

The case of banking in Italy reveals that "capital blight" has not taken place, and that the national authorities have assumed an important role in the single market. We saw that Italian policy-makers provided a timely, coherent response that has already led key forces in the financial sector to restructure in ways to meet the new challenges. Canada provided a different picture with respect to the drift of political power away from the national government. The federal government's plan to shape the financial sector was affected by important developments in the major provinces; especially Ontario and Quebec, and to a lesser extent British Columbia.

An internal or single market does not necessarily have to lead to powers drifting away from national governments. This is often the result of constitutional and legal factors that reflect underlying political objectives or tensions. In Italy, the move towards the single market has strengthened the case of those that would like to bring about major institutional and political reforms that would provide the country with purposive government for the first time in the history of the Republic. Policy preferences have changed and the single market provides an opportunity to accommodate them. In Canada, the presence of an important subnational community has meant that a single set of rules offered the potential for great instability. The result was a division of powers that provided great scope for all governments to impose their own sets of rules and authorities.

The operation of the single market, then, depends more than on just the division of powers and the regulatory framework. It reflects and responds to underlying political forces that may in some instances lead to a weakening of national governments; in the Italian case, it may strengthen it.