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Résumé de l'article

Le présent texte fait partie d'une série d'articles portant sur les services financiers. Ils ont été préparés par M. Jean-Pierre Bernier, en collaboration avec *Quarterly Review*. Faute d'espace, nous n'avons pu faire paraître l'ensemble de ces articles. Il nous a néanmoins paru utile de présenter, dans le cadre du présent numéro, l'analyse de C.L.H.I.A. quant à l'Accord de libre-échange et son impact sur les assureurs et quant au marché unique qui sera instauré en Europe, en 1993. Nous remercions M. Bernier et *Quarterly Review* de nous avoir autorisés à publier les deux études qui suivent.

The New Financial Services[1]

by

Jean-Pierre Bernier[2]

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PART ONE

FREE TRADE: WHAT IT MEANS TO INSURERS

For our analysis of the free trade agreement (in terms of the life and health insurance industry) to make any sense, we must first set the stage.

Point one. It is important to note that Canadian and American life and health insurance companies entered negotiations with different objectives. The U.S. companies wanted equal treatment in financial activities and investments in Canada's non-financial sector. Canadian companies wanted to secure access to insurance markets in the U.S. However, there was one specific common aim. Both Canadian and American companies wanted to benefit equally, without discrimination, from the future liberalization of

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(1) Excerpts from *CLHIA Quarterly Review*, Vol. 4, No. 2, 1989, and Vol. 5, No. 2, 1989, which are being reprinted with the authorization of Canadian Life and Health Association Inc. and that of the author, Mr. Jean-Pierre Bernier.

(2) Prior to joining Imperial Life as asssociate general counsel in 1988, Mr. Jean-Pierre Bernier spent over six years with the CLHIA as vice president and general counsel, where he was instrumental in pushing for financial services reform at all political levels. Before that, he served as legal advisor to the Canadian Bankers' Association, where he worked on the 1980 Bank Act revision.

laws of both countries pertaining to financial institutions. [Refer to *Quarterly Review*, Volume 2, Number 3, 1986; Volume 3, Number 1, 1987 for more background.]

Point two. The CLHIA-ACLI-HIAA joint accord (December 1986) played an influential role in the negotiations which led to the free trade agreement; the negotiators were in no position to go against a very solid trade industry agreement on what all parties wanted. Furthermore, it is highly likely that the accord stopped in its tracks the reciprocity concept which the large Canadian banks were pushing with tremendous force. [Refer to Annex A, "National Treatment, Reciprocity: Two Incompatible Concepts," for a comparison between the national treatment concept advocated by insurers and the reciprocity concept of the banks.]

Point three. With the free trade agreement, the Canadian life and health insurance industry has taken a giant step — in a very short time — to make the federal government recognize a real unfairness: that of obliging non-resident insurers to invest 100 per cent of their Canadian policyholders' funds in Canada and, at the same time, subjecting their investments to foreign ownership restrictions. (The industry's September 1983 proposal to grant Canadian status to these funds was still falling on deaf ears in early 1986. The free trade negotiations began in May 1986.)

The Bottom Line

Now for the bottom line. The free trade agreement between Canada and the U.S. signed in early January is a definite *win* for Canadian and American life and health insurance companies. Here's why.

1. All objectives, of both sides, will be met fully. *For Canadian companies, the status quo is protected.* This means that they will be able to plan ahead and take full advantage of the opportunities offered in the U.S. without fear of being undercut later. (The agreement ensures that free trade in insurance will continue to exist. This is vital for the Canadian companies, which have significant interests and activities in the U.S. market.)

For American companies, exemption has been granted from the 10/25 rule on federal financial institutions and from the forced disposition of equity investments in "Canadianization" programs for non-financial businesses (for example, broadcasting and publication industries). This means that they will be treated equally with their Canadian counterparts. (Article 1703 of the agreement requires amendments to Canadian legislation to exempt U.S. firms and investors from the current rule; this rule prevents any single non-resident from acquiring more than 10 per cent of the shares, and all non-residents from acquiring more than 25 per cent of the shares, of a federally-regulated, Canadian-controlled financial institution. Banks, however, will continue to be subject to the rule that no one person may hold more than 10 per cent of the shares in any one bank.)

2. The national treatment concept, as advocated by the CLHIA-ACLI-HIAA accord on free trade, has been adopted *in its entirety* as the underlying principle of all provisions of the Canada-U.S. free trade agreement. This means that *the two governments have agreed not to discriminate — both now and in the future — between Canadian and American life and health insurance firms and any subsidiaries, including banks, that they may own in each other's country.*

These are the broad reasons why we argue that the life and health insurance industry has "won" with the free trade agreement. There are many specific advantages. But to put them into perspective, one must consider two relevant features of the agreement.

To wit:

- *The agreement covers the entire financial services sector — all four pillars in Canada. However, insurance and financial services are dealt with in two separate and distinct parts. The definition of "financial service" in Part 5 excludes the underwriting and selling of insurance policies. Insurance is covered in Part 4 dealing with services which also include real estate management and agency, data processing and leasing*. [Refer to Annex B, "Why 'Financial Services' Excludes Insurance," for reasons for this split.]
- *Certain provisions of Part 5 – Financial Services – apply to life insurance companies as "financial institutions" or "United States persons."*

The Advantages

1. Although the 10/25 rule concerning foreign ownership will not be removed from federal financial institutions acts (as originally recommended by some large U.S. insurers), the rule will not apply to *American life companies. Essentially, this means that they will be allowed to acquire existing Canadian-owned, federally-incorporated financial institutions (except banks) with a capital base below the prescribed $750 million threshold.*

We must point out, however, that *with Ottawa's new commercial links policy, this acquisition route could be a dead-end for most non-residents.* Indeed, acquisitions by commercially-linked foreign institutions would be prohibited unless they own (at the coming into force of the new legislation) a financial institution with a federal charter which they could use to make acquisitions. This means that Canada, with such an exclusive policy and a far-reaching definition of commercial links, will not be "open for business," as the Prime Minister has so often stated in public.

2. In the future, *Canadian life companies dealing in securities in U.S. financial markets, whether or not affiliated with banks, are guaranteed that they will receive the same treatment as that accorded American life companies.* This, with respect to liberalization of securities laws and associated administrative practices.

3. *American life companies becoming "foreign banks" or "non-bank affiliates of a foreign bank" under Canada's Bank Act, and wishing to engage in cross-pillar activities, will have their applications reviewed by the federal regulatory authority on a* prudential *basis (just as for Canadian insurers).* This will not be done on a reciprocity basis, which would instead hold up applications.

Obviously, this commitment is beneficial. However, we should point out that it falls short of the House of Commons Finance Committee's recommendations of November 1985 to eliminate this inequity for all life companies.

4. *Branch operations of Canadian and American life companies will be protected on both sides of the border.* However, unless the federal government policy on commercial links is changed, a U.S. mutual life insurer operating in Canada on a branch basis with downstream links will be prohibited from incorporating or acquiring a federal life company. Furthermore, it will not be able to branch out into other areas of Canada's financial services industry unless it owns (at the coming into force of the new legislation) a financial institution with a federal charter.

5. *U.S. life companies investments of Canadian assets in non-financial businesses that are subject to a Canadian ownership level will be exempted from (a) any forced disposition of shareholdings and (b) any new "Canadianization" programs.*

6. *Insurance will continue to be sold in Canada by insurance agents who are devoted to their trade on a full time basis.* Canadian regulatory authorities will remain free (a) to keep the current full time requirement as

a criterion of competence and (b) to allow multiple licensing, should an agent wish to enlarge his or her portfolio of products and services to meet consumer demands. (This is provided the added flexibility is non-discriminatory.)

7. *Provisions of the free trade agreement may effectively exempt U.S. life companies from an application of Ontario's unwarranted "equals approach."* (Under this approach, any non-Ontario chartered life company registered to do business in Ontario must comply with the province's severe restrictions on activities, investments, corporate governance and conflicts of interest.) Under the agreement, American life companies are guaranteed to receive treatment no less favorable than the most favorable treatment accorded by the province in like circumstances to Canadian companies.

By way of example, consider the case of the Canadian banks, which need not register in Ontario and, therefore, are exempted from the "equals approach." They will receive the most favorable treatment. It follows that U.S. life companies will be entitled to an exemption as well.

8. *Representatives of Canadian and American life companies will be able to move freely across the border for business purposes.*

9. *Canadian and American life companies will not be subject to any restrictions on the patriation of profits or the proceeds of a sale other than those restrictions that are necessary to implement domestic laws of general application* (such as bankruptcy, securities dealing, withholding taxes, or criminal offences).

10. Consultations between the Canadian department of Finance and the U.S. department of Treasury will be the only avenue available to solve disputes involving financial institutions other than insurance. But *Canadian and American life companies will have access to the dispute settlement procedures of the free trade agreement.* This is a tremendous bonus. For example, if consultations (as a first step to arrive at a mutually satisfactory resolution) should fail, the dispute will be referred to the Canada-U.S. Trade Commission for settlement. And should the Commission fail, within a specific time, to reach an agreement on fundamental rights or benefits, the dispute will then be submitted to both governments (Ottawa and Washington). Obviously, this appeal process is a big plus for insurance companies — something that other financial institutions did not get.

Essentially, the appeal process offers two particular advantages. It provides for added fall-back protection in case the first round of consultations fails. And it ensures that these initial consultations are productive, because the very notion of appeal brings with it the strong possibility that one of the opposing parties will be overruled. And being overruled completely is never as palatable as negotiating a compromise.

ANNEX A

NATIONAL TREATMENT, RECIPROCITY: TWO INCOMPATIBLE CONCEPTS

The "national treatment" concept is the basic principle underlying the January 2, 1988 Canada-U.S. free trade agreement as a whole. In simple terms, it means that neither the government of Canada nor the government of the U.S. will discriminate within their respective jurisdictions between Canadian and American nationals and companies. The same treatment that Canadian suppliers and investors get in Canada will apply to American suppliers and investors doing business in Canada. (This of course, pertains to matters covered by the agreement.) Furthermore, the national treatment concept makes no obligation on either government to alter its respective laws, rules and administrative practices in order to make them compatible. For example, if Canada chooses to treat banks differently than does the U.S., it is free to do so, as long as it does not discriminate between Canadian and American banks. The bottom line to national treatment is that each government remains free to choose whether or not to regulate... and how to regulate.

The "reciprocity" concept, on the other hand, means that Canadian companies should be able to carry on business either directly or through subsidiaries in the U.S. on terms that are as favorable as those on which American companies are able to carry on business in Canada. For example, if Canada allows American banks to engage in both commercial lending and corporate securities underwriting, then Canadian banks should be allowed to do likewise in the U.S., despite American laws that prohibit this sort of mix because of conflicts of interest.The reciprocity concept has the effect of imposing the more liberal laws on the other country. This does not benefit the general public; rather, it provides advantages to private firms seeking to expand their foreign operations.

Contrary to the free trade agreement, the December 1987 discussion draft of the federal Trust and Loan Companies Act [section 1A.3] incorporates the reciprocity concept.

If the reciprocity concept were in force, for example, one could find Canada in the disturbing position of having to bow to the pressures of a few large West German banks to adopt their universal banking system, which favors concentration of power and the dominance of banks.

ANNEX B

THE FREE TRADE AGREEMENT: WHY *'FINANCIAL SERVICES'* EXCLUDES INSURANCE

In Canada, the Finance department oversees both insurance and other financial services. As such, it handled all these areas on the Canadian side of the free trade negotiations.

In the U.S., the department of Trade and Commerce oversees insurance matters. The Treasury department looks after all other financial services. As such, on the American side of the trade talks, Trade and Commerce handled negotiations in the insurance area, while Treasury negotiated the financial services package.

Because of this split in the negotiating process between insurance and other financial services, the negotiating parties deemed it prudent — for supervisory purposes — to keep the two areas separate in the final free trade agreement. Consequently, separate chapters have been written for each of insurance [Chapter 14] and financial services [Chapter 17].

While this division between insurance and financial services makes sense in light of the explanation just given, the Canadian reader may wonder why the Americans would want to extend this distinction to the free trade agreement. The reasons are practical and simple. The U.S. believed it was necessary to allow Treasury to continue negotiating with Canada the removal of barriers confronting U.S. banks and securities firms. What barriers in particular? Canada was imposing on American commercial banks individual capital and asset limitations, and an aggregate limit of 16 per cent of the domestic assets of the Canadian banking sector. In addition, American securities firms, with the exception of several firms grandfathered in 1971, were shut out of the Ontario securities market.

Essentially, Treasury officials were familiar with the discriminatory issues. They had initiated negotiations in early 1985... long before the start of the free trade talks. (Their objectives reflected those of the department of Trade and Commerce; both groups were not seeking special or unique favors within Canada, but rather, treatment equivalent to that accorded domestic Canadian financial institutions.) In May 1986, when the trade talks began, Treasury found itself wrapped up in the overall talks. From that point on, it was simply a question of keeping the right people — those who knew about the problems associated with Canada's Bank Act and Canadian securities laws — at the negotiation table.

ANNEX C

HOW DO NON-U.S. FOREIGN-OWNED COMPANIES FARE WITH FREE TRADE?

Our discussion of the impact of the Canada-U.S. free trade deal on the life and health insurance industry would be incomplete without the mention of its effect on non-U.S. foreign-owned companies.

This is an important issue for many of our readers, given that today there are 22 non-U.S. foreign-owned life companies operating in Canada either on a branch basis or through a Canadian subsidiary. Ten are British, and the others are from different European countries.

The bottom line is that the treatment of these companies in Canada *vis-à-vis* their American counterparts will depend largely on a number of factors. These include (1) the effectiveness of their lobbying efforts for a level playing field; (2) the treatment that Canadian life companies receive in their home jurisdiction; and (3) the position that Canada will take under the free trade agreement toward companies incorporated in the U.S. but controlled by nationals of a third country.

Non-U.S. foreign-owned companies coming to Canada for the first time will have to justify their entry on reciprocal access for Canadian-owned companies in their own country. For example, before Japanese insurers are allowed to enter Canada, Japan's barriers to access would need to be eased. In Japan, years of negotiation and a significant financial commitment are required before a licence to operate is issued.

We note, too, that a level playing field between U.S. and non-U.S. foreign-owned companies will be difficult to achieve if the agreed exemptions for Americans form part of the federal financial institutions acts rather than if these exemptions are provided for by way of regulations, orders-in-council or ministerial discretions. The fact is that changes to these acts, now on a 10-year cycle, carry the risk of becoming entangled in sensitive political debates that could last for many years.

Non-U.S. foreign-owned companies that want to enter Canada's financial sector at the provincial level (where foreign ownership rules are more liberal) would still require Ottawa's prior approval if they are affiliated with a "foreign bank" (as broadly defined in Canada's Bank Act).

It must be understood that there are no rules of origin for insurance and financial services, as there are for trade in goods. The terms of the free trade agreement are meant to extend the benefits of non-discrimination to financial institutions under the control of Canadians and Americans. In other words, equality of treatment is accorded on the basis of the *ownership* of the providers, *rather than the origin of the services* provided.

When insurance or financial services are provided in Canada by companies incorporated in the U.S. but owned by nationals of a third country, the Canadian government is not obliged (pursuant to Articles 1406 and 1705) to discriminate against them. Canada remains free to treat these companies like American-owned companies. However, certain advantages are granted to U.S.-controlled financial firms only. Two specific advantages that are not accorded the non-U.S. foreign-owned companies are (1) the exemption from the 10/25 rule on federal financial institutions; and (2) the exemption from the forced disposition of shareholdings in non-financial enterprises subject to "Canadianization" programs.

PART TWO

EUROPE BEFORE AND AFTER 1992: UNDERSTANDING THE NEW PHENOMENON

Some Basic Facts

1. The term "European Community" (EC) is often used in business and media circles without any explanation of what it comprises exactly. Readers should know that the EC embraces the following member states: Belgium, Britain, Denmark, Federal Republic of Germany, France, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.

2. The *Single European Act* came into force July 1, 1987. It calls for the creation, by December 31, 1992, of "an area without frontiers in which the free movement of goods, persons, services and capital is ensured" — *a genuine integrated market of some 325 million consumers.*

3. To create this "single European market," or "Project 1992" as it is often called, *279 "Directives" would be required, 27 of them dealing with financial services and related matters.*

In December 1988, the *draft "first Directive on freedom of services for life insurance"* was issued. This Directive, when approved, will give all private residents of the EC the right to approach any life insurer authorized in a member state and to apply for a policy, provided the initiative comes from the individual. This is not currently possible in many member states. A series of other life insurance Directives is expected to bring further liberalization and to cover cross-border approaches by life companies and market intermediaries.

4. *In truth, "Project 1992" is an adventure in deregulation; obstacles to free trade in financial services are being removed.* In fact, deregulation appears to be the economic policy of the decade throughout the world.

Freedom of services, or cross-border selling under a single passport, is the real novelty for EC financial firms. The single passport means that, once a firm has met the "fit and proper" tests of its home regulator, it is free to set up branches anywhere else in the EC — or to sell its services across jurisdictional boundaries. That is why a growing number of EC and non-EC financial firms like it.

5. Some EC government officials have no great enthusiasm for freedom of financial services throughout the EC, but they have *recognized that opposition is not a political option.* The European Court of Justice in Luxembourg is already removing barriers to market integration and financial freedom through liberal decisions, as more and more financial firms and executives challenge restrictive local interpretation of the principles of mutual recognition and member state home control.

Piero Barucci, president of the Italian Bankers' Association, reflected a general consensus when he said, earlier this year, that there is no backing down from the unified European market, despite cold feet in some quarters. "This is already written in the future history of Europe," he said.

The Process

6. Directives are initiated by the Brussels-based *European Community Commission.* All financial services Directives are drafted and supervised by the Commission's "Directorate-General 15," the responsibility of which is to cover financial institutions and company law. Life insurance Directives are reviewed by the *Comité Européen des Assurances (CEA) headquartered in Paris. The European Council of Ministers* is the executive arm and the body responsible for approving all Directives.

Once approved, Directives carry the force of law. Most Directives grant member states several years to bring national legislation in line and to implement the necessary administrative changes.

Harmonization Issues

7. In allowing more freedom for financial services providers throughout the EC, the Commission has an important obligation to both companies and consumers. It must *harmonize prudential rules and supervisory standards* [see below] in order to guarantee the solvency and stability of financial services providers, and information and protection for users.

8. *In this regard, the EC has adopted a consumer protection strategy that combines three specific approaches:*

(i) *Limited harmonization* of the essential elements of prudential rules and supervisory standards: that is, with respect to capital adequacy, solvency coefficients, reserves, supervision and control of major risks, and conditions of access to financial activity.

(ii) *Mutual recognition* by member states of the rules and techniques of control implemented by each of them, since these rules and techniques conform to jointly defined minimal principles.

(iii) *Control by the state of origin (home) of a financial institution over all its activities* (including corporate governance and related party transactions). This control is over such activities carried out inside the EC, whether by cross-border provision of services, or by way of a branch established in another member state. Conduct of business rules, that is, those rules covering sales methods and the treatment of customers, are the responsibility of the "host" authorities.

9. *The EC's handling of the harmonization question could undoubtedly be a model for all Canadian authorities currently attempting to harmonize federal and provincial laws and regulations pertaining to financial services.*

10. *Tax harmonization poses significant problems.* Taxation of life insurance companies and premium taxes applied to life insurance contracts vary greatly from one member state to the next. This variation could give rise to discrepancies in prices, leading to distortion of competition. Unfortunately, the reconciliation of different tax structures throughout the EC could be a long and difficult process, because, under the Single European Act, fiscal issues are among the very few that still require

resolution by unanimity, not by a "weighted majority" vote of the 12 member states.

Reciprocity Concerns

11. Like all other Directives for financial institutions, the December 1988 draft "first Directive on freedom of services for life insurance" introduces *a "reciprocity" clause.* Essentially, this means the EC Commission will examine whether financial institutions from the EC member states (there are 20 EC life insurers in Canada) are treated in third countries the same way similar firms would be treated in the EC. *If reciprocity, or similar opportunities, are not guaranteed, the admission process will be suspended until reciprocity is assured.*

The reciprocity clause requires local regulators to submit to the Commission any request from a non-EC firm for entry authorization. Local regulators will not be able to grant approval until the Commission has spent significant time — up to three months — carrying out a reciprocity test.

12. *Britain and Luxembourg dislike the reciprocity idea.* (They are hosts to more foreign financial institutions than are other member states.) They have successfully lobbied the EC Commission to have the measures watered down so that foreign firms *already* established will not be threatened.

The EC Commission has now decided that the reciprocity rule will not be retrospective. In other words, foreign firms that have established subsidiaries (not a branch office) before the end of 1992 will be "grandfathered" and will be granted a single passport. *The only firms likely to be affected are those arriving after 1992.*

13. Branches of non-EC financial firms will *not* be treated as EC undertakings, subject to a single passport and supervision by the member state home authority. These branches, however, will remain under the jurisdiction of the authorities in each of the member states in which they operate. *Canadian life insurers operating through such branches in the EC will be penalized. They will have to contend with 12 different sets of local rules when they sell services. This in itself is a barrier to free trade.*

14. *Major Japanese life insurance companies are now moving to establish footholds within the EC.* The big Swiss banks have bought securities brokerage houses and banking institutions in West Germany and are seeking to consolidate their positions in Britain. They are making sure they are inside the EC before any new barriers go up around the edges.

On this note, we emphasize that Canadian trade officials are convinced Canadian companies can only benefit from Europe's single market — if they jump on the 1992 bandwagon early enough. Says Peter Campbell, a diplomat in charge of the 1992 brief at Canada's mission to the EC in Brussels: "Any company that's big enough to be in Europe can't afford not to be." (This was reported in the *Financial Times of Canada* in early January.)

15. *Canadian life insurers wishing to enter the EC after 1992 will have the burden of proving to Brussels that EC life insurance companies in Canada are extended the same rights and opportunities as Canadian firms operating in the EC. To prove "national treatment" alone, that is, that EC life insurers are treated the same way in Canada as domestic firms, will not be sufficient.*

This task will be extremely difficult and will handicap Canadian life insurers, because Canada will not permit an EC life insurer to acquire an existing Canadian-owned life insurance company.

Canadians could face problems

Contrary to the case of U.S. life insurers, which are exempted from the foreign ownership restrictions (the 10/25 rule) in federal insurance legislation, EC life insurers are not so exempted. Moreover, under Ottawa's proposed commercial links policy, which is unique in the world, commercially linked EC life insurers will be barred from incorporating a trust or loan company. Furthermore, the federal Blue Paper, "New Directions for the Financial Sector," expressly provides that all foreign-owned finns wishing to expand into new areas of financial business will be restricted to the creation of *de novo* institutions.

We should point out that the EC Commission could also prevent life insurance companies from operating in the EC on the grounds that the Canadian separation of financial and commercial interests in the ownership of banks limits EC non-financial owners of life insurers.

16. *At the moment, alliances and joint ventures among insurance groups, or between insurers and banks, are constantly being formed, as EC financial institutions prepare for the intense competition expected in the single European financial services sector, slated for 1992.*

Mergers and acquisitions are considered important because they signify a departure from small, national companies in specialized fields toward huge, pan-European companies offering a broad range of services.

Many member states of the EC are keen to promote rationalization of their respective financial systems through mergers. Laws and regulations are being updated to ensure that EC financial institutions will not be hamstrung by outmoded national regulatory systems. In February, France's Finance Minister Pierre Beregovoy announced plans for a major overhaul of the French insurance industry.

17. *The EC business and competitiveness of Canadian life insurance companies could be hurt by certain government actions/policies on the domestic (federal) front.* These are:

(i) Ottawa's paralysis in modernizing federal insurance legislation.

(ii) Ottawa's concerns about mergers and acquisitions when large financial firms are involved.

(iii) The application of Canadian legislation, often more restrictive than foreign legislation, to the offshore subsidiaries of Canadian life insurers.

(iv) Restrictions on joint ventures and affiliations with companies that are not "regulated financial institutions."

(v) The outright ban on transactions with related affiliates and its very limited exceptions.

(vi) The restricted list of permitted subsidiaries which no longer includes ancillary business corporations.

(vii) Strict limitations on the borrowing power of life insurance companies.

These major hurdles have been well identified in the recently published industry "audit" titled, "Where We Stand on the Legislative Reform of Canada's Financial Services Sector." A copy of the contents may be obtained through the CLHIA's Law Department.