

North American Commercial Banking after the Free Trade Agreement

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In the midst of government deregulation of banks, waning distinctions among types of financial institutions, and new methods of corporate finance outside the traditional roles of banks, Chapter 17 of the Canada-U.S. Free Trade Agreement (FTA) opened the border to the establishment of banks and the provision of banking services from the other country. This article defines some of the choices faced by banks, especially ones of whether, where, and through what form to engage in the international provision of commercial banking services. To make sense of these choices, this article turns to a company-focused, strategic-action framework, in which banks' international activities are viewed as reflections of their perceived strengths within a changing regulatory and competitive environment. This framework allows a discussion of the bilateral and subnational regional implications of the FTA, as well as the interpretation of some basic statistics on current relationships between U.S. and Canadian banks.

Kinds of Banks and Their Regulation

The U.S. Bank Holding Company Act of 1956 defined a commercial bank as an "institution that both accepts deposits and makes commercial loans" (Boreham 1987a: 9). Commercial banks in Canada and the United States have two traditional functions: (1) intermediating between individual investors and borrowers, and (2) settling

The author is very grateful to the Canada-United States Trade Center for financial support of this continuing project. He thanks as well Sungjae Choo and Brian Dunn for data collection and manipulation; Bruce Somer, Andrea Stoldt, and Tracy Whitehead for library assistance; David Berman and John Burkhardt for helpful comments; and several Buffalo-area bankers for insights into their industry and operations.

depositors' payments to third parties. The payment settlement role is the unique one, separating commercial banks from most competing financial institutions. Ironically, the term commercial bank derives from the intermediation role, in which short-term liabilities (demand deposits) are invested in short-term assets (commercial loans for working capital to finance companies' accounts payable). Now, however, this role is being squeezed on two fronts: (1) increased competition from other financial institutions; and (2) disintermediation, under which large companies sell debt securities directly to the investing public (Hamberg 1981; Compton 1987). In response, commercial banks have attempted to augment their profitability by selling credit, management, and information services, and by diversifying geographically. The search for profits, less-restrictive regulation, and improved client services has led many banks into international ventures.

International Banking Versus Multinational Banks

While banks can take advantage of foreign financial opportunities without establishing a physical presence in other countries, multinational banking is an added dimension to a bank's international operations. Donaldson (1988: 18) allowed in his definition of *international lending* any asset or fee service that finances international trade or investment, is in a foreign currency, is made by an international group of banks, or is secured with holdings outside the bank's country. Yannopoulos (1983: 236) referred to banks' dealings in foreign currency-enumarated assets and liabilities as international financial intermediation. Grubel (1989: 61) defined *multinational banking* as "involving the physical presence of a bank abroad", through either an operational or merely a representative office. This same combination has been called *transnational banking* (Yannopoulos 1983: 237). Cho (1985: 2) narrowed the definitions of banking and of multinationality by calling a *multinational bank* "a banking institution: (1) whose major functions in a home country include deposit taking, extension of credits, and provision of related banking services, and (2) that has established institutional presence in the form of *branches* in one or more foreign countries to engage mainly in the provision of such banking services" (italics added). This article will examine the full range of ways in which a bank can establish a presence abroad.

U.S. and Canadian Regulation

Financial services are heavily regulated in both the United States and Canada. Both countries maintain federal and state/provincial chartering systems for financial institutions, although in Canada only

the federal government can grant a commercial bank charter. Both countries require separation of corporations providing different financial services, particularly commercial banking and securities underwriting, and both countries are in the midst of slowly removing many of these requirements (Bartholomew 1989). One major difference between the two countries is that the United States prohibits federally chartered banks from branching across state lines. Within each state, federally and state-chartered banks must abide by each state's regulations on intrastate branches. This has resulted in a proliferation of commercial bank operations in the United States; there are now nearly 15,000. Only 6,000 of these banks operate branch networks, for a total of 43,852 branches (an average of seven branches per bank operating a branch network). This compares with eight "Schedule I" banks in Canada (federally chartered banks with dispersed ownership—no individual or company may own more than 10 percent of the shares of a Schedule I bank), six of which operate nearly 6,700 branches (Boreham 1987a).

Each country also regulates the international operations of its banks, as well as the operations of foreign-owned banks within its borders. In the United States, regulation of the international involvement of domestic banks is stronger. The Federal Reserve Act of 1913 allowed federally chartered banks to branch overseas, but the U.S. operations of U.S. banks were prohibited from international banking functions until the Edge Act of 1919 allowed banks to establish separate subsidiaries to finance international trade. (As amended in 1985, the Edge Act enables corporations to provide a full range of banking services to foreign corporations). In 1981, U.S.- and foreign-owned banks were given the right to establish international banking facilities in the United States to serve foreign clients only. Such facilities are exempt from the Federal Reserve Bank's reserve requirements and interest ceilings (Kim and Miller 1983; Roussakis 1983; Compton 1987). Foreign-bank agencies, branches, and subsidiaries in the United States were largely unregulated (except by states) until the International Banking Act of 1978 required registration with the Federal Reserve Bank, limited new foreign entrants to deposit taking in one state, prohibited foreign banks from non-banking activities from which U.S. banks were prohibited, required foreign banks to buy federal deposit insurance, and brought large banks (with assets worldwide of over US\$1 billion) under deposit reserve requirements (Kim and Miller 1983; Holly 1987).

Canada has severely restricted foreign bank operations. The Bank Act of 1967 limited foreign interests to less than 25 percent ownership of chartered banks. Wholly foreign-owned operations were limited to establishing representative offices, agencies, and "near-banks" that

engaged in a wide range of financial services (Chant 1985). The Bank Act of 1980 permitted federally chartered bank corporations to be owned entirely by another company, including a foreign banking company. These are the "Schedule II" banks (Bartholomew 1989). By 1987, there were 59 foreign-owned Schedule II banks in Canada (Boreham 1987a). This rapid growth reflects great foreign interest in having a Canadian banking presence, as well as some coercion of foreign-owned "non-banks" to request a Schedule II bank charter (Chant 1985).

The Free Trade Agreement

The Canada-U.S. Free Trade Agreement of 1988 includes internationally historic provisions for easing restrictions on international services trade. Chapter 17 of the agreement focuses on financial services, with the greatest direct impact on commercial banking functions. Like most of the agreement, the principle underlying Chapter 17 is that of national treatment: a Canadian financial institution based in or owned by a company based in the United States is to be treated in Canada like any similar Canadian-based financial institution (and likewise for U.S. banks owned by Canadian interests). Under this principle, Canadian-owned banks in the United States may now sell Canadian government securities and will receive any reduction in restrictions on commercial bank sales or underwriting of securities that the United States gives U.S. banks. In addition, the Canadian-owned banks whose interstate networks were established before the U.S. International Banking Act of 1978 are allowed to maintain those networks indefinitely (instead of undergoing a periodic review). Also under this principle of national treatment, U.S. interests in Canada (1) may own collectively any proportion of a Canadian federally chartered financial institution (although no individual or corporation may own more than 10 percent of a Schedule I bank); (2) are not subject to the 16 percent limit on total Canadian commercial bank assets that can be held by foreign-owned banks; and (3) no longer must receive Finance Ministry approval for establishment of branches (once the U.S. interests are chartered as a Schedule II bank corporation). State and provincial restrictions on and regulation of banks remain in force (Caron 1988; External Affairs 1988; Schott and Smith 1988; Bartholomew 1989).

Determinants of Banks' International Operations

Banks can provide their foreign clients with banking services either by exporting those services from the home country, by making contractual

arrangements with foreign-based firms, or by undertaking direct investment (in the client's country or a third country). "Exporting" includes any of the international banking functions mentioned above provided from a bank's home country. The most common contractual ("arm's length") international banking relationship is the maintenance of *correspondent relationships* with foreign banks. Issues, confirmations, and acceptance of trade-related documents may be accomplished through use of a bank's funds on deposit with a foreign bank, or services provided by the foreign bank on behalf of the requesting bank may be compensated by withdrawing a fee from the requesting bank's account with the correspondent. A bank's network of international correspondents may be supplemented in some markets by *representative offices*—foreign outposts that provide information and referral to potential clients of the parent bank. The most simplistic form that allows on-site banking services is the foreign *agency*. Used widely by foreign banks in North America (Yannopoulos 1983), agencies cannot accept deposits from local firms and consumers but can issue credits to international clients, engage in money-market operations, and arrange loans. Foreign bank *branches* are much like domestic branches and can engage in all banking functions. Furthermore, the liabilities of branches are secured by the capital and assets of the whole corporation. *Subsidiaries*, in contrast, are incorporated separately from the parent bank as corporations in the host country, where they are subject to that country's banking regulations. In cases where host country regulation is less restrictive than home country regulation, expansion-minded banks are more likely to establish foreign subsidiaries than branches. In circumstances in which the host country or the parent bank's resources will not allow full ownership of a bank in the host country, a *joint-venture* subsidiary is the only feasible banking relationship. When the foreign partner's stake in the joint venture is a minority interest, the host country bank is called a foreign *affiliate* (Brimmer 1975; Roussakis 1983: 13-30; Kim and Miller 1983; Cho 1985: 6-16; Compton 1987).

U.S. regulations allow other specialized organizational forms for international banking operations as well. The New York State Investment Company Act allows foreign-owned *investment companies* that operate much like agencies but also buy and sell securities (Goldberg and Saunders 1981). U.S.- and foreign-based banks may establish *Edge Act corporations*—U.S. banks limited to conducting international banking activities (including serving the international needs of American companies and all the needs of totally foreign companies), which may branch across states and are not subject to Federal Reserve Bank minimum reserve requirements (Kim and Miller 1983; Roussakis 1983; Compton 1987).

Motivations for and Location of Foreign Bank Operations

The primary factor in a bank's choice among the possible forms of foreign banking involvement is the particular foreign banking location the bank has in mind. Location, in turn, depends on the motivation for a bank's move into international banking. According to Grubel (1989), banks have four motives for establishing foreign operations, each of which has distinct locational requirements. The first and oldest motive is to serve a local market in the absence of local banks (for example, the colonial branches of European banks, which through their descendant banks still exist) or to serve recent migrants from the home country (for example, retail branches of Japanese banks in California). The second motive is to serve the foreign interests of the home country-based clients of the bank (the "follow-the-client" motive). Clients may be followed for varied reasons. Robinson (1972) has noted the difference between trade-related services (which dominated the activities of foreign banks in London in the immediate postwar period) and banking services in support of manufacturers' foreign investments (which increased in importance in the late 1950s). The third motive is the desire to gain tax or regulatory advantages through shell operations in a low-tax or non-regulated, "offshore" (non-market-oriented) environment. This has resulted in the establishment of paper corporations nominally headquartered outside banks' home countries, and in the 1960s it led to the rapid expansion of the Eurodollar market (in reaction to U.S. government restrictions on foreign lending by U.S. banks). The fourth motive for banks to establish foreign operations is that banks participating in international money markets must have operations in the international money centres for information and market-participation reasons (Yannopoulos 1983; Daniels 1986). To Grubel's four motives may be added two non-profit-oriented motives: (1) the tactical motive of oligopolistic reaction, by which a bank establishes a presence in a foreign country to match a move by a home country competitor ("follow-the-leader" behaviour) or to match new local competition by a branch of a bank from the foreign country ("hostage-taking" behaviour)—see Mills (1983); and (2) the managerial motive of prestige derived from a presence in Tokyo, London, or New York (Osborn 1981). There is widespread agreement, however, that during the 1980s the decisions by banks to locate internationally were based more on profit-making goals than on those related to growth, tactics, or prestige (Osborn 1981; Mills 1983: 33; Harverson 1989).

Despite the historical importance of the first motive, Grubel saw local markets as a very limited inducement for banks to establish international operations. Lascelles (1989) concluded that "few banks

compete any longer in the retail banking business outside their home markets". Nigh et al. (1986) statistically compared the size of U.S. banks' assets held by their foreign branches to three independent variables: measures of (1) U.S. business investment, (2) host country manufacturing production, and (3) the openness of foreign bank regulation in each foreign country. Of these three independent variables, the size of U.S. business investment in a country had the strongest, most significant relationship with the size of U.S. banks' assets in branches in that country, supporting the follow-the-client motive. Host-country manufacturing production (a proxy for the local market for banking services) was not significantly related to U.S. banks' assets in foreign countries.

According to Odjagov (1978), the follow-the-client motive describes the establishment of foreign branches and subsidiaries by U.S. banks during the first two decades after World War II—but follow-the-leader behaviour also motivated bank decisions. During the 13 years immediately after the war, New York-based banks dominated foreign branch banking. But from 1958 to 1964 large U.S. banks located outside New York City began to locate branches abroad. Odjagov interpreted these latter decisions as follow-the-leader behaviour, although it is not clear that these companies were not following the internationalization of their clients. These findings suggest that, on a worldwide basis, foreign banking operations are seldom geared toward the provision of banking services to clients based in the host country.

Form of Foreign Banking Operations

Once a host country is selected, the banking form chosen depends in part on the forms of foreign banking allowed in that country, its differential regulation of forms, and the tax advantages of particular forms. For example, some countries (such as Canada) do not allow branches, requiring incorporation as a separate banking company. Other countries do not allow total foreign ownership of banking operations, requiring establishment of a joint-venture subsidiary or affiliate relationship.

Beyond legal restrictions, the motivation for involvement determines the appropriate form. For example, a correspondent relationship is insufficient for offering proprietary information or services to foreign subsidiaries of a bank's domestic customers, but a representative office may suffice. Foreign agencies are able to serve foreign trade financing (Yannopoulos 1983; Compton 1987). And although a low volume of transactions would make establishment of a subsidiary uneconomic, any desire to escape the regulation or taxation

of the home country would require a foreign subsidiary. Finally, any internal constraints on the parent banking company—such as capitalization, foreign experience, and knowledge of country-specific foreign markets—would encourage such lower-risk forms of involvement as representative offices, agencies, or joint-venture subsidiaries (Odjagov 1978).

An econometric model built by Goldberg and Saunders (1981) of the asset size of all foreign agencies, branches, and subsidiaries in the United States compared changes in asset size to the profitability of assets (average interest spread), the rate of domestic investment, the import/GNP ratio (as a proxy for international business), and the expectation of regulatory changes for foreign banks in the United States (the International Banking Act of 1978). Their results suggested that the loan activity of agencies depended more on *international* business and current profitability, and that the assets of branches and subsidiaries responded more to *domestic* U.S. investment. Kim and Miller (1983: 42) echoed this suggestion that the establishment of subsidiaries is the best way for foreign banks to serve the U.S. retail and mid-sized business markets—for those banks that have such a motive.

Determinants of Motivations for International Banking Activity

Thus far, we have seen that a bank's choice of foreign banking form depends on its motivation to enter the foreign arena and its selection of a foreign location, and that the choice of a foreign location depends on the motivation for international banking activity. To understand the likely reactions of banks in the wake of major environmental changes (such as deregulation, disintermediation, and the FTA), we must develop a framework for studying the motivations behind international banking activity.

Odjagov (1978), Gray and Gray (1981), and Yannopoulos (1983) have had some success in viewing the foreign operations of banks as foreign direct investment (FDI), determined by the monopolistically competitive workings of the "eclectic" theory of FDI. In this well-known model promulgated by Dunning (1981), a firm will engage in FDI if it has competitive advantages through which it can gain economic rent in a foreign location and if that economic rent is maximized through ownership of the foreign operation. The model recognizes that much competition is imperfect and that much business practice entails the development, maintenance, and exploitation of competitive advantages (proprietary technology, trademarks, goodwill, economies of scale, production and market locations). *Strategy* has been defined as the development of corporate actions that deploy (and, when

necessary, modify) competitive advantages in the light of the corporate environment (competitors, regulations, input markets)—see Hofer and Schendel (1978). The American Bankers Association has defined *strategic planning* as "the process of determining the overall mission and major objectives of an organization, as well as the policies that will determine the acquisition, use, and disposition of resources to achieve these objectives" (Compton 1987: 46). In this fashion, the locations in which a business operates become part of the competitive advantages of the business that condition its reactions to environmental change. Porter (1980, 1985) has written extensively about the assessment of competitive advantages and of environments, noting that competitors' strengths and weaknesses are crucial environmental elements. The concern here is with the international deployment of banking operations (forms, locations) in a changing regulatory and marketing environment.

What competitive advantages are most relevant to banks' decisions about international operations? Yannopoulos (1983) saw *country-specific* advantages in the use of a bank's home currency as an international standard (dollar, yen, pound, mark). Other country-specific advantages might include a lack of restrictive regulation in a bank's home country, thereby allowing it to gain experience and information about a range of activities, and the international perception that a country has a strong, safe banking system (Neu 1985). In a similar vein, Lord (1987) posited that the regulations and economic characteristics of U.S. states have given expansion-related advantages to banks based in particular states. According to Mills (1983) and Walker (1983), the export-dependence of the Canadian economy has given Canadian banks great experience, expertise, and perhaps advantages in trade financing.

The most important *company-specific* advantage is size. When size distribution is accurately represented in studies of U.S. banks, economies of scale in bank operations appear. Scale may be measured by total bank assets outstanding, by assets minus loan funds on deposit, by total deposits, or by equity capital. Technological changes also appear to be increasing the optimal scale of commercial banks (Tschoegl 1983; Hunter and Timme 1988, 1989). Hunter and Timme (1989) concluded that scope—or product diversification—does not reduce banks' operating costs. And Mills (1983) has noted that a few very large banks may opt for a strategy of global presence in all banking products. Other banks are motivated to pursue more geographically or functionally limited international operations.

Tschoegl (1983) found that, among the world's 300 largest banks, asset size was the best predictor of the number and size of multinational operations. Cho (1985) had analogous results in a study of all

U.S. banks with branches in Singapore or Korea. In reporting on a survey of domestic- and foreign-owned banks in the United States that provide international banking services, Kim and Miller (1983) found that the major international service provided by domestically owned regional banks is short-term trade financing for existing clients. These banks tend to list personalized service and knowledge of clients' businesses as their competitive advantages, but such advantages are limited in geographic extent. The money centre banks, which offer a wide range of banking services and are more likely to be part of a multinational network, included asset size and diversification as major competitive advantages. These advantages are based on geographic spread.

Regional Location within the Host Country

The regional location of an international commercial bank within a foreign country depends on a range of cost, market, and institutional factors. Because of the unique nature of financial industries, costs can be measured using two different approaches. On an international scale, the costs of banking operations are best compared using an "intermediation approach" in which the spread between interest expense and income (controlling for fluctuation in exchange rates and real interest rate differentials) is the major component of cost—see Goldberg (1973). On a subnational scale, the "production approach" is more relevant: costs include operating expenses (labour, physical plant, marketing, and so forth) and profit but not interest expenses (Hunter and Timme 1989: 2-4). In the discussion below, it is these operating expenses that loom largest.

Geographic studies of international banking services and multinational banking offices have emphasized their spatial concentration in a very few cities in each country (Martz and Semple 1985; Daniels 1986; Holly 1987). The reasons for such a concentration include proximity to clients and appropriate labour. The major reason, however, is agglomeration: proximity to other internationally oriented financial institutions (Daniels 1986). When multinational banks are located outside a host country's financial capital, their provision of banking services may be limited. Indeed, Wood (1983) noted that only in Toronto have foreign-owned Schedule II banks attempted to serve the retail market with walk-in branches. Costs (even the subtle cost variations due to agglomeration), of course, are not the only influence on the regional location of international financial services. Goldberg et al. (1989) noted that the most consistently significant variable for explaining the variation in U.S.

states' assets and deposits in foreign banks was the volume of international imports (of merchandise) into each state.

Cross-Border Operations of U.S. and Canadian Banks

Hypothesized Relationships

Based on elements of the framework sketched above, we can form several hypotheses about the cross-border activities of U.S. and Canadian banks:

1. U.S. commercial banks with operations in Canada are likely to have larger assets, deposits, and international branch networks than U.S. commercial banks without operations in Canada.
2. The relationships above will be stronger for U.S. commercial banks that operate subsidiaries in Canada than for U.S. commercial banks relying on correspondent relationships with Canadian banks.
3. The location of U.S. commercial banks affects their propensity for having Canadian operations. New York City banks, because of their base in the country's international banking centre, are more likely than other banks to maintain some Canadian linkages. And banks based in border cities, because of their clients' greater interaction with Canada, are more likely than other banks to maintain some Canadian linkages.
4. Foreign bank subsidiaries in the United States and Canada are less likely to have their own bilateral linkages, relying instead on their parent companies' linkages with the other country.
5. Canadian commercial banks' linkages to U.S. commercial banks are concentrated in New York City and in border cities.

Empirical Overview

Data on the relations and operations of U.S. and Canadian banks in the other country were obtained from the 1989 *Bankers' Almanac and Yearbook* (Thomas Skinner Directories 1989), which lists commercial bank companies operating for at least a year that have some broadly defined international banking activities or relevance to clients engaged in international business. The data set includes 360 private commercial bank companies in the United States, 342 of which are owned by U.S. interests, and 59 such bank companies in Canada, 9 of which are owned by Canadian stockholders or companies. While the data set exhausts the universe of Canadian banks, it includes only those U.S. banks likely to have some kind of international operations, as the vast majority of U.S. bank companies are small and irrelevant

to gaining an understanding of U.S.-Canadian banking relationships. All Canadian banking companies have some relationship (correspondent, representative office, agency, branch, or subsidiary) with U.S. banks, but only 42 (11.7 percent) U.S. banking companies have some relationship (correspondent, representative, or subsidiary) with Canadian banks.

Forty-eight banks in the data set were in New York City, 43 in Toronto, and 13 in Montreal. The largest number of foreign-owned banks (40) was in Toronto. All foreign-owned banks reported in Canada were in either Toronto, Montreal, or Vancouver. In the United States, foreign-owned banks appeared in seven cities besides New York: Chicago, Houston, Los Angeles, Miami, Newark, San Francisco, and Washington, D.C.

Findings

With respect to the first hypothesis, the 34 U.S. banks with Canadian linkages that reported assets and deposits had a mean asset size (US\$21 billion) nearly seven times the mean asset size (US\$3.3 billion) of the other 213 U.S. banks that reported assets and deposits and a mean deposit size (\$15.5 billion) six times the mean deposit size (US\$2.4 billion) of the same 213 U.S. banks. The 42 U.S. banks with Canadian linkages had an average of 12 foreign branches worldwide, compared with an average 0.4 international branches for the other 318 U.S. banks in the sample (recall that the 360 U.S. banks were selected for their relevance to international business). Despite variation around these means, these relationships were highly significant.

As for the second hypothesis, these already strong relationships were much strengthened when the 14 U.S. banks with Canadian subsidiaries were compared with the 318 U.S. banks with no Canadian linkages. But when the size attributes of the 17 U.S. banks with correspondent relationships with Canadian banks were compared to the size attributes of the 213 U.S. banks with no Canadian linkages at all (both groups limited to the 247 U.S. banks that reported asset and deposit sizes), the mean asset size (US\$2.3 billion) and deposit size (US\$1.7 billion) of the linked banks were each *smaller* than for the other 213 banks. Although these relationships between size and Canadian correspondents were not at all significant (because of the variation around the means), the very different characteristics of the U.S. banks with Canadian correspondents and those with Canadian subsidiaries suggest that very different motivations underlie these various forms of linkages.

With respect to the third hypothesis, New York City banks were more likely to have some Canadian relationship: 29 percent of the 48

New York banks versus 9 percent of the other 312 banks. When only subsidiaries were considered as Canadian linkages, a strong relationship was found with New York location: 24 percent of New York City (and U.S.-based) banks had Canadian subsidiaries, compared with 2 percent of the other U.S.-based banks. The six U.S. banks outside of New York City with Canadian subsidiaries were in Boston, Chicago, Detroit, Los Angeles, Pittsburgh, and San Francisco. The 16 U.S. banks outside of New York with Canadian correspondents were in large (but not the largest) cities throughout the country (including six in the Southeast), but none were west of Salt Lake City. These findings correspond to the much greater investment required for a foreign subsidiary than for a foreign correspondent.

Contrary to the fourth hypothesis, foreign-owned banks in the United States were actually more likely to have a Canadian link (21 percent) than domestic banks (11 percent). This very weak relationship was not significant, however. Furthermore, the relationship disappeared when foreign-owned U.S. banks' correspondent relationships with their parent banks' Canadian subsidiaries (that is, intracorporate correspondents) were deleted. Only five foreign-owned Canadian banks reported no U.S. links. All the Canadian Schedule I banks maintain U.S. connections.

With respect to the fifth hypothesis, these connections were generally correspondents in New York, representative offices in a few large U.S. cities (especially Chicago and Dallas or Houston), agencies in New York, and branches in New York and a few large U.S. cities. There were no links to banks or offices in U.S. border cities (for example, Buffalo, Detroit, or Seattle).

Changes after the Free Trade Agreement

Because the chief determinant of a multinational bank's presence in developed countries (outside of London, New York, and Tokyo) is the extent of foreign trade and investment by companies based in that bank's home country, it is expected that the greatest impact of the FTA on cross-national banking will be through increased bilateral and third-country trade and investment in the two countries rather than as any result of the specific provisions of Chapter 17. Neu (1985) concluded that the overall effect of liberalization on the two countries' banking sectors would be minimal. Large commercial banking customers already have access to any large bank in the world, while local banks have competitive advantages in taking deposits and managing assets in small, local markets. Restrictions in Canada on single ownership of its Schedule I banks together with restrictions in

the United States on banking activities and interstate banking minimize the possibility of wrenching change in this sector (Warren 1988).

On a regional scale, a range of changes is possible. Given the huge volume of trade (and trade financing) between the United States and Canada and the concentration of this trade in the province of Ontario and the states of Michigan, New York, and California, the importance of trade activity for international banking could lead multinational banks to establish operations in border cities, despite the absence of a multinational banking agglomeration in these locations. It is very likely that existing domestic regional banks (in the United States) and branches of large banks (in Canada) will continue to exercise their competitive advantages in trade-related services for their regional clients. The potential bilateral regional change is that the banks of each country will compete to service any growth in the banking needs of medium-sized companies—perhaps by establishing a presence in the other country. Even then, however, any presence outside of New York, Toronto, and Montreal is likely to be limited to a few major regional centres, as Leysion et al. (1989) discovered for a range of financial sectors in Great Britain.

One benefit for banks of widespread branches serving retail markets is a ready, inexpensive source of lendable funds (Wood 1983). This source is even more important in Canada than in the United States (Boreham 1987b). While building up such a network is expensive, it could become an important determinant of multinational bank profitability, as competition drives spreads lower on corporate and interbank money markets. Given that Canada's U.S.-owned banks focus on international loan and fee service products for mid-sized companies with expansion needs (Caron 1988), any peripheral branches they do establish may well move capital out of stagnating peripheral economies and into growing national and international markets—see Holly (1987: 650-651). This process is an important component of the profitability of interregional bank networks, as exemplified by the greater ability of peripheral banks to make long-distance loans from consumer deposit holdings after acquisition by a multistate bank holding company (KeyCorp 1989: 42).

Because of their small size and the high cost of funds relative to the large, well-branched Schedule I banks, the 14 U.S.-owned banks in Canada have tended to specialize their services. The 10 small U.S. subsidiaries (under US\$1 billion in assets) have been especially careful to avoid direct competition with the Schedule I banks, even outside of retail banking. For example, National Bank of Detroit Canada (US\$481 million in assets in January 1989) augments its loan activity with “foreign exchange and lock-box services, free funds

transfers between [itself] and the National Bank of Detroit, and providing credit references to US customers” (Ringer 1989). Bank of Boston Canada (US\$264 million in assets in January 1989) grew by acquiring Canadian factoring companies (which buy clients' accounts receivable) and now plans to expand through acquisition of other (especially foreign-owned) lenders to the Canadian middle market (Lake 1989).

Interviews with representatives of U.S. banks in Buffalo (New York) suggest that border banks are attempting to serve another specialized market: small- to medium-sized Canadian companies who need U.S. banking services to finance or advise sales and distribution projects in the United States. These operations will remain in New York State. Their officers will use Schedule 1 of Annex 1502.1 of the Free Trade Agreement, which allows free, temporary border crossing for (among other things) “financial services personnel (insurers, bankers or investment brokers) engaging in commercial transactions for an enterprise” located in the traveler's home country (External Affairs 1988: 226). This is consistent with the overall findings of this article that direct services to the middle market may well occur outside of the two countries' financial centres, but that these services are likely to be tied directly to cross-border trade and investment and will usually occur via low-investment forms of international banking involvement.

Conclusions

This article has constructed a framework within which the international location decisions of banks ultimately depend on their country- and company-specific advantages in banking activities. These advantages (or desires to modify these advantages) influence their motivation for international involvement, the national location to which that motivation leads them, the most appropriate operational form allowed in that nation, and specific locations within that nation. Such a framework is important for a coherent analysis of the myriad influences on the location and type of banking operations, or for attempts to understand the effects of an environmental change such as the Canada-U.S. Free Trade Agreement.

An analysis of the status quo of banking operations in the two countries showed the expected concentration of bilateral connections. U.S. banks with Canadian connections were large, had more international branches in general, were concentrated in New York City, and were more likely than not to be foreign owned. Canadian banks, concentrated in Toronto and Montreal, nearly all had U.S. connections, mainly in New York and the other largest U.S. cities—not in border

regions. The banks of both countries showed substantial differences in their patterns of bilateral branch/subsidiary versus correspondent relationships.

Of the major motivations for banks to undertake international involvement, client servicing is the most relevant to the FTA. The agreement should yield substantial corporate rationalization across the border, with accompanying increases in bilateral trade and investment. Commercial banks will be intimately involved in that trade and investment. The forms through which they will participate will vary with the characteristics of the banks. The largest banks will either expand their bilateral presence or, in some cases, will be enticed to establish operations in New York City, Toronto, or Montreal. Large regional banks should take the steps needed to make them more attractive to their clients' needs for information, trade financing, and working capital. These steps may occur in situ or may entail establishment of foreign offices, agencies, or, in rare cases, branches or subsidiaries in major financial or trade centres of the two countries. It is likely that more medium-sized banks will establish correspondent relationships across the border.

More research is needed on how banks assess their own capabilities and precisely what characteristics will lead banks, especially the large U.S. regional banks, to particular courses of action. Additional questions include the motivations and actions of third-country banks and U.S. banks' use of export trading companies and Edge Act subsidiaries to serve exporting clients and their foreign subsidiaries.

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