

United States-Mexico-Canada Agreement

AUTHORS:

Joel Parsan, Manager, Member Relations, Global Risk Institute

Erik Brown, Research Analyst, Global Risk Institute



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A New Course for North American Trade and its Implications for the Canadian Financial Services Industry

On September 30, 2018, Canada, Mexico and the United States reached a deal to replace the North American Free Trade Agreement (NAFTA) with the United States-Mexico-Canada Agreement (USMCA).¹ The USMCA is the product of almost one and a half years of talks between the three regional partners. Throughout the renegotiation process, Canadian financial service professionals have watched with a keen eye to see what changes could be made to the original NAFTA provisions and what the possible implications might be for the industry. With an agreement in place, it is possible to begin to evaluate the new elements of the USMCA and point to the kinds of first and second-order effects of which financial risk managers should be aware.

In the first analysis, the USMCA largely resembles the original NAFTA in its reference to financial services trade. However, it does include a few key amendments to the rules and standards that govern the industry, and to other trade-intensive sectors of the economy. In so doing, the USMCA presents challenges for a variety of stakeholders, including institutional lenders, equity investors and insurers. Risk managers could stand to re-evaluate their exposure to the multi-sectoral effects of the new agreement, particularly with respect to market, credit and regulatory risk, and adjust their governance strategies accordingly.

This report offers only a preliminary assessment of the USMCA, given the draft text made available to the public as of October 2018. Circumscribed by the sheer length

and complexity of the document, the insights herein are limited to the core Financial Services Chapter (17) and to provisions in other sections that feature most prominently in the initial public and professional commentaries on the agreement. Ultimately, a complete accounting of the risks introduced by the USMCA will not be discernable until the agreement is ratified and in full force, and so institutions should conduct active monitoring in order to identify and respond to new threats as they arise.

WHAT'S AT STAKE FOR THE CANADIAN FINANCIAL SERVICES INDUSTRY?

NAFTA (1994) significantly contributed to the success of the Canadian financial services sector over the past 25 years. NAFTA revolutionized financial services trade, setting a precedent as the first agreement to apply a principles-based method to liberalization.² Since it came into force, financial operations across the North American region have increased, with results that have substantially benefitted Canadian institutions. Over the past decades, Canadian banks have been able to increase their participation in the U.S. and Mexican markets and deliver financial services to a wider array of customers across borders, facilitated by provisions requiring equal access for foreign and domestic firms and freedom from undue discrimination.³ Direct investment by the Canadian

financial sector in the U.S. approximated \$187 billion as of 2016,⁴ and total Canadian-U.S. financial services trade reached \$9.4 billion in the same year; up from \$1.7 billion when NAFTA was first signed.⁵ Canadian banks employ 66,470 employees in over 2000 offices and branches across the U.S. and Mexico.⁶ The NAFTA zone is also an important contributor to the market strength of these institutions, with \$1.28 trillion in assets held and approximately 16% of Canadian bank income earned in the American and Mexican markets.⁷

WHAT HAPPENS NEXT?

With a trilateral consensus now articulated, the political leaders of Canada, Mexico, and the United States can move forward to sign the new agreement. It is likely that the associated ceremony will occur by November 30, 2018,⁸ when Donald Trump, Justin Trudeau and Enrique Peña Nieto attend the G20 Summit in Argentina.⁹ This deadline allows for the outgoing Mexican president to certify the deal before leaving office.¹⁰ The next step requires the legislatures of each country to ratify the agreement, which could include an update of domestic laws to reflect the new provisions. The USMCA cannot enter into full force until it is successfully approved by each of the three parties.¹¹ Ottawa, Washington and Mexico City all have independent ratification processes for international trade deals.

Mexico

In the case of Mexico, the ratification process varies depending on the scope of the new agreement. The President has the power to independently authorize the deal if only minor changes to existing trade law are necessary, while Congressional involvement is mandated in the case of more extensive reforms.¹² For the USMCA, hearings and a Senate vote are required (only the consent of the upper chamber is necessary for international agreements), with a simple majority needed to ratify the document and to integrate its provisions into domestic law. Although incumbent President Peña Nieto will probably sign the USMCA before leaving office on December 1st, it is unlikely that the legislative branch will

review it until the new year.¹³ The results of the federal elections in July portend a relatively positive result for the process going forward. President-Elect Andrés Manuel López Obrador (AMLO) committed to seeing the NAFTA talks through to a signed agreement,¹⁴ and his MORENA political coalition won majorities in Congress.¹⁵ Although some have reservations about the USMCA, AMLO's political allies appreciate the greater significance of the North American trading relationship for investor confidence and the stability of the national economy.¹⁶

Canada

To ratify the USMCA, Ottawa must enact legislative and regulatory changes in order to embed the provisions of the new agreement in domestic law.¹⁷ Both houses of Parliament must pass the agreement on a “yes-or-no” vote for it to garner the necessary approval.¹⁸ The process begins with the issuance of an “Order in Council”, authorizing an official to sign the agreement on behalf of the Government of Canada. Usually this role is allocated to the Prime Minister, Minister of Foreign Affairs or both officials. Given historical precedent, it is likely that the order will come in mid- to late-November, ahead of the prospective signature ceremony on the 30th of the month.¹⁹ Next, the text of the deal will be sent to the Commons for a 21-day review period, after which the implementing legislation can be brought forward. It is likely that a bill will not materialize until mid-February 2019, which would leave a limited timeframe for the legal revisions undergirding the USMCA to pass through the legislature and obtain royal assent before the House of Commons breaks on June 21st for the summer recess (Senate adjourns shortly thereafter).²⁰ With the Prime Minister's party in majority control of the House, however, it is highly likely that the new deal will receive legislative approval.

In the event that the legislative schedule becomes too restrictive, the Government of Canada does have a backup measure it can use to seek approval before the House adjourns.²¹ Under Section 6.3 of the Policy on Tabling Treaties in Parliament, there is an expedited course available if ratification of an international accord is deemed to be “urgently required.” The Minister of

Foreign Affairs, along with other “lead Ministers,” can submit a joint letter to the Prime Minister requesting a procedural exemption and outlining a clear justification for the appeal.²² This contingency further increases the probability that the federal government will successfully oversee the passage of the USMCA.

The United States

Trade Promotion Authority (TPA) defines the relationship between the legislative and executive branches of the U.S. government in free trade negotiations.²³ It also sets forth procedures for the expedited ratification of such international agreements. Under the TPA, Congress temporarily relinquishes its authority over trade to the White House, bound by certain rules and regulations.²⁴ The House and Senate can then rule on the terms of a completed agreement in a “yes-or-no” vote, with a simple majority needed for approval.²⁵ Specifically, Congress does not evaluate the full text of a trade agreement; rather its discretionary authority only extends as far as provisions requiring amendments to U.S. law.²⁶ The current structure and partisanship of the American political process could mire the USMCA in a Congressional dispute that ultimately leads to its rejection. The need for legislative approval of agreements under federal trade practices, coupled with the political uncertainty introduced by the 2018 midterm elections, could create a scenario where partisan disputes manifest through the TPA regulations and prevent the new deal from passing into full force.

Turning to the specifics of the ratification process, the U.S. President must first notify the legislature at least 90 days before the signing of a trade agreement, and then publish the full text within 30 days of the announcement. Some additional reporting requirements need to be fulfilled after the signature ceremony, including an economic analysis of the deal conducted by the International Trade Commission (ITC) that can take up to 105 days to complete.²⁷ 30 days before the implementing bill is introduced in the Congress, the White House must provide the finalized text of the agreement and a Statement of Administrative Action,²⁸ which outlines all of the required regulatory changes that the executive

can implement without passing legislation.²⁹ The House Ways & Means Committee then has up to 45 days to review the bill and report it to the lower chamber, where an additional 15-day period is allotted for the entire assembly to vote on it³⁰ (debate is capped at 20 hours from the point that the proposal is raised for consideration).³¹ Next, the Senate Finance Committee has 15 days to vote on the bill and pass it on to the floor of the upper house, where another 15-day period is allotted for a second vote by all members³² (same time restrictions for debate as in the House apply).³³

Political variables threaten to complicate the ratification of the USMCA, in accordance with the process set forth by the TPA. As of October 2018, the Republican Party maintains a firm grip on both the executive and legislative branches of government, and so a degree of political uniformity is expected between Capitol Hill and the Oval Office. However, the trilateral negotiations extended well past the May 17th 2018 deadline set by House Speaker Paul Ryan in order for Congress to review and approve the new agreement within the current session.³⁴ Thus, the House and Senate will most likely have insufficient time to approve a renegotiated trade deal before the November midterms,³⁵ delaying a vote on the USMCA until the new Congressional session begins on January 3, 2019.³⁶ The next Congress elected on November 6th could well include a Democrat-controlled House of Representatives; an outcome to which election forecasters attach a high probability.³⁷ As argued by William Alan Reinsch, Senior Adviser and Scholl Chair in International Business at the Centre for Strategic and International Studies (CSIS), the Democrats could well oppose passage of the USMCA given the intent of the Party leadership to uniformly oppose President Trump.³⁸ Reinsch also notes that in the event that the Republican Party loses control of the House in November, it could attempt to “jam through” the implementing legislation by truncating the ratification process, although he notes that the restricted timelines make this scenario unlikely.³⁹ Senate Majority Leader Mitch McConnell provided a more definitive rebuff of proposals for expedited approval in mid-October 2018, stating that there was no chance the USMCA could make it through Congress before the end of the year.⁴⁰

FINANCIAL SERVICES PROVISIONS IN USMCA

What’s New is Old Again

The USMCA introduces a number of new provisions for the financial services industry in its Chapter 17, but also borrows key stipulations that were included in Chapter 14 of NAFTA (Financial Services):

Table 1: NAFTA Financial Services provisions that remain in the USMCA

Provisions	Description
National Treatment, Chapter 14, Article 1405	<ul style="list-style-type: none"> Provide investors and service providers of another Party with treatment no less favourable than that which they grant their own investors and service providers.
Most-Favoured Nation Treatment, Chapter 14, Article 1406	<ul style="list-style-type: none"> Provide the investors and service providers of another Party with treatment no less favourable than they accord investors and service providers of any other Party or non-Party.
Prudential “Carve-Out”, Chapter 14, Article 1410	<ul style="list-style-type: none"> The agreement cannot prevent a partner from adopting or maintaining reasonable regulatory measures for their own financial system.⁴¹

Important New Provisions in the USMCA Relating to the Financial Services Sector

The USMCA introduces a new set of principles for the financial services industry. Table 2 describes two key additions in more detail.

Table 2: New provisions in the USMCA related to the Financial Services Industry

Chapter	Topic	Provisions
Chapter 19	Data Storage	Article 19.12 stipulates that a USMCA partner does not have to locate computing facilities in the same jurisdiction in which they are doing business. ⁴² (For example, an American firm operating in Canada could store Canadian client data in the U.S. and is not obliged to store data in Canada). Nevertheless, according to Article 17.20 of the USMCA, regulators in a jurisdiction must have immediate and direct access to customer data upon request notwithstanding where it is stored, and they can require localization if free and open access cannot be guaranteed. ⁴³
Chapter 17	Market Access	Building on the provisions contained in Chapter 14, Article 1403 of NAFTA, the Financial Services Chapter in the USMCA further entrenches market access as a key principle between the trading partners. Article 17.5 prescribes that no USMCA partner should discriminate or place limits on the number of financial institutions, suppliers, transactions, assets or people employed from a USMCA partner. ⁴⁴

Provisions in NAFTA removed from the USMCA

A key NAFTA provision now eliminated from the USMCA is the Investor-State Dispute Settlement Mechanism (ISDS). Based on Chapter 11, Section B of NAFTA, the ISDS manages disputes between states and commercial actors. The provision allows companies to sue governments for alleged discriminatory treatment. An impartial tribunal oversees the judicial process, and the decisions made in these cases are enforceable in the domestic courts of each trading partner.⁴⁵ In the USMCA, Mexico and the U.S. have a similar mechanism at their disposal for specific cases under Chapter 14, Annex 14-D of the agreement.⁴⁶ However, Canada is left with no dispute resolution mechanism for investors except for the provisions outlined in Chapter 31 of the USMCA. In Chapter 31, Canada, Mexico or the U.S. can

bring cases against one another on behalf of investors on a State-to-State basis.⁴⁷ Overall, with the elimination of the ISDS, Canadian financial services institutions have lost a potential dispute resolution mechanism and will now have to lobby government and face the domestic courts of Mexico or the U.S. in situations where they wish to bring a case before a North American trading partner.

Key new provisions in the USMCA that pose second-order risks for the Financial Services Industry

At a broader level, the key changes agreed upon in the USMCA also pose important second-order risks for the industry. Table 3 outlines some of the new provisions agreed upon in the USMCA that could impose ancillary risks on the financial services sector going forward.

Table 3: Key elements of the USMCA

Topic	Provision
Automobiles	<ul style="list-style-type: none"> The USMCA requires that 75% of a car produced must be made in the North American region and that 40-45% of auto content must be made by individuals earning at least \$16 USD per hour in order to qualify for duty free treatment.⁴⁸ Based on the U.S. Section 232 Side Letter (which carves out stipulations that exclude Canada from auto tariffs imposed by the U.S. under national security considerations), Canada will be exempt from future Section 232 measures for at least 60 days, during which negotiations will be open to resolve the issue at hand. Moreover, if Section 232 measures are levelled against it, Canada will still be able to export duty free to the U.S. up to 2.6 million vehicles and up to \$32.4 billion USD worth of auto parts. Both levels exceed Canada's current output.⁴⁹
Agriculture	<ul style="list-style-type: none"> Canada will open and provide new access to the U.S. with respect to tariff rate quotas for dairy, poultry and egg products.⁵⁰ Eliminates current milk classes 7 and 8.⁵¹ According to the Dairy Farmers of Canada, these measures would open up access for the U.S. to approximately 3.6% of Canada's dairy market.⁵²
Intellectual Property	<ul style="list-style-type: none"> For new biologic drugs, 10 years of data protection is allotted, up from the current level of 8 years in Canada.⁵³ General term of copyright protection at "life plus 70 years", up from "life plus 50 years" in Canada.⁵⁴
De Minimis	<ul style="list-style-type: none"> An increase of the De Minimis (duty free) level from \$20 to \$150 for online purchases from the U.S. into Canada.⁵⁵ An increase of the level at which sales tax will be applied to an online purchase from the U.S. into Canada from the current level, \$20 to \$40.⁵⁶

IMPLICATIONS FOR CANADIAN FINANCIAL SERVICES

First-Order Effects¹

Financial Regulations and Privacy Standards

The financial services sector in Canada has been a benefactor of the provisions under NAFTA's Chapter 14 (Financial Services) which encourages National Treatment, Most-Favoured Nation Treatment and a "prudential carve-out" in the financial services sector. This has helped some firms in the industry enter and strengthen their presence in the U.S. and Mexico. Indeed, American and Mexican firms have benefited from the provisions of Chapter 14 as well. For instance, American institutions represent one quarter of all bank exposure in Canada with approximately \$80 billion in assets.⁵⁷

Under Chapter 19, Article 19.12, of the USMCA, a Party may now store data in a different jurisdiction from that which they are operating in. This stipulation poses a challenge for the financial services industry, as the new provisions would allow U.S. and Mexican banks or subsidiaries to store Canadian customer data within the legal jurisdictions of any of the USMCA partners; an arrangement which could run afoul of national or provincial privacy laws. For instance, the provinces of Nova Scotia and British Columbia have laws in place which prohibit data storage of personal information collected by governments, such as health records for example, to be stored in foreign jurisdictions.⁵⁸ Similarly, for those Canadian firms operating in the U.S. or Mexico, there may be legal implications arising from the storage of American and Mexican data on Canadian servers. Financial institutions and regulators may need to devise new governance strategies to reconcile the liberalization of data storage with their obligations to protect the personal information of their customers.

¹ *First-Order Effects refer to the direct costs/benefits of regulatory changes for Canadian institutions under Chapter 17 (Financial Services) of the USMCA.*

The Elimination of the ISDS Mechanism

The ISDS mechanism has been removed from the USMCA agreement which creates a potential loss for Canadian investors and businesses operating in the U.S. and Mexico. Canadian investors and companies who wish to bring proceedings against the U.S. or Mexican government in situations where they feel that they have been discriminated against by a partner's domestic law must now refer to Chapter 31 of the USMCA and request that the Government of Canada bring their complaint forward in U.S. or Mexican domestic courts. Previously, with the ISDS mechanism, Canadian businesses and investors had the opportunity to bring cases before a tribunal independently to assess their merit.

While the ISDS has been an available option, the results under this provision have been mixed for Canada. Sinclair (2018) breaks down Canada's performance under NAFTA's Chapter 11 ISDS mechanism. Since NAFTA came into force and up until January 2018, 41 cases had been brought against Canada under Chapter 11 representing 48% of ISDS cases overall.⁵⁹ Moreover, Canada has won 9 and lost 8 settled cases.⁶⁰ Ultimately, Ottawa has spent \$95 million (CAD) defending itself in ISDS cases⁶¹. Accordingly, the elimination of the ISDS from the USMCA could be seen as a potential win for Canada overall.

However, Canadian financial services firms, particularly banks and pension funds holding assets in the U.S. and Mexico, should remain vigilant of the ISDS repeal, since it denies the industry a direct means of seeking recompense in the event of some disruptive or discriminatory government action. For Canadian financial institutions operating in Mexico particularly, the loss of the ISDS mechanism exposes firms to the Mexican judicial system which has been accused of corruption by American officials in the past.⁶² Thus, Canadian institutions with operations or assets in Mexico may need to reassess their regulatory risk exposure going forward.

Second-Order Effects¹¹

Trade agreements are complex documents, setting standards and regulations across multiple sectors and economies. For the USMCA, second-order risks to Canadian financial services may not manifest until some time after the implementing legislation passes into domestic law in each of the three participating countries. The full spectrum of impact will also depend on the unique exposure of different industry stakeholders. For the most salient provisions in the new agreement, however, it is possible to “game-out” some of the scenarios in which the USMCA could impose greater indirect costs on institutional lenders, insurers and investors.

Increased Automobile Costs

The revised automotive rules-of-origin included in the USMCA portend a range of direct and indirect economic effects, with some potential risks for the financial services sector. As argued by Scott Miller, Senior Adviser with the Abshire-Inamori Leadership Academy at the Center for Strategic and International Studies (CSIS), the updated auto provisions entail a kind of trade “micro-management” because they parse the vehicle production process according to the specific site of manufacture rather than by the source country. Miller suggests that auto-sector facilities already in compliance with the new standards will continue to function as normal, while those plants that fall below the threshold will compensate by either restructuring their operations to cut costs or relocate outside of the NAFTA zone and absorb the 2.5% most-favoured nation tariffs applied to U.S. auto imports.⁶³ Furthermore, larger costs accumulated from the regulatory changes could be passed along to consumers.⁶⁴ Higher automobile prices could lead to a drop in demand for new North American vehicles,⁶⁵ which if it led to an aggregate decrease in total auto sales, could contribute to a decline in applications for new auto loans.

Specifically addressing the Trump Administration’s proposed 25% auto tariff, Miller further argues that price increases may also encourage more drivers to keep older cars for longer periods, creating a road safety issue.⁶⁶ Although it will likely be far less severe under the USMCA (price increases would probably be moderate in comparison), this trend could present indirect challenges

to the insurance industry if the tendency to retain vehicles contributes to a growing rate of accidents due to age-related mechanical failures.

Given the potential increase in prices for new automobiles, there may also be a shift among consumers toward the used-car market.⁶⁷ Its value could increase in the aggregate based on higher demand from consumers seeking a more affordable alternative. If this trend were to persist, there could be a marginal positive effect for institutional lenders with existing auto loans. If a borrower was to default, a bank could possibly see a higher resale price on a repossessed vehicle originally taken as collateral when the loan was first issued.

Finally, it is also possible that the minimum wage requirements under the new trilateral agreement could have adverse effects on the Mexican labour market. With the lowest rates of compensation across the three countries, Mexico could lose its price-competitive advantage in manufacturing over Canada and the United States when obligated to meet a \$16 (USD) minimum wage. Original Equipment Manufacturers (OEM) and parts suppliers may choose to optimize their business practices to maintain profit margins, which could involve layoffs and a push towards greater plant automation. For Canadian institutions exposed to the Mexican financial sector, job losses along the auto supply chain could affect loan settlement and increase personal default risk.

¹¹ *Second-Order Effects refer to the indirect costs/benefits to the financial services industry of the USMCA provisions relating to other economic sectors.*

Pressures on Retail Business

The increase of the *De Minimis* standards from the current level of \$20 to \$150 duty-free and from \$20 to \$40 sales-tax free could have significant multi-level implications for financial institutions exposed to the retail sector. A report published by Pricewaterhouse Cooper (PWC) and commissioned by the Retail Council of Canada forecast that an increase in the *De Minimis* level would instigate a transition in consumer shopping patterns from brick-and-mortar stores to e-commerce platforms, and that Canadian vendors' websites would be sidelined in favour of American competitors.⁶⁸ As per the model applied in the report, a \$200 USD duty- and tax-free threshold would result in a 25% weighted average price reduction for U.S. goods in relation to Canadian retail prices across 10 product categories.⁶⁹ In the defined scenario, the sales decreases for Canadian retailers are projected to range from \$29.84 billion (CAD) in 2017 to \$70.82 billion (CAD) in 2020.⁷⁰ In comparison, total sector sales were \$605 billion in 2016.⁷¹

Although the thresholds advanced in the USMCA for the *De Minimis* and tax-free levels are lower than the figures used in the PWC report, there are still important second and third-order risks for the financial services industry. For instance, lower sales figures may also put downward pressure on Canadian retail equities, decrease commercial loan repayment performance and increase credit default risk in the sector. A possible third-order effect of the change could evolve from the pressures on labour caused by a Canadian retail market squeeze. If domestic vendors face declining earnings because of competition from an increase in duty-free U.S. and Mexican imports, there could be a rise in job losses that also affects repayment rates and default risk on personal loans to former retail employees. However, the lower prices and better product variety that cross-border competition can deliver to Canadians may increase the demand for credit cards or other consumer financing options, which may offset profit losses to commercial banking from declines in personal debt repayment among laid off retail-sector workers.

Increased Stress on Dairy Loans

The import concessions granted in the USMCA to U.S. producers of supply managed agriculture puts greater competitive pressure on the Canadian dairy industry, and could lower some costs for consumers.⁷² However, a decrease in prices could also depress the value of the production quotas farmers purchase through the supply management system.⁷³ Many operators in the dairy and poultry sectors take out mortgages to cover the costs of their protected market share,⁷⁴ and the quota itself serves as collateral for agricultural debt.⁷⁵ The total value of permits in the quota system is upwards of \$35 billion (CAD), \$30 billion of which is reserved for dairy production.⁷⁶ If dairy profits decrease due to greater American market penetration and supply quotas lose their value, farmers could find it increasingly challenging to service their debt and lenders may not fully realize on the collateral. The Canadian financial services industry is not necessarily immune to this risk, with approximately \$38 billion in farm debt (of the \$102 billion total, not limited to dairy) held by chartered banks, according to Statistics Canada figures.⁷⁷ The supply management concessions promised under the USMCA could lower the rates of personal loan repayment and increase default risk. However, the Trudeau Government has promised to support the dairy industry as American imports increase, with Foreign Minister Chrystia Freeland promising “full compensation” for losses incurred.⁷⁸ If realized, this public support could keep many farmers solvent and help to mitigate some of the risk to institutional lenders.

Biologic Prescription Costs and Medical Insurance

Unlike synthetic pharmaceuticals, biologic drugs are produced within genetically engineered microorganisms or mammalian cells. They are also far more complicated in their molecular structure than conventional therapies, and can be an incredibly expensive treatment option for patients.⁷⁹ On average, speciality drugs (including biologics) cost 15 times more than traditional medicines.⁸⁰ Extending the data protection window to 10 years for this class of medications under the new trade agreement limits the access of secondary firms to the information collected by brand-name companies

during the trial process. This restriction could slow the development of Subsequent Entry Biologics (SEB): the closest equivalent to generic substitutes⁸¹ that may provide savings of 10 to 30 percent (according to U.S. Federal Trade Commission estimates).⁸² As argued by Richard Gold, Professor at McGill University’s Faculty of Law and founder of the Centre for Intellectual Property Policy, the data allotments in the USMCA could restrict market competition for biologics, even if standard patent protection has expired, and limit any price reductions that might otherwise accrue.⁸³

The high cost of prescription medications is already a well-known source of risk for the Canadian insurance industry. Biologics and SEBs are both terms used interchangeably with “specialty drugs.”⁸⁴ According to Express Scripts Canada, this class of pharmaceuticals accounted for 2% of insurance claims, but amounted to nearly one-third of total costs in 2017. In terms of expenditure growth, the proportion of money spent on speciality medication rose from 15% in 2008 to 31% in 2017.⁸⁵ The rising cost of speciality medications has pushed more private employers to cap the health coverage that they provide to their workforce.⁸⁶ Furthermore, starting in 2013, twenty-four insurance companies across Canada began to cooperate in the internal pooling of high-cost drug claims for fully insured group plans into an Extended Health Care Policy Protection Plan or “EP3,” subject to certain shared standards. Key to the plan was the uncoupling of pooled claims from premium rates. In addition, the industry created an external pool to share risk and preserve the viability of the new system.⁸⁷

The data rules under the USMCA could strain the risk pooling adopted by Canadian insurers, as the longer exclusivity period for brand-name pharmaceutical companies delays the offsetting effect that cheaper biosimilars could have on private benefit plans. Managers could stress test the effectiveness of current risk management strategies for the 10-year data protection scenario, and adjust where possible to limit their vulnerability to deferred price competition in the biologics market. Insurers may also accommodate for declines in adherence rates for prescribed treatments, as patients avoid taking full dosages because of unaffordability concerns. Non-compliance with prescriptions could increase disability rates and the demand for additional medical services.⁸⁸

Credit Risk for Consumers of Copyrighted Material

The 20-year extension to Canadian copyright protection required under the new USMCA poses a downside risk to institutional and commercial consumers of copyrighted materials, including students and teachers. The extended 70-year license period for natural persons (or 75 years for non-natural persons, subject to conditions)⁸⁹ could translate into hundreds of millions of dollars in increased education costs.⁹⁰ According to a study by Michael Geist (working from data collected by the Ontario Book Publishers Organization), Professor and Chair of Internet and Ecommerce law at the University of Ottawa, public domain accessibility remains an important advantage for educators, with half of the top 20 most popular books used in middle and high school English classes falling into this licensing category. The new copyright provisions under the USMCA would effectively “lock down” many publications scheduled to enter the public domain for decades.⁹¹ Although financial sector exposure to increased costs in the primary and secondary grades may be minimal, the copyright extension could have implications for post-secondary student loans, bolstering high textbook fees and heightening the financial pressures that could increase repayment risk for lenders. However, the changes could have positive consequences for Canadian producers of copyrighted materials,⁹² including creators in music⁹³ and other digital media. Longer IP protection periods could contribute to higher profitability in these industries, improving returns on sector equities or opening new avenues for investment.

CONCLUSION

For almost twenty-five years, NAFTA helped to shape the expectations of the Canadian financial services industry. While many of the sector-specific terms in the agreement are carried over into the USMCA, including National Treatment, Most-Favoured Nation Treatment and the prudential carve-out, there are important additions and omissions in the new text. Provisions like those concerning data storage could become a regulatory compliance problem for firms operating across different jurisdictions within North America. The exclusion of Investor-State dispute measures from the USMCA (Chapter 11 of NAFTA) also deprives Canadian financial service providers of the means for direct arbitration with the U.S. and Mexican governments. Furthermore, financial institutions should stay cognizant of the second-order risks posed by the agreement, including the potential for increased automobile costs, a decay in the creditworthiness of retail businesses, greater stress on dairy loans, strains on medical insurance from high cost biologics, and increased credit risk for consumers of copyrighted material.

Overall, financial risk managers should remain vigilant, maintain flexible governance strategies, and be prepared to re-evaluate and adjust as the USMCA continues to evolve.

ENDNOTES

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