



Auto Safety • Congress Watch • Energy Program • Global Trade Watch • Health Research Group • Litigation Group

POLICY PRIMER

November 2009

The Connection between the World Trade Organization's Extreme Financial Service Deregulation Requirements and the Global Economic Crisis

Now, amidst breathless calls from all quarters for expansive new global financial services regulations to address the global economic crisis is a seeming total lack of awareness that **most of the world's countries are bound to expansive World Trade Organization (WTO) financial services deregulation requirements.** The WTO's financial deregulation provisions locked in domestically, and exported internationally, the model of extreme financial service deregulation that most analysts consider a prime cause of the current crisis. Deregulation (not only liberalization) of the financial service sector – including banking, insurance, asset management, pension funds, securities, and more – is among the most important, but least discussed, aspects of the WTO.

Yet, to date, the only connections most policymakers are drawing between the WTO and the current crisis are of the red-herring variety: panicky warnings about countries increasing tariffs to block imports in response to dire economic conditions. Consider the communiqué issued from the November 2009 and April 2009 G-20 Summits, meetings ostensibly convened so that countries could agree to new domestic and international financial sector regulations needed to respond to the crisis. The declaration called for the completion of WTO Doha Round negotiations, which includes as one of its three central pillars further financial service sector deregulation. The communiqué also called for countries to “refrain from raising new barriers to investment or to trade in goods and services... or implementing WTO inconsistent measures” for 12 months.

Yet, in the last year, governments worldwide have taken various measures to counter the crisis that contradict the fundamental precepts of the current globalization model – and indeed in some cases violate the rules implementing this model, such as those of the WTO. Many of the most basic national and international remedies now being proposed to fix the mess and avoid future meltdowns occupy policy space that governments have ceded to the WTO.

Remedying the crisis will require changes to the various WTO texts including the WTO's General Agreement on Trade in Services (GATS), the Understanding on Commitments in Financial Services and the main GATS Annex on Financial Services. Further, unless the Obama administration takes speedy action to remove the outrageous new, additional deregulation commitments now on the Doha Round negotiating table, this Bush trade-policy hangover will undermine attempts to remedy the financial crisis here and abroad.

Over the last several decades, the U.S. government and corporations have pushed extreme financial deregulation worldwide using “trade” agreements and international agencies. In the 1970s, this involved the dismantling of the Bretton Woods system that was created after the Great Depression to govern capital-flow and exchange-rate policy. Later, starting in the 1990s, it involved the weakening and eventual repeal of the New Deal’s system of banking regulation created to ensure stability and safeguard consumers. This included the Glass-Steagall Act, which created a firewall between commercial and investment banks to prevent the former from speculating with consumers’ savings.

Many people still assume our trade pacts are about traditional matters, such as tariff cuts; in fact, today’s “trade” pacts like the WTO require signatory countries – including the United States – to conform their domestic policies to an expansive *non-trade* deregulatory agenda. One of the most controversial WTO agreements is GATS, which sets out rules for how countries can regulate the “service sectors” of their economies. The WTO Secretariat was unusually direct in describing the implications of the GATS rules: “*Governments are free in principle to pursue any national policy objectives provided the relevant measures are compatible with the GATS.*”

One of the most controversial service sectors covered by the GATS is the financial sector. When many countries initially rejected the extreme banking and insurance deregulation agenda being pushed by U.S. and European governments and corporations, special additional negotiations were launched after the WTO was established. Thus, the WTO’s limits on domestic financial service regulation are contained not only in the original GATS, but in updated commitments that went into effect in 1999 (as part of the Fifth Protocol to the GATS, or Financial Services Agreement (FSA)), as well as in the Understanding on Commitments in Financial Services, to which most of the OECD countries also committed. In all, over 100 countries have made GATS financial services commitments. Domestic policies which do not conform with the extensive regulatory limits in these agreements are subject to challenge in the WTO’s powerful dispute resolution system. Policies that are judged by WTO tribunals to violate the rules must be eliminated or trade sanctions can be imposed on the non-conforming country until the policy is changed.

In the case of the United States, WTO commitments to stay out of regulation of “banking,” “other financial services” and “insurance” are extremely broad.¹ The United States signed on to extra WTO obligations agreed to by most OECD countries that include a “standstill” commitment – meaning we are forbidden from rolling back deregulation (or liberalization) of the expansive financial services we bound to comply with WTO rules.² Translated out of GATS-ese, this means that the United States has bound itself not to do what Congress, regulators and scholars deem necessary – create new financial service regulations. This agreement also includes a commitment for signatories to eliminate domestic financial service regulatory policies that *meet* GATS rules, but that may still “*adversely affect the ability of financial service suppliers of any other (WTO) Member to operate, compete, or enter*” the market.³ The United States is also bound to ensure that foreign

¹ Under WTO definitions “other financial services” include trading in foreign exchange, derivatives and all kinds of securities, securities underwriting, money broking, asset management, settlement and clearing services, provision and transfer of financial information, and advisory and other auxiliary financial services. “Banking” covers all traditional services provided by banks – acceptance of deposits, lending of all types, and payment and money transmission services.

² WTO, *Understanding on Commitments in Financial Services*, A. “Any conditions, limitations and qualifications to the commitments noted below shall be limited to existing non-conforming measures.” (The Understanding is a supplemental agreement to the FSA which governs all U.S. GATS financial service commitments.)

³ WTO, *Understanding on Commitments in Financial Services*, B.10(d).

financial service suppliers are permitted “to offer in its territory any new financial service,”⁴ a direct conflict with various proposals to limit various risky investment instruments.

Meanwhile, the list of reasonable financial service regulations that actually do *not* meet even the core GATS requirements is lengthy, demonstrating why altering this agreement is a necessary aspect of remedying the current crisis. For instance, consider the use of “firewalls” between various financial services so that trouble in one sector does not contaminate the entire system. The Glass-Steagall Act of 1933 and related legislation (including the Bank Holding Company Act of 1956 and the International Banking Act of 1978), which forbid bank holding companies from operating other financial services, applied such firewalls so as to avoid a repeat of the financial collapse that occurred during the Great Depression. While the firewalls applied to domestic and foreign banks alike (especially after the 1978 reforms prior to which foreign banks could skirt some of the safeguards), it had the effect of hindering foreign banks that combined commercial and investment banking services in their attempts to enter the U.S. market. But various U.S. GATS “market-access” commitments in banking services guarantee such access. The Clinton administration, which conducted the WTO financial services negotiations⁵, recognized this conflict, and indeed made a commitment explicitly listed in the U.S. GATS schedule to fix this problem.⁶ The firewalls that prohibited a bank holding company from owning other financial companies were repealed with passage of the Gramm-Leach-Bliley Act in 1999, the year the FSA went into effect.

Sorting out exactly what modicum of policy space remains under these rules requires reviewing the more than 30 pages of financial service sector commitments made by the United States. However, consider just one sector that has been a focus of considerable attention as a source of the financial meltdown: “Trading of Securities and Derivative Products and Services Related Thereto.” The only carve-out that the United States listed regarding regulation of derivatives is for *onion futures* – seriously.⁷

Few in Congress even reviewed the thousands of pages comprising the Uruguay Round Agreements Act in 1994, which implemented the WTO. With this Fast Tracked vote, Congress bound nearly 100 sectors of the U.S. service economy to GATS constraints with little public understanding or discussion. The later FSA, which imposed drastic new limits on Congress’ regulatory authority over financial services, was never even sent to Congress. Meanwhile, creating worldwide limits on domestic regulation of financial services via the WTO was the project of the large financial service firms that Congress was supposed to be regulating for the public interest. “An important distinguishing feature of the FSA relates to the degree of support and the political legitimacy it generated through a shared sense of transatlantic purpose and commitment on the part of the financial services industry itself,” wrote two pro-WTO scholars. “The sector was truly unique in

⁴ WTO, *Understanding on Commitments in Financial Services*, B.7.

⁵ The GATS part of these rules were finalized in 1993-95 and adopted after a major Clinton administration-led campaign to secure congressional passage of the Uruguay Round. Most of the specific financial services obligations were negotiated thereafter, finalized only in 1997 and went into effect in 1999, after the Clinton administration pressured other countries to sign on to what would become the FSA package. Stunningly, the Clinton administration signed the United States to comply with the whole WTO FSA package in 1997 without seeking congressional approval – thus binding Congress to an array of WTO financial service deregulation requirements not contemplated when the Uruguay Round was approved in 1994.

⁶ WTO, *United States of America Schedule of Specific Commitments Supplement 3*, Additional Commitments Paper II, WTO document GATS/SC/90/Suppl.3.

⁷ GATS/SC/90/Suppl.3, at C-26. “Federal law prohibits the offer or sale of futures contracts on onions, options contracts on onions, and options on futures contracts on onions in the United States, and services related thereto.”

that respect, and there is little doubt within the trade policy community that financial sector support in the European Union and the United States was a determining force in concluding the FSA.”⁸

Over the past century, U.S. financial regulation has shifted from strict financial controls over banking and capital markets following the Great Depression to deregulation in the 1980s and 1990s. The WTO locks in the U.S. deregulatory status quo at a time when the model it represents has helped wreck the U.S. and global economy.

Altering the WTO financial services rules is critical for creating domestic policy space to address the crisis. The United States – and U.S.-based financial service firms – used WTO negotiations to export the U.S. model of extreme financial service deregulation to over 100 other WTO signatory countries that have made financial services commitments. For these countries to establish new financial service regulations – and to further the goal of new global regulations – the existing WTO limits must be eliminated. However, even in the face of this crisis, the push for further financial services liberalization continues at the WTO. On the table now in the WTO Doha Round negotiations are proposals for *further* financial services deregulation – tabled by the United States, the European Union and other countries that have been busy ignoring *existing* WTO terms because doing so is the necessary to counter the crisis.

Background and more in-depth description of WTO rules: Prior to the establishment of the North American Free Trade Agreement (NAFTA) in 1994 and the WTO in 1995, the scope of trade agreements was limited to setting the terms of exchange of goods across borders, namely cutting tariffs and lifting quotas. The WTO and NAFTA were called “trade agreements,” but they are more accurately understood as international commercial agreements. More broadly, they can be understood as delivery mechanisms for a comprehensive package of neoliberal policies, many unrelated to trade.

These pacts include binding rules that limit the parameters for signatory nations’ service-sector, investment, procurement, intellectual-property, environmental and product and food-safety policies. Each WTO signatory country is required to “ensure the conformity of its laws, regulations and administrative procedures with its obligations.”⁹ In contrast to the operation of most other international agreements, this new generation of “trade” agreements is strongly enforced. Signatory countries that fail to conform domestic laws to the pacts’ terms may be challenged before dispute resolution bodies established by the pacts. These enforcement bodies are empowered to authorize trade sanctions against nations that fail to bring their policies into conformity with the pacts’ rules. To date, approximately 90 percent of laws challenged at the WTO have been found to violate the pacts’ requirements. In virtually every case, developed and developing countries have changed laws ruled WTO-illegal to bring them into conformity. Given this record, often the mere threat of a WTO challenge by a government – or the claim by the private sector that a policy violates the WTO – results in countries modifying their laws or in a policy initiative being chilled.

Understanding how U.S. WTO commitments could affect domestic and international financial service regulatory proposals now being put forward to address the financial crisis requires reference to several WTO texts.¹⁰ Taken as a whole, the WTO’s limits on financial services regulation are

⁸ Pierre Sauv  and Karsten Steinfa t, “Financial Services and the WTO: What Next?,” Brookings Institution, 2001, at 353.

⁹ WTO, Agreement Establishing the WTO, Art. XVI-4.

¹⁰ The text of the GATS itself contains a series of binding rules which are supplemented by rules contained in a GATS “Annex on Financial Services.” The Annex is part of the original WTO text and applies to over 100 countries making

expansive. These rules not only guarantee foreign financial firms and their products access to U.S. markets, but also include numerous additional rules that limit how our domestic governments may regulate foreign firms operating here:

- **No new regulation:** The United States agreed to a “standstill provision” that requires that we not create new regulations (or reverse liberalization) for the list of financial services bound to comply with WTO rules.¹¹ Given that the United States has made broad WTO financial services commitments – and thus is forbidden by this provision from imposing new regulations in these many areas – this provision seriously limits the policy space available to address the current crisis.
- **Removal of regulation:** The United States even agreed to try to even eliminate domestic financial service regulatory policies that meet GATS rules, but that may still “*adversely affect the ability of financial service suppliers of any other (WTO) Member to operate, compete, or enter*” the market.¹²
- **No bans on new financial service “products”:** The United States is also bound to ensure that foreign financial service suppliers are permitted “to offer in its territory any new financial service,”¹³ a direct conflict with the various proposals to limit various risky investment instruments, such as certain types of derivatives.
- **Certain forms of regulation banned outright:** The United States agreed that it would not set limits on the size, corporate form or other characteristics of foreign firms in the broad array of financial services it signed up to WTO strictures. These expansive “market-access” obligations are likely why the Clinton administration agreed as part of GATS negotiations to fix Glass-Steagall’s “barrier to entry.” The law’s firewall requirement that commercial banks not provide investment services hindered foreign firms that combined both activities in their U.S. market access.
- **Treating foreign and domestic firms alike is not sufficient:** The GATS market-access limits on U.S. domestic regulation apply in absolute terms; that is to say, even if a policy applies to domestic and foreign firms alike, if it goes beyond what WTO rules permit, it is forbidden. And, forms of regulation not outright banned by the market-access requirements must not inadvertently “modify the conditions of competition in favor of services or service suppliers” of the United States, even if they apply identically to foreign and domestic firms. Might aspects of the recent Wall Street bailout eventually “change the conditions of competition” in favor of U.S. firms?

The regulatory limits imposed by GATS rules cover not only all actions taken by all levels of government – “central, regional, or local governments or authorities” – but also actions of “non-

specific commitments in financial services and in the context of the FSA, which was completed in 1997 and went into effect in 1999. In addition, the United States and other OECD countries signed an Understanding on Commitments in Financial Services, which contains further deregulation and liberalization commitments. Thus, the U.S. service sectors listed in the U.S. schedule of commitments must comply with the requirements of GATS, the Annex on Financial Services and the Understanding.

¹¹ WTO, *Understanding on Commitments in Financial Services*, A. “Any conditions, limitations and qualifications to the commitments noted below shall be limited to existing non-conforming measures.”

¹² WTO, *Understanding on Commitments in Financial Services*, B.10(d).

¹³ WTO, *Understanding on Commitments in Financial Services*, B.7.

governmental bodies in the exercise of powers delegated by” any level of government.¹⁴ Thus, GATS regulatory constraints cover private-sector bodies that have a role delegated or approved by government, such as professional associations or industry bodies whose professional qualifications or voluntary “code of conduct” rules are recognized by governments.

There is a common misunderstanding that GATS only affects domestic policies that discriminate against foreign service-sector firms. In fact, GATS does much more than curb discriminatory laws, such as citizenship and residency requirements. GATS – through its Article XVI “market-access” rules noted above – creates certain absolute rights for foreign investors who acquire, invest in or establish service-sector operations within the United States in sectors covered by U.S. GATS commitments. These market-access requirements are extraordinary, as they simply ban certain types of policies – unless a country originally listed them as exceptions in their GATS schedules in the 1990s – even when they are applied equally to foreign and domestic services or suppliers. The following are forbidden: “*limits on the number of service suppliers, including through quotas, monopolies, economic needs tests or exclusive service supplier contracts; limits on the total value of service transactions or assets, including by quotas or economic needs tests; limits on the total number of service operations or the total quantity of a service; limits on the total number of natural persons that may be employed in a particular service sector; policies which restrict or require specific types of legal entity or joint venture through which a service supplier may provide a service.*”¹⁵

There is nothing quite like the GATS market-access rules in any other international commercial treaty. These market-access rules are framed in absolute, rather than relative terms, pre-judging certain types of public policies and practices whether they are discriminatory or not. In other words, non-discriminatory regulations (such as the now defunct Glass-Steagall firewalls) can violate GATS rules even if they treat domestic and foreign firms identically, but hinder some foreign firms from offering the full range of services they are allowed to offer in their home country.

GATS Annex on Financial Services contains a “Domestic Regulation” provision that makes clear that only countries’ domestic financial stability measures that are not “used as a means of avoiding the Member’s commitments or obligations under the Agreement” are permissible if they do not conflict with the pact’s deregulation requirements.¹⁶ That is to say, even if regulatory measures are taken for prudential reasons, they are not safeguarded from the WTO’s array of deregulation requirements, if they in effect undermine these regulatory constraints. Some have disingenuously called this provision the “prudential exception” or “prudential carve-out,” but because it is self-cancelling, it in fact provides no safeguard for financial stability measures that may conflict with the WTO deregulation obligations. Bizarrely, given the loophole already eviscerating the provision, the financial service industry has been lobbying in the context of ongoing GATS negotiations for a narrow interpretation that would limit “prudential” measures to regulations concerning only solvency and financial disclosure.¹⁷

¹⁴ WTO GATS Article I-3-a-ii.

¹⁵ WTO GATS Article XVI.

¹⁶ *Annex on Financial Services*, paragraph 2(a) states that “Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement.”

¹⁷ The Commission on the Future of Health Care in Canada, summary report on Globalization and Health, *Putting Health First: Canadian Health Care Reform, Trade Treaties and Foreign Policy* (prepared by the Canadian Centre for Policy Alternatives), October 2002. Available at <http://www.healthcarecommission.ca>.

Conclusion

At issue is a political question of whether countries now calling for financial reregulation intend to actually reverse the extreme deregulation paradigm implemented by the WTO. The financial interests closely involved in establishing the WTO deregulation regime are keen to avoid real reform at either the national or international levels. But failure to remedy the existing WTO financial service deregulation requirements and eliminate further Doha Round financial service deregulation will fuel public ire against the current terms of globalization generally and the WTO specifically.

As a legal matter, these problems are easy to remedy:

- **Real safeguards for financial stability measures:** The current WTO provisions that fail to safeguard financial service prudential measures must be revised to ensure that financial stability measures are truly safeguarded from attack at the WTO. Countries must be able to define for themselves what prudential regulations are required to ensure financial stability and provide a default in favor of such measures' sanctity, while also providing a means for countering attempts to abuse such a designation. For instance, the current Article 2(a) of the GATS Annex on Financial Services must be replaced with the following language to ensure that prudential measures are not subject to WTO challenge, and similar revisions must be made to other U.S. trade and investment pacts:¹⁸

“Domestic Regulation: Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from adopting or maintaining measures relating to financial services it employs for prudential reasons, including for the protection of consumers, investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system. For greater certainty, if a Party invokes this provision in the context of consultations or an arbitral proceeding initiated under the Dispute Settlement Understanding, the exception shall apply unless the Party initiating a dispute can demonstrate that the measure is not intended to protect consumers, investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or is not intended to ensure the integrity and stability of the financial system.”

- **First, do no further harm:** There should not be further financial service deregulation in any international agreement coming after the hard-learned lessons of the crisis. Practically, this means that the demands and offers on financial services should be taken off the Doha Round negotiating table. There should be a moratorium on financial service commitments for countries now negotiating terms of accession to the WTO, given that the crisis has the proven perils of the extreme deregulation model. Further, the financial service provisions of the pending FTAs with Korea, Panama and Colombia must be renegotiated.
- **Existing WTO and FTA terms that limit financial reregulation should be renegotiated.** This includes elimination of the Understanding on Commitments in Financial Services.

¹⁸ For more information, see Testimony of Todd Tucker, Research Director, Public Citizen's Global Trade Watch Division, For Public Meeting of the Administration Review of the U.S. Model Bilateral Investment Treaty Program, July 29, 2009, at U.S. State Department. Available at: http://www.citizen.org/hot_issues/issue.cfm?ID=2323.

Revoking this text would eliminate the most extreme financial deregulation rules that apply to countries like the United States, Nigeria and most developed nations. As well, the deregulatory elements of the GATS market access rules – namely GATS Article XVI(2) – should also be eliminated. This is the provision that forbids governments from employing nondiscriminatory limits on the size of banks, securities and insurance firms if they agree to provide market access – i.e. to “liberalize” such sectors. Getting rid of this text restores the policy space to address the “too big to fail” problem. Effectively, this change would separate out commitments to provide market access from requirements to simultaneously deregulate such offered sectors.

- **New constraints on all service sector domestic regulations now under negotiation in the Doha Round must be jettisoned.** Given the brutal lessons the current crisis has provided with respect to the perils of extreme financial service sector deregulation – and the Enron scandal provided with respect to energy service deregulation – the WTO GATS Working Group on Domestic Regulation should simply be shut down, and its draft agreement scrapped. There is no excuse for having such a negotiating group, whose remit is to limit domestic regulation at the very time WTO countries are committed to reregulating.
- **Scrap proposed new limits on regulations of the accountancy sector.** If the Doha Round were concluded, one of the texts that would be *automatically* implemented is new “disciplines” to restrict non-discriminatory regulations in the accounting sector. These disciplines, which the now defunct Arthur Anderson firm helped formulate, will restrict accounting regulations to what WTO tribunals judge “necessary,” putting pressure on governments to deregulate as much as possible. This text should be scrapped.

Unless the changes noted above to the WTO financial service terms are implemented, WTO signatory countries should agree to a period during which existing WTO financial services commitments may be withdrawn without being required to negotiate terms of compensation according to normal WTO rules. Either the deregulatory aspects of the WTO financial service terms must be remedied through multilateral negotiations as part of the global reregulation effort, or countries must be allowed to safeguard their domestic reregulation efforts by withdrawing from WTO commitments that undermine such efforts.

Public Citizen is a national nonprofit advocacy organization based in Washington, D.C. This primer is prepared by Public Citizen’s Global Trade Watch division. For more information, please visit www.tradewatch.org. Our blog, EyesOnTrade.org, provides breaking news an analysis on an array of globalization and trade matters.