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Memo to Reporters

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Elimination of WTO's Radical Financial Service Deregulation Requirements Must Be Addressed at Nov. 15 Summit

Amidst breathless calls for expansive new global financial services regulation issuing from all quarters 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. Deregulation (not only liberalization) of the financial service sector – including banking, insurance, asset management, pension funds, securities, and more – has been among the most important, but least discussed, aspects of the WTO.

Yet, in the lead up to this Saturday's G-20 Global Financial Crisis Summit in Washington, the only comments regarding adherence to global trade rules have been of the red herring variety: panicky warnings about the perils of countries lifting tariffs to block imports in response to dire economic conditions – something no country has proposed.

However, in recent weeks, the Bush administration and governments worldwide have taken various measures to counter the crisis that contradict the fundamental precepts of the current globalization model – and in some cases violate the rules implementing this model, such as those of the WTO. Plus, 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 ceded to the WTO a decade ago.

Remedying the crisis will require significant changes to the WTO's General Agreement on Trade in Services (GATS), and specifically its 1997 Financial Services Agreement (FSA). Generally, these pacts lock in domestically and export worldwide the extreme financial services deregulatory agenda favored by the world's banking and insurance giants that fostered the crisis. Specifically, these pacts contain binding commitments by more than 100 countries to stay out of the business of regulating financial services.

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 by mainly OECD countries that include a "standstill" commitment – meaning we are forbidden from rolling back deregulation (or liberalization) for the expansive financial services we bound to

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.

comply with WTO rules.² Translated out of GATsese, 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 elimination of domestic 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 financial service suppliers are permitted “to offer in its territory any new financial service,”⁴ a direct conflict with the 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, which forbid bank holding companies from operating other financial services, applied such firewalls as to avoid a repeat of the financial collapse that occurred during the Great Depression. While the law applied to domestic and foreign banks alike, it had the effect of preventing foreign banks that combined commercial and investment banking services from entering the U.S. market. Various U.S. GATS “market access” commitments in banking services guarantee such access. The Clinton administration, which conducted WTO FSA negotiations, recognized this conflict and indeed made a commitment listed in the U.S. GATS schedule to “fix” this problem.⁵ The provisions of Glass-Steagall 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 WTO’s 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 limit that the United States has listed regarding regulation of derivatives is banning onion futures – no kidding.⁶

Few in Congress even reviewed the thousands of pages comprising the Uruguay Agreements Act in 1994 that implemented WTO. With this Fast Tracked vote, Congress bound nearly 100 sectors of the U.S. service economy to GATS constraints with little understanding or discussion. The 1997 WTO FSA, which imposed drastic new limits on Congress’ regulatory authority over financial service, 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 Congress was supposed to be regulating for the public interest.⁷

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 GATS locks in the U.S. status quo at a time of unprecedented financial liberalization and foreseeable damage wrought by this model to the U.S. and global economy.

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).

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

⁵ WTO, *United States of America Schedule of Specific Commitments Supplement 3*, Additional Commitments Paper II, WTO document GATS/SC/90/Suppl.3.

⁶ 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.”

⁷ Pierre Sauve and Karsten Steinfatt, “Financial Services and the WTO: What Next?” at 353. “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. The sector was truly unique in 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.”

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 105 other WTO signatory countries who adopted the Financial Service Agreement. 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 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 others – that flaunt existing WTO terms because doing so is the necessary course of action to counter the crisis.

Background: Prior to 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.”⁸ 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 all but one case, regarding the European Union’s ban on artificial growth hormones in meat, 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 being forwarded now to address the financial crisis requires reference to several texts. 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” and by a 1997 WTO “Understanding on Financial Services.” The Annex is part of the original WTO text and applies to all countries while the Understanding was agreed to later by a shorter list of mainly developed nations. The United States is one of mainly developed countries that signed the Understanding, so 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.

The WTO Secretariat was unusually direct in describing the operation of the GATS: “*Governments are free in principle to pursue any national policy objectives provided the relevant measures are compatible with the GATS.*”⁹ 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-governmental bodies in the exercise of powers delegated by” any level of government.¹⁰ Thus GATS regulatory constraints cover private-sector bodies that have a role delegated by or approved by government, such as professional associations or industry bodies whose professional qualifications or voluntary “code of conduct” rules are recognized by governments.

⁸ WTO, Agreement Establishing the WTO, Article XVI-4.

⁹ WTO Secretariat. Trade in Services Division, “Everything You Wanted to Know about GATS but Were Afraid to Ask,” October 1999, at 5.

¹⁰ WTO, General Agreement on Trade in Services, Article I-3-a-i.

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. The GATS – through its “Market Access” rules – 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.”*¹¹

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 Act) can violate GATS rules if they unintentionally operate to prevent foreign firms from entering or operating in the U.S. market.

GATS contains a “carve-out” provision that supposedly ensures that the agreement will not undermine domestic laws or regulations – such as those designed to protect investors, depositors, and policyholders, or to ensure the safety and integrity of the financial system.¹² However, this ostensible guarantee is largely eviscerated by several significant loopholes. First, the putative carve-out contains a classic WTO circumvention clause that negates the ability of countries to actually safeguard a domestic policy that conflicts with WTO obligations. The clause starts by noting that countries shall not be prevented from establishing financial service regulatory policies for “prudential reasons,” but then continues by stating: “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.” That is to say that even if regulatory measures are taken for prudential reasons, they are subject to challenge if they in effect undermine the regulatory constraints otherwise established in the agreement. Moreover, the definition of “prudential” is left undefined in the GATS. Thus the question of what constitutes a “prudential” regulation is subject to interpretation by WTO dispute resolution panels were a domestic law challenged. Moreover, 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.¹³

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¹¹ WTO General Agreement on Trade in Services, Article XVI.

¹² WTO, General Agreement on Trade in Services, *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 owned 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.”

¹³ 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>