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NOTES ON GATS RULES FOR INTERNATIONAL TRADE IN BANKING SERVICES FOR PUBLIC FORUM AT WTO, 26 September 2012

Challenges to the political and intellectual assumptions of the GATS rules on banking

Negotiation of the GATS rules for banking was completed in the early 1990s, though countries' commitments only became part of the agreement after negotiations were completed at the end of 1997. While the GATS rules and commitments were actually being negotiated, the overwhelming presumption of policy makers in advanced countries was that benefits from the liberalisation of cross-border financial transactions and of restrictions on the commercial presence of foreign banks would accrue not only to their own financial institutions but also more generally to other economies. It was this presumption which largely shaped the outcome of the Uruguay Round negotiations on financial services despite reservations expressed principally by some developing countries. As a result the GATS rules have much more to say about what should be the limits on counties' regulations, where these are a potential impediment to international trade in financial services, than about the contents of the right to regulate and the development of the statistical data required for valuing offers and commitments, compensation in disputes, and procedures for safeguard actions.

Since the early 1990s the international banking landscape has undergone far-reaching changes. Some of these changes have important implications for regulation, especially in the light of experience during the financial crisis. Of special importance here are transactional innovations, which have required substantial revision of the Basel rules for banks' capital and risk management; greater acknowledgement of the connections between financial stability and macreoeconomic policy, which is leading to the development of guidelines for macroprudential policy; and the greater role in international financial markets of Large Complex Financial Institutions, whose size and the diversification of whose activities have the consequence that their failure is capable of posing systemic threats to financial stability. Moreover the large and potentially destabilising capital flows experienced in connection with the crisis has led to further rethinking concerning the role of capital controls as a protective measure and of the relation between such controls and prudential measures.

The bail-outs of large banks in the United States and some Western European countries since the beginning of the financial crisis, arguably the largest programme of sectoral support by governments in modern history, have implications for policy towards the granting by countries of market access to foreign banks that have benefitted directly or indirectly from such support. The scale of the subsidisation which this life-support has entailed is markedly at variance with assumptions about the overall soundness of the financial sectors of developed countries prevalent in the early 1990s, which, understandably, were part of the mind-set of the negotiators of the GATS rules.

So far negotiations and other work on banking services in the WTO have seemed little affected by the need for fundamental rethinking in the light of the experience of the financial crisis. However, international initiatives currently being developed in other international institutions are likely to produce a substantially reformed Global Financial Architecture.

Specific concerns
A number of specific concerns have been raised by the Stiglitz Commission, UNCTAD, Barbados at the WTO, and NGOS such as Public Citizen (PC).

The basic concern of the *Stiglitz Commission* is that the GATS may restrict the ability of governments reform the regulatory structure in desirable ways. The Commission has given special attention in this context to the containment of financial contagion. The Commission devotes special attention to the following issues:

- the respective roles of home and parent versus host country regulation where the Commission supports an expansion of the latter;
- the vexed question of cross-border bank insolvencies, especially those of institutions too large or too complex to be allowed to fail;
- the consistency of agreements on international trade in banking services with an inclusive and comprehensive international regulatory framework which is not based on the assumption that there should be no presumption that *eventually* there should be full liberalization" This follows from questioning of the benefits of financial liberalisation due to the crisis and more particularly questioning of the poor risk management demonstrated during the crisis by many foreign banks.

Like the Stiglitz Commission *UNCTAD's 2011 TDR* expresses concern as to constraints regarding regulation, reregulation and capital controls due to the GATS rules. Amongst particular points raised by UNCTAD are ambiguities in these rules on capital controls which are capable of rendering illegal the use of such controls in several situations. Moreover UNCTAD also draws attention to the danger that unfavourable interpretation of the specification of financial services in a country's GATS commitments could be used as the basis of challenges to the banning of products which experience has shown to be highly risky.

The 2011 communication of Barbados to the WTO Committee on Trade in Financial Services (WTO, 2011) raises the question whether the financial crisis should lead to a revision of the GATS rules. According to the communication: "the crisis has served to highlight flaws in the global regulatory and compliance environment which hamper the implementation of corrective measures and in some cases make them open to challenge...they point to a need to review some aspects of the global rules including WTO GATS rules...so as to permit remedial measures to be implemented without running the risk of having them viewed as contraventions of commitments...It has been suggested that the prudential carve-out in the GATS permits members to take action on the grounds such action is prudentially required. However, when there is an increasing number of exceptions being introduced on prudential grounds, then this may be a sign that the basic rules need to be addressed."

Some of the subjects which are taken up in the communication of *Barbados* to the WTO Committee on Trade in Financial Services are part of the basic GATS rules and others are relevant only to countries which undertake commitments according to the form prescribed in the Understanding on Commitments in Financial Services. Here I shall concentrate on subjects which are part of the basic GATS rules.

The communication of Barbados draws attention to the following subjects: the provisions on payments and transfers (Article XI of the GATS); restrictions to safeguard the balance of payments

(Article XII of the GATS); limitations on the total value of service transactions or assets as part of the granting of market access (Article XVI of the GATS); and restrictions on the legal form of entities granted such access (also Article XVI of the GATS).
Articles XI and XII of the GATS are designed to address corrective measures adopted in response to traditional balance-of-payment difficulties due to deficits in external payments. The communication of Barbados argues that experience during the crisis suggests that safeguard measures under the GATS should be extended to preventive, i.e. presumably pre-emptive, as well as corrective measures. Moreover the gamut of situations in which safeguard actions would be permitted under GATS rules should be extended to include potential threats to financial stability other than balance-of-payments crises such as heightened systemic risks to a country's financial system and excessive levels of public and private indebtedness.

The communication of Barbados draws attention to limitations on the numbers of service suppliers and on the value of services transactions or assets among the impediments to market access which should be scheduled in commitments according to Article XVI. However, the specification of such limitations as appropriate subjects for WTO scheduling seems anomalous in the light of new regulatory rules on the size of Too Big To Fail financial firms or on the range of their activities and thus the services which they supply - regulatory rules which are now a major part of the agenda for a new global regulatory architecture for finance. A similar point is made in the communication of Barbados concerning Article XVI's inclusion of measures which restrict or require specific types of legal entity among the limitations on market access to be specified in a country's commitments. This too now seems anomalous owing to the new emphasis in regulatory thinking on the appropriateness as part of the conditions for granting market access to foreign financial institutions of the requirement for incorporation as a local subsidiary on the grounds that such incorporation provides local regulators with greater legal authority (a point also made in the report of the Stiglitz Commission).

In a wide-ranging set of criticisms Public Citizen (PC) commentators devote special attention to the GATS rules concerning capital controls and the Prudential Defence Measure of the Annex on Financial Services. The PC commentators question whether these rules provide countries with sufficient flexibility regarding use of such controls or regarding the justification on prudential grounds of particular regulatory measures and of the updating or strengthening of regulatory regimes. Special concerns of the PC commentators include regulatory bans of financial products classified as excessively risky, rules for limitations on market access and restrictions on the range of activities of financial firms; the locking-in of certain forms of deregulation and cross-sectoral retaliation.

In June 2012 *Ecuador* submitted a proposal that the WTO should monitor and review developments related to the global financial crisis owing to the importance indicated by the crisis of a safe regulatory framework assuring WTO member states of the availability of policy tools to prevent intensification of the crisis. Ecuadors' main concern is systemic – that member countries should have the capacity to safeguard the stability of their financial systems on the basis of a clear, agreed understanding of WTO regulations. Here Ecuador focuses in particular on the possible outcomes of discussions on new forms of macroprudential regulation and of techniques of managing cross-border capital movements. At approximately the same time WTO conducted a workshop on trade in financial services and development. During the workshop participants considered the contribution which financial services are capable of making to economic

development, the challenges faced by those designing and implementing financial regulation and supervision in the increasingly globalized environment, and interactions between the liberalization of financial services, regulation, and financial stability.

Ecuador here is echoing an underlying theme of many of the caveats recently expressed concerning the GATS - caveats which are directed at the need for measures addressing the interconnectedness, especially in difficult market conditions, of categories of risk hitherto addressed separately – an interconnectedness previously classified under the heading of systemic risk but now renamed macroprudential risk. As a recent report of the Group of Thirty puts it, macroprudential policy "aims to enhance the resilience of the financial system and to dampen systemic risks that...propagate internally in the financial system through the interconnectedness of institutions... and the tendency of financial institutions to act in procyclical ways that magiify the extremes of the financial cycle. Macroprudential policy uses many of the tools of prudential supervision...but apples them with the goal of reducing systemic risk and increasing the resilience of the financial system to absorb such risk. Recognizing the complementary nature of macroprudential and other areas of economic policy, supervisors charged with implementing macroprudential policy...must inform and be informed by monetary, fiscal and other government policy, while giving due regard to the primary responsibility of the entities in these areas".

From the point of view of developing countries the increased emphasis under macroprudential policy on the links between the stability of the financial sector and macroeconomic stability more generally leads logically to greater acknowledgement of the links between macroeconmic stability and development policy, since in such countries there is an integral connection between such stability and the achievement of development objectives. Such links are evident in the particularly severe threats which macroeconomic instability poses to the livelihoods of people with very limited means and limited or non-existent access to social safety nets, and to the disruption of the investment required for structural transformation. The importance of the links between macroprudential, macroeconomic and development policies is increasingly acknowledged, at least implicitly, in a number of publications of multilateral financial institutions. This acknowledgement is reflected, for example, in thinking about the appropriate policy response to the large and potentially destabilising capital inflows experienced by some emerging-market countries since the outbreak of the financial crisis. That prudential measures and capital controls are closely related substitutes for the purpose of avoiding macroeconomic instability from this source is now much more widely accepted.

Practicalities, data and measurement under GATS rules

In several areas the absence not only of statistical data but also of generally established measurement procedures is likely to prove a serious impediment to application of the GATS rules to international trade in banking services. For example, the resulting problems include valuing countries' commitments, especially under Modes of Supply 1 and 3, the assessments of trade in banking services prescribed under Article XIX, and estimating the effects of emergency safeguard measures and subsidies (once rules concerning these subjects have been negotiated) as well as the effects of the modification of schedules.

In the case of schedule modification not only statistical data but also guidelines as to how measurement should be carried out are lacking. How, for example, might one measure the effect of the withdrawal of a commitment to grant market access to banks in the legal form of a branch

and replace it by the more restrictive requirement of a commitment limited to subsidiaries (a matter covered by Article XVI(e) of the GATS) ?

Statistical and methodological problems were the inevitable consequence of the much more widespread and intrusive extension of multilateral trade rules into subjects covered by countries' domestic regulatory regimes which resulted from the outcome of negotiations on international trade in services in the Uruguay Round. (The traditional purview of the GATT did not pose such problems, since international trade in goods benefits from long-standing systems of data collection and techniques of analysis at both international and national levels.) However, at the time when the GATS was negotiated, policy makers from major developed countries did not consider deficiencies of statistical data a serious obstacle to the undertaking of commitments as to the liberalisation of cross-border services transactions owing to the widespread conviction in such countries that liberalisation would benefit the countries granting improved market access as well as those seeking it. This view was not necessarily shared by the developing countries potentially facing substantial losses of policy sovereignty. However, the issue was sidelined during the Uruguay Round negotiations, and only in 2002 was a manual published on statistics for international trade in services. However, this manual does not address the important practical problems of developing statistics for international trade in banking services.

Possible ways forward
Many of the critics of the GATS suggest revising particular GATS rules.

For example, the PC commentators propose that the contentious second sentence of the Prudential Defence Measure of the Annex on Financial Services ("Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Members' commitments or obligations under the Agreement") be replaced with the following: "For greater certainty, if a Party invokes this provision [the Prudential Defence Measure] 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". The intention here is that the burden of proof in cases in which recourse to the Prudential Defence Measure is challenged would be more explicitly the responsibility of the challenger.

A more ambitious revision of the GATS rules which would reflect the thrust of many of those those supporting revision would be to include a concrete spelling-out of the scope of governments' right to regulate the financial sector in the Annex on Financial Services – a revision which would also require a note to Article XVI.2 cross-referencing its implications for the Article's specification of limitations to market access to be included in countries' schedules.

If a decision were taken to proceed to a revision of the GATS rules, such a revision would presumably be made in accordance with Article X.5 of the Marrakesh Agreement Establishing the World Trade Organisation which states the following: "Except as provided in paragraph 2 above [which references the provision concerning Most-Favoured-Nation Treatment in Article II.1 of the GATS], amendments to Parts I, II, an III of the GATS and the respective annexes shall take effect for the Members that have accepted them upon acceptance by two thirds of the Members and

thereafter for each member upon acceptance by it". However, that revision is possible under WTO rules does not imply that it would be anything but extremely difficult to achieve the required degree of consensus concerning such a change among member countries.

Another possible way forward would be simply to rely on hope that negotiations on banking services will be consigned to a back burner (possibly as part of a similar fate for other issues which have been negotiated as part of the Doha Round). This might be described as the strategy of "letting sleeping dogs lie". However, such hope may reflect excessive optimism as to the likelihood that the dogs will indeed not be awakened owing to the zeal of countries determined to push financial liberalisation through the WTO. There is thus a strong argument that the likely continuation of such pressures justifies recourse to an explicit multilateral decision rather than reliance on the more passive process of consignment to a back burner.

What might such a decision involve? One possibility might be a decision to suspend negotiations on financial services *sine die*. This would end pressures on developing and emerging-market countries through (plurilateral or multilateral) negotiations to undertake commitments to liberalisation which not only might be against their perceptions of their best interests but which might also actually compromise introduction of domestic banking reforms that are an appropriate response to the experience of the financial crisis. Such a suspension might leave in place for some countries what are now inappropriate commitments undertaken during the Uruguay Round negotiations. In favour of such a suspension it is reasonable to assume that regulatory changes inconsistent with these commitments which could none the less be defended under the existing Prudential Defence Measure would not be subject to challenge under Dispute Settlement.

An alternative approach to dealing with the still uncertain scope of the Prudential Defence Measure would be for countries themselves to include in the headnotes to their schedules those parts of their regimes of prudential regulation which they believe should not be subject to challenge. Agreement on permission to so proceed should be easier than agreement on revision of the GATS rules. The WTO secretariat views such inclusion as unnecessary, recommending sole reliance on the Prudential Defence Measure. But this has failed to carry general conviction. It might also be argued that inclusion in countries' schedules of text from national prudential regulation would make the already lengthy GATS agreement unwieldy. However, inclusion of actual text in the GATS could be replaced by the more concise solution of specification of hyperlinks to the address where the relevant text would be available.

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