Auto Safety • Congress Watch • Energy Program • Global Trade Watch • Health Research Group • Litigation Group
Joan Claybrook, President

Background Paper

The WTO's General Agreement on Trade in Services (GATS): Implications for Regulation of Financial Services in the U.S.

SUMMARY: Deregulation of the financial service sector – including banking, insurance, asset management, pension funds, securities, financial information, and financial advisory services – has been among the most important, but least discussed aspects of the World Trade Organization's (WTO) agenda since its 1995 inception. As part of its original WTO commitments, the United States agreed to conform a broad array of financial services to comply with regulatory limits established in the WTO's General Agreement on Trade in Services (GATS). Given the decade-plus push by various financial service firms to roll back domestic regulation, some of the U.S. WTO commitments simply locked into place existing policies. In other cases, for instance regarding the "firewall" policies established in the 1933 Glass-Steagall Act that forbade bank holding companies from operating other financial services, U.S. WTO commitments that contradicted domestic policy were used to push for domestic revocation of existing laws. The United States then used ongoing WTO financial service negotiations to export the U.S. model of extreme financial service deregulation to the other 100-plus WTO signatory countries, including through a 1999 WTO Financial Service Agreement (FSA.)

***

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 particular economic model often known as neoliberalism. WTO, NAFTA and various NAFTA-modeled "Free Trade Agreements" (FTAs) include binding rules that limit the parameters for signatory nations' service-sector, investment, procurement, intellectual-property, environmental and safety policies. In addition to this deregulatory agenda, the pacts establish new property rights regarding intellectual property and foreign-investor treatment.

Each WTO signatory country is required to "ensure the conformity of its laws, regulations and administrative procedures with its obligations."[1] 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

[1] WTO, Agreement Establishing the WTO, Art. XVI-4.

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.

Various WTO, NAFTA and FTA provisions set constraints on how signatory governments may regulate their service sectors. The WTO's General Agreement on Trade in Services, for instance, was established as one of the original WTO agreements in 1995. It applies not only to trade in services *between* countries, but also sets limits on governments may regulate foreign services operating *within* their countries. It also contains two Annexes on Financial Services that set explicit rules in that sector.

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*."[2] 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.[3] 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 government.

Although the U.S. Congress gave the GATS little scrutiny, it was very controversial in other nations. For this reason, while the United States originally sought for GATS rules to apply to all service sectors of all WTO signatory countries, in the end GATS was designed so that it applies only to those service sectors that countries bind to the rules through country-specific "schedules of commitments." In exchange for this compromise, the United States obtained a commitment for talks on further financial service liberalization to be automatically begun under the newly established WTO.

As part of its original 1995 WTO commitments, the United States agreed to conform a broad array of financial services including banking, insurance and other financial services to comply with GATS rules. Given the decade-plus push by various financial service firms to roll back domestic regulation, some of the U.S. WTO commitments simply locked into place existing U.S. policies. Because the GATS includes a "standstill" rule – meaning countries may not roll back liberalization and deregulation once a sector is bound to GATS – these U.S. commitments imposed a limit on future congressional action regarding financial service regulation. This GATS rule made many developing countries unwilling to make broad GATS commitments in financial services. Developing countries that had suffered financial turmoil – and seen the need to develop new

---

[2] WTO Secretariat. Trade in Services Div, "Everything You Wanted to Know about GATS but Where Afraid to Ask," October 1999, p. 5.

[3] WTO GATS Article I-3-a-i.

government policies in response – already had experienced the perils posed by such constraints on policy space imposed by the International Monetary Fund and the World Bank.

In other cases, U.S. WTO commitments represented the *aspirations* of powerful financial service firms who were continuing their domestic push for deregulation. These firms pushed for U.S. WTO commitments that would then be used domestically to push Congress to change existing laws to conform to WTO requirements. For instance, U.S. financial service firms had been working to repeal the Glass-Steagall Act of 1933 which forbid bank holding companies from operating other financial services. The law had been created to establish "firewalls" between various financial services so that trouble in one sector would not contaminate the entire system and cause the sort of financial collapse that occurred during the Great Depression. This firewall policy, which applied to domestic and foreign banks, had the effect of preventing foreign banks that combined commercial and investment banking services from entering the U.S. market. By making "market access" commitments in various banking services, the Clinton administration created a conflict between U.S. WTO obligations and existing U.S. law. The administration recognized this conflict and indeed made a formal commitment listed in the U.S. GATS schedule to support changes to the Glass-Steagall Act.[4] The provisions of Glass-Steagall that prohibited a bank holding company from owning other financial companies were repealed in 1999 with passage of the Gramm-Leach-Bliley Act.

The United States then used ongoing WTO financial service negotiations to export the U.S. model of extreme financial service deregulation to the other 100-plus WTO signatory countries, including through a 1999 WTO Financial Service Agreement (FSA). The push for further liberalization continues. The WTO Doha Round negotiations – initiated in 2001 – included GATS talks that are aimed at further liberalizing financial services, among other service sectors. To date, however, there has been little policy research or public debate on the potential implications of GATS for regulation of financial services in the United States. This lack of debate is significant because GATS, the FSA and the ongoing talks to further liberalize trade in financial services have far reaching implications.

Constraints on Financial Service Regulation Pose Serious Threats to Consumer Protection[5]

A growing proportion of U.S. retirement savings are now invested in mutual funds, insurance annuities and bank savings. Over the past two decades, numerous U.S. employers have replaced traditional "defined-benefit" pension plans that pay out certain amounts during retirement with "defined-contribution" plans. Such defined contribution plans provide employees with funds annually that the employee is to invest. Much has been written about how this trend – branded as a key element of the "Ownership Society" – shifts risk onto retirees, shifts costs off of employers, and created a huge new market for financial service firms. Whatever one's view of the trend, it is clear that under this new reality, a broad array of Americans' retirement security rests increasingly on effective regulation of the financial services sector.

---

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

[5] The following sections summarize portions of a background paper written for the TransAtlantic Consumer Dialogue by Patricia Arnold, Associate Professor, School of Business Administration, University of Wisconsin-Milwaukee, September 2002. *See* http://www.tacd.org/events/meeting5/P_Arnold.doc.

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.[6] 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. Are consumer protections that outlaw unfair and deceptive marketing practices by securities dealers (or insurance companies) "prudential" measures? Are banking laws that cap interest rates, or outlaw red-lining and predatory lending practices "prudential" regulations? Arguably not. The lack of clarity means that an array of laws are subject to WTO threats, which often have a chilling effect in policy initiatives even in the absence of a formal challenge. 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 solvency and financial disclosure.[7]

Regulatory Constraints Cover Policies that Treat Domestic and Foreign Firms Alike

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;*

---

[6] *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."

[7] 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

- *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."*[8]

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.

The implications of the GATS Market Access rules on limiting vital domestic regulatory space cannot be overstated. For instance, consider the ban on establishing new monopolies. Many nations that have privatized services that were operated by the government did so by creating private, heavily regulated not-for-profit monopolies. U.S. examples of such monopolies are Fannie Mae and Freddy Mac, which are government-sponsored, but which operate in the "free market" and guarantee a secondary mortgage market. Other privatization methods barred by GATS rules include establishment of a limited number of competing private for-profit firms, or requirements that a private entity operate as a non-profit corporation.

In addition, specific U.S. commitments to curb non-discriminatory laws are more extensive for financial services than they are for any other service sector. For example, the United States is obligated to endeavor to remove (or limit the effects of) U.S. laws and regulations that "*adversely affect the ability of financial service suppliers of any other (WTO) Member to operate, compete, or enter*" the U.S. market.[9] This commitment is extraordinary because it explicitly applies to laws and regulations that are otherwise consistent with GATS.

In addition, GATS empowers the WTO to develop "disciplines" (rules) to ensure that domestic licensing, qualification and technical standards are "not more burdensome than necessary to ensure the quality of the service."[10] The financial services sector is affected because regulation of banks, insurance companies and capital markets depends heavily on technical standards such as capital adequacy and financial disclosure rules, and on qualification and licensing requirements for brokers, agents, and dealers. U.S. laws may eventually be subjected to "necessity tests" under GATS disciplines that would put the burden on the United States to ensure that our domestic standards are not unnecessarily trade restrictive. Such GATS disciplines have already been drafted for the accountancy sector. The accountancy disciplines mandate that licensing, qualification and technical standards governing accounting and auditing may not be "more trade restrictive than necessary."[11]

---

[8] WTO GATS Article XVI
[9] WTO, *Understanding on Commitments in Financial Services,* paragraph 10(d).
[10] *GATS,* Article VI:4(b).
[11] WTO, *Disciplines on Domestic Regulation in the Accountancy Sector,* 14 December 1998, WTO document PRESS/118. The accountancy disciplines will become effective at the conclusion of the current GATS round in 2005. The WTO adopted a standstill provision that prevents WTO members from enacting new legislation in the interim that

The Sarbanes-Oxley Act of 2002, which limits the type of consulting activities that auditing firms can engage in, could conceivably be challenged within the WTO as an unnecessary barrier to trade.[12] Indeed, various foreign financial service firms have hurled charges of WTO incompatibility at the law. Even without a formal legal challenge, GATS could have a chilling effect on U.S. efforts to regulate financial markets. For instance, foreign companies that list stock on U.S. exchanges have sought exemption from Sarbanes-Oxley on the grounds that the Act discourages international trade in securities and violates international treaties.[13] Exemptions for foreign firms would give U.S. firms additional incentives to move offshore, and further undermine U.S. attempts to regulate its capital markets in the wake of recent accounting and securities scandals.

Exporting Radical Financial Service Deregulation through the WTO

Lack of conformity in the laws and regulations of trading partners are deemed by many in industry to hinder the free flow of international trade in goods and services. To make global investment and trade in financial services seamless, GATS encourages harmonization (i.e. standardization) of laws, regulations and administrative procedures governing banking, insurance, securities and accounting. In addition to the U.S. push for countries to take financial service commitments under GATS and the FSA, this push for regulatory uniformity poses unreasonable risks. The U.S. push for WTO coverage of financial services was a means to export the U.S. deregulatory model worldwide, harmonizing other countries' regulatory systems to the U.S. model.

GATS provides powerful incentives for global harmonization of banking, insurance, securities and accounting standards. Harmonization is not as benign as the term implies. International standard-setting moves decision-making out of the hands of state and federal government and into international arenas that are less accessible, accountable, or responsive to consumers. Rather than raising standards, international harmonization can precipitate a "rush to the bottom," resulting in lower standards, weaker consumer protections, and the watering down of the best investor safeguards in WTO signatory countries. Rather than creating a minimum threshold that all countries must meet, the WTO considers international standards as a ceiling that countries may not exceed. GATS sets up international banking, insurance, securities, and accounting standards as the yardstick that WTO dispute-resolution panels will use to judge whether a nation's domestic standards are more trade restrictive than necessary.[14] Since it is difficult to defend domestic standards that exceed international standards, GATS serves as a downward ratchet.

---

is inconsistent with the disciplines (WTO Council for Trade in Services, *Decision on Disciplines Relating to the Accountancy Sector,* 14 December 1998).

[12] When the accountancy disciplines were being drafted, the issue of whether it is overly burdensome or restrictive to limit the activities or combinations of services performed by accounting firms was raised by the United States (WTO, Working Party of Professional Services, "*Elements to be Addressed in Developing Disciplines for Professional Services: Accountancy Sector",* 20 June 1997, WTO document S/WPPS/W/15).

[13] "Corporate Cleanup Stings Foreigners," *The Wall Street Journal",* Aug. 12, 2002. The *WSJ* reports that the President of the Japanese Institute of Certified Public Accountants, in a letter to his U.S. counterpart, argued that Sarbanes-Oxley "clearly violate international treaties."

[14] *GATS,* Article VI:5(b).

Conclusion

In the final analysis, the WTO agreements have more to do with governance than with trade. Over the past century, U.S. financial regulation has shifted from strict financial controls over banking and capital markets following the Great Depression, to periods of deregulation in the 1980s and 1990s. The WTO GATS locks in the U.S. status quo at a time of unprecedented financial liberalization, and exports this model worldwide. Whether this extreme deregulatory model is beneficial to most people – or sustainable – is a highly contested question. By imposing the model worldwide, the WTO GATS subjects millions of people to becoming unwilling guinea pigs in a radical policy experiment. And, if the experiment goes bad, and absent changes to these international commercial agreements, governments worldwide could face daunting difficulties if they seek to reverse the trend toward financial service deregulation.