

## **The General Agreement on Trade in Services (GATS): Implications for regulation of financial services in the United States**

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Liberalization of trade in financial services, including banking, insurance, asset management, pension funds, securities, financial information, and financial advisory services, has been among the most important and controversial issues on the World Trade Organization's (WTO) agenda since its inception in 1994. The controversy has typically been viewed as a conflict between the interests of poor nations of the South and rich nations of the North that will supposedly benefit economically from exporting financial services. From a US perspective, the case for free trade in financial services rests on the argument that it will increase US exports and reduce the balance of payments deficit, together with the largely unexamined assumption that what is good for export trade is good for the country.

That assumption deserves to be questioned. Trade researchers from the US, Canada and Europe have shown that international trade agreements can have alarming repercussions for health and safety standards, the environment, public services, domestic regulation and democratic rights in the North as well as the South. Attention is now focused on the General Agreement on Trade in Services (GATS) and the ongoing WTO negotiations aimed at further liberalizing trade in all types of services. Critics charge that GATS could threaten public services and undermine domestic regulation.<sup>1</sup>

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 and the ongoing negotiations to further liberalize trade in financial services could have far reaching effects on the US domestic front. Among the critical unanswered public policy questions are the following:

- **Social security and other insurance-like social programs**  
Will GATS jeopardize "insurance-like" social programs such as Social Security, Workers' Compensation, Unemployment Insurance and Medicare?
- **Health care reform**  
Will GATS stand in the way of meaningful health care reform?
- **Regulation of accounting and the securities markets**  
Will GATS weaken efforts to regulate financial markets in the aftermath of recent financial and accounting scandals?
- **Consumer protection in insurance**  
Will GATS undermine state regulation and weaken consumer protections?

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<sup>1</sup> Sinclair, S. and Grieshaber-Otto, J. *Facing Facts: A guide to the GATS debate*. Ottawa: Canadian Centre for Policy Alternatives, 2002.

- **Banking regulation**  
Will GATS contribute to the growth of “too big to fail” transnational financial service firms, leaving taxpayers with the choice of funding bailouts or risking financial crisis?
- **Cross Border Trade and the Internet**  
Will cross-border trade in financial services and offshore regulatory havens thwart national regulation of banking, insurance and capital markets?

Any attempt to answer these questions is necessarily speculative since we are considering the potential policy implications of international trade law that is in the process of being modified and strengthened through successive rounds of negotiations aimed at further liberalization of trade in services. Nonetheless, an examination of the existing GATS treaty and related agreements on financial services<sup>2</sup> strongly suggests that there is reason for concern in each of these policy areas.

### **Social Security**

At present, the US Social Security Program appears to be exempt from commitments under GATS to open borders to trade in financial services. Social Security and other public retirement plans are protected by a clause that stipulates that GATS does not apply to services “provided in the exercise of governmental authority”.<sup>3</sup> However, if Social Security is partially privatized as proposed by the Bush Administration to allow Americans to invest a portion of their social security contribution in private retirement funds, the Social Security Program may be subject to GATS.<sup>4</sup>

The potential implications of GATS for a privatized, or partially privatized, social security system are threefold.

- First, it is likely that GATS would require opening the market for private social security accounts to non-US funds.

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<sup>2</sup> The companion financial services agreements include: 1) the *Annex on Financial Services to the General Agreement on Trade in Services* which provides details on how provisions of GATS apply specifically to financial services, 2) the *Fifth Protocol to the General Agreement on Trade in Services* which contains the national schedules of specific commitments under GATS pertaining to financial services, and 3) the *Understanding on Commitments in Financial Services* which sets forth more stringent rules on financial services liberalizations than those contained in GATS. The more extensively liberalization commitments contained in the *Understanding on Commitments in Financial Services* apply only to countries, including the United States, that have elected to schedule specific commitments in accordance with the *Understanding*.

<sup>3</sup> GATS, Article I 3(b). The *Annex on Financial Services* (1)(b)(ii) further states that statutory social security or public retirement plans meet the definition of “services supplied in the exercise of governmental authority”.

<sup>4</sup> The *Annex on Financial Services*, paragraph 1(c) states that “if a Member allows activities (such as social security or public retirement plans) ... to be conducted by its financial services suppliers in competition with a public entity or a financial service supplier” then the activity will be considered a “service” subject to GATS.

- Second, it would be more difficult to privatize Social Security in a way that ensures that private investment accounts would be restricted to a few, highly regulated, “safe” funds since stringent regulatory requirements could be construed as GATS-illegal trade barriers.
- Third, GATS will make it extremely difficult to restore Social Security to its traditional role should the privatization experiment fail or prove politically unpopular. GATS requires countries to compensate trading partners if they grant new monopoly rights over the supply of a service.<sup>5</sup> This effectively makes privatization a one-way street. US commitments under GATS could curb future legislative attempts to return Social Security to a purely public retirement program.

### **Health Care Reform**

US commitments under GATS to liberalize trade in insurance services, including health insurance, may interfere with future federal and state initiatives to improve access to health care services for vast numbers of uninsured and underinsured citizens. Health care reform could be affected in several ways.

- GATS could undermine future attempts to enact single payer national health care because it effectively prohibits the grant of new monopoly rights.<sup>6</sup>
- Second, any attempt to expand the existing Medicare program to cover children or new services such as prescription drugs might face a challenge under GATS. Since Medicare is a monopoly provider of health insurance for the aged, it may be subject to the US commitments on financial services under GATS. These include a commitment to endeavor to eliminate or reduce the scope of existing monopoly rights.<sup>7</sup> A recent analysis of the Canadian health insurance program indicates that expansion of Canada’s Medicare program could be vulnerable to challenge under Nafta and/or GATS.<sup>8</sup> Any such challenge to the Canadian health insurance program could have serious repercussions for the US Medicare program.
- Third, GATS may create barriers to state and federal initiatives to improve access to health care through HMO and health insurance regulation. The insurance

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<sup>5</sup> GATS, Article VIII (4) and Article XXI.

<sup>6</sup> GATS, Article VIII (4). Note: GATS commitments in financial services apply to services purchased by public entities (*Understanding on Commitments in Financial Services*, paragraph 2).

<sup>7</sup> The *Understanding on Commitments in Financial Service*, B(1) states: “(e)ach Member shall list in its schedule pertaining to financial services existing monopoly rights and shall endeavor to eliminate them or reduce their scope”. The provision applies to services provided in the exercise of governmental authority (except for statutory social security and public retirement plans). Medicare could arguable be affected by this provision. The issue of whether the Medicare program is protected may hinge on a technical ruling as to whether Medicare is a form of social security, protected by the social security exemption.

<sup>8</sup> 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>

industry's position on liberalization of trade in insurance services advocates "pro-competitive" regulatory reform. This means limiting consumer protection regulation to financial solvency and disclosure issues, with no restrictions on pricing and no limits on the types of insurance products allowed on the market.<sup>9</sup> From this perspective, consumer protections and initiatives to improve access to health care, such as mandatory coverage requirements or rate controls, would be seen as anti-competitive barriers to trade.<sup>10</sup>

## Consumer Protection

With a growing proportion of US retirement savings invested in mutual funds, insurance annuities and bank savings, consumer protection in the financial services sector is becoming increasingly important to a broad sector of the US public. Over the past two decades, we have seen drastic cut backs in company-sponsored pension benefits for working people, increases in the eligibility age for Social Security, and proposals that threatens to further erode Social Security benefits. As a result, Americans' retirement security rests increasingly on effective regulation of the financial services sector.

GATS contains a "carve-out" provision that supposedly ensures that the trade agreement will not pre-empt domestic laws or regulations designed to protect investors, depositors, and policyholders, or to ensure the safety and integrity of the financial system.<sup>11</sup> There are several loopholes to this ostensible guarantee:

- The guarantee only applies to regulatory measures taken for "prudential reasons". The definition of "prudential" is left undefined and the question of what constitutes a "prudential" regulation is subject to interpretation and future negotiation. Are consumer protections that outlaw unfair and deceptive marketing practices by insurance companies or securities dealers "prudential" measures? Are laws that mandate that health insurance policies cover needed therapies such as HIV drugs or mental health treatment enacted for "prudential" reasons? Are banking laws that cap interest rates, or outlaw red lining and predatory lending practices "prudential" regulation? Arguably not. The financial service industry is lobbying for a narrow interpretation that would limit "prudential" measures to regulations concerning solvency and financial disclosure.<sup>12</sup>

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<sup>9</sup> International Chamber of Commerce, *Policy statement on the liberalization of trade in insurance services*, Commission on Financial Services and Insurance, 25 May 2000. Also see "U.S., European Union Agree on World Trade Negotiation Objectives", *Best Wire*, July 14, 1999; Snyder, David, "Pro-competitive Regulation on Global Basis – The Prospect of Unprecedented Benefits", *Insurance Advocate*, November 11, 2000; and Brostoff, Steven, "U.S., Euro Insurers Unite on Free Trade", *National Underwriter*, August 2, 1999.

<sup>10</sup> In current GATS negotiations, the US opposes requirements for prior product approval (form or rate) requirements for insurance products supplied to consumers in the business community (*US negotiating proposal on financial service*, available at [www.ustr.gov/sectors/services/docsvcs.shtml](http://www.ustr.gov/sectors/services/docsvcs.shtml)).

<sup>11</sup> *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.

<sup>12</sup> Op cite note 8.

- A major loophole states that “prudential” measures cannot be used as a means to avoid GATS commitments.<sup>13</sup> In other words, even regulatory measures taken for prudential reasons are vulnerable.
- As an insurance industry trade publication stated “it is often a very fine distinction between prudential regulation and regulation that is, in effect, protectionist”.<sup>14</sup> In a dispute, WTO dispute resolution panels will decide whether or not US laws are protected by the carve-out provision.<sup>15</sup> WTO decisions are binding, and the US could be forced to modify its regulations or face sanctions.

### **Threatening Domestic Governance**

There is a common misunderstanding that GATS will only affect domestic laws and regulations that discriminate against foreign firms. In fact, GATS does much more than curb discriminatory laws such as citizenship and residency requirements. It threatens to weaken non-discriminatory domestic regulations, i.e. rules that apply equally to foreign and domestic firms. Critics call the GATS restrictions on domestic regulation the “most excessive restrictions ever contemplated in a binding international treaty”.<sup>16</sup>

- 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”.<sup>17</sup> 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. US laws may eventually be subjected to “necessity tests” under GATS disciplines that would put the burden on the US to ensure that our domestic standards are not unnecessarily trade restrictive.
- 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”.<sup>18</sup>

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<sup>13</sup> *Annex on Financial Services*, paragraph 2(a).

<sup>14</sup> Brostoff, Steven, “U.S. European Insurers Join Forces To Promote Free Trade”, *National Underwriter*, August 2, 1999.

<sup>15</sup> *Annex on Financial Services*, paragraph 4, anticipates “disputes on prudential issues”.

<sup>16</sup> Sinclair, S. and Grieshaber-Otto, J. *Facing Faces: A guide to the GATS debate*. Ottawa: Canadian Centre for Policy Alternatives, 2002.

<sup>17</sup> *GATS*, Article VI:4(b).

<sup>18</sup> 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 is inconsistent with the disciplines (WTO Council for Trade in Services, *Decision on Disciplines Relating to the Accountancy Sector*, 14 December 1998).

- 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.<sup>19</sup> Even without a formal legal challenge, GATS could have a chilling affect on US efforts to regulate financial markets. For instance, foreign companies, that list stock on US exchanges, have sought exemption from Sarbanes-Oxley on the grounds that the Act discourages international trade in securities and violates international treaties.<sup>20</sup> Exemptions for foreign firms would give US firms incentive to move offshore, and further undermine US attempts to regulate its capital markets in the wake of recent accounting and securities scandals.
- Non-discriminatory regulations (i.e. rules that apply equally to US and non-US firms) may constitute *de facto* discrimination if they prevent foreign firms from entering or operating in the US market.<sup>21</sup>
- US commitments to curb non-discriminatory laws are more extensive for financial services than they are for any other service sector. For example, the US is obligated to endeavor to remove (or limit the effects of) US laws and regulations that “***adversely affect the ability of financial service suppliers of any other (WTO) Member to operate, compete, or enter***” the US market. This commitment is extraordinary because it applies to laws and regulations that are otherwise consistent with GATS.<sup>22</sup>

### Harmonization

Lack of conformity in the laws and regulations of trading partners can hinder the free flow of international trade in goods and services. To make global trade in financial services seamless, GATS encourages harmonization (i.e. standardization) of laws, regulations and administrative procedures governing banking, insurance, securities and accounting. 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

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<sup>19</sup> 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).

<sup>20</sup> Corporate Cleanup Stings Foreigners, *The Wall Street Journal*, International Page, August 12, 2002. The *WSJ* reports that the President of the Japanese Institute of Certified Public Accountants, in a letter to his US counterpart, argued that Sarbanes-Oxley “clearly violate international treaties”.

<sup>21</sup> For example, prior to its repeal, the US Glass-Steagall Act prevented foreign banks that combined commercial and investment banking services from entering the US market. The Clinton Administration recognized this as a trade barrier and made a formal commitment under the GATS to support repeal of the Glass Steagall Act. WTO, *United States of America Schedule of Specific Commitments Supplement 3*, Additional Commitments Paper II, WTO document GATS/SC/90/Suppl.3.

<sup>22</sup> WTO, *Understanding on Commitments in Financial Services*, paragraph 10(d).

bottom”, resulting in lower standards, weaker consumer protections, and watered down investor safeguards in the US.

- State regulation of insurance and banking can be a powerful tool to achieve public policy objectives such as caps on exorbitant interest rates, prohibitions on red-lining in insurance, discriminatory lending practices, and so forth. National and international regulators are less likely to be responsive to local concerns. Social policy objectives may be sidelined as GATS creates pressure for state laws to be harmonized and modeled after national and international standards.
- In the US, State regulation of insurance is particularly vulnerable to GATS. The principle of federalism under the US Constitution and the McCarran-Ferguson Act, which gives States the right to regulate insurance, conflicts with the trade commitments the US has made under GATS.<sup>23</sup> The need to comply with regulatory regimes in fifty different States makes it difficult for foreign insurers to enter the US insurance market. To eliminate this *de facto* trade barrier, the US has pledged, under the GATS agreement, to encourage national harmonization of insurance laws.<sup>24</sup> The voluntary adoption by States of “model” insurance laws has been the vehicle for national harmonization. State governments are likely to be subjected to continued pressure to adopt model laws and relinquish control of insurance regulation in the future. For instance, a draft of the European Union’s request for the current round of GATS negotiations, indicates that the EU is asking the US to promote adoption by the NAIC (National Association of Insurance Commissioners) of a model law that would eliminate the need for foreign insurance companies to obtain a license in each individual State.<sup>25</sup>
- GATS also provides powerful incentives for global harmonization of banking, insurance, securities and accounting standards. Other WTO trade pacts and Nafta encourage international harmonization of technical and food standards in ways that threaten to lower public health and environmental standards.<sup>26</sup> These trade agreements turn the common sense understanding of international standards on its head. Rather than a minimum threshold that all countries must meet, they treat international standards as a ceiling that countries may not exceed. GATS is no exception. GATS sets up international banking, insurance, securities, and accounting standards as the yardstick that WTO dispute resolution panels will use to judge whether US standards are more trade restrictive than necessary.<sup>27</sup> Since

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<sup>23</sup> The US has committed to remove the adverse effects of *non-discriminatory* measures that limit the expansion of financial service suppliers into the entire US territory. (*Understanding on Commitments in Financial Services*, paragraph 10).

<sup>24</sup> WTO, *United States of America Schedule of Specific Commitments Supplement 3*, Additional Commitments Paper I, WTO document GATS/SC/90/Suppl.3.

<sup>25</sup> *GATS 2000 Request from the EC and its Member States to the United States of America*, June 3,2002 available at [www.gatswatch.org](http://www.gatswatch.org).

<sup>26</sup> Public Citizen, Global Trade Watch, *Accountable Governance in the Era of Globalization: The WTO, NAFTA and International Harmonization*.

<sup>27</sup> *GATS*, Article VI:5(b).

it may be difficult to defend US standards that exceed international standards, GATS serves as a downward ratchet on US standards.

### **The Pandora's Box: Offshore Regulatory Havens and the Internet**

The combination of Internet technology and liberalization of cross-border trade in financial and telecommunication services opens a Pandora's box of regulatory issues. How will the US effectively regulate financial services when US citizens and businesses are making bank deposits, taking out loans, applying for credit cards, buying health or life insurance, and purchasing mutual funds over the Internet from firms located outside the US? How will consumers be protected? What will prevent US banks, insurers, and investment houses from locating offshore and conducting business over the Internet from regulatory havens?

Although the US has not yet made extensive commitments to allow cross-border supply of financial services (where services are provided to US consumers by firms located outside the US),<sup>28</sup> this Pandora's box could be opened during current or future GATS negotiations.

- The US has already made a broad commitment under GATS to allow US residents to purchase banking and other financial services (with the exception of insurance) offshore.<sup>29</sup> This means that the US is committed to allow US residents traveling abroad (or residents with funds in foreign accounts)<sup>30</sup> to make bank deposits, take out loans, apply for credit cards, buy mutual funds or purchase other financial services from offshore sites. In the era of the Internet, the distinction between cross-border purchases and offshore purchases collapses. In short, US commitments to allow offshore purchases of financial services may have already opened the Pandora's box of regulatory issues associated with cross border trade in financial services.

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<sup>28</sup> WTO, *United States of America Schedule of Specific Commitments Supplement 3*, Horizontal commitments on financial services, WTO document GATS/SC/90/Suppl.3. The schedules deal with four modes of supply of services (1) cross border supply, (2) consumption abroad, (3) commercial presence, and (4) presence of natural persons. (USITC, *U.S. Schedule of Commitments under the General Agreement on Trade in Services, Appendix E: Glossary*). The US has made extensive commitments to open US markets to financial services supplied through modes 2 and 3, but not modes 1 and 4.

<sup>29</sup> *Understanding on Commitments in Financial Services*, paragraph 4(c) commits the US to allow its residents to purchase in the territory of another Member financial services indicated in subparagraphs 5(a)(v) to (xvi) of the *Annex of Financial Services*. These include all banking and other financial services (excluding insurance).

<sup>30</sup> The consumer does not need to be physical present in the territory of the services provider. The USITC defines consumption abroad (supply mode 2) as a mode of delivering services whereby the consumer, **or the consumer's property** receives a service outside the territory of the consumer's country (USITC, *U.S. Schedule of Commitments under the General Agreement on Trade in Services, Appendix E: Glossary*). The Explanatory Note on Scheduling Commitments (GATS Document GNS/MTN/W/164) gives examples of Mode 2 which do not necessarily involved the physical movement of the consumer to the location of the supplier – for instance when a consumer's property alone moves abroad (Matto, A. Financial Services and the WTO, *The World Economy* 23(3) (March 2000), pp 351-386).



- GATS protects offshore tax and regulatory havens. Any attempt by the US to apply sanctions to force the havens to tighten banking or securities laws could be challenged as an illegal barrier to trade. For instance, two years ago, several Caribbean countries considered asking the WTO to intervene when OECD threatened to apply sanctions on them because of their tax policies and alleged lax regulations of financial services.<sup>31</sup>

### **Conclusion**

In the final analysis, GATS has more to do with governance than with trade. Over the past century, financial regulation in the US has oscillated from periods of strict financial controls over banking and capital markets following the Great Depression to periods of deregulation in the 1980s and 1990s. GATS locks in the status quo at a time of unprecedented financial liberalization. International trade agreements could make it extremely difficult to reverse the trend toward deregulation of financial services that has occurred over the past two decades. GATS could lock future generations into a dangerous level of financial deregulation, and constrain future policy choices regarding consumer protection, health care, and social security.

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<sup>31</sup> Canute James, Tax Havens Seek WTO Intervention, *Financial Times*, October 3, 2000.