

**THE WORLD TRADE ORGANIZATION AND FINANCIAL STABILITY:**  
*The Balance between Liberalisation and Regulation in the GATS*

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Comments and suggestions are welcome.

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The paper is first in a series of CERF papers that explore the WTO Agreements and how they affect financial stability

## **Abstract**

The WTO General Agreement on Trade in Services and its Annex on Financial Services provide the international legal framework for the regulation of cross-border trade in financial services. This paper analyses some of the main provisions of the GATS and the Annex on Financial Services to determine its impact on domestic financial regulation and whether the GATS framework can achieve its objectives of liberalising international trade in financial services while allowing states to maintain adequate domestic regulatory institutions. The paper argues that the GATS provides a flexible framework for states to negotiate liberalisation commitments while allowing sufficient domestic regulatory authority to achieve financial stability objectives. The extent to which states can depart from their GATS obligations to achieve regulatory objectives has become the source of academic debate and policy interest. Although the WTO has played little or no role in the financial regulation debate, the GATS contains certain disciplines that could potentially have significant implications for limiting regulatory discretion over financial markets. The paper suggests that the Doha Development Agenda should address some of these issues as they relate to the regulation of cross-border trade in financial services. The role of the WTO in this area raises important issues regarding the institutional design of financial regulation and related issues of global financial governance.

## **Keywords**

International banking law, bank regulation, Basel Accord, finance and development, international trade, World Trade Organisation

**JEL Codes:** G21, G28, K33

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# THE GENERAL AGREEMENT ON TRADE IN SERVICES AND THE BALANCE BETWEEN TRADE LIBERALISATION AND FINANCIAL REGULATION

## Introduction

This paper analyses some of the main issues with respect to the General Agreement on Trade in Services (GATS) and its application to cross-border trade in financial services and domestic regulation of financial markets.<sup>1</sup> The paper argues that the GATS provides a set of flexible rules for member states to negotiate specific liberalization commitments in most sectors of services trade based on the principles of national treatment, market access and transparency. As a general matter, the GATS does not attempt to regulate the content and scope of domestic regulation, but rather merely seeks to ensure that a WTO member's domestic regulation does not pose unnecessary barriers to cross-border trade in services. In financial services, state regulatory autonomy is reinforced by the GATS Annex on Financial Services which provides member states broad discretion to take regulatory measures for *prudential reasons* that may have the effect of restricting cross-border trade in financial services. This so-called prudential-carve-out has become the source of some concern because it allows states considerable regulatory discretion and policy autonomy to adopt and implement prudential regulations that may have the effect of restricting or curtailing cross-border trade in financial services and related capital flows.<sup>2</sup>

As a preliminary matter, however, it should be noted that the GATS has had little, if any, impact on standard setting in financial regulation. Prudential standard setting has been the subject of negotiations mainly amongst developed countries in various international financial standard setting bodies (eg., the Basel Committee on Banking Supervision and the International Organization of Securities Commissions). Legally, the adoption and implementation of prudential regulation is the responsibility of national authorities. Moreover, GATS jurisdiction does not generally extend to a state's regulation of capital flows (except in narrow circumstances discussed below) and therefore has limited impact on issues related to systemic risk and financial stability. Nevertheless, the GATS contains certain disciplines that have the potential to influence some areas of domestic financial regulation. For instance, where states have made specific liberalisation commitments under GATS, Article VI requires states to ensure that regulatory measures are applied in a reasonable, objective and impartial manner, and are based on transparent criteria and not more burdensome than necessary to ensure the quality of the service.<sup>3</sup> The content and scope of domestic

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<sup>1</sup> See generally, World Trade Organization (1999) *The Legal Texts – The Results of the Uruguay Round of Multilateral Trade Negotiations* (Cambridge: Cambridge University Press).

<sup>2</sup> The Annex on Financial Services contains what many observers call the 'prudential carve-out' that allows WTO members to take regulatory measures that may limit cross-border trade in financial services if such measures are taken '*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 or stability of the financial system*'. As discussed below, the relevant WTO Committees have so far not attempted to interpret the scope of the 'prudential exception', and it has not been subject to dispute resolution.

<sup>3</sup> Art VI: 1 & 4 (a) & (b).

regulation, however, remains under the discretion of state regulatory authorities.<sup>4</sup> It is only in areas where states have derogated from specific commitments to liberalise listed sectors that they can be called to account for breach of a GATS commitment. To date, no WTO member state has convened a panel to hear a complaint against another member for adopting financial regulatory measures that allegedly violate a GATS commitment.

The paper argues that the flexible institutional design of the GATS allows WTO member to adopt liberalisation commitments that fit their particular economic circumstances while maintaining adequate domestic regulatory controls and provides states wide discretion to depart from their specific market access and national treatment commitments if they are doing so for a prudential reason. The GATS does not prescribe the content of prudential regulatory controls. The absence of a definition within the WTO of prudential regulation has raised some concerns regarding the potential for a state's prudential regulatory controls to have discriminatory effect on foreign financial services providers in violation of GATS commitments and disciplines. The paper argues that the WTO is not an appropriate forum for establishing international standards of prudential regulation and that it should develop further institutional linkages with other International Financial Institutions (eg., IMF) to determine the extent and scope of prudential regulation.

Moreover, the paper considers the role of WTO dispute resolution in resolving conflicts over interpretations of domestic financial regulation. The paper argues that the *ad hoc* nature of WTO dispute resolution is not well-equipped to balance the competing interests between trade liberalisation and regulation of financial markets. The paper therefore argues that the WTO Council for Trade in Services and Committee on Trade in Financial Services should facilitate negotiations to address these issues with a view to deciding parameters for defining and/or recognising standards of prudential regulation and the extent to which they can limit, or be limited by, GATS obligations and commitments.

The paper's overall objective is to examine the relevant principles of the GATS that influence the domestic regulation of financial markets. Part I discusses the origins of the GATT and World Trade Organization. Part II addresses the negotiations surrounding the adoption of the 1997 Financial Services Agreement (Fifth Protocol to the GATS). Part III analyses the relevant provisions of the General Agreement on Trade in Services (GATS) and how it regulates trade in financial services. Particular emphasis shall be placed on the specific legal obligations of WTO members to provide national treatment and market access to services suppliers of other WTO members. It also examines the GATS Annex on Financial Services to ascertain the extent to which GATS trade liberalization principles are qualified by the right of members to adopt regulatory controls for prudential reasons. In this way, the GATS and the Annex on Financial Services allow states to adopt regulations for financial stability reasons that may have the effect of allowing states to depart from

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<sup>4</sup> As discussed below, the GATS and its Annex on Financial Services provides WTO members with broad discretion to take regulatory measures and/or adopt policies that derogate from specific GATS commitments if the measures are taken for 'prudential reasons' or 'to protect public morals or to maintain public order' or to prevent 'deceptive and fraudulent practices'. Para, 2A, Annex on Financial Services (containing prudential reasons exception) and GATS, Art XIV: (a)-(c) (protecting public morals and public order and prohibiting fraudulent practices).

their GATS commitments. In the case of conflicting objectives between prudential regulation and trade liberalization, this section discusses how the Annex creates a mechanism that allows WTO members to provide mutual recognition of other prudential arrangements, which could potentially lead to increased harmonization and convergence of prudential standards within the GATS framework. The section suggests, however, that this mechanism for harmonization and convergence is inadequate to provide an effective basis for deciding the validity of a member's prudential regulatory measures.

Part IV examines the WTO dispute settlement process and what role, if any, it should play in determining the efficacy and validity of financial regulatory standards. Part IV discusses WTO decision-making and its inter-institutional linkages with other international financial organizations. It argues that the WTO lacks the institutional capacity and expertise to devise international standards of financial regulation, but nevertheless should coordinate its activities with other international economic organizations in balancing trade liberalisation principles with regulatory practices.

### **I. The Origins of the World Trade Organization – *Background to the GATS***

The origins of the WTO Agreements can be found in the failed efforts of the late 1940s to ratify the Havana Charter, which was intended to establish an 'International Trade Organization', designed to provide an international code to govern trade relations that would be subject to binding dispute resolution with ultimate appeal to the International Court of Justice.<sup>5</sup> The ITO's primary objective was to reduce barriers to international trade and investment in order to secure economic reconstruction from the ravages of war and to build a strong economic base to confront the perceived threat of communism. The provisions of the Havana Charter were broad, covering a wide array of economic sectors, including trade in goods, services, intellectual property, extending beyond trade in goods to include trade in services, employment practices, commodity agreements, anti-competitive conduct, and foreign direct investment. The broad scope of the ITO Charter was intended to undo the legacy of protectionism and 'beggar thy neighbour' policies that most developed states had followed in the 1930s.<sup>6</sup>

Further, the ITO was designed to serve as one of the triumvirate of 'Bretton Woods' institutions that included the International Bank for Reconstruction and Development (World Bank) and the International Monetary Fund (IMF).<sup>7</sup> These international organisations were intended to function as part of a broader international economic regulatory regime that aspired not only to free trade and open markets, but also to promote stable monetary relations and sustainable long-term economic development. An important corollary was that world economic recovery was to be achieved through increasing trade liberalization combined with stable exchange rates

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<sup>5</sup> See R. Hudec, 'The GATT Legal System: A Diplomat's Jurisprudence', *Journal of World Trade Law* (1970) vol 4, pp. 615-65.

<sup>6</sup> See W.A. Brown, *The United States and Restoration of World Trade* (1950).

<sup>7</sup> See discussion in Andre Newburg, 'The Changing Roles of the Bretton Woods Institutions: Evolving Concepts of Conditionality', in M. Giovanoli (ed.) *International Monetary Law: Issues for the New Millennium* (Oxford: 2000).

based on a par value system directly linked to the US dollar and gold.<sup>8</sup> Indeed, it was recognized that trade liberalization and financial stability were the linchpins of a successful international economic system.

Although the ITO Charter was signed by over fifty participating states at the United Nations Conference on Trade and Employment in Havana in March 1948, ratification proved difficult for the United States, because the Charter's sweeping trade liberalisation requirements was perceived as a threat to many US industries and could potentially undermine US sovereignty. The proposed Charter's fate was sealed in 1950 when the Truman administration, failing to overcome political opposition, withdrew it from congressional consideration, thus terminating the ITO project. In January 1948, however, an interim Protocol of Provisional Application had taken effect that was signed by eight governments.<sup>9</sup> The provisional agreement was entitled the General Agreement on Tariffs and Trade (GATT) and was intended to codify the trade concessions that had already been made by its signatories during the ratification stage of the ITO Agreement.<sup>10</sup> The agreement established binding tariffs at reduced levels for certain goods and provided flexibility for states to amend domestic laws inconsistent with parts of the GATT.<sup>11</sup> Although the GATT was provisional in nature, it remained in effect after the demise of the ITO and became the only multilateral agreement regulating international trade from 1948 until the World Trade Organization was established in 1995. The GATT became the institutional embodiment of the post-war western consensus in support of trade liberalization.

For nearly fifty years, the GATT's legal framework governed trade relations between the signatory states who were known as 'Contracting Parties'. Over the years, the Contracting Parties undertook more efforts to reduce tariffs further and to extend trade liberalisation to a number of other economic sectors in a series of multilateral negotiations that became known as 'trade rounds.'<sup>12</sup> Significantly, in the 1960s, the Kennedy Round negotiations produced an Anti-Dumping Agreement, while the Tokyo Round negotiations in the 1970s led to a series of agreements adopting principles to restrict non-tariff barriers. These agreements were often referred to informally as 'codes' because they had been approved by only a relatively small number of GATT Contracting Parties (mostly industrialized states) and were known as 'plurilateral agreements' because of their voluntary membership. Although these codes did not apply to all of the GATT membership, they provided the basis for further amendment and extension in the Uruguay Round negotiations, and some

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<sup>8</sup> The IMF established for its members a par value currency exchange rate system in which the value of member currencies was linked at a predetermined rate to the US dollar, which was in turn linked at a predetermined rate to gold. A member's currency exchange value could only be changed to correct a 'fundamental disequilibrium' in that member's balance of payments, but only after consultation with the IMF. See Eatwell & Taylor, *Global Finance At Risk*, chap. 1.

<sup>9</sup> The eight named governments were: Australia, Belgium, Canada, France, Luxembourg, Netherlands, the United Kingdom, and the United States.

<sup>10</sup> Under US law, the GATT was an agreement, not a treaty; its legal standing was based on the President's authority to negotiate reciprocal trade agreements. By law, Congress had the power to approve trade agreements with majority votes of both Houses of Congress, whereas treaty approval requires 2/3 majority of the Senate.

<sup>11</sup> John H. Jackson *The Jurisprudence of GATT and the WTO* 24-25 ((2000)(providing detailed discussion of how the GATT was adopted and the Protocol of Provisional Application).

<sup>12</sup> There have been nine trade rounds beginning with Geneva in 1947, Annecy 1949, Torquay 1951, Geneva 1956, Geneva (Dillon Round) 1960-61, Geneva (Kennedy Round) 1964-67, Geneva (Tokyo Round) 1973-79, Geneva (Uruguay Round) 1986-94.

evolved into binding agreements and annexes in the WTO treaty structure that had binding effect on all WTO members, whereas some 'codes' remained plurilateral with a voluntary WTO membership.<sup>13</sup>

The Uruguay Round negotiations that began in 1986 culminated in the 1994 'Agreement Establishing The World Trade Organization'<sup>14</sup> (the 'Marrakesh Agreement') which created the World Trade Organization. (Croome 1995 122-30). The WTO is an international organization with legal personality that provides a forum for intensive negotiations to obtain binding commitments from its members to reduce barriers to trade and a strong enforcement mechanism for such commitments through a Dispute Settlement Body. The Marrakesh Agreement includes several multilateral trade agreements and associated legal instruments that are found in various Annexes to the Agreement and are binding on all members.<sup>15</sup> The Agreement expressly states that the original GATT 1947 'is legally distinct' from the General Agreement on Tariffs and Trade 1994,<sup>16</sup> and the other WTO multilateral trade agreements, the General Agreement on Trade in Services 1994 (GATS), and the Trade Related Aspects of Intellectual Property 1994 (TRIPS). These agreements and associated legal instruments are integral parts of the Marrakesh Agreement, and binding on all members.<sup>17</sup> Further, special requirements exist for developing countries, which are allowed to negotiate certain departures from WTO principles and commitments.<sup>18</sup>

The GATT 1994 extended tariff bindings to a broader range of products which included further commitments to reduce tariffs (with some tariffs being cut to zero), while only limited progress was made in restricting and curtailing non-tariff measures, such as import subsidies and quotas, for agricultural trade. The trade liberalization principles of the GATT were extended to cross-border trade in services when the GATS became effective in 1995. The GATS is a legally binding multilateral agreement that covers international trade in services. Initially, the GATS contained four main components: (1) a framework agreement setting forth general principles and obligations (i.e. Most Favoured Nation 'MFN'); (2) various annexes covering different services sectors; (3) negotiated schedules of specific commitments by individual members to provide access to their markets; and (4) negotiated lists of exemptions in particular services sectors showing where countries can temporarily exempt themselves from the MFN obligation. The negotiated schedules of commitments and MFN exemptions are analogous to the commitments of tariff schedules under the GATT.<sup>19</sup>

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<sup>13</sup> The Marrakesh Agreement, Annex 4 contains the plurilateral agreements that are respectively, the Agreement on Trade in Civil Aircraft, Agreement on Government Procurement, International Dairy Agreement, and International Bovine Meat Agreement.

<sup>14</sup> See Agreement Establishing The World Trade Organization' (Apr. 1994) in *Agreements Establishing the World Trade Organisation* (199?) pp. ; see also [www.wto.org](http://www.wto.org) .

<sup>15</sup> Art II 1. GATT 1994 is in Annex 1A; GATS is in Annex 1B; and the TRIPS is in Annex 1C.

<sup>16</sup> But the GATT 1994 expressly adopts the provisions of the GATT 1947. GATT 1994 is found Annex 1A of the Marrakesh Agreement.

<sup>17</sup> Marrakesh Agreement, art. II 1.

<sup>18</sup> See Art. XI (2) of the Marrakesh Agreement, and Art. XXXVI (8) of GATT 1994.

<sup>19</sup> It should be noted that, under the GATT, members are not allowed to depart from the MFN principle unless they have taken a waiver, whereas, under the GATS, departure from the MFN principle requires a member to list an exemption.

The foundation principles of the original GATT and the Bretton Woods institutions were premised on the notion that effective international trade liberalization could only take place within a framework of financial stability. Since the collapse of the Bretton Woods fixed-exchange rate regime in the 1970s, the liberalisation and deregulation of financial markets has resulted in dramatic growth in cross-border trade in financial services and capital flows, but has been accompanied by increased foreign exchange volatility and a substantial increase in the number of banking and financial crises (Eatwell & Taylor, 1999). Presently, the Doha Development Agenda dominates WTO discussions. The Doha Development Agenda began in November 2001, marking the start of a new and ambitious round of multilateral trade negotiations. The original agenda was very ambitious, including issues such as services and agriculture (on which negotiations had already begun in 2000); trade in non-agriculture market access; rule-making; and the so-called Singapore issues (competition policy, investment, trade facilitation, and government procurement). After the breakdown of negotiations in Cancun in September 2003, WTO Members reshaped the agenda by dropping most of the Singapore issues (with the exception of trade facilitation), in the hope of providing regained momentum to the negotiations. The Doha negotiations are continuing and are expected to culminate with a Ministerial meeting in Hong Kong in 2005

## **II. THE URUGUAY ROUND NEGOTIATIONS AND THE FINANCIAL SERVICES AGREEMENT<sup>20</sup>**

The introduction of trade in services into the GATT agenda was a significant development in the Uruguay Round negotiations. It quickly became apparent that the financial services sector was a particularly difficult area to negotiate because of different conceptions of how free trade in financial services could be reconciled with countries' regulatory objectives.<sup>21</sup> The importance of financial regulation had become a major issue in reaction to the increased number of financial crises that had arisen in part because of the collapse of the Bretton Woods fixed exchange rate regime in the early 1970s. By the 1980s, there had been several more banking crises and a major sovereign debt crisis involving Latin American countries that highlighted the fragility of the international financial system. The absence of the original Bretton Woods rules to regulate reserve currency values and related controls on cross-border capital flows exposed the international financial system to increase systemic risk that undermined financial stability, which was a key element of the international economic framework that gave birth to the GATT.

The growing number of banking and currency crises in the 1980s and 1990s provided the context for the Uruguay Round negotiations that took place between 1986 and 1993. By 1993, eighty-two countries had participated in negotiations that had resulted in significant but varying commitments to liberalise cross-border trade in

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<sup>20</sup> The impetus for negotiations for a Financial Services Agreement occurred in the context of Uruguay Round of Multilateral Trade Negotiations under the auspices of the General Agreement on Tariffs and Trade. See W. Dobson, 'Financial Services Liberalization in the Millennium Round' in K.G. Deutsche & B. Speyer (2001) *World Trade Organization Millennium Round* 98-100.

<sup>21</sup> See Robert B Self (1996) 'The General Agreement on Trade in Services' pp. 523-553 in T. Stewart (ed.) *The World Trade Organization* (Chicago: American Bar Association). See also Geza Feketekuty (2000) 'Assessing and Improving the Architecture of GATS' pp. 85-111 in P. Sauve and R.M. Stern (eds.) *gats 2000* (Washington DC: Brookings Institution)



financial services.<sup>22</sup> In July 1995, ninety-five WTO members agreed to an interim agreement that took effect on 1 September 1996.<sup>23</sup> Under the interim agreement, the ninety-five signatories undertook market access and national treatment commitments to open their banking, securities, and insurance markets and to treat each other on a most-favoured nation (MFN) basis. The interim agreement, however, was conceived as a temporary deal that would only become permanent if the ninety-five signatories did not withdraw or substantially reduce their commitments by a deadline of 12 December 1997.

Negotiations resumed in April 1997 and led to an agreement being reached by the December 12<sup>th</sup> deadline. This new financial services agreement became known as the Fifth Protocol to the GATS, in which seventy WTO members (including the US, EU and Japan) improved their schedules of commitments on market access and national treatment, while thirty two others maintained existing commitments that had been proposed in the Uruguay Round negotiations or had been undertaken in the 1995 interim agreement.<sup>24</sup> For most signatory states, the Fifth Protocol replaced the pre-existing schedules of commitments on national treatment and market access and the MFN list of exemptions that had been adopted under the 1995 interim agreement with modified and improved concessions in these areas. The Fifth Protocol was legally significant because it created on a permanent basis binding MFN obligations and market access and national treatment commitments.

The Fifth Protocol to the GATS became known as the 1997 Financial Services Agreement. The Agreement was an important achievement because of its broad coverage over most financial services sectors and also in regard to the large number of WTO members who became signatories (102). The Fifth Protocol to the GATS and the GATS Annex on Financial Services became effective on 1 March 1999.<sup>25</sup> At the Third Ministerial WTO Conference in Seattle in late 1999, WTO members considered offers to increase their market access and national treatment commitments beyond those agreed under the Fifth Protocol, but negotiations resulted in impasse. Following Seattle, GATS negotiations resumed in 2000 under the auspices of the Doha Development Agenda (trade round).<sup>26</sup> To this end, the Council for Trade in Services

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<sup>22</sup> See Wendy Dobson & Pierre Jacquet *Financial Services Liberalization in the WTO* 69-72 (1998)(providing a general discussion of Uruguay Round negotiations)

<sup>23</sup> *Ibid.* at 80-85.

<sup>24</sup> See text of Fifth Protocol at <http://gats.info.eu.int>. See Legal Texts and Commitments – The Related Instruments and Protocols. It should be noted that the Fifth Protocol to the GATS does not make the Financial Services Annex a separate agreement under the GATS, but rather is part of the overall GATS Agreement.

<sup>25</sup> The Fifth Protocol was subject to ratification in December 1997 for a period that was originally scheduled to last until 29 January 1999, but was eventually extended by the WTO Council for Trade in Services until 15 June 1999. The Fifth Protocol and the Annex on Financial Services took effect on 1 December 1999. Fifty two WTO members had accepted the Protocol by the due date of 29 January 1999, but the Council for Trade in Services decided to keep the ratification period open until 15 June 1999, by which time the additional eighteen members had signed. Seven WTO members have not yet ratified the Protocol: Bolivia, Brazil, Dominican Republic, Jamaica, Philippines, Poland, and Uruguay.

<sup>26</sup> Art. XIX: 1. It states in relevant part: 'In pursuance of the objectives of this Agreement, Members shall enter into successive rounds of negotiations, beginning not later than five years from the date of entry into force of the WTO Agreement and periodically thereafter, with a view to achieving a progressively higher level of liberalization.'. Article XIX creates an ongoing obligation for WTO members to engage in periodic negotiations for the liberalisation of service sectors through an 'in-built agenda' that began in 2000.

provided a mandate to the Committee on Trade in Financial Services to examine a broad range of issues affecting trade in financial services with a view to making further commitments to liberalise trade in financial services beyond those obtained in the Fifth Protocol. These negotiations continue under the Doha Round and, despite the broad regulatory discretion to apply prudential controls, the negotiating posture of many member states is firmly focused on gaining access to other members' markets by offering access to one's own market on a most-favoured nation and national treatment basis.

## II. The General Agreement on Trade in Services

The relevance of the GATS for financial sector issues lies mainly in its principles governing cross-border trade in financial services and its disciplines for domestic regulation. The GATS contains two main parts: (1) a framework agreement that consists of principles, rules and disciplines to be applied to trade in services, and various annexes, including one on financial services; and (2) a detailed list of WTO members' schedules of specific commitments to liberalize their services sectors based on principles of national treatment and market access. The GATS also incorporates by reference the Understanding on Commitments in Financial Services that allows members to opt for a higher and more robust set of market access and national treatment commitments that would grant non-discriminatory access to all foreign service providers of WTO member states.<sup>27</sup> It has been adopted by thirty one WTO Members (counting the EC as one), mostly developed countries.<sup>28</sup> The thirty members have adopted the Understanding by cross-referencing the Understanding in their schedules of commitments.<sup>29</sup>

### *The GATS provisions*

The jurisdictional scope of the GATS is broad, as it applies to all 'measures by Members affecting trade in services', which include any law, regulation, rule, procedure or administrative action taken by 'central, regional, or local governments or authorities' and any measure taken by 'non-governmental bodies' who exercise delegated powers from state governments or authorities.<sup>30</sup> In financial regulation, this would cover all state laws, regulations and administrative acts involving the regulation and supervision of the financial sector, including the adoption of any

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<sup>27</sup> The Understanding is not part of the GATS, but it is a part of the Final Act of the Uruguay Round.. It is an optional document that sets out a blueprint for making commitments on financial services. It goes beyond market access commitments to specify disciplines on government procurement, non-discriminatory measures, etc. See text in Appendix A.

<sup>28</sup> See Appendix B (containing the list of the countries who adopted it). One of the implicit goals of the Doha trade round negotiations is to persuade other WTO members to make commitments equivalent to those requested in the Understanding.

<sup>29</sup> For example, if you have a look at any of these 31 schedules, you will see that they all contain a horizontal note in the financial services section, saying that the commitments have been undertaken in accordance with the Understanding.

<sup>30</sup> Art. I: 3(a)(i)&(ii).

measures taken by self-regulatory bodies, such as stock exchanges, clearing and settlement systems or professional standards bodies, which were based on conferred or delegated state authority.

The GATS defines ‘services’ broadly to include “any service in any sector except services supplied in the exercise of governmental authority”.<sup>31</sup> The Annex on Financial Services extends this definition further by defining ‘financial services’ very broadly as well to include ‘any service of a financial nature offered by a financial service supplier of a Member.’<sup>32</sup> The Annex goes on to define financial services to include ‘insurance and all insurance-related services’ and ‘[b]anking and other financial services’.<sup>33</sup> Indeed, in the banking and securities sectors, the definition has broad application covering:

[A]cceptance of deposits, lending of all types, financial leasing, payment services, guarantees and commitments, trading money market instruments, foreign exchange, derivatives, exchange rate and interest rate instruments, securities and other financial assets, money brokering, asset management, settlement and clearing services for financial assets, provision of financial information, advisory or intermediation services, and insurance services (GATS Annex on Financial Services).

As noted above, however, an important exception exists for “services supplied in the exercise of governmental authority”.<sup>34</sup> This includes *any* service not provided on a commercial basis or in competition with other suppliers. Regarding state financial policy, this would cover the activities of central banks and other monetary authorities, statutory social security and public pension plans, and public entities using government financial services.<sup>35</sup> For instance, the GATS does not apply to how a member state regulates its central bank regarding monetary policy or open market operations.<sup>36</sup>

The broad scope of the GATS and Annex on Financial Services, however, does not apply to a state’s regulation of capital flows and to related issues of capital account liberalisation, unless the member’s capital controls derogate from its specific commitments (except when justified under the balance of payments exception).<sup>37</sup> For example, a member may not restrict capital flows that are necessary to make payment for cross-border trade in services if such services are subject to market access or national treatment commitments. As a general matter, however, the jurisdictional scope of the GATS does not cover the liberalisation of cross-border capital flows.

### *The Modes of Supply*

The GATS applies to *both* cross-border service flows and the supply of services abroad by natural persons or through commercial establishment. Part I of the GATS defines trade in services as taking the form of four modes of supplying services: cross-border trade, consumption abroad, commercial presence, and presence of

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<sup>31</sup> Art. I:3(b).

<sup>32</sup> GATS Annex on Financial Services, para. 5 (a).

<sup>33</sup> Ibid.

<sup>34</sup> para. 1 (b).

<sup>35</sup> para. 1 (b) (i) & (ii).

<sup>36</sup> This exception would also potentially apply to the reserve requirements imposed by central banks on banking institutions in order to manage monetary policy and to conduct open market operations.

<sup>37</sup> See discussion in B. Hoekman & M. Kostecki (2002) *The Political Economy of the World Trading System – The WTO and Beyond* (Oxford: OUP) p. 259.

natural persons.<sup>38</sup> The most relevant for analysing cross-border trade in financial services are cross-border service flows (mode 1) and commercial presence (mode 3).<sup>39</sup> Cross-border supply is defined to cover services flowing from the territory of one member state into the territory of another member state (e.g. banking or insurance conducted via telecommunications or email).<sup>40</sup> Commercial presence implies that a service supplier of one member establishes a territorial presence, including through ownership or lease of premises, in another Member's territory in order to provide a service (e.g. establishing a bank branch office, brokerage office, or agencies to deliver legal services or communications). Article XXVIII provides that for a mode 3 'commercial presence entity' to be valid in a host country it must be owned or controlled by an entity based in the home country. In the GATS, 'ownership' means more than fifty percent of the voting equity shares in a company, and 'control' means the authority to appoint a majority of the board or to appoint senior managers who are authorised to manage company.<sup>41</sup> The commercial presence mode has been described as the most important,<sup>42</sup> but also raises very difficult issues for host governments regarding regulatory issues and future liberalization of markets.

As defined above, cross-border trade in financial services covers a number of areas, including instances when a service provider based in one country offers financial services in another, or the provider seeks the right of establishment through a branch or subsidiary in another country. The type of establishment may be significant in a regulatory context, as many jurisdictions impose additional regulatory requirements on subsidiaries as opposed to branches.<sup>43</sup>

#### *The GATS General Principles*

The GATS Preamble recognizes the growing importance of trade in services, and states the objective of the Member countries of the GATS to "establish a multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners and the development of developing countries."<sup>44</sup> Regarding national regulation, liberalization of trade in services shall promote "interests of all participants on a mutually advantageous basis and at securing an overall balance of rights and obligations, while giving due respect

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<sup>38</sup> Article 1:2.

<sup>39</sup> It should be noted that *Mode 2* – Consumption abroad – has become increasingly important because of the growth of e-commerce and online financial services. Individuals and businesses utilise online financial services for a number of activities. This has raised the issue to what extent should the state be allowed to impose conditions or restrictions on foreign service providers who provide financial services on the internet to residents of the regulating state.

<sup>40</sup> Mode 1 cross-border supply is defined as 'the supply of a service from the territory of one Member into the territory of any other Member'.

<sup>41</sup> See discussion Guy Karsenty (2000) 'Assessing Trade in Services' in P. Sauve and R.M. Stern (eds.) *gats 2000* p. 45 n. 20. As Karsenty observes, the business entity that is owned or controlled in the host country is an 'affiliate' and the owning or controlling entity in the home country is known as a 'parent company'. Also, other legal terms may be applicable for these business entities (eg., financial holding company).

<sup>42</sup> Self notes that 'commercial presence in the territory of any other Member' is generally 'the mode of choice for a services provider who wishes to do business in foreign countries.' Self (1996) 'The General Agreement on Trade in Services' in T.P. Stewart (ed.) *The World Trade Organization* p. 526.

<sup>43</sup> Because subsidiaries are usually incorporated under host state law and are therefore viewed as separate legal entities, they are more likely to be subject to more comprehensive regulation by host country authorities than branches.

<sup>44</sup> GATS, Preamble.

to national policy objectives”. Given asymmetries with respect to the degree of development of services regulations in different countries, it is important that countries have the tools and possibilities to exercise their right to regulate, and introduce new regulations in order to meet national policy objectives.

Part II of GATS sets forth the “general obligations and principles” of the GATS, which apply to all members and to most services. The two main general principles of part II are most-favoured nation status and transparency. Article II of the GATS contains the most-favoured nation principle that provides, in relevant part, that “with respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than it accords to like services and service suppliers of any other country”.<sup>45</sup> The MFN principle is meant to eliminate discriminatory treatment among services and service suppliers from different member countries. It is subject to important exceptions, however, for regional economic agreements<sup>46</sup> and for exemptions listed by members when they join the WTO which are permitted for a period not exceeding ten years.<sup>47</sup>

Some experts have observed that the GATS’s most-favoured nation principle may prohibit certain informal international and bilateral agreements that are based on reciprocity and mutual recognition (Marchetti, 2003). For instance, the Basel Committee’s principles of consolidated supervision and home-host country control may conflict with the MFN principle because it permits Basel Committee members to assess the adequacy of a foreign bank’s home country regulatory regime as a condition for allowing it to operate in the host country’s markets. US banking law follows this approach under the Financial Services Modernization Act 1999 that requires the Federal Reserve to impose more onerous reporting requirements and capital reserves on foreign banks seeking to establish a financial holding company under US law if the foreign bank’s home regulator does not comply with the Basel Capital Accord. Moreover, in the area of money laundering and financial crime, the US Patriot Act requires foreign banks whose home jurisdictions do not comply with the FATF Forty Recommendations on money laundering and the Eight Recommendations on terrorist financing to be subject to more extensive US regulatory scrutiny and information disclosure as a condition for participating in the US correspondent banking market. The Patriot Act also authorises the US Attorney General and Treasury Secretary to take special measures against jurisdictions that do not comply with FATF or Basel Committee standards on money laundering, which may include sanctions or additional reporting requirements for US banks to comply with before undertaking any type of financial transactions with banks based in those jurisdictions. There is uncertainty regarding whether these unilateral measures and international agreements comply with the GATS MFN principle.<sup>48</sup>

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<sup>45</sup> Article II: 1.

<sup>46</sup> See Article V (allowing departure from MFN principle based on rules regarding “Economic Integration”).

<sup>47</sup> Article II:2 (allowing departure from MFN for a member’s listed exemptions). See GATS Annex on Article II Exemptions. An exemption may be extended for a member through a waiver process under Article XI:3 of the WTO Agreement.

<sup>48</sup> Some of the uncertainty arises from the US government’s view that regulatory measures that depart from market access or national treatment commitments against foreign service suppliers are permitted because they fall into the ‘prudential carve-out’ exception in paragraph 2a of the Annex on Financial

The second basic principle of the GATS is that of transparency.<sup>49</sup> Indeed, a major obstacle to doing business in a foreign country often involves a lack of information regarding the relevant laws and regulations of a particular jurisdiction. This problem has particular importance for trade in services because many of the relevant foreign trade restrictions take the form of domestic regulations. Sufficient information about potentially relevant rules and regulations is critical to the effective implementation of trade agreements. To address this, GATS sets forth a transparency principle in its Preamble and in Articles III and VI. Article III requires that Members publish promptly all measures pertaining to or affecting the operation of the GATS.<sup>50</sup> Moreover, as discussed below, Article VI:4 (a) provides a mandate for WTO members to negotiate domestic regulatory disciplines to ensure transparent criteria for qualification requirements, technical standards, and licensing procedures. There is an obligation to notify the Council for Trade in Services at least annually of all legal or regulatory changes that significantly affect trade in sectors where specific commitments have been made.

A state's laws and regulations should be transparent, setting forth clear standards so that foreign traders can discern exactly what conditions must be fulfilled in order to conduct trade in the host jurisdiction.<sup>51</sup> To improve compliance with the transparency obligation, Article III requires member countries to establish enquiry points for dissemination of trade related laws and regulations to other WTO members on request.<sup>52</sup> Governments must establish these enquiry or contact points in order to respond to trade-related questions posed by suppliers of services in other countries. Several countries have proposed to increase the role played by these contact points by requiring, for instance, that national authorities of WTO members respond to the questions of all "interested persons" that are submitted through these contact points. Other proposals recommend that countries establish sector-specific enquiry points.<sup>53</sup> As a general matter and similar to the MFN obligation, there are no exceptions or exemptions available to WTO members in complying with the obligation of transparency under Article III.

Part III of GATS contains the rules and disciplines for national treatment and market access. Unlike the general obligations of most-favoured nation and transparency, the national treatment and market access principles are specific commitments that are negotiated by members. A member does not incur a market access or national treatment obligation unless it expressly consents to such an obligation for a particular sector or sub-sector of its financial services industry. This is known as a positive-list approach, which means that a member only incurs national treatment and market access obligations if it expressly undertakes a specific commitment for a designated sector or subsector and mode of supply and to the extent that no limitations are imposed by the member. In contrast, a negative list approach

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Services, and moreover that such measures can be justified on the grounds of 'public morals' or 'public order', or to protect the public against fraud and economic crime as set forth in Article XIV (a)-(c).

<sup>49</sup> Article III, III*bis*.

<sup>50</sup> Article III (1) GATS requires each member to publish promptly "all relevant measures of general application" that affect operation of the agreement.

<sup>51</sup> Article III: 1.

<sup>52</sup> However, there is no requirement to disclose confidential information (Article III*bis*).

<sup>53</sup> Moreover, business lobbyists have lobbied for increased transparency of court proceedings and rulings on business disputes should be improved. WTO, Services 2000, Hong Kong Wish List, p. 2.

would only allow a country to avail itself of restrictions and limitations in applying national treatment and market access principles if the country in question specifically lists those restrictions and/or limitations in its schedules of specific commitments.<sup>54</sup> The positive list approach as set forth in the GATS provides more autonomy and flexibility for countries in negotiating their commitments and has particular benefit for developing countries who may lack the necessary expertise to understand which limitations or restrictions to list under a negative-list approach.

Each member's schedules of specific commitments are central features of the GATS. Article XX:3 of the GATS supports this by providing that Members' Schedules are "an integral part" of the GATS and thus constitute important legal obligations under the WTO Agreements. Indeed, the centrality of the Members' schedules as integral components of the GATS means that members cannot avoid their obligations unless expressly allowed under the GATS. Because the GATS covers all services except those provided in the exercise of governmental authority, it implies that a Member may schedule a specific commitment for any type of service.<sup>55</sup> The sectors and subsectors in a member's schedules are mutually exclusive (eg., they cannot contain identical services sectors). Moreover, the principle of transparency found in Article III and in the GATS preamble provides that members should undertake scheduling in a precise and clear manner so that all members can understand the scheduling commitments of all WTO members.

The negotiations over scheduling of commitments for market access and national treatment in financial services began in the Uruguay Round talks in the late 1980s. When the negotiations concluded in 1994, the members agreed to a "standstill" that meant that they could not rescind or restrict their commitments in the future. These schedules of commitments became the basis for future negotiations that have resulted in further commitments by most WTO members.<sup>56</sup> Significantly, these commitments are minimum standards of treatment and do not preclude members from taking autonomous measures to liberalise their markets in both scheduled and unscheduled sectors. In fact, most WTO members provide much greater access to their financial services sectors on both a market access and national treatment basis than what they have actually committed themselves to do in their schedules of commitments.<sup>57</sup> Indeed, the disparity between the level of liberalisation in most members' schedules of commitments and the degree of liberalisation they provide has become so great that GATS liberalisation commitments are a poor indicator of the extent of openness in international financial services markets.

The GATS national treatment principle requires a member to 'accord to services and services suppliers of any other Member . . . treatment no less favourable than that

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<sup>54</sup> For example, the North American Free Trade Agreement (NAFTA) follows a *negative-list* approach. See discussion below.

<sup>55</sup> A specific service cannot fall within two different sectors or subsectors. See GATS 2001 Scheduling Guidelines.

<sup>56</sup> As discussed above, the Fifth Protocol of the GATS was agreed in December 1997 and provided a minimum set of liberalisation commitments in the areas of national treatment and market access.

<sup>57</sup> Many states have undertaken liberalisation commitments as part of regional trading agreements (eg., the EC and NAFTA). Other states have adopted significant liberalisation commitments that extend beyond their GATS commitments as part of economic and financial restructuring programmes of the IMF and World Bank. Moreover, the Asian financial crisis of 1997 encouraged many Asian states (eg., Japan) to undertake unilateral commitments to liberalise trade in financial services in order to enhance foreign direct and portfolio investment. See W. Dobson (2001) pp. 98-100

it accords to its own like services and service suppliers.<sup>58</sup> This is a negotiated commitment that only applies to those sectors and modes of supply for which a negotiated commitment has been expressly undertaken and only to the extent the member has not imposed a limitation in the schedule. The GATS provides that ‘treatment no less favourable’ means both *de jure* and *de facto* treatment.<sup>59</sup> For instance, even though a member may accord *de jure* equal treatment (formally identical treatment) to foreign services or service suppliers, if such identical treatment results in a modification of competitive conditions in favour of a domestic service provider, it will violate the national treatment principle (Marchetti, 2003).

The national treatment principle seeks to ensure that foreigners are afforded equivalent opportunities to compete, whilst members are not under any obligation to guarantee success in the marketplace (Arup, 1999). Moreover, formally differential treatment of foreign service providers can sometimes be justified under the national treatment principle where a host regulator has greater concern regarding the ability of foreign firms to satisfy host state regulatory objectives. Thus, extra regulatory measures imposed against foreigners may be required to ensure that regulatory objectives are met. In the banking sector, a host regulator may seek to impose more stringent capitalization requirements than host state banks are required to meet, or to require that foreign banks establish subsidiaries and a physical presence in the host state territory as a condition for obtaining access to the host state’s payment system or to sell financial products to host state consumers.

The market access principle contained in article XVI reaffirms the binding nature of a member’s ‘specific market access commitments’ in its Schedule and makes it clear that each member’s specific commitments are a minimum standard of treatment to be applied to the services and service suppliers of all WTO members. Article XVI:1 requires members to accord services and service suppliers of other Members “no less favourable treatment than that provided for under the terms, limitations and conditions agreed and specified in its Schedule.”<sup>60</sup> In this regard, Article XVI note 8 makes clear that a member’s authority to restrict cross-border flows of capital may be limited to the extent that it has undertaken a commitment to allow the cross-border supply of services (*mode 1*), or if it has made a commitment to allow the supply of services through cross-border commercial presence (*mode 3*). The provision for *mode 1* suggests that a member may not impose any controls on the movement of capital into or out of its territory if the ‘capital is an essential part of the service itself’.<sup>61</sup> In contrast, regarding commercial presence (*mode 3*), a member is obliged ‘to allow related transfers of capital into its territory’ if the capital is related to the establishment of a commercial presence in the host member’s territory, but only to the extent that the member has committed itself in its schedules to allow *mode 3*

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<sup>58</sup> Art. XVII: 1

<sup>59</sup> Art. XVII: 2.

<sup>60</sup> Article XVI:1 states in whole: “With respect to market access through modes of supply identified in Article I, each Member shall accord services and service suppliers of any other Member treatment no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule.

<sup>61</sup> Article XVI:1 note 8 states in relevant part: ‘If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article I and if the cross-border movement of capital is an essential part of the service itself, that Member is hereby committed to allow such movement of capital’. This would suggest that the member would be restricted from imposing controls on imports or exports of capital if the capital were an essential part of the provision of the service under mode 1 (cross-border supply of service).



commercial presence. This language suggests that the obligation not to restrict capital flows *only* applies to imports of capital accompanying the establishment of a commercial presence.<sup>62</sup> The requirement in *mode 1* that the capital be ‘an essential part of the service’ supplied for a scheduled sector provides a sort of necessity test for determining whether the capital was really essential for the supply of the service in question.<sup>63</sup> In contrast, the requirement in *mode 3* creates a more stringent obligation for the host state not to restrict capital inflows that are ‘related transfers of capital’ to the supply of services in a cross-border commercial establishment (eg., local branch of a foreign bank).

Article XVI:2 sets out six measures that restrict market access and which a member cannot impose on a sector that is subject to a specific commitment, unless the restrictive measure is ‘otherwise specified in its Schedule.’ The first four measures cover quantitative limitations on market access (eg., limiting the number of service suppliers in a particular sector, or limiting the number of persons that may be employed in a particular sector or by a particular supplier). The fifth measure covers controls that restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service, while the sixth measure restricts limitations on the participation of foreign capital.<sup>64</sup>

The rules and disciplines that apply to the principles of national treatment and market access are by far the most significant in influencing the particular types of liberalisation commitments a member undertakes. These provisions have implications for a member’s regulation of cross-border capital flows and may affect existing obligations of IMF members who have not yet assumed Article VIII (2) status under the Fund agreement. Although the positive-list approach allows states to proceed at their own pace in making liberalisation commitments, it has been criticised on the grounds that it takes all services sectors (including those not yet listed in the GATS Scheduling Guidelines) off the liberalisation agenda until a state specifically designates a particular sector for national treatment or market access (Dobson, 2001). The argument asserts that states are subject to protectionist pressures and will be reluctant to designate specific services sectors to be liberalised without institutional and legal commitment. Many of those who hold these views would prefer a negative-list approach in which there would be a presumption that WTO members would

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<sup>62</sup> Article XVI:1 note 8 states in relevant part: ‘If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2© of Article I, it is hereby committed to allow related transfers of capital into its territory’. This suggests that a member is prohibited from imposing capital controls on imports (only) of capital that are related to the provision of a service through commercial presence under mode 3.

<sup>63</sup> For example, a country (say, Country B) might restrict the cross-border distribution of the proceeds of a loan issued by a bank based in Country B to a borrower resident in Country A on the grounds that the foreign exchange controls of Country B might restrict the transfer of some or all of the proceeds of the loan to a person in Country A. However, if Country B has made a specific commitment in its GATS schedules to allow cross-border transfer of the proceeds of bank loans to borrowers in other WTO member countries, then such a restriction by Country B would breach its GATS obligations.

<sup>64</sup> The six types of limitations that a member may not impose on the provision of services in a particular sector where it has made a market access commitment are limitations: (1) on the number of service suppliers; (2) on the total value of services transactions or assets; (3) on the total number of service operations or the total quantity of service output; (4) on the number of persons that may be employed in a particular sector or by a particular supplier; (5) measures that restrict or require supply of the service through specific types of legal entity or joint venture; (6) percentage limitations on the participation of foreign capital, or limitations on the total value of foreign investment. However, a member can impose one of these limitations on a scheduled sector if it has expressly stated or ‘inscribed’ such a limitation in its schedule of specific commitments.

provide full national treatment and market access for all services sectors, except where they have expressly listed limitations or prohibitions in their schedules. This would accelerate the liberalisation agenda in the GATS and potentially undermine the ability of domestic regulators to manage their local financial markets. On the other hand, the negative-list approach may result in a deepening of capital markets by allowing more foreign lenders and financial service providers to enter local markets. This may result in technology and skill transfer to undeveloped economies and an infusion of capital that increases liquidity and perhaps promotes financial stability. Domestic regulators would still have discretion to impose restrictions on cross-border capital flows in the event of a financial or other crisis. Moreover, states that autonomously open their markets outside the GATS negotiating framework (eg., under an IMF or World Bank assistance programme) should be given credit in the GATS for such autonomous efforts.

#### *Domestic Regulation of Financial Services*

Part II of GATS also contains disciplines on domestic regulation of services and services suppliers. Significant barriers to cross-border trade in services can arise from the requirements of domestic regulation. The GATS recognises that domestic regulation can take the form of licensing requirements and technical standards that do not constitute unlawful trade barriers, but which nevertheless pose obstacles to market access and result in excessively burdensome compliance costs that nullify the benefits deriving from a member's liberalisation commitments. To address these barriers, Article VI prohibits members that have undertaken specific commitments<sup>65</sup> from maintaining technical standards and licensing requirements that form unnecessary trade barriers or that nullify or impair commitments that have been undertaken (Art. VI:5).<sup>66</sup> For instance, a member must ensure that its qualification and licensing requirements *and* technical standards and procedures are based on transparent and objective criteria, and are not unnecessarily burdensome to ensure the quality of the service.<sup>67</sup> This suggests that a *necessity* test could be applied to determine whether a member's qualification and licensing requirements or technical standards do not nullify or impair the member's commitments.

In the case of a bank, licensing requirements may take the form of fit and proper standards for senior management and board members, while technical standards may take the form of capital adequacy standards. Under article XVI, these do not constitute restrictions on market access, but they may violate article VI if they are not based on transparent and objective criteria and are more burdensome than necessary to ensure the quality of the service. Moreover, where a member's capital adequacy requirements are higher for foreign banks than for domestic ones, the national treatment principle may be contravened, unless the member has scheduled the limitations on national treatment in its schedule of commitments or the discriminatory measure in question was taken for a prudential reason and thus falls within the prudential exception. However, even if the minimum capital standards are not discriminatory as applied between foreign and domestic banks, they must still comply with the disciplines of Article VI's domestic regulation requirements. Article VI disciplines raise important issues regarding the nature and scope of domestic

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<sup>65</sup> Applies to specific commitments taken under Article XVI (market access), Article XVII (national treatment), and Article XVIII (any other commitments).

<sup>66</sup> For thorough coverage of Article VI disciplines, see Markus Krajewski, *The GATS and Domestic Regulation* (Dordrecht: Kluwer Law International).

<sup>67</sup> Art VI: 4 (a)&(b) and 5 (a).

regulation and could potentially serve as a point of convergence for the development of financial regulatory standards.

Article VI:1 requires members to ensure that all regulatory measures are applied in a *reasonable, objective, and impartial manner* to sectors where commitments have been made. Similarly, where a service provider has applied for authorisation from a domestic authority to provide services, the competent authorities shall respond to the application in a *reasonable period of time* after the submission of the completed application.<sup>68</sup> In considering an application to provide services from a foreign service provider, members are required to establish *as soon as practicable judicial, arbitral, or administrative tribunals* to which a foreign service provider can seek *review and appropriate remedies* for administrative or regulatory actions taken that affect the provision of services by the foreign service provider.<sup>69</sup>

Article VI:4 exhorts WTO members to engage in negotiations to develop disciplines to ensure that regulatory measures *relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services*. These disciplines should be based on objective and transparent criteria and on the principle that regulatory requirements should not be more *burdensome than necessary to ensure the quality of the service*. In contrast with the other Article VI provisions, section VI:4 disciplines apply to all of a member's services sectors, regardless of whether the member has scheduled specific commitments under Part III for market access or national treatment. However, for these disciplines to become effective, they must contain substantive content, which members can only provide through negotiations. To this end, the WTO GATS Committee on Domestic Regulation has achieved very little in its negotiations over domestic regulation disciplines.<sup>70</sup>

In addition, Article VI disciplines may have a disproportionate impact on developing and poorer countries which do not have the sophisticated regulatory apparatus, legal framework and economic system to provide the necessary level of administrative review, notice and regulatory transparency required under Article VI.<sup>71</sup> This could put many developing countries at a disadvantage because of the disproportionate costs of complying with such standards. In contrast, developed countries with the experience and resources to administer complex regulatory regimes will have an advantage in complying with Article VI disciplines.

#### *Domestic regulation and transparency*

Effective supervision requires reliable information on the financial condition of the institution. Access to such information includes the availability of records and the regular publication of financial statements based on accepted accounting standards. The goal is to provide a true and fair view of a firm's financial position with some indication of the broader condition of a particular financial sector. The benefits of transparency, however, are not absolute. Although transparency can provide investors and depositors with more information that can enable them to offset risks, it can also

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<sup>68</sup> Art VI: 3.

<sup>69</sup> Art VI:2 (a). Members are not required to adopt regulatory institutions or procedures where it would be inconsistent with its constitutional structure or legal system. Art. VI: 2(b).

<sup>70</sup> In 2003, the US government proposed minimum requirements for transparency in the publication and accessibility of domestic regulation standards.

<sup>71</sup> Art VI: 2(a) & 3.

result in increased volatility that can, in certain circumstances, undermine financial stability.<sup>72</sup> Therefore, regulators should strike a balance between the application of strict prudential requirements (eg., capital adequacy and transparency) and the need in certain circumstances to forbear in the application of such standards. The optimal level of transparency for financial markets should be determined by the prudential objectives of the regulator that are established by law and/or regulation.

In addition, Article XIV GATS allows members to adopt regulatory measures that depart from their specific commitments and obligations if the measure falls into an Article XIV exception. For example, a member may impose a restriction on a market access commitment where to do so is “necessary to protect public morals or to maintain public order”.<sup>73</sup> The protection of public morals might involve the regulator in adopting measures against financial crime or fraud, while the maintenance of ‘public order’ might involve measures to protect against financial instability, but can only be taken where there is a *genuine and sufficiently serious threat posed to one of the fundamental interests of society*.<sup>74</sup> Exceptions also exist ‘to protect human, animal or plant life or health’.<sup>75</sup> Also in the area of financial services, Article XIV contains an exception allowing a member to take a measure that departs from its specific commitments if it is necessary to prevent ‘deceptive and fraudulent practices’.<sup>76</sup> The chapeau of Article XIV, however, states that a member cannot apply measures in a manner *which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services*. Article XIV appears to adopt a necessity test that allows a member state to depart from its commitments if the measure in question is *necessary* to achieve a valid regulatory objective, and does not constitute an arbitrary or unjustifiable discrimination against members where like conditions prevail. This necessity test would likely constrain the regulatory discretion of national authorities in supervising their financial markets by restricting their ability to impose measures that may conflict with market access or national treatment commitments.

#### *Macroeconomic stability and ongoing liberalisation*

Regarding macroeconomic stability, Article XII of the GATS allows a state to impose restrictions on cross-border trade in services that are necessary to safeguard the balance of payments.<sup>77</sup> This would permit members in serious balance of payments difficulties – or threatened by such difficulties – to restrict trade in services for which they have undertaken commitments. Such restrictions may be utilized by developing countries, or countries in transition, if such measures are necessary to maintain a level of reserves adequate for the prudential management of their economies. These restrictions, however, must not discriminate among members,

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<sup>72</sup> This has also been recognized in the area of monetary policy where Ferrarini has noted that “transparency of the foreign exchange markets coupled with the high volatility sometimes attributed to trading activity has been said to reduce the effectiveness of individual national governments’ monetary policies”. Guido Ferrarini (ed.) (1994) *Prudential Regulation of Banks and Securities Firms*, p. 173.

<sup>73</sup> Art XIV (a).

<sup>74</sup> Art XIV, note 5.

<sup>75</sup> Art XIV (b).

<sup>76</sup> Art XIV ©(i).

<sup>77</sup> The GATT also contains provisions that address financial stability concerns regarding a member’s right to derogate from liberalization commitments when it is suffering a severe balance of payments imbalances. See GATT Articles XII and XVIII:B.

cause unnecessary damage to the trading interests of other members, or be unnecessarily restrictive, and temporarily phased out as the situation improves. Although the restrictions may focus on a particular sector, they must not be used or maintained as a protectionist trade barrier. Restrictions adopted pursuant to Article XII must be reviewed periodically by the WTO Balance of Payments Committee. And a member may not restrict international transfers and payments for current transactions (except as permitted by Article XII) if to do so would violate the members' specific services commitments.

Article XIX addresses the ongoing obligation of states to engage in periodic negotiations for the liberalization of trade in services. It obliges members to 'enter into successive rounds of negotiations, beginning not later than five years from the date of entry into force of the WTO Agreement and periodically thereafter,'. The GATS adheres to the view that increased liberalization in financial services trade will increase the competitiveness of a member's financial sector while enhancing stability by promoting financial innovation and deepening of capital markets. The liberalization process should take account of national policy and regulatory objectives<sup>78</sup> It recognizes that liberalisation measures may have differential impact on developed and developing countries.

Article XXI permits members to reverse binding liberalization commitments after they have been in force for three years without regard to the rationale for such change so long as the member undertaking the modification in commitments provides compensation to other WTO members whose interests are impaired. The GATS also requires member states to engage in ongoing negotiations with a view to taking further commitments to open markets on a national treatment and market access basis.

### ***The Prudential Carve-out***

The prudential supervision of financial institutions and financial markets has become a major policy issue in recent years due to the increasing globalisation of financial markets that has been facilitated by deregulation and liberalisation of the provision of financial services and accompanying capital flows. Many authorities agree that the overall objective of prudential supervisory and regulatory regimes is to promote the development of safe and sound banking systems.<sup>79</sup> Recent banking crises in Asia and Latin America have highlighted the importance of adopting sound prudential regulatory regimes to enhance financial stability that are based, *inter alia*, on the capital adequacy of banks, transparent accounting frameworks, and enhanced corporate governance standards for financial institutions. Outside the banking sector, prudential regulation can encompass conduct of business rules designed primarily to protect consumers, investors and policyholders (Andenas & Avgerinos, 2003)

Prudential rules help financial institutions to measure and manage their exposure to risk. Supervision of a highly regulated financial system is different from supervision of a system open to domestic and foreign competition. Opening financial markets to foreign financial firms can itself contribute to strengthening domestic

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<sup>78</sup> Art XIX: 2 . 'The process of liberalisation shall take place with due respect for national policy objectives and the level of development of individual Members, both overall and in individual sectors.'

<sup>79</sup> See J.L. Eatwell & L. Taylor, *Global Finance At Risk: The Case for International Regulation* (2000); Joseph Norton, *Devising International Standards of Banking Regulation* (1995) ; CAE Goodhart et al. (1999) *Financial Regulation – Why, how and where?* Chap. 2.

financial systems through the creation of more competitive and efficient host-country markets.<sup>80</sup> At the same time, adequate prudential regulation and supervision play an important role in achieving the maximum benefits of liberalization while minimizing the risks. The measures to promote competitive markets must be complemented by measures to ensure the stability of the financial system and to provide adequate protection for consumers of financial services.<sup>81</sup>

The efficient operation of financial markets will depend on the quality of the information that the regulator releases to the public. Prudential supervision often involves a decision by the supervisor regarding how much information to release to the public regarding a particular bank or financial firm. An effective liberalization process should be governed by a legal and regulatory framework that authorizes the regulator to make these decisions based on legally established prudential standards. For instance, the regulator should have a reasonable discretion to decide where to draw the line between adopting regulations that promote competition, on the one hand, and regulations that may restrict competition but serve a legitimate prudential purpose, on the other.

The Uruguay Round negotiators were aware of the importance of prudential regulation to the efficient and stable operation of financial markets. However, WTO member states have taken a variety of views regarding what the prudential carve-out might mean.<sup>82</sup> Many observers have taken the view that the carve-out should be interpreted broadly on the grounds that the banking and financial services industry deserve special treatment because of the systemic risks that banks, investment services firms, insurance companies and other providers of finance pose to the economy (Dobson & Jacquet, 1998). Moreover, in many jurisdictions, national regulatory authorities have typically enjoyed broad supervisory discretion in applying various regulatory instruments to oversee and control financial institutions and market participants.

Accordingly, GATS negotiators agreed on a broadly stated prudential exception that would cover divergent regulatory approaches by allowing member state regulators to depart from GATS commitments *for prudential reasons* as follows:

Notwithstanding any other provision of the Agreement, a member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policyholders, 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

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<sup>80</sup> Key, GATS 2000: Issues for the Financial Services Negotiations, p. 6.

<sup>81</sup> Key, GATS 2000: Issues for the Financial Services Negotiations, p. 7.

<sup>82</sup> For instance, Colombia took the view during Uruguay Round negotiations that the prudential carve-out in paragraph 2 of the Annex on Financial Services and Article VI of the GATS (domestic regulation) should allow Members to take both prudential and non-prudential measures to ensure the stability and integrity of the financial system. Communication from Colombia, S/CSS/W/96 (July 9, 2001). An alternative view was expressed by Malaysia that the prudential carve-out be interpreted strictly according to its language. Council for Trade in Services, Report of the Meeting Held on 3-6 December 2001, Note by the Secretariat, S/CSS/M/13, at 60 (February 26, 2002). Japan and the United States asserted that prudential measures were to be left to the discretion of member states. *Id.* at 57. However, the EC and its Member States interpreted the carve-out as not permitting members to use prudential controls as “means of avoiding GATS market access and national treatment commitments.” Communication from the EC and their Member States, *GATS 2000: Financial Services*, S/CSS/W/39, ¶ 21 (November 22, 2000).

means of avoiding the Member's commitments or obligations under the Agreement.<sup>83</sup>

The first sentence of paragraph 2 (a) is the so-called prudential carve-out which authorises a Member to take prudential regulatory measures that may restrict financial service trade.<sup>84</sup> The second sentence of paragraph 2 (a) qualifies the first sentence, providing that such measures allowed by the first sentence shall not be used as a means of avoiding the Member's commitments or obligations under the GATS. The second sentence appears to authorize members to take 'measures that do not conform to the provisions of the Agreement,' but adds that such measures 'shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.' Some observers note that the scope of the prudential carve-out is ambiguous.<sup>85</sup>

The 'prudential carve-out' allows states to impose regulatory barriers to trade in financial services if such measures are adopted for 'prudential reasons' or to 'ensure the integrity and stability of the financial system'.<sup>86</sup> The definition of 'prudential reasons' includes the protection of investors, depositors, policyholders, or persons to whom a financial service supplier owes a fiduciary duty. No guidance is provided, however, regarding the types of regulatory standards and rules that would be necessary to accomplish these prudential objectives. Similarly, it is not clear what measures would be necessary to ensure the integrity and stability of the financial system. It provides that States will only be allowed to impose regulatory barriers on cross-border trade in financial services if such measures are adopted for 'prudential reasons' and not used to circumvent a member's specific commitments and general obligations under the GATS. The prudential carve-out is essentially an escape clause that provides national regulators with the discretion to take regulatory measures that may contravene GATS obligations and commitments.<sup>87</sup> For instance, some countries, such as China, have taken the view that they can derogate from their specifically negotiated commitments on market access and national treatment if the derogation is taken for a prudential reason.<sup>88</sup>

Moreover, it is not clear what standards of prudential regulation could withstand a challenge in a dispute settlement proceeding. Some countries suggest that a dispute panel might use generally accepted international standards of prudential supervision as a benchmark for determining whether a member's regulatory controls comply with

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<sup>83</sup> GATS Annex on Financial Services, para. 2(a).

<sup>84</sup> WTO Secretariat, GUIDE TO THE URUGUAY ROUND AGREEMENTS 176 (Kluwer Law International 1999).

<sup>85</sup> Kalypso Nicolaidis and Joel Trachtman (2000) 'Policed Regulation to Managed Recognition' in P. Sauve & R.M. Stern, eds., *GATS 2000* (Washington DC: Brookings Institute)(arguing that '[t]he scope of this "prudential carve-out" is unclear') p. 255.

<sup>86</sup> Ibid.

<sup>87</sup> For example, a national authority might argue that it is a prudential measure to adopt restrictions on short-term bank capital inflows to the local market in order to reduce volatility in the banking sector, even though such a measure might directly conflict with a specific commitment not to impose such a measure.

<sup>88</sup> See 'US-China Trade Relations Growing Steadily, Some Stumbling Blocks Remain', Issue 12 (28 June 2002)(discussing US objections at a meeting of the WTO Council on Trade in Services on 5 June 2002 about discriminatory Chinese regulations that impose restrictive branching requirements for foreign non-life insurance firms).

GATS.<sup>89</sup> This may result in using the Basel Capital Accord and other core principles of banking supervision as reference points for assessing whether a member's regulatory restrictions on financial services trade are justified for prudential reasons. The objection to using the Capital Accord or other core principles to determine GATS compliance would be that standard-setting in the Basel Committee lacks accountability and legitimacy because its decision-making process is closed to non-G10 countries.

Paragraph 3 of the Annex seeks to promote harmonization of prudential regulatory practices by encouraging members to negotiate and recognize the prudential regulatory standards of other members with a view to promoting convergence in regulatory standards. The objective would be to make it more difficult to deviate from generally accepted regulatory practices that would depart from a member's general obligations and specific commitments. Specifically, paragraph 3, entitled *Recognition*, allows a member to recognize the prudential measures of any other member in determining how the Member's measures relating to financial services shall be applied.<sup>90</sup> This provision states that 'such recognition, which may be achieved through harmonization or otherwise, may be based upon an agreement or arrangement with the country concerned or may be accorded autonomously.' Further, paragraph 3(b) states that if a member is a party to such an agreement, it<sup>91</sup>

shall afford adequate opportunity for other interested Members to negotiate their accession to such agreements or arrangements, or to negotiate comparable ones with it, under circumstances in which there would be equivalent regulation, oversight, implementation of such regulation, and, if appropriate, procedures concerning the sharing of information between the parties to the agreement or arrangement.

Paragraph 3 (a) & (b) seeks to facilitate bilateral and multilateral agreements or arrangements amongst members that would work on the basis of mutual recognition with an obligation not to exclude other members who commit to adopt regulatory standards substantially in compliance with the standards agreed – either bilaterally or multilaterally – between any members. This mutual recognition framework seeks to encourage members to negotiate a prudential minimum standard or common denominator for banking and financial institutions that operates on an international basis.<sup>92</sup> In theory, this would create a 'level playing field', thus promoting competition objectives, by allowing for comparative advantage to shape the development of international trade in financial services. In practice, however, no negotiations to enter such agreements have taken place. Although the principle of promoting harmonized prudential standards amongst WTO members is an attractive proposition for those who espouse the merits of regulatory competition, the lack of progress by members to make agreements or arrangements in this area demonstrates that this will probably not serve as an effective mechanism for developing efficient and accountable standards of prudential regulation in global financial markets.

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<sup>89</sup> See WTO Doc. S/CSS/W/71, Communication from Switzerland (that prudential regulation should be interpreted according standards set by international bodies, ie. Basel Committee), and WTO Doc.S/CSS/W/27, Communication from United States (that GATS obligations and commitments should not prejudice a member's prudential regulatory discretion).

<sup>90</sup> Annex on Financial Services, para, 3 (a).

<sup>91</sup> Para. 3(b).

<sup>92</sup> These agreements would be recorded with the Trade in Services Division of the WTO Secretariat.



As discussed above, Article XIV GATS (General Exceptions) contains a necessity test, which means that a Member must prove that it is “necessary” to take an exceptional measure. However, the term ‘necessary’ or a ‘necessity test’ is not included in the text of the prudential carve-out. This may imply that it is *not necessary* for a Member to prove that a prudential measure that has the effect of restricting cross-border trade in financial services is necessary to achieve a valid regulatory objective. Compared with other general exceptions in the GATS which have an objective necessity standard, the prudential carve-out is flexible and, to some extent, subjective. According to this view, the prudential carve-out lacks detailed standards and limitations.

Prudential regulation in the GATS could also take account of other concepts, such as public morals and public order as set forth under Article XIV (a) of the GATS. Public morals could potentially apply to justify WTO members departing from their commitments in order to prevent fraud or financial crime, whilst public order could involve members adopting prudential measures to maintain safety and soundness of the banking system. The application of a ‘public morals’ or ‘public order’ exception under Article XIV (a) would involve the use of a necessity test to ensure that the regulatory measures adopted are ‘necessary’ or proportional ‘to protect public morals or to maintain public order.’ This could involve an assessment regarding whether the regulatory measure in question could achieve its objective with the least restrictive impact on trade. It could also involve a proportionality test that would weigh and balance the benefits of the regulatory measure against the corresponding costs imposed on trade.

WTO member states have taken a variety of views regarding how the prudential carve-out should be defined.<sup>93</sup> Some academics have argued that prudential regulation should be understood within a broader international framework of banking supervision that has been established by the various International Financial Institutions (IFIs), including the standard setting bodies at the Bank for International Settlements and the International Monetary Fund.<sup>94</sup> This view holds that, because domestic prudential regulation is being significantly influenced by international standard setting bodies, the WTO and its dispute settlement body should make reference to the prudential standards adopted by international financial standard setters (eg., the Basel Committee on Banking Supervision).<sup>95</sup> According to this approach, prudential regulation should be understood within a coherent international

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<sup>93</sup> For instance, during the WTO meetings, Colombia took the view that paragraph 2 of the Annex on Financial Services and Article VI of the GATS (domestic regulation) should allow Members to take both prudential and non-prudential measures to ensure the stability and integrity of the financial system. Communication from Colombia, S/CSS/W/96 (July 9, 2001). In contrast, Malaysia insisted that there be “no flexibility to introduce any changes to the so-called prudential carve-out”. Council for Trade in Services, Report of the Meeting Held on 3-6 December 2001, Note by the Secretariat, S/CSS/M/13, at 60 (February 26, 2002). Japan claimed that Members should be cautious when discussing limitations respecting the right to take prudential measures. *Id.* at 57. However, the EC and its Member States emphasised that prudential measures should not be used “as a means of avoiding GATS market access and national treatment commitments.” Communication from the EC and their Member States, *GATS 2000: Financial Services*, S/CSS/W/39, ¶ 21 (November 22, 2000).

<sup>94</sup> See Christine Breining and Rolf Weber (2005) ‘Reconciling Liberalized Trade in Financial Services and Domestic Regulation’ unpublished paper on file with author.

<sup>95</sup> *Ibid.*

institutional framework of financial regulation. The various international standard setting bodies that cover banking, securities and insurance services (Basel Committee, IOSCO, and IAIS) provide such a framework and their standards are generally accepted by the majority of countries. The prudential standards established by these international bodies should become benchmarks to determine the content and substantive requirements of prudential regulation under the GATS.<sup>96</sup>

For example, if one were to address the issue of prudential regulation and transparency, it might be relevant to examine the transparency and disclosure standards that have been developed by international standard setting bodies. For instance, in banking supervision, the Core Principles on Banking Supervision were adopted in 1997 by the Basel Committee on Banking Supervision and contain important transparency standards to be applied in the banking sector. Core Principle 21 provides that bank supervisors must be satisfied that banks maintain adequate records produced from generally accepted accounting practices.<sup>97</sup> The supervisor must have access to banking records that allow it to obtain a true and fair view of the financial condition of the bank and the profitability of its business. The bank should publish regularly financial statements that provide a fair view of its condition.<sup>98</sup>

To address some of the uncertainties surrounding this issue, the WTO Council for Trade in Services has provided the Committee on Trade in Financial Services with a mandate to discuss issues related to establishing GATS-compliant standards of domestic financial regulation. The Committee, however, has made little, if any, progress in this area. For instance, the Committee has addressed, but only to a limited extent, the desirability of whether or not to define the scope of the prudential exception; various ideas have been mentioned, including the feasibility of establishing an international standard of prudential regulation,<sup>99</sup> but no formal action has taken place. Although the Committee's terms of reference are broad, and include the possibility of making proposals to the Council regarding all issues related to trade in financial services, the Committee has been under-utilised in this respect, and it is unknown at this time whether any members will, in the near future, make any formal proposals to clarify the 'prudential exception.' Nevertheless, the issue is assuming increasing importance, especially in today's turbulent global financial markets, because states are confronted with the contradictory pressures to keep domestic financial markets open to foreign capital and financial services as part of economic restructuring efforts, whilst also seeking to develop regulatory measures to promote financial stability.<sup>100</sup>

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<sup>96</sup> Ibid.

<sup>97</sup> Basel Committee on Banking Supervision, *Core Principles of Banking Supervision* (1997), Core Principle 21.

<sup>98</sup> Ibid.

<sup>99</sup> See WTO Doc. S/CSS/W/71, Communication from Switzerland (that prudential regulation should be interpreted according standards set by international bodies, ie. Basel Committee), and WTO Doc.S/CSS/W/27, Communication from United States (that GATS obligations and commitments should not prejudice a member's prudential regulatory discretion).

<sup>100</sup> See 'US-China Trade Relations Growing Steadily, Some Stumbling Blocks Remain', Issue 12 (28 June 2002)(discussing US objections at a meeting of the WTO Council on Trade in Services on 5 June 2002 about discriminatory Chinese regulations that impose restrictive branching requirements for foreign non-life insurance firms).

The breadth of the prudential carve-out undermines the stability of expectations of WTO members regarding their negotiated liberalisation commitments in the GATS. There is no uniformly applicable definition of prudential regulation. The lack of generally accepted international standards in this area may result in the emasculation of the GATS in terms of its application to cross-border trade in financial services. At present, national authorities can arguably adopt overly broad regulatory controls that can unnecessarily restrict international trade in financial services on prudential grounds. This could have implications for the efficiency and stability of financial systems. This paper does not suggest any definition of the term. However, it emphasises that the *prudential* concept must be interpreted according to uniform criteria and benchmarks that are recognised internationally. The promulgation of these standards must meet the criteria of accountability and legitimacy so that state authorities adopt and impose prudential regulatory controls for financial stability and investor protection and not for protectionist objectives.

## Dispute Resolution

Unlike international financial standard-setting bodies, such as the Basel Committee on Banking Supervision, the GATS and its Annex on Financial Services are legally binding agreements for WTO members that are backed by the powerful enforcement mechanism of the WTO Dispute Settlement Body. The WTO Dispute Settlement Understanding (DSU) is the agreement that provides for a dispute resolution process (DSP) whereby members may commence proceedings before a panel of experts to determine whether another member's trade restrictions violate obligations under the WTO Agreements. DSP panels are *ad hoc* and rely on a legalistic approach to interpreting WTO agreements and determining compensation for breach.<sup>101</sup> The DSP could potentially be used to interpret whether a member's financial regulatory measures comply with GATS principles and the member's schedules of commitments for market access and national treatment. It could also be used to determine whether a member's regulatory measures are taken for *prudential reasons* and therefore fall within the prudential exception. The *ad hoc* and legalistic nature of DSP adjudications, and the WTO's limited resources to provide expertise in regulatory matters, suggests that the DSP is an inappropriate forum to resolve complex disputes regarding the permissibility of a member's regulatory measures under the GATS. Moreover, most panellists and Appellate Body members are experienced mainly with trade policy, and less with regulatory issues, and so will likely impart a perspective that militates in favour of a member's liberalisation commitments and obligations at the expense of its regulatory objectives. This could potentially weaken domestic regulatory regimes for financial services and thereby increase financial fragility in many financial systems.

Moreover, dispute panels could potentially use various tests and standards of review that would make it difficult to uphold the validity of a regulatory measure that may derogate from a member's commitments. These standards of review might possibly rely on a necessity test (or similar test) that would make it difficult for a

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<sup>101</sup> The Annex on Financial Services provides that experts in the area of financial regulation and trade will be appointed as dispute panelists if a claim is brought under the Annex.

member to demonstrate that its departure from a WTO obligation or commitment was justified on prudential grounds. For instance, a member might be required to show that the prudential measure in question was the least restrictive measure possible to accomplish the regulatory objective. This would substantially limit domestic regulatory autonomy, especially in a sensitive area like banking regulation. Moreover, when evaluating the validity of substantive standards of banking regulation, a panel might possibly resort to the international standards adopted by various supervisory bodies (eg., Basel Committee) as a benchmark for determining the legality of a regulatory measure. This would be objectionable on policy grounds precisely because the standards these bodies approve are determined primarily by the rich industrial states and therefore should not be universally applicable to all countries who are subject to WTO dispute proceedings. The use of the DSP therefore to determine the limits of prudential regulatory standards may undermine the sovereignty and regulatory discretion necessary for WTO members to apply efficient standards of financial regulation.

### ***Standards of Review***

WTO members recognise the breadth of the prudential exception and generally regard it as an escape clause that allows host country regulators to impose regulatory controls for *prudential reasons* if the goal or objective is to promote the stability and integrity of the financial system or to protect policyholders, depositors, or investors. Although a prudential regulatory control cannot be taken for the purpose of avoiding a member's commitments under the GATS, many regulators could potentially adopt a measure that is taken ostensibly for a prudential reason but nevertheless has the effect of undermining or diminishing the effectiveness of a member's specific commitments. The DSP would be in the position of playing an *ad hoc* role in evaluating the types of regulatory measures used by a member and whether such controls cause a member to depart from its schedule of specific commitments. It is argued that the DSP is not an appropriate forum for devising future looking standards for determining whether a member's domestic financial regulation is GATS compliant. Moreover, efficiency and legitimacy concerns suggest that the WTO should adopt additional legislative capacity to find a better synthesis in weighing these issues or should rely on other international economic organizations to implement legitimate standard setting that can be used as a reference for dispute settlement panels. The rapid changes occurring in the financial services sector necessitate a consensus approach to standard-setting that involves all countries – either directly or indirectly – while de-emphasising contentious approaches, such as the DSP.

The DSP is an inappropriate forum to decide disputes regarding the scope and substance of a member's prudential regulation. It is important therefore to reach some consensus over the types of legitimate regulatory standards and practices that could have the effect of restricting trade in financial services but which may be necessary to reduce systemic risk and to protect consumers and investors. These international norms of prudential supervision are not found in binding treaties or in customary international law, nor should they be found in the standards adopted by IFIs, such as the Basel Committee, on the grounds of accountability and legitimacy. Alternative international regulatory structures therefore should be considered as a way of building more efficient international standards of prudential supervision and for determining what types of controls to place on cross-border capital flows. These standards should

be adopted through an effective decision-making process that is accountable to those countries that are subject to its application. Furthermore, these countries must have the opportunity to exercise some type of meaningful influence over the development of such international standards.

The overall objective of WTO members regarding financial sector issues will be to negotiate liberalization commitments on the basis of national treatment and market access but to maintain their regulatory discretion to impose prudential controls that may have the effect of restricting cross-border trade in financial services, possibly in derogation of their specific commitments. The substantive content and scope of a WTO member's prudential controls may not be within the purview of the GATS and WTO dispute settlement process. The GATS does not divest domestic regulators of legal authority to adopt substantive requirements of financial regulation. For many countries, however, there are market pressures and official incentives from international organizations to adhere to the prudential regulatory standards of international financial institutions (IFIs). As mentioned above, a dispute settlement panel or appellate body could possibly decide to use the prudential standards of the IFIs (eg., Basel Committee and IMF) as a benchmark for determining the validity of a member's prudential measures under the GATS. The major objection to this would be on accountability and legitimacy grounds because of the exclusive membership of IFIs and their opaque decision-making structures. Accordingly, WTO members should be reluctant to entertain such proposals until there has been reform of international standard setting.

### **WTO Decision-making and Institutional Linkages**

Under the WTO Marrakesh Agreement, the Ministerial Conference and the General Council have exclusive authority to adopt interpretive decisions of the various WTO agreements.<sup>102</sup> The Ministerial Conference conducts a plenary meeting every two years at which the political leaders of WTO member states meet to set goals and objectives and to approve the work of the General Council. The General Council is composed mainly of trade diplomats from all WTO members, and they meet monthly to prepare the groundwork for the Ministerial Conferences. The Council also serves as the Trade Policy Review Body and the Dispute Settlement Body. It also has the authority to make interpretative decisions of the various WTO multilateral and plurilateral agreements. It also can set the agenda and policy programmes for the three WTO Trade Councils that deal respectively with trade in goods, services, and intellectual property. The Council delegates authority to these Trade Councils to examine proposals by members on trade issues, negotiating procedures, and the division of responsibilities among WTO Committees. It also influences which members will be involved in vetting meetings where WTO policy and negotiation procedures are examined.

For instance, in the area of trade in services, the WTO Council on Trade in Services has responsibility for issuing legally non-binding interpretations of the GATS and its various annexes and may fulfil this function by acting upon the recommendations of various WTO committees that examine particular services sectors. Regarding trade in financial services, the Committee on Trade in Financial

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<sup>102</sup> Marrakesh Agreement, Art IX

Services can make recommendations to the Council on Trade in Services regarding proposed standards and interpretations of the GATS, and any communications by members.

Unlike the IMF and World Bank, the WTO has a horizontal decision-making structure based on one member one vote; all members, more or less, have equal procedural opportunity to influence WTO decisionmaking. Because WTO members each have one vote, in theory each member has equal rights to initiate proposals and to participate in deliberations in the WTO committee system. In practice, however, the WTO General Council makes most decisions based on consensus, and any disputes or objections are usually worked out in committee meetings before the proposal is passed up for Council consideration. The consensus principle may only be set aside in certain situations where members fail to reach consensus on a particular issue, in which case the Ministerial Conference and General Council can render interpretative decisions with the approval of a three-quarter-majority vote of the WTO membership.

The consensus principle, however, usually determines whether a specific proposal is successful. Consensus is usually decided on the basis of any number of meetings of committees and small groups of representatives who convene, sometimes informally, on a more or less *ad hoc* basis to address particular issues of concern. These informal meetings have traditionally been dominated by the so-called *Quad* members – Canada, US, EU, and Japan – who take soundings on the viability of various proposals. The large economically dominant members are usually best equipped to influence such informal negotiations to their advantage – often at the expense of poorer, developing countries - because they usually have better access to information, expertise and resources. Moreover, it is generally understood that for any proposal to be approved based on consensus there must be support from the *Quad* before the proposal can be formally submitted to the relevant Trade Council and then on to the General Council.

The operations of the WTO committee system have been criticized for being opaque and the selection process irregular regarding which members are invited to participate in particular committees. Although each member has one vote, in practice the strongest economic powers exercise most influence in the operations of the organization. Moreover, the consensus principle does not work effectively because most issues are decided in advance in the relevant committees where, it is argued, some countries are not invited to participate, and then later during plenary meetings of the General Council members who are politically less influential will be pressured by more powerful states to go along with what was decided. It is argued that the opaque structure and lack of consistent procedures for determining which members participate in which committees undermines the accountability of the WTO to its members and subjects the poorer, weaker states to the interest of the more powerful states.

As mentioned above, the WTO dispute settlement process allows members to enforce rights and obligations under the WTO Agreements. Unlike the IMF or World Bank which can withdraw benefits to members (eg., restricting access to financing facilities), the WTO as an organization can impose no sanctions nor withhold benefits (with few exceptions) to members who are violating their commitments and

obligations under the Agreements. The only way to hold members accountable for their obligations is through dispute settlement. The DSP is regarded as an accountability mechanism because it allows members to vindicate their rights and to hold other members accountable for breaching their obligations. This accountability mechanism has particular relevance in the financial regulation context because it allows members to challenge other members' regulatory measures if they violate the GATS. Specifically, members may use the DSP to institute proceedings against a country for maintaining domestic regulatory standards that are not transparent or for maintaining measures that may not be least restrictive in terms of their impact on international trade to accomplish a valid regulatory objective.

The DSP, however, has been criticized on a number of grounds, as discussed above, particularly with respect to accountability because its *ad hoc* approach only addresses the issues raised in a particular dispute. This process is haphazard and will not produce efficient or adequate international standards of financial regulation. Moreover, this will have a particularly pernicious impact on the economic growth prospects of poorer countries and may favour developed countries because if dispute panels rely on standards adopted by the Basel Committee and other IFIs, this will undermine the development of efficient economic and financial regulation for many countries.

Also, the WTO negotiation process for liberalization commitments on market access and national treatment is generally benefiting richer countries which have the expertise and negotiating skills to agree to commitments that favour their own political and economic needs often at the expense of developing countries. It should be added that the DSP itself is used much more by developed countries than developing or emerging market members because to institute DSP proceedings is expensive and requires specialized advice and assistance that only developed countries and some developing countries have the resources to afford. This is why very few claims are brought by developing countries, especially against developed countries. Moreover, the WTO has been criticized as lacking legitimacy because it adopts international rules and obligations to regulate trade which infringe the domestic authority of states to govern their economies (Woods & Narlikar, 2001).

#### *International Cooperation with other IFIs*

The efficient regulation of global financial markets requires that international organizations and standard setting bodies operate within a coherent institutional framework that is designed to promote cooperation and coordination of standard setting, implementation, and enforcement. This involves international, regional, and national authorities working together and sharing jurisdictional authority over the supervision and regulation of the financial system as it relates to systemic risk. The existing institutional structure of international financial regulation fails to achieve these objectives in part because there exist few formal institutional linkages that can facilitate the work of the global standard setting bodies with the implementation and enforcement efforts of regional and national authorities. Despite the lack of progress in this area, international economic organisations have taken some steps toward improving cooperation and coordination between themselves in addressing issues that affect financial stability and regulation. These efforts discussed below can provide a basis for further institutional reform at the international level.

For example, under both the GATT and GATS, the WTO has a general obligation to consult and accept certain IMF factual ‘findings of statistical and other facts . . . relating to foreign exchange, monetary reserves and balance of payments’ (art XII: 5(e)).<sup>103</sup> This means that in cases where the WTO is considering the application of a member to impose import restrictions in derogation of its existing commitments because of a balance of payments problem it must consult the IMF regarding factual issues relating to the member’s balance of payments and external financial situation.<sup>104</sup> The WTO, however, is not required to accept the IMF’s interpretations or views regarding whether a country’s financial condition justifies its non-compliance with WTO obligations. Rather, the WTO shall accept all statistical findings and other related facts on a member’s balance of payments and monetary reserves, and any legal determinations by the Fund regarding the consistency of a member’s exchange arrangements with the IMF Agreement (GATT, art. XV:2). As one expert noted, the Fund’s role is to provide its expertise on balance-of-payments assessments, not to decide whether the WTO balance-of-payments exceptions apply (Siegal, 2002).

The WTO balance of payments exceptions provide some flexibility for countries seeking to maintain financial stability during the liberalisation process. The GATT’s experience with the balance of payments exception benefited many developing countries in stabilizing their economies during times of crisis or when there was a clear threat to financial stability. The more lenient standard available for developing countries under the GATT and GATS for restricting imports recognises the special economic pressures they face. This mechanism promotes legitimacy of standards because it allows countries to engage international organizations in negotiations regarding the need for special trade restrictions as they make the transition to liberalized economies.

## Conclusion

The main objective of this paper is to analyse the application of the GATS to domestic financial regulation. The GATS regime is premised on the notion that enhanced competition in financial services will lead to healthier financial institutions and improved financial products for consumers and investors (Kono *et al.*, 1997). It seeks to do this by eliminating discriminatory regulatory practices and reducing

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<sup>103</sup> The relevant provision in the GATS is Article XII, which requires the WTO to consult with the IMF regarding factual issues that concern a member’s application to depart from its commitments on MFN, national treatment or market access when it is having a serious balance of payments crisis or external financial difficulties (art XII (1)).

<sup>104</sup> The WTO Appellate Body has addressed two cases involving the extent of the WTO’s obligation to consult with the Fund regarding import restrictions taken by WTO members that were inconsistent with their GATT commitments. In Argentina case, WTO members seeking to justify import restrictions under the GATT because they were part of an IMF economic restructuring program, and another case involving India maintaining import restrictions under the GATT as part of a developing country exception. The Appellate Body ruled that the GATT panel did not have to take into the IMF’s determination regarding India’s status as a developing country. In the Argentina case, it held that although Argentina had imposed certain surcharges on imports as part of a Fund restructuring program, the Appellate Body held that Argentina was not excused under Article XV (2) of GATT because its import surcharge was not an express condition of the IMF program. Moreover, it held that the WTO dispute panel hearing the case had no legal obligation to consult and to take into consideration the factual findings of the IMF regarding Argentina’s import surcharge.



obstacles to cross-border trade in financial services. Domestic regulators are permitted discretion to impose regulatory controls for a prudential purpose that may restrict cross-border trade in financial services and capital flows. Such prudential regulatory controls, however, cannot be taken to avoid commitments and obligations under the GATS.

GATS Article VI contains standards governing each member's adoption of domestic regulations that apply to trade in financial services. It also provides a negotiating mechanism for WTO members to develop regulatory disciplines of good practice that can potentially make reference to the work of other international economic organisations (IMF and World Bank). The Annex on Financial Services's 'prudential carve-out' allows a member to derogate from its commitments by imposing regulatory measures that may restrict cross-border trade in financial services if such measures are taken for 'prudential reasons', including the 'protection of depositors, investors, policyholders', or to maintain the 'integrity and stability of the financial system.' The Agreement, however, provides little guidance concerning what type of regulatory measures would be GATS-compliant. The Agreement seeks to remedy this in part by creating a framework that allows members to enter agreements recognizing the prudential regimes of other members. Some observers claim that this might lead to some level of convergence or harmonization in prudential standards amongst members, but no such negotiations have occurred so far with little sign of future progress.

Overall, the GATS regime provides a flexible framework for WTO members to negotiate liberalisation commitments while retaining national sovereignty to take regulatory measures that may have the effect of restricting cross-border trade in financial services. At present, members have not undertaken negotiations to establish regulatory disciplines that could provide benchmarks against which they could measure the validity of their domestic regulatory measures. Moreover, the prudential carve-out allows members broad discretion to adopt prudential regulatory measures that may have the effect of departing from GATS obligations. Although the WTO Council for Trade in Services and the Committee on Trade in Financial Services are not presently attempting to define the 'prudential exception', nor are they seeking to establish an international standard of prudential regulation, the importance of determining what measures can be validly taken by WTO members to regulate financial markets and firms without violating GATS commitments and obligations principles has increasingly become a topic of trade policy concern. The IFIs should take the lead in defining international standards of prudential supervision, but do so in a way that involves developing countries and other developed countries that have traditionally been left out of the standard setting process. This is necessary to avoid the scenario of having the WTO dispute settlement process invoked to decide on the validity of a state's prudential regulatory measures.

Although the WTO does not have the capacity or the mandate to set international standards of prudential supervision, the GATS negotiating framework allows members to bargain with one another on issues of national treatment and market access, and to do so in an informed manner that adequately promotes their economic development needs. Nevertheless, liberalization of cross-border trade in financial services and capital flows continue to be a source of concern for financial stability reasons, which suggest the need for international regulatory reform. Thus, even if

WTO balancing favours domestic regulation at the expense of trade, financial stability risks may still arise from trade-led interdependence of banking systems. This why more international prudential mechanisms are needed to deal with these risks and also to promote trade by ensuring that so-called prudential measures are not motivated primarily by protective goals.

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