

**D. Dietrich/J. Finke/C. Tietje**

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Bilateral Trade and Regional  
Integration Agreements

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# **Liberalization and Rules on Regulation in the Field of Financial Services in Bilateral Trade and Regional Integration Agreements**

by

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## A. Introduction

The international financial crisis of 2008/2009 has led to an extensive discussion on the architecture and structure of the international financial system. During and in the aftermath of the crisis numerous legislative and policy initiatives on the domestic, European and international level have been initiated and at least partially implemented. One underlying issue has been the possible correlation between liberalization and deregulation of financial markets and the stability of the international financial system, especially with regard to the situation of developing and least developed countries. The debate so far has been dominated by extremes: While some argue that the causes of the financial crisis cannot be attributed to excessive liberalization and/or deregulation, others blame these trends in particular. A similar line of arguments can be seen with regard to the situation of developing and least developed countries. Some see a clear relation between the economic effects of the financial crisis on these countries and the degree of liberalization and deregulation of their financial services; others deny any such relation.

Irrespective of the views on what has caused the financial crisis and its effects, the discussion on how to prevent such crises in the future quickly focused on the issue of more effective regulation and supervision. In this context, critiques of liberalization and deregulation were concerned that due to international obligations states could not independently determine the appropriate level of regulation and supervision for their financial markets, a concern expressed by the buzzword “policy space”. It refers to existing international legal obligations that supposedly prevent states to adopt measures with regard to financial services that are exclusively based on domestic policy considerations.

Before addressing aspects of “policy space” and related questions concerning financial services, namely from a development perspective, it is essential to clarify the relationship between “liberalization” and “deregulation” of trade in (financial) services. In the context of international economics and international economic law, liberalization refers exclusively to the market-entry possibility of service providers and their non-discriminatory treatment with regard to service providers from other countries (most favored nation obligation) and the host country (national treatment). (De-)regulation, in contrast, is concerned with governmental measures affecting service providers after market entry and on a non-discriminatory basis. Deregulation thus refers to reducing restrictions for service providers within a domestic market. This, however, does not necessarily imply that supervision of financial services will be less stringent. There is no compelling relationship between deregulation and the intensity of financial service supervision. A comprehensive set of rules on regulation in return does not automatically guarantee that these rules are actually applied and their implementation is supervised.

The purpose of this study is to give a structured overview of approaches in current international economic law concerning liberalization and regulation and to present a broad picture of the respective status quo. This predominately legal analysis is supplemented by an economic assessment of key data and policy considerations on liberalization and (de-)regulation of financial markets. One main question that shall be answered by this interdisciplinary study of law and economics is whether the current legal approach of international, plurilateral and bilateral treaties concerning financial services is appropriate in light of economic theory and reality or whether “more policy space” is needed. In this regard, namely development aspects shall be considered.

## B. The International Market on Financial Services Before and After the Crisis – Stylized Facts

Since 2000, trade of financial services grew rapidly for almost all countries, leading to increasingly important financial sectors. Although much of this development is attributed to high-income countries, low- and middle-income countries also benefited from financial integration on average. There were, however, also differences between income groups. The 2008 world financial crisis hit developed and developing countries. The latter have been affected mainly because of reduced risk capacity of international investors.

Trade in financial services has gained momentum since China became a member of WTO in 2001 (figure 1). Between 2001 and 2007, the average annual growth rate has been almost 20 %, with 2007 being the year with the fastest growth so far (29,7 %). By year end 2007, exports of financial services amounted to US\$366 billion, or 11 % of global exports in commercial services – compared to US\$124 billion or 8 %, respectively, in 2001. While in the 1990s, exports of financial services by low- and middle-income countries stagnated or even declined, it gained momentum from 2000 (figures 2,3).<sup>1</sup> By year end 2006 (more recent data is not available), exports of financial services (measured in percent of Gross National Income) was almost 75 % larger than only ten years before. As for imports of financial services by low- and middle-income countries, the overall picture is rather different. In those countries, imports (measured in percent of Gross National Income) more than doubled between 1996 and 2001, but then declined in the two following years by 25 % to about 75 % of Gross National Income and have not changed since. Notwithstanding these different developments, the import of financial services is still more important than the export (figures 4,5).<sup>2</sup> The International Monetary Fund<sup>3</sup> provides further insightful estimates of foreign bank ownership by regions (table 1). According to these figures, foreign banks became more important than ever, especially in Eastern Europe and in Latin America. In the poorer regions (Africa, Middle East, Asian regions), however, the percentage change in foreign bank ownership was almost insignificant.

The rapid growth of trade in financial services is also reflected in changes in the size of the financial industries. Measured in terms of financial liabilities relative to Gross Domestic Product (figure 6), the size of financial sectors increased between 2000 and 2007 by some 20 % for low-income countries (from 22 % to 27 %) as well as for lower middle-income countries (from 36 % to 43 %). While upper middle-income countries have gained only 10 % (from 42 % to 46 %), the size of the financial sector of high-income countries increased by 30 %. The picture changes when considering total financial assets as a percentage of Gross Domestic Product (figure 7). For this, the respective growth rates are 16 % (low income), -1 % (lower middle income), 51 % (upper middle income) and 13 % (high income). Private credit increased since 2000 (figure 8) by about 20-25 %

<sup>1</sup> Income classifications follow World Bank definitions.

<sup>2</sup> Owing to lack of reliable data, trade in financial services cannot be differentiated with respect to the modes of foreign market operation. Neither is country data on foreign direct investment in the financial services sector publicly available on a reliable and comparable basis.

<sup>3</sup> *IMF*, Global Financial Stability Report, 2007.

with the exception of upper middle-income countries for which this figure is more than 90 %.<sup>4</sup>

There are, however, significant differences with respect to the size of the financial systems between country groups (figure 9). Low-income countries still have rather underdeveloped financial sectors, particularly with respect to private credit. The size of the private bond market as well as private credit by financial intermediaries (including banks) is substantially lagging behind other countries. Only with respect to stock market capitalization is there no longer a significant difference between low-income and lower middle-income countries. It is not surprising that the depth and the scope of the financial system are most developed in high-income countries. However, the recent global financial crisis gives formidable evidence for financial resources being inefficiently allocated and thus qualifies the overall picture.

In the course of the global financial crisis starting in August 2007, the upward trend in the changes in international claims of banks has been broken. Since the second quarter of 2008, banks' cross-border claims not only lost momentum but actually decreased (figure 10). Net claims on developing countries have been affected differently, however (figure 11). While countries in Latin America and in the Asia-Pacific region experienced a sharp fall, Emerging Europe has suffered only temporarily. Net claims on countries in Africa and in the Middle East have even increased. This pattern masks, however, the sharp decrease in both, claims and liabilities of international banks. Cross-border claims on developing countries have stabilized by the second quarter of 2009, with borrowing in Asia Pacific, in Latin America and in the Caribbean already expanding slightly. Still observable contractions in other regions have been at least smaller than in the quarters before. International claims of banks on all developing regions, comprising cross-border claims in all currencies and local claims in foreign currencies extended by banks' foreign offices to residents of the host country, increased by mid-2009 (figure 12). This pattern is accompanied by an increasing reluctance by banks to conduct banking business in local currency as there is a shift away from local claims and liabilities in local currencies.<sup>5</sup> Accordingly, developing countries have become increasingly more dependent on the stability of foreign exchange markets.

In sum, there had been a secular positive trend in trade of financial services before the global financial crisis. Developing countries also had their share in this trend, although to different degrees. The financial sectors in many countries became more integrated and developed. However, starting in August 2007, the global financial crisis has put strain on developing countries as well. For the future, this may decelerate the pace of financial integration even if the institutional and legal environment for liberalization remain unchanged.

### **C. International Economic Law and Financial Services Liberalization and Regulation**

Based on the data highlighted in the previous section, the following section will focus primarily on the legal aspects of financial services liberalization. It will address in particular to what extent developing countries are under an obligation to liberalize their financial

<sup>4</sup> For upper middle income countries, this figure is somewhat biased by the temporary decline in private credit in the aftermath of the Asian financial crisis.

<sup>5</sup> BIS Quarterly Review, December 2009, 18f.

sector and, in case such an obligation exists, to what extent international economic law restricts a country's freedom to adopt such regulatory measure which it assumes to be beneficial for its development. In other words: does international economic law restrict the policy space of (developing) countries?<sup>6</sup>

Due to the development that has been aptly described as the 'mushrooming' of Free Trade Agreements (FTAs), the answers to these questions cannot be based on an analysis of the relevant GATS provisions alone, even though the GATS must be the natural starting point of the following analysis. As the more recent generation of FTAs include not only a general chapter on trade in services, but also special provisions with regard to financial services liberalization, this study will focus on a selected number of FTAs as well. These will include the

- North American Free Trade Agreement (NAFTA),
- Free Trade Agreement between the United States and Peru (US – Peru FTA),
- Economic Partnership Agreement between the CARIFORUM States and the European Union (CEPA),
- Association Agreement between the European Union and Chile (EU – Chile FTA),
- Free Trade Agreement between Singapore and Panama (Singapore – Panama FTA).

In addition, this section will consider standards issued by different international institutions, such as the Basel Committee on Banking Supervision or the International Organization on Securities Commissions, international investment protection law, and the impact of World Bank and IMF Conditionality as well as other programs, like the Financial Sector Assessment Program (FSAP).

## I. GATS and its Rules on Financial Service Liberalization and Regulation

GATS provides rules that generally apply to all trade in services, whereas Annexes, Protocols or Understandings to the main agreement add additional provisions for specific disciplines such as trade in financial services. In order to assess the extent to which states are under an obligation to liberalize their financial services, it is necessary to analyze GATS itself, the Annexes on Financial Services (especially the first one) as well as the GATS Understanding on Commitments on Financial Services. The list of relevant WTO documents also includes the Fifth Protocol to the General Agreement on Trade in Services even though it does not add any new substantial provisions. It was necessary because the WTO members at the end of the Uruguay Round (15 April 1994) were unable to agree on the extent to which trade in financial services should be liberalized. But on 3 December 1997, the 5<sup>th</sup> Protocol was finally agreed upon and it became effective on 1 March 1999 for those WTO members that had ratified it. The main function of the Pro-

<sup>6</sup> The term 'policy space' is understood as the degree to which a state is able to determine its financial and regulatory policies independently. Such determination is, at first, a factual question and does not imply whether the existence or non-existence of such 'policy space' is either 'good' or 'bad', 'development friendly' or development 'unfriendly'. See also Gallagher arguing that states that committed themselves to liberalize their financial services have forfeit their policy space; *Gallagher*, Policy Space, G-24 Discussion Paper No. 58, 17.

TOCOL was to bind the ratifying members to the newly negotiated country schedules listed in the Annex of the Protocol.

### 1. *Basic Rights and Obligation*

GATS established a flexible framework for primarily liberalizing, but not as such for deregulation of trade in services. Whereas the MFN principle as well as basic transparency requirements apply to all WTO members, market access and national treatment obligations are only binding to the extent that a WTO member has undertaken special commitments listed in the member's schedule. If WTO members do not agree to liberalize certain service sectors or sub-sectors (positive list approach), they are under no obligation to liberalize trade in services generally or trade in financial services in particular. In addition, WTO members may also add certain restriction to their commitment or limit their commitments to certain modes of supply. Regarding financial services, most developing countries have limited commitments to mode 3 (commercial presence) and basic banking practices. Only developing countries that joined the WTO after it was established had to accept more far-reaching liberalization commitments due to their lack of bargaining power in the admission process.

Based on the distinction between liberalization and deregulation, it should be born in mind that GATS primarily aims at liberalizing, but not necessarily deregulating trade in services, even though it includes provisions that are directed at and impose requirements on domestic regulation.<sup>7</sup> However, these provisions, as will be shown below, do not amount to an obligation to deregulate. Instead, by introducing principles of good governance and a certain level of coherence they aim at the re-regulation of the existing regulatory framework in order to mitigate negative impacts on effective market access caused by domestic (over-)regulation.<sup>8</sup>

Similar to GATT, WTO members are generally obliged to adhere to MFN treatment (Art. II GATS) and transparency (Art. III GATS) with regard to all services except those 'supplied in the exercise of government authority' (Article 1:3 (b) GATS) which are generally excluded from GATS.<sup>9</sup> There are no exceptions or rules that allow developing countries to deviate from these obligations based on their special needs for development. And even though WTO member may exempt specific sectors from the application of the MFN principle (Art. II:2 and 3 GATS), such exemptions must be based on a 'positive'

<sup>7</sup> That GATS is primarily aimed at liberalization, not deregulation, does not imply that there are no requirements that may oblige WTO members to change or even abolish existing regulations, like in case of Art. VI GATS. Still, neither liberalization nor the minimum standards on domestic regulations of Art. VI GATS actually aim at reducing or eliminating regulations. It is thus reasonable to argue that GATS may require re-regulation. However re-regulation must be distinguished from mere deregulation; see *Wouters/Coppens*, in: Alexander/Andenas (eds.), *The World Trade Organization and Trade in Services*, 207 (209).

<sup>8</sup> *Matsushita/Schoenebaum/Mavroides*, WTO, 604: "The barriers to trade in services are *regulatory*."

<sup>9</sup> Those services are defined as services supplied "neither on a commercial basis, nor in competition with one or more service supplier"; Art. I(3)(c) GATS, which, of course, does not clarify the scope considerably. Practice among WTO members has thus been largely incoherent. And even on an abstract level there seems only very little agreement as to which services are actually covered by the Art. I(3)(b) GATS exception, especially with regard to so called 'public services'; *Zacharias*, in: *Wolftrum/Stoll/Feinäugle* (eds.), *Trade in Services*, Art. I, para. 58 et seq.

approach, meaning that a WTO member might grant more rights to other members, for instance based on bilateral agreements.<sup>10</sup>

In contrast to these general obligations, market access (Art. XVI GATS) and national treatment (XVII GATS) are part of specific obligations of WTO members that must be read in conjunction with a country's schedule on service. The schedule lists the sectors in relation to which a state has committed itself to the specific obligations of Art. XVI and XVII GATS (positive list approach).<sup>11</sup> Only if WTO members undertake such specific commitments are they under a legal obligation to grant market access to foreign-service suppliers and adhere to the principal of non-discrimination. In addition, commitments in schedules might be limited to specific subsectors. The financial services sector, for example, is divided into the subsectors 'insurance and insurance-related services' and 'banking and other financial services'. Further, within these subsectors specific activities can be classified.<sup>12</sup> With regard to insurance and insurance-related services, country schedules distinguish between direct insurance, reinsurance and retrocession, insurance intermediation and services auxiliary to insurance (such as consultancy, actuarial, risk assessment and claim settlement). The different categories within the subsector 'banking and other financial services' are usually even more detailed and include activities that are considered to be classical banking business, such as acceptance of deposits and other repayable funds from the public, lending of all types, financial leasing or payment and money transmission services, as well as more advanced banking services, including trading for their own account or for the accounts of customers, money brokering, settlement and clearing services for financial assets, provision and transfer of financial information and other auxiliary financial services.

In particular, developing countries have made use of their right to restrict liberalization to certain subsectors by limiting their commitments to insurance and core banking services (deposit taking, lending, payment and money transmission services, financial leasing, and guarantees and commitments), thereby excluding more advanced, capital-market related services (trading in securities, underwriting and asset management).<sup>13</sup>

In addition, GATS does not secure general or unlimited market access. Instead it aims at prohibiting certain measures that have a particular negative effect on market access (so-called black-list method). Based on Art. XVI:2 GATS the following measures may not be maintained or adopted in case a member has undertaken special commitments:

- limitations on the number of financial institutions,
- limitations on the total value of financial service transactions or assets,
- limitations on the total number of financial service operations or on the total quantity of financial services output,

<sup>10</sup> *Kampf*, in: Grabitz/Hilf, Das Recht der Europäischen Union, Band V, para. 80.

<sup>11</sup> The positive list approach arguably provides more autonomy for countries when negotiating their commitments, UNCTAD, Services, Development and Trade: The Regulatory and Institutional Dimension, TD/B/C.I/MEM.3/2, 6 January 2009, para. 65, which is believed to have "particular benefits for developing countries who may lack the necessary expertise to understand which limitations or restrictions to list under negative-list approach"; *Alexander*, in: Alexander/Andenas (eds.), The World Trade Organization and Trade in Services, 561 (575).

<sup>12</sup> See Guidelines for the Scheduling of Specific Commitments under the General Agreement on Trade in Services (GATS), WTO Doc S/L/92, 28 March 2001, 38.

<sup>13</sup> *Roy/Marchetti/Lim*, Services Liberalization in the New Generation of Preferential Trade Agreements, 31 et seq.

- limitations on the total number of natural persons that may be employed in a particular financial service sector or that a financial institution may employ,
- measures that restrict or require specific types of legal entity or joint venture through which a service may be supplied, or
- limitations on the participation of foreign capital.

If a country undertakes commitments with regard to one or several of these different categories it may limit these commitments to one or more of the different modes of supply covered by GATS: (1) cross-border supply; (2) supply through the movement of consumers to the location of the supplier; (3) supply through the establishment in a country of the commercial presence of legal entities from another country; and (4) the supply through natural persons of one country in the territory of another (see Art. I:2 GATS). WTO members are thus not required automatically by GATS to liberalize their financial service industries. Quite the contrary, it must be emphasized that GATS provides a set of flexible rule to negotiate specific liberalization commitments.<sup>14</sup> Thus, legally speaking, WTO members may independently determine the extent of their liberalization commitments based on their own policy objectives.

As WTO members do not exist in an isolated environment, the indicated independence can, of course, be limited due to restraints and pressure from other members, in particular from developed ones. But this situation has been envisaged by GATS, as the aim of further liberalization shall be achieved through continuing negotiations (Art. XIX GATS). During the course of these negotiations, WTO members are expected to extend their schedules to sectors not yet covered by them. But these expectations are not accompanied by a legal obligation to do so and they have not been fulfilled so far. Most original WTO members (see Art. XI Agreement Establishing the WTO) have generally refrained from agreeing on further commitments with regard to liberalizing their financial services. It has thus been concluded that, with few exceptions, GATS did not trigger ‘real liberalization’ even when WTO members have committed themselves in their schedules.<sup>15</sup> They either represent specific commitments of existing levels of market access with significant restrictions remaining or do not match the actual national practice, meaning that in fact markets are more liberalized, but states refrain from legally committing to this level of liberalization internationally. Only states that joined the WTO after it had been established were actually forced to agree to substantial liberalization commitments, including trade in financial services. That new member were forced to accept more far-reaching commitments than comparable countries that belonged to the founding member, has resulted in considerable asymmetries within the WTO membership.<sup>16</sup>

<sup>14</sup> *Alexander*, in: *Alexander/Andenas* (eds.), *The World Trade Organization and Trade in Services*, 561 (562).

<sup>15</sup> *Roy/Marchetti/Lim*, *Services Liberalization in the New Generation of Preferential Trade Agreements*, specifically exclude the most recent accessions to the WTO (e.g. China). Current commitments on financial services go back either to (adoption of the 5<sup>th</sup> Protocol), the end of the Uruguay Round in 1993 or to 1995 when the first extended negotiation on financial services were concluded, 31 et seq.

<sup>16</sup> *Cooke*, in: *Alexander/Andenas* (eds.), *The World Trade Organization and Trade in Services*, 615 (620).

## 2. Capital Transfer

GATS does not aim at the overall liberalization of international payments and transfers. However, it provides for a 'conditional obligation' according to which WTO members must not restrict current transactions and capital transaction that have been made in relation to service for which a member has undertaken specific commitments.

GATS does not aim at the general liberalization of payments and transfers for international transactions. However, it is widely acknowledged that effective liberalization of trade in services generally depends on the free movement of capital, at least with regard to services such as acceptance of deposits, lending, or trading in securities.<sup>17</sup> GATS thus provides for a 'conditional obligation' to liberalize international transfers and payments with regard to the specific commitments a WTO member has undertaken in its schedule. This obligation covers current transactions (Art. XI:1 GATS) as well as capital transactions (Art. XI:2 GATS). Based on the different language in these provisions it is assumed that Art. XI:1 covers transfers and payments "that are directly related to a service covered by a specific commitment",<sup>18</sup> whereas, according to footnote 8, the extent to which capital transfers must be liberalized depends on the mode of supply: in the case of a cross-border supply (mode 1), the transfer must form an essential part of the service itself while it covers capital related to the commercial presence in cases of mode 3, which includes capital transfers for the establishment of the presence or the repatriation of gains. The exact scope of this obligation is yet not clarified, but it does not seem unlikely that in practice WTO members have liberalized international transfers and payments beyond their legal obligation as they have liberalized trade in financial services beyond their specific GATS commitments. It thus may be presumed that economic realities rather than legal obligation are the driving force of liberalization measures of WTO members.

## 3. GATS and Limits for National Regulation

GATS does not aim at deregulation, nor does it force WTO members to adopt a certain regulatory approach. Instead, it allows for regulatory diversity, in particular with regard to regulating trade in financial services. In addition, it emphasizes the members' right to regulate. However, Art. VI GATS provides for basic procedural as well as substantial standards with regard to domestic regulation. But even infringements of the minimum standards are subject to the exceptions provided for in GATS, including in case of trade in financial services the prudential carve-out exception that allows members to pursue their domestic policies.

An equally important issue with regard to financial services liberalization is a country's ability to regulate its financial market. This requires certain autonomy to set rules that secure the national economic policies and to determine how these rules are implemented and how the implementation process is supervised. Financial services, especially banking, have been perceived as crucial for a country's development and its 'financial sov-

<sup>17</sup> *Tamirisa et. al.*, Trade Policy in Financial Services, 7.

<sup>18</sup> *Christ/Panizzon*, in: Wolfrum/Stoll/Feinäugle (eds.), Trade in Services, Art. XI, para. 17.

ereignty'.<sup>19</sup> The 2005 Declaration of the Ministerial Conference in Hong Kong has thus recognized the relationship between liberalization and the establishment of an effective supervisory framework in order to guarantee the stability of the overall financial system. In addition, ever since the recent global financial crisis developing and developed states alike have focused on their right to regulate. Even the IMF emphasizes that a careful and appropriate regulation of the financial sector is necessary.<sup>20</sup> But at the same time a general agreement exists that, in particular with regard to trade in services, overregulation can contradict states' liberalization commitments. National regulation can cause substantial obstacles to effective market access, which in turn might render the liberalization commitments close to meaningless.<sup>21</sup>

GATS tries to balance these two different interests. Even though not aiming at general deregulation, it provides for some general obligations with regard to domestic regulation (Art. VI GATS). At the same time, with regard to all services covered by GATS, the agreement's preamble recognizes the states' right to regulate including the right "to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives". The preamble stresses particularly the "need of developing countries to exercise this right", thus recognizing the different levels of services regulation in different countries.

a) *Art. VI:1-3 GATS*

Art. VI GATS imposes procedural as well as substantial obligations with regard to domestic regulation.<sup>22</sup> In sectors where WTO member have undertaken specific commitments, general measures that affect trade in services must be administered in an objective and impartial, and thus non-discriminatory manner (Art. VI:1 GATS). In addition, Art. VI:1 GATS adds the requirement of reasonableness, which is subject to some dispute regarding its exact meaning.<sup>23</sup> This in return also influences the degree of judicial review that WTO panels or the Appellate Body are able to exercise. In its strongest form, reasonableness implies some form of a proportionality test, which can result in the exercise of full scrutiny by dispute settlement bodies that would balance the conflicting interests of effective market access against the right to regulate.<sup>24</sup> In its weakest form, however, the reasonable-test is based on generally accepted standards of rationality and sound judgment.<sup>25</sup> Based on the language of Art. VI:1 GATS (using the term reasonable, not necessary or appropriate) and GATS preamble that emphasizes the right to regulate and that must be taken into account when interpreting the agreement, one must conclude that dispute settlement bodies at least should not employ full judicial review, but concede WTO members a considerable amount of discretion. And even though neither WTO

<sup>19</sup> *Treves*, in: Giovanoli (ed.), *International Monetary Law: Issues for the New Millennium*, 111 (118).

<sup>20</sup> *IMF*, *Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management*, 4 February 2009, <[www.imf.org/external/np/pp/eng/2009/020409.pdf](http://www.imf.org/external/np/pp/eng/2009/020409.pdf)>.

<sup>21</sup> *Wouter/Coppens*, in: Alexander/Andenas (eds.), *The World Trade Organization and Trade in Services*, 207 et seq.

<sup>22</sup> *Matsushita/Schoenbaum/Mavroidis*, *The World Trade Organization*, 627.

<sup>23</sup> For a comprehensive overview see *Sunde*, *Grenzen innerstaatlicher Regulierung*, 27-51.

<sup>24</sup> *Trachtman*, in: Petersmann (ed.), *Reforming the World Trading System: Legitimacy, Efficiency, and Democratic Governance*, 205 (211).

<sup>25</sup> *Krajewski*, in: Wolfrum/Stoll/Feinäugle (eds.), *Trade in Services, Art. VI, para. 11*.

panels nor the Appellate Body have decided on the exact meaning of the term ‘reasonable’ in Art. VI:1 GATS, existing jurisprudence with regard to the term ‘reasonable’ in Art. X:3 GATS indicates a less stringent interpretation.<sup>26</sup>

In addition to the procedural requirement set out in Art. VI:1 GATS, WTO members must also provide for some form of judicial review of administrative decisions that affect trade in services, even though this obligation is subjected to an ‘as soon as practicable’ modification (Art. VI:2 GATS). In case of national authorization requirements, the applicant must be informed within a reasonable period of time about the application provided that it had been complete under domestic laws (Art. VI:3 GATS). Regarding professional services, states must provide for adequate procedures to verify the competence of professionals of other member states if they have undertaken specific commitments.

*b) Art. VI:4-5 GATS*

These more or less procedural obligations are supplemented by the substantial provisions of Art. VI:4 and 5 GATS which address the conflict between the right to regulate and obstacles to effective market access based on national (over)regulation. In order to prevent measures relating to qualification requirements and procedures, technical standards and licensing requirements from constituting “unnecessary barriers to trade in services”, the Council for Trade in Services is assigned with developing disciplines thereby limiting a state’s right to regulate. Such disciplines require states to base qualification or licensing requirements on objective and transparent criteria (Art. VI:4(a) GATS). In addition they must not be more burdensome than necessary to ensure the quality of the service (Art. VI:4(b) GATS), and in the case of licensing procedures, not in themselves a restriction on the supply of the service (Art. VI:4(c) GATS).

Especially developing countries have expressed substantial opposition to the introduction of such disciplines. Special attention has been drawn to possible negative effects of necessity tests on states’ independence to determine their domestic regulatory prerogatives.<sup>27</sup> But it must be noted that even until such disciplines are introduced, WTO members are prevented from applying licensing and qualification requirements and technical standards that nullify or impair specific commitments they have accepted in their schedules (Art. VI:5 GATS). The requirement that measures must not be more burdensome than necessary is therefore already binding on WTO members, at least with regard to measures that aim at securing or improving the quality of the service.<sup>28</sup> In case of a dispute as to whether a member has complied with these obligations, a panel in its assessment of the case would be bound by international standards of relevant international organizations as applied by the individual member (Art. VI:5(b) GATS).

<sup>26</sup> WTO, *Dominican Republic – Import and Sale of Cigarettes*, Report of the Panel of 26 November 2004 WT/DS302/R, paras. 7.385, 11.67-11.68.

<sup>27</sup> UNCTAD, *Service, Development and Trade*, para. 70. It has been pointed out that the current draft of the Working Party on Domestic Regulation does not include a necessity-test anymore; *Krajewski*, in: Wolfrum/Stoll/Feinäugle (eds.), *Trade in Services*, Art. VI, para. 52. But critics have pointed out that the draft still includes terms that suggest a comparable standard like the necessity test; see South Centre, *The Draft GATS Domestic Regulation Disciplines – Potential Conflicts with Developing Country Regulations*, SC/AN/TDP/SV/12, October 2009, 3-4.

<sup>28</sup> *Wouter/Coppens*, *Domestic Regulation*, in: Alexander/Andenas (eds.), *The World Trade Organization and Trade in Services*, 207 (257).

Footnote 3 explains that the term ‘relevant international organizations’ refers to “international bodies whose membership is open to the relevant bodies of at least all Members of the WTO”. This indicates that Art. VI:5(b) GATS does not require that the WTO member itself is member of that international organization. Instead it is sufficient if the membership is restricted to the competent bodies of member states, such as regulatory authorities. But in case such organizations limit their membership to a certain group or number of states or their relevant bodies respectively, their standards cannot be referred to in order to clarify the meaning and scope of Art. VI:5(a) GATS no matter how relevant they might be or how much they are followed on a factual basis. At least Art. VI:5(b) would not be a sufficient basis for relying on these standards. Footnote 3 thus excludes the standards of the Basel Committee on Banking Supervision, as membership in the Committee is not open to all WTO members. It was set up by the G10 and only in April 2009 new representatives from the G20 were invited.<sup>29</sup> In addition, it is unclear whether it qualifies as an ‘international organization’ within the meaning of Art. VI:5(b) GATS as it has no founding treaty and rather serves as an informal forum aimed at providing policy solutions and standards. OECD standards also do not qualify. Even though the OECD would undoubtedly qualify as an international organization, its membership is not open to all WTO members, notwithstanding the recent enlargement process.

A possible exception to the list of international organizations that do not fall within the scope of Art. VI:5(b) is the International Organization of Securities Commissions (IOSC). The membership is limited to securities commissions or a similar government bodies, but according to the information of the IOSC, it is not restricted to a certain number or group of states. As of 2009, the membership comprised organizations from more than 160 jurisdictions.<sup>30</sup> Still, problems might arise due to the fact that despite its self-description, the IOSC, like the Basel Committee on Banking Supervision, has not been formed by a treaty or inter-state agreement. It serves as a forum for policy exchange and adjustment to achieve greater coherence in regulation and supervision of securities markets.

Even if standards of international organizations qualify as a basis for determining the meaning of Art. VI:5(a) GATS, it is not the standard itself that is decisive, but the standard “as applied by the individual member” (Art. VI:5(b) GATS). The language of the GATS therefore suggests that if a state expands or limits the scope of the standard in question, then this modified version of the standard and not the original one applies. In addition, it seems plausible to assume that if a state does not apply the standards at all, it cannot be relied on to determine whether a state has fulfilled its GATS obligations with regard to domestic regulations, at least not on the basis of Art. VI:5(b) GATS.

As soon as members agree on specific disciplines for domestic regulation according to Art. VI:4 GATS, the restrictions referred to above do not apply. But so far, it is unclear whether there will be a consensus within the Council for Trade in Services. The second revision of the draft on disciplines on domestic regulation from April 2009<sup>31</sup> was not able

<sup>29</sup> The Committee is currently comprised of representatives from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

<sup>30</sup> *Alexander*, in: Tietje/Brouder (eds.), *Handbook of Transnational Economic Governance Regimes*, 439 (440).

<sup>31</sup> *Disciplines on Domestic Regulation Pursuant to GATS Art. VI:4, Second Revision, 20 April 2009* annexed to the commentary of the South Centre, *The Draft GATS Domestic Regulation Disciplines*

to diffuse concerns among developing states that they would limit their policy space and leave the task of specifying the still rather abstract disciplines to dispute settlement panels. But from a development perspective it should at least be noted that the draft provides for certain, partly far-reaching exceptions. A developing country member is not required to apply the disciplines for a period of not-yet-specified years,<sup>32</sup> and least developed countries are not bound by these disciplines at all (even though they are encouraged to do so).<sup>33</sup> Developing countries also have the possibility to apply for an extension of the transitional time period set out in para. 42, even though the final decision in this case will rest with the Council for Trade in Services, based on a member's level of development, size of the economy, and regulatory and institutional capacity. In addition, developed countries are under a general obligation to provide technical assistance to developing and in particular least-developed countries upon their request. But the specific terms and conditions for such assistance must be mutually agreed on which is likely to limit the scope and effectiveness of the obligation considerably.

Still, even if the WTO members will finally agree on disciplines based on Art. VI:4 GATS, their relevance for providing a general framework concerning domestic regulation especially for financial institutions is limited. The same is true for the obligations that WTO members must observe with regard to Art. VI:5 GATS until such disciplines become effective. The obligations of Art. VI GATS are, like any other GATS obligation, subject not only to the general exceptions of Art. XII and XIV GATS, but also to the 'prudential carve-out' contained in para. 2(a) of the Annex on Financial Services, which along with the other Annexes forms an integral part of the GATS itself (Art. XXIX GATS). Thus, even if Art. VI:5 GATS is aptly characterized as a 'stand-still clause' whose impact is limited to developing countries that had not implemented a comprehensive regulatory and supervisory regime at the time they undertook their commitment,<sup>34</sup> these countries are still not barred from introducing such regimes with respect to financial suppliers based on the prudential carve-out exception, para. 2(a) FSA.

Furthermore, the function of the prudential carve-out as an exception to Art. VI GATS is important for what the disciplines based on Art. VI:4 GATS can actually address. As a matter of definition, the disciplines cannot qualify as prudential measures because the mandate of the Council is limited to Art. VI:4 GATS and does not cover the Annex on Financial Services. If the prudential carve-out had been a special provision relating to domestic regulation within the meaning of Art. VI GATS, it would have been at least possible to argue that the disciplines could include a definition or understanding on what prudential measures exactly are. However, since para. 2(a) FSA constitutes an exception to Art. VI GATS, meaning that a measure inconsistent with that provision and possible disciplines can be justified under the prudential carve-out, the mandate of Art. VI:4 GATS does not extend to specifying the content and scope of para. 2(a) FSA.

– Potential Conflicts with Developing Country Regulations, SC/AN/TDP/SV/12, October 2009, ii-viii.

<sup>32</sup> *Id.*, para. 42.

<sup>33</sup> *Id.*, para. 46.

<sup>34</sup> *Krajewski*, in: Wolfrum/Stoll/Feinäugle (eds.), *Trade in Services*, Art. VI, para. 69.

c) *Impact of the Appellate Body Report 'US Gambling'*

The Appellate Body Report in *US-Gambling* negatively affects the WTO members' ability to regulate trade in services because it qualified regulations on how the services were supplied (including a ban on remote gambling, e.g. internet) as a market access restriction within the scope of Art. XVI GATS. The jurisprudence of the Appellate Body also applies to regulations of trade in financial services. But its limiting effect is mitigated substantially by the prudential carve-out exception.

In *US Gambling* the Appellate Body held that a complete ban not of the service itself – gambling – but a certain modality to supply this service, remote supply of gambling (e.g. internet) – qualifies as a violation of market access obligations (if undertaken for that service sector).<sup>35</sup> It further argued that the US regulation on how to supply the service (face-to-face) qualified as a quantitative restriction because it had the effect of keeping cross-border suppliers out of the US gambling market. The Appellate Body thereby departed from its settled GATT doctrine according to which domestic regulations would be judged against the background of national treatment obligations only.

The decision has considerable impact on the ability of WTO members to independently determine the scope of their domestic regulations.<sup>36</sup> As most members prior to that decision had assumed that such regulations must merely meet the national treatment requirements, they usually had not added them as counter-exceptions to their schedules. By classifying them as market access restrictions and thus incompatible with Art. XVI GATS however, restrictions on how to supply a service that was in accordance with GATS prior to *US-Gambling* were now prohibited by GATS as long as they did not fall within the scope of one of the GATS exceptions.

As a consequence of *US-Gambling*, WTO members could of course alter their specific commitments and add domestic regulations that are affected by the Appellate Body's jurisprudence as exceptions to their commitments. Such a step would, however, be qualified as a withdrawal or modification of commitments that even though possible, even after three years, entitles other WTO members that have benefited from this commitment to claim 'necessary compensating adjustments' (Art. XXI:2(a) GATS).

Notwithstanding its impact on other service sectors, it seems unlikely that *US – Gambling* will have such an adverse effect on the members' ability to maintain comparable regulations with regard to trade in financial services and require major adjustment in their financial market regulations. In contrast to other services, restrictions on trade in financial services can be based on an additional exception: the prudential carve-out, which – as will be shown below – enables states to deviate from their specific GATS obligations to a considerable extent.

<sup>35</sup> WTO, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Service*, Report of the Appellate Body of 7 April 2005, WT DS/285/AB/R, para. 214 et seq.

<sup>36</sup> Pauwelyn, *WTO Softens Earlier Condemnation of U.S. Ban on Internet Gambling*, ASIL Insights.

#### 4. Prudential Carve-out and General GATS Exceptions

The prudential carve-out exception applies in addition to the general exception provided for in GATS. Because it does not require that a measure must be ‘necessary’ or ‘not more burdensome than necessary’ it demands less stringent requirements in order to justify a measures that infringes upon a member’s general or specific commitment. However, by requiring that measures may not be used as a means of avoiding GATS commitments or obligations, the prudential carve-out includes a limiting factor. And even though the exact meaning of this limiting factor is disputed among WTO members and has not yet been specified by either a WTO Panel or the Appellate Body, it still ensures that WTO members enjoy a considerable amount of discretion to choose their regulatory approach. Under the current legal regime it would be unacceptable for the scope of the prudential carve-out to be specified exclusively by referring to international standards, even though these standards would enhance coherence. The lack of coherence and the considerable amount of discretion that members enjoy might even encourage members to abuse the prudential carve-out exception for pure protectionist purposes.

The prudential carve-out supplements the general exceptions of GATS. Whereas Art. XII GATS allows for exceptions in case of balance-of-payment problems, Art. XIV GATS provides a justification for measures necessary *inter alia* to protect public morals or to maintain public order (lit. a) as well as human, animal or plant life or health (lit. b). The structure and language of the Art. XIV GATS exceptions are almost identical to Art. XX GATT, including the *chapeau* according to which measures must not be applied in an arbitrary or unjustifiable discriminatory manner or constitute a disguised restriction on trade in services. These exceptions are, however, less relevant in comparison to the prudential carve-out in case of the financial service sector. Nevertheless, all exceptions, including the prudential carve-out, apply not only to immediate restriction on supplying the service itself, but also on related obligations, especially the obligation to allow international payments and transfers in conjunction with service that form part of a member’s specific commitments.<sup>37</sup>

##### a) The Concept of Prudential Regulation

Prudential regulation is primarily concerned with the safeguard and soundness of individual financial institutions to protect consumers and it aims at leveling the effects of information asymmetry between financial institutions and its customers (micro-prudential approach).<sup>38</sup> But the financial crises highlighted that the concept also encompasses the subject of systemic regulation that focuses on the soundness and stability of the overall financial system (macro-prudential approach). Measures for prudential reasons thus include those “for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed” as well as measures that aim at “ensuring the integrity and stability of the financial system” (para. 2(a) FSA).

<sup>37</sup> In addition international payments and transfers may also be restricted or regulated based on monetary or exchange rate measures; *Tamirisa et. al.*, Trade Policy in Financial Services, 23.

<sup>38</sup> *Yokoi-Arai*, GATS’ Prudential Carve-Out, ICLQ 57 (2008), 613 (631).

The Basel Committee's Core Principles for Effective Banking Supervision provide a comprehensive list of core principles even though this standard is not legally binding on WTO members.<sup>39</sup> Among these widely-used methods are: minimum capital requirements aimed at creating a cushion that can absorb losses from credit risks in times of crises, legal lending limits, large exposure limits, and fit and proper requirements of management as well as incentives not to take too many risks.<sup>40</sup>

*b) The Prudential Carve-out Provision*

According to para. 2(a) FSA “[n]otwithstanding any other provisions of [GATS], a Member shall not be prevented from taking measures for prudential reasons,” which includes, but is not limited to measures “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 and stability of the financial system.” Para. 2(a) FSA, in contrast to GATS Article XIV (general exception) and Art. VI (domestic regulation), thus does not require an objective necessity test.<sup>41</sup> The prudential carve-out exception appears to be more flexible, especially because it lacks detailed standards and limitations that enable WTO members (and panels) to determine its scope and meaning.<sup>42</sup>

A possible starting-point for further specifying the prudential carve-out is the second sentence of para. 2(a) FSA, according to which prudential measures that do not conform with the provisions of GATS are prohibited when “used as a means of avoiding the Member's commitments or obligations” under GATS.<sup>43</sup> However, the relevance of this sentence and its impact on the prudential carve-out exception in sentence 1 are disputed among WTO members.<sup>44</sup> Malaysia, for example, has strongly emphasized that there is no flexibility in limiting the prudential carve-out exception and is supported by Japan that also warned against such steps.<sup>45</sup> The EU, in contrast, is more concerned that states might utilize the prudential carve-out exception as a means to circumvent previous commitments on market access and national treatment.

The meaning of the second sentence and its impact on the prudential carve-out exception might become decisive in cases in which prudential measures discriminate between national and foreign financial institutions. Given the current discussion on minimum capital requirements it does not seem far-fetched that a regulatory authority assumes that the systemic risks originating from internationally active banks could be more effectively controlled by requiring a much higher minimum capital in comparison to

<sup>39</sup> Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision supplemented by Basel Committee on Banking Supervision, Core Principles Methodology.

<sup>40</sup> *Yokoi-Arai*, GATS' Prudential Carve-Out, ICLQ 57 (2008), 613 (632 et seq.).

<sup>41</sup> *Key*, Doha Round and Financial Services, 25; *de Meester*, Testing European Prudential Conditions, JIEL 2008, 609 (644).

<sup>42</sup> *Wang*, in: Alexander/Andenas (eds.), The World Trade Organization and Trade in Services, 601 (604).

<sup>43</sup> *v. Bogdandy/Windsor*, in: Wolfrum/Stoll/Feinäugle (eds.), Trade in Services, Annex on Financial Services, para. 23.

<sup>44</sup> Within the current literature the effect of the second sentence has been described as making the scope and meaning of the prudential carve-out exception “elusive”; *Wang*, Prudential Carve-Out, in: Alexander/Andenas (eds.), The World Trade Organization and Trade in Services, 601 (603).

<sup>45</sup> *Council for Trade in Services*, Special Session, Report of the Meeting Held on 3-6 December 2001 (S/CSS/M/13, 26 Feb 2002), para. 275.

banks whose operations are restricted to the domestic market. Assuming that prudential measures do not conform with international standards for banking supervision, the question might arise whether this requirement has been solely introduced to “avoid the Member’s commitments and obligations” or is applied in such a way.

States like Malaysia and Japan would probably argue that in light of the preamble of GATS and the ‘right to regulate’ stipulated therein, sentence 2 of para. 2(a) FSA does not have a limiting effect. Sentence 1 stresses that the right to adopt prudential measures exists “notwithstanding any other provision of” GATS. However, the introduction of sentence 1 refers to ‘any other provision’ and thus not to sentence 2 of para. 2(a) itself. In addition, the preamble becomes relevant for determining the object and purpose of an agreement, but it cannot alter existing rights and obligations. The ‘right to regulate’ is only guaranteed within the limits of the relevant GATS provision. And finally, the wording of sentence 2 and the structure of para. 2(a) suggest to construe sentence 2 as a limitation to the prudential carve-out exception contained in sentence 1, including its introduction “notwithstanding any other provisions of [GATS].” If a prudential measure violates GATS obligation – for example it does not meet the domestic regulation requirement set out in Art. VI(5) GATS – it falls within the prudential carve-out exception as long as it is not used as a means to avoid the commitments that a state has accepted in its schedule.

Even though sentence 2 operates as a restriction on the prudential carve-out exception, the exact scope of this limitation is unclear. It has been suggested that sentence 2 of para. 2(a) FSA serves the same function as the *chapeau* of Art. XX GATT.<sup>46</sup> Based on the interpretation given to the *chapeau* by the Appellate Body in *US-Shrimp*, sentence 2 would serve as a specification of the more general principle of good faith, which in turn leads to the ‘abuse of rights’ doctrine.<sup>47</sup> As a consequence, sentence 2 would require an assessment as to whether a state by introducing a prudential measure has abused its right to do so. Such an assessment in turn would involve the balancing of rights and interests. As the approach of the Appellate Body in *US-Shrimp* has been interpreted as an implementation of the proportionality principle, transferring this jurisprudence to para. 2(a) FSA would grant panels and the Appellate Body in case of a dispute considerable discretion and power in determining whether or not a prudential measure corresponds to the member’s GATS obligations.

Irrespective of whether such possible influence of a panel or the Appellate Body is desirable or not, the different language of para. 2(a) FSA GATS on the one hand and Art. XX GATT on the other contradict the assumption that the already-existing standards under GATT could be applied with regard to financial services as well. According to Art. XX GATT measures amounting to “arbitrary or unjustifiable discrimination between countries where the same conditions prevail” or “disguised restriction on international trade” cannot be justified even if the requirements set out in Art. XX lit. a) to j) GATT are fulfilled. In contrast, sentence 2 of para. 2(a) FSA does not refer to means that either constitute “arbitrary or unjustifiable discrimination” or a “disguised restriction on international trade”. Instead the language refers to measures used as a means “of avoiding the Member’s commitments or obligations”.

<sup>46</sup> *v. Bogdandy/Windsor*, in: Wolfrum/Stoll/Feinäugle (eds.), *Trade in Services, Annex on Financial Services*, para. 23.

<sup>47</sup> WTO, *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, Report of the Appellate Body of 12 October 1998, WT/DS58/AB/R, para. 158.

The phrase ‘means of avoiding’ could be understood as to require some form of intention.<sup>48</sup> Only if states intentionally aim at avoiding their commitments, prudential measures cannot be justified. However, this interpretation must still rely on observable criteria as well, as states usually do not reveal their intention to avoid their GATS commitments. Others have suggested to refer to the Basel and other international standards to determine whether a measure qualifies as ‘prudential’.<sup>49</sup> The standards would serve as an interpretive tool to determine the ordinary meaning of ‘prudential’, like a dictionary.<sup>50</sup> But equating the many pages long list of core principles and their methodology published by the Basel Committee with a short entry on the meaning of ‘prudential’ in a dictionary, is quite far fetched. Such a step would also neglect the many legitimacy issues raised especially with view of the Basel Core Principles. In addition, these standards might not be suitable for all members. The Basel II Accord, for example, aims at enhancing the safety and soundness of internationally active banks and promotes competitive equality among banks from different countries (on an international market). But countries with just emerging and/or closed financial markets face different problems than those Basel II tries to solve. Lastly, it must be observed that GATS is based on regulatory diversity. Any attempt to standardize prudential measures that are justified under para. 2(a) FSA fails to acknowledge that there might be more than one way to achieve the desired outcome. Thus, as long of WTO members adopt regulatory or supervisory measures in accordance with international standards, a WTO panel or the Appellate Body must accept them as prudential.<sup>51</sup> But these standards are only examples, meaning that even if a measure is not covered by them, it can qualify as prudential.

As the GATS preamble acknowledges the members’ right to regulate, they enjoy a high level of discretion in determining their prudential measures. This high level of discretion must be observed by panels and the Appellate Body as well, which implies that when reviewing measures that a member has qualified as prudential, the dispute settlement body is limited to examine a possible misuse of discretion, which in turn limits the level of judicial review. Thus, the assessment of whether or not a measure avoids a member’s GATS commitment cannot be based on the purely or primarily protectionist effect of that measure. In addition, it should be mentioned that so far most commentators have agreed that disputes concerning the legality of prudential measures within the WTO dispute settlement system are very unlikely to occur.<sup>52</sup>

As a result of the difficulties arising in the context of determining the content of the prudential carve-out exception, states shift towards strengthening the importance of

<sup>48</sup> *Trachtman*, Trade in Financial Services, Col. J. Tran’l L 34 (1996), 37 (72).

<sup>49</sup> Especially Switzerland has recommended “the increased use of the standards developed in the relevant international forums (the Basel Committee, the International Association of Insurance Supervisors, the International Organization of Securities Commissions and the Joint Forum on Financial Conglomerates).” see Communication from Switzerland, WTO Doc. S/CSS/W/71, 4 May 2001, para. 19, on the relationship between international standards and GATS see also *Bismuth*, Financial Sector Regulation, JWT 44 (2010), 489 (498 et seq.).

<sup>50</sup> *De Meester*, Testing European Prudential Conditions, JIEL 2008, 609 (645).

<sup>51</sup> *Bismuth*, Financial Sector Regulation, JWT 44 (2010), 489 (513).

<sup>52</sup> *Yokoi-Arai*, GATS’ Prudential Carve-Out, ICLQ 57 (2008), 613 (640) refers to the fact that “the community of international financial regulators is close-knit, and instituting dispute settlement procedures is a very confrontational step which therefore seems to be unlikely.”; similar *v. Bogdandy/Windsor*, in: Wolfrum/Stoll/Feinäugle (eds.), Trade in Services, Annex on Financial Services, para. 24.

transparency.<sup>53</sup> In addition, some scholars suggest that the future of prudential regulation lies in mutual recognition agreements which would render the need of specifying the prudential carve-out exception close to superfluous.

### 5. *Mutual Recognition of Prudential Measures*

Mutual recognition of prudential measures could solve a lot of problems associated with the prudential carve-out exception. However, given the current unwillingness to accept prudential measures even among the EU member states, it seems rather unlikely that WTO members will rely on such agreements extensively in the near future. In addition, developing countries should carefully examine the positive and negative effects of such agreements.

Mutual recognition is characterized by the principle of substitute compliance: it is the home, not the host state that will supervise the branches of its financial institutions abroad. The possibility to conclude such mutual recognition agreements is stipulated in para. 3 of the Annex on Financial Services (and several PTAs, including those analyzed below). That this provision does not reflect a merely theoretical possibility to deal with the problem of prudential regulation is evidenced by the EU-US negotiation on a framework agreement allowing for the mutual recognition of prudential measures regarding securities.<sup>54</sup> The EU also gathered extensive experience with mutual recognition in its efforts to establish a common market for financial services. But with regard to banking, it is particularly the U.S. that seems to be reluctant to rely on any standards other than genuine U.S. ones, as evidenced by the rather delayed and only partial implementation of Basel II. And all countries, developing and developed alike, consider banking as an essential channel of economic development and prudential measures as “a sacred sovereign right of the nation”,<sup>55</sup> which makes mutual recognition agreements within the banking sector less likely.

Apart from these more general considerations, it is also questionable whether mutual recognition is a meaningful approach with regard to developing countries, because mutual recognition, for one, presupposes a high degree of similarity in supervision powers and enforcement philosophy between the parties, which in turn requires a functioning system of regulatory authorities, know-how and personal infrastructure. In addition, mutual recognition agreements between developed and developing countries might be rather ‘one-sided’. Most developing countries do not have a strong and competitive domestic financial sector. The activities of private institutions, in the case that they exist, are usually limited to the domestic or maybe regional markets, but do not spread to the financial markets of developed countries (this might be different in the case of emerging market economies with a growing financial sector). Thus, mutual recognition would mostly benefit institutions from developed countries at least in cases in which adhering to the

<sup>53</sup> *Yokoi-Arai*, GATS Prudential Carve-Out, ICLQ 57 (2008), 613 (639) referring to the position of Japan, Australia, EU, Norway, Korea and US.

<sup>54</sup> See generally *Tafara/Peterson*, A Blueprint for Cross-Border Access to U.S. Investors, Harvard International Law Journal 48 (2007), 31-48.

<sup>55</sup> *Treves*, Monetary Sovereignty Today, in: Giovanoli (ed.), International Monetary Law: Issues for the New Millennium, 111 (118).

home state regulations has a positive impact on transaction costs that outweigh possible gains by taking advantage of existing regulatory and/or supervisory arbitrage.

## 6. *Understanding on Commitments in Financial Services*

Even though the Understanding on Commitments in Financial Services does not constitute an integral part of GATS like the Annexes, it was included in the Final Act of the Uruguay Round of 14 April 1994. The rules and disciplines contained in the Understanding are thus not binding on all WTO members, but only on those that voluntarily adhere to it by including a head note in their schedules stating that commitments with regard to financial services are undertaken in accordance with the Understanding. Members adopting the Understanding may, of course, schedule conditions and qualifications to the obligations imposed by the Understanding. In addition, all obligations are subject to the prudential carve-out exception. Thus, even though the Understanding imposes a number of new obligations,<sup>56</sup> states still enjoy a considerable amount of freedom to adjust them to their specific policy goals and needs. Moreover, only very few developing countries, such as Nigeria and Sri Lanka, have so far accepted the Understanding. From a developing country's perspective it thus has only a very small impact on a general obligation to liberalize trade in financial services.

## 7. *GATS and its Factual Impact on Financial Market Liberalization*

GATS largely reflects the level of liberalization within countries when negotiating the agreement – it therefore evidences nothing more than the status quo that states had achieved or were willing to achieve.<sup>57</sup> In some cases the multilateral commitment does not even match the national practice or national laws and regulations: The Philippines, for example, allows the formation of companies whose shares are held 100% by foreigners or foreign companies. But their multilateral commitment is limited to allowing (at least) 51% of foreign shares. The phenomenon of guaranteeing multilaterally less than what reflects current internal practice has been explained as rational behavior, because by doing so WTO members maintain bargaining power for the next negotiations rounds.<sup>58</sup> In addition it seems that states are unwilling to be internationally bound in cases of experimental liberalization efforts. But states should realize that a step-back in liberalization – even though it might not violate their GATS commitments – might be incompatible with their other international law obligations, in particular those contained in bilateral invest-

<sup>56</sup> The Understanding imposes a number of additional obligations on those members that adhere to it, among them a standstill obligation, certain restrictions on monopolies, and additional requirements for member when purchasing financial services. In addition, the Understanding imposes further obligations with regard to the supply of financial services through commercial presence and specific obligations on the temporary entry of personnel as well as new financial services that a member must permit if this service has been established and supplied within the territory of another member. With regard to payment and clearing systems as well as official funding and refinancing facilities (excluding possible lenders of last resort) member must accord national treatment. These more far-reaching national treatment obligations also extend in certain cases to self-regulatory bodies listed in the Understanding.

<sup>57</sup> *Roy/Marchetti/Lim*, Services Liberalization in the New Generation of Preferential Trade Agreements, 32.

<sup>58</sup> *Tietje*, Probleme der Liberalisierung, 11.

ment treaties. Reducing the amount of shares a foreign company is legally allowed to hold not only for new market participants but also for foreign companies that have already made their investments, is likely to violate the guarantees contained in BITs.

## II. Preferential Trade Agreements (PTAs)

Art. V GATS explicitly allows members to conclude PTAs under certain circumstances. Within the last 10 years WTO members have made use of this possibility to such a large extent that now there is apprehension as to whether this mushrooming of PTAs will weaken the multilateral trading system. Whereas the earlier PTAs were largely limited to trade in goods, the more recent ones include trade in services as well, including trade in financial services. However their structure and scope might differ considerably. The EU PTAs analyzed in this study follow the positive-list approach of the GATS whereas all US PTAs could be characterized as NAFTA-like, meaning that they liberalize all trade in services except in cases in which the parties listed specific exceptions. Contrary to the assumption that PTAs generally include GATS plus (e.g. new financial services) or at least GATS identical provisions, the analysis will show that there are some sections in the relevant PTAs that constitute GATS minus obligations, e.g. with regard to banned limitations on market access, domestic regulations, and the prudential carve-out. However, the scope of a PTA may not only be determined by the abstract obligations included therein, but also by the volume of specific commitments (positive list approach) or exception (negative list approach) that parties have agreed on.

### 1. Introduction

Like the GATT, the GATS allows for preferential treatment in cases of economic integration (Art. V GATS). Similar to Art. XXIV GATT, such preferential trade agreements for GATS-plus trade liberalization must provide for a substantial sectoral coverage and eliminate substantially all discrimination in the sectors covered. In addition, it prohibits new or more discriminatory measures, even though Art. V:3(a) GATS allows for more flexibility in this regard for developing countries in accordance with their level of development.

All FTAs that will be analyzed in the following have been registered in accordance with Art. V GATS. So far, WTO members have notified 76 of Art. V GATS type preferential trade agreements, meaning that these agreements either cover trade in goods and services (70 out of 76) or are limited to the liberalization of trade in services only (6 out of 76).<sup>59</sup> These agreements have been largely concluded by developed countries, meaning that at least one of the parties belongs to this category of states. The most notable exceptions are preferential trade agreements between some Latin American States (including Chile, El-Salvador, Panama, Costa Rica, and Honduras). Until now, notified preferential trade agreements either with or between African states have been largely limited to trade in goods (one of the few exceptions being the treaty between Morocco and the United

<sup>59</sup> These numbers even though taken from the WTO homepage, are not completely reliable. They merely reflect under which provision the PTAs have been registered with the WTO. Nevertheless, PTAs that have been registered on the basis of Art. XXIV GATT exclusively might still include provisions on trade in services.

States).

The main focus of the following analysis will lie on the relevant and most obvious difference compared to GATS, including not only so-called 'GATS plus' obligations, but also any negative deviations, meaning that the scope of liberalization within the PTA will not match the current GATS level.

## 2. Structure

CEPA and the EU – Chile FTA follow, at least in principle, a similar structure and approach (e.g. 'positive list') like GATS, while the US – Peru FTA as well as the Singapore – Panama FTA follow the negative-list approach adopted by NAFTA and the practice of extensive incorporation and cross-reference between different chapters. Even though differences exist, it is thus justified to describe the EU agreements as 'GATS like' and the US – Peru and the Singapore – Panama FTA as 'NAFTA-like' agreements.

These differences might have a considerable impact on the scope of liberalization that has been or will be achieved by these treaties. Negative-list agreements are generally perceived as having a more significant impact on trade liberalization, whereas the positive-list approach provides more autonomy for countries when negotiating their commitments.<sup>60</sup> Positive-list treaties might thus particularly benefit developing countries that may lack the necessary expertise to understand which limitations or restrictions to list under the negative list approach.<sup>61</sup> However the difference between positive and negative lists might become less important with the growing and continuing experience of developing countries in trade in services negotiations.

Another major difference between both categories of FTAs is that the NAFTA-like treaties include a provision on senior management and board of directors. The application of these provisions is limited to trade in financial services and has thus no impact on the supply of services generally. According to these provisions, states may not require that the senior management or other essential personnel must hold a certain nationality, preferably the one of the host state. The same applies in principle to the board of directors, even though states may impose a 'minority requirement' that allows them to require that a minority of the board of directors be composed of nationals of the host states, persons residing in the territory of the host state, or a combination thereof (Art. 1408 NAFTA, Art. 12(8) US – Peru FTA; Art. 11(9) Singapore – Panama PTA).

With regard to the basic principles of free trade, no substantial differences between the PTAs and GATS exist, with the notable exception that the EU – Chile FTA does not provide for most-favored nation treatment. Neither the chapter on trade in financial services (Title III, Chapter II) nor the general services chapter (Title III, Chapter I) include such obligation. In addition, CEPA limits the MFN obligation to third countries with which the EU or signatory CARIFORUM states conclude an economic integration agreement after the signature of CEPA. It also excludes regional economic integration agreements that aim at creating an internal market or require the parties to significantly

<sup>60</sup> UNCTAD, *Services, Development and Trade: The Regulatory and Institutional Dimension*, TD/B/C.I/MEM.3/2, 6 January 2009, para. 65.

<sup>61</sup> *Alexander*, in: *Alexander/Andenas (eds.), The World Trade Organization and Trade in Services*, 561 (575).

approximate their legislation with a view to removing non-discriminatory obstacles to trade in services (Art. 79(1) and (2) CEPA).

However, all treaties include obligations regarding national treatment and market access. The market access obligations in turn are all based on the black-list approach followed by GATS. But depending on the treaty in question the parties might have agreed to less comprehensive market access obligations. CEPA, for example, does not ban any limitations listed in Art. XVI:2(d) GATS (especially limitations on total number of natural persons that may be employed in a particular service sector) with regard to mode 3 (Art. 67 CEPA). Similarly the US – Peru as well as the Singapore – Panama FTA do not add Art. XVI:2(f) GATS to its black list (limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment).

Regarding national treatment, all EU PTAs, in contrast to the NAFTA-like ones, explicitly provide that national treatment may include formally identical or formally different treatment. Either of them counts as less favorable if a respective governmental measure modifies the conditions of competition in favor of services or service suppliers of one party compared to like services or service suppliers of the other party (Art. 77(3) CEPA, Art. 119(3) EU-Chile FTA). NAFTA also uses a ‘competitive test’ to determine national treatment. Treatment that is either different or identical is in accordance with a party’s national treatment obligation if the treatment affords equal competitive opportunities (Art. 1408(5) NAFTA). Such equal competitive opportunities are afforded if the party does not disadvantage financial services providers of one party in their ability to provide financial services as compared with the ability of the other party’s financial services providers to provide such services, in like circumstances (Art. 1408(6) NAFTA). Even though NAFTA emphasizes that differences in market share, profitability or size do not in themselves establish a denial of equal competitive opportunities, it still provides that such differences may be used as evidence regarding whether equal competitive opportunities are afforded by the other party (Art. 1408(7) NAFTA). Neither the US – Peru FTA nor the Singapore – Panama FTA provides such detailed information regarding national treatment.

Furthermore, all PTAs exclude certain measures from any liberalization commitment. Even though the provisions might differ in detail, they usually include activities conducted by a central bank or monetary authority in pursuit of monetary or exchange rate policies, activities forming part of a statutory system of social security or public retirement plans; and other activities conducted by a public entity for the account or with the guarantee or using the financial resources of the Government. Additionally all PTAs provide that if a party allows any of the last two activities to be conducted in competition with a public entity or a financial service supplier, all provisions regarding trade in financial services apply. States could, however, refrain from making any commitment with regard to services affected by this provision or add them to their exceptions.

From a pro-development perspective special attention should be given to Art. 80 et seq. CEPA which are directed at the temporary presence of natural persons for business purposes, thereby corresponding to mode 4 commitments in the GATS language.<sup>62</sup> So far, developed countries have been rather reluctant to undertake any mode 4 commitments because of its close relationship to the topic of possibly permanent and/or illegal

<sup>62</sup> *Schloemann/Pitschas*, Regulatory Edge, 6.

migration.<sup>63</sup> In contrast to this long-standing practice, the EU and its member states committed themselves to liberalize the supply through presence of natural persons and departed from the positive-list approach governing the other modes of service supply. The presence of natural persons is liberalized by means of Art. 80 et seq. CEPA and the parties may only introduce certain conditions specifying their obligations.

The extent to which these rules apply depends on the form of service and the type of personnel: The provisions on key personnel and graduate trainees apply to all service, thus including the supply of financial services as long as each party has undertaken specific commitment in the sub-sector in question (Art. 81 CEPA). The same is true for the temporary presence of business sellers (Art. 82 CEPA), whereas the EC has excluded financial services from the list of sectors that applies to the presence of contractual service suppliers and independent professionals. In contrast, the CARIFORUM parties extended the obligation contained in Art. 82 also to financial services, but may introduce limitations on their specific obligations pursuant to Annex IV. In addition the obligations of the CARIFORUM states are subject the extensive conditions set out in Art. 83 (2).

### 3. Domestic Regulation

Another subject, in which the PTAs actually appear to establish at least partly ‘GATS-minus’ obligations with regard to trade in financial services, are the provisions on domestic regulation. All PTAs contain basic obligations that are largely identical to or reach beyond the scope of GATS, e.g. regarding response to requests, the establishment of enquiry points, and authorization procedures as well as judicial or quasi-judicial review of administrative decisions. Moreover, states are usually required to make available in advance measures of general application that they propose to adopt.<sup>64</sup> But with regard to qualification requirements and procedures, technical standards and licensing requirements, PTAs neither envisage the introduction of certain disciplines on domestic regulation, like Art. VI:4 GATS, nor do they provide for any requirements that must be observed until such disciplines are introduced, like Art. VI:5 GATS – at least not with regard to the trade in financial services.<sup>65</sup>

<sup>63</sup> *Tietje*, Probleme der Liberalisierung, 12; *Tietje/Nowrot*, Zeitschrift für Ausländerrecht und Ausländerpolitik 2007, 213-222.

<sup>64</sup> Such provisions have been widely criticized by developing countries because it might enable especially multinational companies to influence the legislative process for their needs; *Schloemann/Pitschas*, Regulatory Edge, 24 referring to the position of the SVE states (Small Vulnerable Economies) which include almost all CARIFORUM states. These states have resisted ‘prior comment’ obligations in the deliberation of the WTO Working Party on Domestic Regulation (WPDR). But at the same time transparency is an integral part of any good-governance approach. As a response, some PTAs, like CEPA, soften this obligation by adding a ‘best endeavor’ qualification, which allows states to take their level of development into account, whereas others add that such obligations exist only “to the extent practicable”, like Art. 12.11(3) of the US – Peru FTA, Art. 11.12(2) of the Singapore – Panama FTA, and Art. 123(1) of the EU – Chile FTA.

<sup>65</sup> Even though Art. 102(1)(a)-(c) of the EU-Chile FTA provides similar requirements like Art. VI(4)(a)-(c) GATS except that it adds a ‘best endeavor’ qualification, the provision does not apply to financial services (Art. 95(2)(a)). Similarly, Art. 11.7 of the US – Peru FTA, which is even identical Art. VI(4)(a)-(c) GATS, is not incorporated into chapter 12 on trade in financial services. The same is true for the Singapore-Panama FTA even though the situation is complicated by ambiguous references: Art. 10.9 (5) and (6) are identical to Art. VI(4) and (5) GATS, but they are not expressly incorporated by Art. 11.1(2). Even though it is stated therein that chapter 10 applied only to the extent incorporated into chapter 11 and even though Art. 10.9 is not mentioned, Art. 10.10(1) and (2) list Art. 10.9

That PTAs lack similar provisions compared to Art. VI:4 GATS, which allow for introducing ‘good governance’ principles, might have been of minor importance so far because WTO members have yet been unable to agree on any such disciplines. In addition, some of the EU agreements contain provisions referring to “internationally agreed standards for regulation and supervision”, like Art. 105(2) CEPA and Art. 123(4) EU – Chile FTA.<sup>66</sup> If indeed such standards are implemented and applied, additional disciplines within the meaning of Art. VI:4 GATS seem unnecessary. But Art. 105(2) CEPA and Art. 123(4) EU-Chile FTA merely require that the parties shall make their implementation and application “their best endeavour” – a very soft obligation that in case of CEPA is even further mitigated because the parties shall only endeavor to facilitate their the implementation and application.

#### 4. *New Financial Services*

It has been argued, particularly with regard to CEPA, that allowing services providers to supply new financial service could have a detrimental effect on the local economy in the absence of proper regulation.<sup>67</sup> But it should be emphasized that lack or absence of proper regulation constitutes a factual, rather than a legal problem because even though all analyzed PTAs include provisions that address the subject of new financial services, they actually allow for states to take regulatory and supervisory measures.

By restricting the provisions on new financial services to those services that are already supplied within the territory of one, but not the other party, the PTAs are similar to the GATS Understanding that has not been incorporated into the schedules by all WTO members, especially not by developing countries. But in addition to the Understanding, CEPA, NAFTA and the FTAs add that the parties may determine the juridical form and may require prior authorization for the supply of the service. In case an authorization is required it may only be refused for prudential reasons.<sup>68</sup> And according to Art. 121(1) EU – Chile FTA, a service must only be admitted if it does not require new laws or the changing of existing laws.

Consequently, states may reject or at least restrict the supply of new financial services by introducing prudential regulatory and supervisory measures even in sub-sectors in which they have undertaken specific commitments. Thus, the legal framework allows for a considerable amount of flexibility, which is primarily limited by factual circumstances, like the expectations of financial service suppliers and the lack of the regulatory and supervisory capacity by developing countries.

as one of the provisions that do not apply to Non-conforming and Future Measures – a curious exemption given the fact that 10.9 has not been incorporated explicitly.

<sup>66</sup> The EU thereby seems to pursue their preferred solution to the Art. VI (4) GATS problem, meaning that the WTO should not introduce their own discipline, but should incorporate already existing standard – an approach that so far has been rejected by most other countries including the US. It is therefore not surprising that neither NAFTA nor the NAFTA like agreements include a reference to internationally agreed standards.

<sup>67</sup> *Smith*, EPA Provisions, Trade Negotiations Insights, 4/2009, 10; TWN, EU EPAs, 28.

<sup>68</sup> The differences in the language of GATS Understanding and CEPA as well as the other PTAs analyzed in this study should not be exaggerated as the domestic regulation privilege and prudential carve-out exception of GATS that apply to the Understanding as well allow what has been explicitly referred to in the PTAs. There is no to little room to argue the provisions differ in scope.

## 5. Prudential Carve-Out

Like para. 2(a) FSA, all analyzed PTAs contain a similar prudential carve-out exception. Notwithstanding this similar approach, it should be noted that differences beyond minor deviations exist.<sup>69</sup> It is thus possible that a prudential measure not justified under the FSA might fulfill the requirements set out in the PTAs.

This is especially true for the prudential carve-out exception contained in Art. 104 CEPA. Compared to GATS and most other PTAs, the provision extends the possibility to justify limitations on the specific commitments based on the prudential carve-out exception because it does not add the counter-exception contained in para. 2(a) FSA. Whereas measures that do not conform with GATS “shall not be used as a means of avoiding the Member's commitments or obligations”, such a limitation on prudential measures has not been included in CEPA. Thus, from a strictly legal point of view, the ability to adopt prudential measures is nearly unrestricted under CEPA.

The only other agreement that does not add a counter-exception comparable or identical to para. 2(a) FSA is NAFTA. But in contrast to CEPA, measures adopted for prudential reasons on the basis of Art. 1410(1) NAFTA must fulfill a reasonableness requirement. Only reasonable measures meet the prudential carve-out exception. So far NAFTA arbitral tribunals have not been required to interpret Art. 1410(1) NAFTA, but it is obvious that the term ‘reasonable’ was included to prevent the parties from abusing the prudential carve-out exception.<sup>70</sup> Based on the identical object and purpose, it seems thus plausible that the scope of the prudential carve-out exception of NAFTA is identical to that in para. 2(a) FSA and Art. 12.10(1) US – Peru FTA.

## 6. Relationship PTA – GATS

The relationship between GATS and PTAs is determined by Art. V GATS with regard to WTO members which are not party to the PTA. But GATS does not address the relationship concerning WTO members which are also parties to the respective PTA. On a substantial level the analyzed PTAs usually confirm their consistency with GATS provisions thereby allowing for interpreting the PTA in light of GATS. But they do not (with the notable exception of NAFTA) address the problem of conflicting obligation. However, such conflicts will occur only very rarely, as usually the differences between PTAs and GATS amount to inconsistencies only, but not to treaty conflict. This in turn generally allows for applying both treaties, GATS and the respective treaty at the same time. In contrast to the ‘substantial relationship’, PTAs usually include more detailed provisions concerning the choice of forum for dispute resolution. The range of provisions includes those that allow for parallel proceedings and those that give priority to one of the treaties

<sup>69</sup> Compared to the FSA, most PTAs add, “the maintenance of the safety, soundness, integrity or financial responsibility of financial services suppliers” as an legitimate objective to adopt or maintain prudential measures. Even though specifying the exact scope of the prudential carve-out exception might enhance legal certainty, it seems to have no immediate practical significance that such aims are not mentioned in the FSA as all measures based on ensuring “the safety, soundness, integrity or financial responsibility of financial service suppliers” also aim at the “protection of investors, depositors, financial market participants, policy-holders, or persons to whom a fiduciary duty is owed by a financial services supplier.”

<sup>70</sup> *Schefer*, International Trade in Financial Services, 232.

once proceedings have instituted. However, the effectiveness of these provisions will depend on whether or not WTO panels or the Appellate Body will rely on these non-WTO provisions to determine their jurisdiction – a question that has not been decided yet.

The legal relationship between GATS and PTAs is first determined by Art. V GATS, which allows for more preferential treatment between parties to a PTA or custom union compared to other WTO member. Art. V GATS thus exempts these agreements from the MFN principle if the requirements set out in the provision are met.<sup>71</sup> Still, Art. V GATS governs only the relationship between PTAs and GATS with regard to third WTO members who are prevented from claiming their WTO inconsistency. It is only in this regard that PTAs enjoy priority over GATS, whereas Art. V GATS does not apply when determining the relationship between PTAs and GATS in relation to those WTO members that are parties to both agreements. When attempting to clarify this relationship however, it is necessary to bear in mind the two different levels on which these agreements might interact: substantive law and dispute settlement procedures. While the former refers to the question which treaty will take priority over the other in case of a conflict, the latter deals with problems of forum shopping and conflicting or at least inconsistent judgments.

*a) Substantive Law*

PTAs usually contain a provision according to which the contracting parties “reaffirm their existing rights and obligations with respect to each other under existing bilateral and multilateral agreements ..., including the WTO Agreement” (Art. 1.2(2) Singapore-Panama FTA; see also Art. 1.2 US –Peru FTA) or in which the parties acknowledge “that nothing in this Agreement requires them ... to act in a manner inconsistent with their WTO obligations” (Art. 242 CEPA). Such provisions clarify that the parties did not intend GATS and the respective PTA to conflict and could be referred to as a basis for the principle of ‘harmonizing interpretation’, meaning that because the parties to a PTA emphasize their existing WTO obligation, PTAs should be interpreted consistently with GATS.<sup>72</sup> The limit of this interpretive method is, of course, the irreconcilable language of the treaties. The comparison between the PTAs and GATS has, for example, shown that some PTAs are on an abstract level less comprehensive than GATS regarding the market access obligation. In addition, situations might occur in which PTA provisions have been interpreted assuming that this interpretation is in accordance with GATS, but either WTO panels or the Appellate Body give GATS a different meaning in later proceedings.

In any case, it should be noted that in almost all of these situations there is, at least from a purely legal perspective, no need to clarify the hierarchy between PTAs and GATS because they usually amount to inconsistency between the treaties, but not to a conflict. A conflict exists only in a situation in which both treaties cannot be applied at the same time because applying them would lead to mutually exclusive results, meaning that a

<sup>71</sup> Regarding these requirements see *Cottier/Molinuevo*, in: Wolfrum/Stoll/Feinäugle (eds.), *Trade in Services*, Article V, para. 5 et seq.

<sup>72</sup> With regard to the WTO regime see generally *Marceau*, *A Call for Coherence*, *JWT* 33 (1999), 87-152.

treaty requires what the other treaty (ex- or implicitly) prohibits.<sup>73</sup> But if a treaty only prohibits what the other allows, a conflict does not exist. Such treaty inconsistencies do not require that a treaty will take priority over the other by means of applying, e.g., the principle of *lex specialis* or *lex posterior*. As the relationship between PTAs and GATS will be governed by possible inconsistencies, but not conflicts (except in extreme circumstances), both treaties will usually apply concurrently with regard to their substantial provisions.

The only exception must be made with regard to NAFTA. Even though the parties at first affirm their existing rights and obligations (Art. 103(1) NAFTA), the agreement determines in a second step that “in the event of any inconsistency ... this Agreement shall prevail to the extent of the inconsistency” (Art. 103(2) NAFTA). It is necessary to pay closer attention to two details. The first refers to the choice of language, meaning that Art. 103(2) NAFTA explicitly mentions an inconsistency, instead of a conflict between NAFTA and other agreements. Applying the distinction between treaty inconsistencies and conflicts introduced above, it could be argued that NAFTA claims priority in all cases, in which its substantive provisions differ from other agreements also applicable to the case at hand. Still, determining the exact scope of application of Art. 103 NAFTA is complicated by the fact that Art. 103(1) NAFTA refers only to the GATT and not to the WTO Agreements as a whole because it was drafted and ratified before the establishment of the WTO. However, the US, Canada, and Mexico when negotiating NAFTA were at the same time taking part in the Uruguay Round. Even though its success was not guaranteed, they were at least aware of its possible outcome. It therefore seems reasonable to assume that the reference in Art. 103 NAFTA was to apply with regard to the WTO Agreements as well, especially because Art. 103(1) NAFTA also includes ‘other agreements to which [the NAFTA] Parties are party’.

#### b) *Dispute Settlement Mechanisms*

The same conclusion could – at least theoretically – also apply to the dispute settlement procedures of the WTO and PTAs, but as parallel proceedings are costly and forum shopping is usually deemed undesirable, PTAs provide for a variety of choice-of-forum clauses starting from allowing parallel proceedings to a quite far-reaching extent (CEPA) to giving priority to their own dispute settlement procedures in certain cases (NAFTA).

Before examining some of these provisions, however, it is necessary to clarify that dispute settlement bodies or arbitral tribunals are limited to adjudicate disputes relating to ‘their’ respective treaty. PTA arbitral tribunals are thus excluded from ruling on any possible WTO violations (except where such provisions have been incorporated) as well as where WTO panels or the Appellate Body are confined to the WTO agreements.<sup>74</sup>

CEPA belongs to the category of treaties that allows for a considerable amount of parallel proceedings. Parties are merely excluded from instituting proceedings either under the dispute settlement provision of CEPA or under the WTO Agreement regarding

<sup>73</sup> WTO, *Indonesia – Certain Measures Affecting the Automobile Industry*, Report of the Panel of 2 July 1998, WT/DS54/R, footnote 649; WTO, *Turkey – Restrictions on Imports of Textile and Clothing Products*, Report of the Panel of 22 October 1999, WT/DS34/R, para. 9.92.

<sup>74</sup> For more details on the relevant distinction between jurisdiction and applicable law see *Bartels*, *Applicable Law*, JWT 35 (2001), 499 (501 et seq.); *Pauwelyn*, *Conflict of Norms*, 460 et seq.

the same measure as long as the first proceeding has not ended: Art. 222(2) CEPA. Art. 222(3) CEPA even clarifies that the parties are not precluded from either implementing the suspension of obligations authorized by the Dispute Settlement Body of the WTO or under CEPA. Art. 222 CEPA therefore only prevents parallel proceedings taking place at the same time, which in turn entails accepting the possibility of inconsistent rulings.

In contrast, the EU – Chile FTA at least partially limits the possibility to institute dispute settlement procedures under both the WTO Agreement and the FTA (Art. 189) by establishing WTO dispute settlement as a default procedure: if the parties do not agree otherwise, the dispute must be brought exclusively under the WTO Agreement. However, this default mechanism applies only if the disputed obligations of the parties are “equivalent in substance” (Art. 189(4)(c)). If this is not so, cases can be brought under the FTA as well as under the WTO Agreement. Thus, depending on how narrowly the requirement ‘equivalent in substance’ will be interpreted, the EU – Chile FTA still provides for substantial forum shopping opportunities.

The Singapore – Panama and the US – Peru FTAs follow an even more stringent approach. The complaining party has the privilege to select the forum that it believes to be most favorable for its cause. But once dispute settlement procedures have been requested under one or the other agreement, the selected forum “shall be used to the exclusion of the others” (Art. 15.5(2) Singapore – Panama FTA and Art. 21.3(2) US – Peru FTA).

NAFTA at first glance allows the complaining party to choose the forum in which to settle the dispute, like the Singapore – Panama and the US – Peru FTA (Art. 2005(1) NAFTA). But the following paragraphs actually reveal that Art. 2005 NAFTA establishes NAFTA as the default dispute settlement forum because the parties, before initiating WTO dispute settlement proceedings on grounds that are substantially equivalent to NAFTA, must first notify all other parties to the dispute about their intention. Should one of the parties prefer to settle the dispute under NAFTA the parties first must try to agree on a single forum. If the parties do not reach an agreement, the “dispute normally shall be settled under [NAFTA].” In any case, as soon as proceedings have been instituted, even in violation of Art. 2005(2) NAFTA, “the forum selected shall be used to the exclusion of the other”.

In addition, Art. 2005(3) establishes exclusive NAFTA jurisdiction in cases in which the responding party claims that its action is subject to the environmental agreements incorporated by Art. 104 NAFTA.<sup>75</sup> Even though such trade-restrictive measures usually apply to trade in goods, it does not seem entirely unreasonable that states restrict trade in financial services if the special service in question is linked to or has consequences on environmental issues covered by the Art. 104 NAFTA environmental agreements.

All clauses that give priority to the dispute settlement procedures of one agreement, whether under the PTAs or the WTO, are contained in the respective PTAs only. Any arbitral tribunal established pursuant to the rules of the PTA will thus be obliged to take these provisions into account and, should the treaty provide so, decline its jurisdiction. But so far unsettled is whether WTO panels or the Appellate Body are either obliged or at least permitted to deny their jurisdiction in favor of dispute settlement under a PTA

<sup>75</sup> This includes the Convention on International Trade in Endangered Species of Wild Fauna and Flora, 3 March 1973, as amended 22 June 1979, the Montreal Protocol on Substances that Deplete the Ozone Layer, 16 September 1987, as amended 29 June 1990, the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal, 22 March 1989, on its entry into force for Canada, Mexico and the United States, or any agreement set out in Annex 104.1.

that also applies to the case at hand. The Panel's report in *Mexico Soft Drinks* explicitly left open the question whether or not the NAFTA provision constitutes a legal impediment to the jurisdiction of the panel.<sup>76</sup> Even though there are convincing arguments to the effect that WTO dispute settlement bodies at least may deny their jurisdiction based on a PTA's choice-of-forum clause,<sup>77</sup> a report of the Appellate Body will be necessary to establish legal certainty. In the meantime states should remember that even though there is a possibility that WTO panels will not consider such choice of forum clauses, states that institutes proceedings in contradiction to such a clause violate their obligations under the PTA.

### III. Bilateral and Plurilateral Investment Treaties

Bilateral and plurilateral investment protection treaties usually do not grant a right to market entry to investors such as financial services providers. However, once a foreign investor has entered a certain national market in accordance with domestic law, he may rely on the so-called treatment standards of investment protection treaties. Those treatment standards, namely the guarantees of non-discrimination and of fair and equitable treatment, may have an impact on the ability of governments for regulation of financial services. In this regard, only the US and the Canadian investment protection treaties provide for a prudential carve-out.

Liberalisation and deregulation of financial services might also be subject to legal principles and rules of international investment protection law. International investment protection is provided for by more than 2.700 Bilateral Investment Treaties (BITs) and some plurilateral treaties, e.g. the Energy Charter Treaty (ECT) and Chapter 11 of NAFTA. Besides quite far-reaching substantial protection for investors provided for in these treaties, probably the most important feature of contemporary international investment law is the extensive possibility of investors to directly sue host states for alleged violation of the aforementioned treaties.<sup>78</sup> To date, more than 300 pending or concluded investor-state arbitrations are known. With regard to effects of investment protection provisions in respective treaties on issues of liberalisation and regulation in the financial sector, one may differentiate between provisions explicitly referring to financial services and the application of the so-called general treatment standards of international investment law.

Explicit reference to financial services is made – in accordance with a long-standing practice of respective FTAs – in BITs of Canada and the US. The more or less similar

<sup>76</sup> WTO, *Mexico – Tax Measures on Soft Drinks and Other Beverages*, Report of the Appellate Body of 6 March 2006, WT/DS308/R, para. 54.

<sup>77</sup> These arguments are closely related to the distinction between jurisdiction and applicable law. WTO panels and the Appellate Body are not barred by Art. 23 DSU to take into account non-WTO law in order to determine the scope of the WTO Agreements including its jurisdiction; see *Pauwelyn*, Conflict of Norms, 456 et seq. Thus, even provisions giving priority to dispute settlement under a PTA that also applies to the case at hand, like Art. 2005 NAFTA must be observed by WTO panels and the Appellate Body; see *Finke*, Die Parallelität internationaler Streitbeilegungsmechanismen, 201 et seq., 264 et seq.

<sup>78</sup> For an overview on investment arbitration and further details see, e.g., the contributions in *Tietje* (ed.), International Investment Protection and Arbitration.

provisions on financial services in the BITs of Canada<sup>79</sup> and the US<sup>80</sup> with third countries have the same structure: first, they provide for a general exception for “measures relating to financial services for prudential reasons, including for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system”.<sup>81</sup> Second, a similar non-application of the treaty is provided for with regard to “monetary and related credit policies or exchange rate policies”; this, however, does not affect the freedom of capital and related transfer, and the general prohibition of so-called performance requirements.<sup>82</sup> Third, with regard to disputes which might occur concerning the mentioned provisions on financial services, a special dispute settlement procedure is provided for in the BIT. This special procedure essentially provides for a “financial services veto” of the two competent financial authorities of both state parties to the BIT. By way of such “financial services veto” – a mechanism that is also applied with regard to tax matters (tax veto)<sup>83</sup> – the competent authorities have the possibility to exclude the application of the BIT based on a mutual decision that the subject matter of the dispute is a prudential or monetary/exchange rate measure.

Even though it thus seems that the US and Canadian BIT practice provides for quite far-reaching exceptions for prudential and monetary/exchange rate measures, it is important to note that the US Model BIT stipulates, in addition to the already quoted sentence on the possibility for prudential measures, that “[w]here such measures do not conform with the provision of this Treaty, they shall not be used as a means of avoiding the Party’s commitments of obligations under this Treaty”.<sup>84</sup> This restriction on the possibility of a contracting state to enact and apply prudential measures is highly controversial; some lawyers argue that it actually is “self-canceling”, or at least “creates a burden of proof in favour of the investor and against the government”.<sup>85</sup> This opinion, however, disregards the indicated “financial services veto” which gives the competent authorities the possibility to issue a decision on the disputes prudential measure that is binding for an arbitral tribunal.

Explicit provisions on prudential and similar measures are only known in the model BITs of a North American style. The European BIT approach is different. Just as with regard to tax measures, European BITs do not contain any specific provisions on prudential or related measures. Regulatory measures affecting the financial market are thus subject to the protection against expropriation and the so-called treatment standards of the

<sup>79</sup> See, e.g., Art. XI Agreement between the Government of Canada and the Government of the Republic of Ecuador for the Promotion and Reciprocal Protection of Investments, 29 April 1996.

<sup>80</sup> See Art. 20 Model US Model Treaty (2004) Concerning the Encouragement and Reciprocal Protection of Investment.

<sup>81</sup> Art. 20 (1) US Model BIT. The US Model BITs defines „that the term ‚prudential reasons’ includes the maintenance of the safety, soundness, integrity, or financial responsibility of individual financial institutions“. See footnote 14 to Art. 20 US Model BIT (2004).

<sup>82</sup> Art. 7 and 8 US Model BIT.

<sup>83</sup> For details see extensively *Kampermann*, *Steuersouveränität und internationales Investitionsschutzrecht*, 92 et seq. and passim.

<sup>84</sup> Art. 20 (1), second sentence US Model BIT (2004).

<sup>85</sup> *Robert K. Stumberg*, at the Hearing before the Committee of Ways and Means, U.S. House of Representatives on Investment Protection in U.S. Trade and Investment Agreements, One Hundred Eleventh Congress, First Session, 14 May 2009, Serial 111-200; see also *Gallagher*, U.S. BITs and financial stability, Columbia FDI Perspectives, Perspectives on topical foreign direct investment issues by the Vale Columbia Center on Sustainable International Investment, No. 19, 23 February 2010.

more than 1.000 BITs that have been concluded by EU Member States with third countries. Most important in this regard is the standard of “fair and equitable treatment”.<sup>86</sup> The notion of “fair and equitable treatment” is obviously broad. It is thus not surprising that financial regulatory measures of governments have already and are currently challenged as being in violation of the guarantee of fair and equitable treatment. In a case that was decided in March 2006, *Saluka*, a Dutch subsidiary of the Japanese bank Nomura, was awarded US\$ 181 Million plus US\$55 Million interest in a claim against the Czech Republic. The tribunal in this case followed the investor in its claim that the Czech Republic acted in violation of the fair and equitable treatment standard while – in a situation of a country-wide banking crisis – it bailed-out some Czech banks, but not the one in which *Saluka* held a stake.<sup>87</sup> In another investment arbitration currently pending, certain issues of the global financial crisis of 2007/2008 are at stake. In the ICSID case of *Deutsche Bank AG v. Democratic Socialist Republic of Sri Lanka*<sup>88</sup> the claimant argues that the suspension of payments under a derivatives deal of Deutsche Bank and the state-owned Ceylon Petroleum Corporation (CPC) is in violation of the German-Sri Lanka BIT. The mentioned derivatives deal had been concluded by CPC in an effort to hedge against rising oil prices. The deal started to cause political problems in Sri Lanka once oil prices dropped sharply in the course of the global financial crises.<sup>89</sup>

Even though it is thus not precluded per se that regulatory financial measures may be subject to an alleged violation of the fair and equitable treatment standard, it is important to note that fair and equitable treatment is not an unlimited protection of the investor leaving no policy space for governments anymore. The tribunal in *Duke Energy v. Ecuador* (2008) and more or less identical the tribunal in *Bayindir v. Pakistan* (2009) clearly held as follows:

“The stability of the legal and business environment is directly linked to the investor's justified expectations. The Tribunal acknowledges that such expectations are an important element of fair and equitable treatment. At the same time, it is mindful of their limitations. To be protected, the investor's expectations must be legitimate and reasonable at the time when the investor makes the investment. The assessment of the reasonableness or legitimacy must take into account all circumstances, including not only the facts surrounding the investment, but also the political, socioeconomic, cultural and historical conditions prevailing in the host State. In addition, such expectations must arise from the conditions that the State offered the investor and the latter must have relied upon them when deciding to invest.”<sup>90</sup>

<sup>86</sup> See, e.g., Art. 2 (2) German Model BIT (2008): „Each Contracting State shall in its territory in every case accord investments by investors of the other Contracting State fair and equitable treatment as well as full protection under this Treaty”.

<sup>87</sup> *Saluka Investments BV (The Netherlands) v. The Czech Republic*, UNCITRAL Arbitration, Partial Award of 17 March 2006.

<sup>88</sup> *Deutsche Bank AG v. Democratic Socialist Republic of Sri Lanka*, ICSID Case No. ARB/09/2; for background information see *Peterson*, IARporter 2 (No. 6, 2009), 6 et seq.

<sup>89</sup> It is important to note that disputes of this kind are usually settled by commercial arbitration based on provisions of the International Swaps and Derivatives Association (ISDA) Master Agreements.

<sup>90</sup> *Duke Energy Electroquil Partners and Electroquil SA v. Republic of Ecuador*, Award of 18 August 2008, ICSID Case No. ARB/04/19, para. 339 et seq.; *Bayindir Insaat Turizm Ticaret Ve Sanayi A.S. v. Islamic Republic of Pakistan*, Award of 27 August 2009, ICSID Case No. ARB/03/29, para. 179; see also

Finally, even though limitations on states' autonomy for regulation of the financial markets may arise out of investment protection provided for in bilateral and plurilateral investment treaties, international investment law does not provide for rights of market access. With the exception of some US and Canadian BITs, the majority of international investment treaties is restricted to post-entry protection of investment.<sup>91</sup> Thus, international investment law may only affect the regulation, but not issues of liberalisation of financial services.

#### IV. IMF (and World Bank) Policies and their (Legal) Impact on Financial Market Liberalization

From a legal perspective, IMF and World Bank have few to no options to oblige states to liberalize their financial markets. However, as both organizations play an ever-increasing role in providing development help, they enjoy a considerable amount of factual influence. The much-criticized 'conditionalities' seem to be of less immediate importance as they are based on letters of intent prepared by the state that wishes to draw upon the Fund's resources. The letters refer to the outcome of IMF and World Bank programs (e.g. FSAP and PRSP) and use them as benchmarks as to whether to allow a state to start or continue its drawings. These programs usually require the participation of the state itself. And even though this might be burdensome on the state, it is one of the few possibilities that developing countries can ensure that their policies objectives are taken into account.

The role of the World Bank and the IMF in promoting liberalization of financial services, is difficult to determine, at least from the outside and as a general matter. Especially the IMF has encouraged trade liberalization in the past as part of its programs to foster economic growth and (financial) stability. Still, the extent to which the IMF and World Bank have actually obliged states to liberalize their financial markets (including the international transfer of payments and capital) can only be assessed on a country-to-country basis. States are not forced in principle to undertake financial service liberalizations. Instead recommendations to do so might form part of the Financial Sector Assistance Program (FSAP) or Poverty Reduction Strategy Paper (PRSP), which in turn usually form the basis for the conditions under which states have access to the Fund's financial resources.

##### 1. IMF Surveillance

IMF surveillance based on Art. IV of the Fund's Articles of Agreement was initially restricted on exchange rate policies, but now focuses more generally on the 'economic situation and economic policy strategy'.<sup>92</sup> Irrespective of widespread criticism, the IMF maintained its broad approach since any constraints in the Fund's opinion run "counter

*Saluka Investments BV (The Netherlands) v. The Czech Republic*, UNCITRAL Arbitration, Partial Award of 17 March 2006, para. 305.

<sup>91</sup> For details see *Dolzer/Schreuer*, Principles of International Investment Law, 79 et seq.

<sup>92</sup> *Lowenfeld*, International Economic Law, 639.

to the demands of the membership...for increasing emphasis on the interactions between macroeconomic, structural and social policies.”<sup>93</sup> Thus, depending on the state in question, the scope of review now also includes interest rates, monetary, fiscal and trade policy, and sometime social agenda and priorities. A surveillance report thus might include suggestions and recommendations with regard to liberalizing a member’s financial market and trade in financial services. These suggestions might be persuasive because of the force of the analysis or they might influence internal policy debates and add credibility to those who argue along the same line as the IMF. But the IMF cannot prescribe conduct on individual states. Thus, even if the subject of financial market liberalization is included in a surveillance report, there is no legal obligation connected to it. However, the possible factual relevance of such a report should not be underestimated as it might shape the future relationship between the member and the IMF and exert factual pressure on the state to actually comply with the Fund’s surveillance report.

## 2. *Conditionality*

The term ‘conditionality’ refers to the concept of stand-by-arrangements under Art. V(3) of the Articles of Agreement, which form the basis for drawings made by member states. It has not yet been settled what legal function the conditions for concluding such a stand-by arrangement (in short, conditionalities) fulfill. Sir Joseph Goldstein has stressed that this term “refers ... to the policies that the Fund wishes to see a member follow in order that it can use the Fund’s resources.”<sup>94</sup> Even if that accurately describes the legal situation, it still seems safe to assume that ‘wishes’ can be translated into ‘demand’ or ‘require’.<sup>95</sup> Thus, even if stand-by arrangements are not strictly legally binding on the parties, the conditions set out in these arrangements amount to a factual obligation as states that do not comply with the requirements might not be able to continue their drawing rights or be able to ‘conclude’ another stand-by-arrangement.

As the conditions for stand-by-arrangements differ depending on the individual country and as they are not published either by the IMF or the member state, it cannot be ascertained to what extent states are actually forced to not only liberalize trade in general, but especially trade in financial service as part of the IMF’s conditionality. However, as stand-by-arrangements are based on a letter of intent written by the state that wishes to draw upon the IMF’s recourse, these letters can be used as a basis for determining the arrangement’s conditions, in particular since the IMF staff is involved in their preparation. But even a very cursory analysis of some letters of intent reveals that most of them refer to other IMF programs as a guideline for the necessary internal reforms. The extent to which measures that these programs recommend are implemented is therefore a likely benchmark for the IMF when deciding whether a state has met the conditions for stand-by arrangements and may (continue to) draw upon the IMF’s resources. In determining the impact of IMF conditionality-practice on financial market liberalization, it is thus necessary to analyze the outcome of IMF programs with regard to individual states. Among these relevant programs are the Financial Sector Assistance Program (FSAP) and

<sup>93</sup> External Evaluation of IMF Surveillance: Report by a Group of Independent Experts, Statement by the Managing Director, at 96, para. 6.

<sup>94</sup> *Gold*, Conditionality, 2 (IMF Pamphlet Series No. 31. 1979).

<sup>95</sup> *Lowenfeld*, International Economic Law, 646.

the Poverty Reduction Strategy Paper (PRSP). Without anticipating the result of such a research, it seems reasonable to conclude that states still enjoy some 'policy space' because they are involved in preparing the relevant programs. In addition, states may renegotiate the conditions for drawings even in cases in which they have not met the conditions of the stand-by arrangement. But to efficiently utilize the policy space, states must dedicate considerable resources, such as personnel and money, to conduct the IMF programs.

### 3. *Financial Sector Assistance Program (FSAP)*

The FSAP aims at strengthening the IMF's capacity to perform financial sector surveillance and to identify financial sector vulnerabilities.<sup>96</sup> In addition, the program helps to identify financial sector development needs, which in turn can be addressed through IMF-World Bank technical assistance programs. Participation is voluntary, but developing countries have usually volunteered for FSAP because of possible follow-on technical assistance for supervision and financial sector development. The FSAP can thus be characterized as a mechanism for knowledge transfer regarding best practice on legal, regulatory and supervisory standards.<sup>97</sup> In addition, it should be observed that the program is not conducted exclusively by IMF staff. Quite the contrary: states must commit considerable time and their own staff to prepare the program. Conducting a FSAP is thus burdensome on the developing country – something some of these states might criticize. On the other hand it must be emphasized that this participation is an important factor in influencing the program's outcome and recommendations. As these might determine the conditions of the stand-by arrangement and the basis according to which compliance is measured, it is essential that developing countries utilize their 'policy space' at the time such programs are undertaken.

### 4. *Poverty Reduction Strategy Paper (PRSP)*

PRSPs are the result of a collaboration of IMF and World Bank staff together with a member state in order to develop an agenda of sound economic and social policies that forms the basis for successful participation in the Heavily Indebted Poor Country Initiative (HIPC) launched in the mid 1990's.<sup>98</sup> Countries are eligible for debt relief if a number of quite stringent requirements are met. To these requirements belongs the implementation of reforms and policies set out in the PRSP. The impact of PRSPs is thus similar to the impact that recommendations made on the basis of FSAP have. Even though they are not legally binding, they are factually very important if the IMF uses them as a benchmark to assess a member state's eligibility to draw on the Fund's resources. To what extent this has been the case, in particular concerning financial market liberalization, must be determined with regard to the individual country that has participated in devising a PRSP.

<sup>96</sup> On FSAP see generally *Kupiec*, The IMF-World Bank Financial Sector Assistance Program, in: Evanoff/Kaufman (eds.), *Systemic Financial Crises, Resolving Large Bank Insolvencies*, 69-82.

<sup>97</sup> *Id.*, 70.

<sup>98</sup> *Lowenfeld*, *International Economic Law*, 655.

## D. The Impact of Financial Service Liberalization and Regulation on Economic Development

### I. General Remarks

Liberalization improves the quality and availability of financial services. By influencing the structure and the outcome of financial markets, entry of foreign banks by and large contribute to financial development.

Financial services liberalization improves the quality and availability of financial services as international banks are often endowed with better banking skills and technologies.<sup>99</sup> It also stimulates competition which potentially improves cost efficiency and reliability of domestic banks too. Furthermore, opening financial sectors to international banks requires the leveling of the playing field for all banks active in a country's market and thus to harmonize prudential regulation and supervision. This may further contribute to an improvement in the incentives in the banking industry. International banks may also enhance the quality of corporate governance and thus efficiency of firms. By contrast, Stiglitz raised some concerns regarding the liberalization of banking sectors.<sup>100</sup> For example, foreign banks may squeeze out domestic banks. Since foreign banks tend to mainly serve the financing needs of big multinational corporations or pick out only the less information intensive local borrowers, many local firms would increasingly have problems in raising external funds. Competition could also threaten financial stability by reducing profitability of domestic banks in developing countries making them more vulnerable to shocks unless a well-functioning regulation and supervision has been implemented.<sup>101</sup>

Liberalizing restrictions on foreign bank entry indeed improves the efficiency of the banking system and thus economic growth.<sup>102</sup> There is also detailed evidence that foreign banks in Latin America charged lower interest margins and thus fostered financial intermediation.<sup>103</sup> This holds true particularly for Greenfield foreign banks and not so much for take-over foreign banks.<sup>104</sup> On average, fiercer competition due to foreign bank entry also lowered the operation costs of local banks and thus efficiency in the whole banking sector. Although local banks are pushed into loan segments that are more information intensive, this pattern actually improved credit availability there. Foreign banks eventually

<sup>99</sup> *Levine*, Foreign Banks, Financial Development, and Economic Growth. It is worth noting that liberalization by no means implies a (complete) deregulation as for markets to perform one needs a functioning regulatory system. This has been impressively proved true in the course of the recent world financial crisis.

<sup>100</sup> *Stiglitz*, The Role of the State, 1993.

<sup>101</sup> *Claessens/Demirgüç-Kunt/Huizinga*, How Does Foreign Entry Affect Domestic Banking Markets.

<sup>102</sup> *Demirgüç-Kunt/Levine/Min*, Opening to Foreign Banks.

<sup>103</sup> *Martinez Peria/Mody*, Foreign Participation and Market Concentration. See also *Claessens/Demirgüç-Kunt/Huizinga*, How Does Foreign Entry Affect Domestic Banking Markets, who report that interest margins of foreign banks in developing countries can also be higher than those of domestic banks.

<sup>104</sup> A reasonable reading of this result is that greenfields have stronger links to their parent banks than take-overs, see *de Haas/van Lelyveld*, Foreign Banks and Credit Stability in Central and Eastern Europe.

enhanced access to funding sources for local projects in developing countries.<sup>105</sup> However, especially the African experiences make a case for the notion that foreign bank entry alone cannot stimulate financial development when the institutional, regulatory and contractual environment is poorly developed<sup>106</sup> or if foreign banks are only allowed to take over failed state-owned banks.<sup>107</sup>

## II. Capital Account Liberalization

In order to reap the benefits of liberalized financial markets, countries have to open for substantial international capital flows. Accompanied with sound measures of prudential regulation and wholehearted efforts to stabilize macroeconomic performance, financial stability does not need to be the price of financial integration.

Trade in financial services alone is often unable to allow a full capitalization on the benefits of liberalization without being associated with (some) capital movements. Hence, reaping the benefits of liberalization hinges on three further factors. The first is capital account liberalization beyond simply lifting restrictions on international transfers and payments for current transactions (according to Article XI GATS). Opening national markets to international capital flows more broadly promises further benefits. Among these benefits, the ability to smooth business cycles in general and consumption in particular as well as to diversify risks stand out.

The second factor refers to prudential bank regulation. Opening borders for international capital flows can lead to surges in capital inflows. A major problem here could be that it may fuel excess credit expansion leading to bubbles that will later burst or to exchange rate appreciations that prepare the grounds for future currency crises.<sup>108</sup> Accordingly, prudential measures are needed to convince international investors that their funds will be properly invested so bubbles do not emerge.

A third factor is macroeconomic stability. A major drawback of unleashing international capital flows is the possibility of sudden stops or even reversals in international capital flows. This is particularly problematic when international investors tend to withdraw funds exactly in those times when external funding is hard to obtain anyway. Macroeconomic stability is crucial here as it reduces uncertainty *ex ante*, stabilizes expectations and thus exchange rates and minimizes the probability that international investors have reason to speculate against a currency and to withdraw their investments at once.

The evidence of the economic consequences of financial liberalization is mixed. By liberalizing their financial systems, countries with poor institutions and lacking macroeconomic stability either increased their vulnerability to systemic crises or suffered from declines in financial intermediation because lacking institutions promoted a predatory behavior of some banks.<sup>109</sup>

<sup>105</sup> *Bhattacharya*, The Role of Foreign Banks in Developing Countries.

<sup>106</sup> *Honohan/Beck*, Making Finance Work for Africa.

<sup>107</sup> *Demirgüç-Kunt/Levine*, Finance, Financial Sector Policies, and Long-run Growth, 2008.

<sup>108</sup> *Ostry/Ghosh/Habermeier/Chamon/Qureshi/Reinhardt*, Capital Inflows.

<sup>109</sup> *Demirgüç-Kunt/Levine*, Finance, Financial Sector Policies, and Long-run Growth.

Although liberalization of the financial services sector may seriously threaten a country's financial stability in the short run, it is a necessary condition for long-run economic growth. Neither a ban on foreign currency denominated debt nor a fixed exchange rate regime are appropriate measures to prevent financial crises. Instead, establishing sound legal and economic institutions is a more promising way to mitigate the adverse side-effects of liberalization.

The economic consequences also differ with respect to their short and long-term effects. Rapidly growing countries tend to experience occasional crises. This link is stronger for more financially liberalized countries. Hence, liberalization strengthens financial development which contributes to higher long-run growth.<sup>110</sup> This result is based upon data of 83 countries including developing countries with different stances of development, including Algeria, Congo Republic, Ghana, Nigeria, Peru, South Africa, and Venezuela. Similar conclusions are drawn by Kaminsky and Schmukler who also show that long-run gains from financial liberalization are bought with short-run vulnerability to financial crises.<sup>111</sup> Notably, financial crises often occur as twin crises, in particular since the deregulation of the banking industries in the 1980s. Twin crises are preceded by deep recessions in the respective country and associated with high production losses amounting to some 5 % to 8 % in the two years following a crisis.<sup>112</sup> Typically, prior steps taken to liberalize tend to amplify these costs.<sup>113</sup>

In many cases, currency mismatches were at the core of financial crises.<sup>114</sup> An economy is subject to a currency mismatch if its real wealth (or income) strongly depends on exchange rates. For this to be true, countries have to be indebted to foreigners which requires at least some capital account liberalization, i.e. capital controls must not be too strong. Developing countries in particular face this problem as their households, financial and non-financial firms and governments have to borrow in foreign currency while most of their assets (or income) are denominated in local currencies. When the local currency devaluates, the real debt burden of a country increases which may result in a debt crisis.<sup>115</sup> The problem of foreign government debt drove Mexico's Tequila crisis (1994/95) and the Argentinean crisis (2001/02). In Russia's financial crisis (1998), not only foreign government debt but also the foreign indebtedness of Russian banks turned out to be prob-

<sup>110</sup> *Rancière/Tornell/Westermann*, Systemic Crises and Growth. A mechanism through which the long-run effects work out is the interest channel. With a country's interest rates being higher if international capital flows are closed or government-guided (*El-Shagi*, Capital Controls and International Interest Rate Differentials, *Applied Economics*, 42 (2010), 681-688), accumulation of physical capital is hampered and thus growth. Another mechanism is through stock markets. International portfolio flows improve liquidity of stock markets which positively affects productivity growth (*Levine*, International Financial Liberalization and Economic Growth, *Review of International Economics*, 9 (2001), 688-702). It is, however, still an open question whether short-run costs are merely side-effects that policy may potentially mitigate (for example by imposing restrictions on capital account transactions or by measures of prudential regulation), or whether crises are a necessary condition for long-run growth.

<sup>111</sup> *Kaminsky/Schmukler*, Short-run Pain, Long-run Gain.

<sup>112</sup> *Hutchison/Noy*, How Bad Are Twins?.

<sup>113</sup> *Kaminsky/Reinhart*, The Twin Crises; *Glick/Hutchison*, Banking and Currency Crises.

<sup>114</sup> *Goldstein/Turner*, Controlling Currency Mismatches; *Allen/Rosenberg/Keller/Setser/Roubini*, A Balance Sheet Approach to Financial Crisis.

<sup>115</sup> In a debt crisis the problem is that *borrowers* are unable to serve *existing* debt obligations; lenders respond to this debt overhang by cutting new loans. By contrast, in a banking crisis the problem is that *banks* are unable to raise funds for *new* loans.

lematic. In the Asian crisis (1997/98) currency mismatches on the balance sheets of both, banks and non-financial firms were crucial. Especially in the Asian crisis, banks' individual hedges against currency mismatches did not suffice to shield the entire economy as banks only rolled over the currency mismatch to their borrowers.

Fixing exchange rates in order to reduce the risks associated with currency mismatches is, however, not generally advisable.<sup>116</sup> In this regard, it is important to understand why a country is bound to currency mismatches. Eichengreen, Hausmann and Panizza coined the concept of original sin based on the notion that developing countries simply have inherited the inability to borrow in their own currency and thus cannot escape their past even if they switch to a stability-oriented macro policy.<sup>117</sup> However, even if currency mismatches cannot be avoided, their implications for stability still depend on macroeconomic conditions.<sup>118</sup> Accordingly, the macro policies of countries can, if they aim at macroeconomic stability, at least mitigate the adverse consequences associated with currency mismatches.

An alternative explanation for why developing countries have to borrow in foreign currency is the lack of adequate institutions. Countries can avoid stress in their banking systems due to speculations if they commit to a flexible exchange rate regime and implement a lender of last resort. Then, the ability to offer banks liquidity support and to devalue the national currency reduces the incentives of investors to run on banks.<sup>119</sup> Pursuing a policy of macroeconomic stabilization alone is thus not sufficient, however. It gives local banks a good reason to speculate on a public bailout. Hence, banks have little incentive to follow a prudent business policy so that banks potentially suffer from a commitment problem vis-à-vis investors. This problem is particularly severe if prudential regulation of banks is insufficient or if the legal system is not adequately developed to ensure that contracts will be enforced.<sup>120</sup> Then, investors usually respond by accepting only short-term debt denominated in foreign currency so that a lender of last resort cannot bail the banks out.<sup>121</sup>

Hence, although financial liberalization may eventually increase the probability of banking crises, it is the lack of proper legal and regulatory institutions that makes countries vulnerable.<sup>122</sup> It is thus very important for policy makers to recognize this relationship, the more so since banking crises have been very costly in the past.<sup>123</sup> Any restrictions on maturity and denomination of banks' debt in order to avoid financial vulnerability of countries, however, will not solve the underlying problem of underdeveloped financial, legal and regulatory institutions but merely restrict the volume of international capital flows and thus limit the potential benefits of liberalization.<sup>124</sup>

<sup>116</sup> Empirically, the relationship between adopted exchange rate regimes and financial fragility is mixed; for an overview see *Demirgüç-Kunt/Levine*, Finance, Financial Sector Policies, and Long-run Growth, World Bank Policy Research Paper 4469 (2008).

<sup>117</sup> *Eichengreen/Hausmann/Panizza*, The Pain of Original Sin.

<sup>118</sup> *Goldstein/Turner*, Controlling Currency Mismatches.

<sup>119</sup> *Chang/Velasco*, Financial Fragility and the Exchange Rate Regime.

<sup>120</sup> *Levine*, Law, Finance, and Economic Growth, *Journal of Financial Intermediation*, 8 (1999), 8-35 shows that the stance of the legal and regulatory environment positively affects financial development which in turn fosters economic growth.

<sup>121</sup> *Diamond/Rajan*, Banks, Short-term Debt and Financial Crises.

<sup>122</sup> *Demirgüç-Kunt/Detrage*, Financial Liberalization and Financial Fragility.

<sup>123</sup> *Dell'Ariccia/Detrage/Rajan*, The Real Effect of Banking Crises.

<sup>124</sup> *Kaminsky/Schmukler*, On Financial Booms and Crashes.

### III. Liberalization of Market Entry

Although liberalization of the financial services sector may seriously threaten a country's financial stability in the short run, it is a necessary condition for long-run economic growth. Neither a ban on foreign currency denominated debt nor a fixed exchange rate regime are appropriate measures to prevent financial crises. Instead, establishing sound legal and economic institutions is a more promising way to mitigate the adverse side-effects of liberalization.

Liberalization of both, market entry and international capital flows for financial firms fosters the internationalization of the banking business.<sup>125</sup> But it is only a necessary but not a sufficient condition for international banks to enter a foreign market. Since banks tend to follow their customers first<sup>126</sup>, a further necessary condition is to allow nonfinancial firms to establish local subsidiaries, implying that once international banks have entered, they will start to serve the local markets.<sup>127</sup> On the other hand, having liberalized its capital account without opening domestic banking markets to foreign suppliers will also be insufficient.<sup>128</sup> The reason is that there is also a need for infrastructure that makes sure that the international capital will be channeled to its most productive use. Given the lack of expertise and technological capacity in many developing countries, this infrastructure could in principle be provided by foreign banking firms.

It will take some time, however, for the poor in developing countries to have access to financial services. Besides lack of financial education and physical distance there are two major obstacles for the poor to obtain loans. First, they have no collateral and their future income stream is highly uncertain. Second, financial transactions are often very small so that expected interest payments to banks do not cover transactions costs. Microfinance may help to overcome these obstacles.<sup>129</sup> Although international banks will hardly provide microfinance services, they contribute to improving the situation of the poor indirectly when legal institutions, information systems, and macro policies are good enough to allow economic growth to unfold after the liberalization of market entry.

The decision of banks on their mode of foreign market operation is closely related to non-financial firms' decision on whether to serve foreign markets by exporting goods or by establishing foreign representations. In particular, banks tend to serve foreign markets through subsidiaries (mode 3) if they have a strict productivity margin over competing banks that supply financial services across borders (mode 1).<sup>130</sup> This productivity margin is necessary because the subsidiary structure has a comparative disadvantage with respect to their ability to settle country-specific liquidity shocks.<sup>131</sup> There is also evidence that countries' regulatory framework, political risk and economic risk influence the mode of foreign market entry of international banks. In particular, it is found that banks are more likely to establish a branch network if there is discriminating regulation that treats

<sup>125</sup> *Buch*, Information or Regulation.

<sup>126</sup> *Buch*, Why Do Banks Go Abroad.

<sup>127</sup> *Demirgüç-Kunt/Levine*, Finance, Financial Sector Policies, and Long-run Growth.

<sup>128</sup> *Ryan/Murinde*, International Banking.

<sup>129</sup> For further policy recommendations (beyond financial policies) as to how improve on the poors' situation see also *Demirgüç-Kunt/Levine*, Finance, Financial Sector Policies, and Long-run Growth.

<sup>130</sup> *Buch/Koch/Kötter*, Margins of International Banking.

<sup>131</sup> *Dietrich/Vollmer*, International Banking and Liquidity Allocation.

branches preferentially, if taxes are high, and if political risk is relatively more important than economic risk.<sup>132</sup> The reason for the latter effect is that, in contrast to branch networks, the limited liability associated with a subsidiary structure allows the international bank to protect against country-specific economic risks while being more prone to the risk of expropriation often associated with political risks.<sup>133</sup>

By and large, the empirical evidence is in favor of a stability-enhancing role of international banks in developing countries after liberalization. This holds particularly true for banks operating on-site through local commercial presences. In contrast to domestic banks, these foreign bank subsidiaries can draw on financial support of their parent banks in times when local financial crises impair the refinancing conditions in a country. When expected loans and other local bank deteriorate, however, international banks withdraw funds from developing countries so that aggregate bank lending also becomes more pro-cyclical.

As for the implications of foreign banks, in Latin America these banks provide higher and more sustained loan growth and a greater ability to absorb losses than their domestic peers.<sup>134</sup> In Mexico and Argentina (1994-1999), foreign banks contributed to financial stability because of their relative financial strength.<sup>135</sup> Indeed, foreign banks could take local crises as a window of opportunity to further expand and to gain market shares.<sup>136</sup> Similar observations are made for Emerging Europe (de Haas/van Lelyveld 2004), where foreign banks in formerly communist countries in Central and Eastern Europe have stabilized in times of domestic financial crises although cross-border credit (mode 1) tended to be less stable than credit supply of local subsidiaries (mode 3). Among the mode 3 banks, greenfield foreign banks are even better able to shield loan supply from financial distress in these countries; loan supply by domestic banks unambiguously shrunk.<sup>137</sup>

In times of local financial crises, international banks, in contrast to domestic banks, can refinance their lending activities with funds provided by the parent bank abroad.<sup>138</sup> This, however, requires that there are no restrictions on bank-internal international capital flows, in particular on intra-company debt and profit repatriation. Especially if the latter is restricted it may backfire in that foreign banks shy of entering markets in the first place. Liberalizing these capital flows, however, has two further implications. First, the financial position of parent banks also matters for the credit expansion in the host country. Second, lending of foreign banks in a specific host country also depends on the macroeconomic conditions there relative to those in the other countries in which the bank operates. These two implications make foreign bank lending somewhat more pro-cyclical and negatively correlated with the business cycle in other countries, in particular the parent bank's home country. The reason is that international banks can more easily allocate

<sup>132</sup> *Cerutti/Dell'Ariccia/Martinez Peria*, How Banks Go Abroad.

<sup>133</sup> *Dell'Ariccia/Marquez*, Risk and the Corporate Structure of Banks.

<sup>134</sup> *Crystal/Dages/Goldberg*, Has Foreign Bank Entry Led to Sounder Banks in Latin America?.

<sup>135</sup> *Dages/Goldberg/Kinney*, Foreign and Domestic Bank Participation in Emerging Markets.

<sup>136</sup> *Martinez Peria/Powell/Hollar*, Banking on Foreigners.

<sup>137</sup> *de Haas/van Lelyveld*, Foreign Banks and Credit Stability in Central and Eastern Europe.

<sup>138</sup> *de Haas/van Lelyveld*, Internal Capital Markets and Lending by Multinational Bank Subsidiaries.

funds across the globe to those locations with better investment opportunities. This pattern can be found for Emerging Europe as well as for Asia and Latin America.<sup>139</sup>

International banks may also transmit financial instability from developed to developing countries. At present, however, economic research has not come to a clear conclusion on this issue. Several indicators suggest that developing countries suffered more from the recent global crisis when macroeconomic conditions have made them vulnerable to declines in global economic activity anyway. For example, among the most adversely affected countries are those with current account and fiscal deficits, or which have been strongly dependent on commodity exports.

It is, however, still an open question whether international banks also form an additional channel for the transmission of financial crises from developed to developing countries. The reason is that before the outbreak of the world financial crisis starting in 2007, financial crises in developed countries were rather rare events. Experiences exist only from the Japanese banking crisis in the 1990s. There, Latin American countries suffered from a fall in credit supply by Japanese banks.<sup>140</sup> This effect, however, is not specific to developing countries as it did not differ from the US experience.<sup>141</sup>

As for the recent world financial crisis, there is only little evidence which is also rather mixed. Data provided by the Bank of International Settlements (BIS) indicates, for example, that Eastern European countries with stable macroeconomic developments experienced a rather robust flow of credit by international active banks while countries, which have been seen as particularly fragile already before the crisis, suffered from international banks having withdrawn funds.<sup>142</sup> Especially low-income countries with a strong export orientation in commodity markets and with little leeway for fiscal maneuvers have been heavily affected although their banking systems have only some exposure to western financial centers.<sup>143</sup> But the worldwide fall in economic activity and decreased risk appetite of international investors has started to affect other low-income countries. The share of non-performing loans has increased there, which puts pressure on the financial health of domestic banks and thus on bank lending and private spending.

Conclusions that the existence of capital controls in several countries has helped to moderate the effects of the crisis are premature. Liberalized countries, for which a slowdown or a reversal in net capital inflows is observable, may still end up even better than those without access to international capital markets. In the latter group of countries, the still existing weakness in competition between banks has resulted in high profit margins that contributed to a buildup in capital buffers. A critical question, however, then is whether in such a weakly competitive environment banks will actually free up these buffers and increase lending. Another open issue is whether high margins and bank profits

<sup>139</sup> See *de Haas/van Lelyveld*, Internal Capital Markets and Lending by Multinational Bank Subsidiaries; *Goldberg*, When Is U.S. Bank Lending to Emerging Markets Volatile?; *Martinez Peria/Powell/Hollar*, Banking on Foreigners, respectively.

<sup>140</sup> See again *Martinez Peria/Powell/Hollar*, Banking on Foreigners. There is also evidence for Latin America that, in general, foreign banks transmit external shocks to host countries between 1996 and 2008; see *Galindo/Izquierdo/Rojas-Suárez*, Financial Integration and Foreign Banks in Latin America.

<sup>141</sup> *Peek/Rosengren*, Collateral Damage.

<sup>142</sup> *Dietrich/Knedlik/Lindner*, Mittelosteuropa in der Weltfinanzkrise.

<sup>143</sup> *IMF*, The Implications of the Global Financial Crisis for Low-income Countries.

will suffice to shield those underdeveloped closed banking systems. Even the big banks in the western industrialized countries were highly profitable on the eve of the financial crisis and still collapsed. Finally, the International Monetary Fund reports that liquidity withdrawals have been stronger for branches than for subsidiaries.<sup>144</sup> Theoretical consideration and existing empirical evidence presented above suggest that subsidiary structures are more likely in countries where political risk is less important than economic risks. The reason has been that in those countries banks do not need to fear, e.g., to be expropriated and are willing to take on economic risk because limited liability helps to protect them. To sum up, in more liberalized countries the banking system may be hit harder, but the chance of a recovery in accordance with the global economy is also greater. Moreover, for countries with a high (low) share of foreign bank subsidiaries (cross-border lending), the financial accelerator should also be less strong. Hence, whether capital controls contributed to moderate the effects of the crisis is at least an open empirical question that has not yet been properly addressed.

### E. Policy Implications

- Given the current stand of economic research in this field, politicians should follow a set of general principles on their way to a liberalized and integrated financial system. For financial liberalization processes being successful, countries have to establish and strengthen the rule of law with a particular focus on property rights, and to improve political stability and reduce corruption. Otherwise, capital flows will remain thin, limited to the political establishment, and prone to corruption.
- Having achieved notable improvements in these fields, government should start to build up and advance their country's information infrastructure. This is required to reduce information asymmetries between banks, firms, households, and – at a later stage – international investors in order to prepare the grounds for a competitive financial sector that provides reliable public information about market participants. It is helpful in this regard, e.g., to establish credit registries for households and non-financial firms and to require financial institutions to disclose their financial and business conditions to a broader public. Governments should avoid relying solely on rating agencies. Competition between different information providers should be eventually aimed at.
- These legal and economic institutions being developed, countries should start liberalizing market access for foreign banks. This has to be accompanied by easing the restrictions on international capital flows, not only for financial services provider but – since banks tend to primarily follow customers – for non-financial firms as well. Financial liberalization should be approached in line with improvements in prudential regulation and bank supervision and with a reduction of government discretionary interventions. It implies that existing regulations that hamper markets have to be abolished. This includes but is not limited to interest rate ceilings, credit targets, and use-of-funds regulations. State-ownership in banks has to be continuously reduced without heavily distorting the structure of the banking system. In order to promote incentives and competition, public deposit insurance systems and other means of public

<sup>144</sup> *Ibid.*

support for banks should be limited. Only small and/or poor bank customers should benefit from insurance systems but not the banks or sophisticated investors. In addition, prudential regulation measures are to be adopted. The guiding principle here is to introduce simple rules (first of all capital requirements and leverage restrictions) without giving government much discretionary power over banks. Collaterally to these adjustments, a credible and government-independent supervisory agency has to be established that is also responsible for a timely and reliable disclosure of information about banks.

- Restrictions on certain capital flows (short-term debt versus long-term capital flows), on certain banking services (cross-border lending versus greenfield/subsidiary lending), or on the currency denomination of financial claims (currency mismatches) in an attempt to reduce the stability risks of liberalization are not generally advisable. If governments would do so, they will primarily impede the efficiency by altering the modes of market entry or by unduly discouraging foreign banks to come. Although financial crises following liberalization are often very costly in the short-run, avoiding them by all means also implies forgoing on the long-term gains. A simple analogy may illustrate this argument: a country will never experience a banking crisis if no banks are allowed to exist.
- Macroeconomic stabilization seems to be of second order. However, to fully reap the benefits of liberalization, a country should also aim at improving macroeconomic stability, in particular fiscal discipline. By stabilizing expectations through rule-based macroeconomic (monetary and fiscal) policies, countries will reduce the risks associated with, e.g., currency mismatches. Finance is all about trust and credit, and macroeconomic stability enhances trustworthiness and credibility. It is important to note that rule-based macroeconomic policies do not imply complete surrender of fiscal or monetary autonomy. Instead, flexible rules allow for sufficient policy space and make macroeconomic policy predictable on financial markets.
- There are ways for developed countries to help developing countries to capitalize on the benefits of financial liberalization. First, as the recent world financial crisis has clearly demonstrated, developed countries also have to redesign the regulatory and supervisory environment for banks. That way, developed countries are in charge of exporting financial stability to developing countries. In particular with respect to the cross-border supply of financial services (mode 1) and, to some extent, also to the provision of financial services through local branch networks (mode 3), prudential regulation and supervision in developed countries also matter for developing countries as the home country principle in regulation applies.<sup>145</sup> However, to further improve the effectiveness of regulation, home and host countries should enhance their cooperation, especially with respect to sharing information about banks. This is a general

<sup>145</sup> It is important to recognize that not only discriminatory regulation affects banks' choice of foreign market entry. *Dietrich/Vollmer*, International Banking and Liquidity Allocation, *Journal of Financial Services Research* 37 (2010) e.g., argue that uniformly applied capital regulation implicitly favors mode 3 (commercial presence) over mode 1 (cross-border supply). The reason here is that tighter capital standards has a stronger stabilizing effect for subsidiaries (because of their rather independent financial status) than for banks which lend funds cross-border (because those banks are already more stable due to a better access to geographic diversification).

- Developed countries can help developing countries in their efforts on the way to a liberalized and stable financial system also more directly. In particular, granting aid for the purpose of knowledge- and capacity-building helps to install functioning legal systems based on the rule of law and – to some extent – to build up physical infrastructure by investing in information and telecommunication technologies. Experiences with what is called “best practice in regulation” can also be shared with developing countries to allow them, e.g., keeping pace with financial innovations. But expectations should not be too high in this particular respect. First, there is no common sense of what refers to best practice in regulation and supervision and already small differences can have substantial effects on performance. Second, regulators seem to be doomed to follow financial market developments even in the developed countries. It is thus more important to learn about the basic rules that have to be in place for financial market participants than to attempt regulating each and every single financial product or institution separately.
- With regard to the more legal perspective, all mentioned policy recommendations can be implemented without legal restrictions in force. Indeed, current international, plurilateral and bilateral treaties dealing with financial services actually encourage policy measures as described, namely in the regulatory field. Moreover, with regard to liberalization of financial services one must realize that international economic law has more or less negligible impact. Most countries have a more liberalized foreign trading regime in the services sector than required under their specific GATS or PTA commitments. However, GATS and PTA at least have the important function of ensuring a minimum standard of liberalization of trade in services. It thus remains an important task of the international community to enlarge the scope of legally binding liberalization commitments.
- On a more concrete perspective, governments may apply one of the following regulatory strategies for financial services, or a combination thereof (most advanced economies apply a combination of these three methods):
  - Principle-based regulation is designed to take advantage of competition and the market’s capacity to distribute resources according to supply and demand. The regulatory authority provides for the regulatory principles that are applied, whereas the financial institutions apply these principles to their operations. This approach requires on the one hand financial institutions that can manage their risk profile appropriately and supervision that is able to control this process. Another important factor for a principle-based regulation is effective market discipline which in turn requires a developed market. In addition, information disclosure in order to enable market participants and investors to make qualified evaluation is another essential requirement. The principle-based mode of regulation is thus difficult to apply for developing country. Depending on their specific level of development, they might not possess functioning financial markets and neither efficient nor experienced regulatory bodies.

- Self-regulation fulfills essentially a complementary function to principle-based regulation. It therefore also requires a developed market and experienced as well as skillful regulators – something most developing countries do not have, especially those that have recently or are on the threshold of liberalizing their financial services sector (partly).
- The advantages of the rule-based approach to regulation are quite evident: specific rules in contrast to principles restrict discretion and thus enhance certainty. In addition, it enables institutions to understand the regulatory approach. On the downside, the application of rules tends to leave less room for flexibility. Furthermore, it might restrict financial institutions and therefore limit the growth potential.
- As indicated, all three regulatory approaches mentioned as well as a combination thereof are – in principle and subject to specific aspects in a given case – possible under current international treaties which address financial services. This is mainly due to the fact that aspects of regulation of financial services are with only a few exceptions not subject to legal rules in international trade agreements. This is at least true with regard to specific regulatory approaches. What is subject to international obligations, however, are issues of good governance in the course of regulation of financial markets. This, however, applies to all services and has thus no specific implication on financial services.

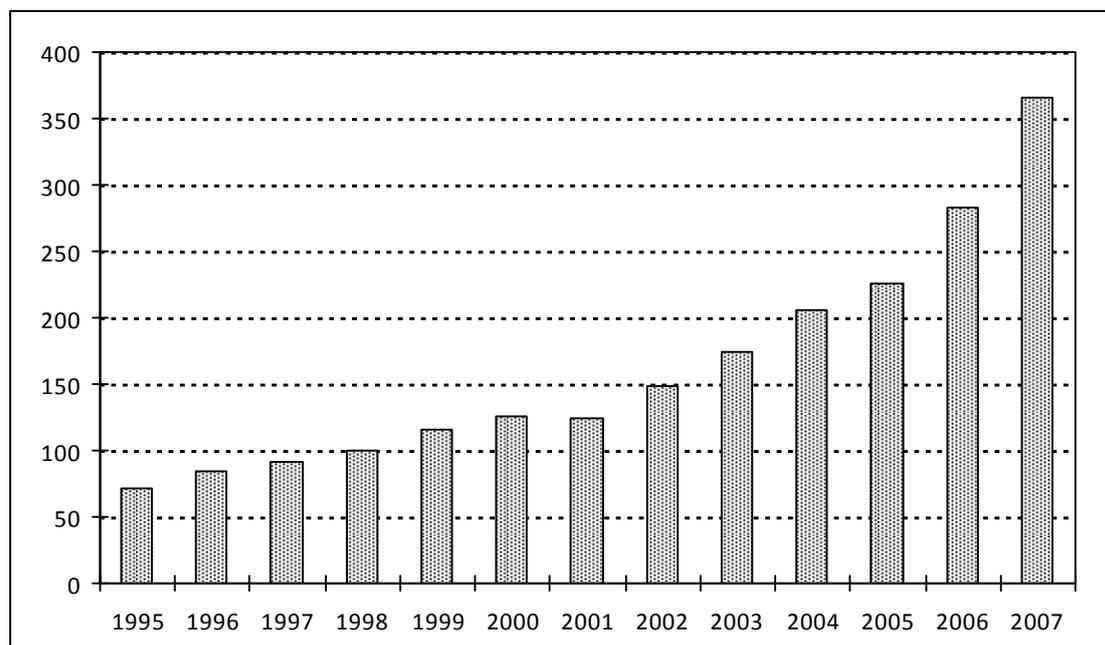
## F. Annex: Tables

Table 1: Foreign bank ownership, by region.

	1995				2005						
	Total bank assets (US\$ billions)	Foreign-controlled total assets (US\$ billions)	Total foreign asset share (percent)	Mean foreign asset share (percent)	Total bank assets (US\$ billions)	Foreign-controlled total assets (US\$ billions)	Total foreign asset share (percent)	Mean foreign asset share (percent)	Change in Foreign Assets (US\$ billions)	Change in Foreign Asset Share (percent)	Change in Mean Foreign Share (percent)
Region (no. of countries)											
All countries (105)	33,169	5,043	15	23	57,165	13,039	23	35	7,996	8	12
North America (2)	4,467	454	10	8	10,242	2,155	21	17	1,701	11	9
Western Europe (19)	16,320	3,755	23	24	31,797	9,142	29	30	5,387	6	6
Eastern Europe (17)	319	80	25	21	632	369	58	49	289	33	28
Latin America (14)	591	108	18	14	1,032	392	38	29	284	20	15
Africa (25)	154	13	8	38	156	12	8	35	-1	-1	-3
Middle East (9)	625	85	14	14	1,194	202	17	17	117	3	3
Central Asia (4)	150	3	2	4	390	9	2	5	6	0	1
East Asia and Oceania (13)	10,543	545	5	6	11,721	758	6	7	213	1	1

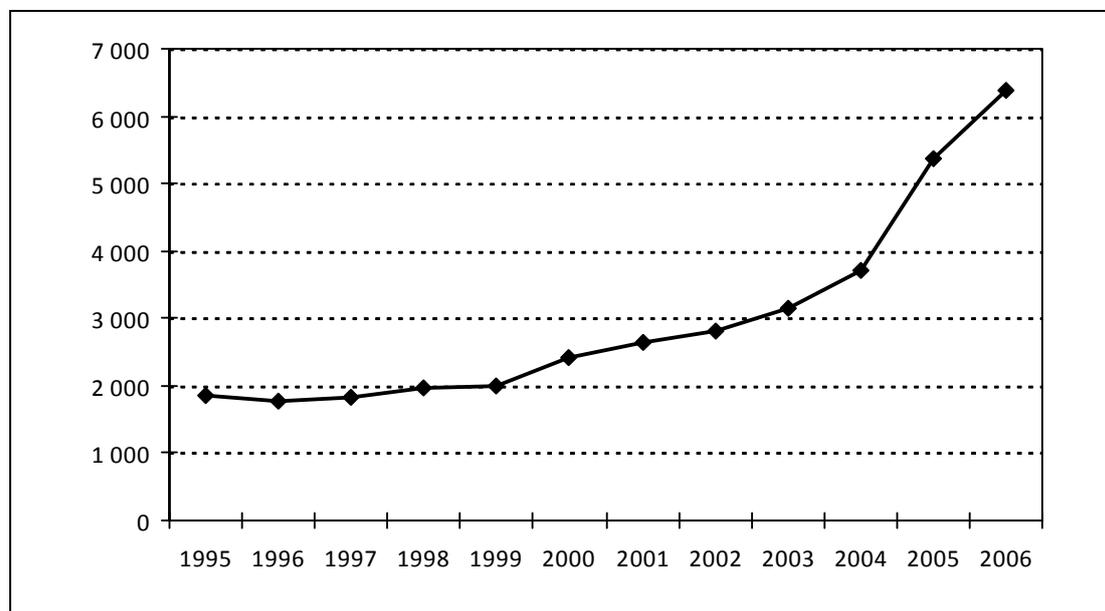
Source: International Monetary Fund (2007), 101.

Figure 1: World exports of financial services (in billions of US dollars)



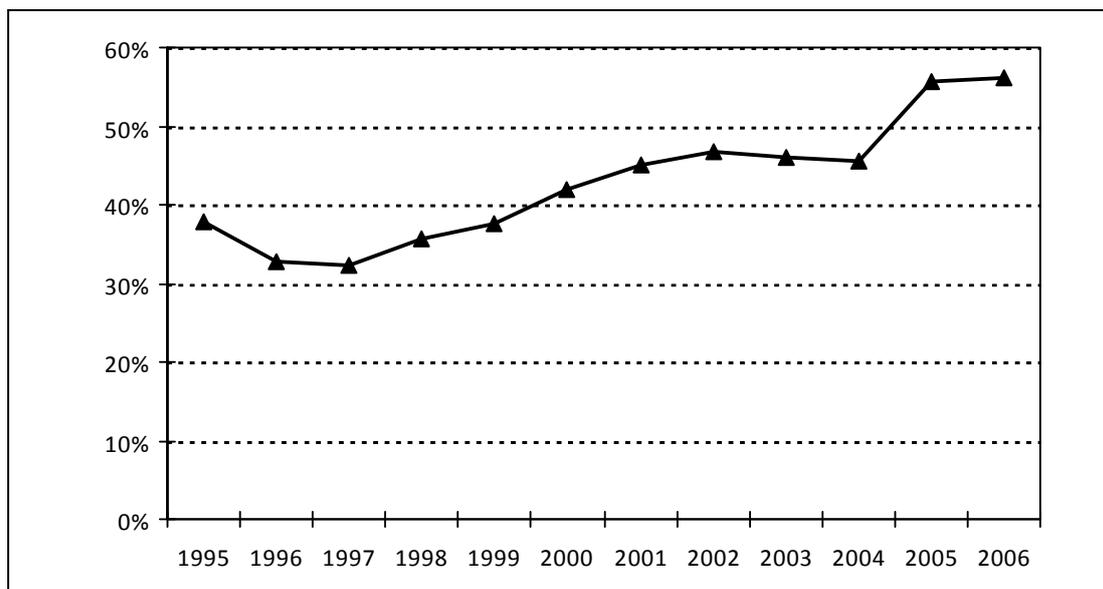
Source: Own calculations based upon WTO – International Trade Statistics.

Figure 2: Exports of Financial Services of Low and Middle Income Countries (in billions of US dollars)



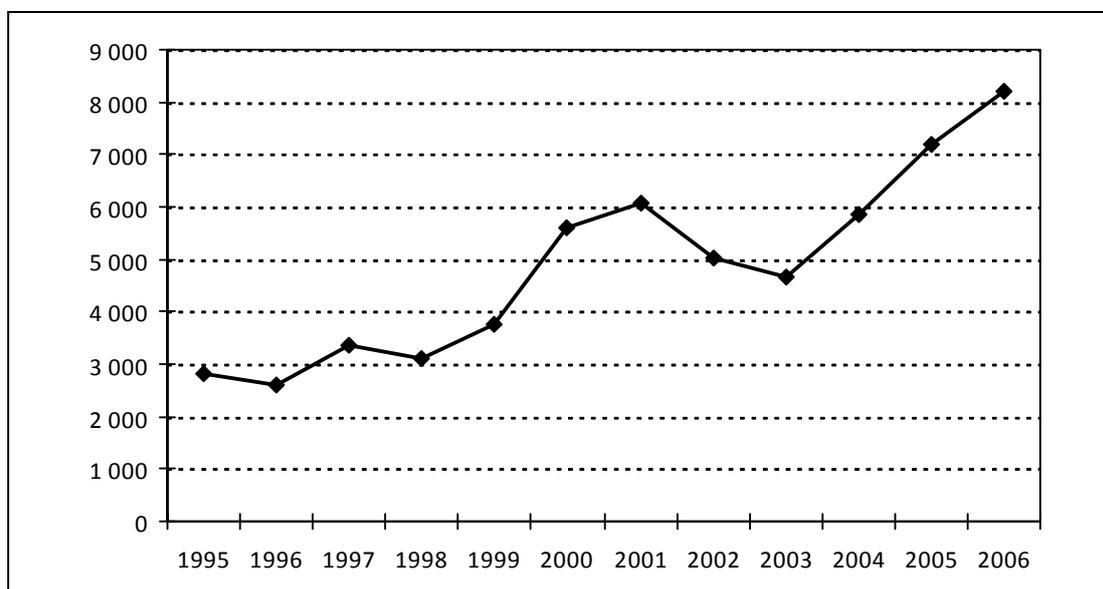
Source: Own calculations based upon UNCTAD – Handbook of Statistics 2009.

Figure 3: Exports of Financial Services of Low and Middle Income Countries (in relation to Gross National Income)



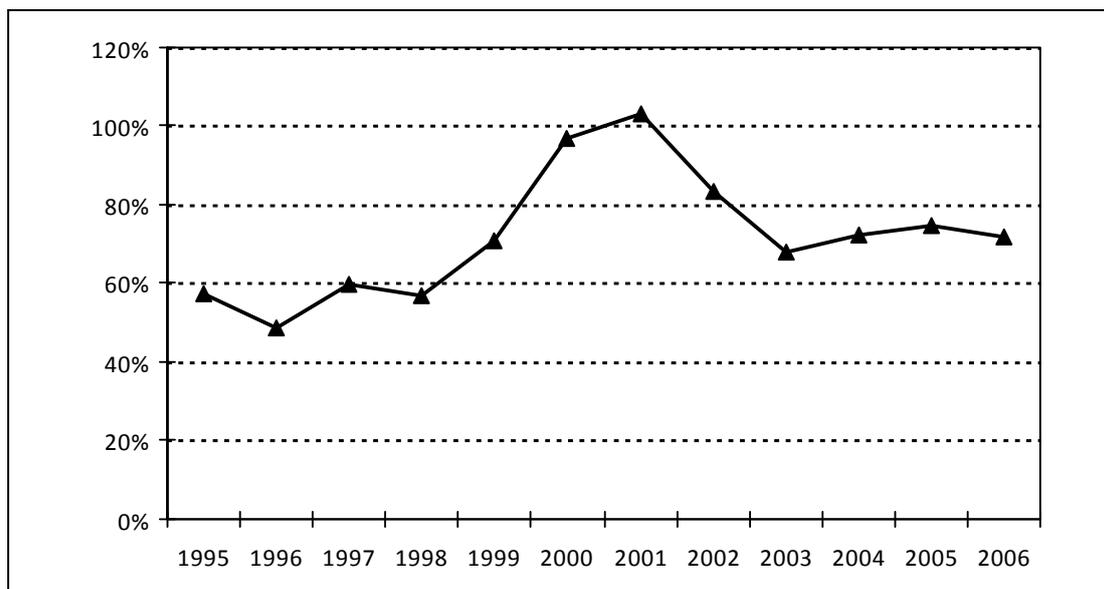
Source: Own calculations based upon UNCTAD – Handbook of Statistics 2009.

Figure 4: Imports of Financial Services of Low- and Middle-Income Countries (in billions of US dollars)



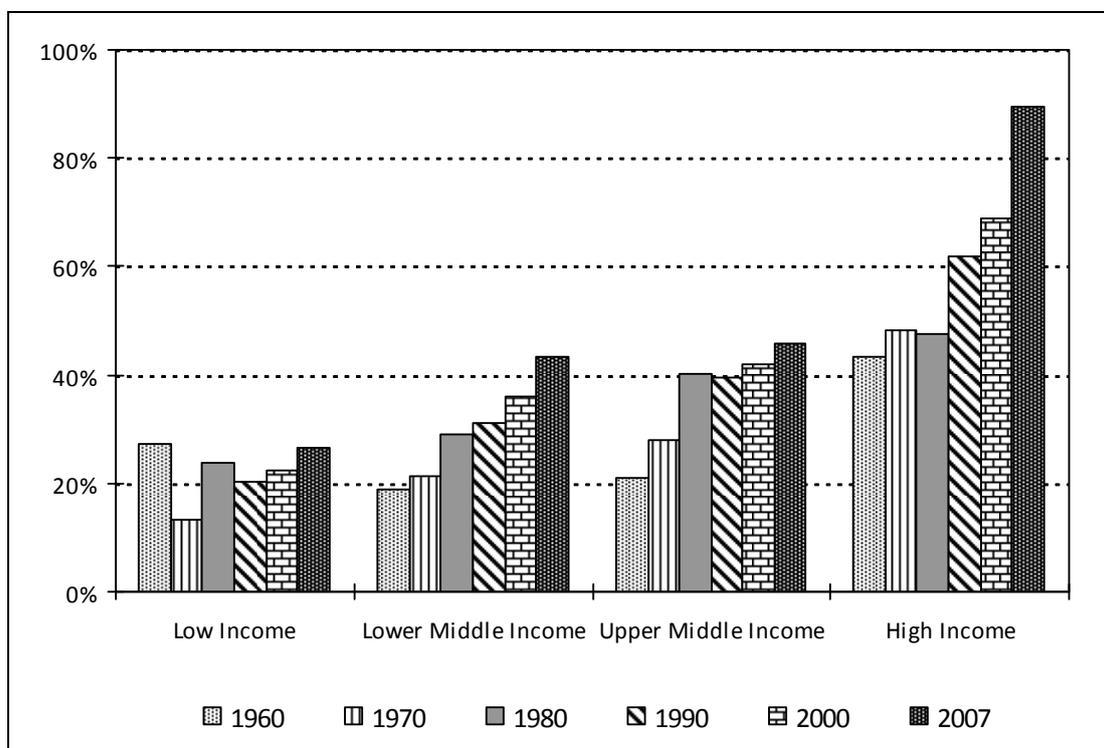
Source: Own calculations based upon UNCTAD – Handbook of Statistics 2009.

Figure 5: Imports of Financial Services of Low- and Middle-Income Countries (in relation to Gross National Income)



Source: Own calculations based upon UNCTAD – Handbook of Statistics 2009.

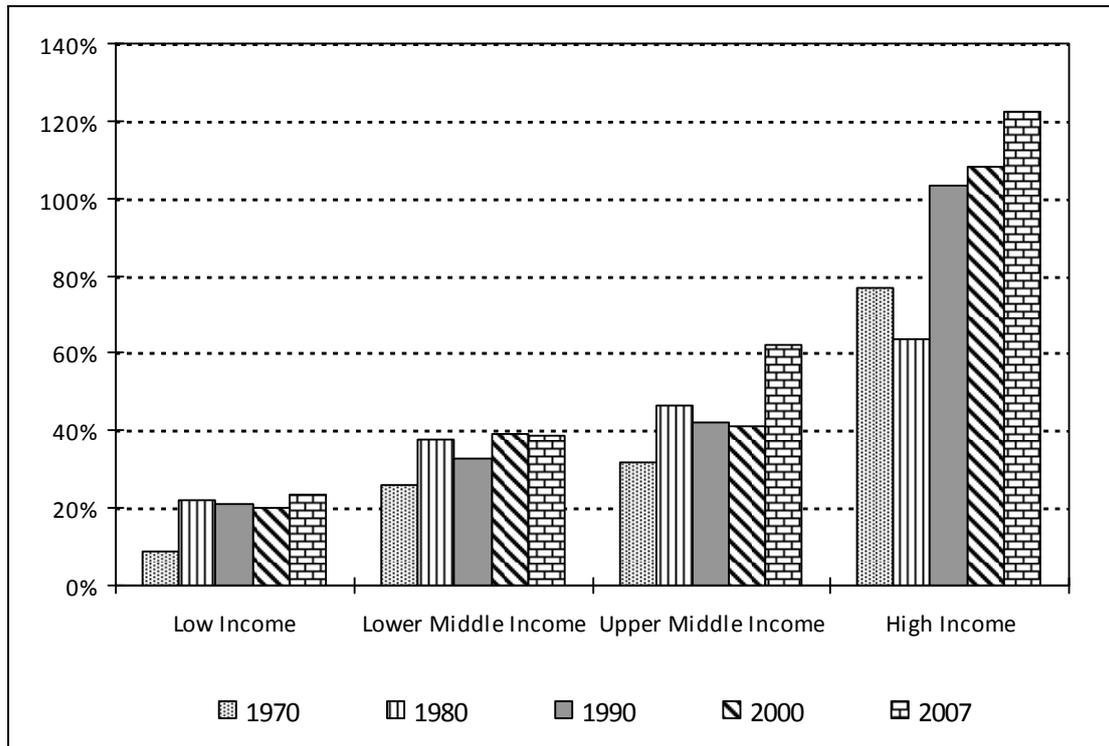
Figure 6: Total financial liabilities (in relation to GDP, median values for each income group)



Source: Own calculations based upon Beck et al. (2009)<sup>146</sup>

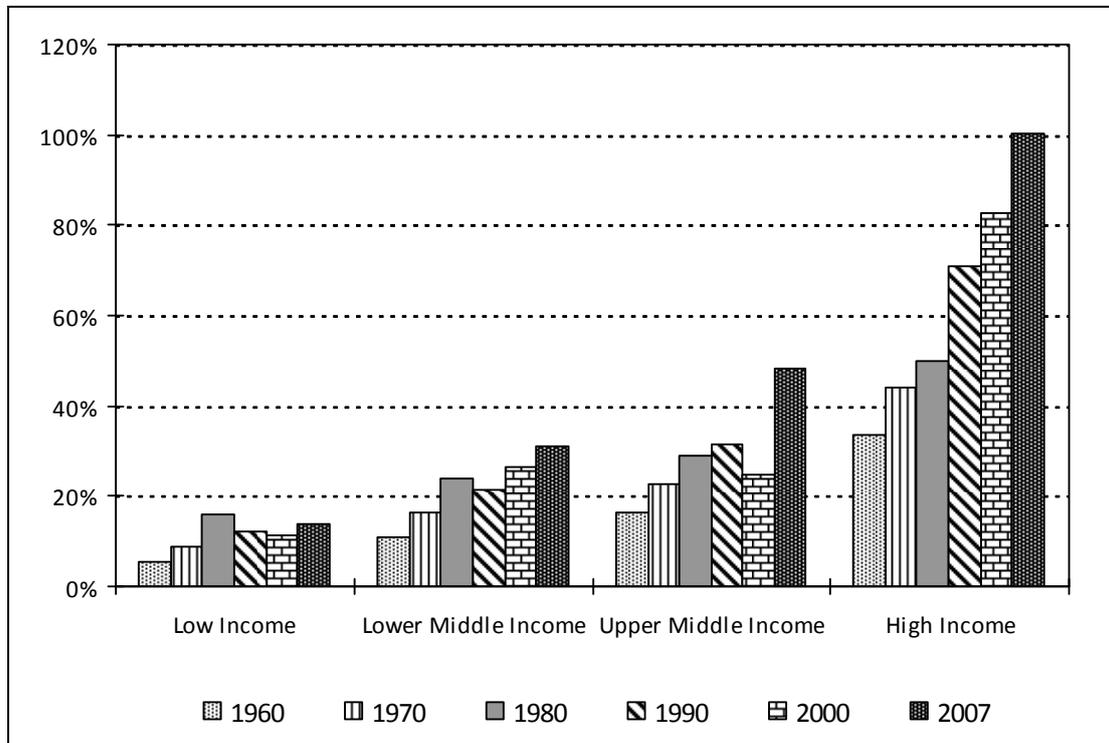
<sup>146</sup> Figures 6 through 9 are based upon Beck/Demirgüç-Kunt/Levine, A New Database – data update 2009.

Figure 7: Total financial assets (in relation to GDP, median values for each income group)



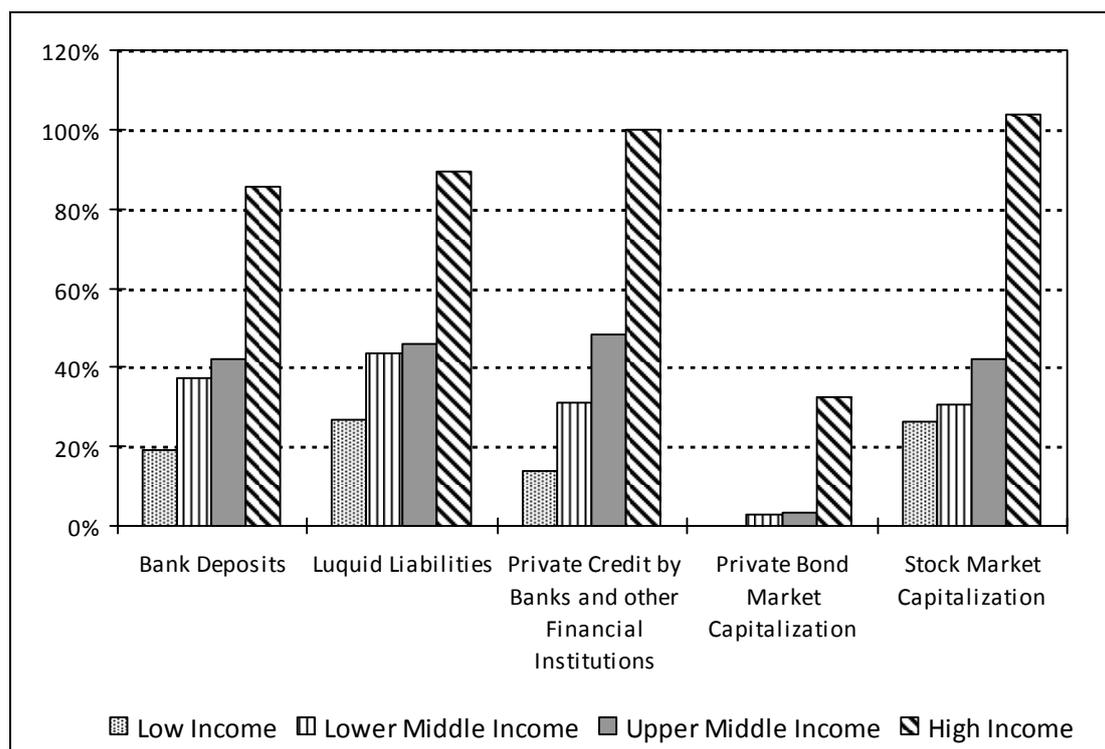
Source: Own calculations based upon *Beck et al. (2009)*

Figure 8: Private credit (in relation to GDP, median values for each income group)



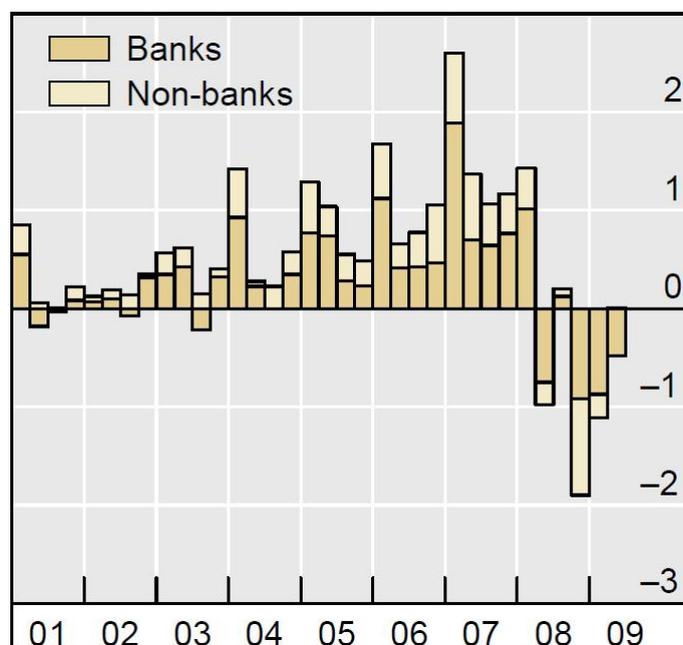
Source: Own calculations based upon *Beck et al. (2009)*

Figure 9: Financial System Size Indicators (in relation to GDP; by end 2007)



Source: Own calculations based upon Beck et al. (2009)

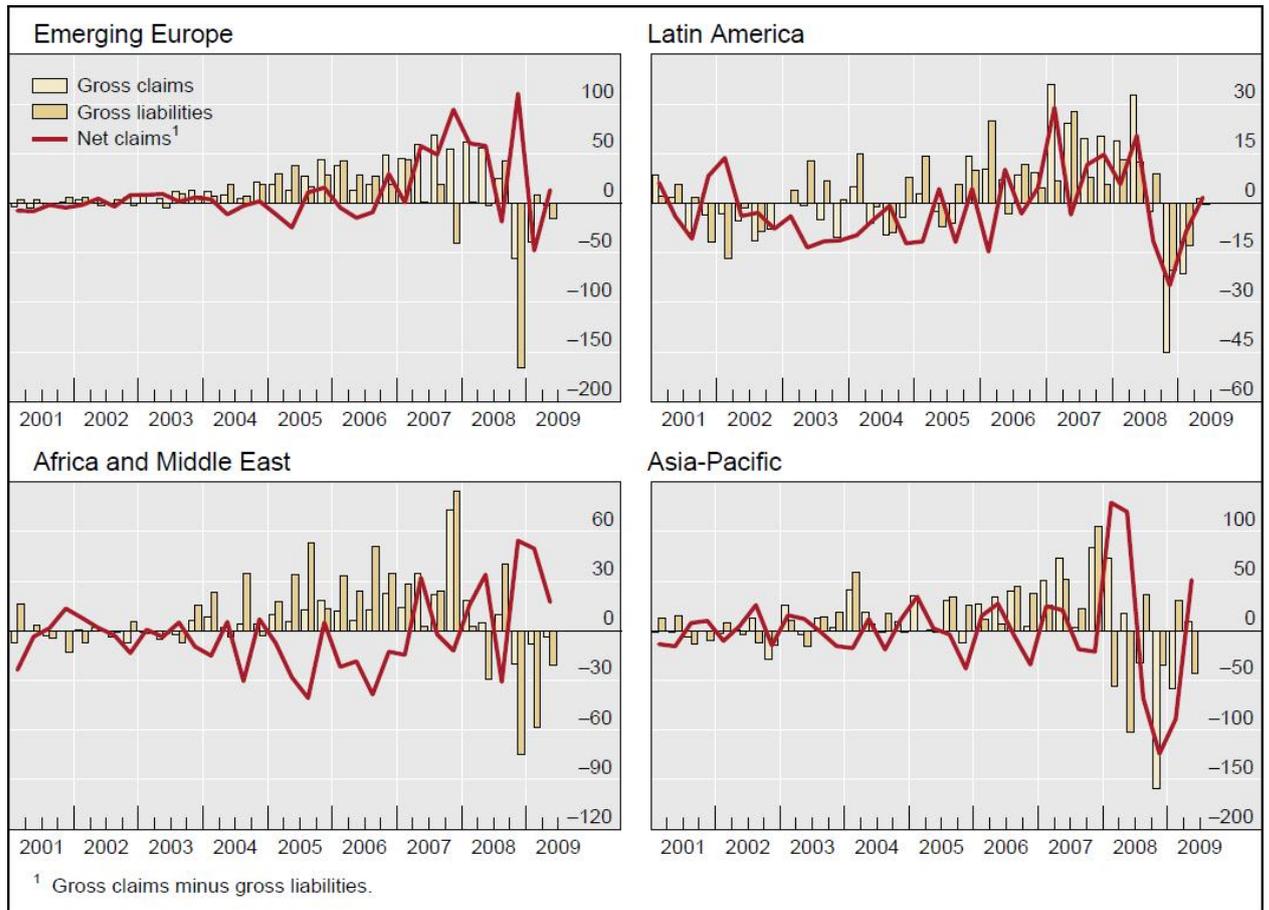
Figure 10: Changes in gross international claims by counterparty sector<sup>a)</sup> (in trillions of US dollars)



<sup>a)</sup> BIS reporting banks' cross-border claims (including inter-office claims) in all currencies plus locally booked foreign currency claims on residents of BIS reporting countries.

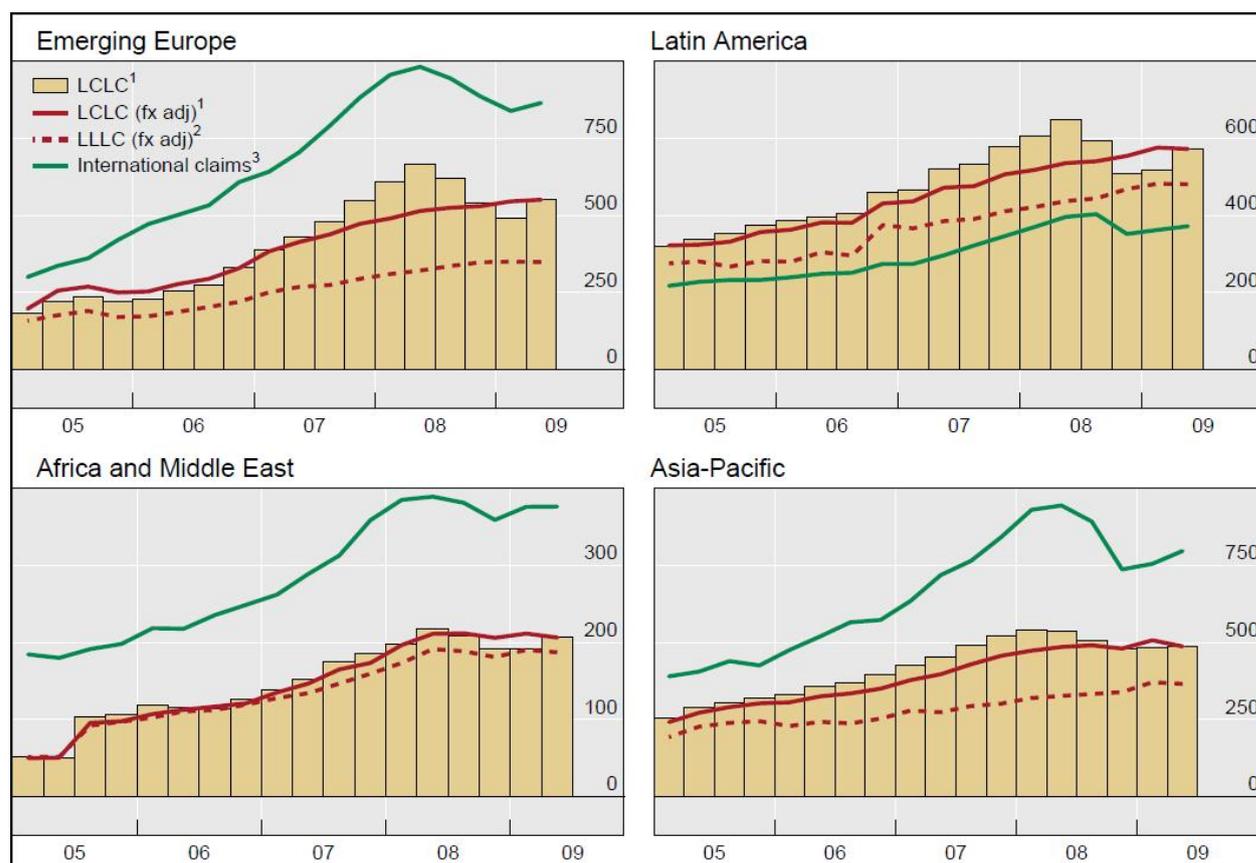
Source: BIS Quarterly Review December 2009, 14.

Figure 11: Changes in cross-border positions vis-à-vis emerging markets (in billions of US dollars)



Source: BIS Quarterly Review December 2009, 17.

Figure 12: Foreign claims, by developing region (in billions of US dollars)



<sup>1)</sup> Local claims in local currency, or local currency claims extended by banks' foreign offices to residents of the host country. The bars show reported claims whereas the solid red line tracks claims adjusted for exchange rate movements.

<sup>2)</sup> Local liabilities in local currency, adjusted for exchange rate movements.

<sup>3)</sup> International claims comprise cross-border claims in all currencies and local claims in foreign currencies extended by banks' foreign offices to residents of the host country; these claims are not adjusted for exchange rate movements, since no currency breakdown is available.

Source: BIS Quarterly Review December 2009, 17.

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