The recent financial crisis has led to widespread recognition of the need to re-regulate the financial sector and reverse financial liberalisation. Yet the current wide-ranging financial reform agenda in the European Union (EU) and other countries is in sharp contrast with the pre-crisis model still being applied in free trade negotiations. The negotiations in the General Agreement on Trade in Services (GATS) and other Free Trade Agreements (FTAs) continue to liberalise trade and investment in a wide range of risky and non-risky financial services as if the financial crisis never happened. As a result, trade rules can be in contradiction with new or proposed EU financial regulations. This is illustrated in this paper with specific examples from the GATS, the Cariforum-EU Economic Partnership Agreement (EPA) and the EU-South Korea FTA.

This discussion paper aims to stimulate the public and political debate about the need to change direction in the ongoing GATS and FTA negotiations on liberalisation of financial services. The technical nature of the issue and the lack of transparency in the decision making process have so far discouraged debate.

It is argued here that the GATS and FTAs should not use the ‘business as usual’ regulatory approach that dates from prior to the crisis and which contributed to financial instability. All regulations and agreements should make the financial sector serve the economy at large as well as the public good rather than promoting the interests of the financial sector itself.

After the financial crisis erupted in 2008, the G-20 leaders agreed to introduce new regulations in the financial sector. These same leaders continue to hail free trade as a vital ingredient to economic recovery and call for concluding the negotiations in the World Trade Organisation (WTO). However, free trade agreements include the liberalisation of financial services. In this context, the UN Commission of Experts on the Global Economic and Financial Crisis, chaired by Professor Stiglitz stated that: “The framework for financial market liberalisation under the Financial Services Agreement of the GATS under the World Trade Organisation and, even more, similar provisions in bilateral trade agreements may restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors.”

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1 Liberalisation of financial services based on a discredited model

While the need for stronger global financial regulation is widely acknowledged and acted upon, the EU and the WTO Secretariat maintain there is no reason why free trade negotiations and agreements should change the usual way they liberalise financial services. The WTO Secretariat² and the EU base this assertion on the argument that the causes of the financial crisis cannot be attributed in any way to the liberalisation of trade in services.

However, it needs to be recognised at the very least that by opening up markets, the GATS supported the spread of risky financial products and operators. In addition, the GATS is based on the notion that liberalisation increases international competition. This increasing competition results in more risky behaviour by the financial sector. Fierce international competition made national regulators and supervisors reluctant to curtail their financial industries through (international) regulations and compelled them to maintain a laissez-faire regulatory environment that enabled the financial industry to become more competitive (and make big profits, which was seen as contributing to GDP and economic growth). This so-called ‘light-touch’ regulation underpinned the dynamics, structure and way of thinking that ultimately led to the financial crisis. As explained in this paper, this model of restricting regulation was integrated in commitments, rules and annexes in the GATS and FTAs regarding financial services liberalisation.

Although many questions and concerns about the lack of financial sector regulation and too much financial liberalisation have been raised since the financial crisis fully erupted in 2008, the EU has not changed its position. The EU continues its pre-crisis model in negotiations on financial services in the GATS and FTAs such as the Cariforum-EU FTA (came into force in December 2009) and the EU-South Korea FTA (signed in October 2009 and not yet ratified as of November 2010).

1.1 Dangers of liberalising before sufficient regulation and supervision

The global financial and economic crisis has revealed the dangers of global liberalised financial markets without having adequate regulatory and supervisory systems in place at equivalent levels. Research has revealed how inadequate regulation and lack of supervision at the time of financial liberalisation is closely entwined with banking crises, also in the past.³ Although GATS negotiators assert that financial regulations are important, GATS and FTA rules liberalise financial services without first ensuring that sufficient regulation and supervision are in place. Financial services negotiators and the WTO Secretariat have also often argued that it is not necessary to regulate before you liberalise in trade agreements, and that ‘more regulation comes along with liberalisation’. The crisis has proven that the opposite was true before the crisis.

Many global and EU financial sector reforms and new supervisory arrangements have yet to come close to reaching the point of agreement or have not yet become operational. Nevertheless, the current GATS negotiations and the new EU FTAs that are being signed (e.g. with South Korea and Cariforum) or negotiated (e.g. with India) continue to push for financial sector liberalisation as usual.

1.2 Financial services as a public good or designed to serve the interests of the rich?

The lack of attention for adequate regulation and supervision results from the fact that the GATS and FTA rules are largely based on the interests of the financial and other services industry.⁴ For instance, the EU has received and used inputs from the financial industry about which regulation should be eliminated in which country during the GATS negotiations.⁵ Lobbyists often argued that stricter regulation and supervision was an unnecessary cost that would, moreover, make the financial industry inefficient, and less competitive and innovative. For example they would have considered regulation aimed at preventing banks from becoming too big to fail, to be a move to impede banks from becoming competitive (through economies of scale and larger profits).

In addition, negotiators were lobbied to liberalise trading in many unregulated, opaque and risky financial products that were very profitable for the financial industry. However, some of these products led to financial instability and ultimately damaged the economy and citizens worldwide.

The fierce international competition made (international) banks increasingly focus on serving the most profitable clients and providing poorer clients with no, fewer or increasingly expensive financial services. This had a negative impact in terms of the economic and public interest on those developing countries that liberalised financial services. In the agricultural sector, foreign banks in developing countries have hardly been financing small farmers nor are they interested in providing services in rural areas. In the industrial sector, foreign banks have been reluctant to provide credit to smaller local companies or the domestic industry as a whole.⁶

In times of crisis, foreign banks withdrew capital, reduced credit and finance for trade, thus undermining the competitiveness of the domestic industry.⁷ Moreover, foreign banks have the capacity to finance large companies and projects that can damage the environment and contribute to climate change.⁸
The huge government bailouts of banks and even speculative operators during the crisis indicate how the financial services industry has serious impacts on the economy and society as a whole. By now, it is widely acknowledged that financial stability is an important public good that has priority over corporate interests. It is also increasingly recognised that the financial sector must serve the public interest and contribute to a sustainable and equitable society, a concept not integrated into the GATS and FTAs.

1.3 Decision-making process too technocratic

Public and political debates to defend the public interest and integrate the lessons of the financial crisis are currently missing in the GATS and FTA negotiations that aim to liberalise financial services. The indispensable public debate is hindered by the complex and technical nature of the issues, the non-transparent nature of the negotiations, and the lack of appropriate knowledge on the part of the public about the consequences. The issues are considered “almost impenetrable for human rights lawyers or domestic policy makers”. As there is much at stake for the public interest, this is very problematic in itself. It has allowed the strong and resourceful lobby of the financial industry to continue to convince EU negotiators to establish the liberalisation of financial services as one of the priorities in the current GATS and FTA negotiations, without taking into account the effects of the financial crisis nor the need to re-regulate financial markets. The enormous financial and economic costs of rescuing the financial sector – amounts that could have saved millions from poverty and hunger – means that all possible measures should be taken to avoid making the same mistakes.

2 How the GATS and FTAs are in contrast with the EU’s financial reforms

The manner in which the GATS and FTAs continue to liberalise financial services has important consequences for how the financial sector can be regulated and reformed. This chapter provides a brief overview of the main issues at stake when GATS and FTAs are specifically applied to financial services. It includes examples of how the GATS and EU FTAs with South Korea and the Cariforum contrast with reforms that the EU is introducing to avoid a new financial crisis. Chapter 4 indicates how regulations to avoid financial instability are less safeguarded from trade disputes then is being argued by negotiators.

It is important to note here that the GATS and the EU FTAs with South Korea and the Cariforum cover a comprehensive and diverse range of financial services in banking, insurance, trading in all kinds of financial products, asset management and financial advice. Trade in those financial services is done in different ways or ‘modes’. Trade not only refers to a financial product crossing the border (e.g. cross-border internet banking) or the crossing of the border by a financial person, (e.g. manager of a foreign bank). The GATS and FTAs also allow banks and other financial services providers to establish themselves in the host country from which they offer their financial services. In other words, all free trade agreements in financial services are also agreements in foreign direct investment by financial services suppliers.

2.1 Why liberalisation limits the right to regulate

Liberalisation of financial services does not remove tariffs as is the case when liberalising goods. Within the GATS and EU FTAs, many services regulations are considered to be barriers to trade and are tackled as follows:

- ‘Scheduling’ financial services

Firstly, each country that is party to the GATS and/or an EU FTA agrees to open up its markets to particular financial services products, providers and ‘modes’ of trade from other members. These financial services are notified in a list, referred to as a country’s ‘schedule’.
of commitments, which is annexed to the agreement.10 Under the GATS, countries can choose how much financial services they will commit to liberalise and which exemptions to make (see below). In the Korea and Cariforum FTAs, the level of liberalisation of financial services is high as a result of Art. V in the GATS, which compels FTAs to substantially liberalise all services sectors. The EU has been insisting that up to 80% of all services sectors are covered in FTAs between the EU and developing countries, and that financial services are included.

Nineteen EU member states – 15 old members and Bulgaria, the Czech Republic, Hungary, and the Slovak Republic – have a high level of liberalisation due to their adherence to the GATS Understanding on Commitments in Financial Services, an optional GATS protocol fostering the most extensive liberalisation possible.11 These EU member states have liberalised trade and investment in many financial products which the financial crisis has shown to be risky, excessively speculative and enhancing instability, such as hedge funds’ operations, over-the-counter (OTC) derivatives trading (including in food commodities), and credit rating agencies.12

Once included in a schedule under the GATS, the listed financial sub-sectors can only be banned, nationalised or their liberalisation modified, when a WTO member compensates for changes made to the schedule to those WTO members who ask for compensation. EU financial reforms that would prohibit committed risky financial services and providers would become very costly if the EU’s trading partners ask for compensation – a serious deterrent against financial reform.14

Some call this a loss of policy space. Others consider these disciplines to be a central driver of deregulation because they are for instance used by the EU in the GATS negotiations to request WTO member countries to do away with certain domestic regulations.15 Indeed, many WTO members received particularly targeted GATS requests from the EU, which incorporated demands to “eliminate” particular prudential measures which, for instance, WTO members put in place after the 1997 financial crisis, or which are currently being considered as a remedy against future financial crises, such as more capital reserves. Chapter 4 explains how financial regulations and reforms can only marginally be safeguarded against these deregulating disciplines.

Non-discrimination
Thirdly, the GATS and FTAs liberalise the scheduled financial sectors by removing host country measures that (1) discriminate between domestic and foreign financial services (‘national treatment’), and (2) discriminate among foreign financial services (‘most favoured nation treatment’ or MFN). The GATS (Art. XVII.3 and the Understanding) and similar EU FTA rules also prohibit or try to limit measures that do not discriminate but prevent foreign financial services from entering and competing in another WTO member country.

EU bailouts in breach of the GATS & FTAs
The bank rescue measures or ‘bailouts’ by EU member states gave competitive advantage to their domestic financial industry over those banks from countries that could not pay for bank bailouts. Since this resulted in less ability of third country banks to enter EU member states’ markets to replace non-competitive and shaky banks, such bailouts contradicted GATS Art. XVII.3. This raises doubts as to which bailouts are allowed.

2.2 Prohibitions on how to regulate the financial sector
Some of the most far-reaching obligations that restrict regulation in those financial sub-sectors committed in the schedules are the ‘market access’ rules, which are identical in the GATS (Art. XVI) and EU FTAs. They prohibit signatory countries from maintaining, amending or adopting many measures and regulations in the financial sector. They require that WTO member states:
Market access rules in contrast with new EU financial regulation

Market access rules in the GATS and FTAs contradict many of the EU's new or proposed financial reforms that are based on lessons from the recent financial crisis and are aimed at introducing more restraint on financial products, their trading and operators. Below are some examples of contradictions that are related to financial services that the EU has liberalised under the GATS and FTAs:

- The EU is considering limiting trading in derivatives, as their risky and speculative nature and lack of transparency have been shown to aggravate financial crises and even food price crises. The EU might potentially limit how much speculators can trade in commodity derivatives (‘position limits’). This might be against the GATS and FTA prohibitions of limiting total number of services operations, the total quantity of services, or limitations on the total value of service transactions, expressed through quotas.

- In order to avoid risky destabilising investment strategies, the European Commission and some European parliamentarians wanted to set limits on how much managers of hedge funds and private equity funds (PE) can borrow (a ‘leverage limit’). This could be in breach of the market access rule that prohibits “limitations on the total value of service transactions or assets in the form of numerical quotas or economic needs tests”. Due to massive lobbying from the hedge fund and PE industry, a new EU Directive adopted by the European Parliament stipulates that a limit on the level of borrowing by hedge funds and PE managers can be set only by supervisory authorities to prevent risks in the financial system. However, authorisation requires information about whether the investment fund managers have set a “leverage limit” that is “reasonable” according to some criteria (Art. 3, 4, 11 and 25): such an authorisation requirement requires a self imposed leverage limit and is close to an economic needs test in order to be allowed to enter a market. A review of this Directive on ‘alternative investment fund managers’ could still impose an overall regulatory limit on the level of borrowing by all hedge funds and PE managers.

- Given the turmoil on the EU’s financial markets in 2010, more regulations are still to be expected to limit or prohibit risky financial products as well as their operators. Also, some fundamental solutions still need to be finalised such as prohibiting banks from becoming too big to fail, which could be done by limiting the size of individual or the total of financial firms and the volume of their transactions. All such limiting measures or prohibitions would be in breach of the GATS and FTA market access rules that apply to financial services in the schedule if done through ‘quotas’ or needs tests. Quotas are particular numerical limitations but even a ban of a service is considered a ‘quota of zero’ by the WTO Appellate Body.

3 How domestic regulation is disciplined rather than the financial sector

Without exception, the GATS rule on domestic regulation (Art. VI), and similar rules in recent EU FTAs, result in particular disciplines that apply regarding all the financial products and providers which countries have committed to liberalise in their schedules.

- Not take measures that limit the number of financial service suppliers (e.g. The number of bank branches);
- Do not restrict the total value of financial transactions or assets;
- Do not limit the total number or the total quantity of financial service operations;
- Do not undertake “economic needs test” to assess whether a financial service is needed;
- Do not restrict or require specific types of legal entity of financial providers, including joint ventures;
- Do not limit foreign ownership of financial services providers, i.e. full mergers and acquisitions have to be allowed.

Unless countries have written explicit exemptions of these market access rules in their GATS or FTA schedules related to their financial sector commitments, they are obliged to respect these rules.
GATS disciplines on domestic regulation contrast with the lesson from the financial crisis that ‘light-touch’ regulation in the financial sector results in financial crises. Another lesson is that preventive regulations are needed against the many unpredictable risks in this sector, even if they might seem “more burdensome than necessary for the quality of the service” or unnecessary barriers to trade (GATS language).

3.1 GATS rules on domestic regulation
First, GATS rules on domestic regulation set disciplines regarding how authorities take administrative decisions and authorise financial services and their providers. Second, disciplines on licensing requirements, technical standards and qualification procedures in the financial sector prioritise protecting liberalisation commitments over policy space to regulate. These measures should not, for instance, undermine or nullify commitments by being more burdensome “than necessary to ensure the quality of the service” (GATS Art. VI.4), as it can be argued that ‘Chinese walls’ within a CRA would be sufficient. Therefore, prohibiting CRAs from providing particular advisory services could be contrary to Art. VI.5 because no exemptions were made regarding which companies could give advisory services. Especially the CRA legislation “could not have been expected by a country at the time commitments were made” (Art. VI.5.a.(iii)). Indeed, CRAs had remained unregulated in the past and central bankers officially accepted that their unregulated ratings were used by banks to make risks assessments.

The European Parliament adopted in November 2010 a Directive to regulate managers of hedge funds and private equity funds (PE). Such a Directive had been resisted for many years at all EU levels, and many did not expect it to be adopted. The Directive prohibits PE managers to strip particular capital of a non-listed company within the two years after it was taken over by a private equity investor. The aim is to prevent short-term profit-taking by a sharp reduction of a company’s assets, underinvestment, redundancies, etc. However, such short-term strategies are key to the high returns sought by investors in PE. The prohibition in the directive could be seen under Art. VI.5 as an impairment of the EU’s GATS commitment to ‘asset management’ as it affects the quality of PE services.

3.2 The GATS Understanding
The GATS Understanding on Commitments in Financial Services (see 2.1.) also has important implications for the EU’s new financial regulations. For instance, the Understanding contains a standstill clause (Art. A) which prohibits any new limiting measures that would contradict commitments and rules under the Understanding. This standstill clause goes against the grain of some possible new EU financial regulations. Members try to curb measures that limit the expansion of the activities of financial service suppliers in their territory. Members should even refrain from taking “other measures” (Art. B.10.(d)) that, although respecting the provisions of the GATS, could thwart the financial service suppliers of any other Member to operate, compete or enter the market. These rules could also contradict many new (proposed) EU
financial regulations, such as conditions and limits to be imposed on over-the-counter (OTC) derivatives trading, which all will curtail risky financial operations.

3.3 The ‘regulatory framework’ in FTAs

The EU-Korea FTA and the Cariforum-EU EPA contain a separate chapter on the ‘regulatory framework’. In each FTA such a chapter has different disciplines for domestic regulation in general and financial services in particular. The disciplines are based on existing disciplinary GATS rules, new domestic regulation disciplines which are not yet decided during the current GATS negotiations, and elements of the GATS Understanding.

How the regulatory framework in FTAs affects domestic regulation in scheduled financial sectors is illustrated by the following examples:

- In the Cariforum-EU EPA, the signatory countries have to endeavour to provide information about proposals for new financial measures or regulations to interested persons in order to allow them to comment before decisions are taken. Similar procedures are being proposed in the current GATS domestic regulation negotiations. Such procedures not only impose a huge burden on any state, they also furnish resourceful foreign financial operators with the right to be heard and the opportunity for their lobbyists to successfully bend new regulations to their interests in an undemocratic way in the host country. This kind of lobbying – called ‘regulatory capture’ – has led in the past to the deregulation of the financial sector (see 1.2.), and has been recognised as a major cause of the financial crisis.

- The EU and South Korea agreed to implement, where practicable, internationally agreed standards for financial regulation and supervision, and for the battle against tax evasion – a clause that is not included in the GATS. The FTA lists quite a few of these international standards, including the Core Principles for Effective Banking Supervision of the Basel Committee on Banking Supervision (more commonly known as Basel II) and the Statement on Transparency and Exchange of Information for Tax Purposes of the G20. In contrast, Cariforum states have rejected mentioning specific international standards because they argue that some of these international standards are not appropriate for their domestic circumstances. Also, Cariforum states have no say in many of these so-called ‘international financial standard setting bodies’. GATS therefore stipulates in Art. VI.5.(b), footnote 3: The term ‘relevant international organisations’ refers to international bodies whose membership is open to the relevant bodies of at least all Members of the WTO. Agreeing to implement existing international standards might hinder future flexibility in regulation.

It is important to note that the EU-Korea FTA (Art. 7.23.3) has omitted the controversial obligation that standards and licensing etc. be “not more burdensome than necessary”. It seems that this GATS rule on domestic regulation was considered inappropriate to deal with the kind of financial crises that Asia have already had to deal with. In comparison, the Cariforum-EU EPA has omitted any requirements regarding standards and licensing.

4 Prudential regulations hardly protected

The GATS Annex on Financial Services and the FTA subsections on the regulatory framework in financial services recognise that signatory countries can take prudential measures “to ensure the integrity and stability of the financial system” and to protect investors, depositors or clients of a financial services supplier.

The GATS Annex and the EU-Korea FTA specify that prudential measures that are not compatible with other provisions in the agreements shall not be used to avoid “commitments or obligations” under the agreement. However, as explained above, those commitments and obligations include applying market access and domestic regulation rules and (for some WTO members) the Understanding, all of which restrict prudential regulations in liberalised financial services, and even prevent efforts to withdraw or reduce liberalisation commitments.

4.1 Uncertainties and grey areas

The WTO Secretariat, some WTO members and GATS proponents assume that all new financial reforms are a priori allowed under the Annex in Financial Services, which they call a ‘prudential carve-out’. However, the formulation of the GATS Annex on prudential measures results in many uncertainties among WTO members and increasing concerns raised by international lawyers and critics on how new financial reforms are protected against GATS rules. What constitutes a prudential measure is not defined and indeed some WTO members have insisted on a tighter definition of its permissible scope, while others prefer to keep the current broad and undefined formulation to allow more policy space.

It needs to be noted that the current GATS Annex on prudential measures does not clearly protect governments’ rights to apply prudential regulations, since draft texts that did so were not adopted during the previous GATS negotiations. Also, the GATS Annex and FTAs do not use the standard WTO formulation to exempt measures from being sanctioned under the WTO dispute settlement, as is done in GATS Art. XIV and GATT (WTO) Art. XX. This means that prudential measures can be brought before...
Uncertainty about banning ‘naked short selling’

The uncertainty about what measures taken by individual WTO members or FTA signatories are or are not ‘prudential’, has already arisen regarding the ban on ‘naked short selling’ (i.e. speculating with securities one does not own). Germany has previously implemented such a ban temporarily and intends to legislate a ban on naked short selling in bonds and shares as a prudential measure to protect investors and increase the stability of the financial system. However, this ban has already been attacked by some as not being prudential (since the German ban in Spring 2010 sharply increased volatility on the financial markets) and protecting German banks from being taken over, and moreover being in contravention of Germany’s commitments in derivatives trading related to the ‘Understanding’ and GATS/FTA market access rules.

A WTO dispute settlement panel and risk being sanctioned, which undermines the priority that should be given to the stability of the financial system and even the economy. It is only when members abstain from such dispute settlement that prudential regulation will not be challenged. So far, no WTO member has brought a prudential regulation before the WTO dispute settlement system, either because they see no problem, have no political will to do so or they are all breaching the rules. However, there is no guarantee that a prudential measure will not be challenged by a GATS or FTA signatory country: this might have a ‘chilling’ effect and result in some reticence in financial reforms.

The WTO Secretariat claims that in the case of a WTO dispute settlement procedure, the Annex would result in the accused country having to defend itself to prove that a challenged prudential measure has not been taken to abuse commitments and obligations. Since no prudential measure has yet been tested in a dispute settlement, it remains very uncertain and very debatable which prudential measures can be considered to be promoting financial stability, which ones are protectionist or discriminatory, and which ones are in other ways going against commitments and obligations. Some examples of such uncertainties are:

- The current international discussions on financial reform (such as in the Basel Committee and the G-20) show that under the disguise of prudential regulations, countries and even regulators or supervisors aim to protect the financial industry of their countries while others consider those same prudential regulations as being against ‘their’ interests. Already before the financial crisis, many so-called prudential measures were taken to promote the domestic industry while these measures caused financial instability and ultimately the financial crisis. Accordingly, there are many different interpretations of when a measure is ‘discriminatory’ and promoting the competitiveness of the domestic financial industry, as forbidden by GATS Art. XVII, and when a measure is ‘prudential’.

- Discriminatory regulations can be prudential, for instance if a host country wishes to diversify the countries of origin of the foreign banks operating in its country in order to avoid that too many banks are in trouble when the dominant home country is in financial crisis. However, if as a consequence a country were to reject banks from particular countries on this basis, this would contravene the GATS MFN rule (see 2.1).

- Measures in the financial sector that protect particular vulnerable groups in society are not protected against trade disputes in the same way as prudential measures taken in order to protect financial services clients or the stability of the financial system. If the EU were to introduce limits on speculative trading in food commodity derivative markets through quantitative limits or even bans on speculators and speculative commodity products, this would not be considered to be prudential as defined in the GATS Annex. This is because such measures to stabilise food prices are not meant to prevent the instability of the financial system, because trading in food commodity derivatives is relatively small, but rather to avoid food prices from becoming too high or volatile (which resulted in more hunger for the poor as in 2008). As such these measures would be considered to contravene the EU’s commitments in GATS and FTAs on derivatives trading. Even the general exception in GATS Art. XIV and FTAs to allow measures necessary to protect human life and health cannot be used. Indeed, derivatives traders and some experts argue, contrary to many other experts, that there is no link between food price spikes and derivatives trading. This raises the question whether banning committed financial products that are considered socially harmful would be allowed.

The EU-Korea FTA adds an obligation that prudential measures shall “not be more burdensome than necessary to achieve their aim” (Art. 7:38). This can result in the EU and South Korea challenging each others prudential regulation to prove that prudential measures are really necessary to protect consumers or the stability of the financial system and are the least trade-restrictive option available. The Cariforum-EU EPA has omitted this additional obligation, which might prevent the signatory countries
from challenging and undermining each other’s financial reforms.

4.2 Introducing new services or avoiding risks?
Those EU and other WTO members that have subscribed to the GATS Understanding on Commitments in Financial Services have agreed (Art. B.7.) to permit “any new financial service” by any other WTO Member as long as the new financial service is supplied in another WTO country and the provider is established in their territory (and the Understanding also guarantees the right of establishment (Art. B.5. & 6.).

This provision on new financial services contrasts with the current knowledge that new and innovative financial services can be very risky and trigger a financial crisis, as was the case with US collateralised debt obligations (CDOs) of sub-prime mortgages, which were sold in the EU.

The riskiness of such a provision seems to have been recognised in the FTAs negotiated by the EU with the Cariforum40 and South Korea.41 The respective articles on how to treat new financial services by foreign financial services providers include additional prudential safeguards as compared to the Understanding. Under both FTAs, the signatory countries have the right to determine the juridical form of new financial services and to require authorisation of such services in a reasonable way.

Although the related article in the Cariforum-EU EPA (Art. 106) applies not only to financial services providers established in the country as in GATS but to any mode of supply which is scheduled, the new financial service must be similar to those services that a signatory host country permits its own financial service suppliers to provide. The EU-Korea FTA defines a new financial service almost in the same way as in the GATS Understanding, except that the new financial service must already be offered in the home country. In addition, the introduction of a new financial service should not require “a new law or modification of an existing law” (Art. 7:42).

5 Controls on cross-border capital flows restricted
In order to ensure full international operation of the liberalised services and investments, the GATS and EU FTAs

New moves towards capital controls
This ever-growing freedom of capital movement in FTAs contrasts with the increasing number of official arguments, even by the IMF, in favour of using capital and currency controls, especially in times of financial crisis and huge speculation. It also contrasts with the different forms to control capital inflows recently introduced by Brazil, Taiwan, South Korea and Indonesia. Examples of how new anti-crisis measures contradict FTA and GATS rules are:

- In June 2010, South Korea curbed cross-border capital flows by setting limits on currency derivatives trading and bank loans in foreign currency.43 These measures are in breach of the EU-Korea FTA commitments on derivatives trading and related rules on market access. South Korea could also be seen as not fulfilling all the conditions that allow restrictions on capital movement e.g. they should not interfere with investors’ ability to earn a market rate of return, and avoid unnecessary damage to commercial, economic or financial interests of the other Party. Also, South Korea’s measures could be considered as not short term nor strictly necessary for exchange rate policy since they are basically economic in the sense that they prevent volatile or expensive currencies that damage Korea’s exports, and avoid asset bubbles and sudden cross-border outflows in the future.

- In November 2010, Thailand announced it was considering capital controls and perhaps a financial transaction tax.44 Its main argument was that it wanted to have all possible options open, and that the threat of taking any such measure was already a strong deterrent for speculators.

- EU leaders endorsed in mid-June 2010 the introduction of a bank levy and a tax on financial transactions among others to compensate for losses due to bank failures and restrain volatility in financial markets. However, the European Commission has expressed doubts as to whether a tax on financial transactions would be compatible with Article XI of the GATS.45 This indicates how interpretation of GATS or FTA rules could restrict policy space as there are no clear definitions and experts disagree on whether transaction taxes are defined as restrictions on international transfers.46
have rules that guarantee freedom of movement of capital. When applied to financial services and their providers, these rules can have far-reaching consequences as described below. Financial services suppliers can move huge amounts of capital across borders, for instance to invest abroad for clients or for speculative currency trading. Large cross-border capital movements negatively affect the value of exchange rates and the monetary and financial stability policies of governments, especially in developing countries. This was true in 2010 in emerging market countries, where huge capital inflows resulted in higher exchange rates against the dollar, which in turn made their exports more expensive (see box New moves towards capital controls).

GATS Art. XI prohibits restrictions on international payments for current account transactions related to all financial services (sub-)sectors listed in the schedules. This Art. XI is an ‘indispensable’ GATS discipline according to a WTO dispute settlement panel47 because it guarantees profit repatriation48 and all payments. In addition,49 a WTO country must:
- Permit capital inflows and outflows in case it is committed to liberalisation of cross-border trade in financial services;
- Permit capital inflows ‘related’ to financial sectors for which establishment was committed. In case a country has liberalised derivatives trading, such inflows can be huge.

In case of serious (imminent) balance-of-payment problems (GATS Art. XII), a country can restrict cross-border money transactions and trade in committed services, but only when it fulfils fifteen restraining conditions and criteria, such as: Being temporary and non-discriminative, not being more excessive than what is needed and not causing unnecessary damage to the commercial or economic interests of other WTO members. The so-called prudential carve-out (see chapter 4) is not likely to be acceptable as a means to justify capital flow restrictions that are used only for economic reasons and not for protecting financial stability or clients of financial suppliers.50

In the FTAs concluded by the EU with Cariforum and South Korea, even less restrictions on capital movements are possible. This greatly benefits internationally operating financial services providers. All legal current payments between residents of the contracting parties have to be allowed according to the FTAs. No restrictions can be imposed on capital transfers related to all legal and scheduled foreign direct investments, including repatriation of the investments themselves. This also relates to credit and loans by all investors, and portfolio investment51 in the EU-Korea FTA. Only in ‘exceptional’ circumstances, when exchange rate and monetary policies are in ‘serious’ difficulties, can measures be taken, and these measures must be strictly necessary and must be of short duration, according to both FTAs. The EU-Korea FTA stipulates even more restrictive conditions than the GATS before implementation of such exchange rate policies is allowed. In fact, the EU is imposing on its trading partners EU rules that severely restrict capital controls: The Lisbon Treaty (Art. 63-66) only allows the EU states to restrict freedom of capital movement with third countries in very exceptional circumstances.

6 Continued negotiations and a new EU investment mandate

In the aftermath of the financial and economic crisis, many have changed their perspective on how the financial sector actually works. The long reform agenda of the financial sector and the continued financial turmoil at the international, EU and national levels show that the financial sector needs to be regulated and its expansion restricted. For instance, in the second half of 2010, the EU has agreed to regulate hedge funds and private equity funds (asset management) to some degree and has been discussing new legislation to control over-the-counter (OTC) derivatives trading in a way that will somewhat shrink this sub-sector. Both sub-sectors are part of the financial services sector in the GATS and FTA negotiations.

Nonetheless, the EU’s negotiation mandate on financial services has not changed since the crisis. EU politicians and negotiators continue to call for free trade agendas and for finalising the WTO, GATS and FTA negotiations. They still fail to recognise that liberalising financial services based on the pre-crisis ‘light-touch’ deregulatory model contradicts the re-regulation agenda of the EU and many other countries.

6.1 GATS continues a risky negotiation agenda

In 2009 and 2010, EU negotiators have continued to insist on more market access for financial services during GATS negotiations that are part of the current WTO negotiations in the ‘Doha Round’. This means they are seeking market access for European banks and other financial services that are still not fully re-regulated (e.g. Basel III will not be fully implemented until 2019) and still very risky (e.g. several EU banks still receive support, while turmoil continues to dominate EU bond, currency and derivatives markets).

The EU has so far not shown any intention of withdrawing its requests tabled in 2002 to WTO members in the context of GATS negotiations. These bilateral EU requests52 for substantial market opening in financial services contained a deregulatory agenda with the purpose of increasing the international competitiveness of the EU’s financial industry – i.e. according to pre-crisis thinking (see ‘deregulation’ under 2.1.). The most audacious case is the EU’s requests
to countries like Brazil, Chile and India to liberalise according to the GATS Understanding on Commitments in Financial Services with far-reaching liberalisation and deregulation clauses as explained above (see 2.1., 4.1.).

In July 2008, some WTO members indicated they intended to “eliminate” requirements for capital reserves at foreign branches or “remove” prior authorisation for insurance companies. In addition, some WTO countries also were willing to liberalize trade in risky financial products such as derivatives, and risky operators such as hedge funds (“asset management for sophisticated consumers”). At the same time, the EU had been insisting for significant liberalisation of financial services in the GATS negotiations.

In the WTO’s Committee on Trade in Financial Services, some developing countries have tried to discuss the impact of the crisis on the financial sector and on developing countries, the legality of the bailouts in the financial sectors by developed countries, and the policy space available under GATS to enact financial reforms. The discussions have been met with fierce resistance by the US, the EU, the WTO Secretariat and others. In February 2010, a background paper by the WTO secretariat refused to make a connection between the GATS rules and commitments on financial services, the global economic crisis and financial reforms. The paper dodged many uncertainties raised by various international trade lawyers about the potential GATS challenges against new financial regulations.

So far, any concerns about conflicts between financial reforms and GATS rules are being answered by the WTO Secretariat, the EU and some WTO members with the argument that the ‘prudential carve-out’ of the GATS Annex can always be used. But if most, if not all, new financial regulations need to be exempted from GATS rules through this GATS Annex, at least this indicates that something is seriously wrong with applying the current GATS rules and commitments to financial services.

### 6.2 A new EU mandate on investment for future FTAs

After concluding the FTAs with Cariforum and South Korea, the EU is undertaking many efforts to conclude new FTAs that include financial services liberalisation in the same way as before the financial crisis. This is not only the case with African countries (full EPAs), but also with Canada, and with Asian and Latin American countries whose markets are profitable to the EU financial industry.

Under the Lisbon Treaty, the EU collectively has since December 2009 exclusive competence to negotiate foreign direct investment agreements. This removes the competence of EU member states to negotiate bilateral investment treaties (BITs). Although the way in which this new EU mandate will be handled was still under debate by the end of 2010, the EU has already tried to integrate more protection for foreign investors in FTA negotiations with India and Canada in 2010. This could result in foreign direct investment by foreign financial firms (e.g. foreign bank branches) receiving far-reaching protection under FTAs in the same way as under BITs. Such investor protection includes rules for fair and equitable treatment, full security and protection, protection and compensation in case of expropriation, and freedom of capital movements.

### 7 Conclusions and recommendations

The negotiations to liberalise financial services in the GATS and EU FTAs continue to use the pre-crisis model that supports expansion of financial services without sufficient regulation and supervision and restricts financial regulation rather than enhancing regulation and supervision of the financial industry. This business-as-usual approach in the negotiations fails to integrate the lessons from the crisis and instead reinforces rules that promote the spread of risky financial products and fierce international competition that is stimulating risky behaviour. By limiting the policy space to regulate and reform the financial sector, the GATS and FTAs are in sharp contrast with the ongoing financial reform agendas at the international, EU and national levels. This paper provided many examples of contradictions between GATS and FTA rules and financial reforms. Just one example is the fact that the EC itself questioned whether the financial transaction tax can be justified under Article XI of the GATS on free capital flows. Some argue that all such contradictions can be solved by using the so-called prudential carve-out in the GATS Annex.

However, if most financial reforms need to be exempted from GATS rules, then there is clearly something wrong with applying GATS rules to financial services.

The compatibility between new financial regulations and GATS has increasingly been questioned inside and outside the WTO, leaving many uncertainties as to whether financial reform measures will be subject to WTO and FTA dispute settlement procedures.

More political, public and academic debates are needed in order to deal with the uncertainties and contradictions, to avoid that the GATS and new EU FTAs contribute to financial instability or undermine any financial reform, and to make trade agreements supportive of a financial sector that serves the interests of the economy, society and sustainability.

Proposals for solutions, ranging from modest steps to more long-term changes, should be part of these renewed debates. These could include the following steps in the GATS and FTAs:
7.1 Rolling back commitments
- Developing countries with comprehensive financial services liberalisation commitments that pose a risk to financial stability and their economy should be allowed to withdraw their current GATS commitments according to GATS Art. XXI. However, the EU and other WTO members should not request to be compensated for such withdrawal of commitments.
- Under FTAs already concluded by the EU, developing countries should be able to withdraw their financial services sectors commitments for prudential reasons without compensation. Rules to allow such changes, as well as to allow countries to refrain from making financial sector commitments, should be established in FTAs.
- If the EU or any other developed country would like to withdraw their financial services commitments to allow essential financial reforms, they should compensate developing countries and not developed countries. After all, it is the latter who pushed the incorporation of the deregulatory model into services free trade agreements.
- No compensation should be offered or sought if withdrawal of commitments is fully based on (new) financial standards established by international standard-setting bodies in which all members of the WTO (or relevant FTAs) can participate.

7.2 Prudential regulation to be fully applied and not abused
- Countries should be allowed to fully use their right to regulate and introduce prudential regulations that are not only based on widely accepted international standards but also those needed given the circumstances in the country or resulting from democratic decisions and not from financial industry lobbying.
- Rules on domestic regulation should be fully in line with the financial sector reform agenda and beyond. The current negotiations in the GATS and FTAs should be reversed and must ensure that rules on domestic regulation do not restrict any financial prudential measures.
- A new external panel of independent supervisors and financial regulation experts should be established to avoid (new) financial and prudential regulations and withdrawal of commitments from being abused but also to allow more policy space for domestic financial regulation.

7.3 No deal on GATS negotiations without new global financial reform
No GATS deal nor any EU FTAs should be concluded that includes liberalisation of financial services and capital movement until new financial regulation and supervision – set at the national, regional/EU and international (preferably UN) levels – have become operational. Also, all free trade negotiations should reverse the non-interventionist approach and integrate the lessons from the financial crisis that full trade liberalisation and unregulated free markets contain many risks and lead to economic crises.

7.4 Financial services out of the GATS and FTAs
Financial services and the free movement of capital should ultimately be taken out of the GATS and FTAs. Regulating trade (liberalisation) in financial services and capital movements should be integrated into financial reforms and decided upon by much more democratic international financial and standard setting bodies – i.e. not in the G20. This should allow reforms that integrate the public interest as well as sustainability needs into the financial sector. There is an urgent need for the GATS and FTAs to be fully supportive of reforms that reverse the current contribution of the financial sector to social exclusion (see 1.2) as well as climate change, and stop the financialisation of the economy.
The GATS Understanding on Commitments in Financial Services is an optional GATS protocol that has only been adopted in 1997 by 30 mostly developed WTO members. It fosters among others very extensive liberalisation commitments in the schedules of the signatory countries.

The GATS' schedules of specific commitments are the lists per country which indicate what (sub-)sectors in services a country has 'committed' or 'bound' i.e. are liberalised and subject to GATS rules; these lists often include financial services' (sub-)sectors; the list also includes exemptions which exclude a country from applying GATS articles XVI-XVII. Large (investment) banks often offer derivative contracts and are party to them.

As one example, the EU's GATS request to liberalise financial services to Thailand states "eliminate these ceilings" in foreign ownership (Source: Gats 2000 – Request from the EC and its Member States (hereinafter the EC) to Thailand, [2002, non published negotiation document].)

(Over-the-counter (OTC)) trading in derivatives is a financial service often listed in GATS and free trade agreements' schedules. Large (investment) banks often offer derivative contracts and are party to them.

For an explanation of these financial products, see: SOMO website, EU financial reforms glossary, <http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/glossary>, (September 2010).

See GATS Art. XXI and Art. XIV.

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(OVER-THE-COUNTER (OTC)) trading in derivatives is a financial service often listed in GATS and free trade agreements’ schedules. Large (investment) banks often offer derivative contracts and are party to them.


Corporate Europe Observatory, Venture ventriloquists – How investment fund lobbyists used SMEs as a front to lobby MEPs, Brussels, 16 June 2010, <http://www.corporateeurope.org/lobbyocracy/content/2010/06/venture-ventriloquists> (December 2010).


See e.g. CARIFORUM-EU EPA, Art. 87 and Art. 105 (under the regulatory framework); EU-Korea FTA, Art. 7.37: under sub-section on financial services.

EU, Credit Rating Agencies Regulation No 1060/2009, adopted 16 September 2009: see among others Art. 8, Annexes; Annex 1, Section B, Art. 4 states: “a credit rating agency shall not provide consultancy or advisory services to the rated entity or a related third party regarding the corporate or legal structure, assets, liabilities or activities of that rated entity or related third party.”

This was accepted under certain conditions by the “Basel II” accord on capital requirements, see: <http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_proposal_en.pdf> (September 2010).


Ibidem: provisional Art. 29 (a) “Asset stripping”. 

Endnotes


5 As one example, the EU’s GATS request to liberalise financial services to Thailand states “EU industry raises this issue”: GATS 2000 – Request from the EC and its Member States to Thailand, [2001, non-published negotiation document].


8 See for instance the ‘dodgy deals’ mentioned on <http://www.banktrack.org>.


10 The GATS’ schedules of specific commitments are the lists per country which indicate what (sub-)sectors in services a country has ‘committed’ or ‘bound’ i.e. are liberalised and subject to GATS rules; these lists often include financial services’ (sub-)sectors; the list also includes exemptions which exclude a country from applying GATS articles XVI-XVII.


12 The GATS Understanding on Commitments in Financial Services is an optional GATS protocol that has only been adopted in 1997 by 30 mostly developed WTO members. It fosters among others very extensive liberalisation commitments in the schedules of the signatory countries.


See Art. 7.24 on governance in the EU-S Korea FTA.


WTO, Financial services, Background note by the Secretariat, S/C/W/312, S/FIN/W/73, 3 February 2010.


T. Tucker, Answering critical questions about conflicts between financial re-regulation and WTO rules hitherto unaddressed by the WTO Secretariat and other official sources, Public Citizen Memorandum briefing, 22 June 2010.


WTO, Financial services, Background note by the Secretariat, S/C/W/312 and S/FIN/W/73, 3 February 2010: discussed by T. Tucker, That’s All They’ve Got?, Public Citizen, March 2010.


The last year of EU-Cariforum EPA/FTA negotiations was 2007, during which the problems with innovative financial products such as securised debt (CDOs) were already disrupting the US financial markets.

The negotiations ended after the financial crisis had already erupted in 2008 in the EU whose banks etc. were affected by CDOs.


European Commission, Innovative financing at a global level, Staff Working Document SEC(210)409 final, 1 April 2010.

T. Tucker, The WTO conflict with financial transaction taxes and capital management techniques, and how to fix it, Public Citizen Memorandum briefing paper, 9 July 2010.

See among others: T. Tucker, Answering critical questions about conflicts between financial re-regulation and WTO rules hitherto unaddressed by the WTO Secretariat and other official sources, Public Citizen Memorandum briefing, 22 June 2010.

For instance, in the course of the current GATS negotiations on financial services, the EU requests Chile that Chile eliminates the ‘restriction’ that prior authorisation by the Central Bank is required before transferring dividends from Chile abroad because this is in breach of Article XI: M. Vander Stichele, GATS negotiations in financial services: The EU requests and their implications for developing countries, SOMO, 2005, <http://somo.nl/publications-en/Publication_601/at_download/fulllfile/>. See GATS Article XVI (‘Market Access’), footnote 8.


See: EU-Korea FTA Art. 8.2: “capital participation in a juridical person with no intention of establishing or maintaining lasting economic links”.

See paper by M. Vander Stichele, GATS negotiations in financial services: The EU requests and their implications for developing countries, SOMO, 2005.

54 WTO, Financial services, Background note by the Secretariat, S/C/W/312 and S/FIN/W/73, 3 February 2010.

55 T. Tucker, That’s All They’ve Got?, Public Citizen, March 2010.


57 See paper by M. Vander Stichele, GATS negotiations in financial services: The EU requests and their implications for developing countries, SOMO, 2005.
Colophon

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