Further Thoughts on the GATS Rules for Banking Services

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The introduction of the post-crisis regulatory architecture for the financial sector reflects far-reaching shifts in thinking concerning the appropriate scope and practice of financial regulation in comparison with that prevalent at the time of the drafting of the GATS rules on international trade in banking. These shifts have provided a further fillip to the debate among GATS commentators as to how far the rules accommodate prudential measures and reforms likely to constitute key elements of this new architecture. What follows is a review of major contributions to this debate together with some ideas on ways forward in response to the potential shortcomings of the GATS rules.

A number of recent commentators have argued that the GATS rules do constitute an impediment to regulatory reforms and other policy measures under discussion or likely to be required as part of the response to the current financial crisis. These include the Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System - more concisely known as the Stiglitz Commission - published in September 2009 (United Nations, 2009), the 2011 edition of UNCTAD's *Trade and Development Report* (UNCTAD, 2011), a communication to the WTO from Barbados, and papers of a major NGO, Public Citizen. On the other side in a recent article in the *Economic and Political Weekly* B.K.Zutshi, former Indian Ambassador to the GATT, has mounted a defence of the scope for countries' policy and regulatory autonomy provided by the GATS rules (Zutshi, 2011).

Discussion of GATS rules bearing on the prudential regulation of banks must start from acknowledgement that no interpretations of these rules can be definitive in the absence of the resolution of eventual legal challenges under the WTO's dispute settlement procedures concerning the way in which they have actually been applied.[1] Nevertheless, changes in the context of prudential policy since the GATS rules on banking were designed and the possibility of conflicts between initiatives for reform, on the one hand, and pressures within the WTO to undertake further liberalisation of banking sectors, on the other, justify re-examination of these rules. Although the re-examination here supports the case that the rules are characterised by substantial shortcomings, it is also argued that revision of key provisions of the GATS is unlikely any time soon, and that the outcome of any initiative for renegotiation would anyway be unpredictable. Other ways of

[1] The note at the end of this paper on the case concerning Chinese electronic payments services brought by the United States, as the first case submitted for Dispute Settlement regarding the GATS rules on international trade in banking services, none the less illustrates how some of the concepts discussed in this paper can be deployed in such challenges.

countering possible threats in the rules to countries' policy autonomy regarding the key subjects of capital controls and financial regulation can none the less be conceived. These might include agreement to suspend negotiations on the basis of existing GATS rules and taking advantage of GATS provisions on the scheduling of commitments in ways which are not necessarily inconsistent with Zutshi's defence of the GATS - even if they go beyond his arguments in a direction which Zutshi himself would not necessarily approve.

Before particular issues raised by the GATS are taken up in greater detail, certain general points should be recalled.

The GATS rules on banking were intended to be a vehicle for the progressive liberalization of cross-border transactions of banking services (where such transactions include not only cross-border trade but also the other three modes of cross-border supply specified in Article I of the GATS). In spite of safeguards written into the agreement at the instance principally of developing country negotiators, of which the most important was the restriction of commitments to sectors or activities specified by the country undertaking them (the positive-list approach), during both the Uruguay Round and the Doha Round negotiations the rules have provided the framework through which pressure is brought to bear on countries to open their banking markets to foreign participation. The positive-list approach in practice has not provided countries with protection from such pressures even when the targets are arguably inappropriate. Indeed, such pressures have recently been exercised in disregard of recent changes in the climate of opinion concerning financial deregulation generally and the limitations on liberalization which countries may reasonably wish to retain in the light of these changes.

Negotiation of the GATS rules for banking was completed in the early 1990s, though countries' commitments became part of the agreement only after negotiations were completed at the end of 1997. Since the early 1990s the international banking landscape has undergone far-reaching changes. Some of these have important implications for regulation, especially in the light of experience during the financial crisis. Of special importance here are transactional innovations, which have required substantial revision of the Basel rules for banks' capital and risk management; greater acknowledgement of the connections between financial stability and macroeconomic policy, which is leading to the development of guidelines for macroprudential policy (which major developed countries and multilateral institutions such as the IMF now concede can include expanded recourse to capital controls); and the greater role in international financial markets of Large Complex Financial Institutions, whose size and the diversification of whose activities have the consequence that their failure is capable of posing systemic threats to financial stability.

More recently, the bail-outs of large banks in the United States and some Western European countries, arguably the largest programme of sectoral support by governments in modern history, have implications for policy towards the granting by countries of market access to foreign banks that have benefitted directly or indirectly from such support – support without which their existence as

cross-border competitors to domestic banks in other countries might have been fatally compromised. At the time when the GATS rules were negotiated, the playing field for international banking activities was not by any means completely level. Indeed, one of the objectives of the international agreements concerning banks reached during this period, of which the Basel Capital Accord of 1988 was one and the GATS rules another, was to remove or reduce impediments to competition among banks which often still benefited from various state subsidies and other forms of protection but which in the United States and parts of the EU had not, as is currently the case, recently emerged from official life-support. The scale of the subsidisation which this life-support has entailed is markedly at variance with assumptions about the overall soundness of the financial sectors of developed countries prevalent in the early 1990s, which, understandably, were part of the mindset of the negotiators of the GATS rules.

REGULATION AND CAPITAL CONTROLS IN THE GATS RULES

Regarding financial regulation, the preamble of the GATS recognises "the right of Members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives and, given asymmetries existing with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise this right". On its own this statement is very general. Doubts as to the exact scope of its legal purchase are raised by parts of the Vienna Convention on the Law of Treaties concerning treaties' preambles. According to Article 31 of the Convention, the interpretation of the GATS including its preamble would have to take account of the ordinary meaning of its terms, its objects and purpose, relevant elements of its context and of subsequent agreements and practice, and special meanings of terms intended by the parties to the agreement. Article 32 allows recourse to supplementary means of interpretation such as the preparatory work leading to the treaty and the circumstances of its conclusion. According to Article 27 of the Convention "a party may not invoke the provisions of its own internal law as justification for its failure to perform a treaty".

Article VI of the GATS contains provisions designed to ensure that regulations affecting services are administered in a reasonable, objective and impartial manner. Article VII requires that national and international standards for the authorization, licensing or certification of services are exercised in a non-discriminatory manner. In accordance with the positive-list approach to market access of the GATS, Article XVI provides that, with respect to activities for which a country undertakes commitments, limitations on the number, value, foreign participation as well as certain other restrictive measures should be specified in countries' commitments. Article XVII contains similar provisions regarding the specification of limitations in the country's commitments on national (i.e. non-discriminatory) treatment for foreign suppliers of services.

Article XIX on progressive liberalisation provides for successive rounds of negotiations with a view to achieving higher levels of liberalisation. The Article none the less recognises that the process of liberalisation should take account of countries' need for flexibility regarding liberalisation in the light

of national policy objectives and levels of development. As part of the establishment of guidelines and procedures for each round of negotiations, assessments of trade in services on both an overall and a sectoral basis should be carried out – an assessment which, it is reasonable to assume, requires statistical data on the four modes of supply defined in Article I.2, including those of banking services. Article XXI contains the procedures for the modification of schedules of commitments. These procedures are specified at a somewhat general level, covering notification, negotiations with member countries affected by the modification, and compensatory adjustments including modifications of schedules by countries affected by the initial modification.

The Annex on Financial Services provides a list and definitions of financial services which, it was hoped, would serve as the basis of the classifications used in countries' schedules of commitments – a hope actually met during the negotiations by many member countries only approximately. The Annex elaborates the provisions of Article VII regarding the recognition of standards as these apply to financial services. Section 2(a) of the Annex on domestic regulation provides a "prudential carve-out", now usually referred to as the Prudential Defence Measure, with the following wording: "Notwithstanding any other provision of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, 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". Exercise of the policy latitude provided by this sentence is qualified as follows: "Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement".

An alternative option of making commitments in accordance with rules inspired by the negative-list approach (under which commitments are comprehensive in coverage except with respect to listed exceptions) is provided by the Understanding on Commitments in Financial Services. As noted by Zutshi, the Understanding is not an integral part of the GATS. Nevertheless provisions of the Understanding are legally binding parts of the commitments of several countries. Moreover, despite the Understanding's lack of formal legal status within the GATS, some of the rules of the Understanding merit special attention since they illustrate concepts being promoted by major industrial countries during the original negotiations.

Limitations and exceptions to commitments under the Understanding are to apply only to existing non-conforming measures and not to future measures. A country is to grant suppliers of financial services from other parties to the agreement the right to establish or expand within its territory a commercial presence including through the acquisition of existing enterprises. Particularly interesting in the light of the experience of the current crisis is the provision that a country making its commitments according to the Understanding is to permit suppliers with a commercial presence to offer any new financial service in its territory. This last provision is presumably designed to enable a foreign financial institution to supply in such a country all the financial products or other services which the foreign institution is authorised to supply in its parent country. This would include

structured financial products and derivatives which contributed in no small measure to both the outbreak of the current crisis and to subsequent contagion.

Although the Understanding guarantees to foreign suppliers of financial services access to payment and clearing systems operated by public entities and to official funding and refinancing facilities available in the normal course of business, it does not confer the right of access to lender-of-last-resort facilities. Such access becomes especially important during a financial crisis.

Controls on external payments are covered in the GATS in Articles XI and XII and in a footnote to Article XVI. Article XI.1 prohibits restrictions on payments and transfers for current transactions related to a country's commitments. Article XI.2 contains a similar prohibition for capital transactions. According to Article XII, in both cases these prohibitions may be overridden by a country's need to undertake actions to safeguard the balance of payments in the event of serious external financial difficulties. Consultations concerning the need to take such actions should be based on statistical and other empirical findings of the IMF and on the Fund's assessment of the country's external financial position. The footnote to Article XVI on the rules for the granting of market access specifies that capital movements integrally related to commitments under Mode of Supply 1, i.e. from the territory of one country into that of another, must be allowed. Transfers of capital related to commitments under Mode of Supply 3, i.e. through a commercial presence, are similarly to be allowed.

RECENT CAVEATS CONCERNING THE GATS RULES ON BANKING

The Stiglitz Commission and UNCTAD

Recent criticisms of the GATS rules from reports drafted under the auspices of the United Nations are to be found in United Nations, 2009 (better known as the report of the Stiglitz Commission) and in chapter IV of UNCTAD, 2011.

The basic concern of the Stiglitz Commission is that "The framework for financial market liberalisation under the Financial Services Agreement of the General Agreement on Services (GATS) under the WTO...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" (chapter 3, para. 208). A special concern of the Commission is the danger of financial contagion: "Problems in the banking system in one country can spread to other countries in which that bank has branches or subsidiaries" (chapter 3, para. 210).

The Commission devotes special attention to a number of policy issues.

- Concerning the role of home or parent versus host country regulation, the Commission supports an expansion of the latter which it considers more likely to introduce and enforce prudential rules and to promote institutional diversity within the banking sector. For these

reasons the Commission supports requirements by countries to admit foreign banks only as locally incorporated subsidiaries.

- The Commission raises the question - without making its own suggestion for the resolution – of cross-border bank insolvencies, especially those of institutions too large or too complex to be allowed to fail: here it draws attention to unsatisfactory features of the way in which losses are assumed by depositors in different countries.
- As part of the questioning of the benefits of financial liberalisation due to the crisis and more particularly of the poor risk management demonstrated during the crisis by many foreign banks, which has undermined the case for granting them market access owing to supposedly favourable effects on the competencies of domestic banks which would result, agreements on international trade in banking services need to be reassessed for their consistency with the "inclusive and comprehensive international regulatory framework" which is now required. Moreover "one of the lessons of the current crisis is that there should be no presumption that *eventually* there should be full liberalization" (chapter 4, para. 95).
- The Commission expresses concern over agreements (amongst which it does not specifically mention the GATS rules on banking) which may restrict countries' ability to revise capital-account regulations in the light of lessons learned during the crisis.

Like the Stiglitz Commission, UNCTAD, 2011 expresses concern as to constraints regarding regulation, reregulation and capital controls due to the GATS rules. On capital controls UNCTAD, 2011 draws attention to ambiguities in these rules which are capable of rendering illegal the use of such controls in several situations. Concerning the Prudential Defence Measure of the Annex on Financial Services the Report draws attention to what it believes is a contradiction between the scope which it appears to provide for prudential measures, on the one hand, and the qualification that they must not be used to avoid commitments undertaken under the GATS, on the other. The Report notes that the European Commission itself has acknowledged that its proposal for a tax on financial transactions may fall foul of the rules of GATS Article XI concerning restrictions on financial payments and transfers[2]. Moreover UNCTAD, 2011 draws attention to the danger that unfavourable interpretation of the specification of financial services in a country's GATS commitments could be used as the basis of challenges to the banning of products which experience has shown to be highly risky. Other observations of UNCTAD, 2011 concern the impediments to future regulation contained in the provisions of the Understanding.

Barbados at the WTO

[2] The compatibility of such a tax with the GATS would depend on its design (for example, its coverage of financial products and transactions), on its purpose (which might be to impose on the banking sector a contribution to meeting the costs of the financial crisis for which the sector is responsible rather than to serve as part of a strengthened prudential regime), and on the point at which it is imposed. If the tax does not discriminate between residents and non-residents, it would not violate the principle of national treatment. It might be challenged under Article XI as constituting an impediment to payments and transfers required by countries' commitments.

The communication of Barbados to the WTO Committee on Trade in Financial Services (WTO, 2011) raises the question whether the financial crisis should lead to a revision of the GATS rules. According to the communication: "the crisis has served to highlight flaws in the global regulatory and compliance environment which hamper the implementation of corrective measures and in some cases make them open to challenge...they point to a need to review some aspects of the global rules including WTO GATS rules...so as to permit remedial measures to be implemented without running the risk of having them viewed as contraventions of commitments...It has been suggested that the prudential carve-out in the GATS permits members to take action on the grounds such action is prudentially required. However, when there is an increasing number of exceptions being introduced on prudential grounds, then this may be a sign that the basic rules need to be addressed."

Some of the subjects which are taken up in the communication of Barbados are part of the basic GATS rules and others are relevant only to countries which undertake commitments according to the form prescribed in the Understanding on Commitments in Financial Services.

Regarding the rules of the GATS which apply to all WTO member countries the communication draws attention to the following: the provisions on payments and transfers (Article XI); restrictions to safeguard the balance of payments (Article XII); limitations on the total value of service transactions or assets as part of the granting of market access (Article XVI); and restrictions on the legal form of entities granted such access (also Article XVI). Among the rules of the Understanding the communication draws attention to the following: limitation to existing non-conforming measures of limitations and qualifications to commitments of the Understanding in a WTO member country's schedule; removal or limitation of the effects of measures adversely affecting the ability of other member countries' suppliers of financial services "to operate, compete or enter the Member's market"; and permission for other WTO member countries established in a country's territory to offer any new financial service.

Articles XI and XII of the GATS are designed to address corrective measures adopted in response to traditional balance-of-payment difficulties due to deficits in external payments. The communication of Barbados argues that experience during the crisis suggests that safeguard measures under the GATS should be extended to preventive, i.e. presumably pre-emptive, as well as corrective measures. Moreover the gamut of situations in which safeguard actions would be permitted under GATS rules should be extended to include potential threats to financial stability other than balance-of-payments crises such as heightened systemic risks to a country's financial system and excessive levels of public and private indebtedness. Article XII.3 does provide the following latitude as to the character of safeguard restrictions which a country may adopt: "In determining such restrictions, Members may give priority to the supply of services which are more essential to their economic or development programmes". However, for example, measures designed to protect a country's banking sector from global turbulence would not necessarily be covered since "such restrictions shall not be adopted for the purpose of protecting a particular service sector".

The communication of Barbados draws attention to limitations on the numbers of service suppliers and on the value of services transactions or assets among the impediments to market access which should be scheduled in commitments according to Article XVI (and which have thus been the subject of continuing pressures for removal in WTO negotiations). However, the specification of such limitations as appropriate subjects for WTO scheduling seems anomalous in the light of new regulatory rules on the size of Too-Big-To-Fail financial firms or on the range of their activities and thus the services which they supply - regulatory rules which are now part of the agenda for a new global regulatory architecture. A similar point is made in the communication of Barbados concerning Article XVI's inclusion of measures which restrict or require specific types of legal entity among the limitations on market access to be specified in a country's commitments. This too now seems anomalous owing to the new emphasis in regulatory thinking on the appropriateness as part of the conditions for granting market access to foreign financial institutions of the requirement for incorporation as a local subsidiary on the grounds that such incorporation provides local regulators with greater legal authority (a point also made in the report of the Stiglitz Commission).

The communication of Barbados suggests a radical change in the Understanding's restriction on limitations and qualifications in a country's commitments to those already existing. Instead limitations and qualifications to commitments regarding non-conforming measures would become possible at any time. Regarding the Understanding's provision for the removal or limitation of the effects of measures adversely affecting the ability of other member countries' suppliers "to operate, compete or enter the country's market" the communication draws attention to possible inconsistencies with plans to introduce higher capital requirements for firms above a certain size. Regarding the Understanding's obligation for a country to permit the suppliers of another member country established in its territory to offer any new financial service, the communication draws attention to the case for amending the obligation to permit countries greater scope to limit services which they wish to discourage.

Public Citizen

The criticisms of the Public Citizen (PC) commentators are, like the points made in the communication of Barbados, wide-ranging, and cover both particular policy issues and the overall thrust of the GATS rules (for example, Tucker, 2010, and Wallach and Tucker, 2010). The PC commentators are sceptical that the rules concerning controls on capital transactions and the Prudential Defence Measure provide countries with sufficient flexibility regarding use of such controls or the justification on prudential grounds of particular regulatory measures and of the updating or strengthening of regulatory regimes. Substantial technical commentary from legal literature is marshalled in support of their scepticism. More generally the PC commentators draw attention to the imprecise and untested scope of key concepts in the GATS rules such as "capital", "current transactions", and "prudential".

Particular concerns of the PC commentators include regulatory bans, rules for limitations on market access and restrictions on the range of activities of financial firms; the locking-in of certain forms of

deregulation (in ways which may difficult to reverse or be reversible only through recourse to the untried procedures of Article XXI on the modification of schedules); and cross-sectoral retaliation.

- On regulatory bans the PC commentators go beyond the communication of Barbados which targets only the rules of the Understanding. Their concern is that the banning of particular financial services or products deemed to be included in one of the categories of financial service specified in the Annex with respect to which a country has undertaken a commitment could be actionable.
- The PC commentators believe that the rules of GATS Article XVI.2 regarding limitations on the number of service suppliers, the value of service transactions or assets, or on the total number of service operations could prove an obstacle to the introduction of firewalls between banking and securities or between banking and insurance. The rules concerning limitations on legal form in the same Article could act as an impediment to measures designed to strengthen local control over foreign financial firms (a point also made by the Stiglitz Commission and the communication of Barbados).
- The concerns of the PC commentators as to the locking-in of deregulation involve a number of points: the very general character of the language in Article VI of the GATS (Domestic Regulation) which means that the Article provides little guidance as to what is GATS-compatible, the absence of a proper definition of "prudential" and of key terms in the provisions of the GATS pertinent to the control of capital movements (which complicate the task of identifying what is and what is not likely to be protected from challenge), and the resulting uncertainty even as what forms of post-crisis reregulation and structural changes in countries' legal regimes (concerning, for example, the range of activities permitted for different categories of financial firms) would be judged as compatible with a country's schedule of commitments.
- Owing to the rules on cross-sectoral retaliation of the WTO agreements a country found in dispute settlement to be in violation of its commitments regarding banking services could in principle be subject to compensatory measures affecting its goods trade.

Among their policy recommendations the PC commentators propose the following: clarification as to the meaning of key terms of the GATS rules which should include greater leeway under the heading of restrictions for tax measures such as taxes on financial transactions and for measures designed to safeguard the balance of payments (including capital controls) which do not have a solely protectionist purpose; and a shifting of the burden of proof to the complainant in cases involving recourse to the Prudential Defence Measure (a proposal discussed further below).

Zutshi's reply

Zutshi believes that the points raised by commentators concerning potential impediments posed by the GATS to reforms of financial regulation and to recourse to capital controls are misguided. Central to his position is his belief that the Prudential Defence Measure does provide countries with the regulatory and policy autonomy which they are likely to require. The second sentence of paragraph

2(a) on domestic regulation he views not as a restriction on this autonomy but as "an anti-circumvention safeguard to ensure that there is no abuse of the Measure with the intent of avoiding a commitment" – in other words to ensure good faith with regard to countries' use of the Measure.

Likewise he rejects the criticism that the GATS does not provide the necessary scope for the use of capital controls since here too the constraints specified in the rules are designed only to prevent their use in a way which would frustrate commitments in countries' schedules. Interestingly here too he cites the Prudential Defence Measure as grounds which a country might cite as justification of its recourse to capital controls. Drawing attention to the Measure in this context underlines the key role with respect to countries' policy autonomy under the GATS of a rule whose practical scope can be confirmed or contradicted only by eventual case law. Zutshi's reference to the Prudential Defence Measure in connection with the right to impose capital controls none the less implies that uncertainty concerning the scope of the Measure may extend to the use of capital controls if a country justifies such controls on the basis of the Measure.

Zutshi also believes that the critics of GATS rules are guilty of insufficient clarity in the way in which they distinguish between the modalities for making commitments under the rules, on the one hand, and the commitments actually undertaken, on the other, which, *inter alia*, leads them to pay too little attention to procedures for modifying their commitments under Article XXI as opposed to amending the rules themselves. However, he does accept the point made by the PC commentators concerning the lack of clarity regarding the precise definition of certain terms in the GATS, in particular "current" and "capital" transactions.

DIVERGENT PERSPECTIVES

The divergences concerning the GATS rules in the commentaries discussed above are undoubtedly connected to differences in the perspectives from which the subject is approached.

The observations of the Stiglitz Commission and the UNCTAD Trade and Development reflect fairly general concerns that international rules and standards reflecting pre-crisis views as to the benefits of financial liberalisation may prove an obstacle to reform and reregulation that target shortcomings in the existing financial system, some of which are long-standing and others of which were highlighted by the crisis itself. The communication of Barbados also bases its argument for a review of the GATS rules on overall considerations: "when there is an increasing number of exceptions [to the GATS rules] being introduced on prudential grounds, then this may be a sign that the basic rules need to be addressed." But the communication gives more detail as to the rules which are seen as demanding attention. All three of these critics of the GATS rules – the Stiglitz Commission, UNCTAD and Barbados – are unwilling simply to wait for the adjudication of Dispute Settlement Panels as to what is and what is not permitted under the Prudential Defence Measure.

The more fleshed out caveats of the PC commentators have clearly been influenced by the tenacious pursuit by governments of major developed countries, in particular that of the United States, of the

policy objective of opening the financial markets of developing countries to both cross-border transactions and to the commercial presence of their banks. Since the conclusion of the Uruguay Round negotiations in 1997 this objective has been pursued both through pressures for additional liberalisation during the Doha Round and - perhaps more importantly – through provisions in bilateral trade and investment agreements. The PC commentators undoubtedly view the aftermath of the financial crisis and the consequent change in the climate of opinion concerning banks and their operations as an opportunity to mobilise political forces which check – or better still in certain areas reverse - movement in the direction of further cross-border financial liberalisation regardless of countries' needs for autonomy regarding regulation and of the far-reaching changes in the global regulatory architecture currently being designed by the Financial Stability Board (FSB) and the bodies in Basel and elsewhere whose work is subject to FSB coordination and scrutiny .

Zutshi's perspective is that of a participant in the original negotiation of the GATS rules. At the time of this negotiation the climate of opinion in the dominant developed countries favoured liberalisation *à outrance*, and the major developing-country negotiators had to mount a long drawn-out defensive operation, in which Zutshi himself played an important role. The success of this operation depended on consideration of arguments concerning, and possible consequences of, the different rules on the table during negotiations which covered at least as much cross-border investment (under Mode of Supply 3 of Article I of the GATS) as they did service transactions analogous to trade in goods, and which in consequence had to incorporate jurisprudential lessons drawn not only from GATT rules but also from Friendship, Commerce and Navigation Treaties and from conditions historically associated with the granting of market access to multinational enterprises. But, multifaceted as the negotiations thus had to be, the understanding which underlay them was none the less rooted in the then prevailing historical context of both the realities and the conceptualisation of the supply and regulation of financial services.

Upon one thing the PC commentators and Zutshi are in agreement, namely the central importance of the Prudential Defence Measure of the Annex on Financial Services with respect to countries' policy autonomy regarding prudential and other measures designed to assure the integrity and stability of the financial system. Where they differ is over the effectiveness which they are prepared to accord the Measure for this purpose, with Zutshi but not the PC commentators taking a sanguine view. Similarly the procedures which are to be followed under GATS rules for capital controls are regarded by Zutshi as fully justified for the purpose of preventing the use of such controls to frustrate countries' GATS commitments and as based on a natural extension to the GATS of the GATT procedures for the scrutiny within the WTO of whether measures taken by countries to safeguard their balance of payments are justified. The PC commentators, the Stiglitz Commission and UNCTAD's Trade and Development Report, on the other hand, have reservations concerning the policy autonomy which these rules are likely to accommodate in practice. These reservations are no doubt influenced by the pre-crisis, post-war history of the opposition to such controls of the Bretton Woods

Institutions since under GATS rules it is the IMF which is to pass judgement on facts related to the balance-of-payments position of a country imposing controls[3].

As already noted, the absence of case law complicates assessment of these divergent positions. Nevertheless, there is one much discussed historical case of the imposition of capital controls which merits attention in the context of the GATS rules. Moreover examination of the compatibility of these rules with some of the changes in regulatory regimes currently either being introduced or under discussion illustrates in a concrete way some potential shortcomings.

ACTUAL EXPERIENCE AND FUTURE PROBLEMS

Malaysia's 1998 measures

At the beginning of September 1998 in the aftermath of the Asian financial crisis Malaysia introduced new regulations regarding non-resident accounts and capital transactions. Approval of the central bank was required for transfers of funds between external accounts except for the purchase of ringitt assets in Malaysia, and for the conversion of ringitt held for not more than one year in external accounts into foreign currencies. Non-resident sellers of Malaysian securities were required to hold on to their ringitt proceeds for at least a year and to carry out all purchases and sales of ringitt securities through authorised depository institutions. Domestic credit facilities to non-resident correspondent banks and to non-resident stockbroking companies as well as obtaining ringitt credit facilities by residents from non-residents were prohibited. Approval was required for investments abroad of more than 10,000 ringitt in any form and for payments under a guarantee for non-trade purposes.

These measures were unfavourably received by most of the financial sector and the financial press in major Western countries and by the IMF. Some flexibility was introduced by the Malaysian government in February 1999: foreign direct investors were permitted to repatriate the proceeds of sales of portfolio investments after paying a levy; and the requirement that non-resident holdings of Malaysian securities be kept in the country for at least a year was replaced by graduated exit taxes. However, the pertinent question in the context of the GATS rules on international trade in banking services is whether the actions of the Malaysian government were compatible with the country's commitments under the GATS.

Matching the limitations in Malaysian WTO commitments with the measures of September 1998 is an exercise which is difficult for an outsider to carry out with precision. However, various limitations in these commitments regarding both cross-border supply and supply through a commercial presence are worthy of note.

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[3] The IMF is currently modifying its previous opposition to controls over capital movements as part of the development of new policy guidelines for macroprudential policy currently under consideration for correcting weaknesses in regulation revealed by the financial crisis. But this modification is still at an early stage and the wariness on the part of critics of the GATS concerning the role of the IMF as a judge of compliance with GATS rules is understandable.

In the case of cross-border supply in Malaysia's commitments, financial services associated with cross-border lending to residents in excess of a threshold level can be undertaken only jointly with Malaysian banks – which are of course subject to the directives of their regulator. Money and foreign exchange banking services involving ringitt assets and financial assets issued in Malaysia must be effected through authorised dealers and money and foreign exchange brokers incorporated in Malaysia – institutions which once again would be subject to national regulatory authority. In the case of trading in financial instruments, dealing is limited to contracts traded on specified exchanges abroad. Participation in the issuance of securities and in services related to such issuance requires authorization. Trading on Malaysian stock exchanges must be transacted through companies incorporated in Malaysia which are members of the exchange. The limitations regarding commercial presence also include rules as to the permissible transactions of entities meeting the conditions for the granting of market access.

In the case of supply through a commercial presence, foreign banks are subject to several restrictions as to the institutional form, the categories of transaction which they are permitted to undertake, and the counterparties with which they are permitted to do business.

The Malaysian restrictions of September 1998 on lending and certain other transactions by banks, a major objective of which was to prohibit lending for the purpose of shorting the ringitt, were administered by the banks themselves (Sheng, 2009: 216). In view of the extensive authority over banks attributed to the regulatory authority in the limitations in Malaysia's schedule of WTO commitments, the restrictions would not have been susceptible to a challenge under the GATS. The limitations on securities business specified in the country's commitments are mainly institutional and do not cover the prescription of holding periods as such. Had Malaysia been challenged in the WTO as to the compatibility of its imposition of such a holding period with the commitments in its schedule, it could have cited its right to such action under the Prudential Defence Measure. Since the holding period would have qualified as a control over capital movements, an opinion on its justification might have been requested from the IMF, which in turn might have drawn attention to the substantial recent improvement at the time of imposition in the country's balance of payments on current account. However, no challenge was forthcoming.

Ring-fencing and MIFID II

As part of its policy response to the financial crisis, United Kingdom will follow the recommendations of its Independent Commission on Banking that most retail activities should be ring-fenced in legally, economically and operationally separate subsidiaries, and that systemically important banks (including those subject to ring-fencing) should have additional loss-absorbing capital in excess of requirements under Basel III. The objective of ring-fencing is to enhance the stability of the financial system: the ring-fenced institutions will be smaller, less complex, and have fewer connections with the rest of the system, thus reducing their role as both potential sources and victims of financial contagion; the improved transparency of their operations will improve the capacity of managers,

supervisors and investors to monitor and manage the institutions' risk taking; and the resolution regime for insolvent banks, once ring-fencing is in place, will be simplified.

The United Kingdom government is apparently prepared to accept any adverse competitive effects resulting from these measures for its banks from those of other countries in the European Economic Area (EEA) which, after the legislation comes into effect, will be able to enter the country's market under EEA rules without being subject to the new restrictions (but also without benefiting from the legal protection available to the creditors of ring-fenced banks). However, the United Kingdom's initiative has also stimulated broader debate within the European Union concerning ring-fencing. For example, Commissioner Michel Barnier has set up a high-level committee to examine the pros and cons of the separation of retail and investment banking in a report expected in summer 2012 (Westlake, 2011).

It should be mentioned here that the concept of ring-fencing is also used in other areas of international bank regulation, for example, the differential treatment of branches and subsidiaries with respect to rights to banks' assets in cross-border insolvencies. Ring-fencing has connections to the concept of subsidiarisation which is now the subject of increased attention as part of the agenda of regulatory reform. In cross-border financial regulation, subsidiarisation refers to the condition that foreign banks granted market access should incorporate as local subsidiaries, which are then regulated in the same way as domestic firms (a subject which figures prominently in criticisms of the GATS rules discussed earlier in this paper).

Proposed revisions of the regulation of the EU's single financial market may also be difficult to accommodate within the commitments of the schedule of the European Communities and their Member States (EC). For example, the second Markets in Financial Instruments Directive (MIFID II), extends the existing framework of EU rules from equities to all asset classes and to OTC markets as well as organised exchanges. Interestingly supervisory powers will be strengthened through according national supervisors, in coordination with the European Securities and Markets Authority, the authority to ban specific products, services or practices in cases where there is a perceived threat to investor protection, financial stability or the functioning of markets.

The head note to the schedule of the EC does include the following provision: "The admission to the market of new financial services or products may be subject to the existence of, and consistency with, a regulatory framework aimed at achieving the objectives indicated in Article 2(a) of the Financial Services Annex [the Prudential Defence Measure]". The banning authority under MIFID II, like the proposed measures of United Kingdom, thus may well be covered by the policy autonomy accorded by the Prudential Defence Measure, although there can be no guarantee of the comprehensiveness of this coverage. Nevertheless, if the Prudential Defence Measure is to provide protection to countries from challenges to measures introduced as part of the response to crisis and of the new global financial regulatory architecture, its scope and applicability may eventually

overwhelm those of countries' scheduled limitations, a situation not envisaged as its objective when the GATS rules were negotiated.

Practicalities, data and measurement under GATS rules

If – when tested in dispute settlement - the coverage of the Prudential Defence Measure were to leave open to challenge several categories of new regulation or reregulation owing to commitments undertaken in accordance with the specification of limitations in Article XVI, the rules of Article XXI on the modification of schedules would come into play. In this case the absence not only of statistical data but also of generally established measurement procedures would prove a serious impediment to application of the GATS rules. It has been noted by various commentators (including the author in Cornford, 2009) that these lacunae pose measurement problems for various subjects included in, and various procedures prescribed by, the GATS. These problems include valuing countries' commitments, especially under Modes of Supply 1 and 3, the assessments of trade in banking services prescribed under Article XIX, estimating the effects of emergency safeguard measures, subsidies, and of the introduction of disciplines regarding measures relating to qualification requirements and procedures, technical standards and licensing (once rules concerning these subjects have been negotiated) as well as the effects of the modification of schedules.

In the case of schedule modification, not only statistical data but also guidelines as to how measurement should be carried out are lacking. How, for example, might one measure the effect of the withdrawal of a commitment to grant market access to banks in the legal form of a branch and replace it by the more restrictive requirement of a commitment limited to subsidiaries (a matter covered by Article XVI(e) of the GATS)? The first place to look for methods of such measurement might be the subdiscipline of economics, Law and Economics (a standard reference here being the encyclopaedic treatise of Richard Posner, *Economic Analysis of Law*, which has now gone through several editions). A major problem here is that this subdiscipline has little to say about international transactions. Moreover the methods proposed by its exponents for measuring the effects of country's internal regulations are not easily adapted to cross-border transactions or, indeed, to many of the regulatory restrictions listed in Article XVI of the GATS. It is none the less possible to conceive of ways in which the problem of measuring the costs of changes in countries' schedules might be approached on the basis of the accounting data (income statements and balance sheets) for the banks affected. For example, the shift from a branch to a subsidiary might well raise the cost of financing banks' liabilities, and this increased cost could serve as a starting-point for measuring the cost of the shift and of the revised commitment[4]. Nevertheless, while potentially fruitful, such an approach would be highly novel in the context of services trade and is unlikely to be tried any time soon.

Statistical and methodological problems were the inevitable consequence of the much more widespread and intrusive extension of multilateral trade rules into subjects covered by countries'

[4] Such a shift involves at least two subjects with implications for valuation: the impact on actual cross-border supplies of the services affected (and thus on the suppliers); and the new commitment as compared with the pre-existing one.

domestic regulatory regimes which resulted from the outcome of negotiations on international trade in services in the Uruguay Round. (The traditional purview of the GATT did not pose such problems, since international trade in goods benefits from long-standing systems of data collection and techniques of analysis at both international and national levels.) However, at the time when the GATS was negotiated, policy makers from major developed countries did not consider deficiencies of statistical data a serious obstacle to the undertaking of commitments as to the liberalisation of cross-border services transactions owing to the widespread conviction in such countries that liberalisation would benefit the countries granting improved market access as well as those seeking it. This view was not necessarily shared by the developing countries potentially facing substantial losses of policy sovereignty. However, the issue was sidelined during the Uruguay Round negotiations, and only in 2002 was a manual published on statistics for international trade in services (United Nations, etc., 2002).

However, this manual does not address the practical problems of developing statistics for international trade in banking services. Zutshi acknowledges - and describes as regrettable – the failure in this area but does not address the question of its longer-term implications for the use of GATS rules for negotiations and other work on international trade in banking services within the WTO. However, in the author's view the failure raises serious questions regarding the functionality of the existing GATS rules as a usable part of a reformed regulatory architecture for international finance.

POSSIBLE WAYS FORWARD

The revisiting of the GATS rules on banking suggested by Stiglitz Commission, the UNCTAD Trade and Development Report, the communication of Barbados and the PC commentators is clearly intended to be for the purpose of revising these rules. Amongst the revisions, that of the PC commentators stands out for its explicitness. They propose that the contentious second sentence of the Prudential Defence Measure ("Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Members' commitments or obligations under the Agreement") be replaced with the following: "For greater certainty, if a Party invokes this provision [the Prudential Defence Measure] in the context of consultations or an arbitral proceeding initiated under the Dispute Settlement Understanding, the exception shall apply unless the Party initiating a dispute can demonstrate that the measure is not intended to protect consumers, investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or is not intended to ensure the integrity and stability of the financial system" (Tucker, 2010: 18). In other words, the burden of proof in cases in which recourse to the Prudential Defence Measure is challenged would be the responsibility of the challenger (a shift in responsibility, which Zutshi considers redundant since in his view the burden of proof is already on the challenger (Zutshi, 2011:72)). A more ambitious revision of the GATS rules which would be in accord with the thrust of those supporting their revision would be to include a concrete spelling-out of the scope of governments' right to regulate the financial sector in the Annex on Financial Services – a revision

which would also require a note to Article XVI.2 cross-referencing its implications for the Article's specification of limitations to market access to be included in countries' schedules.

If a decision were taken to proceed in this way, such a revision would presumably be made in accordance with Article X.5 of the Marrakesh Agreement Establishing the World Trade Organisation. This states the following: "Except as provided in paragraph 2 above [which references the provision concerning Most-Favoured-Nation Treatment in Article II.1 of the GATS], amendments to Parts I, II, an III of the GATS and the respective annexes shall take effect for the Members that have accepted them upon acceptance by two thirds of the Members and thereafter for each member upon acceptance by it". That revision is possible under WTO rules does not imply that it would be anything but extremely difficult to achieve the required degree of consensus concerning such a change among member countries. Zutshi (Zutshi, 2011: 77 and 82) emphasises the integrity of the GATS as an overall framework for trade in services, and several member countries might well reject revision on the grounds of the damage to this integrity which the revision would entail. So although there are good reasons for questioning the appropriateness of the GATS rules for banking services, especially in the light of the generally agreed need for a new framework of global, regional and national financial regulation, agreement on revision of the text of the rules is not necessarily a realistic prospect.

Another possibility would be simply to rely on hope that negotiations on banking services will be consigned to a back burner (possibly as part of a similar fate for other issues which have been negotiated as part of the Doha Round). This might be described as the strategy of "letting sleeping dogs lie". However, such hope may reflect excessive optimism as to the likelihood that the dogs will indeed not be awakened owing to the zeal of countries determined to push financial liberalisation through the WTO. Regardless of the subsidisation of the banking sector and tougher regulations being undertaken in their domestic markets, the commercial and ideological pressures driving the efforts of the United States and the EU to open the financial markets of emerging-market and other developing countries are unlikely to go away, particularly once the most immediate risks to their threatened banking sectors begin to recede. There is thus a strong argument that the likely continuation of such pressures justifies recourse to an explicit multilateral decision rather than reliance on the more passive process of consignment to a back burner.

What might such a decision involve? One possibility might be a decision to suspend negotiations *sine die*. This would end pressures on developing and emerging-market countries through (plurilateral or multilateral[5]) negotiations to undertake commitments to liberalisation which not only might be against their perceptions of their best interests but which might also actually compromise their

[5] Opposition to plurilateral negotiations among developing countries has led to the floating of an alternative procedure for achieving agreement among a limited group of industrialised countries on the liberalisation of services trade (presumably including that in banking services). This would consist of negotiating an agreement on liberalisation through the option provided by Article V of the GATS on economic integration. Past history suggests that such an agreement would subsequently be used as a vehicle for bringing pressure on countries which were not parties to the agreement to undertake similar levels of liberalisation.

introduction of domestic financial reforms that are an appropriate response to the experience of the financial crisis. Such a suspension might leave in place for some countries what are now inappropriate commitments undertaken during the Uruguay Round negotiations. But during such a suspension it is reasonable to assume that regulatory changes inconsistent with these commitments which could none the less be defended under the existing Prudential Defence Measure would not be subject to challenge under Dispute Settlement.

Another alternative (which could in fact be adopted either in conjunction with *sine die* suspension of negotiations or in isolation) is, perhaps paradoxically, suggested by Ambassador Zutshi's own discussion of the issue of the definition of prudential measures (Zutshi, 2011: 71). According to Zutshi "This writer's recollection is that the need and desirability of defining 'prudential measures' was debated during the negotiations but the idea was abandoned because it was felt that a definition, howsoever exhaustive, would not necessarily capture all possible needs of the future and may, in fact, restrict the scope of remedial action. Since the objective was to give a broad-based authority for regulatory intervention...it was felt that a list of illustrative and non-exhaustive policy goals would give greater flexibility to members for such intervention". If multilateral agreement is unattainable on the listing or specification of measures which might be included under the right to financial regulation, as Zutshi suggests, then an alternative approach to dealing with the still uncertain scope of the Prudential Defence Measure would be for countries themselves to include in the headnotes to their schedules those parts of their regimes of prudential regulation which they believe should not be subject to challenge. Agreement on permission to so proceed should be easier than agreement on revision of the GATS rules. The WTO secretariat views such inclusion as unnecessary, recommending reliance on the Prudential Defence Measure (a position justified in WTO, 2010: paras. 21-34). But this has failed to carry general conviction as the discussion of this paper suggests. It might also be argued that inclusion in countries' schedules of text from national prudential regulation would make an already lengthy agreement unwieldy. However, inclusion of actual text in the GATS could be replaced by the more concise solution of specification of hyperlinks to the address where the relevant text would be available.

ANNEX: NOTE ON *CHINA-CERTAIN MEASURES AFFECTING ELECTRONIC PAYMENTS SERVICES*

Experience of dispute settlement under the GATS rules for international trade in banking services is limited to the still ongoing case which the United States brought against China in February 2011, *China–Certain Measures Affecting Electronic Payment Services*, following abortive consultations between the two countries in October 2010. The United States case is directed against measures which it alleges maintain the monopoly on the supply of electronic payments services (EPS) of China UnionPay Co. Ltd. (CUP). The principal services supplied under an EPS system are the following: (1) the processing infrastructure which enables and manages the transmission of transaction information and payments; (2) the process and coordination of approving or declining a transaction which would permit a purchase or the disbursement of cash; (3) the transmission of transaction

information among the system's participants; (4) the determination and reporting of the net financial position of relevant institutions for all authorized transactions; and (5) the facilitation, management and other participation in the transfer of net payments owed among the system's participants. The target of the request for dispute settlement of the United States are the following Chinese measures: requirements which mandate the use of CUP and/or establish CUP as the sole supplier of EPS for all domestic transactions denominated and paid in the Chinese currency, RMB; requirements that RMB-denominated payments cards issued in China bear the CUP logo; requirements that all automated teller machines (ATMs), merchant and processing equipment, and point-of-sale (POS) terminals in China accept CUP cards; requirements on acquiring institutions, i.e. institutions which sign up merchants to accept payments cards, to post the CUP logo and to be capable of accepting all payments cards bearing the CUP logo; prohibition of the use of non-CUP payment cards where the issuing bank and the acquiring bank are different; the requirement that all inter-bank transactions for bank cards be handled through CUP; and the requirement that CUP be used to handle RMB transactions in Macao and Hong Kong using bank cards issued in China and to handle RMB transactions in China using RMB cards issued in Hong Kong and Macao. The United States maintains that these measures are inconsistent with China's obligations under GATS Article XVI (Market Access) - because they limit the number of suppliers for RMB-denominated transactions which are paid in RMB - and under Article XVII (National Treatment) – because they promote CUP's position vis-à-vis foreign suppliers through regulatory requirements having this effect. China's defence has so far focussed, *inter alia*, on the coverage of activities and institutions in its GATS commitments, on the existence in other countries of national networks for the clearance and settlement of domestic payment card transactions, and on the scope of the banking services left unbound by the limitations specified in these commitments.

Amongst points of interest for this paper which are raised by this case are a reference by the United States to the Understanding on Commitments in Financial Services, the characterisation of the term "prudential", in China's commitments, and the question of how compensation might be assessed if the Dispute Settlement Panel rules in favour of the United States.

Concerning the role of CUP in the exchange of information among financial institutions, the United States draws attention to the provision in the Understanding forbidding countries' frustration of their commitments by impeding the ability to communicate and process information. However, as noted elsewhere in this paper, the Understanding is not an integral part of, and thus lacks independent legal standing under the GATS, and China's commitments are not undertaken in accordance with the Understanding's rules.

In the section concerning licensing of its commitments as to market access through a commercial presence, China defines its solely prudential criteria for authorization to deal in financial services as containing "no economic needs test or quantitative limits on licenses". This restricted definition does not provide broader indications as to the character of China's prudential regime for financial institutions.

As of now we do not know what will be the eventual decision of the Dispute Settlement Panel and any subsequent possible recourse to appeal in this case. However, if the outcome were to entail compensation by China, the statistical and measurement void as to the transactions covered by the GATS rules, to which attention is drawn elsewhere in this paper, would have to be faced as part of determining the value of such compensation.

[Documents consulted for this note include WTO, "Report of the Working Party on the Accession of China: Addendum CLII – The People's Republic of China", WT/ACC/CHN/49/Add.2, 1 October 2001; "China – Certain Measures Affecting Electronic Payments Systems (DS143)", Executive Summary of the First Written Submission of the United States of America, 20 September 2011; "China – Certain Measures Affecting Electronic Payments Systems (DS143)", Executive Summary of the Second Written Submission of the United States of America, 2 December 2011; and "China – Certain Measures Affecting Electronic Payments Systems (WT/CD413", 11 January 2012.]

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