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Before the
Subcommittee on Domestic and International Monetary Policy,
Trade and Technology
Committee on Financial Services
U.S. House of Representatives

"Increasing Efficiency and Economic Growth
Through Trade in Financial Services"

November 15, 2005

Financial services liberalization under the General Agreement on Trade in Services (GATS) is one part of the larger process of achieving markets that are competitive and efficient on a global basis and strengthening domestic financial systems. Trade in financial services—together with enhanced prudential regulation and supervision and other basic structural reforms—can play an important role in helping countries build financial systems that are more competitive and efficient, and therefore more stable. The Doha round negotiations offer an opportunity to contribute further to this effort by supporting and building upon political and market forces for liberalization and by obtaining binding commitments subject to the WTO dispute settlement mechanism.

This afternoon, I will try to put financial services liberalization in the GATS in perspective by focusing on three issues:

1. the relationship between efforts in the WTO to open markets and the work on strengthening domestic financial systems that is taking place in other international fora;

2. the importance of undertaking binding commitments in the GATS;

3. using the Doha round negotiations to go beyond traditional market opening to include regulatory transparency.

1. Complementary and mutually reinforcing relationship between trade liberalization and strengthening domestic financial systems, including prudential regulation and supervision

[1] Dr. Key is testifying in a personal capacity as a former Staff Director of the Subcommittee. This statement is adapted from her book THE DOHA ROUND AND FINANCIAL SERVICES NEGOTIATIONS (AEI Press, 2003) and her chapter on financial services in THE WORLD TRADE ORGANIZATION: LEGAL, ECONOMIC AND POLITICAL ANALYSIS, Arthur Appleton, Patrick Macrory, and Michael Plummer, eds. (Springer, 2005).

The financial sector is a critical component of a nation's economy: it not only contributes directly to output and employment but also provides an essential infrastructure for the functioning of the entire economy. Opening markets to foreign financial firms can benefit both consumers of financial services and the domestic economy as a whole. The presence of foreign firms can create more competitive and efficient markets for financial services, thereby supporting economic growth and development and contributing to a more resilient domestic financial system. At the same time, however, ensuring adequate prudential regulation and supervision of financial firms and markets, together with other fundamental domestic structural reforms to strengthen domestic financial systems, is essential to obtain the maximum benefits of liberalization while minimizing the risks. Basic structural reforms include increasing transparency and accountability in both the private and public sectors; introducing effective risk management techniques; and developing the institutional infrastructure, such as insolvency laws and appropriate judicial procedures.

Work aimed at strengthening domestic financial systems is taking place in a variety of international fora, ranging from the International Monetary Fund (IMF) to specialized bodies such as the Basel Committee on Banking Supervision. This work includes promoting cooperation and coordination among financial supervisors and setting voluntary—but widely accepted—international minimum standards and codes of good practices. The Financial Sector Assessment Program of the IMF and World Bank, which involves assessing the strengths and vulnerabilities of a country's financial sector, includes monitoring and helping to build institutional capacity for implementation of the international standards and codes.

Because measures to promote competitive markets and to strengthen domestic financial systems are complementary and mutually reinforcing, the relationship between financial sector liberalization and regulation has two distinct dimensions. On the one hand, liberalization requires reducing or removing anticompetitive regulations that pose unnecessary barriers to trade in services. On the other hand, liberalization requires increasing the strength and quality of certain regulations and, in some areas, introducing new regulations. Thus the process of liberalization involves, among other things, reaching a consensus on where to draw the line between regulations that are simply anticompetitive barriers to trade—and should therefore be eliminated—and regulations that serve legitimate purposes.

For financial services, the GATS contains a "prudential carve-out" for domestic regulation that is designed to ensure that the obligations or commitments a country has undertaken in the GATS will not interfere with the ability of the national authorities to exercise their responsibilities for prudential regulation and supervision. This provision was included in the GATS at the insistence of financial regulators, who made it clear that the inclusion of financial services in a multilateral trade agreement such as the GATS would be unacceptable without a specific carve-out from the obligations of the agreement for prudential measures.

The prudential carve-out allows a country to take prudential measures "for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed" or "to ensure the integrity and stability of the financial system" regardless of any other provisions of the GATS. Thus prudential measures could, in principle, be inconsistent with a country's national treatment or market access commitments or its MFN obligation. To guard against abuse of the prudential carve-out, the GATS provides that prudential measures may not be used to avoid a country's obligations or commitments under the agreement.

The prudential carve-out differs from other exceptions for domestic policy contained in the GATS in one very significant respect.[2] In contrast to health and safety, for example, where only "necessary" measures are excepted, *all* prudential measures are excepted. As a result, a prudential measure may not be challenged on the ground that it is not "necessary" or "least trade restrictive." Moreover, the prudential carve-out overrides the GATS requirements for domestic regulations.

The absence of a necessity test does not, however, resolve the issue of whether a measure is prudential or is being used to avoid the obligations of the agreement. An allegedly prudential measure that violates a country's obligations or commitments under the GATS might be challenged on the grounds that its purpose is really trade restrictive rather than prudential and therefore it does not fall within the scope of the prudential carve-out. This question is subject to WTO dispute settlement procedures and potentially to a determination by a dispute settlement panel.

Financial regulators do not seem particularly concerned about this possibility. Several factors appear to account for this lack of concern. First, prudential issues are dealt with intensively in other international fora, so there is some basis for assuming that certain types of rules will be considered prudential. Moreover, a WTO member that was concerned about whether a particular measure would be generally accepted as prudential had the option of listing that measure as a limitation when making initial commitments for national treatment and market access, thereby avoiding the need to rely on the prudential carve-out. Second, and extremely important, only governments, not private parties, may bring claims to dispute settlement in the WTO. Absent a truly egregious action, governments may prefer to respect each other's ability to determine which rules may be prudential. Third, if a prudential or other financial services issue did reach a WTO dispute settlement panel, the GATS contains a provision, included at the insistence of financial regulators, that any dispute settlement panel dealing with financial services must have the appropriate expertise regarding the specific financial service at issue.

To date, there has been no dispute settlement proceeding and no requests for consultation on a financial services issues. So the scope of the prudential carve-out and its antiabuse provision remain untested in WTO jurisprudence.

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[2] In addition to the domestic policy exceptions in the GATS, a separate exception for national security allows a WTO member to take any action that the member considers necessary for the protection of its essential security interests.

2. Importance of undertaking binding commitments in the GATS

A fundamental element of the GATS that is important for financial services, and, of course, for other services as well, is that it provides a mechanism for parties to undertake legally binding commitments subject to enforcement under the WTO dispute settlement mechanism. A GATS commitment is permanent in the sense that it cannot be withdrawn without compensation of trading partners. The GATS does, however, provide a balance-of-payments safeguard that allows commitments to be suspended temporarily in the event of "serious balance-of-payments and external financial difficulties or threat thereof," subject to certain conditions.

Failure to honor a GATS commitment could open a country to a dispute settlement proceeding and, ultimately, to WTO-sanctioned retaliatory measures by its trading partners, which could be extremely costly. Thus binding even existing liberalization is extremely important. Indeed, a major reason for the existence of "binding gaps"—which are created by a country's failure to bind in the GATS liberalizing measures that are already in effect or scheduled to go into effect—is a reluctance to make commitments that are subject to enforcement through the WTO dispute settlement mechanism and may not be withdrawn without compensation of trading partners.

Since the conclusion of the previous GATS negotiations on financial services commitments in December 1997, further market opening for financial services has taken place in a number of emerging market economies, either through unilateral action or as part of the conditionality in IMF stabilization programs. Without concomitant changes in GATS commitments, new binding gaps are created. Unlike the financial services chapters in the North American Free Trade Agreement (NAFTA) and most U.S. bilateral free trade agreements, the GATS does not contain a "ratchet" that would automatically lock in or bind new liberalizing measures that reduce or eliminate barriers to national treatment or market access. Thus it is important to use the Doha round negotiations to close binding gaps.

Undertaking binding commitments in the GATS can also be an integral part of a country's longer-term policy reform agenda. For example, China, as part of its WTO accession agreement, made phased commitments in the GATS to open its banking sector to foreign direct investment within five years, that is, by December 11, 2006. In agreeing to this deadline in the WTO, the Chinese government was also in effect setting a domestic political deadline for major reform of China's banking and financial system.

China's commitments in the GATS for foreign direct investment in the banking sector include licensing based solely on prudential criteria and removal of customer and geographic restrictions on local currency business. Licensing based solely on prudential criteria means, among other things, no economic needs tests or numerical quotas on licenses, no restrictions on juridical form, and no ceilings on foreign ownership. State ownership interests in domestic banks remain unaffected by China's GATS

commitments--that is, elimination of the ceilings on foreign ownership interests does not mean that the state is committing to give up any ownership interest.

3. Beyond traditional market opening: Regulatory transparency

In the Doha round financial services negotiations, expanding and strengthening market-opening commitments ("market access" and "national treatment") is, of course, the highest priority. A more difficult issue is how far the Doha round financial services negotiations should extend into the realm of domestic structural reform—that is, reducing or eliminating nonquantitative and nondiscriminatory structural barriers to trade in financial services. In considering whether, or to what extent, it is realistic or appropriate to negotiate and bind in the GATS financial services liberalization that goes beyond national treatment and market access, it seems reasonable to proceed selectively.

An important area that goes beyond traditional market-opening that could usefully be negotiated in the WTO is regulatory transparency. The GATS already contains a general transparency obligation that requires countries to publish all laws, regulations, administrative decisions relating to trade in services. In the Doha round negotiations, the United States is advocating inclusion of stronger GATS rules on regulatory transparency applicable to all services sectors in which specific commitments have been made. In addition, in bilateral "requests" for liberalization made to individual countries, the United States is seeking commitments for transparency in financial sector regulation similar to the transparency commitments in the financial services chapters in recent bilateral free trade agreements, such as those with Chile and Singapore. GATS commitments on regulatory transparency could complement and build upon the work on transparency that is part of the ongoing international efforts to strengthen domestic financial systems.

Regulatory transparency is qualitatively different from other domestic structural reforms because it involves rules about developing and applying rules, that is, procedural as opposed to substantive barriers. Procedural reform can, however, engender substantive change. Increased transparency in developing and applying regulations can lead to higher quality regulations. Such regulations are likely to be clearer; more effective and less burdensome in achieving their goals; and applied more reasonably, objectively, and predictably. Regulatory transparency helps to achieve these goals because it promotes accountability—that is, it creates an environment in which regulatory authorities must explain and accept responsibility for their actions with regard to development and application of rules.

A fundamental element of transparency in developing regulations involves establishing a meaningful procedure for interested parties to comment on a proposed regulation prior to its adoption in final form. Specific approaches would, of course, vary among countries—and over time within countries—depending on the legal system, the institutional arrangements for financial regulation and supervision, and the size and stage of development of financial markets. Transparency in applying regulations includes, for

example, requiring regulators to publish requirements for authorization to provide a service and to respond to a request for information about the status of an application.

Although increased transparency per se should contribute to both substantive and procedural fairness in financial services regulation, principles specifically designed to enhance procedural fairness in applying regulations are usually linked with proposals for greater regulatory transparency. The GATS already addresses some basic elements of procedural fairness in applying regulations. Several of these, however, cover only those services for which specific commitments to national treatment or market access have been made; for example, requirements that regulations must be applied in a "reasonable, objective and impartial manner" and that regulatory authorities must act on applications in a timely fashion. A provision of the GATS that applies more generally requires a country to maintain a mechanism for appeal of an adverse regulatory ruling affecting trade in services.

Conclusion

A continuing challenge in financial services negotiations in the WTO is to provide support for and to build upon political and market forces that are creating pressures within a country for market opening and domestic structural reform. A country's "readiness" for reform is critical. As the GATS explicitly recognizes, liberalization of trade in services is an ongoing process. For financial services, this process is being driven largely by market forces and new technologies. It is also being driven by the growing recognition among policymakers that market opening can benefit host-country consumers of financial services and, at the same time, contribute to the resiliency of domestic financial systems. The development of international minimum standards and codes of good practices for sound financial systems and their implementation by individual countries provides a strong foundation for moving ahead with further liberalization of trade in financial services in the Doha round negotiations.