FINANCIAL SERVICES NEGOTIATIONS IN THE WORLD TRADE ORGANIZATION

INTRODUCTION

In December 1997, World Trade Organization (WTO) Members concluded multilateral negotiations to assure more open and transparent markets for banking, securities, insurance, and other financial services. These negotiations, which were held under the overall framework of the General Agreement on Trade in Services (GATS), encompassed all financial services and sectors, most notably: insurance and insurance related services; traditional banking services, such as acceptance of deposits and lending of all types; securities and derivative related services; asset management; provision and transfer of financial information; and advisory services. The resulting agreement involved a significantly broader range of countries and included substantially improved market access and national treatment commitments compared to those in an interim agreement reached in 1995. Much of the importance of the accord lies in its making this treatment legally enforceable through the WTO's dispute settlement procedures.

The 1997 agreement included improved commitments from 70 members, including entirely new offers from five members. This will bring to a total of 102 the number of WTO members with financial services commitments, accounting for over 95 percent of world trade in financial services as measured by revenues. Commitments made by WTO members in 1997 also include significant improvements in terms of (1) foreign firms' right to establish, (2) foreign firms' right to full majority ownership of financial institutions, (3) guarantees that the existing rights of foreign firms in these markets will be preserved ("grandfathering"), and (4) the right to participate fully in domestic markets on the basis of substantially full national treatment. Under the agreement, several WTO members also either withdrew their broad MFN exemptions based on reciprocity or reduced the scope of limited MFN exemptions.

THE GENERAL AGREEMENT ON TRADE IN SERVICES

The General Agreement on Trade in Services (GATS) is one of the most significant accomplishments of the Uruguay Round of Multilateral Trade Negotiations that concluded in December 1993. The GATS is the first multilateral, agreement governing international trade in services that has an effective enforcement mechanism. It covers every possible means of supplying a service, including the right to establish commercial presence in an export market.

The GATS is composed of four principal parts: the main text containing general principles and obligations; annexes that deal with rules for specific sectors; "schedules" that list positively by sector individual countries' specific market access and national treatment commitments; and, if applicable, individual countries' lists of exemptions describing measures which the country is temporarily not

applying on a "most favored nation" basis. The GATS is grounded on several fundamental disciplines:

- *National treatment:* Countries should treat foreign and domestic services and service suppliers equally. This ensures a level playing field in the domestic market between local and foreign services and service suppliers.

- *Market access:* Unless a member takes an exemption to this obligation a member may not impose any of six specified measures limiting market access in sectors in which the member has undertaken a national treatment obligation.

- *Full coverage:* In principle, the GATS covers all services sectors except for those provided "in the exercise of government authority," although countries are not obliged to make national treatment or market access commitments in all sectors.

- *Additional disciplines:* Additional disciplines are imposed with respect to such matters as transparency, monopolies, transfers, and domestic regulation.

The GATS provides several means by which countries can take exceptions to certain of these principles. Most favored nation treatment is a general obligation of the GATS and is applicable in all sectors, scheduled or unscheduled. However, countries may take exceptions from the MFN obligation, but only, in principle, for up to ten years.

With respect to national treatment and market access, WTO members make commitments to open markets in specific sectors through negotiations with other members. WTO members "bind" these in a schedule that lists the sectors for which commitments are made, specifying the extent of market access and national treatment being given in those sectors. These schedules use a "positive" list approach, meaning that countries must list a sector in order to have market access and national treatment commitments in it. In so doing, however, it can identify restrictions, qualifications, exceptions, and, where appropriate, the time-frame for phasing-out restrictions in given sectors. If a country schedules a sector, but does not list any restrictions or exceptions, it is effectively binding the full range of GATS market access and national treatment obligations for that sector. Countries can in general only modify or withdraw these commitments after negotiations with other affected countries, but this would be rare since it could lead to compensation for other countries negatively affected by the change.

The Uruguay Round was only the beginning of an ambitious process to liberalize global trade in services. The GATS requires more negotiations, the first to begin by 2000, to move members toward higher degrees of market openness.

FINANCIAL SERVICES NEGOTIATIONS UNDER THE GATS

At the end of the Uruguay Round negotiations in 1993, negotiations in four sectors, including financial services, remained unfinished. Specific commitments to provide market access and national treatment in financial services were made, but the United States and some other WTO members did not consider these commitments adequate to conclude an agreement. The Second Annex on Financial Services to the General Agreement on Trade in Services (GATS) and the Decision on Financial Services adopted at the end of the Uruguay Round provided for extended negotiations in this sector. WTO members agreed to hold the next round of negotiations during the first half of 1995.

These negotiations concluded in July 1995 with only an "interim" agreement, because, again, negotiators from some members, in particular the United States, decided that the results were not satisfactory. During this round of negotiations, only 43 WTO members had improved their schedules of specific commitments or removed, or narrowed their MFN exemption in financial services.

The United States remained a full participant in the 1995 interim arrangement, with market access and national treatment commitments and entitled to all commitments scheduled by other participants. In its own schedule, in force from June 30, 1995, the United States committed to protect the existing investments of foreign financial services providers in the United States. However, the United States stopped short of guaranteeing full market access, national treatment or MFN treatment in the future by reserving the right to provide differential levels of treatment to both new foreign entrants to the U.S. financial market and to existing foreign firms seeking to expand or undertake new activities.

BUILDING MORE OPEN AND RESILIENT FINANCIAL MARKETS

In the past, a multilateral undertaking in financial services set in the context of trade law would have been inconceivable to many, particularly for a number of emerging market countries. That negotiators were able to reach a comprehensive agreement on trade in financial services in 1997 – a year of significant financial market turbulence – makes the 1997 agreement even more of an achievement. WTO members' success in concluding an agreement, despite a difficult environment, is a reflection of the international community's increasing recognition that financial sector opening is an essential part of financial system strengthening. Indeed, the WTO GATS negotiations on financial services need to be viewed as part of a broader strategy to achieve both a greater degree of global financial system integration and strengthening at both the domestic and global levels.

Financial market opening can contribute to financial system strengthening in a number of important ways. First, opening of the financial system generally introduces a greater degree of competition to domestic financial services markets, which usually leads to lower cost financial intermediation

and higher quality financial services. Furthermore, foreign financial service suppliers contribute to financial market strengthening, particularly in emerging market economies, through the introduction of new financial techniques and products, improvements in human capital and transfer of skills, and improvements in financial market practices and infrastructure. Foreign financial services companies can also play a critical role in helping economies recover from financial crises through the provision of funding for bank recapitalization and new techniques for managing distressed assets. All of these factors contribute to greater economic efficiency and thus greater overall economic output and welfare.

Financial system strengthening, however, entails much more than financial liberalization alone. As the Asia crisis has shown, the creation and enforcement of a robust regime of prudential regulation are indispensable for maintaining financial sector stability. WTO negotiators were mindful of this during the Uruguay Round, when they crafted the Financial Services Annex to the GATS. An important provision of the Financial Services Annex allows WTO members to develop and maintain a strong prudential regime to enable them to prevent developments that threaten the stability of the financial system and respond to them when they occur. This includes the ability to implement measures to protect investors and depositors and to ensure the integrity and stability of the financial system. (This provision is often referred to as "the prudential carve-out.")

Since the Mexico crisis of 1994 and the Asia crisis that began in 1997, many emerging market economies also have needed, and will continue to need, to implement difficult and wide-ranging financial sector reforms to ensure greater financial system stability. Necessary reforms include: strengthening prudential regulation, disposal of high volumes of problem assets, orderly closure or recapitalization of weak or insolvent banks, and reforms to increase system-wide efficiency, including opening to external competition. The United States and the international financial institutions, particularly the International Monetary Fund and the World Bank, have dedicated great resources and attention to assist countries in their efforts to strengthen their financial systems through program lending and technical assistance. Furthermore, during the WTO GATS negotiations, U.S. negotiators worked flexibly with emerging market countries, including encouraging them to phase in further liberalization and reform over an agreed time-frame.

At the global level, the international community has also been working toward reforming the global financial architecture to reduce the frequency and severity of financial instability in the future and, when instability occurs, to deal with it more effectively. This effort dates from the 1994 G-7 Leaders Meeting in Naples, at which President Clinton and other G-7 Leaders recognized that the world needs a global financial architecture commensurate with today's challenges and called for a review of the existing system. The first set of reforms from this process were adopted at the 1995 G-7 Leaders' Meeting and have been referred to as the Halifax initiatives. Recognizing the need to expand on this effort, in April 1988, Treasury Secretary Rubin and Federal Reserve Chairman Greenspan invited finance ministers and central bank governors from 22 countries (the G-7 countries and fifteen other countries) to meet and discuss broader and deeper measures. Reflecting the

important role of emerging market economies in the global economy, fourteen emerging market economies were invited to participate in this process for the first time. This process launched a work program that focused on three primary issues: (1) transparency and accountability; (2) strengthening of financial systems; and (3) managing international financial crises.

Three working groups addressed each of these issues and presented interim or final reports to ministers and central bank governors on October 5, 1998. Some of the more important recommendations in these reports include the following.

- Enhancing transparency and accountability:
  - That countries improve standards for private sector information disclosure and enforce high-quality accounting standards;
  - That countries improve the coverage, frequency, and timeliness of data on foreign exchange reserves, external debt, and financial sector soundness; and
  - That the international financial institutions improve their disclosure practices.
- Strengthening financial systems:
  - The development of agreed principles and best practices in several areas, including corporate governance, risk management, and financial safety net arrangements.
  - That national financial supervisors and regulators enhance their cooperation and coordination, through a variety of mechanisms or institutional arrangements still under consideration.
- Preventing future crises and managing those that do occur better:
  - That governments promote better risk management by limiting the scope and clarifying the design of guarantees they extend to private firms.
  - That countries implement and enforce effective insolvency and debtor-creditor regimes to promote better private sector risk management and more efficient restructuring of distressed financial assets.
  - That countries consider using "collective action clauses" in sovereign and quasi-sovereign bonds issued in foreign offerings to facilitate cooperation and orderly crisis resolution.

- That the IMF consider extending its 1989 policy of lending into arrears in appropriate circumstances to reflect the evolution of modern markets.

1997 FINANCIAL SERVICES NEGOTIATIONS AND AGREEMENT

The United States approached the 1997 round of negotiations by seeking a comprehensive agreement that would provide substantially full market access and national treatment for U.S. financial service providers in foreign markets. U.S. negotiators consulted frequently with U.S. financial services representatives to gain their insight. These institutions were also extremely active during the negotiations in engaging foreign governments and foreign financial services companies and identifying areas of common interest. Formal negotiations began in April 1997, and concluded December 12, 1997. During the negotiations, members again had an opportunity to improve, modify or withdraw their commitments in financial services.

Entering into the negotiations, the United States submitted a conditional offer that included comprehensive commitments covering insurance, banking, securities, and other financial services which would guarantee market access and national treatment to foreign service suppliers in the U.S. market on an MFN basis subject to existing state and federal laws. This offer was conditioned, however, on other countries making comprehensive commitments to provide fair and adequate treatment to U.S. financial service providers.

The end result of the 1997 negotiations, embodied in countries' individual offers as attached to the *Fifth Protocol to the General Agreement on Trade in Services*, is significantly broader in scope than the 1995 agreement and includes substantially improved market access and national treatment commitments. A total of 70 WTO members made commitments in the *Fifth Protocol*, of which five WTO members (Bolivia, Costa Rica, Mauritius, Senegal, and Sri Lanka) made commitments in financial services for the first time.

The 1997 agreement encompasses the full range of financial services and covers over 95 percent of world trade in financial services as measured by revenue. Financial services covered under the Agreement are defined in a comprehensive, nonexclusive fashion in the Financial Services Annex. For banks, they include the traditional services provided by banks, such as acceptance of deposits, lending of all types, financial leasing, and money transmission services. The agreement also covers trading in foreign exchange, derivatives and all kinds of securities, securities underwriting, money brokering, asset management, settlement and clearing services, provision and transfer of financial information, and advisory and other auxiliary financial services.

Some foreign countries offered new commitments to eliminate or relax limitations on: (1) foreign ownership of local financial institutions; (2) the juridical form of commercial presence (branches, subsidiaries, agencies, representative offices, etc.); and (3) the expansion of existing operations.

These commitments will translate into significant improvements in the ability of foreign financial service to establish and compete in these markets. Several WTO Members withdrew broad MFN exemptions based on reciprocity or reduced the scope of their MFN exemptions. The United States, for example, replaced a broad MFN exemption, taken in the face of earlier unsatisfactory offers from other countries, with a limited exemption targeted at countries that maintain policies of forced divestiture in their insurance sectors. Important progress was also made in "grandfathering" the operations and rights of existing branches and subsidiaries of foreign financial institutions that are wholly or majority owned by foreigners in overseas markets.

The 1997 financial services agreement is a significant achievement for several reasons. Commitments in the agreement are legally binding, which guarantees a level of market access and national treatment to foreign financial services providers and makes their operating environment more predictable. In making these commitments, several countries sent an important signal to global markets that they would not close their markets to foreign financial firms. Having established basic principles and negotiating mechanisms as well as a foundation of specific commitments from which to build, the agreement also provides significant traction for future multilateral negotiations.

SPECIFIC IMPROVEMENTS IN THE 1997 FINANCIAL SERVICES COMMITMENTS

During the 1997 round of the WTO Financial Services Negotiations, both developed and emerging markets made important improvements in their market access and national treatment commitments. Among developed economies, some notable improvements include:

- Japan provided a WTO guarantee for extensive market access for foreign financial firms by binding on an MFN basis in its additional commitments section certain bilateral financial services agreements that it had reached with the United States.

- Canada, for the first time, committed to change its regime governing establishment of foreign banks to allow foreign banks to establish via direct branches.

- Members of the European Communities (EC) made significant improvements over their 1995 commitments that include the elimination of a large number of country-specific market access restrictions. Some examples are:

  - Austria eliminated an economic interest test for the licensing of foreign bank branches and subsidiaries.

  - Belgium eliminated a measure that required financial institutions to engage in securities trading only through stock exchange firms incorporated in Belgium.

  - Italy eliminated a local incorporation requirement for securities dealers and for fund management companies.

- For its part, the United States removed its prior broad MFN exemption and agreed that it would continue to maintain the substantial degree of market access and national treatment afforded under current laws, both federal and state. The United States also included a commitment to national treatment for foreign firms under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

Substandard commitments by many key emerging markets had been a major stumbling block in the 1995 negotiations. By contrast, the 1997 round of financial services negotiations made significant advances in opening markets for financial service providers in many important emerging markets in terms of rights of establishment, national treatment, improved guarantees of the right to maintain existing ownership and activities, and new commitments to allow full majority ownership of domestic financial firms by foreign investors.

Asian emerging market economies made some of the most notable improvements in their commitments during the 1997 negotiations.

- Indonesia grandfathered foreign participation in existing joint ventures, eliminated its ceiling on equity portfolio investment, relaxed discriminatory capital requirements, expanded the geographic scope of operations, and bound new entry for nonbanks and securities.

- Korea, among other things, relaxed foreign portfolio investment ceilings, eliminated ceilings on individual foreign equity participation in securities and asset management companies, allowed the establishment of branches and joint ventures of foreign asset management firms, and eliminated approval requirements on the establishment of representative offices of foreign securities companies.

- Thailand fully grandfathered existing foreign bank branches. It relaxed for a period of ten years its 25 percent foreign equity limit for locally-incorporated banks and similar limits for finance companies. It bound that it would guarantee the absolute amount of equity holdings of the foreign shareholders that enter Thailand during this ten-year period.

- The Philippines grandfathered existing foreign equity levels in banks, increased guaranteed rights of foreign ownership of domestic banks and securities houses to full majority ownership, and increased the number of branches banks are allowed to establish.

- Malaysia bound itself to permit 51 percent ownership in existing joint venture insurance companies by existing foreign shareholders and allowed the establishment of majority-or wholly-foreign owned fund management companies.

Emerging market economies in other regions also made substantial improvements in their commitments.

- Peru and Bolivia made their first commitments to open banking and securities markets.
- Brazil confirmed and significantly expanded the scope of foreign firm establishment in its market and bound current practice for the entry of securities firms.
- Mexico extended national treatment to foreign pension fund managers and raised the allowable aggregate foreign participation level in the domestic financial sector.
- Egypt allowed up to 100 percent foreign ownership of bank subsidiaries.
- Many Eastern European countries removed significant barriers to new establishment, acquisition, and full majority ownership of banks and securities firms. For example, Poland committed to market access through licensed branches for foreign insurance companies, banks, and securities companies and advisors. The Czech Republic eliminated an "economic usefulness" criterion for authorization of banking activities by domestic banks or branches of foreign banks.

As a result of these accomplishments, U.S. securities firms are now guaranteed the right to enter foreign financial markets in virtually every participating WTO member country. Industrialized countries and most emerging markets also provide rights for new establishment and all industrialized countries and most emerging markets allow foreign securities companies to hold 100 percent of the equity of local subsidiaries.

NEXT STEPS

Countries have until January 29, 1999, to ratify the Agreements concluded in December 1997. If ratified as anticipated, the agreement will enter into effect on March 1, 1999. In addition, there are a number of active WTO accession negotiations underway, including with key countries such as Russia and China. The United States will continue negotiating with these countries to ensure that they make commitments that meet the standards set by the WTO Financial Services Agreement. The next services negotiations in the WTO are scheduled to begin by the year 2000.