



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

A Scientific Study

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List of Abbreviations

AB	Appellate Body
ABS	Asset Backed Securities
BIS	Bank of International Settlements
BIT	Bilateral Investment Treaty
CDS	Credit Default Swaps
CEPA	Economic Partnership Agreement between the CARIFORUM States and the European Union
DC	Developing Country
FSA	Annex on Financial Services
FSAP	Financial Sector Assistance Program
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
ICLQ	International and Comparative Law Quarterly
ILEAP	International Lawyers and Economists Against Poverty
IMF	International Monetary Fund
IOSC	International Organization of Securities Commissions
LIC	Low- Income Country
MFN	Most Favoured Nation
NAFTA	North American Free Trade Agreement
PRSP	Poverty Reduction Strategy Paper
R&D	Research and Development
WTO	World Trade Organization

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1. Introduction

The international financial crisis of 2007/2009 has led to an extensive discussion on the architecture and structure of the international financial system. During and in the aftermath of the crisis, numerous legislative and policy initiatives at the domestic, European and international levels were initiated, and at least partially implemented. One underlying and crucial issue has been the possible correlation between liberalization and deregulation of financial markets and the stability of the international financial system, especially with regard to the situation of developing and least developed countries. The debate so far has been dominated by extremes: while some argue that the causes of the financial crisis cannot be attributed to excessive liberalization and/or deregulation, others blame these trends in particular. A similar line of argument can be seen with regard to the situation of developing and least developed countries. Some see a clear relationship between the economic effects of the financial crisis on these countries and the degree of liberalization and deregulation of their financial services sector; others would deny the existence of any such relationship.

In the context of international economics and international economic law, liberalization refers exclusively to the market entry possibility of service providers and their non-discriminatory treatment with regard to service providers from other countries (most-favored-nation obligation) and the host country (national treatment). Regulation/deregulation, in contrast, is concerned with governmental measures affecting service providers after market entry implemented on a non-discriminatory basis. Deregulation thus refers to reducing restrictions for service providers within a domestic market. This, however, does not necessarily imply that supervision of financial services will be less stringent. There is no compelling relationship between deregulation and the intensity of financial services supervision. A comprehensive set of rules on regulation, in turn, does not automatically guarantee that these rules are actually applied and that their implementation is supervised.

The interrelationship between financial market liberalization and deregulation, on the one hand, and the exposure of Low-Income Countries (LICs) to the financial crisis (domestic and international), on the other, is both an issue of economic policy making and of law. This is due to the fact that a large number of states are no longer entirely free to make autonomous economic policy decisions. Developed, developing and least developed countries alike are today subject to different international legal regimes restricting their regulatory freedom. However, this does not mean that the crucial questions of liberalization and regulation of financial markets are comprehensively determined by international law. To the contrary, financial markets, and more specifically financial market products, are always characterized by a domestic embeddedness. Financial market products are necessarily linked to a specific domestic legal order: they are – in other words – the ‘children’ of domestic jurisdiction. An investor who buys, for instance, shares in a Luxembourg investment fund does not only trust the issuer, but also Luxembourg’s reputation for the quality of its legislation and administrative practices in the area of finance. This is quite a unique feature of financial market products. Unlike with physical products and most services, financial market products always feature one specific jurisdiction and are, thus, products that are deeply rooted in one specific domestic legal order. One may conclude from this special characteristic that financial products are always domestic products. However, this is not so, as they are offered not only in their domestic market, but also on a worldwide basis, and in this sense they are ‘international’ or better still: ‘transnational’. Therefore, one may speak of transnational financial products and markets in order to highlight their shared double characteristic of always being both domestic and international.

The embeddedness of financial market products has consequences for any analysis of the relationship between the interests and needs of LICs with regard to financial markets, on the one hand, and international legal regimes for financial services, namely Preferential Trade Agreements (PTAs), on the other. Because of the situation described above, it is possible and important to analyze the relevant international legal obligations and rights affecting the financial markets-related regulatory measures of LICs in light of economic theory. However, it is not possible to make concrete suggestions with specific details as to the necessary and/or desirable domestic regulatory structure within LICs. This will

always depend on the specific situation within a certain state. Any policy recommendation on specific domestic regulatory measures beyond the general, internationally recognized standards of best practice would be useless, as it would not reflect the specific needs and interests of a specific domestic jurisdiction.

Irrespective of the caveat above, it is important to be clear about the existing regulatory autonomy ('policy space') of LICs in light of the principles and rules of the law of the World Trade Organization (WTO), PTAs and other international and plurilateral economic agreements. This study will thus discuss both economic theory and policy considerations as well as the international and plurilateral legal framework for the liberalization and regulation/deregulation of financial services. Even though the term 'financial services' usually includes banking and insurance services, the focus of the study is limited to the special interests and needs of LICs with regard to banking only.

2. The International Market for Financial Services Before and After the Crisis – Some Stylized Facts

Since 2000, and before the global financial crisis, there has been a secular positive trend in trade in financial services. Although much of this development is attributed to high-income countries, developing countries have also shared in this trend, although to different degrees. The financial sectors in many countries, including low- and middle-income countries, have become more integrated and developed. However, starting in August 2007, the global financial crisis has put a strain on both developed and developing countries. This event may decelerate the pace of financial integration even if the institutional and legal environment for liberalization remains unchanged.

Trade in financial services has gained momentum since China became a member of the WTO in 2001 (Figure 1). Between 2001 and 2007, the average annual growth rate has been almost 20%, with 2007 being the year with the fastest growth so far (at a rate of 29.7%). By the end of 2007, exports of financial services amounted to US\$366 billion or 11% of total global commercial services exports – compared to the US\$124 billion or 8% for 2001, respectively. While in the 1990s, exports of financial services by low- and middle-income countries stagnated or even declined, they gained momentum from 2000 onwards (Figures 2, 3).¹ By the end of the year 2006 (more recent data is not available), exports of financial services (measured as a percentage of gross national income) were almost 75% higher than only 10 years before. As for imports of financial services by low- and middle-income countries, the overall picture is rather different. In these countries, imports (measured as a percentage of gross national income) more than doubled between 1996 and 2001, but then declined in the two following years by between 25% to about 75% of gross national income, and have not changed since. Notwithstanding these different developments, the import of financial services is still more important than their export (Figures 4, 5).² The International Monetary Fund³ (IMF) provides further insightful estimates of foreign bank ownership by region (Table 1). According to these figures, foreign banks have become more important than ever, especially in Eastern Europe and in Latin America. In poorer regions (Africa, Middle East, and parts of Asia), however, the percentage change in foreign bank ownership has been almost insignificant.

The rapid growth of trade in financial services is also reflected in changes in the size of the financial industry. Measured in terms of financial liabilities relative to gross domestic product (Figure 6), the overall size of the financial sector increased between 2000 and 2007 by some 20% for both low-income (from 22% to 27%) and lower middle-income (from 36% to 43%) countries. While in upper middle-

¹ Income classifications follow World Bank definitions.

² Owing to lack of reliable data, trade in financial services cannot be differentiated with respect to the modes of foreign market operation. Also country data on foreign direct investment in the financial services sector is not publicly available on a reliable and comparable basis.

³ IMF, Global Financial Stability Report, 2007.

income countries it expanded by only 10% (from 42% to 46%), the financial sector of high-income countries increased by 30%. The picture changes when considering total financial assets as a percentage of gross domestic product (Figure 7). For this, the respective growth rates are 16% (low-income countries), -1% (lower middle-income countries), 51% (upper middle-income countries) and 13% (high-income countries). The level of private credit has also increased by about 20-25% since 2000 (Figure 8), except in upper middle-income countries where it has increased by more than 90%.⁴

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

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

3. The Impact of Financial Services Liberalization and Regulation on Economic Development

3.1 Mapping the Issue

3.1.1 Financial Liberalization, Financial Development, and Economic Growth

According to standard economic theory, financial development contributes to economic growth. One mechanism is that developed financial systems are able to improve the efficiency of capital allocation. This implies that a given amount of funds will be directed to their first-best use, increasing the total factor productivity of the economy. Also improving the efficiency of capital allocation means that more funds can be mobilized, thereby adding to the total stock of capital. Another, related mechanism is that developed financial systems are better able to capitalize on the long-term chances of short-term economic downturns.⁶ When the aggregate demand for goods and services is weak, firms have little incentive to direct resources in tangible capacity building or replacement investment. Instead,

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

⁵ BIS Quarterly Review, December 2009, pp. 18f.

⁶ Aghion, Banerjee, Volatility and Growth, chapters 2 and 3.

productivity-enhancing investments such as R&D become relatively more profitable. But because this type of investment is long-term in nature and more intangible, it is harder to get funding for it, especially in difficult times when corporate profits are squeezed by a downturn in the business cycle – unless the financial sector is well developed. Since even in highly developed economies financial markets are imperfect, sound prudential regulation measures are important for both mechanisms to work. Accordingly, these measures contribute to the development of the financial system and, thus, to economic growth.

Financial services liberalization should foster financial development by improving the quality and availability of financial services, as international banks are perceived to be endowed with better skills and technologies compared to domestic banks, especially in DCs.⁷ It should also stimulate competition, which potentially improves cost efficiency and also the reliability of domestic banks. Furthermore, opening up the financial sector to international banks brings about a level playing field for all banks active in a country's market, and thus makes prudential regulation and supervision more efficient. This may further contribute to an improvement in the incentives within the banking industry. Finally, international banks may also enhance the quality of corporate governance and thus the efficiency of non-financial firms.

Based on this understanding of economics, the General Agreement on Trade in Services (GATS) has established a flexible international framework for liberalizing trade in financial services. In particular, GATS makes provisions to ensure that this will take place in a transparent and predictable manner once a country wants to liberalize trade in this field. As opposed to popular belief, liberalization by no means implies mere 'deregulation', as for markets to perform well a functioning regulatory system is needed. Accordingly, GATS does not aim for a deregulation in financial services, even though it includes provisions that are directed at and impose requirements on domestic regulation.⁸ Instead, by introducing principles of good governance and a certain level of coherence, GATS is ultimately focused on the continuing improvement of existing regulatory frameworks in order to mitigate the negative impact of undue domestic regulation.⁹

3.1.2 Specific Difficulties in Developing Countries

For any financial liberalization process to be successful, countries have to establish and strengthen the rule of law (focusing in particular on property rights), improve political stability, enhance the economy's organizational capital, and reduce corruption. Otherwise, capital flows will remain thin, limited to the political establishment, and also prone to corruption.

In DCs, there are three major obstacles particularly for the poor to accessing financial services and to obtaining loans (besides physical distance and lack of financial education), which cannot be accounted for under the standard economic reasoning outlined above. First, because of asymmetric information problems, households and firms need to have collateral and stable future income streams, but often they do not possess any collateral and their income is highly uncertain. Second, financial transactions are often very small so that the expected interest margins for banks do not fully cover the transactions costs involved (such costs play no role in the standard economic model). As a result of both market deficiencies, it will take at least some time for people in DCs to have access to financial services, especially the poor.¹⁰

⁷ Levine, Foreign banks, financial development, and economic growth.

⁸ That the GATS is primarily aimed at liberalization, not deregulation, does not imply that there are no requirements that may oblige WTO members to change or even abolish existing regulations, like in the case of Article VI GATS. Still, neither liberalization nor the minimum standards on domestic regulations of Article VI GATS actually aim to reduce or eliminate regulations. It is thus reasonable to argue that the GATS may require re-regulation. However re-regulation must be distinguished from mere deregulation; see Wouters/Coppens, GATS and Domestic Regulation, in: Alexander/Andenas, 209.

⁹ Matsushita/Schoenebaum/Mavroides, WTO, 604: "The barriers to trade in services are *regulatory*."

¹⁰ Microfinance may help to overcome these obstacles, but international banks often hardly provide these services; they can contribute to improving the situation of the poor at most indirectly by fostering economic growth and employment and by thus reducing uncertainty with respect to income. For further policy recommendations (beyond financial policies) as to how to improve the situation of the poor, see also Demirgüç-Kunt/Levine, Finance, Financial Sector Policies, and Long-run Growth.

The third, and perhaps most important obstacle, results from a combination of legal uncertainty, limited organizational capital, and an unstable political environment: first, with legal uncertainty, contract enforcement is weak and the shadow economy large. Therefore, reluctance to offer financial services and funding prevails. This problem may arise even when potential customers, especially loan applicants, possess collateral and earn a relatively stable income. Second, when the organizational capital of a society is underdeveloped, it is harder to organize and develop complex production chains associated with deep specialization and division of labor. Often, policy makers in DCs respond to this problem by assigning the control of economic activity to government bodies, and by concentrating on the economic performance of companies in only a few industries, in particular export-driven firms and those linked to commodities. Financial relationships with these government agencies and state-owned enterprises might be easier for banks to establish and maintain. Third, in doing so, countries make room for corruption, especially under politically unstable conditions. Moreover, they tend to neglect other fields that are also important for financial sector development.¹¹ In particular, governments should build up and advance the national information infrastructure so that it provides reliable public information about financial market participants. This is required to reduce the information asymmetries between banks, firms, households, and – at a later stage – international investors, in order to prepare the ground for a competitive financial sector. In this regard, it would be very advantageous to, for example, establish credit registries for households and non-financial firms and to require that financial institutions disclose their financial and business conditions to the broader public. Similarly, the size of sectors in the shadow economy will often need to shrink so that income streams become predictable for financial institutions. In some countries, an overhaul of the tax system may be a prerequisite for this. These additional requirements are often neglected so that broad financial development remains hampered. Meanwhile, unsustainable and overshooting developments occur in some sectors, often associated with excess indebtedness and asset price bubbles.

3.1.3 Long-Run Effects of Liberalization

Liberalization tends to improve the quality and availability of financial services. By influencing the structure and outcome of financial market activities, the entry of foreign banks by and large contributes to financial development and thus to economic growth.

Empirically, the long-run effects of liberalization have largely been mixed. The brighter side of liberalizing the restrictions on foreign bank entry is that this, indeed, tends to improve the efficiency of the banking system and thus promote economic growth.¹² There is detailed evidence that foreign banks in Latin America have charged lower interest margins and thus helped foster financial intermediation.¹³ This holds true particularly for greenfield bank subsidiaries, but not so much for takeovers.¹⁴ On average, fiercer competition due to foreign bank entry has also lowered the operating costs of local banks and thus increased the efficiency of the whole banking sector. Although foreign banks mainly serve larger firms, they also push local banks into segments that are more information-intensive; a pattern which has actually improved the availability of financial services, especially credit, in many countries.¹⁵

However, evidence on the availability of financial services to small- and medium-sized enterprises is more mixed, and thus less encouraging. Foreign banks eventually enhanced access to funding sources for local projects in at least some DCs.¹⁶ But there is also macroeconomic evidence which indicates that this result may not hold for poor countries. In these, more foreign bank penetration tends to be

¹¹ For a detailed analysis see Rajan, *Fault Lines*, chapters 2 and 3.

¹² Demirgüç-Kunt/Levine/Min, *Opening to foreign banks*. This view is challenged by, for example, Stiglitz, *Capital Market Liberalization, Economic growth, and Instability*.

¹³ Martínez Peria/Mody, *Foreign Participation and Market Concentration*. See also Claessens/Demirgüç-Kunt/Huizinga (*ibid*), who report that the interest margins of foreign banks in DCs can also be higher than those of domestic banks.

¹⁴ A reasonable reading of this result is that greenfields have stronger links to their parent banks than banks that have been taken over, see de Haas/van Lelyveld, *Foreign Banks and Credit Stability in Central and Eastern Europe*.

¹⁵ Beck/Demirgüç-Kunt/Honohan, *Finance for All*, pp. 77 ff.

¹⁶ Bhattacharya, *The Role of Foreign Banks in Developing Countries*.

associated with lower levels of private sector credit-related activity and slower aggregate credit growth.¹⁷ This finding is, however, not conclusive regarding causality. For example, according to firm-level data, enterprises in 35 developing and transition countries, including small- and medium-sized enterprises, indeed reported facing fewer obstacles to obtaining financing in countries with a higher level of foreign bank presence – small enterprises though benefited to a lesser extent.¹⁸ In a similar vein, more recent empirical work shows that it is not foreign bank penetration per se that is associated with tighter financing constraints for small- and medium-sized enterprises, rather an underdeveloped economic, institutional and legal environment.¹⁹ This observation may help explain the African experience, which supports the notion that foreign bank entry alone cannot stimulate financial development when the overall contractual and institutional environment is poorly developed²⁰ or if foreign banks are only allowed to takeover failed state-owned banks.²¹

The darker side of lifting restrictions on foreign bank entry and liberalizing capital flows relates to their contribution to the instability of financial and economic development, and will be considered next.

3.1.4 Financial Stability and Economic Growth

Liberalization of the financial services sector often comes along with serious threats to a country's financial stability in the short run. However, financial liberalization itself is not the root cause of financial instability, rather the inadequacy of the legal environment and of regulation and supervision.

From a theoretical perspective, the effect of financial liberalization and integration on financial stability is ambiguous.²² On the one hand, it should allow to diversify risks, to make markets more liquid, to reduce the risk of mispricing in financial markets, and to induce the stronger competition that should strengthen market discipline.²³ Hence, when capital flows freely, accumulation of physical capital is fostered and so is growth.²⁴ On the other hand, Stiglitz, among others, has raised concerns regarding a uniform and unreflecting liberalization of financial sectors.²⁵ Foreign banks may squeeze out domestic banks, and since foreign banks tend to mainly serve the financing needs of large (multinational) corporations or cherry pick the less information-intensive local borrowers, many local banks would have only risky assets to take on. Furthermore, competition with foreign banks could threaten financial stability by reducing the profitability of domestic banks in DCs, which would additionally incite them to take on even more risks. Both these effects make banks more vulnerable to shocks, which qualifies the notion of improved risk diversification, unless well-functioning regulation and supervision has been implemented.²⁶ In addition, foreign banks can easily withdraw resources regardless of whether a country is in financial distress, thereby posing a further threat to it.²⁷ Finally, asymmetric information between domestic borrowers and foreign lenders can cause herding behavior leading to excessive investment cycles, which may later bust. Hence, it seems to be not unlikely that liberalizing the financial services sector may result first and foremost in an additional risk to financial stability and may even reduce growth prospects.²⁸

¹⁷ Detragiache/Tresselt/Gupta, Foreign Banks in Poor Countries. A reason for this observation could be that foreign banks are less inclined to be engaged in relationship lending, which is more information-intensive; see Dell'Ariccia/Marquez, Information and Bank Credit Allocation, and Garber, Buttressing Capital-Account Liberalization.

¹⁸ Clarke/Cull/Martinez Peria, Foreign Bank Participation.

¹⁹ This result holds despite the fact that foreign banks have different lending technologies and organizational structures. See Beck/Demirgüç-Kunt/Martinez Peria, Bank Financing for SMEs.

²⁰ Honohan/Beck, Making Finance Work for Africa.

²¹ Demirgüç-Kunt/Levine Finance, Financial Sector Policies, and Long-run Growth.

²² For an overview see also Ferguson/Hartmann/Panetta/Portes, International Financial Stability.

²³ Levine, International Financial Liberalization.

²⁴ El-Shagi, Capital Controls.

²⁵ Stiglitz, The role of the state.

²⁶ Claessens/Demirgüç-Kunt/Huizinga, How does foreign entry affect domestic banking markets.

²⁷ Bhagwati, The Capital Myth; for a theoretical foundation of this reasoning see also Stiglitz, Capital-Market Liberalization.

²⁸ Stiglitz, Capital-Market Liberalization.

The evidence on the macroeconomic consequences of financial liberalization is indeed mixed.²⁹ By liberalizing their financial systems, it is countries with poor institutions and lacking macroeconomic stability that have either increased their vulnerability to systemic crises or suffered from declines in financial intermediation.³⁰ Notably, financial crises often occur as twin crises. They are, however, often preceded by deep recessions in the respective country. Twin crises amplify these recessions, with production losses amounting to some 5% to 8% in the two years following a crisis.³¹ Typically, the steps taken prior to liberalizing are associated with increases in the probability of these costs being at the upper bound.³²

Rapidly growing countries tend to experience occasional crises. This link is, however, stronger for more financially liberalized countries. Hence, liberalization strengthens financial development, which in turn contributes to higher long-run growth.³³ After all, it is still an open question whether short-run costs are merely side-effects that policy may potentially mitigate (e.g. by imposing restrictions on capital account transactions or by measures for prudential regulation), or whether crises are a necessary condition for long-run growth.³⁴

In any case, however, it does not seem that financial liberalization itself is the root cause for financial instability, but rather the inadequacy of the legal environment and of regulation and supervision - the adverse consequences thereof are just exaggerated by liberalization.³⁵ The overall lesson to be learnt at this point is that progress, especially in terms of establishing a sound contractual and institutional environment, is of key importance and that without this progress foreign banks will have only little to add to financial development, stability and growth.

3.2 Capital Account Liberalization

3.2.1 Capital Account Liberalization in an Integrated Economic Policy Strategy

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

While the GATS deals with liberalization of trade in services, it does not aim to achieve the general liberalization of payments and transfers for international transactions.³⁶ However, it is widely acknowledged that effective liberalization of trade in financial services depends on the free movement of capital, at least with regard to services such as accepting deposits, lending, or trading in securities.³⁷ Moreover, even capital account liberalization beyond the simple lifting of restrictions on international transfers and payments for current transactions (according to Article XI of the GATS) may be required, in order to reap the benefits of liberalized financial markets.

Accordingly, the GATS provides for a conditional obligation to liberalize at least international transfers and payments related to the specific commitments a WTO member has undertaken in its schedule. The extent to which capital transfers are to be liberalized depends on the mode of supply: in the case of a

²⁹ A survey of empirical macroeconomic evidence on the effects of financial globalization is given by Kose et al., *Financial Globalization*. There, it is pointed out that the empirical findings so far often depend on the specific measure of capital account liberalization and on the channel through which liberalization is perceived to affect economic development.

³⁰ Demirgüç-Kunt/Levine, *Finance, Financial Sector Policies, and Long-run Growth*.

³¹ Hutchison/Noy, *How Bad Are Twins?*

³² Kaminsky/Reinhart, *The Twin Crises*; Glick/Hutchison, *Banking and Currency Crises*.

³³ Rancière/Tornell/Westermann, *Systemic Crises and Growth*. This result is based upon data for 83 countries, including DCs at different stages of development, such as Algeria, Congo Republic, Ghana, Nigeria, Peru, South Africa, and Venezuela. Similar conclusions are drawn by Kaminsky and Schmukler who also show that long-run gains from financial liberalization are bought with short-run vulnerability to financial crises (see Kaminsky/Schmukler, *Short-run Pain, Long-run Gain*).

³⁴ Aghion/Banerjee, *Volatility and Growth*.

³⁵ Eichengreen/Mussa, *Capital Account Liberalization*, p. 21.

³⁶ Christ/Panizzon in: Wolfrum/Stoll/Feinäugle, *Article XI GATS*, para. 17.

³⁷ Tamirisa et. al., *Trade Policy in Financial Services*, 7.

cross-border supply (Mode 1), the transfer often forms an essential part of the service itself. In the case of a bank wishing to establish a commercial presence in a foreign country (Mode 3), it will be engaged in making a foreign direct investment, which is part of the capital account. But whether or not this capital account transaction is actually associated with a cross-border capital flow depends on the method of funding this activity. If, for example, a bank issues debt in the host country in order to acquire a domestic bank, there is no capital transfer at all. Only later, for example, when the bank wishes to repatriate profits from its foreign operations, may a capital flow occur, but out of the host country.³⁸ But this pattern is rather uncommon in DCs, as the local pool of capital available to foreign banks for setting up a local presence is often non-existent here. Hence, especially for DCs, allowing capital to actually flow across borders is essential for foreign financial institutions to be able to offer financial services.

Critics argue that there is a major downside to capital account liberalization in that it makes countries more vulnerable to financial instability which may not only increase the volatility of economic activity but may also slow down long-term growth.³⁹ In order to mitigate these potential costs of capital account liberalization and to reap its benefits, two further factors are crucial. The first is prudential bank regulation and supervision. Opening borders to international capital flows can lead to surges in capital inflows. A major problem here is that these could fuel excess credit expansion in specific sectors, leading to bubbles that later burst, or prompt an overshooting of the exchange rate and pave the way for future currency crises.

The second factor is macroeconomic stability. A major drawback of unleashing international capital flows is the possibility of sudden stops or even reversals in international capital flows. This is particularly problematic when international investors tend to withdraw funds at exactly those times when external funding is hard to obtain.⁴⁰ Macroeconomic stability is crucial as it reduces uncertainty *ex ante*, stabilizes expectations and thus exchange rates, and minimizes the probability that international investors will have reason to speculate against a currency and to withdraw all their investments at once.⁴¹

As it is crucial to avoid disruptions in the international financial system, international policy cooperation, both in terms of macroeconomic policy and prudential regulation, is thus decisive.⁴² For this, developed countries also have to make their own contribution, since global imbalances (large current account and capital account deficits and surpluses) are symmetrical phenomena to be avoided by all parties.

3.2.2 Causes of Instability in Financially Integrated DCs

Currency or maturity mismatches make a country vulnerable to sudden stops or even reversals in capital flows, which may amplify financial difficulties and stress. These mismatches are, however, often a response of international investors to the inadequacy of the legal environment, of regulation and supervision, and of macroeconomic policy.

In order to draw precise policy conclusions, one has to understand the specifics of financial crises in DCs at first. In many cases, currency mismatches have been at the core of financial crises.⁴³ An economy is subject to a currency mismatch if its households, financial and non-financial firms and government have to borrow in foreign currency while most of their assets (or incomes) are denominated in local currencies. This makes real wealth (or income) strongly dependent on exchange

³⁸ This mechanism already indicates that foreign direct investment does not need to be a safer way of external finance, which is in contrast to Bhagwati, *The Capital Myth*.

³⁹ Bhagwati, *ibid.* For theoretical foundations of this reasoning see Stiglitz, *Capital Market Liberalization*.

⁴⁰ Stiglitz, *Capital Market Liberalization, Economic Growth, and Instability*.

⁴¹ Fischer, *Capital Account Liberalization*.

⁴² IMF, *Initial Lessons of the Crisis*.

⁴³ Goldstein/Turner, *Controlling Currency Mismatches*; Allen/Rosenberg/Keller/Setser/Roubini, *A Balance Sheet Approach to Financial Crisis*.

rate movements: when the local currency devaluates, the real debt burden of the country increases, which may result in a debt crisis, a phenomenon prevalent in many DCs.⁴⁴

Although this mechanism is fairly well understood theoretically, there is still no general agreement as to how to measure the exposure of a country to a currency mismatch in practice. Simple measures such as the share of foreign currency denominated debt in total outstanding debt understate the impact of economic development and economic policy on the risks associated with a currency mismatch. A more appropriate way to measure the extent of a currency mismatch is net foreign currency assets times the share of foreign currency denominated debt, divided by the country's exports. This measure takes into account that: 1) a country may also possess assets denominated in foreign currency, including central banks' international reserves; 2) foreign currency denominated debt contributes only little to financial vulnerability if it accounts for just a small share of total debt; and 3) income from exporting goods and services can be used to back up foreign currency denominated debt.⁴⁵

Problems with foreign government debt drove Mexico's Tequila crisis (1994/95) and the Argentinean crisis of 2001/02. In Russia's financial crisis (1998), not only foreign government debt but also the foreign indebtedness of Russian banks turned out to be problematic. During the Asian crisis (1997/98), currency mismatches on the balance sheets of non-financial firms were a crucial factor. There, banks' individual hedges against currency mismatches did not suffice to shield the entire economy, as banks only rolled over the currency mismatch to their borrowers.

Fixing exchange rates in order to reduce the risks associated with currency mismatches is generally not advisable.⁴⁶ In this regard, it is important to understand why a country is bound to undergo currency mismatches. Eichengreen, Hausmann and Panizza have coined the concept of 'original sin', based on the notion that DCs have simply inherited the inability to borrow in their own currency and thus cannot escape their past, even if they switch to a stability-oriented macro policy.⁴⁷ However, the macro policies of countries can, if they aim to achieve macroeconomic stability, mitigate the adverse consequences associated with currency mismatches and thus lower the probability that currency mismatches turn out to be dangerous. The reason is that the stability implications of currency mismatches crucially depend on macroeconomic conditions.⁴⁸

An alternative explanation for why DCs have to borrow in foreign currency is the lack of an adequate contractual, institutional and regulatory environment: in principle, countries could avoid stress in their banking systems due to speculation if they commit to a flexible exchange rate regime and institute a lender of last resort.⁴⁹ Then, the ability to offer banks liquidity support and to devalue the national currency would reduce the incentive of investors to make a run on banks.⁵⁰ However, pursuing such a policy mix would not be sufficient. This is because it would give local banks a good reason to speculate on a public bailout. Hence, banks would have little incentive to follow a prudent business policy so they could still potentially suffer from a commitment problem vis-à-vis investors. This problem is particularly severe if prudential bank regulation and supervision is insufficient or if the legal system is not adequately developed to ensure that contracts will be enforced.⁵¹ In such a case, investors usually respond by accepting only short-term debt denominated in foreign currency for which help from the lender of last resort is limited by the amount of its foreign exchange reserves.⁵² All this may help to

⁴⁴ In a debt crisis, the problem is that *borrowers* are unable to serve *existing* debt obligations; lenders respond to this debt overhang by cutting new loans. By contrast, in a banking crisis, the problem is that *banks* are unable to raise funds for *new* loans.

⁴⁵ Goldstein/Turner, *ibid.*

⁴⁶ Empirically, the relationship between adopted exchange rate regimes and financial fragility is mixed; for an overview see Demirgüç-Kunt/Levine, *Finance, Financial Sector Policies, and Long-term Growth*.

⁴⁷ Eichengreen/Hausmann/Panizza, *The Pain of Original Sin*.

⁴⁸ Goldstein/Turner, *Controlling Currency Mismatches*.

⁴⁹ There are, of course, other arguments for and against flexible exchange rates. A discussion on these is, however, far beyond the scope of this study.

⁵⁰ Chang/Velasco, *Financial Fragility and the Exchange Rate Regime*.

⁵¹ Levine (*Law, Finance, and Economic Growth*) shows that the nature of the legal and regulatory environment positively affects financial development which, in turn, fosters economic growth.

⁵² Diamond/Rajan, *Banks, Short-term Debt and Financial Crises*.

explain why in the Asian crisis, local banks raised much short-term debt on international capital markets and invested in projects that, under normal circumstances, would not be considered creditworthy. Governments here were seen by international investors as being responsible for their countries' banks, both in terms of regulating their lending and in terms of backing their debt – either explicitly or implicitly by, for example, committing to a fixed exchange rate regime.

As a result of short-term foreign borrowing, sudden stops or even reversals in cross-border capital inflows may occur and aggravate the distress when bank assets eventually devalue. From an ex ante perspective, short-term foreign debt is necessary for inducing international investors to lend funds to DCs if the proper legal and regulatory institutions are lacking. From an ex post perspective, short-term foreign debt may contribute to financial fragility. But it is not capital account liberalization itself that causes financial instability. The mere empirical observation that financial crises occur more often and are more severe in countries that have recently liberalized capital account transactions is not sufficient to make a case against liberalization. Instead, it is the lack of proper legal and regulatory institutions that makes countries vulnerable.⁵³

3.2.3 The Relationship between Legal and Economic Institutions, Macroeconomic Stability and Capital Account Liberalization Revisited

Establishing sound legal and economic institutions should be an objective in order to mitigate the adverse side effects of liberalization. DCs should also credibly commit to improving macroeconomic stability. By stabilizing expectations through rule-based macroeconomic policies, countries will reduce the risks associated with, for example, currency mismatches.

It is very important for policy makers to recognize the relationship between legal and economic institutions and liberalization; the more so since banking crises have been very costly in the past.⁵⁴ Any restrictions on maturity and the denomination of bank debt in order to avoid financial vulnerability, though potentially mitigating additional stress within crisis periods, will not solve the underlying problem of underdeveloped financial, legal and regulatory institutions. Instead, these will merely restrict the volume of international capital flows and thus also limit the potential benefits of liberalization.⁵⁵

Policy makers in DCs therefore should, first and foremost, establish and strengthen the rule of law, focusing in particular on property rights. This is, however, also critical for improving macroeconomic stability. To reap the full benefits of liberalization, it is important that a country commits itself in a credible manner to improving macroeconomic stability, particularly fiscal discipline. By stabilizing expectations through rule-based macroeconomic (monetary and fiscal) policies, countries will reduce the risks associated with, for example, currency mismatches. Finance is all about trust and credit, and macroeconomic stability enhances trustworthiness and credibility. It is important to note that rule-based macroeconomic policies do not imply a complete surrender of fiscal or monetary autonomy. Instead, flexible rules allow for sufficient policy space and make macroeconomic policy predictable for financial markets.

Prudential regulation measures should be adopted before opening the market to foreign suppliers. The guiding principle here would be to introduce simple rules (first of all capital requirements and leverage restrictions) without giving government much discretionary power over banks, and without overly discriminating between the recipients of loans in order to avoid the emergence of investment bubbles. State ownership of banks has to be reduced continuously, and confined to those financial services which cannot or are unlikely to be provided privately, but without heavily distorting the structure of the banking system. In addition, a credible, independent supervisory agency has to be established that is also responsible for a timely and reliable disclosure of information on banks. Government discretionary interventions in other industries should be reduced. Existing regulations that hamper markets and are

⁵³ Demirgüç-Kunt/Detrageche, Financial Liberalization and Financial Fragility. See also IMF, Reaping the Benefits of Financial Globalization.

⁵⁴ Dell'Ariccia/Detrageche/Rajan, The real effect of banking crises.

⁵⁵ Kaminsky/Schmukler, On financial booms and crashes.

not sufficiently justified by other policy objectives should also be abolished. This includes but is not limited to interest rate ceilings, credit targets, and regulations on the use of funds. In order to promote incentives and competition, public deposit insurance systems and other means of public support for banks should be limited. Only small and/or poor bank customers should benefit from insurance systems, not banks or sophisticated investors.

Capital controls may help in parallel to moderate the risk of a financial crisis after international capital flows are liberalized, but only under certain circumstances. In particular, if the economy is operating near its full potential (so that the emergence of boom-and-bust cycles is likely), if the level of foreign exchange reserves is adequate (so that there is no further need to accumulate foreign assets) and if the currency is not undervalued (so that further appreciations would eventually only have to reverse), controls may be justified for individual countries. Nonetheless, there are two major problems with this approach. First, it is often very difficult to tell whether a country satisfies these conditions. Second, capital controls may be less attractive from a global perspective as they may contribute to even larger global imbalances, and these, as we know, played a substantial role in the recent financial crisis.⁵⁶

When a DC is to some extent already open to international capital flows, policy makers should be aware of their country's limits of resilience (including fiscal and monetary capacity). The potential threat of a sudden reversal in capital flows should be considered seriously, and should encourage policy makers to strengthen their efforts to make progress with respect to legal and economic institutions and macroeconomic stability.

3.3 Liberalization of Market Entry

3.3.1 Why and How Do Financial Institutions Go Abroad?

For foreign banks to enter new markets, lifting restrictions on market entry alone is not sufficient. The mode of foreign market entry depends on bank-specific characteristics, as well as on a host country's regulatory framework, political risk, and economic risk.

In order to derive policy recommendations regarding the market entry of foreign banks, the consequences of liberalized market access have to be assessed. For this, in turn, it is necessary to understand the *raison d'être* for a financial institution to supply financial services to or within a foreign country. Note that financial sector liberalization of both market entry and international capital flows is not on its own sufficient for market entry to occur, although of course necessary for the internationalization of the banking business.⁵⁷ Since banks tend to follow their customers first⁵⁸, a further necessary condition would be to allow non-financial firms to establish local subsidiaries, implying that once international banks have entered, they will start to serve the local markets.⁵⁹

Liberalizing its capital account without opening domestic banking markets to foreign suppliers will also be insufficient for a country to foster its financial development.⁶⁰ The reason being that there is also a need for specific techniques (e.g. credit scoring, risk management, etc.) and market structures (e.g. wholesale funding, money markets) that will ensure that the international capital is channeled to its most productive use. Given the lack of expertise and technological capacity in many DCs, these techniques and structures could in principle be provided by foreign financial firms.

The decision of banks on their mode of foreign market operation is closely related to non-financial firms' decision on whether to serve foreign markets by exporting goods or by establishing foreign representations. In particular, banks tend to serve foreign markets through subsidiaries (Mode 3) if they

⁵⁶ Ostry/Ghosh/Habermeier/Chamon/Qureshi/Reinhardt, Capital Inflows; on the causes of the recent crisis see also IMF, Initial Lessons of the Crisis.

⁵⁷ Buch, Information or Regulation.

⁵⁸ Buch, Why do Banks Go Abroad.

⁵⁹ Demirgüç-Kunt/Levine, Finance, Financial Sector Policies, and Long-run Growth.

⁶⁰ Ryan/Murinde, International Banking.

have a strict productivity margin over competing banks that supply financial services across borders (Mode 1).⁶¹ This productivity margin is necessary, in part because subsidiary structures have a comparative disadvantage with respect to their ability to deal with country-specific liquidity shocks.⁶² There is also evidence that a country's regulatory framework, political risk, and economic risk influence the mode of foreign market entry adopted by international banks. In particular, it has been found that banks are more likely to establish a branch network if there is discriminating regulation that treats branches preferentially, if taxes are high, and if the political risk involved is relatively more important than the economic risk.⁶³ The reason for this is that, in contrast to branch networks, the limited liability associated with a subsidiary structure allows international banks to protect against country-specific economic risks while being more prone to the risk of expropriation that is often associated with political risks.⁶⁴

3.3.2 Stability Implications of Foreign Banks

By and large, the empirical evidence for DCs is in favor of a stability-enhancing role for international banks in periods of local financial crises. However, aggregate bank lending also becomes more pro-cyclical because foreign banks withdraw funds from DCs when loans and other local bank assets are expected to deteriorate in the course of the business cycle. New financial products should be considered less relevant for financial development in DCs, and should only be introduced at later stages of financial development.

As for the implications of foreign banks for financial stability, these banks feature higher and more sustained loan growth and a greater ability to absorb losses than their domestic peers in Latin America.⁶⁵ In Mexico and Argentina (1994-1999), foreign banks contributed to financial stability because of their relative financial strength.⁶⁶ Indeed, foreign banks often took local crises as a window of opportunity to expand further and to gain market share.⁶⁷ Similar observations have been made for Emerging Europe, where foreign banks have helped stabilize formerly communist countries in Central and Eastern Europe in times of domestic financial crises. Having said this, cross-border credit (Mode 1) has tended to be less stable than the supply of credit by local subsidiaries (Mode 3).⁶⁸ Among the Mode 3 banks, greenfield foreign banks were even better able to shield the loan supply during the period of financial distress, while the supply of loans from domestic banks shrank visibly.⁶⁹

In times of local financial crises, international banks, in contrast to domestic banks, can refinance their lending activities with funds provided by the parent bank abroad.⁷⁰ This, however, requires that there are no restrictions on bank-internal international capital flows, in particular on intra-company debt and profit repatriation. Indeed, if the latter is restricted, this may backfire in that foreign banks will shy from entering markets in the first place. Liberalizing these capital flows, however, has two further implications. First, the financial position of parent banks also matters for credit expansion in the host country. Second, foreign bank lending in a specific host country also depends on the macroeconomic conditions there relative to those in the other countries in which it operates. These two implications make foreign bank lending more pro-cyclical and negatively correlated with the business cycle in other countries, especially the parent bank's home country. In other words, DCs, while facing lower net capital inflows when their own business cycle slows down, also benefit from higher net capital inflows and thus better access to finance when business cycles elsewhere experience a downturn. This pattern

⁶¹ Buch/Koch/Kötter, Margins of International Banking.

⁶² Dietrich/Vollmer, International Banking and Liquidity Allocation.

⁶³ Cerutti/Dell'Ariccia/Martinez Peria, How Banks Go Abroad.

⁶⁴ Dell'Ariccia/ Marquez, Risk and the Corporate Structure of Banks.

⁶⁵ Crystal/Dages/Goldberg, Has Foreign Bank Entry Led to Sounder Banks in Latin America?.

⁶⁶ Dages/Goldberg/Kinney, Foreign and Domestic Bank Participation in Emerging Markets.

⁶⁷ Martinez Peria/Powell/Hollar: Banking on Foreigners.

⁶⁸ de Haas/van Lelyveld, Foreign Bank Penetration.

⁶⁹ de Haas/van Lelyveld, Foreign Banks and Credit Stability in Central and Eastern Europe.

⁷⁰ de Haas/van Lelyveld, Internal Capital Markets and Lending by Multinational Bank Subsidiaries.

can be seen, for example, in Emerging Europe as well as in Asia and Latin America.⁷¹ The reason for this structural behavior is that international banks, in contrast to domestic banks, can more easily allocate funds across the globe to those locations with better investment opportunities.

Before the global financial crisis that started in August 2007, the volume of new financial products like asset backed securities (ABS) and their close counterparts grew rapidly. This was in part because of misaligned incentives in the banking industry due to low interest rates and regulatory arbitrage. The necessary reforms in terms of both macroeconomic policies and bank regulation and supervision in developed countries aim to limit the risks associated with the new products without unduly restricting their corresponding risk sharing capacity. DCs have participated only a little in these new markets. Indeed, such products should be considered less relevant for financial development in these countries. Instead, less complicated financial services, such as deposit taking, business and household lending and the insurance of standard risks to life and property, are of priority here. Hence, foreign suppliers should focus on these financial services, which (almost by definition) are also easier to regulate and supervise for the authorities in DCs.

3.4 The Global Financial Crisis of 2007-09

The recent global financial crisis has raised concerns about international banks transmitting financial instability from developed countries to the developing world. At present, however, economic research has not come to a clear conclusion on this issue. Several indicators suggest that DCs suffered more from the recent crisis when macroeconomic conditions were such that they were already vulnerable to a decline in global economic activity. For example, among the most adversely affected countries are those with current account and fiscal deficits, or which have been strongly dependent on commodity exports.

International banks may also form an additional channel for the transmission of financial crises from developed countries to the developing world. For example, during the Japanese banking crisis in the 1990s, Latin American countries suffered from a fall in the supply of credit from Japanese-owned banks.⁷² This effect, however, was not just specific to DCs, as it does not differ from what was experienced in the US.⁷³

As for the recent crisis, DCs could have been affected by the turbulence in international financial markets directly through three channels: by contractions in cross-border lending (Mode 1); by contractions in local lending by foreign subsidiaries; and by contractions in cross-border interbank lending.⁷⁴ But the evidence relating to these direct transmission channels is not conclusive. For example, data provided by the Bank for International Settlements (BIS) indicates that countries with stable macroeconomic development experienced a rather robust flow of credit from internationally active banks, while those already seen as particularly fragile before the crisis suffered from international banks withdrawing funds.⁷⁵ Especially low-income countries with a strong export orientation in commodity markets and with little leeway for fiscal maneuvers were heavily affected, although their banking systems have had only some exposure to western financial centers.⁷⁶ But the worldwide fall in economic activity and decreased risk appetite of international investors has started to affect other DCs by and by. The share of non-performing loans has increased in these countries, putting pressure on the financial health of domestic and foreign banks and thus on bank lending and private spending.⁷⁷

⁷¹ See de Haas/van Lelyveld, *Internal Capital Markets and Lending by Multinational Bank Subsidiaries*; Goldberg, *When Is U.S. Bank Lending to Emerging Markets Volatile?*; Martínez Peria/Powell/Hollar, *Banking on Foreigners*, respectively.

⁷² See again Martínez Peria/Powell/Hollar, *Banking on Foreigners*. There is also evidence for Latin America that, in general, foreign banks transmitted external shocks to host countries between 1996 and 2008; see Galindo/Izquierdo/Rojas-Suárez, *Financial Integration and Foreign Banks in Latin America*.

⁷³ Peek/Rosengren, *Collateral Damage*.

⁷⁴ For these effects in emerging market economies see Cetorelli/Goldberg, *Global Banks and International Shock Transmission*.

⁷⁵ Navaretti/Calzolari/Pozzolo/Levi, *Multinational Banking in Europe*, see also Dietrich/Knedlik/Lindner, *Mittelosteuropa in der Weltfinanzkrise*.

⁷⁶ IMF, *The implications of the global financial crisis for low-income countries*.

⁷⁷ Evidence on this can be found, for example, for Croatia, Macedonia and Turkey; see ECB, *Financial Stability Challenges*.

Liberalized countries, for which a slowdown or a reversal in net capital inflows has been observable, may still end up even better than those without access to international capital markets. In the latter group of countries, the still existing weakness in competition between banks has resulted in high profit margins that have contributed to a build-up in capital buffers. It is, however, unlikely that in such a weakly competitive environment, banks will actually free up these buffers and increase lending. Moreover, high margins and bank profits are often not sufficient to shield underdeveloped closed banking systems, given that even big banks in western industrialized countries that were highly profitable on the eve of the financial crisis still collapsed.

The IMF reports that liquidity withdrawals have been stronger for branches than for subsidiaries.⁷⁸ This means that for countries with a high share of foreign bank subsidiaries (and thus low cross-border lending), the financial accelerator should be less strong. In a recent comparative study based upon BIS data, Latin American and Caribbean countries were least exposed to the financial crisis because foreign bank lending was conducted by local subsidiaries, denominated in domestic currency and broadly funded from a domestic deposit base.⁷⁹ Research in this field has already suggested that these lending patterns are indeed more likely in countries where political risk is less important than economic risk, where regulation and supervision meet some minimum standards, and where the rule of law applies.

What is less contested is that DCs have been hit by second round effects, mainly through traditional trade linkages and bursting commodity price bubbles. Both of these have led to deteriorations in asset quality in DCs too, thereby restricting access to external finance here.⁸⁰ The more a country exhibits homegrown vulnerabilities such as domestic house price bubbles, the stronger this effect has been.⁸¹ However, recent indicators already suggest that world trade is recovering at a fast pace, mainly driven by emerging countries and DCs. Hence, it is reasonable to consider DCs to be benefiting from the recent, yet fragile, recovery in the world economy.

3.5 Shaping the Process of Liberalization: an Economic Perspective

The objective of financial services liberalization is to foster financial development and economic growth without unduly threatening financial stability. As economic analysis has shown, there are several problems a country should address to make liberalization successful. Among these problems are: a lacking rule of law, political instability and corruption, strong government influence on economic activity (in terms of commanding and controlling this), unreliable regulatory and supervisory capacity, underdeveloped information structures, as well as macroeconomic instability and unsound fiscal and monetary policies.

The sequencing of addressing these problems depends on the respective path and stance of the country in consideration. There is no blueprint with respect to which problems need to be solved first and before liberalization, the more so as solving problems is gradual and perhaps never finished. Moreover, some problems are interrelated and should be sorted out simultaneously. In this respect, it is also crucial to recognize that even a purely domestic liberalization of the financial services sector (i.e. without allowing foreign suppliers to enter domestic markets) would require the very same problems to be adequately addressed.⁸² International liberalization could offer additional chances for development, but is also associated with the risk that existing deficiencies may result in an even worse situation.

Nevertheless, a general guiding principle for liberalization can still be derived from the above analysis. First, without progress with respect to political stability, the rule of law and corruption, capital flows will remain thin, limited to the political establishment, prone to corruption, and be likely to fuel investment bubbles. Second, prudential regulation measures introducing simple rules on capital

⁷⁸ IMF, The implications of the global financial crisis for low-income countries.

⁷⁹ Kamil/Rai, The Global Credit Crunch.

⁸⁰ IMF, The implications of the global financial crisis for low-income countries.

⁸¹ De Haas/Knobloch, In the wake of the crisis.

⁸² Eichengreen/Mussa, Capital Account Liberalization.

requirements and leverage restrictions should be adopted and independent supervisory agencies should be established before opening the market to foreign suppliers. Third, existing regulations that are not sufficiently justified by other policy objectives should be abolished. This includes, but is not limited to, interest rate ceilings, credit targets, and regulations on the use of funds. State ownership of banks should be reduced continuously and confined to those financial services which cannot or are unlikely to be provided privately. In order to promote incentives and competition, the means of public support for banks should be limited to small and/or poor bank customers. Fourth, countries should start liberalizing market access for foreign banks with regard to core banking services while easing the restrictions on international capital flows in parallel. Finally, efforts to improve fiscal and monetary stability should be exerted continuously throughout the process of liberalization.

Liberalization of financial services can have positive long-term effects for DCs, depending on certain economic, political and legal requirements like sound regulatory and supervisory institutions, adherence to the rule of law and basic principles of good governance. At the same time, financial services liberalization increases the risk of financial crises, which might in turn require flexible responses. The following section will address how financial services liberalization is dealt with from a legal perspective (especially under Free Trade Agreements) and whether the respective treaties allow for sufficient leeway to take account of specific development interests and flexible responses to financial crises.

4. Financial Services Liberalization in FTAs

A comprehensive legal analysis of financial services liberalization in international economic law is hampered by the phenomenon that has been aptly described as the ‘mushrooming’ of Free Trade Agreements (FTAs).⁸³ The issue of financial services liberalization is not only dealt with in GATS, but also in the relevant sections of FTAs, especially the most recent generation which include special provisions addressing this topic. As most DCs have either not undertaken a far-reaching commitment under the GATS or have limited their commitments to the level of liberalization to which they had already committed unilaterally,⁸⁴ the focus of this study will turn to the legal impact of FTAs. The GATS will be considered only if it introduces additional obligations, in other words, in so far as FTAs contain ‘GATS-minus’ obligations or if it serves as the common basis for all FTAs. In addition, this study concentrates on the banking sector and thereby disregards insurance services, which are also covered by the rules on financial services.

⁸³ As of 31 July 2010, some 474 RTAs have been notified to the WTO, see: http://www.wto.org/english/tratop_e/region_e/region_e.htm. Yet not all of them cover trade in (financial) services. So far, WTO members have notified 76 of Article V GATS type FTAs, meaning that these agreements either cover trade in goods and services (70 out of 76) or are limited to the liberalization of trade in services only (6 out of 76). It should be noted, however, that these numbers even though taken from the WTO homepage, are not completely reliable. They merely reflect under which provision the respective FTA has been registered. FTAs that have been registered on the basis of Article XXIV GATT exclusively might therefore still include provisions on trade in services. The agreements that also cover trade in services have been largely concluded by developed countries – that is to say, at least one of the parties belongs to this category of states. The most notable exceptions are preferential trade agreements between some Latin American States (including Chile, El Salvador, Panama, Costa Rica, and Honduras). Until now, notified preferential trade agreements either with or between African states have been largely limited to trade in goods (one of the few exceptions being the treaty between Morocco and the United States).

⁸⁴ Roy/Marchetti/Lim, *Services Liberalization in the New Generation of Preferential Trade Agreements*, 32. In some cases, the multilateral commitment does not even match the national practice or national laws and regulations: The Philippines, for example, allows the formation of companies whose shares are held 100% by foreigners or foreign companies. But their multilateral commitment is limited to allowing (at least) 51% of foreign shares. The phenomenon of guaranteeing multilaterally less than what reflects current internal practice has been explained as rational behavior, because by doing so WTO members maintain bargaining power for the next round of negotiations. In addition it seems that states are unwilling to be internationally bound in cases of experimental liberalization efforts. But states should realize that taking a step back in liberalization – even though it might not violate their GATS commitments – might be incompatible with their other obligations under international law, in particular those contained in BITs. Reducing the amount of shares a foreign company is legally allowed to hold not only for new market participants but also for foreign companies that have already made their investments, is likely to violate the guarantees contained in BITs.

Because of the sheer number of FTAs in force or currently being negotiated, it is necessary to limit the FTAs that are considered by this study. In order to focus on the interests of DCs and how they are affected, the study will include the following agreements:

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

4.1 Basic Structure

In order to assess the scope of financial services liberalization in FTAs, it is necessary to clarify the basic structure of these agreements, which in turn requires a very brief look at the structure of the GATS as well. The GATS, in contrast to the FTAs just mentioned, does not contain a separate chapter on financial services. Instead, the general obligations with regard to services as such provide the legal framework for the supply of financial services as well. However, based on the difficult negotiations with regard to financial services, there are special provisions that either alter or expand some of the general GATS provisions and which can be found in:

- 1. and 2. Annex on Financial Services; and
- the Understanding on Commitments on Financial Services⁸⁵

While the Annexes form an integral part of the GATS, the provisions of the Understanding are not legally binding for all WTO members. However, some WTO members have included a reference to the Understanding in their schedules, which is interpreted as a unilateral declaration to be bound by it.⁸⁶

Unlike the GATS, the NAFTA and the US-style (or NAFTA-like) FTAs contain a special chapter dealing exclusively with liberalization of trade in financial services, which means they include special provisions on most-favored-nation (MFN) obligations, national treatment, and market access, like chapter 11 of the Singapore-Panama FTA or chapter 12 of the US-Peru FTA. In addition, other chapters (especially those on investment and cross-border services) are (partially) incorporated by cross-reference (see Art. 11.1 (2) of the Singapore-Panama FTA and Art. 12.1 (2) of the US-Peru FTA). The picture is less clear for European-style FTAs. Whereas the CEPA contains a separate section on trade in financial services, although it limits its scope to the specific characteristics of this domain, the EU-Chile FTA follows the NAFTA approach.⁸⁷

A common feature of all treaties considered (including the GATS) is the distinction between obligations that apply to financial services as soon as the relevant treaty becomes effective and those that apply only if states undertake specific commitments. The former usually include the MFN obligation,⁸⁸ certain transparency requirements and additional disciplines regarding domestic regulation,

⁸⁵ A list of WTO documents relevant for trade in financial services must also refer to the 5th Protocol. But in contrast to the Annexes and the Understanding it does not add any new substantial provisions. It was rather necessary because at the end of the Uruguay Round WTO members were unable to agree on the extent to which trade in financial services should be liberalized as well. However, when the Protocol was agreed upon on 3 December 1997 and became effective on 1 March 1999 it bound those members who had ratified it to the newly negotiated country schedules listed in the Annex of the Protocol.

⁸⁶ von Bogdandy & Windsor in: Wolfrum/Stoll/Feinäugle, GATS, Understanding on Commitments in Financial Services, para. 2.

⁸⁷ See for example Article 103.1 CEPA according to which Section 5 of the treaty sets out the principles of the regulatory framework for all financial services liberalized pursuant to Chapters 2, 3 and 4 of the second title dealing with trade in services in general.

⁸⁸ It should be noted that the EU – Chile FTA does not include an MFN obligation, neither in the chapter on trade in financial services (Title III, Chapter II) nor in the general services chapter (Title III, Chapter I). In addition, the CEPA limits the MFN obligation to third countries with which the EU or signatory CARIFORUM states conclude an economic integration agreement after the signature of the CEPA. It also excludes regional economic integration agreements that aim at creating an

whereas the latter cover market access and national treatment obligations. The extent of liberalization commitments is thus not determined by the treaty itself, but rather by a country's schedule, which lists the sectors or subsectors that are subject to liberalization commitments.

4.1.1 Market Access Obligations

Neither the GATS nor any FTA secures general or unlimited market access. Instead, they aim to prohibit certain measures that have a particular negative effect on market access (so-called 'blacklist' method). Based on Article XVI:2 GATS, the following measures may not be maintained or adopted in case a member has undertaken special commitments:

- limitations on the number of financial institutions;
- limitations on the total value of financial service transactions or assets;
- limitations on the total number of financial service operations or on the total quantity of financial services output;
- limitations on the total number of natural persons that may be employed in a particular financial service sector or that a financial institution may employ;
- measures that restrict or require specific types of legal entity or joint venture through which a service may be supplied; or
- limitations on the participation of foreign capital.

Even though FTAs do not deviate from this method, the parties might have agreed to less comprehensive market access obligations. The CEPA, for example, does not ban any limitations listed in Article XVI:2(d) GATS (especially limitations on total number of natural persons that may be employed in a particular service sector) with regard to mode 3 (Article 67 CEPA). Similarly, the US-Peru FTA, as well as the Singapore-Panama FTA, does not add Article XVI:2(f) GATS to its black list (limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment).

4.1.2 National Treatment

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

4.1.3 Exclusions

Furthermore, all treaties exclude certain measures from any liberalization commitment. Even though the provisions might differ in detail, they usually include activities conducted by a central bank or monetary authority following monetary or exchange rate policies, activities forming part of a statutory system of social security or public retirement plans, and other activities conducted by a public entity for

internal market or that require the parties to significantly approximate their legislation with a view to removing non-discriminatory obstacles to trade in services (Art. 79(1) and (2), CEPA).

the account or with the guarantee or using the financial resources of the government. Additionally, all FTAs provide that if a party allows any of the last two activities to be conducted in competition with a public entity or a financial services supplier, all provisions regarding trade in financial services apply. States could, however, refrain from making any commitment with regard to services affected by these provisions or add them to the exceptions in their schedules.

4.1.4 Positive/Negative List Approach

Whether parties are obliged to grant market access and observe the principle of non-discrimination with regard to financial services, is not determined by the respective treaty provision, but by a country's schedule for services. These schedules list the sectors for which a state has agreed on specific liberalization commitments, distinguishing between market access, on the one hand, and national treatment, on the other. As concerns the financial service sector, these specific obligations can again be limited to certain subsectors like the following taken from the CEPA:⁸⁹

- **Insurance and insurance-related services⁹⁰**
- **Banking and other financial services**
 - Acceptance of deposits and other repayable funds
 - Lending of all types, including inter alia consumer credit, mortgage credit, factoring and financing of commercial transactions
 - Financial leasing
 - All payment and money transmission
 - Guarantees and commitments
 - Trading for own account or for the account of customers, whether on an exchange, in an over-the-counter market or otherwise
 - Participation in issues of all kinds of securities, including underwriting and placement as agents
 - Asset management, such as cash or portfolio management, all forms of collective investment management
 - Advisory and other auxiliary financial services for all the activities (including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring)
 - Provision and transfer of financial information and financial data processing and related software by providers of other financial services
- **Other**
 - Registration of offshore companies and trusts
 - Central bank deposit services and central bank reserve management
 - Financial leasing with an option to buy and factoring
 - Investment and property unit trust services
 - Mutual funds and venture capital services

Even though all treaties require that a party must undertake specific commitments before they become binding, two different approaches with regard to how states bind themselves exist. In the case of the so-called 'positive list' approach, a party is only bound to grant market access to foreign services suppliers and to comply with the principle of non-discrimination if it has accepted commitments for the relevant sector or subsector. This approach has been adopted in the GATS and in all European FTAs. In contrast, the NAFTA is based on the 'negative list' approach, according to which a party has committed itself by becoming a party to the treaty, but may list exceptions to a certain sector or subsector. The US-Peru FTA incorporates both methods: while cross-border trade is only liberalized to the extent specified in the respective annex (positive approach, see Article 12.5(1) US-Peru FTA), other

⁸⁹ Parties are of course free to design their own set of subsectors, but they usually base them on the WTO Guidelines for the Scheduling of Specific Commitments under the General Agreement on Trade in Services (GATS), WTO Doc S/L/92, 28. March 2001.

⁹⁰ The insurance sector is, like the banking sector, divided into different categories as well. But as the study is limited to the banking aspects of trade in financial services these categories are not listed here.

forms of trade are governed by the negative list approach. This structure is also found in the Singapore-Panama FTA.

The different impact of these two concepts is arguably more pronounced in practice, especially for DCs, than one might assume from a theoretical viewpoint. The positive list approach provides not only more autonomy for countries when negotiating their commitments.⁹¹ These countries “may [also] lack the necessary expertise to understand which limitations or restrictions to list under a negative list approach.”⁹² From a DC’s perspective, it is thus preferable to base specific commitments on a positive list approach.

This result is further supported by a ‘side effect’ of the negative list approach: It has the same consequences as the much-debated and criticized standstill provisions. A negative list obliges the parties to liberalize all sectors/subsectors and modes, except those that are explicitly exempted from this obligation. In practice, countries list all existing measures that do not comply with its liberalization commitments. If a country has committed itself unilaterally, it actually complies with its liberalization commitments. It could not add a non-conforming measure to its schedule, even if the unilateral liberalization was more of an experiment than a definite step, because a non-conforming measure does not exist. Countries are thus barred from revoking any liberalization measures they have undertaken unilaterally. If, however, the respective FTA adopts a positive list approach, unilateral liberalization measures do not automatically become part of the country’s liberalization commitments. Only if the relevant sectors/subsectors and modes are included in a country’s schedule, does a corresponding international obligation exist. If there is no correlation, unilateral liberalization commitments could be revoked without violating the FTA.⁹³

As a consequence, some ‘positive list treaties’ have included so-called ‘standstill provisions’. According to the GATS Understanding, for example, “any conditions, limitations and qualifications to the commitments” included in the GATS Understanding are “limited to existing non-conforming measures”. At the FTA level, a standstill obligation can be found in paragraph 9 of the headnote to the schedules for the CARIFORUM states listed in Annex IV F of that treaty: “[...] the Signatory CARIFORUM States shall maintain the conditions of market access and national treatment in the meaning of Articles 67 and 68, and Articles 76 and 77 applicable according to their respective legislation to services, service suppliers, investors and commercial presences of the EC Party at the time of the signature of this Agreement.” The meaning of this obligation seems to be rather straightforward: even if certain sectors/subsectors have not been liberalized, CARIFORUM states are now obliged to apply unilateral liberalization commitments and practices henceforth. But paragraph 9 of the headnote for Annex IV F adds two qualifications: the requirement to maintain the conditions of market access and national treatment at the time of the signature of the CEPA applies “without prejudice to the ... commitments ... in this Annex”. Furthermore, public services are excluded. Despite the fact that the term ‘public services’ has not been defined in the treaty (which may lead to considerable disagreement between the parties), the scope of the qualification remains somewhat unclear. *Kelsey* suggests that reservations to the commitments which are less liberal than the status quo will prevail, which in turn leads her to the conclusion that the CEPA becomes effectively a ‘negative list treaty’.⁹⁴ Indeed, requiring reservations to the commitments in order to circumvent the standstill obligation would alter the whole system of positive commitments. In addition, *Kelsey* is concerned, that even those sectors/subsectors that are not listed in a country’s schedule are covered by the standstill obligation because paragraph 2 of the headnote states that “[t]his Schedule includes only those service activities in which the signatory CARIFORUM States are undertaking commitments” and paragraph 9 must be treated as a commitment of that Schedule.⁹⁵ As a consequence, even the status quo of sectors not part

⁹¹ UNCTAD, Services, Development and Trade: The Regulatory and Institutional Dimension, TD/B/C.I/MEM.3/2, 6. Jan. 2009, para. 65

⁹² Alexander, GATS and Financial Services in: Alexander/Andenas, 575.

⁹³ If, however, the measure in question also applies to investments that were made while the country unilaterally liberalized a certain sector, it could violate the investment protection obligation contained in either the BIT or the respective FTA. Countries must thus carefully evaluate whether they are actually free to revoke unilateral liberalization commitments.

⁹⁴ South Centre, Legal Analysis of Service and Investment in the CARIFORUM-EC EPA, 27.

⁹⁵ *Id.*, at 27 et seq.

of the commitments would be locked in – a result incompatible with the ‘classic’ positive list approach.

This understanding is, however, based on the assumption that the standstill obligation in Annex IV F forms part of a country’s commitments – an assumption that must be called into question. The heading of Annex IV F, for example, reads as follows: “List of Commitments in Service Sectors (referred to in Article 69, 78, 81, and 83)”. The headnote does not form part of the list – taking the meaning of the term literally – instead it explains the list that follows the headnote. This list actually enumerates the different service sectors, while the standstill obligation does not mention any of them. It thus seems reasonable to assume that the obligation only applies to service sectors that are included, not to say, listed in the schedule. To separate the headnote from the list of commitments is also supported by the language of Article 69 CEPA, according to which the liberalized sectors “are set out in lists of commitments included in Annex IV”. First, not the whole of Annex IV is a list of commitments, because these lists are ‘included’ in Annex IV, which suggests that the Annex consists of something more than just the lists. In addition, the headnote is not a list. Thus, the standstill obligation applies only to those sectors that are included in the lists of commitments.

This raises the question, however, whether it is the standstill obligations or the commitments that prevail in case the latter are less liberal than the status quo. According to *Kelsey*, the reservations to the commitments would prevail. This would render the standstill obligation close to meaningless because in the case of restrictions these would prevail, whereas in the case of full commitments a standstill obligation is not needed. The only reasonable interpretation, which would respect the positive list approach and give (some) effect to the standstill obligation, would thus be to subject the commitments to the standstill obligation. In case states have undertaken commitments, they must sustain the status quo if it is more liberal than the commitments. This would also take into account the experience with regard to the GATS: states, especially DCs, have undertaken commitments, but these commitments do not reflect the level of unilateral liberalization in order to retain bargaining power for future negotiations.⁹⁶ However, the language of paragraph 9 of the headnote for Annex IV F of the CEPA is more than ambiguous in this regard. In the future, such ambiguity should be prevented to the greatest extent possible. In case of a dispute, it allows an arbitration tribunal to adopt an interpretation that was not previously anticipated by the parties when negotiating the treaty. In addition, the parties themselves might not fully understand the effect of the obligations they have accepted. Depending on the country in question, standstill clauses can have a substantial effect, especially if a state has been experimenting to find the right level of liberalization by committing itself unilaterally. In order to assess the consequences of standstill obligations properly, however, it seems necessary to evaluate whether withdrawing unilateral liberalization commitments is economically feasible. In addition, it should be taken into account that the standstill obligation, like every other obligation, is subject to prudential carve-out. It is thus possible to restrict unilateral liberalization commitments for the purpose of prudential regulation.

4.1.5 Modes of Supply

Besides limiting specific commitments to certain subsectors (or not making any at all), states also have the possibility to restrict their specific commitments to certain modes of supply that have been introduced by the GATS and which are followed by all FTAs:

- cross-border supply (Mode 1)
- consumption abroad (Mode 2)
- supply through commercial presence (Mode 3)
- supply through the presence of natural persons (Mode 4)⁹⁷

⁹⁶ Roy/Marchetti/Lim, *Services Liberalization Agreements*, 32.

⁹⁷ Some of the FTAs introduce a slightly different categorization. Title II CEPA, for example, distinguishes between commercial presence (chapter 2), cross-border supply (chapter 3) and the temporary presence of natural persons for business purposes (chapter 4). In Article 75 CEPA “cross-border” is then defined as the supply of a service “(i) from the territory of a Party into the territory of the other Party (Mode 1); (ii) in the territory of a Party to the service consumer of the other Party (Mode 2).”

Mode 1 applies to cases in which neither the consumer nor service supplier cross any borders, but stay in the territory of their respective home countries. Offering a loan or other financial products to a consumer in a different country in writing or orally would require that this country has made specific commitments with regard to Mode 1. Mode 2, in contrast, refers to situation whereby the consumer travels to a third country to access financial services offered by a financial services supplier in that country, for example, to take out a loan.⁹⁸ While in Mode 2 the consumer travels to the place where the service is offered, Mode 3 enables the supplier to ‘travel’ to the consumer’s home country by establishing a foreign branch/subsidiary in that country or by buying a local bank in part or whole. Mode 4 applies to a similar situation: instead of establishing a commercial presence, natural persons supply the financial service through their presence. This could include the personnel of a foreign bank without a commercial presence in that country who are preparing the takeover of a local bank, or visits with customers with whom there has previously been contact via Mode 1.⁹⁹

4.1.6 Scope of Financial Services Liberalization

Neither FTAs nor the GATS require DCs to automatically liberalize their financial service industries. Instead, it should be emphasized that these treaties provide a set of flexible rules for negotiating specific liberalization commitments, especially if based on the positive list approach.¹⁰⁰ DCs are thus able to restrict the liberalization of certain sectors/subsectors in general or add restrictions to their schedules. Such restrictions should, however, not be based on protectionist motivation. Instead, it is necessary to evaluate the legal, political and economic conditions of a specific DC in order to determine which forms of liberalization are feasible. The economic analysis has, for example, shown that in times of financial crisis, liquidity withdrawals have been stronger for branches than for subsidiaries.¹⁰¹ It thus seems advisable to either encourage the establishment of subsidiaries or even restrict Mode 3 in this regard. Yet, the economic analysis has also demonstrated that foreign banks are more likely to establish a branch network if there is discriminatory regulation that treats branches preferentially, if taxes are high, and if the political risk involved is relatively more important than the economic risk. Limiting ‘Mode 3 liberalization’ to the establishment of subsidiaries might thus prevent any meaningful liberalization from taking place at all. From a legal perspective, the FTAs enable the parties concerned to take their specific situation into account when negotiating the treaty. Still, it requires that DCs have a thorough and realistic understanding of the implications of financial services liberalization.

In this context, it should also be noted that with regard to the GATS, DCs have made use of the different options provided by the treaty and restricted liberalization to certain subsectors, especially insurance and core banking services (deposit taking, lending, payment and money transmission services, financial leasing, and guarantees and commitments), and thus excluding more advanced, capital market-related services (trading in securities, underwriting and asset management).¹⁰² In addition, even the commitments accepted by DCs under the GATS usually do not amount to ‘real’ liberalization. The specific commitments either represent the existing levels of market access with significant restrictions remaining or do not match with the actual national practice, meaning that markets are in fact more liberalized, but states refrain from legally committing to this level of liberalization internationally.¹⁰³ The same can be observed for some of the FTAs as well. Even though it is true that DCs tend to accept rather more commitments within the context of FTAs than under GATS,¹⁰⁴ not all of them are

⁹⁸ The distinction between Mode 1 and 2 might be difficult to make, especially if the services are delivered via phone or the internet because neither the place of delivery nor the time when the service is delivered may be determined without doubt; see Gkoutzinis, *International Trade in Banking Services and the Role of the WTO*, *International Lawyer* 39 (2005), 877, 894.

⁹⁹ v. Bogdandy/Windsor in: Wolfrum/Stoll/Feinäugle, *Annex on Financial Services*, para. 14.

¹⁰⁰ Alexander, *GATS and Financial Services*, in: Alexander/Andenas (eds.), *Trade in Services*, 562.

¹⁰¹ See above part C IV.

¹⁰² Roy/Marchetti/Lim, *Services Liberalization Agreements*, 31 et seq.

¹⁰³ Roy/Marchetti/Lim, *Services Liberalization Agreements*, 32. Only states that joined the WTO after it had been established were actually forced to agree to substantial liberalization commitments, including trade in financial services. That new members were forced to accept more far-reaching commitments than comparable countries belonging to the group of founding members, has resulted in considerable asymmetries within the WTO membership, see Cooke, *Alternative Approaches to Financial Service Liberalisation* in: Alexander/Andenas, 620.

¹⁰⁴ With regard to the CEPA, see South Centre, *Legal Analysis of Service and Investment in the CARIFORUM-EC EPA*, 83 et seq.

genuinely new. Instead, they also tend to reflect the liberalization level achieved before, unilaterally.¹⁰⁵ However, this conclusion does not entirely apply to US FTAs, which have, to some extent, led to ‘real’ liberalization, albeit in the insurance and not the banking sector.¹⁰⁶

4.2 Right to Regulate?

An equally important issue with regard to financial services is a country’s ability to regulate its own financial markets. This requires a certain autonomy to set the rules to support national economic policies, to determine how these rules are implemented and how the implementation process is supervised. Financial services, especially banking, have been perceived as crucial for a country’s development and its ‘financial sovereignty’.¹⁰⁷ The 2005 Declaration of the Ministerial Conference in Hong Kong thus recognized the relationship between liberalization and the establishment of an effective supervisory framework in order to guarantee the stability of the overall financial system. In addition, ever since the recent global financial crisis, developing and developed states alike have focused on their right to regulate. Even the IMF emphasizes that careful and appropriate regulation of the financial sector is necessary.¹⁰⁸ But, at the same time, general agreement exists that with regard to trade in services, in particular, overregulation can contradict states’ liberalization commitments. National regulation can cause substantial obstacles to effective market access, which in turn might render the liberalization commitments made close to meaningless.¹⁰⁹

The question as to what extent states are free to regulate their financial markets has been discussed under the heading ‘right to regulate’. The significance of this phrase, however, should not be overestimated. Even though it plays quite a prominent role in the literature on the GATS, it is only mentioned in its preamble. It thus does not constitute an independent right, but serves as a guiding principle in interpreting the GATS’ provisions with regard to national regulation. The same can be said about the CEPA. Even though the right to regulate is mentioned in Article 60.4 CEPA, it belongs to the part that lists the objectives of the treaty. As an objective, it must be taken into account when interpreting the specific CEPA provisions with regard to their object and purpose. In addition, the GATS and the CEPA are the only agreements considered in this study that mention the right to regulate at all.

4.2.1 Regulatory Models

Before turning to the question how of FTAs restrict a country’s ability to regulate its own financial markets, it is useful to give a short introduction to possible regulatory models. This summary will necessarily be confined to a rather high level of abstraction. It nevertheless reveals how some approaches to regulation might be more appropriate for DCs and their limited resources than others.

A rather widespread regulatory model is the so-called ‘principle-based approach’ to regulation. It is designed to take advantage of competition and the market’s capacity to distribute resources according to supply and demand. The regulatory authority provides for the regulatory principles that financial institutions then apply to their operations. Principle-based regulation thus implies some form of self-regulation and allows for considerable flexibility towards new products and systems.¹¹⁰ But both principle-based and self-regulation methods require financial institutions that can manage their risk profile appropriately and supervisory bodies that are able to control this process. Another important factor for principle-based regulation is effective market discipline, which in turn requires a developed market. In addition, information disclosure for enabling market participants and investors to make

¹⁰⁵ Haddad/Sauvé/Stephanou, *Financial Service Liberalization* in: Haddad/Stephanou (eds.), *Financial Services and Preferential Trade Agreements*, 6.

¹⁰⁶ Roy/Marchetti/Lim, *Services Liberalization Agreements*, 35.

¹⁰⁷ Treves, *Monetary Sovereignty Today*, in: Giovanoli, 118.

¹⁰⁸ IMF, *Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management*, 4. Feb. 2009, www.imf.org/external/np/pp/eng/2009/020409.pdf

¹⁰⁹ Wouter/Coppens, *Domestic Regulation*, in: Alexander/Andenas, 207 et seq.

¹¹⁰ Yokoi-Arai, *GATS’ Prudential Carve-Out*, ICLQ 57 (2008), 634.

qualified decisions is another essential requirement. Principle-based regulation is, thus, difficult to apply for DCs. Depending on their level of development they may neither possess functioning financial markets nor the efficient and experienced regulatory and supervisory bodies that are required.¹¹¹

It therefore seems to be more prudent for DCs to emphasize a rule-based approach to regulation; one under which specific rules are applied that restrict discretion and thus enhance certainty. In addition, this would enable financial institutions to better understand the regulatory approach. On the downside, the application of rules tends to leave less room for flexibility. Furthermore, it might restrict financial firms and therefore limit potential growth.¹¹² However, DCs that do not possess sufficient know-how and experience regarding the regulation and supervision of financial markets should rather accept these possible negative impacts in the short run.

4.2.2 Impact of FTAs on Domestic Regulation

Before focusing on the relevant provisions of the FTAs that deal with or have an impact on domestic regulation of financial services, it should be noted that the FTAs considered in this study do not introduce any general disciplines on national regulation of financial services (the notable exception being the US-Peru FTA). States are thus free to adopt the regulatory model, which they consider to be most suitable, including the regulatory and supervisory framework. In addition, none of the FTAs imposes a general obligation to deregulate, meaning that states may determine their level of regulation and supervision. This freedom, however, is somewhat limited in the case of EU FTAs, which refer to international regulatory standards. These standards could of course reduce DCs' regulatory freedom. Yet, as will be discussed in more detail below, none of the EU treaties actually requires the implementation and application of (what in any case are non-binding) international standards within a certain time period. Instead, parties must show their (best) endeavor, which allows for sufficient latitude to consider specific development interests. 'Best endeavor' in this regard could also mean not to implement any international standard – the scope of the words 'best endeavor' always depends on the specific circumstances in a given case.

Even though FTAs do not impose general rules on domestic financial services regulation (e.g. like Article VI GATS), this does not mean that FTAs are silent on the issue altogether. But the provisions are usually limited to transparency and procedural issues rather than any substantial regulation requirements.

4.2.2.1 Information Requirements and Enquiry Points

Based on Article 1411 NAFTA and Article III GATS, all FTAs specify the parties' obligations concerning the publication of new or changed laws and regulations on financial services. Yet, the NAFTA differs from the GATS in so far as it obliges the NAFTA parties not only to publish in advance new regulations and laws coming into force, but "any measure of general application that the Party proposes to adopt in order to allow an opportunity for such persons to comment on the measure" – at least to the extent practicable (Article 1411 NAFTA). The FTAs generally follow the NAFTA example. The slightly different language used does not change the obligation in substance except in the case of the CEPA. Article 105(1) CEPA on effective and transparent regulation is subject to a "best endeavour" qualification. Thus, CARIFORUM states that have ratified the CEPA are under no strict legal obligation to make proposed changes public in advance. This, however, does not imply that states can remain inactive. Article 105(1) CEPA has practical consequences in so far as states are obliged to make considerable efforts to meet the requirements of that provision. This could include setting up an official publication system or other medium to ensure that the information of all interested persons is available in either a written or electronic form. The CEPA therefore takes into account that information requirements provide technical challenges to CARIFORUM states and allows them to deal with these problems without violating the treaty. As such, it is more developing country-friendly than any of the other FTAs. Yet, it does not address the criticism that such information requirements might expose governments and legislators to the lobbying activities of powerful

¹¹¹ *Id.* at 634.

¹¹² *Id.* at 635.

international banks and other financial services suppliers, who in turn might be able to influence or even prevent, for example, new, more consumer-friendly laws.¹¹³ Even though this criticism voices a legitimate concern, it should be noted that “all interested persons” also includes civil society interest groups. Their political influence might, of course, be more limited than that of internationally active banks. It is, however, not clear if the position of civil society interest groups would be better or the influence of business lobbying groups less if new measures concerning financial regulations are not published in advance. The latter might, for example, possess better informal access to financial regulators and supervisors, which would help safeguard their interests. Thus, the possible negative impact of provisions like Article 105(1) CEPA depends to a very great extent on the true situation of the country concerned.

In addition, according to the NAFTA and all FTAs, the regulatory authorities must make available country requirements for completing applications related to the provision of financial services to all interested persons. This requirement is closely connected to the establishment of so-called ‘enquiry points’. While Article 1411(6) NAFTA allows for a rather short transitional period of up to 180 days after the date of entry into force of NAFTA for establishing such points, Article 86 CEPA does not provide for a specific timeframe. Arguably, CEPA parties are thus obliged to comply with Article 86 CEPA from its date of entry into force. The language used by the US-Peru FTA and the Singapore-Panama FTA concerning the establishment of enquiry points is not as clear. Yet, Article 12.11(7) US-Peru FTA and Article 11.12(6) Singapore-Panama FTA respectively oblige the parties to maintain or establish appropriate mechanisms for responding to inquiries from interested persons concerning financial service regulations and laws. This, in practice, has arguably the same effect as the NAFTA and CEPA provision asking for the establishment of enquiry points. In contrast to these treaties, the EU-Chile FTA does not contain any comparable provision, at least not with regard to inquiries from interested groups or persons. Instead, the parties must establish contact points that aim to facilitate communication between the parties themselves (Article 190 EU-Chile FTA). This treaty is thus modeled on Article III GATS.

The establishment of enquiry points has also been criticized as an unduly cumbersome constraint on the regulatory abilities and resources of DCs.¹¹⁴ However, DCs that are WTO members must have already established such enquiry points. Even though Article III GATS applies only to requests from other WTO members and not to investors or financial services suppliers from these countries, the experience that WTO members have been able to gain since 1995 (or from the date of their WTO admission) should put into perspective the additional effort involved to open existing enquiry points to requests from investors or service suppliers. The only meaningful exception might be Article 86 CEPA. As has already been pointed out elsewhere, the language of Article 86 CEPA implies that the enquiry points would be responsible for dealing with requests relating to the whole treaty and not just to trade in services, like under Article III:4 GATS, or financial service laws and regulations, like under the US-Peru and Singapore-Panama FTAs.¹¹⁵ The specific language used could, of course, be a result of a drafting error because Article 86 CEPA is part of the general provision of chapter 5, which is limited to trade in services. In addition, it only refers to enquiries from investors and service suppliers. It thus seems reasonable to assume a narrow understanding, which does not include requests other than those made by service suppliers and investors with regard to trade in services. This interpretation is also backed by the list of enquiry points listed in Annex V. The CARIFORUM states distinguish between enquiry points for services, on the one hand, and for investors, on the other. In addition, it should be noted that quite a few CARIFORUM states already seem to have established special investment offices or centers that aim to facilitate foreign investments, and that Article 86 CEPA does not include any requirements on, for example, the timeframe within which a request by an investor or service supplier must be answered. It is therefore justified to conclude that the CEPA does not impose any unreasonable or disproportional requirements.¹¹⁶

¹¹³ Schloemann/Pitschas, *Regulatory Edge*, 24 referring to the position of the SVE states (Small Vulnerable Economies), which include almost all CARIFORUM states. These states have resisted ‘prior comment’ obligations in the deliberation of the WTO Working Party on Domestic Regulation (WPDR).

¹¹⁴ South Centre, *Legal Analysis of Service and Investment in the CARIFORUM-EC EPA*, 67.

¹¹⁵ Schloemann/Pitschas, *Regulatory Edge*, 10.

¹¹⁶ Schloemann/Pitschas, *Regulatory Edge*, 10 consider the impact “overall negligible”.

With regard to information requirements, the US-style FTAs add additional obligations. At the time a party adopts final regulations, it “should ... address in writing any substantive comments received from interested persons with respect to the proposed regulations.” Yet, in addition to the soft language indicated by “should” instead of “shall”, this requirement also applies only “to the extent practicable” (Article 12.11(4) US-Peru FTA, Art. 11.12(3) Singapore-Panama FTA) – just like the one to allow a reasonable length of time between the publication of final regulations and their date of effectiveness (Article 12.11(5) US-Peru FTA; Art. 11.12(4) Singapore-Panama FTA). In times of crisis, in particular, when there may be only very little time for adopting new laws and regulations, it seems that parties would not have to comply with these obligations, as neither of them would then be practicable. This interpretation would correspond to the “emergency exception” included in Art. III:1 GATS with regard to publication requirements. Still, the obligation to address the received enquiries would require additional resources. It would therefore be helpful for DCs if the requirement “to the extent practicable” is clarified in a manner so that it must be understood as meaning in relation to the existing regulatory and supervisory resources of a state. The same applies to Article 12.11(11) US-Peru FTA – a provision that is not found in any other FTA and that obliges the regulatory authority that has denied an application to inform the applicant of the reasons for its decision, at least to the extent practicable.

4.2.2.2 Application and Judicial Procedures

The issue of minimal standards for application procedures is already dealt with under the GATS. The FTAs do not add to the requirements set out by Article VI:3 GATS – at least not to a great extent. Thus, the regulatory authority must inform the applicant of the status of its application at the applicant’s request. If additional information is needed to decide the application, the relevant authority must notify the applicant without undue delay.

The most significant differences concern the rules regarding when and how an application must be decided. The EU-Chile FTA and the CEPA follow the GATS and require that decisions on complete applications (according to national laws and regulations) must be made “within a reasonable period of time”, whereas the NAFTA and the US-style FTAs set a time limit of 120 days. This requirement is, however, not as strict as it appears. Where it is not practicable for a decision to be made within this time period, the applicant must be informed without undue delay and the regulatory authority “shall endeavor to make the decision within a reasonable time thereafter.” Complex and time-consuming applications may thus be decided within a longer time period, even though the provision suggests that the relevant authorities must be able justify why longer periods are necessary. What is reasonable cannot be determined at an abstract level, but only with regard to a specific case and its specific circumstances.¹¹⁷

The GATS also addresses the requirement of establishing judicial, administrative or arbitral review procedures for the review of administrative decisions affecting trade in services (Article VI:2(a) GATS). These procedures must be prompt, open to service suppliers and investors, and offer, where justified, appropriate remedies. In case such procedures are not independent of the agency that issued the administrative decision, the WTO member must ensure an impartial and objective review. Identical requirements are to be found in Article 87 CEPA which, as a general provision, applies to all administrative decisions with regard to trade in services, thus including trade in financial services. Article 19.5(1) US-Peru FTA adds a few additional requirements and some clarifications. The tribunals must, for instance, be independent of the office that is entrusted with the enforcement of administrative decisions and able to correct administrative actions. In addition, the parties must have a reasonable opportunity to support or defend their positions and a right to a “decision based on the evidence and submissions of record or, where required by domestic law, the record compiled by the administrative authority”. In contrast to the CEPA and the US-Peru FTA, the EU-Chile FTA does not provide for a similar or comparable provision. This is also true for the Singapore-Panama FTA – at least with regard to financial services; even though Article 10.9 of that treaty is identical with Article VI:2(a) GATS, Article 11.1 postulates that chapter 10 provisions apply only to the extent they are

¹¹⁷ See Krajewski in: Wolfrum/Stoll/Feinäugle, Art. VI GATS, para. 26 and Wouter & Coppens, Domestic Regulation, 16 with regard to the GATS.

incorporated, but does refer to Article 10.9. However, Article VI:2(a) GATS applies to all FTA parties that are at the same time a WTO member, as it is not limited to cases in which specific commitments have made, like Article VI:1, 3 or 5. Possible non-compliance could therefore be challenged with reference to the Dispute Settlement Understanding (DSU) instead of the FTA provisions on dispute settlement.

4.2.2.3 Senior Management/Board of Directors

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

4.2.2.4 Substantial Rules on Regulation – International Standards

In contrast to the EU-style FTAs, neither the NAFTA nor the US-Peru or the Singapore-Panama FTA make any reference to internationally agreed standards for financial market regulation and supervision and the fight against money laundering. With regard to the EU treaties there are, however, notable differences in the language of the respective provisions. While Article 123(4) EU-Chile FTA requires the parties to make their best endeavors to implement and apply these standards, this obligation has been mitigated in the CEPA. Even though Article 105(4) CEPA also refers to international standards, the parties "shall [only] endeavour to facilitate" their implementation and application. The CEPA provision thus allows for more flexibility to take into account the difficulties that DCs may encounter. In addition, the CEPA places a significantly different emphasis. While the goal of the EU-Chile FTA is that such standards are implemented and applied, the CEPA aims at facilitating their implementation. A CEPA party has therefore complied with its Article 105(4) obligation if it has addressed national obstacles that prevent it from applying and implementing these standards, even though it may not have actually taken this last step. Besides this difference concerning the exact wording of both provisions, two major problems exist: what exactly are internationally agreed standards, and do the parties enjoy any influence on how standards are applied and implemented?

The latter problem is closely connected to the discussion of the suitability of these standards for DCs and their developing or emerging financial markets. The main criticism is aimed at the rather abstract provisions of the Core Principles of the Basel Committee. Applying and specifying them requires considerable knowledge and supervisory resources. In addition, the Core Principles try to utilize the knowledge of large banks to assess minimum capital requirements, as they are at least partly based on the banks' own credit risk models. Given the complexity of global banks, it seems pragmatic to shift the burden of developing appropriate credit risk models to those who possess the respective knowledge. Yet, it seems imprudent to put the fox in charge of the henhouse, which implies that regulators and supervisors must be able to understand and control the banks' own credit risk models. This monitoring task threatens to overburden regulatory and supervisory authorities, in general, and those from DCs, in particular. In addition, the Core Principles follow the principle-based regulatory model, while it appears that clear and simple rules would be more suitable for DCs. Yet, it is unclear whether the treaty language would allow deviations from internationally agreed standards if it shows that they are unsuitable for DCs. Such an understanding could be based on the fact that the parties' obligation to implement and apply these standards is subject to the "best endeavour" qualification. "Best endeavour" would not refer to procedural limitations that might delay the process of implementing these standards, like limited resources, but add a substantial element: if states have tried to implement these standards but in the process of doing so realize that they do not promote effective regulation and supervision of their financial markets, they have made their "best endeavours". This interpretation has yet to be confirmed and given the scope of possible interpretations, it would be more sensible to exchange "best endeavour" for "to the extent practicable" or other language that would obviously allow for a

consideration of whether the agreed standards are actually feasible for the financial markets of DCs.

In addition, neither the CEPA nor the EU-Chile FTA clarifies which standards must be considered as “internationally agreed” upon. At first, the language implies that the standards do not have to be internationally binding because the term “agreement” just means some form of consent, but not one that is backed up by the force of law. Thus, Organisation for Economic Co-operation and Development (OECD) standards, those of the International Organization of Securities Commissions (IOSC) or the Basel Committee’s Core Principles for Effective Banking Supervision, which are not legally binding, would qualify as being relevant standards if they are “internationally” agreed upon. The term “internationally” suggests that an unspecified number of states or their institutions must participate in formulating these standards. Disagreement will most certainly arise with regard to the number of states that have participated in or have had the chance to participate in the related discussions.

A literal understanding would even include bilateral agreements, as they have been concluded between two states. This, however, would lead to absurd results because common standards between the US and Canada would be quasi-binding on the parties of the CEPA. The drafting history of the CEPA at least indicates that Article 105(4) of the treaty includes standards of organizations to which CARIFORUM states are not a party, because an earlier draft referred to standards “under agreements to which they are parties”.¹¹⁸ Changing the language arguably implies that standards are still internationally agreed upon within the meaning of Article 105(4) CEPA if not all CEPA states had participated in drafting them. This, however, does not rule out the requirement that those states must at least have had a chance of doing so. Such an interpretation would correspond to Article VI:5 GATS. This refers to international standards for assessing whether a member has complied with the licensing requirements set out in Article VI:4 GATS until the WTO has introduced its own disciplines. Applicable are the international standards of the “relevant international organizations”; defined in footnote 3 as “international bodies whose membership is open to the relevant bodies of at least all Members of the WTO”. This would exclude organizations that limit their membership to a certain group or number of states or their relevant bodies respectively, like the Basel Committee on Banking Supervision¹¹⁹ or the OECD.¹²⁰ Such an interpretation would ensure that states are only bound by standards that they have been able to influence, that is, by actually participating in the underlying process. Not participating in formulating these standards, even if they could have, would not render these standards as ‘non-international’ within the meaning of Article 105(4) CEPA or Article 123(4) EU-Chile FTA.

Even if this interpretation is a reasonable construction of the relevant FTA provisions, especially in light of safeguarding their parties’ autonomy, it is not the only reasonable interpretation possible. The language of the GATS is quite different to that of the CEPA and the EU-Chile FTA, as the former refers to and then defines “relevant international organizations”, whereas the latter are silent in this regard. “Internationally” could therefore also be understood as standards that are applied and agreed upon by the economically most relevant states, including states from all continents or regions. Such an interpretation would arguably cover standards formulated by the Basel Committee, but still exclude those of the OECD.

As there is more than just one ‘correct’ interpretation of what internationally agreed standards would be, and as the parties have to make their “best endeavours” to implement these standards, it seems preferable to either include a list of relevant standards or at least specify what organizations are covered by this term. If the parties fear that such an approach would limit their ability to consider future

¹¹⁸ See Schloemann/Pitschas, *Regulatory Edge*, 25.

¹¹⁹ Membership in the Committee is not open to all WTO members. It was set up by the G10 and only in April 2009 were new representatives from the G20 invited. The Committee is currently comprised of representatives from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. For details on the Basel Committee see Rost, in: Tietje/Brouder (eds.), *Handbook of Transnational Economic Governance Regimes*, 319 et seq.

¹²⁰ OECD standards do not qualify for the same reason as those of the Basel Committee: notwithstanding the recent enlargement process, membership is not open to all WTO members.

standards by organizations or institutions that do not yet exist, it would be sensible to allow the parties to actually determine in a suitable setting what standards should be included on a case by case basis. The EU-Chile FTA, for example, would appear to provide such a setting as it establishes the Special Committee on Financial Services (Article 127 EU-Chile FTA). Its functions include supervising the implementation of financial services liberalization and any other issue referred to it by the parties. One of these referred issues is the cooperation and exchange of information and experience with regard to internationally agreed standards. Yet, it remains to be seen whether this Committee will be used as a forum to decide upon which standards qualify as being “internationally agreed” or to discuss the appropriateness of these standards for DCs.

4.2.2.5 Substantial Rules on Regulation – GATS-like Provisions

Article VI GATS imposes not only procedural, but also substantial obligations concerning domestic regulations.¹²¹ In sectors where WTO members have undertaken specific commitments, general measures that affect trade in services must be administered in a reasonable, objective and impartial manner (Art. VI:1 GATS). These principle-like agreements are supplemented by Article VI:4 and 5 GATS, which address the conflict between the right to regulate and removing obstacles to effective market access based on national regulation/overregulation. In order to prevent measures relating to qualification requirements and procedures and technical standards and licensing requirements from constituting “unnecessary barriers to trade in services”, the Council for Trade in Services is assigned with developing disciplines, thereby limiting a state’s right to regulate. Until such disciplines are introduced, WTO members must still observe the requirements listed in Article VI:4(a)-(c) GATS. Thus, qualifications and licensing requirements must be:

- based on objective and transparent criteria;
- not more burdensome than necessary to ensure the quality of the service; or
- in the case of licensing procedures, not in themselves a restriction on the supply of the service.

Special attention has been drawn to the possible negative effects of the necessity test on the independence of DCs to determine their domestic regulatory prerogatives.¹²² And even though all FTAs (except the CEPA) contain provisions similar to Article VI GATS, none of these has incorporated or been made applicable to trade in financial services.¹²³ Thus, all FTAs impose less stringent obligations than the GATS, with the result that the criticism concerning the necessity test and other constraints on a state’s possibility to determine its domestic regulation does not apply to FTAs.

The only exception that must be mentioned is Article 12.12(2) US-Peru FTA, which contains a provision that is identical to Article VI:1 GATS. All measures of general application concerning financial services must be administered in a reasonable, objective, and impartial manner. Whereas the latter two requirements are not that contested, there is some dispute regarding the understanding of the word “reasonable” and its practical consequences. In its strongest form, reasonableness implies some form of a proportionality test, which can result in the exercise of full scrutiny by dispute settlement bodies charged with balancing the conflict of interest between ensuring effective market access and maintaining the right to regulate.¹²⁴ In its weakest form, however, the test of reasonableness is based on generally accepted standards of rationality and sound judgment.¹²⁵ Based on the language of Article 12.11(2) US-Peru FTA and Article VI:1 GATS (using the term “reasonable”, not “necessary” or “appropriate”), one must conclude that dispute settlement bodies should at least not employ full

¹²¹ Matsushita/Schoenbaum/Mavroidis, *The World Trade Organization*, 627.

¹²² UNCTAD, *Service, Development and Trade*, para. 70. It has been pointed out that the current draft of the Working Party on Domestic Regulation does not include a necessity test anymore; Krajewski in: Wolfrum/Stoll/Feinäugle, *Article VI GATS*, para. 52. But critics have pointed out that the draft still includes terms that suggest a comparable standard like the necessity test; see South Centre, *The Draft GATS Domestic Regulation Disciplines – Potential Conflicts with Developing Country Regulations*, SC/AN/TDP/SV/12, Oct. 2009, 3-4.

¹²³ See Article 95(2)(a) EU-Chile FTA and Article 12.2 US-Peru FTA, which does not include Article 11.7. Similarly, Article 11.1(2) Singapore-Panama FTA does not refer to Article 10.9. Yet, this clarity is somewhat obscured by Article 10.10(1) and (2) that list Art. 10.9 as one of the provisions that do not apply to non-conforming and future measures – a curious exemption given the fact that 10.9 has not been incorporated into Chapter 11 anyway.

¹²⁴ Trachtman, *Negotiations on Domestic Regulation*, in: Petersmann, 211.

¹²⁵ Krajewski in: Wolfrum/Stoll/Feinäugle, *Article VI GATS*, para. 11.

judicial review, but concede that states enjoy a considerable amount of discretion. And even though there has been no decision clarifying the exact meaning of the term “reasonable” in Article 12.11(2) US-Peru FTA or Article VI:1 GATS, existing WTO jurisprudence interprets it in Article X:3 GATT, which indicates a less stringent interpretation.¹²⁶ Therefore, even the US-Peru FTA does not provide a necessity test when it comes to domestic regulation in the field of financial services.

Although none of the FTAs introduces obligations identical or similar to Article VI:5 GATS with regard to trade in financial services, it is still possible that this assumed development-friendly approach does not have the practical relevance hoped for. ‘GATS-minus’ provisions in FTAs are irrelevant if the FTA parties are at the same time WTO members, and thus bound by the more stringent GATS provisions. This is generally true for Chile and all CARIFORUM states, except The Bahamas, which is not yet a WTO member. That the GATS-minus obligations might not have any effect is, however, mitigated in cases like Article VI:5 GATS, in which the relevant GATS provision requires that special commitments have been made under the GATS. Thus, Chile and the CARIFORUM states must observe the GATS Article VI: 5 obligations in case they have accepted special commitments under GATS with regard to financial services. In that case both treaties, the FTA and the GATS, apply at the same time and DCs are arguably bound by the more stringent GATS provision because the two treaties do not conflict with each other. When negotiating new FTAs, DCs must therefore pay careful attention to whether the ‘GATS-minus’ provisions that are assumed to be development-friendly have any practical consequences. It might therefore be more prudent from a development perspective to agree on specific technical assistance or other programs that help to establish effective regulation and supervision in the long run. This is because economic analysis has shown that these are in any case necessary requirements for economically successful liberalization.

4.2.3 New Financial Services

4.2.3.1 Introduction

All the FTAs considered in this study follow the NAFTA approach by including a provision dealing with the admission of new financial services. They thus contain a ‘GATS-plus’ obligation because neither the GATS nor the legally binding Annexes address the issue of new financial services. These are only briefly mentioned in B(7) GATS Understanding, but the provisions of the Understanding are only binding to the extent that WTO members refer to them in their schedules.¹²⁷

The aim of these provisions is to facilitate innovation in the financial services sector, assuming that these innovations would make financial markets more sophisticated and enhance diversity, thereby increasing economic as well as financial market stability. In the aftermath of the global financial crisis and the later economic crisis, it has been argued that new financial instruments, like credit default swaps (CDS) or asset backed securities (ABS), either caused or were at least a major factor responsible for turning the US subprime crisis into a full-blown global financial crisis. Critics thus argue that the unrestricted admission of such new financial instruments could have a detrimental effect on the local economy in the absence of proper regulation¹²⁸ and might endanger the stability of the financial market.¹²⁹ No matter how persuasive such criticism may appear at an abstract level, it is necessary to look into the obligations of DCs regarding new financial services in more detail before assessing the possible impact of these provisions and providing possible solutions.

4.2.3.2 What are New Financial Services?

While the US-style FTAs copy the NAFTA definition of new financial services, the EU FTAs replicate the definition included in the GATS Understanding. Even though both definitions differ to a certain

¹²⁶ Panel Report, Dominican Republic – Import and Sale of Cigarettes, WT/DS302/R, paras. 7.385.

¹²⁷ Thus far, most DCs that have accepted specific commitments with regard to financial services in their schedules have still not incorporated the GATS Understanding. It has therefore not had any notable practical significance within the WTO legal order to date.

¹²⁸ Smith, EPA Provisions, Trade Negotiations Insights, 4/2009, 10; TWN, EU EPAs, 28.

¹²⁹ ILEAP, African Financial Services Trade and Negotiations, 15.

extent, such differences are unlikely to be of great practical relevance. In order to be ‘new’ the financial service must be provided in the territory of the home state but not within the territory of the host state. In addition, the definition does not only include the selling of products not sold in the host state’s territory (hence, ‘new’ financial product), but also any new form of delivery related to existing and new products.¹³⁰ New financial services thus include new financial products, delivered in either a new or already existing manner, and already existing products delivered in a new form. An example of the latter is e-banking (if it just replaces the way in which banking services have been supplied so far) or the selling of financial products by telephone (especially insurances) if this form of delivery has not yet been used within the host country’s territory. New financial products might include the aforementioned CDS, ABS and other forms of derivatives.

This distinction between products and the way in which they are delivered is quite important because states, when accepting certain liberalization commitments, do so with regard to financial products (or services) like lending, money transmission, or guarantees, but not with regard to how these services are delivered. The latter issue is not usually connected to restrictions on market access and national treatment, but determined by domestic regulation.¹³¹ Related restrictions are, therefore, not usually listed in a country’s schedule. As a consequence, including new forms of product delivery in the definition of new financial services does not add to a country’s specific commitments, but imposes restrictions on domestic regulation because states are generally obliged to allow these services, even though they may introduce constraints for consumer protection purposes based on the prudential carve-out. It must, however, be noted that this conclusion is based on the definition of new financial services only and that all treaties, except the GATS Understanding, impose additional requirements for new financial services. These additional requirements apply to all new financial services, which includes new forms of supply. It is thus necessary to analyze these requirements before finally assessing to what extent the provisions on new financial services restrict a country’s ability to regulate new forms of delivery.

4.2.3.3 Market Access or National Treatment?

As indicated, only B(7) GATS Understanding (if included in a country’s schedule) provides for an unbound access of new financial services restrained by just the prudential carve-out. All other FTAs add additional requirements for the admission of new financial services, which can be categorized as follows:

1. NAFTA and NAFTA-like FTAs, such as the US-Peru FTA, the Singapore-Panama FTA, and the rather unusual CEPA.
2. The EU-Chile FTA, which provides for such far-reaching limitations that it is not clear whether it has any practical consequences for the admission of new financial services.

Common to all FTAs is that the parties can determine the juridical form through which the service will be provided and may require prior authorization for the supply of the service. If such authorization is required, a decision must be made within a reasonable length of time and it may only be refused for prudential reasons.

The most important difference between B(7) GATS Understanding and the provisions in NAFTA-like FTAs is that new financial services must only be admitted if the admitting party allows its own financial service suppliers to offer these services under its domestic laws. This requirement seems to alter the character of the obligation. Whereas the GATS Understanding lists new financial services as part of the additional rules on market access, the provisions in the NAFTA-like FTAs also contain national treatment-like requirements:

¹³⁰ Even though the NAFTA and US-style FTAs, in contrast to the GATS and EU FTAs, do not explicitly distinguish between delivery related to existing or new products but include the sale of new financial products and new forms of delivery of any service, it seems reasonable that the new forms of delivery include new and existing products.

¹³¹ Regulating the manner in which financial services are delivered can, of course, be subject to a country’s national treatment obligation if these regulations distinguish between national and foreign banks.

- The provisions on new financial services apply only to services that the relevant party permits its own financial institutions under its domestic laws.
- In addition, the 'like circumstances' requirement that forms an essential part of national treatment provisions like Art. XVII GATS must be satisfied.

Until now, most commentators have neglected the hybrid character of the FTA provisions regarding new financial services, and have not dealt with its practical consequences. The first question that arises is whether states could ban all financial services and forms of delivery that are not explicitly allowed. This would allow DCs, in particular, to control the access of new services and to avoid any negative implications that may be associated with them. Because they do not allow their own service suppliers to provide certain services, they are under no obligation to admit the same new financial services from the suppliers of the other party. Based on the language of the relevant provisions, it would be reasonable to assume that such a measure would not violate the FTA.

It could, however, be argued that a complete service ban is incompatible with the object and purpose of these provisions to allow the admission of financial innovations without lengthy renegotiations of schedules and commitments. In order to support such reasoning one could apply the rationale of the Appellate Body (AB) decision in the case of *U.S. - Gambling*. The AB held that national regulations banning a service completely are not only subject to the national treatment obligation, but have to be evaluated with regard to market access commitments as well.¹³² If states have not listed these regulations as exceptions to their specific market access commitments, they violate the prohibition of quantitative restrictions. It is, however, questionable whether the holding of the AB can be transferred to the admission of new financial services.

The significant difference between the situation in *US - Gambling* and the admission of new financial services is that in the latter case specific commitments have already been made (at least according to the rather creative reasoning of the AB), whereas such commitments are absent in the case of new financial services. The rationale of including these provisions was to avoid renegotiating schedules in times of rapidly changing financial markets. It could thus be argued that the provisions on new financial services replace the list of commitments and actually constitute an independent commitment for new financial services. In that case, the commitment is limited to situations in which the relevant party has or would allow its own financial suppliers to deliver the financial service under its domestic laws. It therefore includes the restriction that was missing in the case of *US - Gambling*. Based on the foregoing arguments, it thus seems reasonable that DCs can actually avoid the automatic or quasi-automatic admission of new financial services if they prohibit these services under their domestic laws. Yet, there has been very little research so far that deals particularly with new financial services provisions in FTAs. In addition, the absence of international arbitral or other decisions that address the interpretation of these provisions is clearly visible. The results, however plausible, are therefore only preliminary and subject to further discussion and research.

Attention should also be paid to the fact that at least the NAFTA and the CEPA, in contrast to the US-Peru and Singapore-Panama FTAs, broaden the scope of application as they do not require that new services must be identical to those permitted for the financial service suppliers of the relevant party under its domestic laws. Instead, the language of Article 1407(1) NAFTA and Article 106 CEPA just requires that the new service is similar to the one that is supplied domestically.

As mentioned above, this analysis does not apply to Article 121 EU-Chile FTA. Instead of making the admission of new financial services dependent on whether they are permitted for national service suppliers under domestic laws, Article 121 EU-Chile FTA determines that the introduction of the new service must not require a new law or the modification of an existing law. The language differs considerably from the NAFTA-like FTAs. It could, however, be argued that the different wording still has the same effect, because changing laws only becomes necessary if the existing laws do not cover or prohibit the supply of a specific new financial service. Commentators, however, suggest that the

¹³² WTO, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Service*, Report of the Appellate Body of 7 April 2005, WT/DS/285/AB/R, para. 214 et seq.

language in the EU-Chile FTA was introduced in order not to infringe upon the freedom of the legislature. New financial services do not have to be admitted if the legislature has to introduce new or change existing laws, though it is the executive that is actually required to change existing or introduce new regulations.¹³³ The EU-Chile NAFTA thus does not provide for a national treatment-like requirement, which in turn also explains the absence of the ‘like circumstances’ requirement in Article 121.

Even though the EU-Chile FTA does not include limitations based on national treatment elements, it incorporates other market access restrictions. New financial services:

- must only be admitted within the scope of the subsectors and financial services included in the admitting country’s schedule; and
- are subject to the terms, limitations, conditions and qualifications of that schedule.

These limitations were introduced to maintain the integrity of the positive list approach and to prevent expansion through automatic and ‘artificial’ financial innovations.¹³⁴ Because new financial services under the EU-Chile FTA are bound to the level of liberalization that has been agreed upon in a country’s schedule, it is unclear what additional effect Article 121 might have. If the liberalization commitments as they are reflected in a country’s schedule cannot be exceeded, it seems as if Article 121 might only be of a declaratory nature. New financial services must already be allowed based on the general market access and national treatment obligation. This conclusion applies at least to new financial products in subsectors not liberalized or restricted by a country’s schedule, but not to new forms of delivery that are usually addressed by domestic regulation. Thus, the parties of the EU-Chile FTA must generally allow new forms of delivery of already existing products, whereas the NAFTA-like FTAs arguably enable the parties to ban them completely for all financial suppliers. The obligation to allow new forms of delivery is, however, restricted by the prudential carve-out, which, as will be shown below, would allow the restriction of these services for reasons of consumer protection.

Even though the EU-Chile FTA follows a distinct approach with regard to new financial services, the meaning of Article 106 CEPA is clarified in a way similar to that of Article 121 EU-Chile FTA. Footnote 24 provides that Article 106 CEPA “applies only to financial services activities covered by Article 103 and liberalized according to this Title.” Especially the last part of the footnote raises interesting questions because it is not clear what constitutes liberalization “according to this Title”.¹³⁵ If a country restricts, for example, liberalization commitments to traditional banking activities, is it still obliged to allow new financial services with regard to other subsectors (e.g. securitization) because it has “liberalized [financial services] according to this Title”? Based on the language used, for instance in Article 69 CEPA, a sector is liberalized if special commitments have been undertaken and if the sector has been listed in a country’s schedule. As states usually do not liberalize whole sectors per se, but limit their commitments to special subsectors, this practice would be undermined if new financial services could be offered in a sector that has not been included in a country’s schedule. In addition, it would seem contradictory if a financial services supplier from another party were to be allowed to offer new financial services in a subsector that has not yet been liberalized, even if it could not offer ‘old’ financial services. Such an interpretation would actually invite financial services suppliers to create artificial new services which in turn could evade a country’s schedule. Footnote 24 must thus be interpreted as restricting the new financial services obligation to subsectors that are part of a country’s specific commitments.

4.2.3.4 New Financial Services and Modes of Supply

If the provisions on new financial services constitute some form of additional commitments outside a country’s schedule (with the exception of the EU-Chile FTA), the next fundamental problem that must be addressed is to which modes of supply these commitments apply. Countries may limit market access and national treatment to different modes of supply in their schedules. This option, however, does not

¹³³ Sáez, Trade in Financial Services in: Haddad/Stephanou (eds.), *Financial Services and Preferential Trade Agreements* (2010), 123, 146.

¹³⁴ *Id.*, at 145

¹³⁵ South Centre, *Legal Analysis of Services and Investment in the CARIFORUM-EC EPA*, 86.

exist if there are no schedules with regard to new financial services. Could a new financial service be supplied by Mode 1 or 2 even though the country has not undertaken any specific obligations with regard to these modes concerning 'old' financial services? Could an EU bank, for example, offer e-banking in the CARIFORUM states without establishing a branch or subsidiary in the host country if e-banking is in principle allowed in these countries?

The answer to this question is not always straightforward. The US-Peru FTA, like B(7) GATS Understanding, specifies that the new financial services provision applies only to suppliers from the other party "established in its territory". Even though this requirement indicates that new financial services commitments are limited to Mode 3 (commercial presence), "established in its territory" could also refer to "financial service suppliers of another Party", which would alter the whole meaning of the requirement. The language of these provisions is thus inconclusive. Yet, Article 121 EU-Chile FTA might contribute to solving this interpretation problem. Like Article 12.6 US-Peru FTA and B(7) GATS Understanding, it obliges the parties to permit the new financial services of "financial service suppliers of the other Party established in its territory". Yet, the provision continues by adding "in its territory". In that case, "its" can logically refer only to the admitting state, but not "the other Party". Thus, comparing B(7) GATS Understanding and the US-Peru FTA with the EU-Chile FTA supports the conclusion that these treaties limit new financial services commitments to Mode 3 supply.

This finding, however, does not directly apply to the NAFTA, the Singapore-Panama FTA and the CEPA because none of the treaties includes an "established in its territory" requirement. Still, all of them provide that a state may determine the institutional and juridical form through which the service must be supplied. This would allow these countries to pass legislation that financial service suppliers from another party must be incorporated under their domestic laws if they want to supply the new financial service. With regard to Article 106 CEPA, it has thus been assumed that states may limit the new financial services provisions to Mode 3.¹³⁶ But this conclusion does not take into account that a company may be incorporated under the laws of one state, even though it has its seat in another state. It depends very much on this other state whether such a company has any legal status under its domestic laws. Even if a financial services supplier is incorporated under the laws of, for example, the Dominican Republic it might have its seat in some other state (depending on the domestic law of that state). This financial service supplier would fulfill the requirements of the CEPA and could thus supply new financial services not only through Mode 3, but also through Mode 1, 2 and 4. This finding may, however, not apply to the CEPA because of the explanatory footnote already mentioned, because it restricts the application to services that have been liberalized under the CEPA. This could be understood as including limitations with regard to the modes of supply as they are included in a country's schedule. If banking services are limited to Mode 3, for example, Mode 1 services are arguably not liberalized.

4.3 Prudential Regulation and Prudential Carve-out

The prudential carve-out exception applies in addition to the general exception provided for in FTAs. Because it does not require that a measure must be 'necessary' or 'not more burdensome than necessary', it demands less stringent requirements in order to justify a measure that infringes upon a member's general or specific commitment. However, the prudential carve-out also includes a limiting factor, as most FTAs require that measures may not be used as a means of avoiding the FTA's commitments or obligations. Even though the exact meaning of this limiting factor is disputed and has not yet been specified by an international court or tribunal, it still ensures that states enjoy a considerable amount of discretion to choose their regulatory approach.

The economic analysis has stressed the importance of prudential regulation for the stability of financial markets and the success of financial sector liberalization. All FTAs take this importance into account by providing a comparably far-reaching exception for restrictions in the name of prudential regulation. This concept is primarily concerned with the safeguard and soundness of individual financial

¹³⁶ Schloeman/Pitschas, *Regulatory Edge*, 26.

institutions, that is, with a view towards protecting consumers and leveling the effects of the asymmetry of information between financial institutions and their customers (micro-prudential approach).¹³⁷ But the financial crises has highlighted that this concept also encompasses the subject of systemic regulation that focuses on the soundness and stability of the overall financial system (macro-prudential approach).

The Basel Committee's Core Principles for Effective Banking Supervision include a comprehensive list of the core principles for prudential regulation, like minimum capital requirements to create a cushion for absorbing losses from credit risks in times of crises, legal lending limits, large exposure limits, requirements for a fit and proper management, as well as incentives to discourage excessive risk-taking.¹³⁸ Though there might be widespread agreement that these principles form part of prudential regulation, neither experts nor states have been able to decide on a consistent and standardized application. This, in turn, leads to the question of whether states may independently determine how these principles are applied. Even though all treaties allow for prudential measures, none of them actually specifies what prudential measures are. However, it is necessary to analyze these provisions in more detail, because the extent to which this exception applies largely determines the autonomy of DCs with respect to their regulatory and supervisory system. To simplify matters, the analysis will use the GATS prudential carve-out as a starting point before focusing on the deviations and alterations within FTAs.

Due to the difficulties associated with determining the content of the prudential carve-out exception, one could assume that the future of prudential regulation lies in mutual recognition agreements, which would render the need to specify the prudential carve-out exception close to superfluous. This section will thus focus on this issue as well, even though the FTAs differ considerably regarding mutual recognition agreements with respect to prudential regulation of financial services: whereas the CEPA emphasizes mutual recognition, all other FTAs include provisions on mutual recognition, but do not apply them to their chapter on financial services.

4.3.1 GATS Prudential Carve-out

According to paragraph 2(a) of the Annex on Financial Services (FSA), “[n]otwithstanding any other provisions of [GATS], a Member shall not be prevented from taking measures for prudential reasons,” which includes, but is not limited to, measures “for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system.” Thus paragraph 2(a) FSA, in contrast to Article XIV (general exception) and Article VI:5 GATS (domestic regulation), does not require an objective necessity test.¹³⁹ The prudential carve-out exception appears to be more flexible, especially because it lacks detailed standards and limitations that enable WTO members (and panels) to determine its scope and meaning.¹⁴⁰

In order to specify the prudential carve-out's scope of application, it is necessary to concentrate on the second sentence of paragraph 2(a) FSA. According to this sentence, prudential measures that do not conform to the provisions of the GATS are prohibited when “used as a means of avoiding the Member's commitments or obligations”.¹⁴¹ However, the relevance of this sentence and its impact on the prudential carve-out exception in sentence 1 are disputed among WTO members.¹⁴² Malaysia, for example, has strongly emphasized that there is no flexibility in limiting the prudential carve-out exception and is supported by Japan which has also warned against such steps.¹⁴³ The EU, in contrast,

¹³⁷ Yokoi-Arai, GATS' Prudential Carve-Out, ICLQ 57 (2008), 631.

¹³⁸ *Id.*, 632 et seq.

¹³⁹ Key, Doha Round and Financial Services, 25; de Meester, Testing European Prudential Conditions, JIEL 2008,644.

¹⁴⁰ Wang, The Prudential Carve-Out in: Alexander/Andenas, 604.

¹⁴¹ v. Bogdandy/Windsor in: Wolfrum/Stoll/Feinäugle, Annex on Financial Services, para. 23.

¹⁴² Within the current literature, the effect of the second sentence has been described as making the scope and meaning of the prudential carve-out exception “elusive”; Wang, Prudential Carve-Out, in: Alexander/Andenas, 603.

¹⁴³ Malaysia, Council for Trade in Services, Special Session, Report of the meeting held on 3-6 Dec, 2001 (S/CSS/M/13, 26 Feb 2002), para. 275.

is more concerned that states might utilize the prudential carve-out exception as a means to circumvent previous commitments on market access and national treatment.

The meaning of the second sentence and its impact on the prudential carve-out exception might become decisive in cases in which prudential measures discriminate between national and foreign financial institutions. Given the current discussion on minimum capital requirements, it does not seem far-fetched for a regulatory authority to assume that the systemic risks originating from internationally active banks could be more effectively controlled by requiring these to hold a higher minimum capital than banks whose operations are restricted to just the domestic market. Assuming that prudential measures do not conform to international standards for banking supervision, the question might arise whether this requirement has been solely introduced to “avoid the Member’s commitments and obligations” or is applied in such a way.

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

Even though sentence 2 operates as a restriction on the prudential carve-out exception, the exact scope of this limitation is unclear. It has been suggested that sentence 2 of paragraph 2(a) FSA serves the same function as the *chapeau* of Article XX GATT.¹⁴⁴ Based on the interpretation given to the *chapeau* by the Appellate Body in *US -Shrimp*, sentence 2 would serve as a specification of the more general principle of good faith, which in turn leads to the ‘abuse of rights’ doctrine.¹⁴⁵ As a consequence, sentence 2 would require an assessment of whether by introducing a prudential measure a state has abused its right to do so. Such an assessment would, in turn, involve the balancing of rights and interests. As the AB approach in *US - Shrimp* has been interpreted as an implementation of the proportionality principle, transferring this jurisprudence to paragraph 2(a) FSA would grant panels and the AB considerable discretion and power in any dispute to determine whether or not a prudential measure corresponds to the member’s GATS obligations.

It is already questionable whether such influence on the part of a panel or the AB is desirable. The more persuasive legal argument, however, is based on the different language used in paragraph 2(a) FSA, on the one hand, and in Article XX GATT, on the other. Article XX GATT measures amounting to “arbitrary or unjustifiable discrimination between countries where the same conditions prevail” or “disguised restriction on international trade” cannot be justified even if the requirements set out in Article XX lit. a) - j) GATT are fulfilled. In contrast, sentence 2 of paragraph 2(a) FSA does not refer to means that constitute either “arbitrary or unjustifiable discrimination” or a “disguised restriction on international trade”. Instead, the language refers to measures used as a means “of avoiding the Member’s commitments or obligations”.

The phrase “means of avoiding” could be understood as to require some form of intention.¹⁴⁶ Only if states intentionally aim to avoid their commitments, prudential measures cannot be justified. However,

¹⁴⁴ v. Bogdandy/Windsor in: Wolfrum/Stoll/Feinäugle, Annex on Financial Services, para. 23.

¹⁴⁵ Appellate Body Report, United States — Import Prohibition of Certain Shrimp and Shrimp Products, WT/DS58/AB/R, para. 158.

¹⁴⁶ Trachtman, Trade in Financial Services, Col. J. Tran’l L 34 (1996), 72.

this interpretation must still rely on observable criteria as well, as states usually do not reveal their intention to avoid their GATS commitments. Others suggest determining the prudential character of a measure by applying the Basel and other international standards.¹⁴⁷ The standards would serve as an interpretation tool to determine the ordinary meaning of ‘prudential’, like with using a dictionary.¹⁴⁸ But equating the long list of core principles and their methodology published by the Basel Committee with a short entry on the meaning of ‘prudential’ in a dictionary is quite far-fetched. Such a step would also neglect the many legitimacy issues raised, especially in view of the Basel Core Principles. In addition, these standards might not be suitable for all members. The Basel II Accord, for example, aims to enhance the safety and soundness of internationally active banks and to promote competitive equality among banks from different countries (in an international market). But countries with just emerging and/or closed financial markets face different problems than those whose problems Basel II tries to solve. Lastly, it must be observed that the GATS is based on regulatory diversity. Any attempt to standardize prudential measures that are justified under paragraph 2(a) of the FSA fails to acknowledge that there might be more than one way of achieving the desired outcome. Thus, as long as WTO members adopt regulatory or supervisory measures in accordance with international standards, a WTO panel or the AB must accept them as being prudential. But these standards are only examples. Therefore, even if a measure is not covered by these standards, it can still qualify as being prudential.

As the GATS preamble acknowledges members’ right to regulate, they enjoy a high level of discretion in determining their prudential measures. This high level of discretion must be observed by panels and the Appellate Body as well. This implies that when reviewing measures that a member has qualified as being prudential, the dispute settlement body is limited to examining a possible misuse of discretion, which in turn limits the level of judicial review. Thus, the assessment of whether or not a measure avoids a member’s GATS commitment cannot be based on the purely/primarily protectionist effect of that measure. In addition, it should be mentioned that so far most commentators have agreed that disputes concerning the legality of prudential measures are very unlikely to occur within the WTO dispute settlement system.¹⁴⁹

4.3.2 FTAs Prudential Carve-out

As already pointed out, all FTAs contain a prudential carve-out exception similar to the one in paragraph 2(a) of the FSA. Notwithstanding this apparent resemblance, however, it should be noted that differences beyond minor deviations exist.¹⁵⁰ It is thus possible that a prudential measure that is not justified under the FSA might fulfill the requirements set out in the FTAs or the other way around.

This is especially true for the prudential carve-out exception contained in Article 104 CEPA. Compared to the GATS and most other FTAs, the provision extends the possibility to justify limitations on the specific commitments based on the prudential carve-out exception, because it does not add the counter-exception contained in paragraph 2(a) FSA. Whereas measures that do not conform to the GATS “shall not be used as a means of avoiding the Member's commitments or obligations”, such a limitation on prudential measures has not been included in the CEPA. Thus, from a legal point of view, the CEPA allows states extensive freedom to adopt prudential measures, even though this freedom is not unrestricted: the measure must still be prudential.

¹⁴⁷ Switzerland, in particular, has recommended “the increased use of the standards developed in the relevant international forums (the Basel Committee, the International Association of Insurance Supervisors, the International Organization of Securities Commissions and the Joint Forum on Financial Conglomerates).” see Communication from Switzerland, WTO Doc. S/CSS/W/71, 4 May 2001, para. 19.

¹⁴⁸ De Meester, *Testing European Prudential Conditions*, JIEL 2008, 645.

¹⁴⁹ Yokoi-Arai, ICLQ 57 (2008), 640 refers to the fact that “the community of international financial regulators is close-knit, and instituting dispute settlement procedures is a very confrontational step which therefore seems to be unlikely”; similarly, von Bogdandy/Windsor in: Wolfrum/Stoll/Feinäugle, *Annex on Financial Services*, para. 24.

¹⁵⁰ Compared to the FSA, most FTAs add, “the maintenance of the safety, soundness, integrity or financial responsibility of financial services suppliers” as a legitimate objective for adopting or maintaining prudential measures. Even though specifying the exact scope of the prudential carve-out exception might enhance legal certainty, it seems to have no immediate practical significance that such aims are not mentioned in the FSA, as all measures based on ensuring “the safety, soundness, integrity or financial responsibility of financial service suppliers” also aim at the “protection of investors, depositors, financial market participants, policy-holders, or persons to whom a fiduciary duty is owed by a financial services supplier.”

The only other agreement that does not add a counter-exception comparable or identical to paragraph 2(a) FSA is the NAFTA. But in contrast to the CEPA, the measures adopted for prudential reasons on the basis of Article 1410(1) NAFTA must fulfill a reasonableness requirement. Only reasonable measures meet the prudential carve-out exception. So far, NAFTA arbitral tribunals have not been required to interpret Article 1410(1) NAFTA, but it is obvious that the term “reasonable” was included to prevent the parties from abusing the prudential carve-out exception.¹⁵¹ Given the identical object and purpose, it thus seems plausible that the scope of the prudential carve-out exception of the NAFTA is identical to that in paragraph 2(a) FSA and in Article 12.10(1) US – Peru FTA.¹⁵²

4.3.3 Mutual Recognition of Prudential Measures

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

4.3.3.1 Mutual Recognition and Financial Services

Mutual recognition is characterized by the principle of substitute compliance: it is the home, not the host state that will supervise the branches of its financial institutions abroad. The possibility to conclude such mutual recognition agreements is stipulated in paragraph 3 FSA, Article 10.10 Singapore-Panama FTA, Article 103 EU-Chile FTA, Article 85 CEPA and Annex 11-B US-Peru FTA. Yet, only paragraph 3 FSA and the CEPA provision apply to all services including financial ones. The provisions of the Singapore-Panama, EU-Chile and US-Peru FTAs have not been incorporated into the respective chapters for financial services.

The requirements of paragraph 3 FSA for mutual recognition agreements on financial services largely mirror those of Article VII GATS that apply to services in general. The most important one is that other WTO members must have the possibility to negotiate their accession to such mutual recognition agreements or to negotiate comparable ones, including “equivalent regulation, oversight, implementation, and, if appropriate, procedures concerning the sharing of information between the parties”. Thus, the GATS just generally allows to conclude such agreements if certain procedural and substantial requirements are fulfilled, but does not advocate them as a meaningful tool for specifying what makes a regulatory or supervisory measure prudential. It is thus categorically different from Article 85 CEPA, which establishes a quite ambitious timeframe for concluding mutual recognition agreements.¹⁵³ Yet, according to Article 85(3) CEPA, the focus of these agreements will be on accounting, architecture, engineering and tourism. Even though this list is not intended to be conclusive, it illustrates the emphasis of the CEPA parties. It is therefore rather unlikely that the concept of prudential regulation will be clarified through a mutual recognition agreement binding all the CEPA parties. If, however, negotiations should start, the CARIFORUM states should pay close attention in order to safeguard their interests.

4.3.3.2 Appropriateness of Mutual Recognition

That mutual recognition agreements are not merely a theoretical possibility to deal with the problem of prudential regulation is evidenced by the EU-US negotiations on a framework agreement for allowing the mutual recognition of prudential measures regarding securities.¹⁵⁴ The EU has also gathered extensive experience on mutual recognition with its efforts to establish a common market for financial services. But, as all countries, developing and developed alike, consider banking as an essential channel

¹⁵¹ Schaefer, *International Trade in Financial Services*, 232.

¹⁵² See Pangourias, *Banking Regulation*, 62, note 209.

¹⁵³ See Schloema/Pitschas, *Regulatory Edge*, 8 *et seq.* for details.

¹⁵⁴ See generally Tafara/Peterson, *A Blueprint for Cross-Border Access to U.S. Investors*, *Harvard International Law Journal* 48 (2007), 31-48.

of economic development and prudential measures as “a sacred sovereign right of the nation”,¹⁵⁵ mutual recognition agreements within the banking sector are less likely.

Apart from these more general considerations, it is also questionable whether mutual recognition is a meaningful tool for DCs. Mutual recognition, for one, presupposes a high degree of similarity in supervision powers and enforcement philosophy between the parties, which in turn requires a functioning system of regulatory authorities, know-how and personnel. In addition, mutual recognition agreements between developed and DCs might be rather ‘one-sided’. Most DCs do not have a strong and competitive domestic financial sector. The activities of private institutions, where they exist, are usually limited to the domestic or maybe regional markets, but do not spread to the financial markets of developed countries (this might be different in the case of emerging market economies with a growing financial sector). Thus, mutual recognition would mostly benefit institutions from developed countries, at least in cases in which adhering to home state regulations has a positive impact on transaction costs that outweighs the possible gains from taking advantage of existing regulatory and/or supervisory arbitrage.

4.4 FTA – GATS Relationship

As regards the so-called ‘GATS-minus’ obligation in FTAs, the question arises whether this has any practical relevance if the relevant states are both WTO members. If both treaties apply at the same time, the more stringent GATS standard might be binding irrespective of the less comprehensive FTA. Development-friendly GATS-minus provisions included to acknowledge a DC’s level of development might thus be ineffective.

Yet, none of the FTAs clarifies the relationship with the GATS at a substantial level, which in turn leads to the parallel application of both treaties as long as they do not conflict with each other. But as GATS-minus obligations usually amount to nothing else than a treaty inconsistency, conflicts in the sense that one treaty requires a state to act in a manner inconsistent with another treaty usually do not exist. The notable exception to this conclusion is the NAFTA, which determines that “in the event of any inconsistency ... this Agreement shall prevail to the extent of the inconsistency” (Article 103(2) NAFTA). Even though it is highly questionable whether this or a similar provision will be applied by a panel or the AB,¹⁵⁶ it still evidences the will of the parties to give priority to the NAFTA. Such a provision might thus be useful in the case of GATS-minus obligations, which might be leveled by the parallel application of the GATS.

5. Bilateral and Plurilateral Investment Treaties

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

Liberalization and deregulation of financial services might also be subject to legal principles and rules of international investment protection law. International investment protection is provided for by more than 2,600 Bilateral Investment Treaties (BITs) and some plurilateral treaties, such as the Energy

¹⁵⁵ Treves, *Monetary Sovereignty Today*, in: Giovanoli, 118.

¹⁵⁶ The problem of whether non-WTO law might be applied by a WTO Panel or the AB is highly contested; for a summary of arguments see Marceau, *A Call for Coherence*, *JWT* 33 (1999), 87 *et seq.* and Bartels, *Applicable Law*, *JWT* 35 (2001), 499.

Charter Treaty (ECT) and Chapter 11 of the NAFTA. Besides the quite far-reaching and substantial protection for investors provided for under these treaties, probably the most important feature of contemporary international investment law is the extensive possibility of investors to directly sue host states for alleged violation of the aforementioned treaties.¹⁵⁷ To date, there have been more than 300 known investor-state arbitrations, either pending or concluded. With regard to the effects of investment protection provisions in respective treaties on issues of financial sector liberalization and regulation, one may differentiate between provisions explicitly referring to financial services and the application of the so-called ‘general treatment standards’ of international investment law.

Explicit reference to financial services is made – in accordance with the long-standing practice of respective FTAs – in the BITs of Canada and the US. The more or less similar provisions on financial services made in the BITs of Canada¹⁵⁸ and the US¹⁵⁹ with third countries have the same structure: first, they provide for a general exception for “measures relating to financial services for prudential reasons, including for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system”.¹⁶⁰ Second, a similar non-application of the treaty is provided for with regard to “monetary and related credit policies or exchange rate policies”; this, however, does not affect the freedom of capital and related transfer, and the general prohibition of so-called ‘performance requirements’.¹⁶¹ Third, with regard to disputes which might occur concerning the mentioned provisions on financial services, a special dispute settlement procedure is provided for in the BIT. This special procedure essentially provides for a ‘financial services veto’ for the two competent financial authorities of both state parties to the BIT. By way of such a financial services veto – a mechanism that is also applied with regard to tax matters (tax veto)¹⁶² – the competent authorities have the possibility to exclude the application of the BIT based on a mutual decision that the subject matter of the dispute is a prudential or monetary/exchange rate measure.

Even though it thus seems that the US and Canadian BIT practice provides for quite far-reaching exceptions for prudential and monetary/exchange rate measures, it is important to note that the US Model BIT stipulates, in addition to the already quoted sentence on the possibility for prudential measures, that “[w]here such measures do not conform with the provision of this Treaty, they shall not be used as a means of avoiding the Party’s commitments of obligations under this Treaty”.¹⁶³ This restriction on the possibility of a contracting state to enact and apply prudential measures is highly controversial; some lawyers argue that it is actually “self-canceling”, or at least “creates a burden of proof in favour of the investor and against the government”.¹⁶⁴ This opinion, however, disregards the financial services veto mentioned, which gives the competent authorities the possibility to issue a decision on the disputed prudential measure that is binding for an arbitral tribunal.

Explicit provisions on prudential and similar measures are only known in the model BITs of a North American style. The European BIT approach is different. Just as with regard to tax measures, European BITs do not contain any specific provisions on prudential or related measures. Regulatory measures affecting the financial market are thus subject to the protection against expropriation and the so-called ‘treatment standards’ of the more than 1,000 BITs that have been concluded by EU Member States

¹⁵⁷ For an overview on investment arbitration and further details see, for example, the contributions in Tietje (ed.), *International Investment Protection and Arbitration*.

¹⁵⁸ See, for example, Art. XI Agreement between the Government of Canada and the Government of the Republic of Ecuador for the Promotion and Reciprocal Protection of Investments, 29 April 1996.

¹⁵⁹ See Art. 20 US Model Treaty (2004) Concerning the Encouragement and Reciprocal Protection of Investment.

¹⁶⁰ Art. 20 (1) US Model BIT. The US Model BITs defines “that the term ‘prudential reasons’ includes the maintenance of the safety, soundness, integrity, or financial responsibility of individual financial institutions”. See footnote 14 to Art. 20 US Model BIT (2004).

¹⁶¹ Art. 7 and 8 US Model BIT.

¹⁶² For details see extensively Kampermann, *Steuersouveränität und internationales Investitionsschutzrecht*, 92 et seq. and passim.

¹⁶³ Art. 20 (1), second sentence of US Model BIT (2004).

¹⁶⁴ *Robert K. Stumberg*, at the Hearing before the Committee of Ways and Means, U.S. House of Representatives on Investment Protection in U.S. Trade and Investment Agreements, One Hundred Eleventh Congress, First Session, May 14, 2009, Serial 111-200; see also Gallagher, *U.S. BITs and financial stability*, *Columbia FDI Perspectives*, Perspectives on topical foreign direct investment issues by the Vale Columbia Center on Sustainable International Investment, No. 19, February 23, 2010.

with third countries. Most important in this regard is the standard of 'fair and equitable treatment'.¹⁶⁵ A notion of what is fair and equitable treatment is obviously broad. It is thus not surprising that financial regulatory measures implemented by governments have already been and are currently being challenged for supposedly violating this guarantee of fair and equitable treatment. In a case that was decided in March 2006, Saluka, a Dutch subsidiary of the Japanese bank Nomura, was awarded US\$181 million, plus US\$55 million in interest, in a claim against the Czech Republic. The tribunal in this case followed the investor in its claim that the Czech Republic acted in violation of the fair and equitable treatment standard when – in the situation of a countrywide banking crisis – it bailed out some Czech banks, but not the one in which Saluka held a stake.¹⁶⁶ In another investment arbitration that is currently pending, certain issues relating to the global financial crisis of 2007/2008 are also under discussion. In the International Centre for Settlement of Investment Disputes (ICSID) case of *Deutsche Bank AG v. Democratic Socialist Republic of Sri Lanka*¹⁶⁷ the claimant argues that the suspension of payments under a derivatives deal between Deutsche Bank and the state-owned Ceylon Petroleum Corporation (CPC) is a violation of the Germany-Sri Lanka BIT. This derivatives deal had been concluded by CPC in an effort to hedge against rising oil prices. However, it started to cause political problems in Sri Lanka once oil prices dropped sharply during the course of the global financial crisis.¹⁶⁸

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

“The stability of the legal and business environment is directly linked to the investor's justified expectations. The Tribunal acknowledges that such expectations are an important element of fair and equitable treatment. At the same time, it is mindful of their limitations. To be protected, the investor's expectations must be legitimate and reasonable at the time when the investor makes the investment. The assessment of the reasonableness or legitimacy must take into account all circumstances, including not only the facts surrounding the investment, but also the political, socioeconomic, cultural and historical conditions prevailing in the host State. In addition, such expectations must arise from the conditions that the State offered the investor and the latter must have relied upon them when deciding to invest.”¹⁶⁹

Finally, even though limitations to state autonomy in the regulation of financial markets may arise out of the investment protection provided for under bilateral and plurilateral investment treaties, international investment law does not provide for rights of market access. With the exception of some US and Canadian BITs, the majority of international investment treaties are restricted to post-entry protection of investment.¹⁷⁰ Thus, international investment law may only affect the regulation, but not liberalization, of financial services.

¹⁶⁵ See, for example, Art. 2 (2) German Model BIT (2008): “Each Contracting State shall in its territory in every case accord investments by investors of the other Contracting State fair and equitable treatment as well as full protection under this Treaty”.

¹⁶⁶ Saluka Investments BV (The Netherlands) v. The Czech Republic, UNCITRAL Arbitration, Partial Award of 17 March 2006.

¹⁶⁷ ICSID Case No. ARB/09/2; for background information see Peterson, IARporter, 2 April 2009.

¹⁶⁸ It is important to note that disputes of this kind are usually settled by commercial arbitration based on provisions of the International Swaps and Derivatives Association (ISDA) Master Agreements.

¹⁶⁹ *Duke Energy Electroquil Partners and Electroquil SA v. Republic of Ecuador*, ICSID Case No. ARB/04/19, Award of 18 August 2008, para. 339 et seq.; *Bayindir Insaat Turizm Ticaret Ve Sanayi A.S. v. Islamic Republic of Pakistan*, ICSID Case No. ARB/03/29, Award of 27 August 2009, para. 179; see also *Saluka Investments BV (The Netherlands) v. The Czech Republic*, UNCITRAL Arbitration, Partial Award of 17 March 2006, para. 305.

¹⁷⁰ For details see Dolzer/Schreuer, *Principles of International Investment Law*, 79 et seq.

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

From a legal perspective, the IMF and the World Bank have few to no options to oblige states to liberalize their financial markets. However, as both organizations play an ever-increasing role in providing development assistance, they enjoy a considerable amount of de facto influence. The much-criticized IMF ‘conditionalities’ seem to be of less immediate importance, as they are based on letters of intent prepared by states wishing to draw upon the Fund’s resources. These letters refer to the outcome of IMF and World Bank programs (e.g. FSAPs and PRSPs) which are used as benchmarks for establishing whether a state should be allowed to start or continue with its drawing. These programs usually require the participation of the state itself. And even though this might be burdensome for the states involved, it is one of the few possibilities that DCs have of ensuring that their policy objectives are taken into account.

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

6.1 IMF Surveillance

IMF surveillance, based on Article IV of the Fund’s Articles of Agreement, was initially restricted to exchange rate policies, but now focuses more generally on the ‘economic situation and economic policy strategy’.¹⁷¹ Irrespective of widespread criticism, the IMF has maintained its broad approach since any constraints, in the Fund’s opinion, run “counter to the demands of the membership...for increasing emphasis on the interactions between macroeconomic, structural and social policies.”¹⁷² Thus, depending on the state in question, the scope of review now also includes interest rates, monetary, fiscal and trade policy, and sometimes the social agenda and other priorities. A surveillance report thus might include suggestions and recommendations with regard to liberalizing a member’s financial markets and trade in financial services. These suggestions might be persuasive because of the force of the analysis or they might influence internal policy debates and add credibility to those who argue along the same lines as the IMF. But the IMF cannot prescribe the conduct of individual states. Thus, even if the subject of financial market liberalization is included in a surveillance report, there is no legal obligation connected to it. However, the possible de facto relevance of such a report should not be underestimated, as it might shape the future relationship between the member and the IMF, and exert real pressure on the state to actually comply with what the Fund proposes.

6.2 Conditionality

The term ‘conditionality’ refers to the concept of ‘stand-by arrangements’ under Article V (3) of the Articles of Agreement, which form the basis for drawings made by member states. It has not yet been settled what legal function the conditions for concluding such a stand-by arrangement (in short, conditionalities) fulfill. Sir Joseph Goldstein has stressed that this term “refers ... to the policies that the Fund wishes to see a member follow in order that it can use the Fund’s resources.”¹⁷³ Even if that accurately describes the legal situation, it still seems safe to assume that “wishes” can be translated into

¹⁷¹ Lowenfeld, *International Economic Law*, 639.

¹⁷² External Evaluation of IMF Surveillance: Report by a Group of Independent Experts, Statement by the Managing Director, at 96, para. 6.

¹⁷³ Gold, *Conditionality*, 2 (IMF Pamphlet Series No. 31. 1979).

“demands” or “requires”.¹⁷⁴ Thus, even if stand-by arrangements are not strictly legally binding on the parties, the conditions set out in these arrangements amount to a de facto obligation, as states that do not comply with the requirements might not be able to continue with their drawing or be able to ‘conclude’ another stand-by arrangement.

As the conditions for stand-by arrangements differ depending on the individual country concerned, and as they are not published by either the IMF or the member state, it cannot be ascertained to what extent states are actually forced to not only liberalize trade in general, but financial services trade in particular, as part of the IMF’s conditionality. However, as stand-by arrangements are based on a letter of intent written by the state that wishes to draw upon the IMF’s resources, this letter can be used as a basis for determining the conditions for the arrangement, especially since the IMF staff is involved in its preparation. But even a very cursory analysis of some letters of intent reveals that most of them refer to other IMF programs as a guideline for the necessary internal reforms. The extent to which the measures that these programs recommend are implemented is therefore a likely benchmark for the IMF when deciding whether a state has met the conditions for a stand-by arrangement and if it may (continue to) draw upon Fund resources. Thus to determine the impact of IMF conditionality on financial market liberalization, it is necessary to analyze the outcome of IMF programs for individual states. Among these relevant programs are the FSAP and the PRSP. Without anticipating the result of such research, it seems reasonable to conclude that states still enjoy some ‘policy space’ because they are involved in preparing the relevant programs. In addition, states may renegotiate the conditions for drawings, even in cases in which they have not met the conditions of the stand-by arrangement. But to efficiently utilize the policy space, states must dedicate considerable resources, such as personnel and money, to conduct the IMF programs.

6.3 Financial Sector Assistance Program (FSAP)

The FSAP – a joint effort between the IMF and the World Bank – aims to strengthen the IMF’s capacity to perform financial sector surveillance and to identify financial sector vulnerabilities.¹⁷⁵ In addition, the program helps to identify financial sector development needs, which in turn can be addressed through IMF-World Bank technical assistance programs. Participation is voluntary, but DCs have usually volunteered for FSAPs because of possible follow-up technical assistance for supervision and financial sector development. The FSAP can thus be characterized as a mechanism for knowledge transfer regarding best practices for legal, regulatory and supervisory standards.¹⁷⁶ In addition, it should be observed that the program is not conducted exclusively by IMF staff. Quite on the contrary: states must commit considerable time and their own staff to prepare the program. Conducting a FSAP is thus burdensome for the DC – something some of these states might criticize. On the other hand, it must be emphasized that this participation is an important factor in influencing the program’s outcome and recommendations. As these might determine the conditions of the stand-by arrangement and the basis according to which compliance is measured, it is essential that DCs utilize their ‘policy space’ at the time such programs are undertaken.

6.4 Poverty Reduction Strategy Paper (PRSP)

PRSPs are the result of a joint collaboration between staff of the IMF, the World Bank and the member state. They seek to develop an agenda of sound economic and social policies that form the basis for successful participation in the Heavily Indebted Poor Country Initiative (HIPC) launched in the mid-1990s.¹⁷⁷ Countries are eligible for debt relief if a number of quite stringent requirements are met. To these requirements belongs the implementation of reforms and policies set out in the PRSP. The impact of a PRSP is thus similar to that of the recommendations made on the basis of a FSAP. Even though it is not legally binding, it can in fact be very important if the IMF uses it as a benchmark for assessing a member state’s eligibility to draw on Fund resources. To what extent this has been the case,

¹⁷⁴ Lowenfeld, *International Economic Law*, 646.

¹⁷⁵ On FSAPs see generally Kupiec, *The IMF-World Bank Financial Sector Assistance Program*, in: Evanoff/Kaufman 69-82.

¹⁷⁶ Kupiec, *id.*, 70.

¹⁷⁷ Lowenfeld, *International Economic Law*, 655.

in particular concerning financial market liberalization, must be determined with regard to the individual country that has participated in devising a PRSP.

7. Summary

In principle, external financial liberalization is a useful step for facilitating economic growth and development. To reject financial services liberalization is not a meaningful response to the possible negative effects of liberalization. Instead, DCs should analyze their domestic economic situation in order to determine which steps and measures must be taken before and while liberalizing financial services. It is, however, important to realize that liberalization does not automatically lead to positive economic results. Its success depends rather on measures taken prior to liberalizing financial markets, and on an ongoing analysis and examination of the constantly changing domestic and international financial markets.

The general political framework for successful liberalization requires stable political conditions, adherence to the rule of law, particularly with respect to property rights, and an efficient means of reducing corruption. Otherwise, capital flows will remain thin, limited to the political establishment, and prone to corruption.

Moreover, financial markets, whether in a developed or developing country, need regulatory and supervisory governmental structures in order to function. Thus, financial services liberalization has to go hand in hand with the introduction and establishment of regulatory and supervisory structures. As to whether in a given situation regulatory and supervisory measures have to be adopted first, before liberalizing the market for financial services, cannot be determined and assessed in abstract terms. This will depend essentially on the general legal situation in a given country. A country with a (relatively) well-functioning legal system in terms of the key essentials of a legal order (property rights, rules on liability, etc.) and an effective judicial system may liberalize its financial markets more quickly, without much risk for market stability, than those countries with problems in this regard. The finer points of 'sequencing' must thus always be determined on a case-by-case basis.

Some basic prudential regulation measures should be adopted before opening up a market to foreign financial services suppliers. As principle-based regulation threatens to overburden inexperienced regulators and supervisors and may allow for too much political discretion, DCs should introduce simple rules of prudential regulation (first of all, capital requirements and leverage restrictions). Moreover, an independent supervisory agency should be established that is also responsible for a timely and reliable disclosure of information on financial services suppliers.

Existing regulations that hamper markets and which are not sufficiently justified by other policy objectives should be abolished. This includes, but is not limited to, interest rate ceilings, credit targets, and use-of-funds regulations. State-ownership of banks should be reduced continuously and confined to those financial services, which cannot or are unlikely to be provided privately. In order to promote incentives and competition, public deposit insurance systems and other means of public support for banks should be limited. Only small and/or poor bank customers should benefit from insurance systems, not sophisticated investors.

When these legal and economic institutions are developed and working effectively, countries should start liberalizing market access for foreign banks with regard to core banking services – in contrast to more advanced services like securitization, these are crucial for basic economic development. The process of liberalization has to be accompanied by easing the restrictions on international capital flows, not only for financial services providers but – since banks tend to follow their customers – for non-financial firms as well. For liberalization to be successful, it is crucial that it starts by allowing the supply

of simple financial products like deposit-taking, lending, payment and money transmission services, financial leasing, guarantees and commitments, and the insurance of standard risks to life and property.

In order to follow these guidelines derived from economic considerations, DCs must be able to actively influence and shape the financial services liberalization process with respect to both timing and the services involved. Whether or not this is possible will depend on political realities, the policy space provided by international law, and the path and stance of economic development and of legal and economic institutions. Furthermore it is important to recognize, as already indicated, that there is no single blueprint for successful liberalization as DCs differ with respect to these dimensions. Gradual differences and the time it may take to address open issues can have an impact on the success of liberalization.

As for the legal perspective, liberalization of financial services can be accomplished through the GATS or at a bilateral or regional level. Most recent FTAs, especially those between DCs and developed countries, include provisions on financial services liberalization. However, DCs should be careful not to treat financial services as a point of leverage in FTA negotiations. Liberalization commitments require that DCs are willing and able to allocate a considerable amount of resources to proper regulation and supervision. Poorly regulated and supervised liberalization might lead to negative impacts on economic growth and financial stability.

As a renegotiation of the GATS is rather unlikely, FTAs theoretically enable the parties to take a more development-friendly approach. However, in a FTA setting, DCs are possibly subject to more direct pressure from the other parties, especially developed countries. DCs must therefore carefully evaluate whether FTAs further their economic interests. The negotiating power of DCs is greater in the multilateral setting of the WTO. In addition, deviations from the GATS might not lead to the anticipated results. So-called 'GATS-minus' obligations, even though binding in the FTA context, are of limited value, especially if the respective parties have also undertaken special commitments under the GATS.

With regard to domestic regulation, the current FTAs impose rather low-level obligations concerning requirements for transparency and the procedures for applications. The obligation to provide for judicial or quasi-judicial review might be more difficult to meet as it presupposes a functioning judicial system. However, DCs should be aware that basic transparency requirements and judicial review form part of the overall political and legal framework that is required for successful financial liberalization anyway.

A need for change arises primarily with regard to the clarity of the language applicable in plurilateral trade agreements. In particular, the provisions on internationally agreed standards in EU FTAs are too ambiguous. It is neither clear what kind of standards these provisions refer to nor what action they require. Even though the soft language of these provisions might benefit DCs as they do not impose specific obligations, it would be preferable to specify their actual meaning. Especially if developed countries would in turn provide technical and financial assistance as well as the know-how for establishing and operating the regulatory and supervisory institutions that will apply and implement these standards. This would help address the capacity building problems that DCs encounter and facilitate regulatory and supervisory stability. However, the treaties should explicitly allow for deviations from these standards if they are not suitable for DCs. In order to institutionalize such decisions, it seems meaningful to either set up or expand the functions of a committee on financial services.

Similarly, the provisions on new financial services are unclear. Even though FTAs, in comparison to the GATS Understanding, restrict their scope of application considerably, it is unclear to which extent states may restrict new financial services without invoking the prudential carve-out. If DCs want to prevent that artificial 'new' financial services are provided in order to circumvent existing restrictions based on their schedules, they should limit their scope to services that national service suppliers are allowed to supply under domestic laws and to Mode 3 supply. In addition, DCs should avoid any language, like in the CEPA, that includes services that are not identical but similar to those allowed under domestic laws. The alternative approach followed by the EU-Chile FTA could have a similar

effect. A country analysis might clarify which of the two is more effective or might have unknown practical side effects.

All FTAs allow states to deviate from their obligations for prudential reasons (prudential carve-out). From a development perspective, the CEPA provision allows DCs the largest policy space to determine their prudential measures. Again, the vagueness of the provision might help DCs to pursue their economic interest if they have the institutional capacity to do so. But it also includes the danger that states adopt measures under the guise of prudential reasons. It would thus be preferable if states could agree on a more specific definition; one allowing for enough leeway to react to financial or economic crisis. However, all attempts to specify the content of the prudential carve-out have been unsuccessful so far. Nevertheless, as the prudential carve-out exception is central to understanding the exact scope of liberalization commitments, it might be a sensible compromise to agree on an interpretation that takes into account the specific interests of DCs. In addition, DCs could link their consent to more specific commitments regarding financial and technical assistance by developed countries.

On a broader level, DCs should also pay close attention that their FTA obligations are coherent with other obligations, especially those agreed under BITs. Even though the economic analysis is still inconclusive as to whether restrictions on capital transfers in times of crisis are a sensible measure for ensuring financial and economic stability, treaties should at least allow for such measures. Otherwise states could not resort to them even if additional research were to demonstrate their usefulness. Restrictions on capital transfers could be justified on the basis of the prudential carve-out. It is, however, uncertain whether the prudential carve-out applies to restrictions on all capital transfers and not only to those of financial services suppliers. And even if it does, BITs usually allow for the free transfer of capital without providing for a prudential carve-out. While being justified under the relevant provisions of FTAs, regulatory measures might violate provisions in BITs. In order to achieve coherence between FTAs and BITs it might be meaningful to include investment chapters in FTAs and make a rule-based, non-discretionary prudential carve-out provision applicable to them.

To conclude: the focus of this study is on FTAs and other related agreements under international economic law. FTAs are a viable alternative to the GATS for financial services liberalization. They provide for a flexible set of rules that allows DCs to gradually liberalize their financial markets. Yet, not all provisions take sufficiently into account the interests and needs of DCs. As the success of liberalization depends on a well-functioning domestic legal order and on sound regulatory and supervisory institutions, DCs should bargain for more specific technical and financial assistance that would allow them to overcome the problem of restricted resources and capacities.

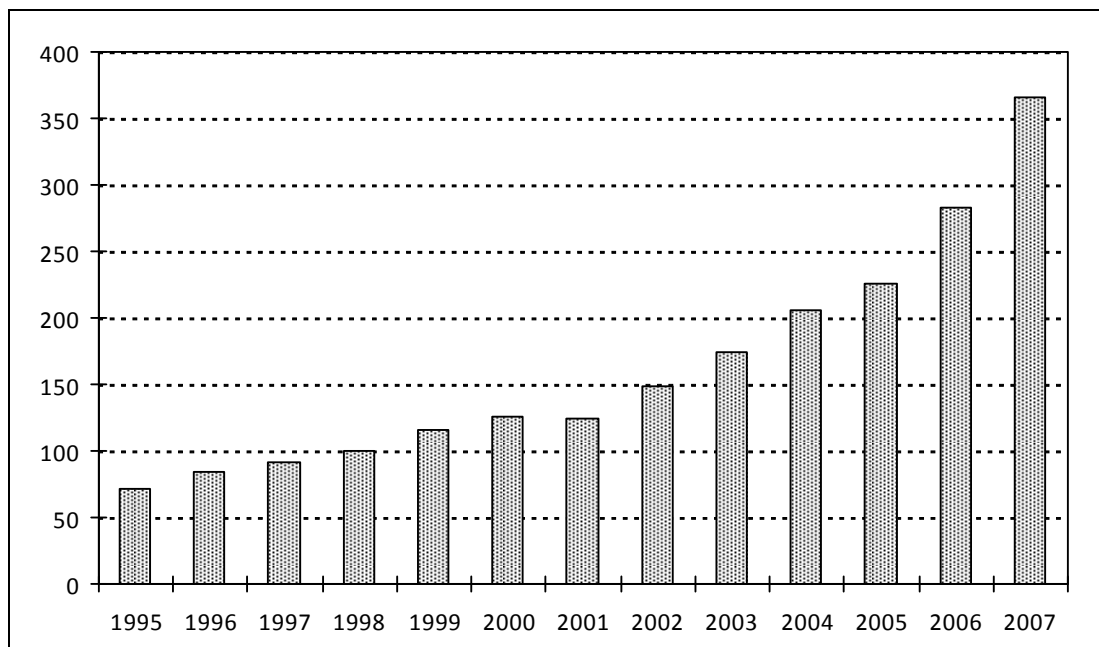
Annex I: Tables and Figures

Table 1: Foreign bank ownership, by region

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

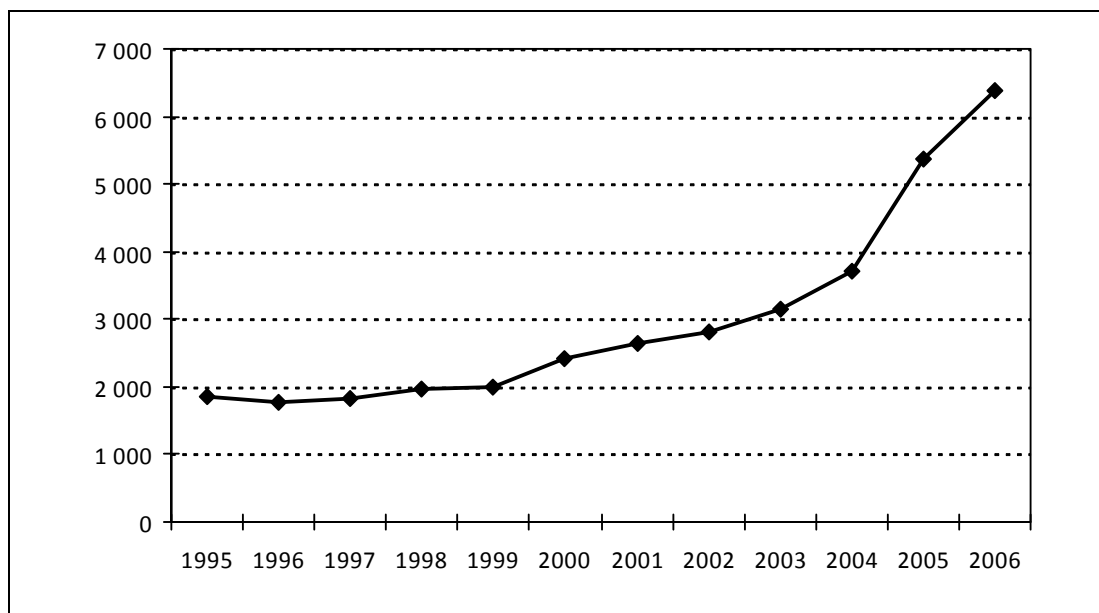
Source: International Monetary Fund (2007), p. 101.

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



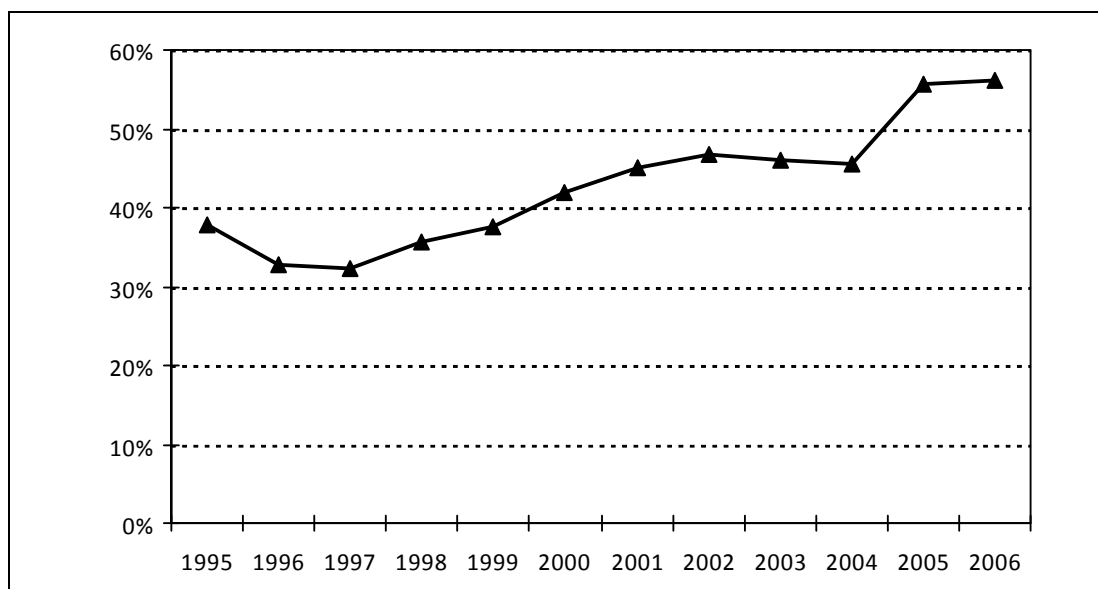
Source: Own calculations based upon WTO – International Trade Statistics.

Figure 2: Exports of Financial Services excluding insurance of Low- and Middle- Income Countries (in millions of US dollars)



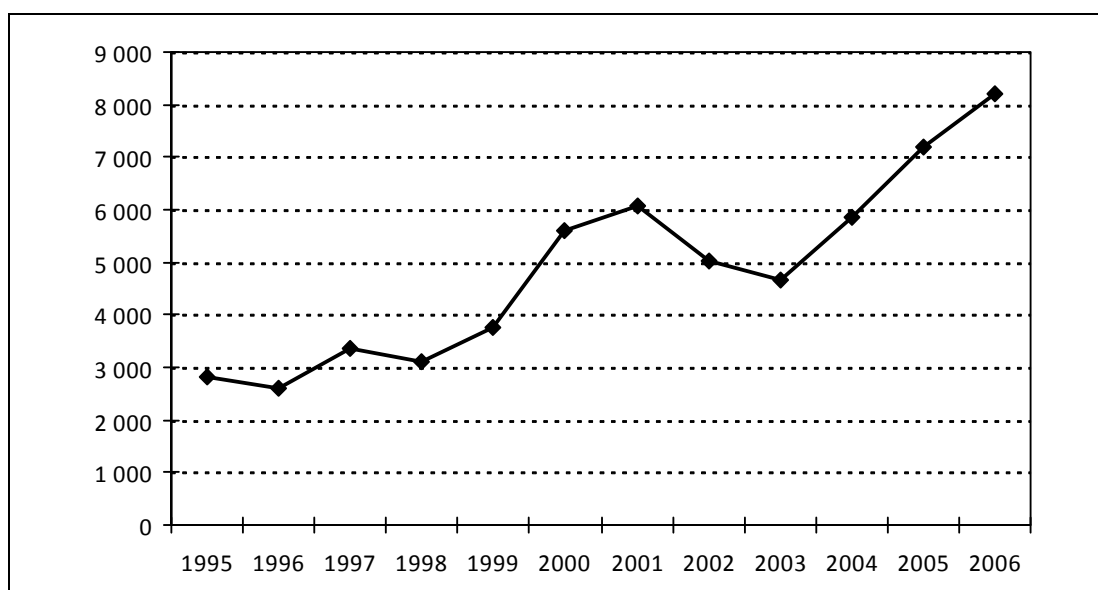
Source: Own calculations based upon UNCTAD – Handbook of Statistics 2009.

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



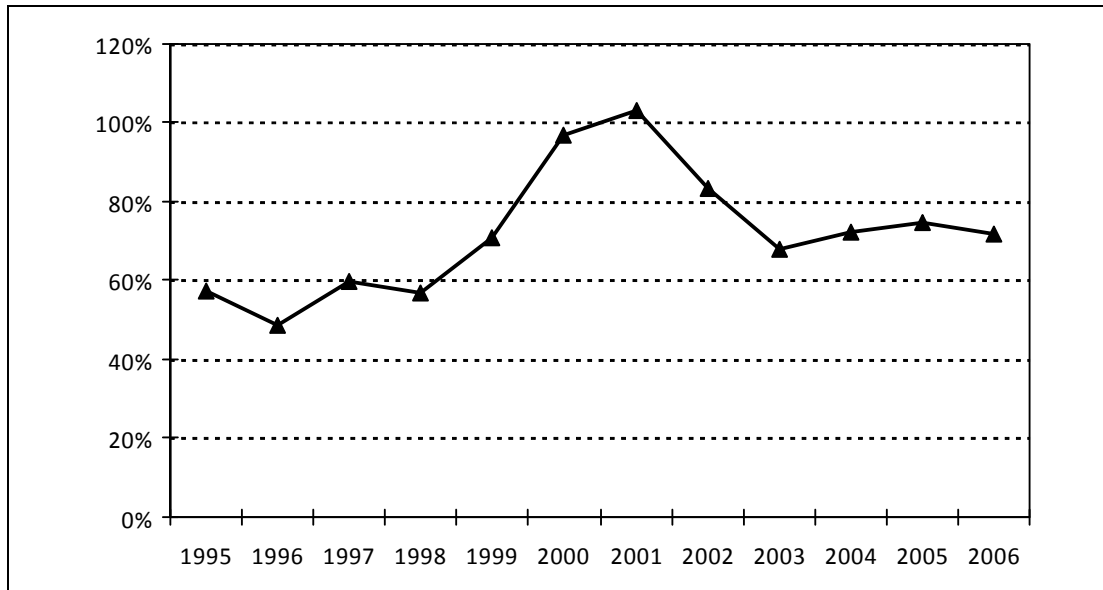
Source: Own calculations based upon UNCTAD – Handbook of Statistics 2009.

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



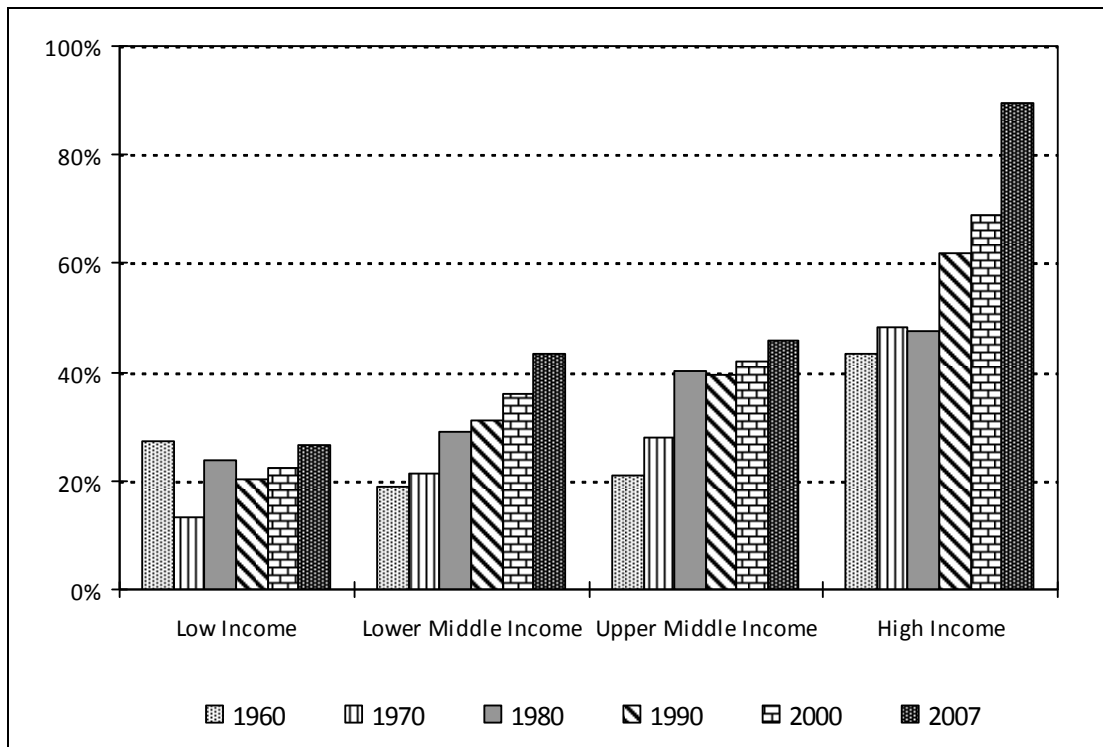
Source: Own calculations based upon UNCTAD – Handbook of Statistics 2009.

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



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

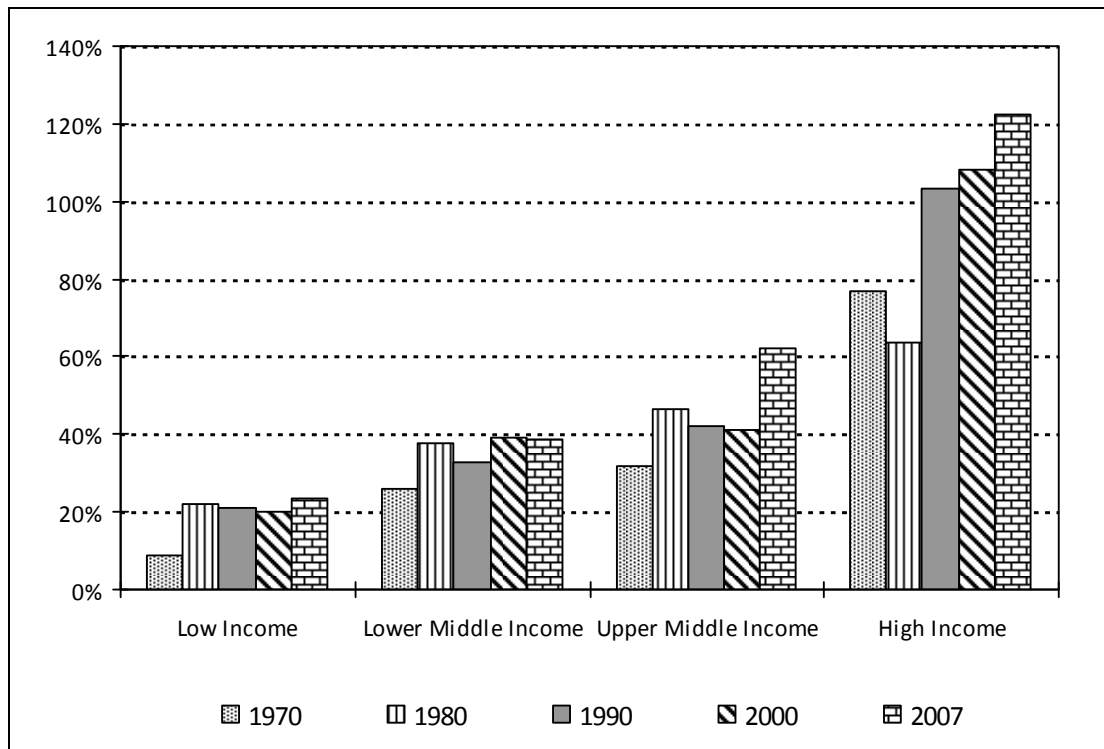
Figure 6: Total financial liabilities (in relation to GDP, median values for each income group)



Source: Own calculations based upon Beck et al. (2009)¹⁷⁸

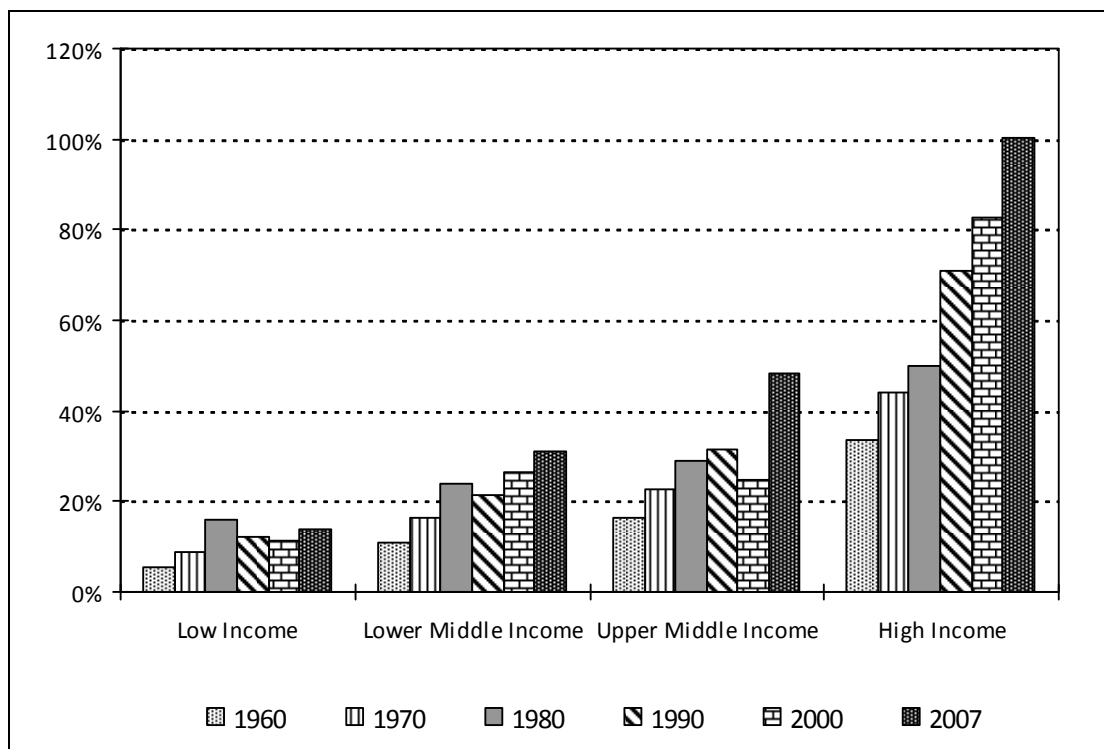
¹⁷⁸ Figures 6 through 9 are based upon Beck/Demirgüç-Kunt/Levine, A New Database – data update 2009.

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



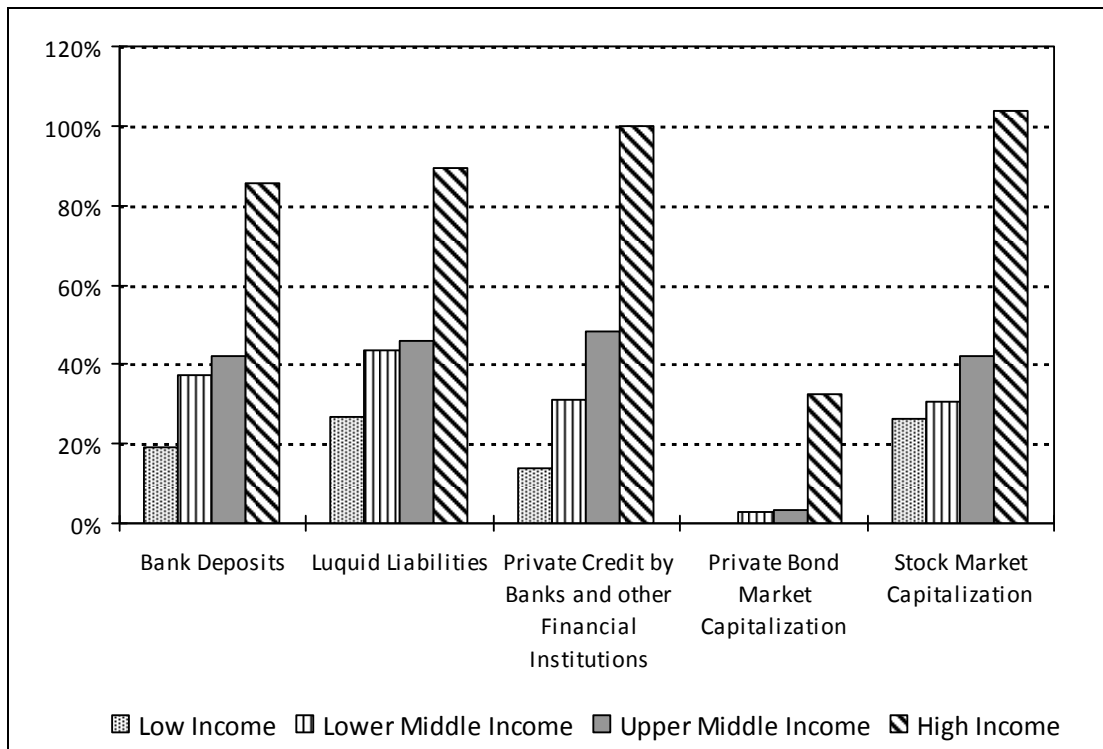
Source: Own calculations based upon Beck et al. (2009)

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



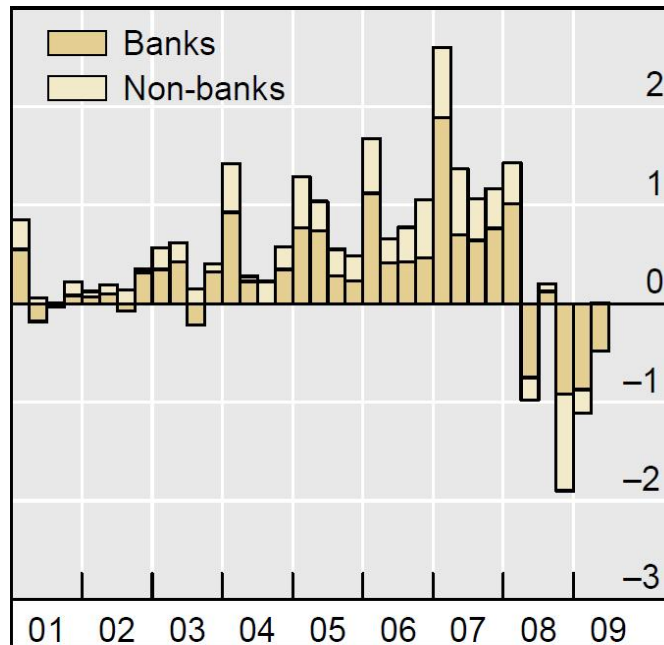
Source: Own calculations based upon Beck et al. (2009)

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



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

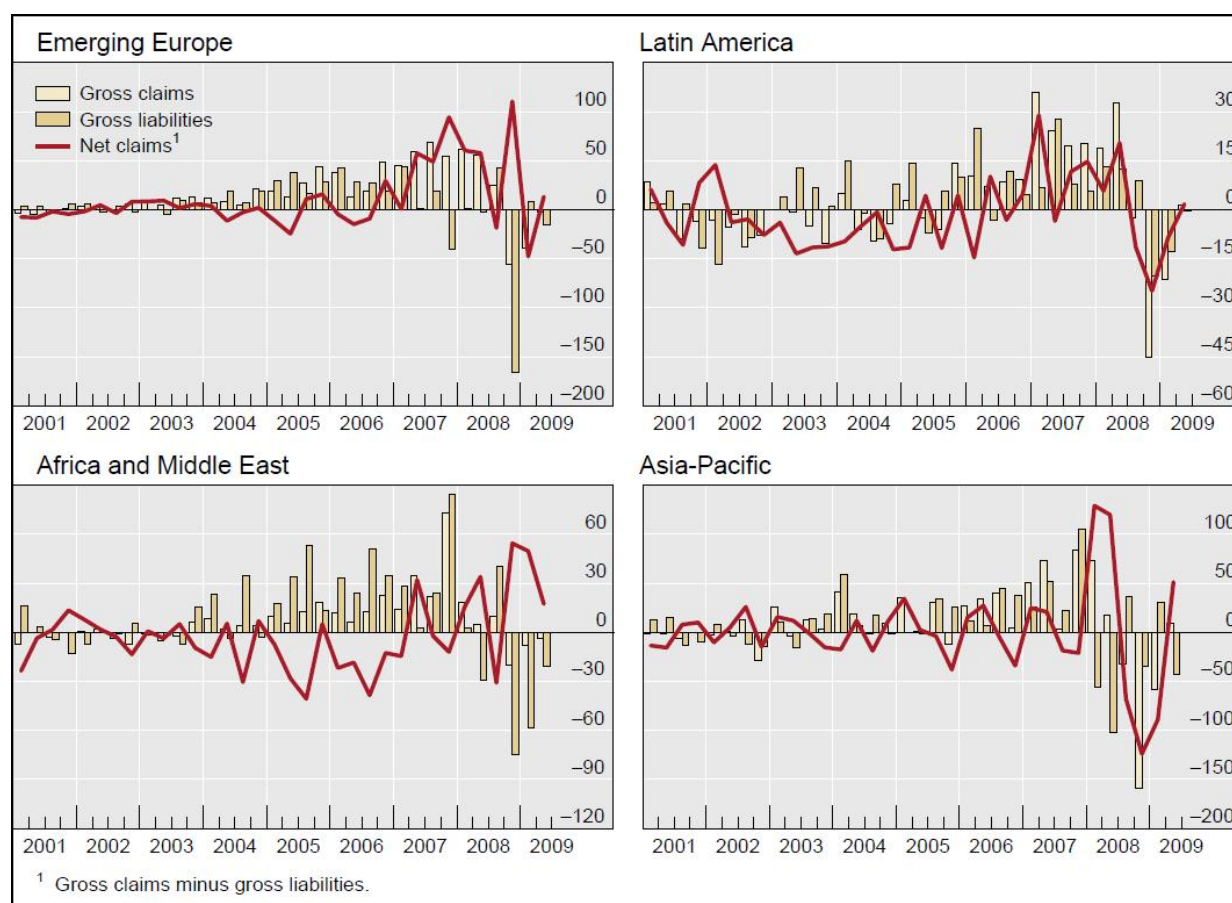
Figure 10: Changes in gross international claims by counterparty sector^{a)} (in trillions of US dollars)



^{a)} BIS reporting banks' cross-border claims (including inter-office claims) in all currencies plus locally booked foreign currency claims on residents of BIS reporting countries.

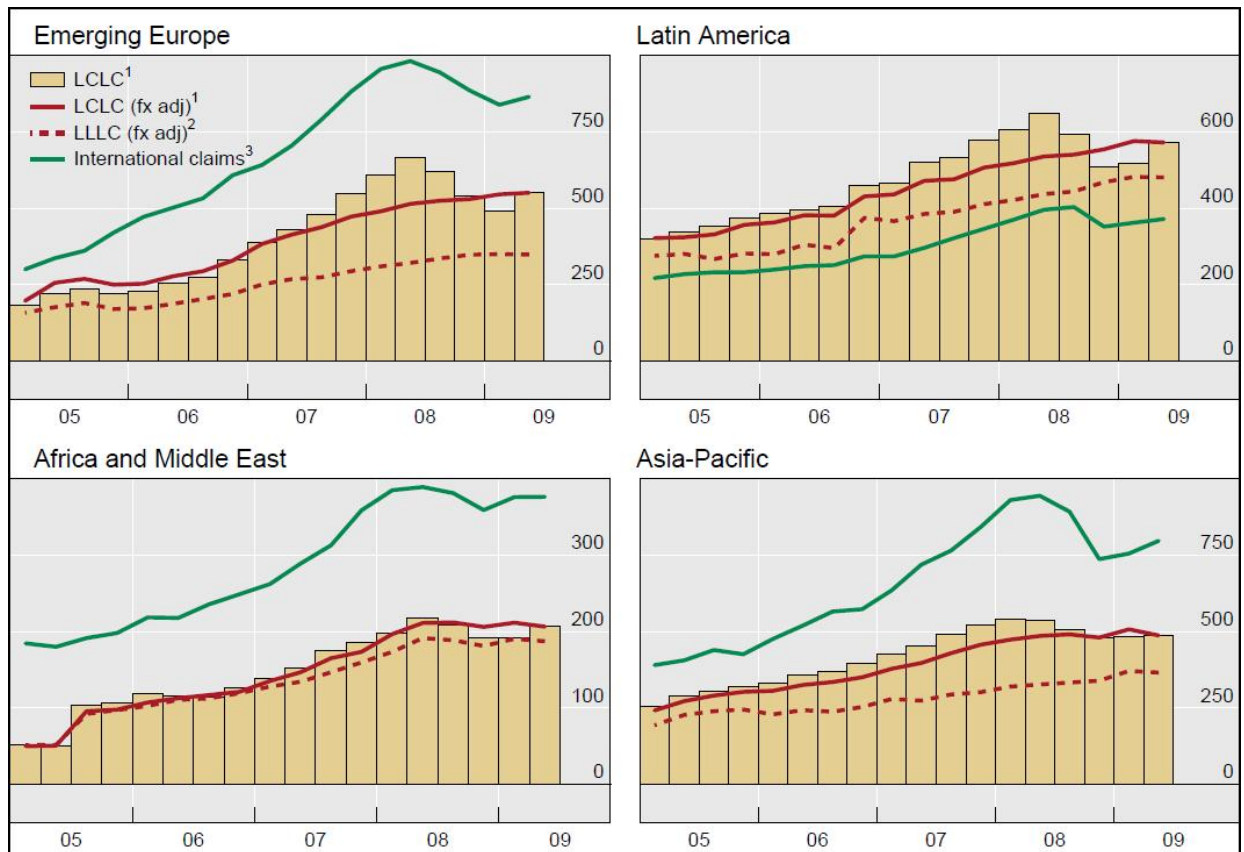
Source: BIS Quarterly Review December 2009, p. 14.

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



Source: BIS Quarterly Review December 2009, p. 17.

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



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

²⁾ Local liabilities in local currency, adjusted for exchange rate movements.

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

Source: BIS Quarterly Review December 2009, p. 17.

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