GATS negotiations in financial services:
The EU requests and their implications for developing countries

Based on speech on 1 and 3 December 2005 in conferences on financial services in Bern and Bonn by Myriam Vander Stichele, Senior Researcher at SOMO (Center for Research on Multinational Corporations), Amsterdam

In the process of the GATS negotiations, the EU has been making requests to many developing countries to liberalise its financial services sectors. Liberalisation under GATS means more than market opening for services by foreign financial firms (banks, insurance companies, pension fund management, mutual funds, etc.). GATS is mainly about giving foreign service providers, including the financial industry, more freedom to invest so that foreign services can be provided. This means that GATS is more than trade in financial services and that GATS is also an investment agreement!

The EU requests described below do not mean that developing countries will make immediate market opening commitments. Developing countries have the right to ignore any of these requests. The following article however, gives an insight in the kind of requests made by the EU and what the consequences might be for developing countries who positively respond to those requests.

GATS negotiation process is very much geared towards market opening of services through a process of "requests" and "offers". The EU always mentions financial services as one of its (five) key sectors in which it wants to see liberalisation under GATS, for instance in the EU's renewed requests in order to have "improved offers" by May 2005. The additional negotiation methods sought by the EC during 2005 has resulted in new “plurilateral” requests, agreed in December 2005 at the Hong Kong Ministerial Conference, including on financial services which were submitted on on 28th February 2006.

The first GATS requests made by the EU in 2002 included the requests to 94 countries to open up their financial industry. Of these countries, 20 were least developed countries and 30 low income countries. The EU requests to developing countries made a difference between the more developed developing countries and the least developed countries (LLDCs, called 'vulnerable economies'). The revised requests made by the EU in January 2005 remained largely unchanged regarding financial services.

Note that the EC has also been negotiating financial services liberalisation in regional trade agreements such as with Chile and Mexico (10 pages!), and currently in negotiations with Mercosur.

When asking for liberalisation of the financial industry of a country, the EU is doing it in the following ways.

1. Swift liberalisation

The EU requests have aimed at achieving very quick and broad liberalisation in the financial industry of many countries, because the EU financial industry was sucessfully lobbying the EU negotiators.

*** According to the GATS "Understanding on Commitments in Financial Services"**

The EU is requesting many "emerging market" countries such as Argentina, Brazil, Chile, China, India, Indonesia, Korea, Malaysia, Mexico, Philippines, South Africa, Uruguay to liberalise in the way as is prescribed in the “Understanding on Commitments in Financial Services” of the GATS agreement.

The Understanding provides a set of full market openings to be applied by WTO members that implement the Understanding[1]. Such broad market opening relates to almost all sectors and all definitions of “trade in financial services” and to many sectors that have not yet been liberalised by many countries e.g. pension fund management, all forms of insurance including social security (e.g. in Chile). Moreover, governments may not introduce new conditions that are more restrictive than those already existing. The Understanding erodes the exemption public financial services have under the rules in the GATS agreement.
The most far reaching condition under the Understanding is the rrequirement that WTO members remove any obstacle to foreign financial services that remains even if all the provisions of the GATS agreement have been respected! Following on, the Understanding provides guarantees that foreign financial service suppliers are permitted to introduce any new financial service.

The wish of the EU for swift liberalisation of financial services by other countries is also reflected in the following leaked EU requests of 2002:

- The EU has made requests to take away measures that limit foreign ownership of banks, insurance companies and certain other sub-sectors in financial services. This request has been made to many countries and means that foreign financial services companies should be able to fully take over the domestic financial industry.

- The EU has made a request to India and the Philippines to eliminate a ceiling of up to 15% (India) or 30% (Philippines) of total assets of the banking system which may be in hands of (totally owned) foreign banks.

- The EU has requested the elimination of the requirement that (Advisory) Boards consist of a percentage of nationals, and not foreigners, e.g. in India and many other countries.

- The EU has requested to remove the limited number of licenses for branches of commercial banks e.g. in Philippines.

- The EU has requested to privatize and liberalize the state monopoly on reinsurance and retrocession services, in Brazil. The EU has also requested access to insurance services in privatisation projects e.g. Philippines.

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1 See for more explanation chapter 6 of the SOMO Report: M. Vander Stichele, Critical Issues in the Financial Industry, 2005 (update), which can be downloaded at <http://www.somo.nl/html/paginas/pdf/Financial_sector_report_05_NL.pdf>

- Government procurement liberalisation is requested by the EU e.g. to allow foreign financial companies to provide certain financial services to state or municipal agencies, in Brazil and Argentina. However, government procurement liberalisation has been resisted by developing countries in the GATS negotiations because it should only be about "transparency".

The impact of these EU requests can be derived from experience that has shown that as soon as developing country are opening their markets, foreign financial firms often rapidly take over a large part of the domestic financial industry. For instance, the foreign financial industry increased its presence, through acquisitions etc., by 364 % in Latin America in four years (1996-2000). As a consequence, local banks have little chance to survive in poor developing countries although some of them are much better in serving local small companies and poorer clients. The problem is that foreign banks and insurance companies focus on rich clients and rich regions ('cherry picking'): this results in lack of lending to small and medium enterprises, farmers, the poor e.g. Mexico and Argentina. Lack of lending by foreign banks has lead to lack of finances to stimulate the industry and economy of those countries. The focus on the rich clients has stimulated the gap between rich and poor.

Because local banks want to survive the competition from foreign financial services, local banks might take too much risks, which can result in destabilisation of a country's banking system. Also, in order to operate well in new markets, foreign banks attract the best managers from local banks to the foreign banks. The result is that expertise goes from local to foreign banks. Why does the EU argue that more expertise and efficiency will be transferred to local banks by liberalisation of financial services?

2. Trying to get rid of regulatory measures

In the EU requests for market opening in financial services, the EU has been asking many countries to remove a whole list of various governmental measures which are in place in the requested countries because the EU considers them as trade barriers (read: measures that undermine the expansion and profit making of foreign financial firms). The different kind of measures that the EU is requesting to be removed are discussed below.

2.1. Financial stability measures

The following measures which have been put in place by governments to promote the stability of their financial system, and to avoid a financial crisis that has many negative consequences, have been targeted in the EU requests.

- **Stability measures of Chile:**
  - The EU has requested to eliminate the measure that prior authorisation by the Central Bank is needed before transferring dividends from Chile abroad. The EU sees this as a restriction on payments and financial transfers which is forbidden under Article XI.
  - The EU requests to eliminate what it sees as a restriction, namely that invested foreign capital can only be remitted abroad after 2 years, in practice 1 year, that is has been invested in Chile. This is called the "Chile tax" because investments that are remitted before 1 or 2 years has to pay a tax.

These requests indicate how the EU is not respecting the policy by a country to avoid a financial crisis. These Chilean measures were effective because Chile was hardly affected by Argentinean crisis and have been praised by the international community of being good examples of measures that are needed for financial stability.
The reason why the EU has making these requests to Chile is because the US has been able to more or less negotiate this Chile tax away in its bilateral trade agreement with Chile and the EU wanted the same freedom of capital movement for the European financial industry. In other words, this is not at all negotiating from a development perspective.

Lessons learned by Asian and other countries in crisis

The EU requests have been targeting the following measures to be removed, even though some of them have been put in place after countries have experienced a financial crisis that was disruptive for their economies and societies. The EU is requesting to:

- eliminate a prohibition in Korea for insurance companies to invest more than 15% of their total assets in real estate. Remember, one of causes of the Asian financial crisis was too much and irrational investment in real estate;
- "specify" limitations in Korea for lending by credit card members. Note that Korea has been having a major credit card crisis for some time in the beginning of century;
- remove the limitation on credits (loans, guarantees) provided by foreign branches to single customers, and take account of capital in the head office of the bank. Remember that during the crisis too high exposure to a few clients was a major problem whereby default in repaying loans by one or a few customers lead to serious problems or bankruptcy of a bank;
- eliminate regulations that limit the operations of hedge funds (Investment Trust Management companies), although hedge funds have been identified as one of the investors that can contribute to a financial crisis;

The EU has also requested that foreign banks can get offshore banking licences which is forbidden in India. The EU has requested to Thailand to take away its limitation that foreign banks with an offshore license cannot get access to the Thai market through full branch licence. This contradicts the EU policy against uncontrolled money transfers and money laundering that often happens through offshore banking where there are less stringent monitoring measures and where less taxes need to be paid.

Capital requirements

The EU wants to take away measures by which governments require money reserves to be located by foreign owned bank branches in the country itself. The EU has been requesting to replace existing measures as follows:

- Allow branches to use the parent banks’ capital to meet prudential money reserve requirements, e.g. in India.
- Take into account the guarantee extended by the branch’s head office or by another foreign bank for additional lending volume, e.g. in India.
- Allow borrower limits to take into account the foreign banks global capital, e.g. in India.

In other words, the EU made requests that money reserves do not need to sit in countries and that capital of a bank sitting abroad can be used for prudential reserves. However, as the experience of several financial crises in Argentina has shown, there is no guarantee that the parent company/bank will transfer the necessary financial reserves in times of a financial crisis in a country in which it did not hold reserves. The EU is requesting to eliminate these local capital requirements because the international banks, and other financial firms, want to use their capital around the world to make as much profit as possible. This is far from taking concerns of developing countries into account.

Prudential regulations

The EU has been requesting many countries to remove measures that governments have put in place to ensure the integrity or quality of the financial industry sector and avoid problems of financial instability. Examples of such requests have been made to the following countries:

- Brazil is requested to eliminate the case by case authorisation for the establishment of all kind of financial institutions.
- South Korea is requested to remove restrictions on recruitment and employment of professionals in life insurance, non life insurance and reinsurance.
- Mexico is requested to make commitments so that foreign financial companies can trade (for their own account or that of customers) in derivative products; note that derivative products are non-transparent and not so much regulated so that too much wrong assessments made by those buying or selling derivative products can lead to a financial crisis.

The EU wants the elimination of restrictions (on foreign banks) to provide different kind of services ('allfinanz', 'universal banks'). For instance the EU has asked South Korea to remove the rule that financial institutions are prohibited from operating at the same time in different sub-sectors. However, even the US has only since 1999 allowed financial firms to operate in different sub-sectors at the same time, such as banking and insurance. In many Western countries, the supervision of the allfinanz firms is still in evolution because previously, the supervisors of banks, insurance companies and pension funds were separate institutions with too little communication between them. Asking countries to allow allfinanz or universal banks means that these countries first need to put in place costly complex supervisory institutions and the appropriate legislation.

2.2. Economic development undermined

The EU has been asking that countries take away measures that are in place for stimulating economic development and fighting poverty, as follows:

- EU has been asking to remove the requirement of mandatory lending to small and medium enterprises (SMEs) e.g in South Korea. However, the experience has shown that foreign banks avoid lending to SMEs, small farmers and the poor in countries like Mexico and Argentina, which has stifled economic development in those countries.
- The EU considers that special requirements by the government for lending to SMEs and agro-business need to be mentioned as exemptions of the commitments made e.g. by the Philippines. This means that such governmental measures are not considered to be exempt of GATS rules nor belonging to the right to regulate.
- EU raises questions about the requirement applied to all banks in Malaysia to provide (lending) quotas for low-cost housing. This means that EU considers this as a limitation that should be mentioned in the GATS schedules. Again, these measures to provide poorer families with the financial resources needed for housing are not considered falling under the GATS "right to regulate", but rather as a trade barrier (read: profit making restriction) that must be exempted from the GATS agreement (Art. XVI), and ultimately eliminated.

These EU requests raise a serious problem: Who will decide during the negotiations which regulations are prudential and which ones are not? Will bullying tactics during the negotiations undermine domestic regulation during the negotiations? So far, some developing countries have been reluctant to open up under GATS, or have the Ministry of Finance or Central bank following negotiations e.g. by Chile.

The has also been EU asking for "clarifications" about restrictions and discriminatory measures against foreign banks, e.g. in India and the Philippines. This assumes that local banks have the same behaviour as foreign banks that can move abroad their investments and capital much more easily. The problem is that the GATS rules are designed to take away discrimination between foreign and national banks once a country makes a commitment, mostly through the GATS article XVII obliging a country to give “national treatment” to a foreign supplier of a service sector whose market opening has been committed under the GATS. Consequently, it becomes much harder to support the domestic financial industry, e.g. to allow it to fairly compete against foreign banks.

3. Trade negotiators ignore lessons from financial crises

The EU acknowledges that regulation is necessary but makes little links during the negotiations whether countries to whom requests are made to have the necessary regulations in place. The EU mainly argues that opening up financial services increases efficiency but ignores the growing evidence that only the richer segments of society benefit from these improved services.

What is worrying is that Western negotiators brush aside concerns raised by developing countries while the risks of financial instability are not fully analysed or discussed. This undermines the use of GATS exemption clauses by developing countries.

The GATS agreement has three ways by which is increases the risk of financial instability[2]:

- risks of financial instability when (developing) countries open up to foreign service providers who have unexpected or risky behaviour
- foreign financial services are often linked to a high level of cross border capital movement which leads to high foreign exchange movements that puts pressure on the exchange rate; this can undermine the value and stability of the national currency
- GATS rules can increases the risks of financial instability and financial crisis because they have an impact on government regulation!

Western GATS negotiators ignore the experience of previous financial crisis that liberalization needs to be gradual and well sequenced, underpinned by costly capacity building of financial authorities in developing countries. When the necessary national financial safeguards are not in place, trade negotiations should not push for financial sector liberalisation since the global financial architecture is not reformed and financial firms increase poverty and unsustainable development. EU trade negotiators hardly consult with their Central Banks and those responsible for financial stability in their own countries.

Host countries must spend additional resources for regulatory and supervisory measures to handle changes and risks by new foreign financial firms.

2 See for more explanation chapter 6 of the SOMO Report: M. Vander Stichele, Critical Issues in the Financial Industry, 2005 (update)

The EU requests should raise a debate about what development perspectives are lacking in the EU negotiation position on financial services. Also, the debate should challenge the EU's position which is fully influenced by the financial sector lobby, and not by civil society. In order to have balanced GATS negotiations that ensure that globalisation becomes more equitable and sustainable, the direction of the negotiations need to be stopped and another approach is needed. So far, EU officials have not been willing to listen to this message.

For information see:

M. Vander Stichele, "Critical issues in the Financial Services Industry", SOMO, April 2005, <http://www.somo.nl/html/paginas/pdf/Financial_sector_report_05_NL.pdf>

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