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REINVIGORATING OPEN TRADE IN FINANCIAL SERVICES

I. INTRODUCTION

1. Global work on economic recovery and regulatory reform[1] is well underway. Likewise, there is new momentum in bilateral, regional and multilateral trade negotiations. Against this backdrop, it is important to reinvigorate efforts to open trade in financial services as an essential component of economic recovery and as a driver of increased trade and investment flows. Financial services liberalization in conjunction with global efforts toward consistent regulation will advance the G20's economic recovery and reform agenda.

2. G20 leaders have highlighted the critical role vibrant financial markets play in providing the credit and capital essential for economic growth, especially in developing countries. Financial services firms operating in a sound regulatory environment help companies manage risk, raise debt and equity, carry out acquisitions or sales, and help individuals mobilize their savings and plan and invest for the future. Capital markets facilitate economic growth and development by substantially broadening the range of vehicles for savings and investment and lowering the cost of capital for businesses and entrepreneurs.

3. Notwithstanding these benefits, some regulatory reform efforts and trade policy discussions suggest that a need for "de-globalization" or "dis-integration" of financial markets is the right conclusion to draw from the financial crisis. This is sometimes driven by the perception that open markets in financial services were a contributor to the crisis.

4. According to the WTO, this is not the lesson to be drawn from the crisis. In a Secretariat Note that analyzed the financial crisis, the WTO concluded that "none of the root causes of the financial crisis can be attributed to services trade liberalization as provided for in the GATS,

[1] Attached as Annex 1 is a summary of key measures to strengthen financial institutions, enhance supervision, mitigate risk and address 'too big to fail'

namely granting market access and national treatment" and "the crisis [also] cannot be attributed to the involvement of foreign financial institutions . . . ."[2]

5. The proper response to the crisis is not financial protectionism and shutting down global markets through balkanized regulatory regimes,[3] but reinvigorated support for open markets.[4] The expansion of trade in financial services and with it, financial deepening, will contribute to economic growth and recovery.[5]

6. The G20 leaders have agreed with this approach. At the Toronto Summit they declared:

> [F]inancial sectors in some emerging economies need to be developed further so that they can provide the depth and breadth of services required to promote and sustain high rates of economic growth and development. It is important that financial reforms in advanced economies take into account any adverse effects on financial flows to emerging and developing economies. Vigilance is also needed to ensure open capital markets and avoid financial protectionism.[6]

7. This paper sets forth some principles that should inform negotiations on trade in financial services, whether in bilateral or regional FTAs or in the Doha Round.

II. BENEFITS OF OPEN FINANCIAL SERVICES MARKETS

8. Liberalization of financial services is central to advancing economic growth in developed and developing countries, as economists have empirically demonstrated.[7] As financial markets develop, they create long-term economic growth, stronger, more competitive financial institutions, and a more stable financial system.

9. Indeed, the World Bank has estimated the value of further liberalizing trade in financial services for developing countries at $300 billion.[8]

10. Diversified financial services markets enhance economic growth and financial stability by developing new avenues for investing savings and funding entrepreneurial activity beyond the

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[2] *See* Council for Trade in Services and Committee on Trade in Financial Services, *Financial Services: Background Note by the Secretariat*, S/C/W/312, S/FIN/W/73, February 3, 2010, para. 96 ("WTO Financial Services Secretariat Note").

[3] Unharmonized regulatory regimes may result in unnecessary restrictions on the cross-border financial services business or require global financial institutions to enter into transactions in a fragmented way. This in turn impedes centralized, global risk management and reduces the potential for loss absorbency.

[4] For example, Malaysia has responded to the financial crisis by implementing a broad liberalization package aimed at improving access to both the conventional and Islamic financial sectors. *See* WTO Financial Services Secretariat Note at para. 117, n. 83.

[5] *See* WTO Financial Services Secretariat Note at para. 69.

[6] G20 Toronto Summit, "Toronto Summit Declaration," June 2010, para. 13, available at http://www.g20.utoronto.ca/2010/to-communique.html.

[7] *See, e.g.*, WILLIAM R. CLINE, FINANCIAL GLOBALIZATION, ECONOMIC GROWTH, AND THE CRISIS OF 2007-09, pp. 33, 141-42 (Peterson Institute 2010) (analyzing 80 studies of financial liberalization and concluding that "the great preponderance of empirical evidence is on the side of a positive growth effect of openness.").

[8] World Bank, *Global Economic Prospects and the Developing Countries* at p. 172, Table 6.3 (2002).

banking sector. As Managing Director of the Monetary Authority of Singapore, Heng Swee Keat, observed:

> [The] bigger challenge lies less in having more stringent regulations, but more in development and innovation of financial services to complement . . . economic development. Savings rates in Asia are high, but these have to be efficiently intermediated to support productive investments. In most parts of Asia, the banking system dominates the intermediation channel. Developing a stronger second channel through the capital markets, venture funds and private equity to support a range of entrepreneurial activities can raise the efficiency and resilience of the system. This will also provide a wider range of asset classes to meet the investment needs of a rising middle class.[9]

11. The development of financial markets is assisted by the presence of foreign suppliers of capital markets-related services, whether through commercial presence or the delivery of services cross-border. Experience demonstrates that foreign suppliers enhance competition and bring to a market additional capital, technology, products and expertise. Each of these factors can reduce the cost of financial services, and thereby improve the competitiveness of domestic companies that use these services.

III. OPEN TRADE IN FINANCIAL SERVICES IS FULLY COMPATIBLE WITH SOUND REGULATION OF FINANCIAL MARKETS

12. The most persistent and unjustified concern about opening trade in financial services is that it equates liberalization with deregulation. This is not the case. Trade in financial services focuses on questions of market access and nondiscriminatory treatment, not the prudential conditions that apply in the market in question. Opening markets to foreign competitors can be done without prejudice to regulatory standards. Liberalizing trade in financial services is about open markets, clear rules and fair competition, not deregulation.

13. Indeed, sound regulation is essential to healthy, open, and competitive markets. A key aspect of liberalization is designing regulations that protect investors, promote fair, efficient, and transparent markets and reduce systemic risk. Individuals and companies seeking to invest or raise funds will not rely on the financial markets unless they have confidence that those markets are well regulated.

14. Financial services regulations typically include:

- Standards that a supplier must meet in order to be authorized or licensed to do business in a market, such as standards that address capital adequacy and liquidity, the supplier's knowledge, resources, skills, and risk management procedures ("*authorization requirements*");

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[9] Keynote Address by Heng Swee Keat, Managing Director, Monetary Authority of Singapore at the Paris EUROPLACE International Financial Forum, "Next State: Policy Challenges in Asia," October 26, 2009, paras. 16-17, available at http://www.mas.gov.sg/news_room/statements/2009/Speech_by_Mr_Heng_Swee_Keat_for_Paris_Europlace_conference_on_26_October_2009.html.

- Rules of conduct for a supplier doing business in a market, including rules relating to disclosure of information (including risk warnings) to customers, disclosure of information about the supplier, execution of orders, and the protection of customer assets ("*conduct of business rules*"); and
- Rules relating to fraud, insider dealing, and market manipulation ("*market abuse rules*").

15. An effective regulatory regime will maximize access for suppliers and consumers without undermining key regulatory objectives. As the International Organization of Securities Commissions ("IOSCO") has noted, a regulator often conducts a:

> [cost-benefit] analysis to facilitate an understanding of the financial and other costs of the proposed regulation to the intermediary as compared to the benefits the regulation is expected to produce for investors and other market participants.[10]

16. Each country's commitments to broaden market access would continue to be subject to exceptions for prudential measures and for measures taken to safeguard the balance of payments. These exceptions provide additional latitude necessary for regulatory reform efforts. Concerns about regulatory capacity can be addressed by making commitments subject to a reasonable phase-in period, consistent with increasing regulatory capabilities.

17. In fact, the WTO Secretariat has confirmed that in responding to the financial crisis, market access commitments on financial services did not hinder Members' flexibility to make the regulatory choices they deemed necessary to stabilize their economies.[11] Most countries maintained, rather than contracted, market access and implemented new policies for the limited purpose of closing regulatory loopholes and temporarily supporting financial institutions.[12]

IV. CAPITAL MARKETS LIBERALIZATION

18. A single capital markets transaction today often includes more than one kind of financial activity and may involve all four "modes" of supply. For example, an underwriting of debt securities may require in-person meetings (including due diligence) with management of the issuer, as well as electronic and telephonic exchanges of information. In addition, the issuer may enter into a derivatives contract with the underwriter to hedge an interest rate risk. As a result, in order to most sensibly integrate their consumers with global financial markets and to secure the benefits of capital-markets liberalization, countries will need to make commitments with respect to all capital markets-related activities and in all four modes of supply.

V. CROSS BORDER ACCESS (MODE 1)

19. Countries should permit suppliers and consumers of capital markets-related services to transact business on a cross-border basis, and such suppliers and their services should be entitled to national treatment.

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[10] Technical Committee of the International Organization of Securities Commissions, "Regulation of Remote Cross-Border Financial Intermediaries," February 2004, p. 4, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD162.pdf ("IOSCO Report").

[11] *See* WTO Financial Services Secretariat Note at para. 117.

[12] *See* WTO Financial Services Secretariat Note at para. 117.

20. Countries should facilitate cross-border access by exempting foreign suppliers under certain circumstances from authorization requirements (described at paragraph 14 above). As described in the IOSCO Report, many Members currently do offer such exemptions, taking into account one or more of the following factors:

- whether the investor is sophisticated (as defined in local law), thereby recognizing that the securities laws need not protect sophisticated investors in certain circumstances;
- whether the foreign supplier is well regulated in its home jurisdiction (i.e., unilateral or mutual recognition of other regulators);
- whether the foreign supplier solicits customers, or actively markets its services, in the local jurisdiction; and
- whether the securities transaction is "intermediated by" (i.e., conducted through) a locally authorized supplier.[13]

21. As recognized in the IOSCO Report, the regulation of cross-border suppliers is based on "considerations relating to the goals of investor protection, efficient capital markets, and the appropriate balance between these two."[14] Even when such suppliers are exempted from authorization requirements, the provision of the services typically would remain subject to the conduct of business and market conduct rules described above that are aimed at investor protection and safety and soundness concerns.

VI. CONSUMERS WHO TRAVEL ABROAD (MODE 2)

22. Countries should allow their consumers to obtain any capital markets-related service when they travel outside their home territories. Many countries already permit their consumers to do so, based on a balancing of the goals of investor protection and efficient capital markets as referred to in the IOSCO Report.

VII. COMMERCIAL PRESENCE (MODE 3)

23. Countries should permit foreign suppliers of capital markets-related services to establish a new commercial presence or acquire an existing commercial presence in their territories. Such suppliers should be able to choose their corporate form (e.g., a 100%-owned subsidiary, a branch or a joint venture) and be treated no less favorably than domestic suppliers (i.e., national treatment). Countries are of course free to regulate financial products offered by foreign suppliers on the same terms as apply to those offered by domestic suppliers.

VIII. THE MOVEMENT OF PERSONS (MODE 4)

24. Countries should permit temporary entry into their territories for persons who supply capital markets-related services to work with clients or to staff a commercial presence.

IX. REFLECT EXISTING FAVORABLE MARKET ACCESS CONDITIONS IN COMMITMENTS

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[13] *See* IOSCO Report at pp. 5-9.

[14] IOSCO Report at p. 1.

25. Many countries currently provide market access that is consistent with some or all of the recommendations described above. In most cases, however, this level of access is not reflected in their international commitments. Countries – both developed and developing – should at a minimum ensure that their commitments reflect the level of market access afforded under their domestic laws. This will afford the legal certainty and predictability that stimulate economic activity.

X. TRANSPARENT REGULATION

26. Regulation must be transparent: both suppliers and consumers of capital markets-related services must know what the rules are and have confidence that the rules will be applied consistently and fairly. Although there are different ways to achieve this goal, in general, regulators should: (i) propose regulations in draft form and provide interested parties the opportunity to comment on such draft regulations, where practicable; (ii) make publicly available the requirements that suppliers must meet in order to supply a service; and (iii) enforce laws and regulations according to fair and transparent criteria.

XI. PROCESSING OF FINANCIAL DATA

27. Countries should permit financial institutions freely to transfer information outside of the local jurisdiction for processing. They should also permit financial institutions to perform certain functions, such as trade and transaction processing, in their home jurisdiction rather than require that those activities be conducted by a local affiliate.

XII. INVESTMENT PROTECTIONS

28. Where bilateral or regional trade agreements include investment chapters, it is important that they include meaningful protections for investors in financial services institutions, including non-discrimination, fair and equitable treatment, free transfers of profits and capital, prompt, adequate, and effective compensation for any expropriation, and the ability to use international arbitration to resolve disputes. Robust investment protections can encourage billions of dollars of investment.

The organizations that have produced and endorsed this paper represent the shared interests of financial services firms operating in markets across the global economy. They share a commitment to stable, competitive and sustainable financial markets that support economic growth and benefit society.

Annex 1: The changing regulatory landscape in financial services: key measures to strengthen financial institutions, enhance supervision, mitigate risk and address 'too big to fail'

New regulatory capital requirements intended to buffer firms against losses	New leverage and liquidity rules to make firms better able to weather instability	Prohibition of 'proprietary trading' by investment banks	Greater alignment of pay and long term risk management to ensure remuneration does not encourage excessive risk-taking.	New approaches to supervision of systemic risk as well as prudential conduct	Reform of derivatives markets directed towards increasing transparency and use of exchanges.	Greater oversight of credit rating agencies and certain fund managers	New measures to ensure financial services firms can fail without systemic risk, or taxpayer support
New Basel III standards will impose higher regulatory capital ratios on financial institutions. Additional measures under consideration for 'Systemically Important Financial Institutions' and in the US, enhanced prudential standards for certain institutions specifically provided for in Dodd Frank. New tougher definitions of Tier 1 capital, essentially limiting core regulatory capital to common equity.	New ratios for leverage and liquidity in Basel III intended to help guard against excessive gearing and ensure that institutions can raise capital quickly.	In the US, under the 'Volcker Rule' trading done solely for the short term financial gain of an investment bank will be prohibited.	Financial Stability Board guidelines, translated into new European guidelines through CRDIII and that proscribe large upfront cash bonuses to market practitioners responsible for material risk. US regulators are considering similar moves. General industry shift to much greater remuneration in equity, deferred remuneration and clawback against performance failure.	Much greater awareness of need to understand systemic risk at a global level, driven by FSB and IMF. Creation the European Systemic Risk Board in the EU and the Financial Stability Oversight Council in US, to monitor and report to governments on potential systemic risk. Shift in prudential culture away from micro focus on individual firms to parallel understanding of counterparty and network risk.	Reform in both EU and US to ensure, where practicable and appropriate, greater standardisation of derivative contracts, greater use of central clearing and greater transparency to regulators and markets on what is being traded.	Greater supervision of rating agencies and greater transparency of rating agency methodology and evidence base. New rules on the regulatory oversight of private equity and hedge funds and their managers in the EU and US	US and EU regulators all requiring development of 'living wills' for financial firms, ensuring regulators understand their counterparty risk and can resolve them quickly and without systemic instability. Widespread consideration of forms of 'contingent' debt, convertible into equity if a financial firm finds itself in trouble. In the US, the creation of an orderly liquidation regime to handle the resolution of failed firms. New regular stress tests to determine the strength of institutions.