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FINANCIAL SERVICES TRADE AFTER THE CRISIS: POLICY AND LEGAL CONJECTURES

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ABSTRACT

The financial crisis of 2008–09 has cast doubt on the utility and effectiveness of the General Agreement on Trade in Services and of services trade law more broadly in providing instruments that are able to deal adequately with the trade-related regulatory fallout from the financial crisis and the potentially distortive measures taken to mitigate its effects. In many ways, the financial crisis has confirmed the impression of the minimal relevance of the current multilateral legal framework regulating trade in services for the prevention and management of financial crises. The crisis and the regulatory reforms that are enacted in its wake offer a propitious opportunity for revisiting the substance of services trade regulation. This should be done with a view to strengthening services trade law to better manage the downside risks of financial protectionism and offer a more credible platform for confronting the trade and investment disputes whose numbers this article considers likely to rise in the coming years.

I. INTRODUCTION

In September 2009, in the midst of financial turmoil of a severity the world had not witnessed since the 1930s, the G-20 leaders reaffirmed their commitment to 'refrain from raising barriers or imposing new barriers to investment or to trade in goods and services'.[1] They further pledged to minimize any negative impact of domestic policies, including fiscal policy and financial sector support schemes, on trade and investment.[2] Still, several measures enacted in the wake of the financial crisis, including subsidies and 'buy,

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1 G-20, 'Leaders' Statement: The Pittsburgh Summit', 24–25 September 2009, para 48, http://www.pittsburghsummit.gov/mediacenter/129639.htm (visited 21 October 2010).

2 Ibid.

hire and/or lend local' requirements adopted in support schemes in the financial sector and stimulus packages, could be open to legal challenge under World Trade Organization (WTO) rules and investment treaty obligations relating to non-discrimination and transparency.[3]

This article explores the various ways in which the financial crisis of 2008–09 and its aftershocks may impact on the future conduct of financial services liberalization and rule-making in a *trade policy setting*. The last three words are italicized for a purpose: in searching for the origins of the extreme turbulence experienced in financial markets of late, one would be hard pressed to find a trace of trade policy. The economic and financial reverberations of the crisis continue to be felt and its regulatory fallout remains uncertain. However, it cannot be likened to the process of progressive dismantling of impediments affecting access to, and operation in, financial markets that was launched in 1999 through the entry into force of the rules regulating financial services enshrined in the General Agreement on Trade in Services (GATS) and the adoption of the Fifth Protocol[4] To The General Agreement On Trade In Services, S/L/45, 3 December 1997 (and through the numerous preferential trade agreements that have done likewise since then).

This article, co-authored by an economist and a lawyer, imparts a deliberately dual narrative to the analysis on offer. It does so with a view to advancing insights—in diagnosis and prescription—that are informed by both big picture policy considerations and the nitty-gritty legal (i.e. rule-making) challenges deriving primarily from the ambiguous and incomplete nature of the GATS and of similar rules governing financial services trade and investment in preferential settings. We consider each of these in turn in the analysis that follows.

II. POLICY CONJECTURES

A. Tracing the origins of the financial crisis

The financial upheaval the world has confronted over the past two years must be seen not so much as a crisis of liberalization—and almost certainly not of trade and investment liberalization—but rather of perverse regulation, lax supervisory practices, and derelict corporate governance.[5] While the origins of the financial crisis cannot be reduced to any single cause nor traced

[3] Organisation for Economic Co-operation and Development, WTO, United Nations Conference on Trade and Development, 'Report on G20 Trade and Investment Measures (September 2009–February 2010)', 8 March 2010.

[4] Fifth Protocol to the General Agreement on Trade in Services, S/L/45, 3 December 1997.

[5] Opinions naturally differ on this point. For instance, a United Nations expert group headed by Nobel laureate Joseph Stiglitz recently concluded that the financial services provisions of the GATS and similar rules found in preferential trade agreements could be seen to 'restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors'. See United Nations, 'Report of the Commission of Experts of the President of the United

to any single country or class of financial intermediary, the crisis is widely regarded as having taken root in an environment of regulatory incentives encouraging excessive risk-taking, and characterized by undue proximity between market operators and between regulators and regulatees. No attempt at understanding the financial crisis of 2008–09 can be made without also considering the intellectual canvas against which it proceeded, one that long championed the innate virtues of market efficiency, financial innovation and financial market opening, literally as ends in themselves.[6]

Trade historians might take solace from the fact that a financial crisis can be good news for financial market opening. Indeed, looking back only a decade, the Asian financial crisis of 1997–98 and its subsequent spread to other emerging country markets prompted a clear, pro-liberalizing, trade policy response. At the time, several emerging country governments sought to exploit the signalling properties of trade agreements, and notably that of the incipient GATS, by ratcheting up their commitment to more open and non-discriminatory financial regimes through legally binding undertakings anchored in schedules of commitments.[7]

There are, alas, reasons to doubt that the latest episode of financial turmoil might generate similar effects. One is that the crisis has only marginally affected some of the world's leading emerging markets. These markets have spent the better part of the last decade strengthening their macro-prudential regimes and cleaning up the balance sheets of leading domestic financial institutions. This time around, the crisis has befallen the countries and institutions arguably least in need of policy signalling. Indeed, the financial crisis took root in countries ranked among the most open to trade and investment in financial services, and whose bound commitments under the GATS and preferential trade agreements (PTAs) typically lock-in the actual level of (largely) non-discriminatory access afforded by domestic regulatory regimes.

An important distinguishing feature of the financial crisis of 2008–09 was its anchoring in a number of advanced industrialized nations. Such countries were long believed to have the most robust macro-prudential regimes and the most sophisticated supervisors enforcing the strictest regulatory regimes. They were also blessed with financial institutions widely seen as operating

Nations General Assembly on Reforms of the International Monetary and Financial System', September 2009, ch 3, para 208.

6 Cf. Nouriel Roubini and Stephen Mihim, *Crisis Economics* (London: Penguin, 2010); UK Financial Services Authority, 'The Turner Review – A Regulatory Response to the Global Banking Crisis', March 2009; Viral V. Acharya and Matthew Richardson (eds), *Restoring Financial Stability – How to Repair a Failed System* (New Jersey: Wiley, 2009).

7 Wendy Dobson, 'Further Financial Services Liberalization in the Doha Round?', No PB02-8 International Economics Policy Brief, 2002, at 6; Sydney J. Key, *The Doha Round and Financial Services Negotiations* (Jackson, TN: AEI Press, 2003).

cutting-edge risk-management systems developed by the best financial engineers money could buy.

B. Direct and indirect contextual considerations

Even though the financial crisis had little to do with trade policy as a central contributing factor, this article posits both policy and legal ramifications flowing from its resolution. On the policy side, a number of effects are likely to shape the climate within which trade and investment liberalization in financial services will proceed in future.

For starters, the financial crisis has arguably dented the legitimacy of the traditional *demandeurs* in financial services negotiations. Recent years have seen the marked ascent of a number of emerging country players in the financial field. Such a trend is certain to fuel increasingly offensive market-access interests likely to find expression in trade and investment policy in the coming years, whether in the WTO or under PTAs and bilateral investment agreements (BITs). The fact remains, however, that developed countries, by a large margin, are the main exporters of financial services today and hence they are the predominant *demandeurs* in financial services negotiations. The Organisation for Economic Co-operation and Development (OECD)-centric nature of the financial crisis is likely to complicate the advocacy of further trade-induced financial market opening by its chief protagonists. This problem is likely to be felt more acutely at the WTO level than under PTAs to the extent that individual OECD countries with significant export interests in financial services—e.g. the USA, Japan, Canada, Switzerland and leading EU Member States—enjoy significantly greater negotiating leverage within bilateral confines than in Geneva discussions.

Secondly, the financial crisis must be situated against the backdrop of a changed, liberalization-adverse ideological environment. Its regulatory fall out coincides with the ongoing prosecution of the Washington Consensus and its advocacy of financial and capital account liberalization. This trial has been proceeding since the conclusion of the Uruguay Round and thus largely predated the onset of the financial crisis. Still, just as the financial crisis has shaken the economics profession and notably the manner in which open economy macro-economics is taught, it is also likely to have marked an important inflection point following a 30-year period of almost theological belief, both in business and policy circles, in the inherent efficiency of markets, the innate virtues of financial innovation and a clear bias towards light(er) regulatory approaches, especially in standard-setting financial centres such as New York or London.

From a trade policy perspective, such a changed ideological climate could affect both the pace and nature of *negotiated* market opening in financial services. This is so even though one may remain relatively sanguine over prospects for continued *unilateral* market opening on the part of the world's key emerging markets, i.e. those countries on the receiving end of most requests for further financial liberalization in a trade policy setting.[8] Indeed, the future relevance of trade and investment rules may well lie as much in preventing governments of OECD countries from succumbing to the (diminished giant) temptation to backslide and undo the edifice of trade and capital mobility painstakingly erected over the past six decades, as in driving the process of financial opening in emerging markets.[9]

C. The trade policy fallout from the financial crisis: possible transmission channels

From the above considerations, five channels linking the financial crisis to the conduct of financial services negotiations can be identified. Each one of these channels calls into question beliefs and policy assumptions that have long formed the basis upon which financial services negotiations have proceeded.

The first channel relates more centrally to investment policy and concerns the optimal degree of foreign presence in domestic financial markets. To the extent that some (typically large) foreign financial operators may be seen as vectors of financial contagion in crisis situations, host-countries may express legitimate concerns that a significant foreign financial presence in domestic markets might heighten macro-prudential risks. In turn, this could legitimize, on prudential grounds, calls for the maintenance or introduction of tighter restrictions on the entry of foreign operators (Mode 3 in GATS parlance), stricter quantitative caps on foreign equity holdings or broader limitations on the permissible scope of post-entry operations by foreign service providers.

The second, closely related, channel concerns the desirability, once more on macro-prudential grounds, of continuing to allow entry of foreign financial institutions through direct branching as opposed to via subsidiaries. The (largely successful) battle to secure access through direct branching has been one of the fiercest fought by OECD governments (and the financial industry) in their quest for financial market opening since the inception of the GATS. Such market opening has also ranked high on PTA radar screens.[10] Yet here again, legitimate concerns of a prudential nature might be expressed

[8] The reason for this lies in the growing recognition—measured in continued autonomous policy reforms on the part of many developing country governments—of the central role that a properly regulated, pro-competitive, financial system can play in overall allocative efficiency and medium-term growth prospects.

[9] Cf. Daniel Price, 'The New Face of Anti-Globalization: Economic Recovery and Reform Efforts', in Alexei Monsarrat and Kiron Skinner (eds), *Renewing Globalization and Economic Growth in a Post-Crisis World – The Future of the G-20 Agenda* (Pittsburgh: Carnegie-Mellon University and the Atlantic Council, 2009) 73–76.

[10] Cf. Mona Haddad and Constantinos Stephanou (eds), *Financial Services and Preferential Trade Agreements – Lessons from Latin America* (Washington, DC: World Bank, 2010).

regarding the contagion risks that highly leveraged, foreign-established, financial institutions represent for host-countries, all the more so given the limited jurisdictional reach of domestic regulators over foreign branches. Concerns of this nature were heightened by home-country calls for foreign branches to rein in activities abroad and concentrate on lending at home as a counterpart to domestic bailout schemes. Rolling back regulations allowing for entry via direct branching would in many countries require a modification or withdrawal of existing commitments scheduled under the GATS and under PTAs. Trade law would thus appear, in this instance, as a potential rampart against de-liberalization. It may also, *a contrario sensu*, be seen as a potential hurdle to prudential policy design and implementation.

The third channel through which the financial crisis of 2008–09 might be felt in trade policy circles concerns the preference that host-country regulators may henceforth have for commercial presence as a means of ensuring more effective prudential oversight of foreign established financial operators. While such 'forced establishment' requirements might be deemed tantamount to service sector performance requirements—an area where the GATS, unlike the General Agreement on Tariffs and Trade (GATT), imposes no multilateral disciplines,[11] the prudential concerns fuelling such requirements have already surfaced visibly in proposals regarding the Alternative Investment Fund Managers Directive and the regulation of credit-rating agencies. Any determined move in this direction would affect the modal distribution of services trade commitments, contributing to a further weakening of cross-border trade in financial services (so-called Mode 1). The latter is already the form of trade (alongside the movement of service suppliers) towards which host-country regulators have typically exhibited the greatest precaution in market-opening terms.

The fourth channel through which the financial crisis might affect the future conduct of financial market opening in a trade setting concerns the desirability of using trade agreements, and notably their financial services chapters, to secure the concomitant liberalization of capital account transactions and related limitations on short-term capital movement. While the liberalization of trade in financial services and associated cross-border payments and transfers requires, by definition, that certain restrictions on capital transactions be lifted, a number of countries, most notably the USA, have in recent years shown a marked proclivity to require more sweeping capital account liberalization from their trading partners in the context of financial services negotiations. This trend has been most noticeable in the context of North–South PTAs. The degree to which such pressures might be maintained in the future remains an open question. This is because of the changed US administration, whose views on financial liberalization may well be

[11] Performance requirements affecting the goods trade are disciplined by the Agreement on Trade-Related Investment Measures (TRIMs Agreement) under the GATT.

more tempered than that of its predecessor, and because countries which maintained greater restrictions on capital transactions (and which took a stricter stance on financial leverage) appear to have weathered the financial storm with greater ease than those which adopted a more liberal policy stance.

The fifth and final channel through which the financial crisis might affect the conduct of trade negotiations in financial services concerns host-country attitudes towards financial innovation and the calls, embedded in the GATS Understanding on Commitments in Financial Services and in numerous PTAs, to treat 'new' financial services favourably in regulatory approval terms (i.e. host-countries should allow trade in financial services that have secured home-country regulatory approval). As noted above, the financial crisis has shaken the long-held belief in the innate virtues of (all forms of) financial engineering, with leading financial market authorities openly questioning the societal value added of much financial innovation.[12]

D. Needed for trade-facilitating and dispute prevention purposes: an internationally coordinated regulatory response

An important challenge confronting the trade and finance communities is whether the—to date primarily national—response to the financial crisis might increase the likelihood of a trade or investment challenge to regulatory measures taken on prudential grounds. Simply stated, are we about to determine the true remit of the GATS prudential carve-out through binding trade and investment arbitration? We believe that the financial crisis may have increased the likelihood that the answer to this question will be in the affirmative. This is so even though judicial activism is not the natural reflex of central bankers and financial supervisors, whose preference lies more with club-like discussion and mediation in Basel at the Bank for International Settlements (BIS) than with adversarial and legally enforceable litigation in Geneva (at the WTO) or under the arbitral proceedings of various tribunals concerned with investment disputes. And this is so even though the scope for successfully prosecuting a financial services complaint under trade law continues to be constrained (as the following section will show) by the incomplete and ambiguous nature of the rules governing trade in financial services.

To date, countries have largely acted according to national impulses, with differing market structures and political climates generating diverse policy proposals. The more such trends predominate, the greater the risk that some jurisdictions may impose regulatory requirements which, while infused

[12] Prominent examples of such commentaries came from individuals such as Paul Volcker, former Governor of the US Federal Reserve; Mervyn King, the current Governor of the Bank of England; and Lord Turner, head of the United Kingdom's Financial Services Authority.

with prudential objectives, might still be excessive, unduly burdensome or serve as a cover for industrial policy activism in the financial sector.[13] Trade and investment litigation targeting prudential measures is likely to be significantly less if G-20 governments succeed in adopting common reform proposals that move the world in the direction of internationally agreed regulatory reforms in finance.

E. Addressing competitive distortions

A further means to gauge the likely fallout of the financial crisis on trade and investment diplomacy in finance is through the answers to a number of important questions on pro-competitive conduct arising from the unprecedented financial bailouts the world has witnessed. Although a number of policy measures were temporary and subject to early reversal, such as when bailed-out institutions paid back capital infusions to their home-country governments, the scale of recent governmental intervention in financial markets is unlikely to have been competition-neutral in all instances. Such a reality raises complex policy challenges at the interface of trade, investment and competition policy. It also confronts the competing, and at times contradictory, logics of trade and financial policy, with the former anchored in respect for the principle of non-discrimination and the latter principally concerned with principles of soundness and security and the avoidance of systemic market failures in financial markets. Such a clash of regulatory cultures, in turn, raises a number of fundamental questions, some of which might ultimately have to be mediated in a trade policy arena. Such questions include the following:

(1) Should respect for non-discrimination (national treatment and most-favoured nation treatment) always and everywhere trump macro-prudential and financial stability concerns and the measures required to restore or maintain such stability? Simply stated, can financial bailouts ever be fully nationality-blind?
(2) How discriminatory have financial bailouts been in reality? Such an empirical question clearly points to the central importance of transparency and of multilateral monitoring and surveillance, which the

[13] As with any major crisis, the policy response to the financial crisis runs the very real risk of regulatory overshooting, with the immediacy of emotion and political expediency succeeding over measured responses. There is already some evidence of this in both the EU and the USA, although in both instances it is important to disentangle legitimate public policy concerns over the compliance costs, fairness and ultimate effectiveness of proposed regulatory fixes from more narrowly commercial lobbying efforts on the part of the financial industry aimed at watering down any significant departures from the pre-crisis regulatory *status quo*. See Chris Giles, 'IMF Fears Rules will Kill Off Securitization', *Financial Times*, 8 October 2009, 3. See also Nikki Tait, 'EU tries to break logjam on hedge funds', *Financial Times*, 14 April 2010, 3 and T. Braithwaite and S. O'Connor, 'US Financial Rules System Faces Overhaul', *Financial Times*, 4 June 2009, 4.

WTO has usefully taken up more resolutely in the trade and investment fields in the wake of the financial crisis in partnership with the OECD and the United Nations Conference on Trade and Development (UNCTAD). Yet more credible monitoring in the financial field is likely to require closer co-operation and coordination among the trade, finance and competition policy communities than we have witnessed to date. The fact that the worlds of trade and finance already operate through multilateral agencies, whereas the competition world does not, could be problematic in this regard.

(3) Does the interconnectedness of financial markets and of financial market operators, particularly those involved in wholesale markets, imply that what have largely been *de jure* national bailouts have *de facto* most-favoured-nation (MFN) effects that may lessen their distortive impact? Once again this is largely an empirical challenge that would require the expert opinion of financial market specialists from the BIS, the Financial Stability Board (FSB) or the International Monetary Fund (IMF) working in concert with their trade and competition counterparts.

(4) Potentially anti-competitive effects of financial bailouts are not sufficiently documented. In the EU, at the end of December 2009, Directorate General for Competition (DG Competition) had issued 81 advisory notes on the competition impact of financial bailouts, 75 of which were deemed unproblematic from the perspective of the EU's state aid policy. In six cases, however, the impact on competition—through excessive market concentration leading to concerns over possible abuse of dominance—was deemed sufficient to prompt demands for remedies, typically in the form of forced divestitures.[14] In such instances, might one not assume that cross-border trade and investment opportunities could also be compromised and existing GATS or PTA commitments potentially nullified or impaired? Thus, the risk of bailout-induced problems of market contestability, while generally limited, cannot be discounted. Nor can trade and investment litigation be discounted, for this very reason. Similarly, the rising level of judicial activism witnessed under BITs and PTAs featuring comprehensive investment disciplines suggests that scope exists for investor–state lawsuits targeting prudential measures in finance as forms of indirect expropriation. The likelihood of such litigation is all the greater as few investment chapters in PTAs (and even fewer in BITs) feature a prudential carve-out analogous to

[14] See Thorsten Beck, Diane Coyle, Mathias Dewatripont, Xavier Freixas, and Paul Seabright, *Bailing Out the Banks: Reconciling Stabililty with Competition – An Analysis of State-Supported Schemes for Financial Institutions* (London: Center for Economic Policy Research, 2010).

that found in GATS or in the financial services chapters of or annexes to PTAs.

F. The financial crisis and the unfinished agenda in services rule-making

The regulatory response, both national and international, flowing from the financial crisis and its resolution, is also likely to have repercussions for the unfinished rule-making agenda in services trade. This is particularly so with regard to the need for a fully fledged subsidy regime for trade in services, as well as for embedding a necessity test able to deal with unduly burdensome, disproportionate, inadvertent or disguised domestic regulatory restrictions on trade and investment in services (including financial services).

In the following sections, we explore more fully the legal ramifications of the financial crisis by taking up the issue of how it might revive and inform the quest for more effective multilateral disciplines in these unfinished areas of GATS rule-making. As it happens, these are areas with readymade institutional anchors and negotiating mandates. Coming to our punch line early, we ask: why waste a crisis when useful advances can come from it in good-governance, pro-competitive, rule-making terms?

III. LEGAL CONJECTURES

A. Assessing the relevance and effectiveness of existing trade disciplines

Flexibility and softness stand out as two central traits of the supra-national legal framework governing the various measures adopted to remedy the consequences of the financial crisis. The principles and rules adopted under the aegis of the FSB,[15] the BIS and the Basel Committee on Banking Supervision (BCBS) are all neither binding nor enforceable.[16] Meanwhile, the GATS still lacks a comprehensive framework to tackle non-discriminatory, but nonetheless unduly burdensome, regulatory measures; the potentially distortive effects of subsidization in services trade;[17] or the prosecution of anti-competitive practices, among others. Such substantive shortcomings would appear, *prima facie*, to weaken the chances of a successful legal challenge before the WTO adjudicating bodies under current rules. In the meantime, and absent any effective disciplines, it is worth examining

[15] Cf. FSB, 'Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability', 18 June 2010.

[16] See also Mamiko Yokoi-Arai, 'GATS' Prudential Carve Out in Financial Services and its Relation with Prudential Regulation' 57 International and Comparative Law Quarterly 613 (2008), at 636. Of course, the softness of a rule does not necessarily imply that it is not respected. This is because of reputation costs and the interest in being a reliable 'member of the club'. See Chris Brummer's contribution in this volume. Also Daniel W. Drezner, *All Politics is Global: Explaining International Regulatory Regimes* (Princeton, NJ: Princeton University Press, 2007).

[17] See Pietro Poretti, *The Regulation of Subsidies within the General Agreement on Trade in Services of the WTO: Problems and Prospects* (Alphen aan den Rijn: Kluwer Law International, 2009).

under which conditions a non-violation complaint under GATS Article XXIII:3 could be invoked. Other than the extremely onerous features of this provision, which are analogous to GATT Article XXIII:1(b),[18] the existence of specific commitments in the relevant sector is warranted. In the case of financial services, this condition would be easily fulfilled in a complaint raised against a developed country, as most developed countries undertook far-reaching commitments in financial services based on the Understanding on Commitments in Financial Services.

The state of affairs described above need not be unduly worrisome if the measures adopted to promote financial recovery are temporary, as the G-20 leaders pledged in Pittsburgh in November 2009. However, it could become a cause for greater concern if the above measures durably distort competitive conditions in the marketplace, affording undue advantages to certain institutions over others or rescuing otherwise unviable institutions from the exigencies of market exit.[19] Equally worrisome are the potentially trade-distorting effects of enticing bailed-out institutions to curtail or withdraw from activities abroad with a view to buttressing domestic lending activities.

The GATS, like all WTO agreements, is an incomplete contract.[20] As befits any agreement in an area that was previously uncharted, the wording of several GATS obligations, for instance, that define services that are excluded from the Agreement's remit or the prudential carve-out applicable to trade in financial services, is drafted in an (often deliberately) ambiguous manner. Meanwhile, several key substantive obligations, notably those on subsidies (Article XV), emergency safeguards (Article X), government procurement (XIII)[21] or domestic regulation (Article VI), which constitute the so-called 'unfinished rule-making agenda of GATS', remain a work in progress 23 years after the launch of the Uruguay Round, in some cases with decidedly slim chances of successful closure.[22]

The financial crisis of 2008–09 underscores the importance of developing effective legal disciplines able to help governments counteract the potentially

[18] Cf. Panel Reports, *Korea – Measures Affecting Government Procurement (Korea – Procurement), WT/DS163/R*, adopted 19 June 2000; and *Japan – Measures Affecting Consumer Photographic Film and Paper (Japan – Film)*, WT/DS44/R, adopted 22 April 1998.

[19] See European Commission, 'Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis', OJ C 83/1 of 7 April 2009.

[20] On the incompleteness of the WTO agreements, see Henrik Horn, Giovanni Maggi and Robert W. Staiger, 'Trade Agreements as Endogenously Incomplete Contracts', National Bureau of Economic Research Working Paper No 12745, December 2006.

[21] As to government procurement, the Understanding on Commitments in Financial Services entails an exception to the overall absence of disciplines on government procurement by requiring that public entities respect MFN and non-discrimination when they purchase financial services.

[22] Cf. Pierre Sauvé, 'Completing the GATS Framework: Addressing Uruguay Round Leftovers', 57(3) Aussenwirtschaft 310 (2002).

trade-restrictive effects of financial rescue measures—including those taken on prudential grounds—and to remove the temptation for governments to resort to overtly protectionist financial measures. The question arises of how far the GATS provides them with such means and, if it does not, what can or should be done in future to equip the GATS (and PTAs featuring disciplines on services trade) with the ammunition needed to ensure the continued relevance of trade law in addressing the regulatory fallout from financial crises whose periodic occurrence is a constant in market economies.

B. The need for clarity on the scope of agreed disciplines

The need for financial authorities to enact prudential regulation in response to the various types of market failures buffeting financial markets is unanimously agreed. Indeed, and paradoxical as it may seem in the wake of the most recent episode of acute financial turmoil, the financial sector ranks in virtually all countries among those subject to the greatest regulatory scrutiny. True to form, the GATS, like trade agreements in general, has little to say on the substantive content of prudential rules or the policy rationales behind their enactment. The remit of trade policy generally lies elsewhere, in determining whether the regulatory objectives that nations set for themselves, and the means to achieve them, are broadly proportionate and necessary according to objective, verifiable criteria and that they do not serve as disguised restrictions to trade or investment. As discussed below, to date the GATS (and PTAs covering services trade) falls short of the above objective by virtue of the inability of WTO Members to reach agreement on the substantive elements of a necessity test for services trade.

As regards the scope of trade disciplines in the services' realm, Article I:3(b) of the GATS (and equivalent provisions found in all PTAs covering trade in services) largely exempts from the Agreement's remit any service provided in the exercise of governmental authority, i.e. public services that are provided on a non-commercial (i.e. not for profit) and non-competitive basis (i.e. not in competition with any other service or service supplier).[23]

The GATS clarifies the sector-specific meaning of Article I:3 in a series of sectoral annexes. In the area of financial services, the Financial Services Annex specifically excludes from the scope of the GATS: (i) activities of central banks and monetary authorities relating to monetary or exchange rate policies; (ii) activities forming part of a statutory system of social security or public retirement plans; and (iii) activities conducted by public entities either for the account or with the guarantee or using governmental financial resources. The Financial Services Annex, however, clarifies that the above activities (with the exception of monetary and exchange rate activities which

[23] GATS Article I:3(b) and (c). Also Eric Leroux, 'What is a "Service Supplied in the Exercise of Governmental Authority" Under Article I:3(b) and (c) of the General Agreement on Trade in Services?', 40(3) Journal of World Trade 348 (2006).

are clearly monopolistic state prerogatives) would not escape the purview of the GATS if these services are supplied in competition with private financial service suppliers.

The above provisions of the Financial Services Annex clearly raise numerous interpretive questions, not least of which is whether the types of emergency interventions that financial authorities enacted during the financial crisis fall within or outside the scope of monetary and exchange rate policies and whether some of the beneficiaries of financial bailouts—e.g. entities such as Freddie Mac or Fannie Mae—fit the definition of the public services benefitting from the carve-out and the prosecutorial immunity it affords, in principle, to carved-out entities.[24]

C. Determining the scope and limits of the prudential carve-out in GATS

The Financial Services Annex to the GATS complements and, in some instances, modifies the scope of various GATS provisions in the area of financial services. As Uruguay Round negotiations pursued the development of a horizontal framework and vertical sectoral provisions in a concurrent manner, negotiators realized, alongside GATS Article XIV on General Exceptions which the framework agreement incorporated in a generic, all-inclusive manner, that there was a need for a provision that would exempt from the scope of the GATS those regulatory interventions in the financial sector which responded to prudential concerns. As a result, drafters of the GATS reached agreement on a so-called 'prudential carve-out' in Paragraph 2 of the Financial Services Annex. They did so, however, without defining what this category of measures actually entailed.[25] The legal discipline, entitled 'Domestic Regulation', reads:

> (a) *Notwithstanding any other provisions of the Agreement*, a Member shall not be prevented from taking measures for prudential reasons, including 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. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement. (emphasis added)

[24] Paragraph 1(b)(iii) of the GATS encompasses a catch-all category of activities performed by a supplier. The most interesting aspects relate to the definition of public entity and the benchmark that would make a certain activity 'governmental' rather than private. See Armin von Bogdandy and Joseph Windsor, 'Annex on Financial Services', in Rüdiger Wolfrum, Peter-Tobias Stoll and Clemens Feinäugle (eds), *WTO – Trade in Services: Max-Planck Commentaries on World Trade Law* (Leiden NL: Martinus Nijhoff Publishers, 2008) 618, at 633.

[25] Australia's proposal to define such measures did not have any substantial support from WTO Members. See the Committee on Trade in Financial Services meetings held on 13 April 2000, 25 May 2000, 13 July 2000 and 9 October 2000, S/FIN/M/25-28.

The negotiating history of the GATS reveals that, while WTO Members agreed on the need to insert such an exception into the Financial Services Annex, discussions about the actual scope of the provision under the auspices of the Committee on Financial Services have been few.[26] There are two likely reasons for such relative silence. First, negotiations in financial services concentrated largely on the market opening dimension, such that discussions among Members focused on the actual scope of Articles XVI and XVII of the GATS (market access and national treatment, respectively), rather than on non-discriminatory regulatory measures (Article VI). Second, it appears that several Members took the view that discussing further and perhaps defining the precise remit of the prudential carve-out could actually reduce their regulatory flexibility when enacting such types of measures.[27] Several early assertions that prudential measures should enjoy full prosecutorial immunity under the GATS were rooted in such a perception, which financial supervisors and central banks felt strongly about, but which made trade officials uneasy over the prospect of demands for similar carve-outs in other service sectors. The ultimate compromise reached would submit prudential measures to the WTO dispute settlement provisions, but ensure that any WTO dispute in financial services would involve panellists with the requisite expertise in the financial service issue under dispute.

While there is no WTO jurisprudential guidance regarding the interpretation of the prudential carve-out, its wording clearly suggests that the prudential carve-out is an exception provision with a function similar to that found in GATT Article XX or GATS Article XIV. This means that derogations from any obligation enshrined in the GATS can be justified if the conditions laid down in Paragraph 2 are met. The carve-out covers a potentially broad range of measures so long as it can be shown that they are adopted for prudential purposes. The initial burden of proof lies with the complaining party, who will need to adduce evidence showing the violation of a substantive GATS obligation. Once established, the burden of proof to establish the affirmative defence shifts to the respondent. As with other general exception clauses, Paragraph 2 involves a two-tier test: first, the WTO judiciary will need to examine whether the measure is taken for prudential reasons. A rational relationship between the measure and the objective pursued should be regarded as the minimum required by this provision. This view is corroborated by the last sentence of Paragraph 2(a).[28]

[26] See Juan Marchetti, 'The GATS Prudential Carve-out', in Panagiotis Delimatsis and Nils Herger (eds), *Financial Regulation at the Crossroads – Implications for Supervision, Institutional Design and Trade* (Alphen aan den Rijn: Kluwer Law International, 2010) (forthcoming).

[27] See Key, above n 7, at 39.

[28] It was argued that the latter sentence also encompasses an intent test. See Bogdandy and Windsor, above n 24, at 635.

If the above criterion is met, the complaining party will have to prove that such measures still violate relevant GATS provisions. If this is successfully established, it will then be for the respondent to prove that the measures are not used as a means of avoiding its obligations or scheduled commitments. This second tier of the test differs from the second tier of the GATT Article XX test. In the case of the last sentence of Paragraph 2(a), it appears that no demonstration of 'discrimination in application' is required. We submit, however, that a broader discrimination test seems to be implied here and that a delicate balancing exercise between the objective pursued and the alleged discriminatory treatment is warranted. For such a determination, the panellists would probably envisage recourse to other sources, such as the work done within the IMF or the BCBS, to determine the adequacy and necessity of the prudential intervention at stake.

D. Towards a necessity test for services? Addressing the trade-inhibiting effects of non-discriminatory domestic regulatory conduct

It is generally accepted that the bulk of measures taken to strengthen the resilience of domestic financial systems in the aftermath of the crisis were non-discriminatory in nature.[29] In assessing the possibly adverse impacts that such measures may still have on trade, Article VI of the GATS as well as the prudential carve-out of the Financial Services Annex take centre stage.

In GATS-speak, domestic regulation, as defined in Article VI:4, relates to national measures aimed at ensuring the quality of the service supplied and which do not discriminate (and thus do not fall under the national treatment obligation of GATS Article XVII) nor do they constitute quantitative limitations (and thus do not come under the market access obligation of GATS Article XVI). Due to the intangible nature of services and the lesser relevance (than in goods trade) of the border as a locus of trade regulation in services markets, domestic measures can become the greatest barriers to services trade even in the absence of overt discrimination.[30] In the financial sector, non-discriminatory measures with the potential to significantly restrict trade are not uncommon. Onerous reserve requirements, the impact of which may be felt more acutely by new entrants or less well-established foreign service providers, are one example. The potential trade-restrictive impact of domestic regulations stands in sharp contrast to the weak legal disciplines meant to curtail such practices under Article VI:4 of the GATS.

Such a situation inevitably entails greater reliance on the WTO's adjudicating bodies. However, challenging domestic regulatory conduct in services

[29] See Beck et al., above n 14. See also WTO Secretariat, 'Financial Services', Background Note, S/C/W/312, 3 February 2010.

[30] See Panagiotis Delimatsis, *International Trade in Services and Domestic Regulations – Necessity, Transparency, and Regulatory Diversity* (Oxford: Oxford University Press, 2007).

trade, and particularly non-discriminatory conduct, is fraught with controversy, as the *US—Gambling*[31] case demonstrated.

It would appear that the additional disciplines on domestic regulation emerging from the most recent discussions within the GATS Working Party on Domestic Regulation (WPDR) are unlikely to address the above tension satisfactorily. This is because Article VI:4 has a limited scope *ratione materiae*, covering only measures relating to qualification requirements and procedures, licensing requirements and procedures and technical standards. This means that the bulk of the financial recovery measures adopted during and after the financial crisis would be likely to escape the purview of any newly agreed disciplines. This said, such disciplines will assume greater relevance once national laws describing the new regulatory conditions under which financial activities can be pursued (and thus, for instance, under which a licence to provide financial services can be obtained) are adopted.[32]

Absent greater progress under the Article VI:4 work programme, and notably the continuing impasse over the desirability of embedding a necessity test for services trade, the obligations enshrined in Article VI:1, which requires that measures of general application affecting trade in services be administered in an objective, reasonable and impartial manner,[33] could prove beneficial.[34] Whereas this obligation is conditional on the presence of specific commitments, the fact that the commitments undertaken in the financial sector (notably by developed countries) tend to be comprehensive suggests that such an obligation may have significant ramifications for domestic regulatory conduct. Accordingly, any further strengthening of this discipline involving the codification of criteria with which to determine the objectivity, impartiality and reasonableness of domestic regulatory measures (as opposed to their administration) would be welcome. For the time being, however, the lack of effective disciplines on the potentially trade-restrictive effects of origin-neutral regulatory measures clearly diminishes the 'bite' of the GATS and lessens its relevance as an instrument with which to better manage the latest and future episodes of financial turmoil.

[31] Panel Report, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services* (*US – Gambling*), WT/DS285/R, adopted 20 April 2005, as modified by Appellate Body Report, WT/DS285/AB/R.

[32] For a discussion of the sometimes far-reaching scope of these disciplines, see Panagiotis Delimatsis, 'Concluding the WTO Services Negotiations on Domestic Regulation – Hopes and Fears', 9(4) World Trade Review 643 (2010).

[33] Panagiotis Delimatsis, 'Due Process and "Good" Regulation Embedded in the GATS – Disciplining Regulatory Behaviour in Services Through Article VI of the GATS', 10 Journal of International Economic Law 13 (2007); Markus Krajewski, 'Article VI GATS (Domestic Regulation)', in Wolfrum et al., above n 24, at 165.

[34] Cf. Bart De Meester, 'The Global Financial Crisis and Government Support for Banks: What Role for the GATS?', 13 Journal of International Economic Law 27 (2010), at 52.

The paradox of the 'necessity' stalemate in the GATS discussions originates in the reluctance of regulators—above all (but not only) those of the USA—to see sovereign regulatory decisions subject to the potential scrutiny of unelected, non-specialist, trade judges.[35] Such a stalemate offers the rare example of a political economy configuration in which trade rules (or, more precisely, the lack thereof) are shaped more by the desire of regulators than those of industry. This is all the more paradoxical in the case of the USA, the world's leading exporter of services (including financial services) and whose internationally active firms are arguably most likely to be victims of unduly burdensome regulatory conduct or disguised restrictions on trade and investment in foreign markets.

The financial crisis offers a readymade opportunity to link the processes of services trade liberalization with those of regulatory reform and institutional strengthening, not only domestically, but also across borders.[36] Several ideas were advanced on how the GATS and prudential standards might, in the future, be linked.[37] Equally pressing is the need to create stronger co-operation networks between regulators, which would allow more regular exchanges of information on domestic and regional reform initiatives and help identify best practices as well as better manage crises.[38] Such networks should be encouraged within the new, more inclusive, governance mechanisms of international financial regulation that are emerging in the aftermath of the crisis. At a time when the virtues of multilateral co-operation are assuming renewed prominence, agreements relating to the mutual recognition of prudential measures in accordance with Paragraph 3 of the Financial Services Annex may also become much more appealing as a way of facilitating trade in financial services, promoting regulatory convergence and reducing the scope for trade tensions. In drawing up such agreements, the parties should be encouraged to use international standards (notably those created in Basel) to the greatest extent possible.

[35] This concern may be somewhat less in the area of financial services to the extent that the Financial Services Annex explicitly provides that any WTO dispute in the sector shall feature panel expertise drawn from national rosters of financial services specialists.

[36] Currently, we see a fairly nationalistic (or regional, in the case of the EU) approach towards institutional strengthening. See, for instance, European Commission, 'Regulating Financial Services for Sustainable Growth', COM (2010) 301 Final, 2 June 2010, at 3. For a tentative criticism, see Iain Begg, 'Regulation and Supervision of Financial Intermediaries in the EU: The Aftermath of the Financial Crisis', 47(5) Journal of Common Market Studies 1107 (2009).

[37] See the contribution by Thomas Cottier and Markus Krajewski in this volume.

[38] Cf. FSB, 'Promoting Global Adherence to International Cooperation and Information Exchange Standards', 10 March 2010. See also G30, 'Financial Reform – A Framework for Financial Stability', 2009.

E. Disciplining the distortive effects of subsidies in services trade

A cursory review of the rescue measures enacted in the aftermath of the financial crisis suffices to show that many such measures constituted, in one way or another, a form of subsidy that would be routinely open to legal challenge under the GATT.[39] Subsidies carry the potential for severely affecting the nature and extent of competition in finance both within a domestic market and across borders.[40] It is precisely this type of concern that makes the case for promoting greater coordination of regulatory responses to the crisis beyond the nation-state level a compelling one.

Together with tourism and transport services, finance is one of the service sectors where subsidies are most prevalent.[41] The financial crisis has clearly done little to stop this trend. Faced with significant financial turmoil and the prospect of systemic failure among financial institutions deemed too big to fail[42] as well as the concomitant fear of contagion, governments intervened during the crisis by providing financial institutions with staggering (in some cases unlimited) levels of direct support through capital injections and liquidity-guarantee schemes. Such substantial subsidization can distort competition in financial markets and put national beneficiaries in an advantageous position in a post-crisis environment.

In addition, as national banks and governmental institutions have become major shareholders in distressed financial institutions, such institutions could well exert a significant influence on the level of financial globalization and interconnectedness in the post-crisis era. For instance, once national shareholders become sellers after a few years, domestic banks may become less internationalized, or even exclusively domestically owned, if shares end up primarily in the hands of domestic investors, thereby potentially reducing the higher levels of financial market internationalization prevailing in the years preceding the financial crisis. Important distortionary effects on the allocation of capital within and across borders could thus be seen.[43]

Unfair competitive practices may arise when governmental support for financial institutions is attached to the granting of loans by these institutions to revitalize the national economy. Whereas such support schemes are

[39] Around 80% (i.e. over US$ 9.5 trillion) of the federal relief in the USA alone was provided to services. See Gary Horlick and Peggy Clarke, 'WTO Subsidy Disciplines During and After the Crisis', in this volume.

[40] See WTO Secretariat, above n 29.

[41] See WTO, Working Party on GATS Rules, 'Subsidies for Services Sectors – Information Contained in WTO Trade Policy Reviews', S/WPGR/W/25/Add.5, 27 March 2007.

[42] For those elements that make a bank systematically important, see IMF, BIS, FSB, 'Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations – Background Paper', October 2009.

[43] FSB, 'Exit from Extraordinary Financial Sector Support Measures', Note for the G20 meeting of Ministers and Governors on 6–7 November 2009, November 2009.

adopted as emergency measures and are typically temporary[44] (and admittedly several measures of this type have since been withdrawn or banks have foregone the use of guarantees),[45] their continuous application is tempting. In times of prolonged macro-economic instability, pressure exerted by special interest groups for continued state support may mount and indeed be difficult to reverse, particularly in jurisdictions where the financial sector is weakly constrained by competition law.[46] Depending on how a domestic support scheme is structured, severe distortions to the competitive relationships of service suppliers in the marketplace can be generated.

While state aid schemes displaying characteristics similar to those described above can be challenged under the WTO Agreement on Subsidies and Countervailing Measures in the case of trade in goods, competitive distortions in services markets will remain largely unchallenged owing to the absence of a dedicated set of subsidy disciplines under the GATS. Absent such a regime, on which scant negotiating progress has been achieved since the early days of the Uruguay Round, potentially trade and investment-distorting subsidies of the type applied during the financial crisis can proceed with almost full impunity. This should not be taken to mean that the GATS does not apply to subsidies, which unquestionably constitute measures affecting trade in services under GATS Articles I:1 and XXVIII(a). Thus, in order to escape the scope of Article II, subsidies would have to be included in the list of MFN exemptions of a given Member. By the same token, they cannot be discriminatory unless they are scheduled,[47] limiting eligibility to nationals either sectorally or via so-called horizontal limitations.[48] Otherwise, intervening Members are not allowed to discriminate against foreign, albeit like, financial service suppliers present in their territory.[49]

As noted above, negotiations on subsidies within the Working Party on GATS Rules have not made any substantial progress to date.[50] This would

[44] See also WTO, Trade Policy Review Body, 'Report to the TPRB from the Director-General on Trade-related Developments', WT/TPR/OV/W/3, 14 June 2010.

[45] See European Commission, 'The application of State aid rules to government guarantee schemes covering bank debt to be issued after 30 June 2010', DG Competition Staff Working Document, 30 April 2010, at 3. See also IMF, 'A Fair and Substantial Contribution by the Financial Sector', Final Report for the G-20, June 2010.

[46] In theory at least, the resumption of normal lending activities to the benefit of the economy at large is regarded as a *conditio sine qua non* for the acceptance of otherwise actionable subdidization practices. See European Commission Communication, 'Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis', OJ C 83/1 of 7 April 2009.

[47] See WTO, 'Guidelines for the Scheduling of Specific Commitments Under the General Agreement on Trade in Services (GATS)', S/L/92, 28 March 2001, para 16.

[48] Cf. WTO, Working Party on GATS Rules, 'Limitiations in Members' Schedules Relating to Subsidies', S/WPGR/W/13/Add.2, 30 August 2004.

[49] Cf. Poretti, above n 17.

[50] See also Rudolf Adlung, 'Negotiations on Safeguards and Subsidies in Services: A Never-Ending Story?', 10 Journal of International Economic Law 235 (2007).

appear to reflect a clearly revealed policy preference for regulatory inaction on the part of those WTO Members with the deepest pockets. Here again, the financial crisis offers a basis for reconsidering the scope and likely substantive elements for a subsidy regime in services trade whose remit might be either horizontal (i.e. applicable to all sectors) or limited to a specific sector, such as financial services. There are strong reasons to believe that the traffic-light approach espoused in the area of trade in goods could be replicated in the services' realm.

The special and ubiquitous nature of finance, and the possible need for prudential considerations to be allowed to override non-discrimination principles in times of acute financial turmoil, suggest that any subsidy regime for financial services would need to feature a number of defining elements; these include the need for temporary measures; the certainty of policy reversal once crisis conditions abate; the need for governments to apply market interest rates to credit or loan guarantee schemes; the need for adequate multilateral surveillance of bailout conditions by multilateral agencies such as the IMF and the FSB working in tandem with the WTO; as well as the need for ensuring that any short-term disbursement of state aid is subject to proper competition-policy scrutiny in the relevant markets likely to be affected by governmental support measures.

IV. CONCLUSION

While the GATS and trade-induced financial services liberalization are not to blame for the latest financial crisis, such a statement leaves unanswered the question of whether the GATS (and trade law more broadly) can or should play a more critical role in shaping the post-crisis financial architecture. The crisis and the regulatory reforms likely to be enacted in its wake offer a propitious opportunity for revisiting the substance of services trade regulation. This should be done with a view to a substantive strengthening of services trade law that could better manage the downside risks of financial protectionism and offer a more credible platform for confronting the trade and investment disputes whose numbers this article considers likely to rise in the coming years. This article identified a number of contextual considerations and policy channels, some direct, others less so, likely to shape the climate within which trade and investment liberalization in financial services will proceed in the future. The main policy conclusion drawn is that the crisis is likely to complicate the quest for *negotiated* market opening in financial services, and more so at the WTO than the PTA level.

Each of the policy channels identified questions, beliefs and policy assumptions that have long formed the basis upon which financial services negotiations have proceeded. The first channel relates to investment policy and concerns the optimal extent of foreign presence in domestic financial markets. The second, closely related, channel concerns the desirability of encouraging entry of foreign financial institutions via direct branching as opposed to subsidiaries. The third channel concerns the preference that host-country regulators may henceforth have for commercial presence as a means of ensuring more effective prudential oversight of foreign established financial operators. Such 'forced establishment' requirements would be likely to affect the modal distribution of services trade commitments, contributing to a further weakening of cross-border trade in financial services. The fourth channel concerns the desirability of using trade agreements and their financial services chapters to secure the concomitant liberalization of capital account transactions and related limitations on short-term capital movement. The fifth, and final, channel concerns host-country attitudes towards financial innovation and the calls to treat 'new' financial services favourably in terms of regulatory approval.

The article contends that the likelihood of friction at the trade–finance interface has increased as a result of extensive governmental intervention in financial markets, such that judicial activism, including in the investment field, may be expected to increase in the future, resulting in legal challenges of measures enacted on prudential grounds. The resolution of such disputes will require delicate balancing acts and highlights the potentially competing and, at times, contradictory, logics of trade and financial law and policy. They also recall the crucial importance of buttressing currently weak multilateral disciplines on non-discriminatory regulatory conduct, not least because the crisis, and the changed ideological climate it appears to have ushered in, might well fuel regulatory overshooting. They also recall the useful role that competition disciplines operating at the interface of trade and investment law, could play in mitigating the potentially distortive effects of state intervention in financial markets. The article draws attention to the inadequacies and shortcomings of existing trade law in services if the GATS and PTAs featuring services disciplines are to play a useful role in addressing the potentially trade- and investment-restrictive and competition-impairing effects of the extensive financial rescue measures taken in the wake of the crisis of 2008–09. As currently drafted, existing service sector disciplines are either too vague or insufficiently developed to assume such a role.

The post-crisis period affords a unique opportunity to clarify the scope of GATS law in financial services; to establish with greater precision the remit of the prudential carve-out; and to complete long-stalled rule-making journeys on the key outstanding GATS disciplines of necessity and subsidies without which the law of services trade runs the very genuine risk of remaining a construct more theoretical than real.