

**MULTILATERAL TRADE
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THE URUGUAY ROUND**

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TEST OF THE APPLICABILITY OF CONCEPTS, PRINCIPLES
AND RULES TO THE FINANCIAL SERVICES SECTOR

INTRODUCTION

The international financial system is becoming increasingly complex, primarily because of the expansion of banking services and the appearance of new participants (brokerage houses, insurance and mortgage companies, securities firms, factoring institutions) and instruments in the market. This market has the twin particularity of being one of the most globalized and interconnected sectors of the world services economy, as well as one of the most highly regulated at the international level.

At present, the international financial system is in the midst of a process of transformation, deregulation and increasing automation.

The transformation process is the result, firstly, of the fact that clients are increasingly well informed, and therefore seek to obtain the best conditions and the best services. Secondly, there is fierce competition among banking and non-bank institutions, stock market intermediaries, insurance companies, credit card firms and specialized financial institutions. In the specific case of banking institutions, this transformation process is characterized by continual consolidation through the acquisition of small banks by large and prosperous ones with a view to reducing operating costs. Banks are also diversifying their business with a view to reducing risks.

Deregulation is the immediate consequence of this process of consolidation. The new rules emphasize profits. For banks, the rules oblige them to be more efficient and prudent in lending out their funds. In this process of deregulation, the securities market is expected in future to have a decisive influence over the control of banks, perhaps greater than that of central banks.

As far as increasing automation is concerned, the effects of technological developments stem from the possibility of increasing the number of operations and services at lower cost and of enabling some firms to compete in financial services with highly advanced technology.

All the foregoing means that the financial system is tending to become internationalized, and primarily the large financial institutions of developed countries. In these circumstances, the financial institutions of developing countries may be affected very adversely; therefore, the options open to them are modernization, competition, specialization with a

view to offering a better quality service, association with complementary financial institutions to offer joint products and learning to use traditional technology efficiently.

It should be pointed out that, according to a number of studies that have been made, the sudden and indiscriminate opening up of the sector has a negative effect on the growth of developing countries, and this has been shown by the experience of some countries where an abrupt process of banking deregulation has actually led to a loss of several percentage points in their gross domestic product.

Despite this stimulating and spectacular process which financial services are undergoing, major structural differences remain between the financial services provided by developed nations and those of developing countries. Perhaps the clearest example of these imbalances is provided by banking activities. Although the IMF does not provide figures on "trade" in banking services, it does give a rough idea of its possible dimensions: according to IMF data, total external liabilities of the banking institutions of industrialized countries during the present decade averaged 75 per cent of the total liabilities of international banking institutions. Combined with the fact that roughly 19 per cent of the remaining 25 per cent is in the hands of "off-shore" centres, we may conclude that the developing countries' share of world liabilities is a mere 6 per cent.

A comparison of assets shows the gap between the world shares of developed countries and developing countries: of the total of US\$5,024.3 billion in 1988, developed countries accounted for 3,807.5 billion, off-shore centres for 1,050.3 billion, and developing countries for the remainder (166.5 billion dollars).

Another example of the developing countries' disadvantage in trade and financial services is provided by insurance: during the present decade, developed countries accounted for 95 per cent of insurance premiums (ten countries for 90 per cent), and developing countries for the remaining 5 per cent.

Accordingly, the need is clear for developing countries to create sufficient economies of scale in their financial systems so that, together with a process of gradual opening up, they can have access to the financial markets of developed countries and make a positive contribution to world trade in financial services.

Applicability Test

According to the GATT secretariat's reference list, the financial services sector can be broken down into the following types of activities:

- wholesale and other bank deposit services;
- services related to the administration of financial markets;

- financial leasing;
- other credit-granting services (personal loans, mortgages, credit card and other credit services);
- services related to securities market (brokerage, securities issue and registration, portfolio management);
- other financial intermediation (including investment and property trusts);
- other services auxiliary to financial intermediation (loan broking, financial consultancy, foreign exchange services etc.).

The main purpose of this paper is to evaluate the repercussions that would arise from the application of some concepts, rules and principles included in the Montreal document to trade in financial services.

This exercise does not prejudice Mexico's negotiating position; it is purely a simulation of the applicability of the concepts to this sector. Two fundamental scenarios will be considered throughout what follows:

Scenario I. Agreement is reached only on the cross-border movement of financial services, which could take the following forms:

- I.A. - the cross-border service is provided temporarily; or
- I.B. - the cross-border service is provided indefinitely.

In this connection, it should be pointed out that the case may also arise where a consumer has to travel abroad in order to acquire a service which cannot be provided in his country of origin, or while abroad he may have to acquire a service, such as securing a guarantee, owing to a specific regulation in the host country. Although this may be important in some cases, it is not considered central from the standpoint of this document.

Having made this observation, we may say that the market for financial services is, broadly speaking, a highly atomized one, particularly in some of its segments, in which respects it is different from other services sectors.

In addition, and again unlike other services activities, financial operations usually involve considerable continuity and recurrence: a bank's client deposits or withdraws funds frequently; an investor with a brokerage firm may buy or sell regularly; a firm engaged in foreign trade may constantly require foreign exchange operations. In the case of leasing, provision of sureties or bonded warehousing, the degree of continuity or regularity is considerably smaller. Again, rapid technological progress facilitates accelerated cross-border operations in traditional services as well as the emergence of new services.

For the above reasons, as well as the large number of potential clients and the constant demand for services, we consider that scenario I.A is hardly feasible, and therefore throughout this exercise we shall refer exclusively to scenario I.B.

Scenario II. Agreement is reached on the cross-border movement of factors of production (establishment of financial institutions in other countries and flows of manpower) which could take the following forms:

II.A - the financial institution is established temporarily;

II.B - the financial institution would be established indefinitely;

II.B.1 - the financial institution recruits its manpower from any country (local, home country of the institution or a third country);
or

II.B.2 - the financial institution may only recruit local manpower.

As in the case of hypothesis I.A, it seems highly unfeasible that a sectoral agreement would be negotiated providing for the temporary establishment of financial institutions in other countries.

Nevertheless, the only way in which such an agreement could be negotiated would be if the temporariness referred not to the physical continuity of the operations but rather to the majority ownership of the equity. In other words, there could conceivably be the case where a financial intermediary would be established for a specific period as the majority shareholder, at the end of which period it would have to become a minority shareholder. It may even be said that when establishing themselves firms have an element of temporariness in countries where a firm is registered for a period of 99 years, although obviously here the temporariness is far slighter, with a possibility that it will not be renewed.

1. Progressive liberalization

As in other sectors, in financial services liberalization is not a synonym for deregulation: the negotiations concern only the regulations that limit trade in services and not the national rules and legislation serving development policies or internal regulation.

As indicated above, scenario I refers to the cross-border movement of financial services, and for the reasons given this is considered feasible basically when indefinite, i.e. scenario I.B.

In the case of banking, progressive liberalization would involve the gradual elimination of the restrictions contained in all regulations limiting trade in cross-border banking transactions. It should be pointed out that these restrictions usually concern the "passive" or liabilities side of operations; in other words, banks cannot tap resources or issue commercial paper, or have trust funds or manage investment funds of

various kinds. The assets or "active" side, however, i.e. basically the granting of loans, is usually liberalized as it is carried out with resources tapped in other countries.

Liberalization would imply changes in the application both of credit policy and of monetary policy, since instruments such as exchange controls, money supply control and even interest rate policy would be affected by liberalization in this sphere. It should be pointed out that, given the technological developments which have changed the specific features of the way in which banking transactions are carried out, it is difficult for regulations effectively to control cross-border trade in such services. There is no "Maginot line" for capital movements.

While progressive liberalization of trade in bank services would involve the gradual elimination of regulations basically designed to prevent the tapping of resources, it would not imply that they should no longer be regulated.

In other words, while freedom to carry out cross-border banking operations would be provided, it would then be necessary to support or even to strengthen their supervision.

Furthermore, progressive liberalization could involve a gradual easing as regards the scale of the operations that could be carried out.

It might be the case that progressive liberalization in scenario I.B would prove relatively attractive for firms providing banking services. They would not be subject to certain national regulations governing such aspects as legal reserve requirements, credit ceilings, interest rates, and so forth, which would mean better than national treatment in comparison with local firms. However, this scenario would not be attractive for the host country which would not be able to tap foreign investment resources and would have difficulty in tapping tax resources and also in regulating and supervising operations.

With regard to services related to securities markets, here again progressive liberalization would involve a gradual easing of the regulations that hinder trade in these services, such as brokerage firms and investment companies.

As in the case of banking services, the liberalization of these operations would affect the domestic financial policy guidelines, so that progressive liberalization would have to take account of the local situation in different countries. Similar considerations apply to the cases of other non-bank financial intermediaries, in particular foreign exchange firms and financial leasing. In this form, there would be no way in which foreign firms would be subject to the host country's rules.

For progressive liberalization to be in line with the Montreal document, developing countries should be allowed a margin of flexibility in opening up their financial markets, in keeping with their ability to compete and in line with their sectoral policies. Reciprocity in the negotiations on trade and financial services will have to be relative.

This would mean that developing countries, whose financial sector in general does not have either the technological or the financial resources of the developed countries, would be able to foster the healthy and self-sustained development of their own intermediaries.

With regard to scenario II, progressive liberalization would involve the establishment of financial institutions in the host country. Such establishment could be temporary, II.A, or indefinite, II.B, for the same reasons as were considered in the previous scenario. Likewise, these comments will focus on scenario II.B, which may or may not involve cross-border flows of labour.

It should be pointed out that since financial services are generally capital-intensive, it would in any event be highly appropriate for progressive liberalization to include manpower flows.

In the case of banking, the second scenario would involve the gradual elimination of restrictions contained in all regulations limiting the establishment of institutions and preventing the free flow of capital. Thus, in this scenario the process described above would also have adverse effects on the host country's various economic policy instruments. The most glaring case is where developing countries see their financial sector's share of gross domestic product shrink. Consequently, it would be necessary to follow the Montreal document and allow developing countries greater flexibility with regard to progressive liberalization.

As far as the other financial intermediaries are concerned, this scenario would involve the establishment of the institution in the host country, and it would have to operate under the regulations imposed by the host country. For brokerage firms, for example, it would be expected that foreign brokers would be recognized as such by the authorities of the host country to be able to work in both local and foreign brokerage firms. Likewise, this scenario would imply the trading of securities of foreign markets.

Likewise, guarantee/surety-bond or insurance agents should be entitled to accreditation by the authorities concerned. Progressive liberalization in the case of scenario II.B.1 would imply recognition of the certification of such agents issued in their country of origin.

For developing countries, these elements would be considered in the light of relative reciprocity, in the sense that the process would be gradual.

The "traditional" conception of reciprocity here takes on another meaning, since developing countries, in accordance with the Montreal document, will grant relative reciprocity. So far, the question of reciprocity in financial markets has prevailed, in particular among OECD member countries. In other words, reciprocity is applied when a country accedes to the request of a foreign financial institution to enter the local market. In this case, relative reciprocity means that developed countries will grant entry to their markets for firms of developing countries without expecting automatic reciprocity from the latter.

2. Market access

In the spirit of the Montreal document, financial services may be supplied according to the preferred mode of delivery, in accordance with the legal framework of the country receiving the services.

With regard to scenario I.B, market access for financial services on an indefinite basis would be closely linked with advances in progressive liberalization of local regulations applying to the cross-border trade in such services, so that market access will be determined by the pace of progressive liberalization. In scenario II.A, as regards market access, the possibility of cross-border movement of production factors on a temporary basis would also consist in the establishment of a foreign institution under a concession for a number of years as the majority shareholder. At the end of the agreed period, the foreign institution would have to become a minority shareholder or sell all its equity holding.

In the case of scenario II.B, market access for financial institutions on an indefinite basis would be determined not only by establishment but also by the facilities granted by national regulations for their operations.

For financial intermediaries, market access would be provided for in accordance with the host country's domestic legislation, but this would not in itself guarantee national treatment.

There might be new financial sub-sectors, such as factoring, where the application of the concept of market access would even imply a process of regulation. In some countries, this activity continues to be subject to few or even no regulations, so that once again market access is not synonymous with deregulation. In view of the considerations on labour flows given above, we shall concentrate on scenario II.B.1.

Under this scenario, market access would be guaranteed if, and only if, the increasing circulation of manpower among countries party to the sectoral agreement is permitted. It would even be necessary to allow the movement of labour among the various intermediaries. In the case of some specific activities, the requirements might be greater, such as, for example, accreditation of stockbrokers of foreign brokerage firms.

Some flexibility has to be introduced here as regards the participation of developing countries. While market access implies the reduction or elimination of the type of barriers mentioned, clearly developing countries should have the flexibility to open up their financial markets at a different pace from the developed countries, and not necessarily in all activities of the sector. This is also important for reasons of structure and market size. Equality of circumstances cannot be expected, for example, in the case of the purchase of financial institutions, if, for example, this concerns an exporting country which has eighteen banks and a low level of assets and the banks of an importing country which has more than 14,000 institutions, ten of which could exceed the total assets of the exporting country's eighteen institutions.

3. National treatment

In this simulation, national treatment is interpreted as a long-term objective in the process of progressive financial liberalization, especially for developing countries. Consequently, it is not necessarily considered that this treatment should exist as from the first measures on market access. The problem is more complex if we take account of the multiplicity of domestic legislation governing markets in accordance with development needs or economic policy objectives.

In the case of scenario I.A., it is hardly feasible that trade in cross-border financial services should invoke national treatment if the regulations are hard to apply in practice.

As in the case of the two concepts already analyzed, here we emphasize the applicability of national treatment to scenario II, and in particular scenario II.B.1, for the reasons already mentioned.

For bank financial intermediaries, national treatment would mean imposing on foreign banks located in the country the same conditions as local banks as regards minimum reserve requirements, gearing, interest rate policy, sectoral allocation of resources, taxation, requirements for the establishment and closing of branches, capitalization levels, administrative sanctions and fines for non-compliance with directives of supervisory bodies, loan loss reserve provisions and, in general, the rules governing borrowing and lending operations.

It should be pointed out that the Basle Committee has been working towards the unification of certain criteria for maintaining bank soundness, such as the definition of net capital or minimum capital of banks, so as to be able to achieve some regulatory uniformity allowing the establishment of advantageous rules of competition.

It is also interesting to point out the implications of national treatment in cases where banks are state-owned and so ultimately subject to different regulations, like any state-owned entity, with respect to current expenditure and investment policy, regulations on the purchase and leasing of movable property and real estate, salaries and so forth. If national treatment were requested as regards the banking policy guidelines referred to in the previous paragraph, national treatment should also be obtained in the budgetary policy aspects mentioned in this paragraph, unless the host country decided partially or totally to deregulate in these areas.

With regard to brokerage firms, this concept would imply operating on an equal footing in terms of the amounts of capital required to be able to act as an intermediary in the market, as well as equal requirements concerning the good reputation or moral fitness of shareholders, ability and technical expertise of operators, and so forth.

For guarantee/surety companies, a policy of comparable premiums could be required, as well as similar regulations governing the operations to be covered and the relevant requirements.

For foreign exchange firms the concept of national treatment implies the need to maintain the same instruments of supervision and control so as to comply with the host country's foreign exchange policy objectives. Regulations on minimum capital, registration and notification of operations etc. should also be the same.

With regard to other kinds of financial intermediaries such as leasing, bonded warehousing, factoring etc., national treatment would refer to compliance with specific requirements as mentioned in the previous sub-sectors.

Finally, with respect to scenario II.B.1, national treatment with regard to labour would basically involve the following elements: equality in general conditions of work for foreign labour compared with local labour; possibility of being re-hired in another sub-sector of the financial sector; equality of requirements for authorization to act as guarantee/surety-bond or insurance agents or securities dealers.

4. Transparency

The concept of transparency should be applied in the same way as in Article X of the General Agreement. This implies the undertaking to publish any new law or regulation on trade in services.

Thus, in the financial sector transparency would signify publication of all relevant legislation of countries parties to the agreement. Furthermore, bearing in mind that the most feasible scenario for negotiations would be scenario II.B.1, i.e. involving the right of indefinite establishment and cross-border flows of labour, transparency would also mean publication of regulations dealing with foreign investment, immigration and labour matters.

This effort of disclosure in this sector would involve serious complications in cases where, in such legislation, there were significant differences between national or federal legislation and state, provincial, municipal or cantonal legislation. It should be pointed out that while regulations on the operation of bank or non-bank financial intermediaries are quite homogeneous at the national level, there is greater heterogeneity as regards labour or immigration matters.

The foregoing, combined with the fact that some states of the host country may establish different requirements for granting the right of establishment, would mean that the effort to compile and publicize the various pieces of legislation could represent a major cost for developing countries. Furthermore, transparency would mean that foreign financial institutions established in the importing country should provide information on their operations as required, and failure to do so would be sufficient ground for withdrawing the right of establishment. At present, failure to comply with this provision is sufficient grounds for withdrawing the authorization to provide a specific type of financial service.

Taking into account that some developing countries lack the necessary infrastructure to carry out the information effort which the application of this concept implies, it would be advisable to establish "contact points" in the countries, which would indicate the sources from which the relevant information could be obtained. This is different from "information points", which imply the need for costly operations of compilation and computer-processing of laws and other regulations.

In addition, there should be no prior consultation requirement as regards any change in regulations governing any of the financial services, since these are considered strategic in most countries.

5. Most favoured nation/non-discrimination

There are various positions in the Negotiating Group on the form in which such treatment might be granted; optional (to be granted through bilateral negotiations), conditional (subject to signing the agreement) or unconditional (without discrimination against any country).

With regard to the negotiations on services, the content of this clause has not yet been defined. Nevertheless, it is recognised that its effects would vary both between countries and between sectors.

The idea which has prevailed so far is that there should be no discrimination against services exports or exporters from a particular third country.

Thus, for the scenarios we have mentioned (I and II), non-discrimination would involve the following:

Scenario I

- Non-discrimination between countries on the cross-border import and export of financial services.

Scenario II

- Non-discrimination between countries in the granting of market access.
- Non-discrimination of any kind against foreign workers to work in the host country of foreign institutions.
- Non-discrimination against foreign workers recruited by local firms.

It should be pointed out that the effect of the application of this concept may vary according to whether m.f.n. treatment is optional, conditional or unconditional, as mentioned at the start of this section.

In this connection the delegation of Mexico favours the option of unconditional treatment, at least for developing countries. Since the

developing countries participation in world financial markets is minimal, the granting of such treatment would have a virtually negligible marginal cost for developed countries.

6. Increasing participation of developing countries

Financial activities are one of the basic sectors for the development process of developing countries. It is increasingly acknowledged that the effectiveness of government economic policies depends primarily on the soundness and efficiency of the financial market, although not exclusively its banking markets. These have been viewed as the most important catalyst for the development process. Hence an important dilemma: while the need to modernize the sector and make it more efficient is clearly understood, it is also obvious that this should take place in line with national economic guidelines, whence the need for local firms to predominate in this sector.

While some attempts to modernise this sector exist, many countries have a very limited capacity for participation in this market. There is a risk that the developing countries' financial systems may be absorbed by the international intermediaries of developed countries if the sector is opened up unduly rapidly and without consideration for the disadvantages of developing countries. The lack of development of insurance, surety-bonds/guarantees and factoring or of capital markets leaves these sub-sectors very vulnerable to foreign competition.

The big international financial intermediaries have a wealth of experience, act simultaneously in various markets, offer a wide range of services efficiently and at low cost and have a considerable technological capacity. In addition, their large volumes of capital and networks of branches and international offices provide further advantages: they can operate at a loss during some periods in order to try to maintain their presence in a market until their competitiveness increases, and compete with low costs for their services, sacrificing profits in order to enter new markets.

Increasing participation of developing countries would seek to check or even reverse the trends tending to marginalize them. The indiscriminate opening up of the sector would lead to a high concentration of the market in foreign hands, as a result of the displacement of local intermediaries.

Once again, access to the markets of developed countries would have to be secured by relative reciprocity aimed at increasing participation of developing countries, which could take various forms. We may mention the following:

- flexibility as regards timing, forms and regulations, for carrying out progressive liberalization and granting national treatment;
- through an opening of the developed countries' markets for financial services of developing countries without expecting similar concessions in return;
- access to information and data processing networks;

- transfer of technology. A possible way of contributing to the development of these countries would be by the transfer of technology which could take the form of allowing the foreign institution to be majority shareholder for a reasonable period, at the end of which it would become a minority shareholder;
- personnel training, through the recruiting of skilled and specialized manpower in developing countries by financial institutions in developed countries.

An agreement on financial services would hardly be viable if it jeopardizes the developing countries' economic development policies. It should be pointed out that in many cases their money and credit policies could be seriously disrupted by the unlimited participation of large international financial intermediaries.

7. Regulatory situation

The Montreal document recognizes that governments regulate services sectors in order to foster their own development policies and safeguard the application of their macro-economic policies.

Again, in the case of the financial sector there is a marked imbalance in the degree of development of regulations on these services both between developed countries and developing countries and even among the latter. The "degree of development" of the regulations is understood to mean the effectiveness with which they seek to supervise, control or guide the various financial activities that have been generated. Thus, degree of development is not synonymous with a greater or lesser degree of market openness.

Thus, while a number of countries have made efforts to open their markets, there nevertheless remains a considerable amount of legislation and regulations governing both the domestic activities of their institutions and the modalities for the establishment and participation of foreign institutions in those markets.

Even developed countries have opened their markets to international competition without this implying the total elimination of restrictions. They support, for example, the right to establishment, which continues to be directly or indirectly regulated in many countries which have undertaken liberalization or deregulation processes.

However, for developing countries the use of specific existing and new regulations will continue to be an integral part of their development policies. This is set forth in section 7(h) of the Montreal document, and thus liberalization will not be synonymous with deregulation. What is more, a possible opening up of new sub-sectors, as in the case of factoring firms, would imply that those sub-sectors be regulated, just as a possible liberalization of traditional services, such as banking or stockbrokerage, would imply a more advanced system of supervision and control.

8. Safeguards and exceptions

It is expected that mechanisms for safeguards and exceptions will form an integral part of the conclusion of sectoral agreements on services, including financial services. Otherwise, the agreements would be so rigid that a large number of countries would be unable to subscribe to them.

However, despite the need to provide possible safeguards in a sectoral agreement on financial services, it will be necessary to spell out very precisely the modalities for their application. These would refer to infant industries, balance-of-payments and growing and unforeseen imports of a service.

In this connection, safeguards should be provided for the infant industry case, which in the financial services sector could apply to some sub-sectors which may be considered new in a given country. The safeguard could consist in maintaining sufficient flexibility in the regulatory structure to allow for the development of the service in question.

This concept could clearly be applied to a number of sub-sectors of the financial sector of developing countries. These would evidently include factoring and services related to securities markets. However, in traditional sectors too the infant industry concept could be applied, although at first sight this might not seem to be so. In the case of banking, for example, although a number of developing countries have venerable banking institutions, the technological revolution in such services in industrialized countries is so huge that developing countries are permanently left behind and consequently virtually in the position of an infant-industry situation.

In addition, in other sub-sectors where the technological revolution has perhaps been a secondary factor, there are other elements of an internal nature which maintain the financial services of developing countries in the position of an infant industry. There is, for example, the case of insurance and surety-bonds/guarantees, which for reasons that may have to do with culture and market structure have not developed, so that indicators such as the level of premiums in relation to GDP are extremely low compared with other countries, thus reflecting one of the characteristics of an infant industry.

In the case of balance-of-payments difficulties, the application of a safeguard could be triggered by a high and rising level of demand for imports of financial services which could adversely affect the implementation of a country's development and economic growth programmes. Under such circumstances, safeguards could be applied most viably in such areas as foreign-exchange firms, international bank operations, international credit card services or possibly also foreign security dealings.

The inability of local financial institutions to cope effectively with foreign competition highlights the economic difficulties of a structural nature. Some degree of restructuring of domestic financial intermediaries might also be required, and safeguards could guarantee or ensure that the process of progressive liberalization does not lead to a smaller participation of host country institutions.

In the three situations, the application of safeguards would involve temporarily suspending the liberalization process (for example, the cross-border flow of capital), regardless of the stage reached.

The safeguards mechanism is more complicated in scenario II, because it would involve additional elements for its application to foreign institutions resident in the importing country. Nevertheless, the regulations - especially in developing countries - may provide that if national treatment is the long-term objective, account could be taken of emergency situations for resorting to safeguards, even after the process of granting market access and full national treatment has been completed.

With regard to exceptions, these could refer basically to questions of national security and consumer protection, as well as fiduciary responsibilities.