

Coverage of Prudential Measures in the GATS: Some conclusions of a WTO Appellate Body

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Since issuance of the framework of the General Agreement on Trade in Services (GATS) as part of the results of the Uruguay Round negotiations, there has been a continuing controversy as to the scope which it provides for financial regulation. The principal focus of this controversy has been the so-called of the “prudential carve-out” or “prudential exception” of paragraph 2(a) of the Annex on Financial services. This provides latitude under GATS rules for measures taken by members for prudential reasons affecting their financial sectors, notwithstanding other provisions of the GATS. A recent dispute between Panama and Argentina was the occasion for the first official WTO decision which addresses this latitude.

The controversy over the prudential carve-out has focussed primarily on the conditions under which action under this heading would be admissible. Some commentators have taken the view that its admissibility might be constricted owing to the qualification in the same paragraph of the Annex that measures not conforming to the provisions of the GATS “shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement”. Attention has also been drawn to the generality of key terms in the carve-out which renders its coverage of particular measures uncertain.

In the aftermath of the Global Financial Crisis (GFC) and the initiation of global and national agendas for financial reform, questions as to the scope of GATS constraints on financial regulation have become more insistent. These now focus on the extent to which they apply to macroprudential measures (directed at the stability of the financial system) as well as microprudential measures (targeting the stability of individual financial firms). Under macroprudential measures there has been special attention to the treatment in the GATS of capital controls. In the absence of evidence of willingness among members of the WTO to clarify or extend the wording of the Annex on Financial Services, the applicability of provisions of the GATS to regulation of financial services and the precise scope of prudential carve-out have to await the findings of rulings in disputes.

The dispute between Panama and Argentina (WT/DS453/R and WT/DS453/AB/R of which the latter is summarised at greater length in SUNS 8223, 18 April 2016) concerned measures taken by Argentina regarding access to its stock market and reinsurance sector, the allocation and valuation of transactions for tax purposes, the registration of branches, and controls over the market for foreign exchange. Of special interest in the context of the GATS coverage of prudential measures Panama claimed that the requirements related to access to Argentina’s market for reinsurance services and to its stock market were inconsistent with paragraph 2(a) of the Annex on Financial Services.

Argentina’s requirements apply to countries classified as “non-cooperative” for tax purposes. To obtain the status of “cooperative” for tax purposes a country must sign with Argentina an agreement on exchange of tax information or a convention on avoidance of international double taxation, provided that there is an effective exchange of information, or have initiated with Argentina negotiations necessary for concluding such an agreement or convention.

According to the Appellate Body (AB), the original ruling of the Dispute Settlement Panel (DSP) erred in its acceptance of Panama’s challenge to the designation of countries as “cooperative” and “non-cooperative” as inconsistent with Article II.1 of the GATS which assures a member’s suppliers of national treatment. The AB also rejected Panama’s claims

that Argentina's measures were inconsistent with National Treatment under some other provisions of the GATS.

Most importantly from the point of view of the definition of measures covered by the prudential carve-out of paragraph 2(a) of the Annex on Financial Services the AB confirmed the ruling of the DSP that the paragraph covered all categories of measure affecting the supply of financial services through the four modes of supply specified in Article I of the GATS so long as they are taken for prudential reasons. Financial services for this purpose include all insurance, insurance-related, banking and other financial services specified in the comprehensive list of definitions of the Annex. Panama's appeal case did not concern other requirements of paragraph 2(a) so that issues related to the latitude furnished for different prudential measures by the provisions of the Annex was not addressed in the AB's report.

These points can be clarified by a more detailed discussion of the AB's findings.

Panama argued that the DSP had erred in finding that paragraph 2(a) of the Annex covered all categories of measure specified in paragraph 1(a) and thus also in the comprehensive list of definitions of financial services in paragraph 5. The DSP's error according to Panama was due to failure to delimit the financial services covered by the prudential carve-out in accordance with the title, "Domestic Regulation", of paragraph 2 of the Annex. Restrictions on market access according to Panama are covered in Article XVI and are not covered under Domestic Regulation. The latter is covered primarily in Article VI. Specifically mentioned in this Article are authorization for the supply of a service on which a commitment has been made by a Member, qualification requirements and procedures, technical standards and licensing requirements, regulations which are not to constitute unnecessary barriers to trade in services. Panama conceded that the prudential carve-out could cover inconsistencies with any provision of the GATS as long as the prudential measure could be classified as belonging to Domestic Regulation.

The AB accepted the DSP's interpretation of the coverage of financial services in paragraph 2(a), thus contradicting Panama's claim of its delimitation to Domestic Regulation. For this purpose the AB advanced the following arguments.

Paragraph 1(a) of the Annex opens with the statement that "this Annex applies to measures affecting the supply of financial services" –with no limitation on their applicability. The broad scope of the prudential measures in paragraph 2(a) covered by the Annex is confirmed in the AB's view by the clause "notwithstanding any other provisions of the Agreement" spelling out in general terms the latitude provided for such measures.

Prudential measures are a subset of those included the definition of Article XXVIII of the GATS of which according to Article XXIX the Annex on Financial Services is "an integral part". According to this definition measure "includes any measure taken by a Member, whether in the form of a law, regulation, rule, procedure, decision administrative action, or any other form". Moreover the preamble of the GATS recognises Members' rights "to regulate, and to introduce new regulations, on the supply of services in order to meet national policy objectives". As the AB puts it, "An interpretation limiting the types of measures that could potentially fall under paragraph 2(a) would not be inconsonance with the balance of rights and obligations that is explicitly recognized in the preamble of the GATS".

Thus in the AB's view paragraph 2(a) of the Annex may justify measures taken for prudential reasons which are inconsistent with any of a Member's obligations under the GATS. Such inconsistencies could include limitations on a Member's obligations as to most-favoured-nation treatment (Article II), national treatment (Article II and Article XVII), or market access (Article XVI). However, owing to the limited scope of Panama's appeal the AB refrained from an opinion on the consistency of Argentina's restrictions on access to its stock markets and its insurance sector with the definition of "prudential" regulation.

Prudential reasons are defined in paragraph 2(a) “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”. At a general level the DSP discussed at some length the definition of prudential measures and its relation to restrictions by Argentina which were the subject of Panama’s claim. With regard to restrictions on access to Argentina’s reinsurance sector the DSP accepted as relevant to the achievement of prudential objectives protection of the insured, ensuring the solvency of insurers and reinsurers, and avoidance of the possible systemic risk of the insolvency and failure of direct insurance companies. With regard to requirements to be fulfilled by stock market intermediaries as a condition for access to Argentina’s stock market the DSP accepted as prudential the request for relevant information from the regulatory authorities of other jurisdictions in pursuit of the objectives of investor protection, the reduction of systemic risk, and the prevention of money laundering and terrorist financing.

The findings of the AB in this case indicate the broad range of measures which in its view should fall within the purview of the Annex on Financial Services. However, the question of which policies inconsistent with the GATS can be justified under the prudential carve-out remains largely open and will have to be thrashed out in future cases submitted for dispute settlement or in discussions in the WTO Committee on Financial Services.

Issues in the debate over the applicability of GATS rules to post-GFC regulatory regimes will be illustrated here for controls over capital movements and for possible inconsistencies between new regulatory rules and national treatment.

Restrictions on capital movements in the GATS are covered primarily in Articles XI and XII. Article XI.2 prohibits restrictions on capital transactions related to a country’s commitments as to market access and national treatment. However, according to Article XII, this prohibition may be overridden by a country’s need to undertake actions to safeguard the balance of payments in the event of serious external financial difficulties. Consultations concerning the need to take such actions are then to be based on statistical and other empirical findings of the IMF and on the Fund’s assessment of the country’s external financial position. Questions here relate to whether these rules provide latitude for the macroprudential measures which are an important part of the post-GFC regulatory agenda.

“Macroprudential policy aims to enhance the resilience of the financial system systemic risks and to dampen systemic risks that spread through the financial system via the interconnectedness of institutions, their common exposure to shocks, and the tendency of financial institutions to act in procyclical ways” (Group of Thirty, 2010: 21). Under the heading of macroprudential policy capital controls are now envisaged as an appropriate response not only to classical balance of payments crises where the policy challenge is the exhaustion of a country’s foreign-exchange reserves but also to other threats to a country’s financial stability. Unsurprisingly since the beginning of the GFC official views of the relation between macroprudential measures and capital controls have been extended.

This is evident, for example, in an IMF document on capital flow management measures (CFMs, an IMF term for capital controls) and macroprudential measures (MPMs). The IMF here draws a distinction between the two on the basis of their primary objectives. However, the IMF also acknowledges that there are situations where CFMs and MPMs overlap: “To the extent that capital flows are the source of systemic financial risks [which they have been in several financial crises], the tools used to address those risks can be seen as both CFMs and MPMs. An example could be when capital inflows into the banking sector contribute to a boom in domestic credit and asset prices. A restriction on banks’ foreign borrowing...would aim to limit capital inflows, slow down domestic credit and asset price increases, and reduce banks’ liquidity and exchange rate risks. In such cases the measures...would be considered both CFMs and MPMs” (IMF, 2012: 21).

The IMF now also accepts a temporary role for CFMs on capital outflows for countries which face domestic or external shocks which are large relative to the ability of either macroeconomic adjustment or financial sector policies on their own to handle. What remains to be seen is how far this new, more flexible view of situations where capital controls are an appropriate part of policy packages targeting financial stability is eventually translated into interpretation of GATS rules on capital controls and prudential measures – whether in particular the prudential carve-out can justify recourse to capital controls for reasons of avoiding financial instability.

According to the prescription of national treatment in Article XVII of the GATS, in the sectors inscribed in its schedule of commitments, and subject to any conditions and qualifications set out therein, “each Member shall accord to services and services suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than it accords to its own like services and service suppliers”. This seems clear enough. However, as regulation in the aftermath of the GFC becomes more complex and the rules of regulatory regimes discriminate between different financial firms and transactions in pursuit of the objective of financial stability, strict adherence to the principle of national treatment may become difficult.

A potential source of such difficulties are the special sectoral capital and liquidity requirements which several jurisdictions have also imposed or are expected to impose in addition to the standard capital and liquidity requirements of the Basel Capital Accords. Such special sectoral capital requirements may be applied to particular exposures such as mortgage lending, unsecured consumer credit or particular subcategories of such credit, lending on commercial property, and lending to other parts of the financial sector. Special liquidity requirements may target either banks’ assets or their liabilities or funding. Requirements to increase buffers of liquid assets during credit booms can provide banks with larger reserves which can be drawn down to meet margin calls or withdrawals of financing when the boom is followed by contraction. Moreover supplementary liquidity requirements during booms can help to moderate cyclical increases in maturity mismatches by curbing credit expansion financed by volatile short-term funding.

In principle all these rules can be framed to apply in a non-discriminatory way, i.e. in a way that observes national treatment between domestic and foreign institutions. Nonetheless, their very complexity makes them potentially contentious and a potential vehicle for the provision of regulatory treatment perceived as favouring domestic over foreign institutions.

Regulators’ awareness of possible conflicts between efforts to reform global financial regulation and the liberalisation of trade in financial services is no secret, as are their reservations concerning the latter when they are a source of such conflicts. A member of the Board of Governors of the United States Federal Reserve System recently expressed such a caveat as follows: “Proposals to include prudential requirements or, more precisely limitations on prudential requirements in trade agreements would lead us farther away from the aforementioned goal of emphasizing shared financial stability interests, in favour of an approach to prudential matters informed principally by reticence amongst financial regulators will inform future considerations of commercial advantage.” (Tarullo, 2014). One can hope that awareness of such interpretation of the GATS rules which overlap prudential regulation of finance.

References

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