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The World Trade Organisation General Agreement on Trade in Services: Deregulating Trade in Banking Services in developing countries

by

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Thesis submitted in accordance with the requirements for the degree of Doctor Legum in the Faculty of Law, Department of Mercantile Law at the University of the Free State

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Table of Contents

CHAPTER 1: GENERAL INTRODUCTION AND THEME OF THE THESIS

1.1 General 8

1.1.1Brief History, role and purpose of Trade in Banking Services 8

1.1.2 The purpose of Trade in Banking Services 11

1.2 SecurityPerformance Required by Host Country when granting entry to Foreign Bank 12

1.2.1 Risk of fraudulent security 17

2. Theme of the Thesis 18

2.1 Issues Dealt with in the Thesis 18

2.2 Scope of the Thesis 22

2.3 Structure of the Thesis 23

2.4 Research Methodology 23

CHAPTER 2: AN ANALYSIS OF TRADE IN BANKING SERVICES IN THE EUROPEAN UNION, THE UNITED STATES OF AMERICA, CHINA AND SOUTH AFRICA

2.1 Aim and Purpose of the chapter 25

2.2 The European Union (EU) 25

2.2.1 Introduction 25

2.2.2 The Evolution of the European Banking System 27

2.2.2.1 The Harmonisation process 28

2.2.2.2 The Deregulation of Entry 1957-1973 29

2.2.2.3 The Harmonisation of Banking Regulation (1973-1983) 31

2.2.2.3.1 The First Banking Directive 32

2.2.2.3.1.1 Harmonisation provisions of the First Banking Directive 33

2.2.2.3.1.2 The European Commission's White Paper 38

2.2.2.4 The Second Banking Directive 42

2.2.2.4.1 Objective and Nature of the Second Banking Directive 45

2.2.2.4.2 Harmonisation of the Second Banking Directive 48

2.2.2.4.2.1 Minimum Capital Requirement 50

2.2.2.4.2.2 Reciprocity (liberalisation provision) 51

2.2.2.5 The Importance of the Banking Legislation 53

2.2.3 Conclusion 55

2.3 The United States of America (US) 58

2.3.1 Introduction 58

2.3.1.1 Historical background 59

2.3.1.2 The US Banking Legislations 59

2.3.2 State Geographical Barriers 60

2.3.3 US Branch banking protection 61

2.3.4 Liberalisation Legislations 63

2.3.4.1 Causes of change in banking services 65

2.3.4.2 Relief under State and Federal Law 66

2.3.5 The International Banking Act of 1978 68

2.3.5.1 Section 5 of the Act 69

2.3.5.2 The Statute 70

2.3.6 Conclusion 72

2.4 CHINA 73

2.4.1 Introduction 73

2.4.1.1 Background 74

2.4.1.2 Unfavourable Treatment of Domestic banks with regard to Taxation 76

2.4.1.3 Deposit Insurance 77

2.4.2Policy Responses to Resolve Banking Problems 79

2.4.2.1 To Improve Bank's Risk Management 80

2.4.3 The Banking Laws of China and the Basel Principles 80

2.4.4 Licensing structure 81

2.4.5 Regulations and Requirements 83

2.4.5.1 Information Requirements 84

2.4.6 Is China's requirements in conformity with the Basel Core Principles 84

2.4.7 New Chinese Banking Regulation opens the market 85

2.4.7.1 Regulation of the People's Republic of China on Administration of Foreign-funded Banks ("The Regulation") 87

2.4.8 Dissolution of Foreign Banks' Branches 92

2.4.9 Conclusion 92

2.5 SOUTH AFRICA 93
2.5.1 Introduction 94
2.5.1.1 Historical Background 97
2.5.2 The Legislative Text 99
2.5.3 Opening up of South African Banking Sector to Foreign banks by the 1990 Banks Act 99
2.5.3.1 Prudential Requirements 100
2.5.3.1.1 Capital Adequacy 100
2.5.3.1.2 Large Exposures 102
2.5.4 Foreign Banks doing Business in South Africa 103
2.5.5 Conclusion 107

CHAPTER 3: THE CREATION OF A NEW INTERNATIONAL NORM-THE WORLD TRADE ORGANISATION'S GENERAL AGREEMENT ON TRADE IN BANKING SERVICES

3.1 Introduction 109
3.1.1 Background information to Trade in Banking Services 111
3.2 Interpreting the Agreement on Trade in Banking Services 117
3.3 Trade in Banking Services-Protective Measures 120
3.3.1 The Prudential Carve-out 122
3.3.2 Measures for Prudential reasons 125
3.3.2.1 Minimum Capital Requirement 125
3.3.2.2 Endowment Capital 126
3.3.2.3 Legal Lending Limits 127
3.3.2.4 Fit and Proper Person Requirement 127
3.4 The Proposals for Liberalisation of Trade in Banking Services 128
3.4.1 Developed Countries' Proposal 128
3.4.1.1 The United States' Proposal 129
3.4.1.2 Most Favoured Nation Treatment (MFN) 129
3.4.1.3 National Treatment 130
3.4.2 The European Union's Proposal 131
3.4.2.1 Transparency 132

3.4.3 The Developing Countries' Proposal 132

3.4.3.1 Transparency 133

3.4.3.2 National Treatment Principle 133

3.5 Objections to Trade in Banking Services 134

3.5.1 Comparative advantage 135

3.5.2 Infant Industry Protection 135

3.5.3 National Security 135

3.6 Final Text 137

3.6.1 Most Favoured Nation Treatment 139

3.6.1.1 Nature of MostFavouredNation Treatment of Article II: 1 140

3.6.1.2 Generalisation of Most Favoured Nation Treatment 147

3.6.1.2.1 Limiting Article 148

3.6.1.2.2 Transparency 150

3.6.2 National Treatment 151

3.6.2.1 Nature of National Treatment under Trade in Banking Services 151

3.6.2.2 Exceptions to National Treatment relating to Trade in Banking Services 155

3.6.3 Market Access 157

3.6.3.1 Market Access, definition and coverage 157

3.6.3.2 Market Access and Progressive Liberalisation 161

3.6.4 National Treatment and Market Access 163

3.6.6 Schedules of Specific Commitments 165

3.6.6.1 Interpretation of specific commitments in members' schedule 170

3.7 Legal structure of Banking Services-Documents under the GATS/WTO 171

3.7.1 The Annex on Financial Services 171

3.7.1.1 Scope 172

3.7.1.2 Normatic Rules 174

3.7.1.2.1 Domestic Regulation 174

3.7.2 Recognition 176

3.7.3 The Present State of Prudential Carve- out 176

3.7.4 Dispute Settlement 177

3.7.5 The Understanding on Commitments in Financial Services 177

3.8 Second Protocol to the GATS 183

3.9 Conclusion 185

CHAPTER 4: TRADE IN BANKING SERVICES INVOLVING ESTABLISHMENT OF A COMMERCIAL PRESENCE (MODE 3)

4.1 Introduction 188

4.2 Advantages of Commercial Presence 190

4.3 Definition of Commercial Presence 197

4.4 Forms of Commercial Presence 199

4.4.1 Subsidiaries 203

4.4.2 Branches 204

4.4.2.1 CompetitiveMarkets 205

4.4.2.2 Safety and Soundness 205

4.4.3 Agencies 207

4.4.4 Representative Offices 207

4.5 Prudential Carve -out 209

4.5.1 Prudential Carve –out and Branches 209

4.5.2 Prudential Carve- out and Subsidiaries 212

4.6 Fundamental Principles of Commercial Presence 213

4.6.1 Market Access 215

4.6.2 National Treatment 217

4.6.3 Most Favoured Nation Treatment 218

4.7 Foreign Direct Investment and Commercial Presence 220

4.7.1 Definition of Foreign Direct Investment in Banking 223

4.7.2 Determinants of Foreign Direct Investment Localisation in the Banking Sector 223

4.8 Foreign Banks in Developing Countries 225

4.8.1 Determinants of Foreign banks entry in Developing Countries 226

4.9 Why Foreign Banks Penetration is low in Developed Nations 228

4.10 Conclusion 231

CHAPTER 5: CROSS-BORDER TRADE IN BANKING SERVICES (MODE 1)

5.1 Introduction 234

5.1.1 Capital Account Liberalisation 235

5.2 Preconditions for Capital Account Liberalisation 239

5.2.1 Benefits of Capital Account Liberalisation 243

5.2.2 Capital Movement 245

5.2.3 Payments and Transfers 247

5.3 Capital Account Liberalisation Issues 251

5.3.1 Capital Account Liberalisation and Real Exchange rate 251

5.4 Capital Inflows 253

5.5 Meaning and rationale of Cross-border Banking 256

5.6 Closing the loopholes in the law relating to Capital Account Liberalisation 258

5.6.1 Preserving National Regulatory space and flexibility on Capital Account Liberalisation 258

5.7 Pace and Sequencing of Liberalisation of Capital Account 261

5.7.1 Sequencing matters 262

5.8 Exchange rates 266

5.9 Use of Capital Controls 266

5.10 Macroeconomic and structural measures to manage capital inflows 267

5.10.1 Structural measures 268

5.10.2 Macroeconomic measures 268

5.11 Overview of Capital Account Liberalisation 270

5.12 Conclusion 272

CHAPTER 6: CONCLUSIONS, RECOMMENDATIONS AND LAW REFORM PROPOSALS

6.1 Introduction 274

6.2 International Trade in Banking Services 284

6.2.Recommendations 284

6.2.1. Recommendations relating to Prudential Carve- out 286

6.2.2 Recommendations relating to National Treatment 286

6.2.3 Recommendations relating to the overlap between Market Access and National Treatment 286

6.2.4 Recommendations relating to the liberalisation provision 288

6.3 Regional Trade in Banking Services 288

6.4 Conclusion 289

BIBLIOGRAPHY 291

CHAPTER 1

GENERAL INTRODUCTION AND THEME OF THE THESIS

1.1 General Introduction

1.1.1 Brief History, role and purpose of Trade in Banking Services

When the General Agreement on Tariffs and Trade was instituted in 1947,[1] its mandate excluded trade in financial services.[2] Financial services form an integral part of the GATS with a specific Annex on Financial Services,[3]the Uruguay Round expanded the scope of GATT-WTO system to include non-goods sectors,[4] thus liberalising trade in banking services.[5] The GATS is about liberalisation of the entry of foreign banks and foreign bankings services providers into a country.[6] The negotiations broke new grounds by introducing core GATT disciplines to trade in banking services.[7] It put in place a set of disciplines that now regulates trade in banking services among close to 150 countries.[8] GATS negotiators faced a significant challenge when having to craft a comprehensive set of disciplines in this area.[9] Trade in banking services is complex, in particular due to the various forms of delivery that

[1] Aley 2000:189.

[2] Geld and Sageri 1990:1.

[3] Footer 1995: 479.

[4] Chormg-Huey and Naheed 1995:133-134. The WTO could be seen as a much-enlarged GATT, absorbing both the old areas that had de facto remained outside the system and the new subjects that were not part of it at all. Or it can be seen as a greatly reinforced GATT too, with better rules overall and much better system to deal with (or prevent) disputes. In reality however the WTO is much more than a GATT-PLUS.

[5] Understanding the WTO-services-rules for growth and Investment <http://steam.hq.unu.edu/presentations/wtoenglish/e-doc/english/thewto_e/what is... (accessed 2006/10/03).

[6] Ibid.

[7] Guojan 2010:2. Further WTO negotiations have also produced agreements on trade in information technology products and telecommunications. The Uruguay agreement succeeded in developing the General Agreement on Trade in Services-GATS as a sort of a framework agreement for the entire landscape of services trade. The agreement went relatively far embracing the traditional GATT concepts (MFN, national treatment, schedules of concessions) but clearly had to adapt those concepts for the new terrain encountered. Furthermore, this services agreement leaves a great deal open, in some cases like financial services calling for specific ongoing negotiations.

[8] Panizzon ea 2008:236-237.

[9] Ibid.

are involved and the extensive nature of regulation. The result is somewhat complex. Some obligations, in particular the most favoured nation treatment (MFN) obligation, apply to any measure affecting trade in banking services. Others, like the market access and national treatment obligations, apply only in respect of banking service sectors or sub-sectors of a member's choosing. Additional obligations have been adhered to on a voluntary basis, in particular those contained in the Understanding on the Commitments in Financial services.[10]

The GATS is the most significant product of the Uruguay Round of trade negotiations, in terms of coverage, the most far-reaching among the international legal instruments that regulate the terms of trade in banking services among nations.[11] The GATS provides the legal basis on which to negotiate the multilateral elimination of barriers that discriminate against foreign service providers, and otherwise deny them market access.[12] Liberalisation of trade in banking services has a very specific connotation,[13] with characteristics that clearly differentiate it from similar process for goods or even other services.[14] Liberalisation of trade in banking services involves, at least, work toward the following three fundamental freedoms:[15] the freedom to establish a commercial presence in the foreign territory in question through subsidiaries, branches, or offices; the freedom to offer banking services in a country in question preferably without being required to obtain specific authorisation from the host country; the freedom to users to obtained banking services from any supplier without considering the nationality of the banking services supplier; and the absence of foreign exchange controls that limit the free circulation of capital.

[10] Panizzon ea 2008:236-237.

[11] The 1997 Financial Services Agreement reached in the Uruguay Round is perhaps the most important single development in the multilateral trading system since the General Agreement on Tariffs and Trade itself came into effect in 1947. Financial services relate mainly to insurance, banking and securities services. See Lowenfied 2002: 113; International Legal Materials 1994:1141.

[12] Kennedy 1999:348.

[13] Aguirre 1995:1058.

[14] Ibid.

[15] Ibid.

Restrictions on international transactions in services are embodied in a country's laws, regulations and other policy measures. Under the GATS, these restrictions will have to be liberalised, thus creating a regime comparable to duty-free regimes for goods.[16] The process of liberalisation of trade in banking services has traditionally been particularly difficult because of its tremendous potential implications.[17] The process has faced diverse barriers in the form of foreign exchange controls, strict limits on direct cross-border trade in banking services, and various limitations on the right of establishment.[18] These barriers exist for a number of reasons:[19] the ever-present systemic implications in the banking sector where confidence is a key factor, makes the danger of contagion unusually high, and the cost of a bank's failure can easily exceed the bank's own value; the fundamental role that banking services play in a country's overall economy generally makes governments very reluctant to accept the predominance of foreign institutions in this sector;and the potential for free competition is normally fairly restricted in the banking sector either by governments for the protection of systems and users generally through prudential rules. UnderUS pressure, the Uruguay Round talks included trade in banking services.[20] This has occurred in part because of the growing importance of formal finance as GNP per head rises and because a number of developing countries are now seen as sizable prospective markets.[21] Another reason is the dramatic growth of trade in banking services between industrial countries over the last two decades, which has been partly spurred by rapid technological innovation.[22]

The basic mandate for the US negotiators in the Uruguay Round is found in the Trade Act of 1988.[23] Section 1101 (a) (9) contained two basic objectives with respect to services:[24]

[16] Geld and Sagari 1990:20; Jackson and Sykes 1997:15-16.

[17] Aguirre 1995:1058-1059.

[18] Ibid.

[19] Ibid.

[20] Raj 1999:60. Thirty-five countries, including the Quad Members, permit 100 per cent ownership of subsidiaries or branches. Sixty-four countries have grandfathered acquired rights of foreign banks.

[21] Aly 2000: 189.

[22] Ibid.

[23] Lang 1999:801.

gaining market access for banking services and establishing an international system to banking services agreement. The latter objective eventually ripened into the General Agreement on Trade in Services (GATS).[25] GATS, as it emerged from the Uruguay Round represented the first multilateral effort to establish rules governing trade in banking services and to provide a framework for multilateral negotiations.[26] Its structure resembles that of the GATT with general principles and obligations for all members,[27] annexes covering specific sectors and schedules listing the members' specific access commitments.[28] These are the legal instruments used to liberalise trade in banking services.[29]

The response of developing countries to the US proposal to liberalise trade in banking services through, the deregulation of trade in banking services ranges from cautious to hostile.[30] Partly this reflects concern about the perceived comparative advantage of industrial countries and the desire of strong vested interest to continue to use the banking system as an instrument of public policy. It also reflects the weak situation of the banking industry in many developing countries.[31] It is for this reason that the legal and policy framework of the GATS governing trade in banking services was chosen as the focus of study in the thesis.

[24] Lang 1999:801.

[25] Ibid.

[26] Randhawa 1987:163-164.

[27] Guojun 2010:74.

[28] Ibid.

[29] Ibid.

[30] Gelb and Sagari 1990: 1-5.

[31] Ibid.

1.1.2 The purpose of Liberalisation of Trade in Banking Services

The purpose of liberalisation of trade in banking services is the removal of barriers through a process of negative integration.[32] In the negative form of economic integration, participating countries undertake legal obligations to eliminate direct legal barriers and measures that discriminate against non-residential banks.[33] To achieve this purpose, international legal commitments of economic integration routinely refer to restrictive measures that participating countries should abolish or shall adopt.[34] Legal instruments addressing these explicit barriers constitute forms of negative economic integration because they do not set de novo rules and standards regulating the activities in question, but rather limit themselves to prohibiting national rules that restrict banking activities. The liberalising force of negative integration relies on the enforceability of legal commitments undertaken by participating countries. When sovereign jurisdictions commits themselves to abolishing restrictions on market access as well as regulations that discriminate against foreign banks, the credibility of the liberalisation exercise relies on the ability of affected markets actors or other sovereign states to enforce these legal commitments through a judicial process based on the rule of law. Today, the penetration of foreign banks in countries where financial liberalisation has taken place over the past years has become significant. In several countries, like Tanzania, the largest retail bank is a foreign-owned subsidiary and foreign-owned banks may dominate the banking markets.[35]

1.1.1 Security Performance Required by a Host Country when granting entry to Foreign Banks

Banks and banking systems are inherently unstable because of three characteristic attributes of banks.[36] Firstly, the intermediary function of banks necessarily implies a

[32] Gkoutzinis 2005: 898.The term negative refers solely to the legal effects of integration commitment. It is conceivable that instruments of negative integration are set out in positive language, mandating rather than prohibiting certain measures.

[33] Ibid at 878-889.

[34] Ibid at 886-887.

[35] Caprio ea 2006:33.

[36] Panourgais 2006:18-19.

relatively high degree of financial gearing, or ratio of debt to equity capital. For banks to continue to fulfil an intermediary rather than a mere lending function they are bound to operate on a relatively modest capital base.[37] Secondly, the vulnerability of banks to sudden deposit withdrawals also increases the likelihood of such withdrawals. This is because depositors will be alert to the need to withdraw their own funds ahead of others in the event of any disturbance that could adversely affect confidence and lastly, lack of transparency-creates the potential for a vicious circle of precautionary deposit withdrawals leading to collapse and insolvency.[38] Against the background of these inherent risks, host countries have imposed extensive entry conditions on foreign banks. Some of the more important conditions are capital adequacy and deposit insurance.[39]

(i) Capital Adequacy

Capital regulation in the form of minimum capital requirement is the most popular instrumentin current banking regulation.[40] Illustrative of the standards imposed on banks which want authorisation is that concerning capital adequacy.[41] The importance of adequate bank capital for bank soundness is generally recognised.[42] When capital becomes negative, a bank is no longer able to meet its obligations in full and becomes insolvent. Capital provides a cushion for absorbing a broad range of risks, many of which are difficult

[37] Cranston 1997: 53-54.

[38] Ibid.

[39] Ibid at 78-91.

[40] Furubotn and Richer 1990: 91-92.

[41] Cranston 1997: 89. The Revised Basel Framework of June 2006 sets out the details of the agreed Framework for measuring capital adequacy and the minimum standard to be achieved which the national supervisory authorities represented on the committe will propose for adoption in their repective countries. This Framework and the standard it contains have been endorsed by the central Bank Governors and Heads of Banking Supervision of the Group of Ten Countries.

[42] Levinson 2010: 81. Capital is critical to banks health; it represents the resources available to pay depositors and trading partners in the event of loses. It can take serveral forms, such as equity (money raised when a firm issued shares), retained earnings (past profits that a firm set aside rather than using then for dividends and expansion), or loan-loss reserves (money held in expectation of future losses).

to measure and control individually.The calculation of minimum capital requirement is the focus of Basel II.[43]

Capital adequacy is the most important measure of a bank's soundness.[44] Without sufficient capital even the most conservatively run institution cannot survive, while more aggressively managed banks can ride out the consequences of their risk-taking if they command sufficiently large capital resources. Capital adequacy rules are perhaps the outstanding example of convergence at the international level in banking regulation. The international standards on capital adequacy grew out of the work of the Basel Committee on Banking Supervision.[45] The fundamental objective of the Committee's work has been to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among international active banks.[46] This Framework will be applied on a consolidated basis to internationally active banks.[47] This is the best means to preserve the integrity of capital in banks with subsidiaries by eliminating double gearing.[48] Further, as one of the principal objectives of supervision is the

[43] Ibid. 146 of the 251 pages of the Basel II document is devoted solely to the calculation of minimum capital requirements.

[44] The Basel Accord on Minimum Capital Requirement http://www.bis.org (accessed 2010/05/03):10-15; Rutova and Vokheimer 2010:84-93.

[45] Federal Reserve Bulletin 2003:397.The Committee consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States.

[46] Ibid at 8. The Basel Committee believes that the revised Framework will promote the adoption of stronger risk management practices by the banking industry, and views this as one of its major benefits. The committee notes that, in their comments on the proposals, banks and other interested parties have welcomed the concept and rationale of the three pillars (minimum capital requirements, supervisory revised framework and market discipline) approach on which the revised framework is based. More generally, they have expressed support for improving capital regulation to take into account changes in banking and risk management practices while at the same time preserving the benefits of a framework that can be applied as uniformly as possible at the national level.

[47] Lee 1999:2-16.

[48] Ibid. The scope of application of the Framework will include, on a fully consolidated basis, any holding company that is the parent entity within a banking group to ensure that it captures the risk of the whole banking group.

protection of depositors, it is essential to ensure that capital recognised in capital adequacy measures is readily available for those depositors. Accordingly, supervisors should test that individual banks are adequately capitalised on stand-alone basis.[49]

The Basel Committee developed a new approach to the calculation of capital requirement.[50] This approach allows banks, for the first time, to use their internal risk-management models to determine regulatory capital requirements. The Basel Accord adopted the 8 per cent solvency risk ratio for banks as indicative of minimum acceptable capital as the numerator and assets, suitably adjusted in value to reflect their varying risk characteristics, as the denominator. That is capital is divided into Tier 1, core capital,[51] and Tier 2, supplementary capital.[52] Tier 2 capital is limited to 100 per cent of Tier 1 capital.[53] The Basel committee considers that the key element of capital on which the main emphasis should be placed is equity capital[54] and disclosed reserves. Not withstanding this emphasis, the member countries of the committee also consider that there are a number of other important and legitimate constituents of a bank's capital base which may be included within the system of measurement. The committee has therefore concluded that capital, for the supervisory purposes, should be defined in two tiers in a way which will have the effect of requiring at least 50 per cent of a bank's capital base to consist of a core element comprised of equity capital and published reserves from post-tax retained earnings (Tier 1). The other element

[49] Walker 2003: 5.

[50] The Basel Accord on minimum capital requirement <htt://www.bis.org> (accessed 2010/5/03):10-14.

[51] Ibid.Notably permanent shareholder equity and disclosed reserves.

[52] Ibid. Notably, undisclosed and revaluation reserves, preference shares, and subordinated debt.

[53] Cranston 1997:90.

[54] Ibid. This key element of capital is the only element common to all countries' banking system; it is wholly visible in the published accounts and is the basis on which most markets, judgement of capital adequacy is made; and it has a crucial bearing on profit margins and bank's ability to compete. This emphasis reflects the importance the committee attaches to securing and appropriate quality of the total capital resources maintained by major banks.

of capital (supplementary capital) will be admitted into Tier 2 limited to 100 per cent of Tier 1.[55]

(ii) Deposit insurance

Secondly, national regulatory arrangements usually include some form of deposit insurance or guarantee scheme in the event of bank failure.[56] The primary objective of deposit insurance is often held to be the prevention of contagious bank runs. Deposit insurance represents an integral part of the financial safety net in most countries; the rationale supporting deposit insurance depends on the public policy objective of each particular government. In the case of a bank failure, the insurer pays off the insured depositors, thereby preventing direct effects of the failure on the depositor and money holdings of the economy. Most importantly, however, the need for depositors at other banks to be concerned about the safety of their deposits is removed, and thus the danger of chain reactions and of a collapse of the banking system disappears.[57] This is why deposit insurance systems have been adopted in many countries following financial crisis or disruption in financial systems. The exposition of deposit insurance makes it politically acceptable to liquidate insolvent banks, given at less sophisticated depositors will be protected.[58] While deposit insurance necessitates other forms of regulation, the nature and scope of that regulation will depend on the precise terms of the insurance scheme. In particular, the regulatory implications will vary according to the coverage offered and the way in which insurance premiums are paid.[59] It is important to emphasize the difference between a flat fee and a variable fee insurance system which manifests itself here. While the variable fee

[55] The Basel Accord on minimum capital Requirement. http://www.bis.org (accessed 2010/05/03) at 14. Tier 2 capital consist of undisclosed reserves which may be constituted in various ways according to differing legal and accounting regimes in member countries. Under this heading are included only reserves which, though unpublished have been passed through the profits and loss account and which are accepted by the bank's supervisory authorities; Revaluation reserves; General provisions/general loan-loss reserves; hybrid debt capital instruments and subordinated term debts.

[56] Cranston 1997:78-79.

[57] Ibid.This argument, if valid, applies to all liabilities which can be withdrawn on short notice- under whatever name they may appear in the balance sheets of financial firms.

[58] Yokoi-Arai 2005: 67-68.

[59] Ibid. In reality it is impossible to avoid these problems totally. But there is no reason not to try to approximate such a solution as far as possible.

system is not concerned with the risk of individual bank failures as such and constrains it via its influence on the insurance premium, the flat fee system is forced to care directly about this risk and to limit it through certain non-price measures. That is, it must attempt to force banks to save, in order to protect the insurance fund.[60] If the deposit insurance is 100 per cent and universal there need be little concern that one bank failure will have adverse effects on others and the avoidance of failure, as distinct from protection of the insurance fund in the event of failure, ceases to be an appropriate policy goal. However, if as is generally the case, deposit insurance is something less than 100 per cent, regulators will be concerned both to protect the insurance fund against the consequences of individual bank failures and prevent such failure for fear that a contagious effect on other, sounder institutions could lead to wider losses for the fund.[61] It is thus clear that the performance security that should be provided must be the basic 8 per cent capital requirement and the 100 per cent deposit insurance. The success is not, however, solely in raising capital levels as such but ensuring that total reserves more accurately reflect total risk.

1.1.2 Risk of fraudulent security

Deposit protection in the form of flat-rate deposit insurance schemes such as existed in many countries encourages banks to substitute deposit insurance for capital, since they can lower their capital ratios without having to pay an additional risk premium in order to attract deposits. This is because insurance fees do not vary with a bank's capital structure, and the insurance enables highly leveraged banks to avoid having to pay more for deposits.

[60] Cranston 1997:58-59. In principle there is no reason not to be more concerned about an individual bank failure than about the failure of any other firm. It is only the possibility of chain reactions which should be our concern, that is, the possibility of the failure of sound banks and the banking system as a whole through banks runs. If an individual bank, as such, probably implies no social costs beyond the direct costs to the depositors, shareholders and employees. A collapse of the whole banking system, however, represents a heavy social cost, given the importance of the banking and monetary system for the efficient operation of an economy. But this does not require minimisation of the probability that even one bank will fail; it only requires the elimination of the risk of adverse chain reactions.

[61] Ibid. Under these circumstances regulators will wish to choose the worst of both worlds when defining and measuring capital: subordinated debt should then be excluded while assets should be valued on a liquidation basis.

Thus, the bank's private cost of highly leveraged capital structure is below the social costs. The difference is paid for by the insurance agency in the form of a greater risk exposure.[62]

1.2 Theme of the Thesis

This thesis will research the necessity of opening up banking services to international trade. For international trade in banking services, the most generally accepted principle is national treatment, which seeks to ensure equality of competitive opportunity for domestic and foreign banks providing banking services in a host country. Under a policy of national treatment, foreign banks are treated as nearly as possible like domestic banks. They have the same opportunities for establishment that domestic banks have, they can exercise the same powers in the host country, and they are subject to the same obligations.

1.2.1 Issues Dealt with in the Thesis

The debate on trade in banking services is centred on a north/south split as well as on the desirability, scope, and context of trade in banking services.[63] One specific issue that arises in the developing country's context is the infant industry protection for domestic banks. The GATT article III paragraph 4 national treatment provision is compatible with infant industry protection tariffs levied at the border. A similar option for protecting domestic banks does not exist in the services context where foreign commerce is present because the border element is absent. The transfer of banking skills and know-how is often one of the crucial considerations for developing countries when granting foreign banks market access and subsequent national treatment. A frequent proviso of many of them is a regulation relating to the hiring and training of local staff by foreign banks. The GATS is silent on the issue as it is on the infant industry protection clause in general. In relation to the rules and disciplines of the GATS, firstly, the supply of banking services through the commercial presence of

[62] Furubotn and Richter 1990:60. But why should deposit insurance affect the investment behaviour of banks? Deposit insurance insures the depositors and does not protect the capital of the bank's stockholders. Unless the deposit insurance finances bailout, the bank's capital bears the same risk with or without deposit insurance.

[63] Swacker ea 1999: 271.

foreign banks in the territory of any other member as defined in article 1:2(c) of the GATS isapre-eminent article dealing with establishment of foreign banks.[64]

On the trade side this thesis is directly concerned with some of the key issues of negotiating services, namely, market access, national treatment, and progressive liberalisation. At the same time it cannot be separated from the questions of foreign direct investment.[65] It is for the latter reason that many developing countries have been reluctant to participate in the negotiations on trade in services in general and trade in banking services in particular. Developing countries believed that the forum provided by the multilateral trade negotiations in the Uruguay Round was not the correct one to address multilateral foreign direct investment issues. Secondly, transparency issues: the duty to notify and make information available is unlikely to prove adequate in practice.[66] Instead, a more active stance by national regulatory authorities even in developed market economies, in order to monitor various international service operations will be required, though doubtless, this will stretch many bodies to the limits of their resources, an issue that the agreement fails to address.

The agreement also includes an additional provision in article III bis that providesthat members will not be required to disclose confidential information if disclosure should in any way impede law enforcement, or otherwise be contrary to the public interest, a somewhat cursory recognition of the difficult challenges,which many regulatory bodies face. For example, in the financial services sector, central banks are responsible for banking supervision and the exercise of prudential control, while at the same time they have a duty to ensure that confidentiality is not compromised. Thirdly, market access: banking is characterised by a number of submarkets, and the granting of market access to foreign banks may only apply to some of those submarkets. The importance of this cannot be

[64] Raj 1999:1259.

[65] Ibid.

[66] Footer 1995: 460-465.

underestimated for many developing countries.[67] Liberalisation of the domestic banking system in some of these countries is seen as surrendering a degree of autonomy and flexibility in macroeconomic and development policies, particularly in such areas as exchange control, monetary policy, and the allocation of credit. Fourthly, national treatment: article XVII of the GATS on national treatment, is modelled on GATT, article III paragraph 4. It is essentially designed to ensure that foreign suppliers of banking services are not subject to discriminatory treatment under an importing country's internal taxes, laws, and regulations. Cross-border trade in banking services is treated essentially the same as that in goods. This treatment could differ, however, when trade in banking services is the establishment of a commercial presence. An unfavourable type of discrimination may exist where a foreign bank enjoys de jure coexistence with domestic banks, but experiences de facto inequality of competitive opportunity. For example, capitalisation requirements of foreign banks may be more stringent for prudential reasons. This distinguishing treatment is frequently justified by application of differing regimes for domestic and foreign banks.[68] The problem could be solved if a higher degree of co-ordination existed among the discrete supervisory authorities. Another example of unfavourable discrimination is in the application of exchange control to foreign banks, although such application may intrude on the other areas of the country's monetary policies. Similarly, domestic antitrust legislation to control monopolies and mergers may not be intended to deter or exclude foreign direct investment, but the effect may still have a protectionist impact.[69] Fifthly, banking is a highly regulated industry, the regulatory framework includes regulations on entry ("fit and proper" criterion), on the scope of permissible activities (banks' power), and on rules of conduct of business (regulation on capital, on large exposure, and so forth). Regulations are applied to national and foreign suppliers of banking services. To assess the economic logic of national banking regulations and specific issues raised by a fast-growing trade in banking services, one must first review the economics of the potential market failures that explain the need

[67] Market access is not mandatory but requires opting in by sector, but even if a member state submits a "positive list" it may opt out of certain of the requirements for full market access set out in the General Agreement.

[68] Raj 1999:1259.

[69] Ibid.

for banking regulations: imperfect (asymmetrical) information, which could prevent the proper functioning of unregulated private markets; the potential for bank runs and the related fear of systemic crises; and indirect subsidies, which create distortions in international trade. Sixthly, the GATS envisages liberalisation of banking services at the multilateral level while it ignores the need for institution building with respect to prudential implications arisingfrom globalisation of banking. It addresses prudential implications arising from its deregulation effect only through its prudential carve-out, which covers all national measures for prudential reasons.[70] Instead, a more active stance by national regulatory authorities even in developed market economies, in order to monitor various international service operations, will be required. Seventhly, the two outstanding issues confronting the Most Favoured Nation Principle (MFN) where banking services are supplied through a commercial presence, are: the compatibility of MFN treatment with procedures that place ceilings on the total number of foreign banks entry into a particular market; and the eligibility of receiving the benefits of concessions under GATS through application of the MFN principle. In the first case, the permitted level of commercial presence for foreign banks is at issue. Application of the unconditional MFN treatment is problematic because the granting of market access is bank specific rather than aimed at particular countries. This specificity runs counter to the fundamental MFN principle as enshrined in multilateral trading relations and lastly, Restrictive Business Practices and Anti-dumping: the number of activities with anti-competitive effects that might be considered relevant in the financial services context include so-called "club arrangements" which are primarily professional associations and grouping with specific objectives involving matters like payments systems, quotation, clearing, and settlement systems for securities markets and other financial instruments. They can prove very effective in discrimination against foreign suppliers of banking services in favour of domestic ones. Other restrictive business practices include various types of exclusive dealing as well as discriminatory and predatory pricing. This latter activity, known commonly as dumping when applied to goods, is bound to be prevalent

[70] Panourgias 2006: 93.This prudential clause has not yet been tested in dispute settlement and its coverage is still uncertain, especially since countries may have different perceptions on this issue for historical reasons. For example European countries with a universal banking tradition could argue that traditional line-of-business restrictions (ie separation of banking, securities and insurance) cannot be justified on prudential grounds.

because banking is a service sector that offers possibilities and incentives for price discrimination. In particular the practice of cross-subsidisation allows the local financial services of multinational financial institutions to gain a foothold in a particular market or increase their market share through aggressive pricing. As with trade in goods, the difficulty with bringing an anti-dumping action in banking services lies in demonstrating material injury. No specific article in the GATS deals with anti-dumping; the article on emergency safeguard measures[71] is too vague and offers no guidelines. For such cases, presumably it could only be contained within the wide scope of article IX on business practices. Lastly, regulatory harmony: on the matter of governing foreign banks, that is their ability to use international networks to evade taxes and regulations of foreign exchange exposure and their ability to resort to unfair pricing practice, progress can be expected to be too slow. The duty to notify and make information available is not enough.[72]

This thesis argues that harmonisation of prudential and supervisory regulations are warranted where entry is restricted by differences among national regulations. However this should be done without preventing the host state from retaining the right to regulate foreign banks' activities in the host state only to the extent that such regulation is necessary for the protection of public interest. The host state may also intervene in those matters expressly reserved to it, notably liquidity, monetary policy and advertising.

1.2.2 Scope of the Thesis

This thesis will cover the traditional services provided by banks, such as money transmission services. For the purpose of this thesis a comparative discussion of the history and development of trade in banking services is required for the proper understanding of trade in banking services. The thesis will also focus on the principles for regulating the liberalised provision of trade in banking services because of the unique character of such services and because, despite the increasing liberalisation of trade in banking services, national regulatory systems still differ substantially. Attempts made by the Basel Committee with its Core Principles for effective banking regulation and supervision will be discussed to see

[71] See GATS art. X.

[72] Sapir ea 1999: 51-52.

whether or not these attempts have assisted to link disparate regulatory regimes with a view toward ensuring that all banks are supervised according to common principles.[73]

2.3 Structure of the Thesis

Chapter 1 provides a general introduction to the thesis. The theme and scope of the thesis are also set out in chapter 1. Chapter 2 will focus on an analysis of trade in banking services in the EU; US; China and South Africa because the issue of trade in banking services in these countries is taken more seriously. The reason for the choice of China and South Africa as particular case studies is that, the Chinese economy has achieved one of the world's faster growth rates in the past two and half decades, and has attracted foreign banks into China. South Africa is chosen because the work is done and submitting to a South African University.The purpose of chapter 3 is to explain the nature and role of the different types of disciplines in relation to GATS and Trade in banking services. Chapter 3 is structured to enable the reader to understand in broad terms the general legal nature and fundamental principles of trade in banking services. Chapters 4 and chapter 5 look at the forms of cross-border banking under the GATS. These two chapters will focus on the first and third modes of supply. Lastly, chapter 6 contains conclusions reached based on the issues dealt with in this thesis and it also contains some recommendations.

2.4 Research Methodology

Firstly, an analysis of the main problems experienced with the liberalisation of trade in banking services by developed and developing countries was done. A wide search was conducted to find the relevant articles and books. An in-depth examination of WTO original documents and articles of the chosen jurisdictions was done in an attempt to extract the legal principles relevant to this study. The issues commonly in dispute between the host and home countries were compared in an attempt to find solutions to the main problems explored in this thesis. The issues most commonly raised seemed to relate to the fact that national regulatory regimes that have hitherto governed banking services are increasingly under strain. Whether their concerns are orderly markets, the safety and soundness of

[73] See chapters 3 and 4. The Basel core principles have been drawn up by the Basel Committee in close collaboration with the supervisory authorities in fifteen emerging markets countries; the Basel Committee has also consulted with many other supervisory authorities throughout the world.

banks or the protection of depositors and regulators fear that the pressure of these international capital flows may undo or overwhelm their efforts. Their usual pleas is for international harmonisation of national regulatory regimes, so as to coordinate their efforts, create a “level playing field”, and prevent a competitive “race to the bottom” among national regulators that ultimately harm the participants in these markets and the reluctance of the WTO to prevent this.

CHAPTER 2

AN ANALYSIS OF TRADE IN BANKING SERVICES IN THE EUROPEAN UNION, THE UNITED STATES OF AMERICA, CHINA AND SOUTH AFRICA

2.1 Aim and Purpose of the Chapter

The objective of this chapter is to analyse the liberalisation process that has taken place in the European Union, the United States of America, China and South Africa's banking services industry and evaluate it in the context of negotiations on multilateral liberalisation of banking services within the WTO framework. In particular, as the path adopted by these countries represent the best case of successful extensive liberalisation in the banking services industry. It is worth exploring whether this route could represent a blueprint for opening up markets worldwide. Hence, the sequences of liberalisation and problems faced by these countries in liberalising their markets are here studied in order to provide insight in the areas that are likely to be most difficult to open internationally and contribute to lifting impediments to multilateral negotiations.

These countries liberalised trade in banking services under the GATS by,[74] removing capital account restrictions to permit cross-border supply and consumption abroad; grant market access to all; that is, grant everyone the right to establish in the national market or service it freely; and ensure national treatment, that is, the authorities should seek to treat all banks, regardless of country of origin, on an equal basis and make them all subject to the same regulatory and tax regimes. [75]

2.2 The European Union (EU)

2.2.1 Introduction

The investigation of the sequencing of liberalisation in the EU's banking services industry is the primary objective of this section. The relevance of the EU's model for financial liberalisation is firstly that, the EU's route towards liberalisation in banking services could be

[74] Gkoutzinis 2005:886-900.

[75] Ibid.

regarded as a blueprint for opening up markets of multilateral liberalisation within the WTO framework.[76] This is because, during the GATS negotiations, the European Union played a relevant and leading role in promoting the liberalisation program.[77] As a matter of fact, the creation of a "regional market" –the so-called Single Market for Financial Services – well in advance of the WTO negotiations, seems to have helped Western European Countries which entered the negotiations as a single compact group, relatively prone to extend the benefits of the Single Market to third Countries.[78] Coordination of bank legislation, that is, the strengthening of prudential measures, while introducing pieces of domestic deregulation and the recognition that a "level playing field" can be more easily attained, if there is a consensus on minimal harmonisation of rules, represents the focal point of the overall architecture of the Single Market Program (SMP).[79] The EU's path towards the creation of an integrated, common market highlights the need for minimum harmonisation as a realisable goal instead of full harmonisation of rules.[80]

This section analyses the provision of trade in banking services in the EU which requires member states to grant access to their domestic jurisdictions.[81] The necessity of such a study for the present purpose is self-evident, because the members of the European Union[82] are also members of the WTO and are obliged at their discretion, to transpose[83] the

[76] Bongini 2003:1.

[77] Ibid.

[78] Dermine 2003: 1-20.

[79] Ibid.The SMP stimulated a degree of internationalisation of European Union banks, a phenomenon which took a number of forms regarding increased trade in banking services.

[80] Ibid. Minimum harmonisation requires minimum agreement on essential rules, mainly in the field of prudential regulation and supervision.

[81] Kent and Norton. The EU Single Banking Market Programme: Fit for the purpose. http: //www.global-vision.net (accessed 04/12/2012): 1-4.

[82] Manell 1999:1730-1731. The treaty that established the European Economic Community (EEC), which is one of three European Communities established under three separate treaties, is generally known as the treaty of Rome. The other treaties established the European Coal and steel Community and the European Atomic Energy Community. The term European Community (EC) or European Union (EU) is commonly used to refer to all three European Communities.

[83] Ibid. The Legislation of the European Union may take two primary forms. A Regulation which has general application, is binding in its entirely and is directly applicable to all member states. It does not require national implementing legislation to become effective in member states. It is essentially a Federal Law of

regional European Union banking laws provisions into their domestic laws.The section then proceeds to give a rationale for the European Commission's Second Banking Directive. Basically, it is argued that these two instruments are designed to facilitate the operation of the European internal market.[84] The study then proceeds to the European Commission's Second Banking Directive and draws some conclusions.[85]

2.2.2 The Evolution of the European Banking System

The actions taken by the European Commission and the Council of Ministers can be divided into five time periods:[86] Deregulation of entry into domestic markets from 1957 to 1973; various attempts toward harmonisation of regulations from 1973 to 1983; and the 1992 directives regarding a single banking license, home country control, mutual recognition and freedom of cross-border services.

Over the last couple of decades most of the regulations and constraints imposed on banks by national authorities have gradually been dismantled.[87] In the context of the single market,[88] it was felt necessary to remove most of the legal barriers imposed on banks with the aim of generating more pressure and in turn a better allocation of resources. The liberalisation of the banking services industry has taken place gradually through two important moves. On the one hand, member states have made a pre-emptive move to deregulate national banking sectors in the advent of the creation of a single market,[89] lifting

Europe. A Directive in contrast, is not directly applicable in the member states. Its provisions normally require positive implementation (called "transposition") in the domestic laws of member states.

[84] Cordero 1990: 2.

[85] Ibid. A Directive is a Community act adopted by the Council or the Commission. Directives are binding on any member states to which they are addressed as regards the result to be achieved but leave the choice of form and methods to the national authorities. They state the reasons on which they are based, are communicated to the countries to which they are addressed, and take effect on the date of their communication. They generally lay down a time-limit for implementation. They are published in the Official Journal of the European Communities.

[86] Dermine 2002:3.

[87] Dixon 1991: 99-116.

[88] Howell 2002:7.

[89] Kent and Norton. The EU Single Banking Market Programme: Fit for the Purpose http://www.global-vision.net (accessed 04/12/2012):1.

every restriction on quantities and prices. On the other, there has been a process of approaching the different EU's banking legislations, so as to harmonise regulations governing the banking industry across Europe, providing a "level playing field" for all credit institutions operating in different member states and ensuring that competition is not distorted.[90] To measure the process of banking deregulation and harmonisation in the EU, a data set consisting of the implementation dates of the main European Union Directives affecting the banking industry was assembled.[91] Overall the positive benefits in terms of economic performance resulting from the harmonisation of banking regulations, accord well with the expectations of the authorities and member states. The creation of a single European Banking market has opened domestic banking sectors,[92] created more cross-border activities and in turn, more competition, which has all translated into greater banking activities.[93]

2.2.2.1 The Harmonisation Process

The twelve original member states of the European Union: Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom,[94] agreed in 1977 to remove diverging national legal and policy frameworks which constituted the obstacles that kept banks operating in separate national systems. Their removal and replacement by only one community legal policy framework would open the way for their integration into a European banking system, allowing all banks in the

[90] Manvell 1999:1731. The recognition that a level playing field can be more easily attained if there is a consensus on minimum harmonisation of rules represents the focal point of the overall architectural of the Single Market Program (SMP).

[91] Bongini 2003: 57. Table 1 below will give details of the sequences of relevant Directives relating to the issue of banking integration in the European Union.

[92] Kent and Norton.The EU Single Banking Market Programme: Fit for the Purpose http://www.global-vision.net (accessed 04/12/2012):1-2. The EU Single Banking Market Programme represents the vanguard of the Single Market Programme for services. The principle of a single banking market allowsfor consumers to purchase financial services from any part of the EU and for financial intermediaries to supply financial services to any part of the EU. The European Union has been enacting and implementing various banking directives with the aim of creating a single EU banking market. This is part of a wider aim to create a single market in services.

[93] Dixon 1991: 99-116.

[94] Ibid. The treaties establishing the European Communities have been revised several times through the Single European Act (1987), the Treaty on European Union, the so-called Maastricht Treaty (1992), and the Treaty of Amsterdam (1997).

European Economic Community to operate in a single internal banking market.[95] To remove those obstacles and set up a new scheme would require the authorities of the member states and of the Community to engage in a process of harmonisation of the provisions directly or indirectly applicable to banks and their activities. This was done in the Community's First Banking Directive of 1977.[96] To give effect to the objectives of the economic union, the twelve countries agreed to share one uniform banking law in their national laws. The legal basis for this is contained in the Treaty of Rome establishing the European Community (EC).[97] Article 57(2) and 61(2) of the Treaty specifically provides for the adoption of laws on the right of establishment and on the freedom to provide services in the banking field respectively.[98] The text of the EEC Treaty as it entered into force in 1957 is evidence of the fact that the member states were conscious of the specific issues raised by the liberalisation of banking services. Indeed, on the one hand, according to article 57[99] unanimity in the Council was required for the adoption of directives relating to the harmonisation of public regulation of the banking sector.[100] On the other hand article 51 in its second paragraph provides:[101]

> "The liberalisation of banking services connected with movements of capital shall be effected in step with the liberalisation of movement of capital."

The application of those laws in all member states without discrimination, as required under article 7, would result in creating a European banking system.[102] Thus, the Treaty provides the legal basis for the creation of such a system within the framework of coordinated

[95] Van Empel 2008:25-30.

[96] Manvell 1999: 1732. Directive 77/80/EEC. The adoption of the First Banking Directive by the European Commission in 1977, constitute the European Union's first major attempt to harmonise European Banking Laws.

[97] Manvell 1999: 1732. The Treaty of Rome provided the European Commission with the authority to pass regulations and directives, to make decisions and recommendations, and to issue opinions. Hereafter referred to as the Treaty of Rome. In its preamble the Treaty states that the member states concluded it for the purpose of laying the foundation of an ever closer union among their peoples.

[98] Codero 1990:2-6; Barfield 1996:52-74.

[99] Van Empel 2008:25. Now, art. 47.

[100] Ibid. This specific regime has been withdrawn.

[101] Ibid.

[102] Van Empel 2008:25.

economic, common to and subject to a single supervisory scheme resulting from harmonised banking laws. In such a system, nationals of member states would be able to exercise on an equal competitive footing the right both to set up principal or secondary banking establishments anywhere in the community and to offer from there all types of banking services, including those connected to capital movements.[103]

2.2.2.2 The Deregulation of Entry 1957-1973

The objective of the 1957 Treaty of Rome was the transformation of highly segmented national markets into a single common market.[104] This objective was achieved by means of two types of measures: the recognition of the right of establishment and the coordination of legislation wherever necessary.[105] The foundation for a European common market in banking services was laid in 1973 with the Council Directive on the Abolition of Restrictions on Freedom of Establishment and the Freedom to provide Services in Respect of Self-employed Activities of Banks.[106] In addition, credit institutions operating in the same country would be subject to equal prudential and supervisory rules.[107] This directive applies the national treatment principle, which ensures the equal regulatory and supervisory treatment of all firms operating in one country. Although in 1973, entry restrictions could not be discriminatory the objective of the initial treaty was still far from being met.[108]

Despite the fact that the treaty provides a legal basis for the creation of a European banking system, the community is far from having an integrated banking system.[109] The community, which has the obligation and the power to adopt directives harmonising economic activities

[103] Van Empel 2008:25.

[104] Dermine 2002:3.

[105] Ibid.See arts. 57(2) and 61(2), where the treaty specifically provides for the adoption of laws on the right to establishment and on freedom to provide services in the banking field respectively.

[106] European Documentation 1989:27. In essence, however, this Directive achieved little more than the freedom of establishment-based on non-discrimination between national and non-nationals call for in the EEC Treaty.

[107] Dermine 2002:3. That is national treatment principle.

[108] Ibid.The Rome Treaty.

[109] Kent and Norton The EU Single Banking Market Programme: Fit for the Purpose http://www.global-vision.net (accessed 04/12/2012):3-4.

such as those in which banks are engaged, has not adopted all those necessary to bring about banking integration.[110] International competition through the supply of cross-border services was severely restricted by regulations on capital flows. Furthermore, there was no coordination of banking supervision, so that banks operating in different countries could be subject to different rules.[111] This additional burden raised the costs of operating internationally. This led to the second phase of harmonisation of banking regulations.

2.2.2.3 The Harmonisation of Banking Regulation (1973-1983)

The reasons for which it proved so difficult to come to an agreement between the member states on the details of harmonisation of banking regulation at the EC level must be sought in the specific place banking has within the overall economy and society.[112] Banks are privileged channels through which private savings find their way to industrial and commercial investments, and they have therefore a pivotal role in the economy: without a sound banking-system the modern capitalist economy is simply inconceivable. Indeed, a specific regime obviously makes sense only if all players concerned are made subject to that specific regime. This then was the starting point when the Treaty was entered into in 1958.[113] The banking sector was subject to regulatory restraints in each member state, albeit in different terms and to different extents of severity, from one state to another. Accordingly from the start there was never any doubt that, if free establishment for banks and free movement of banking services were to be achieved, this could only be on the basis of a regulatory regime which would meet substantially the preoccupation of the banking sector,[114] shared between member states. Hence discussions and negotiations through the

[110] Kent and Norton The EU Single Banking Market Programme: Fit for the Purpose http://www.global-vision.net (accessed 04/12/2012):3-4.What is more, those that it has managed to adopt have not only been modest in their content of common rules for banks, but they have shown themselves to be precarious legal vehicles of harmonised supervisory provisions.

[111] Cordero 1990: 1.

[112] Cranston 1997:27-90.

[113] Ibid.

[114] Ibid.

years focused on harmonisation of the regulatory framework, with free establishment and free movement of banking services being conditioned by the scope of this harmonisation.[115]

The first important step in the harmonisation process of approaching the national legislations was made in 1973 through the adoption of Council Directive 73/183,[116] by which the restrictions on freedom of establishment and provision of financial services by credit institutions in other member states were removed. In addition credit institutions operating in the same country would be subject to equal prudential and supervisory rules.[117] In practice, this directive did not have much impact since in most member states, there still remained many restrictions on the free movement of capital in addition to the requirement for branches to maintain a minimum level of capital.

2.2.2.3.1 The First Banking Directive

During the last two decades, the international banking industry has been the subject of several scandals.[118] In 1974, due to foreign currency trading losses, the HerstattBank of Germany collapsed when it was unable to meet its obligations to other banks.[119] In 1982, Banco Ambrosiano was shut down when $1.4 billion was unaccounted for and customer withdrawals diminished the bank's necessary working capital.[120] The largest and the most scandalous banking event by far was the collapse of the Bank of Credit and Commerce International (BCCI) in 1991 which resulted in the loss of at least $9.25 billion for

[115] Van Empel 2008:26. In the dissussion of the various stages through which EC Legislation has moved in this field, reference will be made to various EC Directives as they were enacted through the years. It should be noted, however, that in 2000 the EC legislator decided to consolidate the various banking directives into one single directive, viz. "Directive/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions".

[116] Ibid.

[117] Van Empel 2008:26. That is the national treatment principle.

[118] Rodriguez 1994:213.

[119] Gard 2007:170-172.

[120] Ibid.

creditors.[121] Responding to these banking scandals the Commission adopted several directives to prevent future banking disasters.

In 1977, the Council adopted the First Banking Directive, which was the initial step in a series of directives attempting to create an internal EC banking market and establishing certain guidelines for supervision of credit institutions.[122] The twelve original member states of the European Commission agreed in 1977 to liberalise trade in banking services under the First Banking Directive.[123] To give effect to the objectives of the Economic Union, the twelve countries agreed to share one uniform banking law in their national laws, the basis of which was provided in the Rome Treaty of 1957,[124] which was transposed into the First Banking Directive of 1977.[125] The 1977 Directive was a first step towards the harmonisation of the regulations.[126] It was a general programme, which without providing any specific regulation, called for further directives.[127]

2.2.2.3.1.1 Harmonisation Provisions of the First Banking Directive

The First Banking Directive consists of several provisions that significantly harmonised the banking services industry in the European Union for credit institutions, also known as

[121] Gard 2007:170-172. The Bank was not adequately supervised and authorities did not discover its fraudulent practices until the damage was irreparable.

[122] Ibid at 213-214.

[123] Hawell 2000: 7. Directive 77/780/EEC cleared many obstacles to the freedom of establishment for banks and introduce home country supervision and a common position for granting of banking licenses.

[124] Kleimeier 2002:1.

[125] Gunter 1992:9. The First Banking Directive, issued when the members of the European community were buffeted by the oil shocks of 1970s, represented a rather modest programme of harmonising banking regulations.

[126] Bajec and Fabris 2005:153-155.The First Banking Directive regulates the establishment of credit institutions, freedom to provide services and minimum amount of intial capital; it defines the basic criteria for issuing an operating license to a credit institution as well as the conditions under which an operating license can be revoked.

[127] Hopt 1993: 314-315. The Directive itself acknowledges its modest scope when it says in its third paragraph that whereas " the conditions required for a common market for credit institutions cannot be created by means of a single Directive.... it is therefore necessary to proceed by successive stages". Directives on Supervision of Credit Institutions on a Consolidated Basis, on a uniform Format for Bank Accounts, and on Consumer Protection were adopted by 1987.

commercial banks.[128] The key provisions of the First Banking Directive can be categorised into five groups for harmonisation purposes:[129] rules eliminating banking services barriers along member states borders; rules promoting the free establishment of branches by European credit institutions in other member states;[130] uniform rules for key authorisation requirements for credit institutions;[131] uniform rules for key supervisory standards; and rules mandating equal treatment of non-European Union credit institutions.

In its preamble, the first Banking Directive provides that,[132]

> "To make it easier to take up and pursue the business of a credit institution, it is necessary to eliminate most obstructive differences between the laws of the member states as regards the rules to which these institutions are subject".

This piece of legislation defined a credit institution as "an undertaking whose business is to receive deposits and other repayable funds from the public and to grant credit for its own account".[133]

However, the principle of taking up the business of a credit institution is applicable to a notion of "foreign bank's branch" that comprises only EC banks. This is illustrated by article 9(1):[134]

[128] Manvell 1999:1732.

[129] First Council Directive of 12 December 1977 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking up and Pursuit of the Business of Credit Institutions (77/80/EEC) Official Journal of the European Communities (herein after First Directive).

[130] Commission of the European Communities 1997:12. In the *Somafer* rullingof 22nd November 1978, the ECJ held that, "the concept of branch implies a place of business which has the appearance of permenancy, such as the extension of the parent body, has a management and is materially equipped to negotiate business with third parties, so that the latter although knowing that there will if necessary be a legal link with the parent body, the head office which is abroad, do not have to deal directly with such parent body may transact businss at place of business consistuting the extension."

[131] Ibid. Art. 3(1) of the First Directive defined "Authorisation" as an instrument issued in any form by authorities by which the right to carry on the business of a credit institution is granted.

[132] Van Empel 2008:28-29.

[133] Kaufman 1991:130-131. According to article 1 of the First Banking Directive, "Branch means a place of business which forms a legally dependent part of a credit institution and which conducts directly all or some of the operations in the business of credit institutions."

[134] Ibid.

> "Member states shall not apply to branches of credit institutions having their head office outside the community, where commencing or carrying on their business, provisions which result in more favourable treatment than that accorded to branches of credit institutions having their head office in the community".

Consequently, by virtue of article 4, a member state as then allowed, notwithstanding the fact that a branch is not a separate legal entity, still to require a branch on its territory to have separate own funds to the minimum required in that member state for an independent credit institution.[135]

Hence, the entry and the establishment rules for foreign EC banks are the same as for domestic institutions in each member state.[136] The national treatment provisionof article 9 of the directive introduces the principle of reciprocity which will be later on adopted by the Second Banking Directive.[137] It regulates the banks of non-member states and requires member states not to apply less stringent rules to branches of credit institutions from third countries than to branches of credit institutions from member states. [138]

> "Without prejudice to paragraph 1, the community may, through agreements concluded in accordance with the Treaty with one or more third countries, agree to apply provisions which, on the basis of the principle of reciprocity, accord a branch of a credit institution having its head office outside the community identical treatment throughout the territory of the Community".[139]

National treatment, however, states nothing more than foreign and domestic banks should compete on a "level playing field", provided that they play in accordance with the host country national requirements.[140] This means that foreign banks need to obtain the authorisation from the competent supervisory body of each host country where they wish

[135] Kaufman 1991:130-131.

[136] Rodriguez 1994:214-215.

[137] Gunter 1992: 11.

[138] Kaufman 1991:130-131.

[139] Ibid.

[140] Ibid.

to establish a branch and to conform to the host country's requirements on such things as minimum capital, solvency ratio, legal form, organisational and operational structures.

The First Banking Directive imposes upon each member state the obligation to provide for a system according to which no credit institutions can commerce activities as such without a prior authorisation from the public authority concerned.[141] This provision was indeed inserted into article 3 of the First Banking Directive by the so-called "BCCI-Directive" Directive 95/26/EC, which was adopted in the aftermath of the failing of the BCCI-Bank, which had aptly illustrated the risk involved in allowing for home state control and mutual recognition where a credit institution operated on an "off shore" basis within the EC-territory.[142] Conditions to be met for obtaining a bankinglicence should be in any case:[143]

(i) The credit institution must possess separate own funds;

(ii) The credit institution must possess adequate minimum own funds (what is adequate in this regard was left at this stage to the individual member states' decision); and

(iii) There should be at least two persons who effectively direct the business of the credit institution. Those persons must be of sufficiently good repute and have sufficient experience to perform such duties.[144]

Home-country control,[145] that is, the overall supervision of a credit institution's operation in several member states by the competent authorities in the member states where it has its head office, was later to be regarded as a yardstick for further progress in the implementation of this First Banking Directive. Although the directive introduced a system

[141] Van Empel 2008: 29-35.That is a banking lincense.

[142] Ibid.

[143] Ibid at 31. It seats in one member state, with limited public authority resources (Luxemburg) whilst in fact operating predominantly in another member state, notably the UK.

[144] Van Empel 2008: 29-35. To be sure, where it is established at some later date that the conditions mentioned are no longer met, the banking license should be withdrawn.

[145] Kent and Norton the EU Single Banking Market Programme: Fit for the Purpose http://www.global-vision.net (accessed 04/12/2012):3. Home country control means that banks are regulated in accordance with the legislative framework of their home country, the domestic regulator being the parent.

of authorisation of credit institutions,[146] it provided for subsequent further harmonisation of authorisation criteria as where and when the member states had reached agreement on supervision requirements.[147] This is one of the sources of support for the process of harmonisation.[148] The directive also stipulated that a credit institution should possess adequate minimum own funds.[149]

The First Banking Directive hindered the formation of a body of homogenous rules for the common organisation of economic activities, among them banking.[150] It uses empty notions such as "adequate minimum own funds"under article 3(2), and "sufficiently good repute or lack of sufficient experience", under article 3(2) second paragraph. These are key notions on which the authorisation for the credit institution to engage in business depends, yet the directive does not define them. On the issue of the technical requirements for the supervision of a credit institution in article 6(1) as an on-going concern, the directive limits itself to providing for the establishment-but only for the purpose of observation- of ratios between assets and/or liabilities the content of which was to be determined by a banking advisory committee.[151]For the purpose of actual supervision, the competent authorities of each member state are allowed to apply their own coefficients.[152]

[146] See First Directive art.3 (1).

[147] Rodriguez 1994:216.

[148] Van Empel 2008:28. Thus the fact that the Directive is titled the First Coordination Directive describes it as the 'first' reveals that a series of coordinating directive was envisaged even at the time that one was issued. This is confirmed in its third para."whereas" stating that given the extent of these difference (between credit institutions), the conditions required for the common market for credit institutions cannot be created by means of a single directive.

[149] Bajec and Fabris 2005: 154-155. Art. 3(2) provides, "without prejudice to the conditions of general application laid down by national laws, the competent authorities shall grant authorisation only when the following conditions are complied with: the Credit Institution must possess separate own funds; the credit Institution must possess adequate minimum own fund; there shall be at least two persons who effectively direct the business of the credit institution. Moreover, the authorities concerned shall not grant authorisation if the persons referred to in the third indent of the first subparagraph are not of sufficient good repute or lack sufficient experience to perform such duties".

[150] Cordero 1990:5-10.

[151] Ibid.

[152] Ibid.

After the 1977 First Banking Directive, the European banking markets were still fragmented for the following reasons:[153]

(1) A bank wishing to operate in another country still had to be authorised by the supervisors of that country;

(2) A foreign bank remained subject to supervision by the host country, and its range of activities could be constrained by host country laws;

(3) In most countries, branches had to be provided with earmarked capital as if they were new banks;

(4) Finally, as already mentioned, the supply of international banking services was severely impaired by restrictions on capital flow.

The inability to agree on a common set of regulations prompted a new approach toward European integration.[154]

2.2.2.3.1.2 The European Commission's White Paper

Progress towards an integrated financial market before the 1985 White paper was very limited.[155] The First Banking Coordination Directive of 1977 set out the minimum legal requirements credit institutions had to meet in order to be authorised in member states namely:[156] to have adequate capital and to be directed by at least two people of good repute and experience. If a credit institution met these requirements a basic right of establishment was created, allowing banks which had their head offices in one member state to set up branches in other member states. The principles of home country control were also introduced. This directive was a useful first step, but the basic right of establishment does not create a free internal market.[157] Secondly, there was one other

[153] Cordero 1990:8-20.

[154] Ibid.

[155] Gunter 1992:5-8.

[156] See the First Directive.

[157] Gunter 1992:5-8. One of the biggest barriers to the free establishment of branches in the Community is that, with the exception of the UK, all the member states require foreign branches to comply with domestic minimum capital regulations and to maintain their own endowment capital (own funds). This means that, in effect, branches are treated as separate banks, even though their creditors are creditors of the bank as a whole, and not just of that branch. The UK is the only Community country to recognise that this is inappropriate, although it does require that foreign branches maintain adequate liquidity levels and keep within agreed foreign currency exposure guidelines. This "own funds" requirement

measure which concerned banking before the White Paper was commissioned. This was the 1983 Directive on Consolidated Supervision.[158] This laid down the rule that where one institution owned more than 25 per cent of another the two should be supervised together, on a consolidated basis. The home authorities would thus be able to get a global view of the group's activities. Although helpful, this directive did not represent the removal of any major barriers to business. The starting-point for the new banking legislation is the White Paper,[159] which identifies six directives and two recommendations needed to complete the free movement of services in the banking sector.[160]

While most international agreements have used the national treatment principle, which ensures the equal treatment of all firms operating in one country, the European Commission has used a powerful method of integrating home country control with minimal harmonisation of national regulations. In 1985, the European Commission published a White Paper on the completion of the internal market, which provided for the free circulation of persons, goods, and capital in the European Union.[161] The Commission's White Paper of 1985 on completing the Internal Market called for a new approach to financial services legislation, arguing that the principle of mutual recognition established by the Court of Justice in the *Cassie de Dijion case* could be adopted to allow the free movement of financial services within the EU.[162] The Commission proposed that banks should be able to provide banking services in any EU member state, provided that they were authorised by their home state, in accordance with harmonised prudential standards.[163] Other member states would be required to recognise their home state authorisation and would be unable to impose

represents a major impediment to branching, especially if a bank wished to set up branches in a number of member states, because it means that large amounts of capital have to be tied up quite unnecessarily. An added complication is the definition of a branch's capital varies from state to state.

[158] Rodriguez 1994:216.

[159] EuropeanCommission 1985:14.

[160] Gonzalez 1993: 41.

[161] Dixon 1991:34.

[162] Kaufman 1991: 98.

[163] Ibid.

additional licencing requirements. Thus the foundations of the passporting system for banks were laid.

In the context of banking, the White paper called for a single banking license, home country control, and mutual recognition.[164] The development of the banking stability framework in the EU can essentially be traced back to 1985, the year in which the single market approach to banking services was introduced with the Commission's White Paper. The 1985 White Paper was the culmination of a number of economic, political and legal factors which provided the political willingness for undertaking economic reform, namely in the direction of market liberalisation and further market integration within the Community.[165]

In mid-1985 the Commission presented its White Paper on completing the internal market, which contained concrete plans for the removal of all remaining physical, technical and fiscal barriers between the EC countries by the end of 1992.[166] As earlier mentioned, this White Paper identifies six directives and two recommendations needed to complete the free movement of services in the banking sector.[167] Directives are the principal instrument provided by the treaty for bringing about freedom for banks to establish and provide services across borders as well as freedom of capital movement. Nevertheless, the list of proposals included in the White Paper timetable also includes some recommendations besides directives. They have no binding force, as stated in article 189 of the Treaty.[168] Their effect is based on the notion that the EC institution that issues them can exert on the recommendations addressees as well as on gentlemen's agreement-entered into with parties that were consulted, while the text of the recommendation was being drafted. Thus,

[164] Kaufman 1991: 98. These principles were incorporated into the Second Banking Directive under which, all EU countries would be able to establish branches or supply cross-border financial services in the other countries of the EU without further authorisation, provided that the bank was authorised to provide such services in the home country.

[165] Dermine 2002: 5-15.

[166] Ibid.

[167] Ibid.These are: A directive on the Own funds of credit institutions; A directive on solvency ratio for credit institutions; A recommendation on deposit protection schemes; A recommendation on the monitoring and control of large exposures; A directive on the re-organisation and winding up of credit institutions; A directive on the annual accounts of banks; and A directive on the accounts of foreign branches.

[168] The Treaty of Rome will be referred to as the Treaty.

recommendations are even less suitable than directives for bringing about the necessary substitution of divergent national provisions by minimum uniform Community ones that are required to complete the internal market in banking and capital movement. The Commission is aware of the need for binding instruments. It had considered submitting some of its proposals to the council for adoption as recommendations because it feared that it could not secure the necessary unanimity there. After, the Single European Act introduced amendments in Council voting requirements, substituting unanimity by qualified majority in many cases, particularly under article 57(2). Some of those proposals can now be submitted as proposed directives since they stand good chances of being adopted by a qualified majority vote in the Council.[169] The Commission announced its intention to concentrate supervisory control in the hands of home country authorities.

The 1985 White Paper put forward three key principles of legal and market integration:[170]

(a) Minimum harmonisation: the commission adopted the principle of the "lowest common denominator", that is, the minimum level of coordination and harmonisation among national standards, necessary for a truly integrated internal market;

(b) Mutual recognition: the principle states that, once minimum agreement has been reached on essential rules, each member state would have to recognise the validity of rules, applied in other countries. Thus, if a product or service satisfied the basic standards in one country, it may be sold throughout the Community.

(c) Home country control principle charges each member state's supervisory authority with the responsibility of supervising national financial institutions even when doing business in the territories of member states.

The Commission's approach towards achieving the liberalisation of banking services is based upon three principles:[171]

[169] Cordero 1990: 67.

[170] Bongini 2003: 15-16. The cross-border provision of banking services would be facilitated essentially through the extension of the Cassie de Dijon doctrine from industrial and agricultural products under article 28 as extended by article 30 of the EEC Treaty to the free circulation of "financial products" throughout the Community.

[171] Ibid at 15-20.

- introduction of a single licensing system for financial institutions permitting both the establishment of branches and the provision of services throughout the community;
- common rules on the supervision and regulation of financial institutions;and
- the principle of home country control.

Therefore, if the White Paper proposals on minimum necessary coordination of banking provisions as well as the application of mutual recognition and home country principles are adopted that will entail the opening up of a European banking area, but also the policy and regulation and the operation of banks under uniform conditions, the adoption of the proposal would result in what is termed here the opening up of the European banking system.[172]

2.2.2.4 The Second Banking Directive

Discarding the initial idea that banking integration had to be attained through the harmonisation of all national regulationrestraining trade in banking and to the compliance of common laws and policies,[173] the EU legislative record on banking services in the 60's and 70's yielded a very modest harvest: progress towards an integrated financial area was very limited, given the long deferred implementation dates and possibility of leveraging on safeguards clauses used in the directives, which were extensively used by those member countries willing to defer the impact of liberalisation on their banking systems as long as possible.[174] Member states selected a more pragmatic approach embedded in the 1985 White Paper which set out a comprehensive program for the achievement of the Single Market by 1992.[175] In this respect, the White Paper could be regarded as a full framework for dealing with the sequence of liberalisation in banking services.Inspired by the White Paper signed in 1985 by the European Commission there was a shift from detailed harmonisation of rules to a system that effectively combines minimum harmonisation of

[172] Bongini 2003: 15-16.

[173] Ibid at 5-20. See the First Banking Directive. Given the very different instances at stake, this goal was too ambitious and proved unsuccessful.

[174] Ibid.

[175] Ibid.

rules with the principle of mutual recognition and home country control.[176] The principle of mutual recognition implies that any credit institution and certain financial institutions authorised to operate in their home country are granted a "single passport",[177] being able to open branches and provide services in any other EU country without the need of further authorisation from the host country authorities. By shifting the responsibility of supervising banks from the host to the home country, the Second Banking Directive ensured that the same member state that grants a charter to a credit institution under the "single banking license" agreement would be the one controlling and supervising its activities independent of its place ofoperation.[178]

The core element of the Second Banking Directive is constituted by article 18,[179]the first paragraph of which reads as follows:[180]

> "The member states shall provide that the activities listed in Annex 1 may be carried out within their territories either by the establishment of a branch or by way of provision of services, by any credit institution authorised and supervised by the competent authorities of another member state, provided that such activities are covered by the authorisation."

In a brief analysis of this provision attention should be drawn to the following elements:[181]

(i) Credit institution: it has been agreed that this notion should remain defined

[176] Bongini 2003: 15-16. The main advantage in adopting mutual recognition rests on its ability to instigate an endogenous process of convergence in national regulations. The process is no longer imposed top-down by compulsory compliance to the dictate of EC Directives rather it is induced by bottom-up competitive forces stemming from the interaction of operators, regulatory and organisational systems.

[177] Manvell 1999:1733-1734.The implementation of the single passport concept was made possible by the Single European Act (SEA) of 1985, which committed member states to achieving a Single Market by 1992. Firstly, the SEA placed the free movement of capital at the same level as that of goods and services, providing the basis for Directive 88/361, which established the basic principle of free movement of capital as directly enforceable as a matter of Community law, both between member states and with third countries. Secondly, the SEA lifted the unanimity requirement and introduced voting by qualified majority for the adoption by the Council of harmonisation measures for the achievement of the internal market.

[178] Rodriguez1994:217-218.

[179] Van Empel 2008: 30-31.

[180] Ibid.

[181] Ibid.

as it had already been in article 1 of the First Banking Directive.

(ii) Authorisation and supervision by the competent authorities of another member state, in accordance with this directive.

This is the essence of the combination of home state control and minimum harmonisation. As for minimum harmonisation, the Second Banking Directive has taken the level of harmonisation much further than the First Banking Directive, as far as conditions for obtaining and keeping the banking license are concerned.[182] In particular, whilst the earlier directive did not go beyond the mere principle of minimum financial requirements, now, precise figures and ratio are laid down, both for the initial (absolute amount) and for the solvency ratio as related to the own funds of the credit institution concerned (percentage). This latter ratio allows for relating the extent of the financial requirement to the scope of the activities of each individual bank.[183]

The principle of minimum harmonisation entails the harmonisation of uniform prudential standards in all member states to the existence of similar competitive conditions for all credit institutions operating in different member states.[184] Though member states are allowed to set more stringent prudential and regulatory standards, by virtue of the principle of mutual recognition, no member state will tend to deviate from those minimum standards since that would act against the interest of its national credit institutions operating under competitive disadvantage in less restrictive member states. Likewise, the Second Banking Directive opened up a process of competitive deregulation in the range of banking activities permitted in EU countries, leading to the adoption by all member states of the universal banking model.[185] This allows banks to carry on traditional activities such as deposit acceptance and the granting of loans, in addition to investment activities such as, money brokering, portfolio management and securities underwriting.[186]

[182] Van Empel 2008: 30-31.

[183] Ibid.

[184] Haynes 1989: 215.

[185] Gunter 1992: 10-15.

[186] Ibid at 217.

2.2.2.4.1 Objective and Nature of the Second Banking Directive

The objective of the EC's Second Banking Directive is to create a truly internal market.[187] Any banking institution authorised in a member state of the EU will be able to establish branches and offer its services freely throughout the European Union to individuals and businesses.[188] The approach of the Second Banking Directive is based on the policy decision endorsed in a White Paper from the Commission to the European Council entitled "completing the internal market" ("the White Paper").[189] The Second Directive rests on the principle that each member staterecognises the banking licenses of other member states.[190] The Directive establishes the procedural measures necessary to create a true internal banking market within the EU. A single license provides for effective supervision of credit institutions by clarifying which banking authority is responsible for the supervision.This was a fresh start marked by the commission's White Paper on the internal market as reflected in the field of banking services by a 1988 proposal for a Second Directive on the Coordination of laws, regulations and administration provisions relating to the taking up and pursuit of the business of credit institutions.[191] The Commission's approach to banking services is the same as that underlying the 1985 White Paper,[192] and therefore the entire single market programme. It is based on three fundamental, interdependent and complementary concepts:[193]

(i) minimum essential harmonisation;

(ii) mutual recognition; and

(iii) home country control.

[187] Cruson and Werner 1989:210.

[188] Ibid.

[189] Ibid In accordance with the White Paper, the Second Directive does not create a uniform body of banking laws for the EU.

[190] Rodriguez 1994:217-218.

[191] Kaufman 1991:120-123.

[192] Cruson and Werner 1989:209. The Second Banking Directive contains provisions regarding the establishment of credit institutions subsidiaries of non-EEC credit institutions and also takes the final step toward full implementation of the freedom to establish branches of EEC credit institutions. The First Banking Directive, however, remains the principal source of EEC Law regarding the establishment of branches in member states between non-EEC credit instutions.

[193] Dixon 1991: 55.

Each one is essential to attain the overall goal of a single financial market in the Community.[194] It is true that mutual recognition could be accompanied by the changeover from the host, to the home, country control principle. This would allow banks with secondary establishments in several member states to benefit from having to abide by only one set of national supervisory provisions namely that applied by home authorities to the banks' headquarters.[195] Still, the sets of provisions applied to banks subject to different home authorities should not be so divergent as to give rise to distortions of competition. Therefore, the objective of completing the Community's internal market by integrating the twelve markets of the member states could not be achieved without a minimum degree of regulatory uniformity, however high it may have to be to ensure competitive equality.[196] Mutual recognition will only be accepted and put into practice, however, if it is accompanied by the implementation of a minimum essential level of harmonisation of prudential standards, to protect investors and borrowers.[197] This minimum set level of standards is necessary because without it, market forces would reduce the minimum standards of each country to those of the member state with the most relaxed system of banking supervision. The Commission does not intend this to happen. Minimum harmonisation means, setting sufficient minimum regulation to ensure borrowers and savers are protected and to safeguard the stability of the banking industry. It does not mean reducing supervisory standards to the level of the lowest common denominator. The standards set may be higher than those currently in force in some Community countries and lower than those of others, but that is not a primary consideration.

Now, with the elements of mutual recognition and minimum essential harmonisation in place, the principle of home country control can be applied. Under this the activities of

[194] Dixon 1991: 55.The early approach of the Commission was to try to achieve the complete harmonisation of all national standards and regulations. This turned out to be impossible, because the huge differences in national standards meant that in most cases no agreement could be reached, and where agreement was possible it was an extremely long process. Instead, the principle of mutual recognition was adopted. The idea of this is that the banking supervisory authorities of each member state supervise and regulate their banking institutions.

[195] Cruson and Werner 1989:212-213.

[196] De Rosa 2003: 29.

[197] Ibid.

banking institutions throughout the Community, carried out by providing cross-border services or by branches in other member states in which the institution is based, the host country shall still be responsible for some aspects of regulations. Using this approach of basic home country control, backed by mutual recognition, the commission aimed to remove all the remaining barriers to a free banking market in Europe by 1992.[198]

The Second Banking Coordination Directive is the centre-piece of the commission's programme for an internal market in banking,[199] and it is by far the most important piece of Community legislation on the removal of barriers to the free provision of banking services yet to be proposed. The Commission issued the directive on 13th January 1988,[200] and it was finally adopted on 18th December 1989.[201] Its provisions were to be implemented by the member states over the three years to January 1993.[202] The Directive plugs a number of gaps left by the First Banking Coordination Directive of 1977,[203] and, together with two parallel directives on solvency ratios and own funds of institutions,[204] forming a comprehensive framework for regulating all Community banking business, [205]the Second

[198] Dixon 1991:55-56.The principles of home country regulation and mutual recognition have been inspired by the Casse de Dijon (EC Commission vs. Germany case No 205/84, ECR 3755). In this case, the European Court of Justice found Germany could not prohibit the import of Liquor that was lawfully produced and sold in France solely because the alcoholic content was too low for it to be under German law.

[199] Cruson and Werner 1989: 209-211. The Second Banking Directive will permit any credit institution authorised in a member state to established branches in other member states and to offer its services freely throughout the Community to individuals and businesses.

[200] Cruson and Werner 1989: 209-211.

[201] Ibid.

[202] Ibid.

[203] Ibid. After the implementation of the First Banking Directive, three obstacles to freedom of establishment of branches in other member states still remain for EU banking institutions. Firstly, an EU banking institution wishing to set up a branch in another member state still has to be authorised by the banking authorities of the host country; secondly, it remains subject to the supervision by the host country and to restrictions to host countries' laws on the range of permitted activities; and thirdly, in most member states, branches have to be provided with earmarked "endowment capital", as if they were new banks.

[204] Ibid. Own fund can be defined as the banking institution's own capital including iterms which can be treated as capital under national rules.

Banking Directive is intended to:[206] remove the remaining barriers to freedom of establishment of branches; and grant full freedom to provide banking services throughout the EU.[207]

The Second Directive applies to all credit Institutions in the EC.[208] In its article 1(6) there is a definition, by exclusion, of 'financial institutions':[209]

(a) "an undertaking other than a credit institution;

(b) which cannot carry on these activities: acceptance of deposits and other repayable funds from the public, credit reference services and safe custody service."

This definition constitutes an innovation with respect to the First Banking Directive.[210] Its legal consequences are linked to the content of article 18(2) of the Second Banking Directive,[211] in which the subsidiaries of credit institutions are allowed to provide the activities listed in the Annex of the directive throughout the territory of the Community, if they fulfil several conditions provided in paragraph 2. The reason for article 18(2) lies in the fact that, in some member states, credit institutions are not allowed to carry out some of the activities listed in the Directive's Annex;[212] only subsidiaries are allowed to do so.

[205] Cruson and Werner 1989: 207.The Second Banking Directive will profoundly affect the way in which banks will do business in the EU in two ways: firstly a common EU banking market will promote the growth of EU banks and make them stronger competitors in the EU as well as the world market.; secondly, non-EU banks will have to obtain approvals on the basis of reciprocity before they can do business on an EU-wide basis.

[206] Ibid at 209-210-212.

[207] Ibid. This is the centrepiece of the Second Directive.

[208] Kaufman 1991:120. Except those which were specifically excluded by the First Banking Directive. Those institutions which the directive excluded from this definition are: National central banks; post office and certain other institutions specific to each member state.

[209] Official Journal of the European Communities 2000:12.

[210] Kaufman 1991:120.

[211] Van Empel 2008:30-32.

[212] Ibid.For Example, Leasing, factoring, mortgage credit, safekeeping and administration of securities.

2.2.2.4.2 Harmonisation Provisions of the Second Banking Directive

The most important aspect of the Second Banking Directive is the provision for a "single banking license".[213]This will allow any credit institution which is authorised to act as such in any member statetoautomatically set up branches, or to supply cross-border services, in all the other member states, without having to obtain further authorisation from each state.[214]The banking model adopted by the EU is the Universal Banking model,[215] which permits banks to undertake investment banking activities, while leaving it to national regulators to control financial conglomerates, the ownership structure of banks, and their relationship with industry.

The Annex to the Second Banking Directive set forth the activities integral to banking and for which therefore, the single banking license is valid:[216]

1. Deposit-taking and other forms of borrowing;
2. lending (consumer credit, mortgages, factoring, trading finance);
3. financial leasing;
4. money transmission services;
5. issuing and administring means of payment (credit cards, travellers cheques, and bankers drafts);
6. guarantees and commitments;
7. trading for own account or for account of customers in:
    - (i) foreign exchange
    - (ii) financial futures and options
    - (iii) money market instruments (cheques, bills, CDs,)
    - (iv) exchange rate and interest rate instruments
    - (v) transferable securities;

(8) participation in share issues and the provision of services related to such issues;

(9) advice to undertakings on capital structures, industrial strategy and related

[213] Rodriguez 1994: 217-218.

[214] Dixon 1991: 59.

[215] Gunter 1992:10.

[216] Cruson and Werner 1989: 213-214.

questions, and advice and services relating to mergers and the purchase of undertakings;

(10) money broking;

(11) portfolio management and advice;

(12) safekeeping and administration of securities;

(13) credit references services;and

(14) safe custody services[217]

A bank will be able to provide any of the services on the list in all other member states, provided that it is authorised to do so in its home country.[218] It will be able to provide these services, even if the host country does not allow its domestic credit institutions to provide them.[219] For example, if it is authorised by its home member state license to engage in foreign exchange transactions, it is permitted to do so anywhere in the EU, as foreign exchange is an activity listed in the Annex. The Annex encompasses all of the activities that currently in the opinion of the Commission, constitute the core oftraditional banking services in the EU.

This concept of mutual recognition does not extend to institutions which do not have this authorisation, even if their business is included in the directive's list of recognised activities and if they are allowed to provide these services in their home countries.[220]

2.2.2.4.2.1 Minimum Capital Requirement

The Second Banking Directive set minimum prudential standards such as minimum capital requirement of EUR 5 million for credit institutions and clear limitations on branch to the bank level,[221] reducing in turn the cost of opening new offices. Article 4 (1) established an

[217] Hayness 1989:217. The Directive is incompatible with The Investment Services Directive. Items seven and eight would traditionally have been seen by securities firms as their area. It is clear that there is a significant degree of overlap between the activities permitted to banks and securities firms under these directives. This inevitably leads to questions as to the extent to which banks and securities houses will be competing on a level playing field albeit supervised by different referees.

[218] Cruson and Werner 1989: 213-215.

[219] Ibid.

[220] Dixon 1991: 60.

[221] Howell 2002:7.

initial capital holding of 5 million EUR for credit institutions as a "minimum" requirement for the authorisation from the competent authorities of member states.[222] This requirement is a "complement" to article 3 of the First Banking Directive. To address the need for minimal harmonisation of regulations, the Second Banking Directive called for harmonised capital adequacy standards and large exposure rules, and supervision control of banks' permanent participation in the non-financial sector.[223]

The harmonisation process has enabled the Community to remove some of the long-outstanding backlog measures rather than proceed to adopt those which are required by present conditions or will be required in the near future. EC banks are to be monitored under EC capital rules, which largely follow those of the Bank for International Settlement (BIS).[224] These banks will be able to open branches in any EC country and operate on a universal banking model, under which they can carry out most, if not all, kinds of investment services business.[225]

2.2.2.4.2.2 Reciprocity (liberalisation provision)

Article 9 of the directive incorporates a reciprocity requirement requiring other countries to give certain specified treatment to EC banks as a condition for banks from these countries taking advantage of the directive's liberal rules for providing banking services within the EU.[226]

Article 9(3) provides that if the Commission determines "that a third country is not granting Community Credit institutions effective market access comparable to that granted by the Community to credit institutions from that third country," the council may authorisethe Commission to open up negotiations to obtain such "comparable competitive

[222] Cruson and Werner 1989: 224.

[223] Hayness1989: 217.

[224] Gunter 1992:11.

[225] Ibid.

[226] Cruson and Werner 1989:228.For the establishment of a banking institution subsidiary or the acquisition of the participation in an EU bankig institution by a non-EU bank, the Second Directive establishes a requirement of reciprocity.

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opportunities" for EU credit institutions.[227] Article 9(4) provides that negotiations may also be opened by the Commission on its own, without Council authorisation, whenever it appears to the Commission "that Community credit institutions in a third country do not receive national treatment offering the same competitive opportunities as are available to domestic credit institutions and that the conditions of effective market access are not fulfilled."[228] Furthermore, such a determination may also lead to member states being required to close their markets to "acquisition of holdings by direct or indirect parent undertakings governed by the laws of the third country in question." Article 9 (4) further provides that such acquisition bans cannot apply to acquisitions that have already been made or to future acquisitions of entities already authorised to operate in the EU. Existing authorised institutions from third countries are thus grandfathered, and are treated on a par with EU institutions. These proposals provoked a tremendous amount of opposition, both within the EC and from third countries.[229] Because of the strength of feeling against these reciprocity provisions,[230] the Commission did eventually change them. The demand for reciprocity treatment has been toned down into one either for national treatment, or for effective market access, comparable to that which the third country's banks receive in the Community market.[231]

Throught the adoption of the reciprocity clause, the Community acquires a provision which already exists in the legislation of most liberal states for instance, the UK and Switzerland.[232] It gives legal content to something that is an undeniable fact: that the European Community is one of the most liberal and open financial markets in the world. For several decades, large

[227] Kaufman 1991: 130-131. Art. 9(3) "without prejudice to paragraph 1, the Community may, through agreements concluded in accordance with the Treaty with one or more third countries, agree to apply provisions which, on the basis of the principle of reciprocity accord a branch of a credit institution having its head office outside the Community identical treatment throughout the territory of the Community."

[228] Ibid.

[229] Ibid.The UK, Germany, Luxembourg and the Netherlands were all against the provisions, fearing that, instead of resulting in better treatment of EC banks, they would merely mean that non-EC banks would be denied access to the European markets.

[230] Cruson and Werner 1989: 228. This reciprocity is an EU-wide reciprocity, that is, banking institutions

[231] Hayness 1989 at 218.

[232] Bongini 2003:34-35.

numbers of non-Community banks have been established in almost all of the EC countries and offer a broad range of banking services.[233] Lack of effective market access for EU institutions can lead to negotiations, whereas lack of national treatment and effective market access can lead to either negotiations or prospective entry bans.[234]

2.2.2.5 The Importance of the Banking Legislation

The Community's banking legislation will affect banks in three main ways:[235] they will be able to open branches throughout the Community without having to meet the host countries' authorisation requirements, and with far less bureaucracy than at present; they will be able to provide the entire range of services that they do in their home countries in the other member states; and with the removal of exchange controls, banks will be able to provide cross-border services without any restrictions. The great majority of the existing regulatory barriers will be removed by the legislation, together with the bureaucracy which faces banks at present. Some barriers, however, will still remain, in the form of host country control over certain matters.[236]

Table 1[237]

DIRECTIVES	**ISSUE DATE**	**IMPLEMETATION DATES**	**Remarks**
First Banking Directive (77/780/EEC)	1977	1979	Established authorisation procedures for deposit taking institutions
Consolidated supervision Directive	1983	1985	Bring EC supervisory arrangements in line with the revised Basel Concordat

[233] Gonzaley 1993: 17.

[234] Ibid The EU schedule of commitments under the GATS, entered into in 1997, precludes use of the Second Banking Directive reciprocity requirements against countries that tabled their own MFN commitments. Now that the GATS has been actually adopted by such countries the reciprocity requirement is now history.

[235] Dixon 1991: 116-117.

[236] Ibid.

[237] Bangini 2003:57.

(86/635/EEC)			
Bank account Directive (88/361/EEC)	1988	1992	Harmonises accounting rules and reporting
Capital liberalisation Directive (88/361/EEC)	1988	1992	Requires the removal of exchange controls with the aim of enabling free movement of capital within the EEC
Own Fund Directive (89/299/EEC)	1989	1993	Provides a common definition of banking capital in accordance with the 1988 Basel Capital adequacy Agreement
Solvency Ratio Directive (89/647/EEC)	1989	1993	Sets common minimum risk-adjusted capital adequacy requirements in accordance with the 1988 Basel Capital Adequacy Agreement
Monitoring and control large Exposure Directive (92/121/EEC	1992	1993	Institutions have to submit annual report to supervisory authorities, detailing all large exposures (defined as more than 15 per cent of the institutions' own funds) as well as their largest exposures, even if these are less than the mentioned ceiling

The first steps towards "levelling the playing field" for banks across Europe were made in the 1970s by granting the freedom of establishment and passing the First Banking Directive.[238] Since cross-border banking activities remained subject to host country supervision, the potential for national discretion remained substantial. The major step towards closing the remaining gaps was made with the Second Banking Directive, which became effective in 1993.[239] The directive establishes, among other things, the acceptance of the principles of mutual recognition of banking licences, of minimum harmonisation, and home country control. Furthermore, the directive eliminates the need to get local banking

[238] Buch and Heinrich 2002:3.

[239] Ibid.

charter in a foreign country, subjects foreign branches to homecountry supervision and abolishes the need for foreign branches to hold a certain amount of endowment capital.[240] As a result, Europe is one of the most open regions worldwide towards foreign competition in banking.[241] In Europe, there are virtually no restrictions to the market entry of foreign banks in place, indicating a slightly more liberal regime in comparison to high income countries in average and to less developed countries in particular.

Table 2: Liberalisation of banking activities in EU member states[242]

Country	Lifting of capital controls	Interest rate derogation	First Banking Directive	Second Banking Directive
Belgium	1991	1990	1993	1994
Denmark	1982	1988	1980	1991
France	1990	1990	1980	1992
Germany	1967	1981	1978	1992
Greece	1994	1993	1981	1992
Ireland	1985	1993	1989	1992
Italy	1983	1990	1985	1992
Luxembourg	1980	1990	1981	1983
Netherlands	1992	1981	1978	1992
Portugal	1992	1992	1992	1992
Spain	1979	1992	1987	1994
UK		1979	1979	1993

2.2.3 Conclusion

The banking sector reforms are moving gradually making use of the entire time window allowed by the directives and sometimes being late in complying with the dates of the directives. The general impression is that the EU banking systems shared the following sequences of banking liberalisation:

(1) coordination of banks legislation, that is, the strengthening of prudential measures while introducing pieces of domestic deregulation;

[240] Buch and Heinrich 2002:3.

[241] Ibid.

[242] Ibid.

(2) the recognition that a "level playing field" can be more easily attained if there is a consensus on minimal harmonisation of rules represents the fiscal point of this overall architecture of the single market program;

(3) Discarding the initial idea that financial integration had to be attained through the harmonising of all national regulations restraining trade in banking services and compliance with common laws and policies. Given the very different circumstances at stake, this goal was too ambitious and proved unsuccessful. The EU legislative record on banking services in the 60s and 70s yielded a very modest harvest. Progress towards an integrated banking area was very limited, given the long implementation dates and the possibility of leveraging on safeguards clauses included in the directives, which were extensively used by those members countries willing to defer the impact of liberalisation on banking systems as long as possible.

The principal items which have been harmonised are:

- the definition of what constitutes a credit institution;
- the calculation of ratios to establish banks' solvency, liquidity and profitability;
- the annual accounts;
- supervision on consolidated basis;
- the obligation for supervisory authorities to cooperate and exchange information;
- the requirement that all banking businesses be licensed;and
- the indication of minimum licensing criteria.[243]

The route towards liberalisation in banking services taken by the EU might represent a blueprint for opening up markets worldwide. The EU path towards the creation of an integrated common market highlights the need for minimum harmonisation as a realisable goal instead of full harmonisation of rules. Minimum harmonisation requires minimum agreement on essential rules, mainly in the field of prudential regulations and supervision. It represents an important precondition for attaining any further achievement in liberalisation,

[243] Partial agreements as regards minimum levels have been achieved for: prior licensing requirements; requirements in respect of major shareholders of banks; deposit insurance and large exposure limitations.

through mutual recognition of home country rules and standards and the acceptance of home country responsibility in the supervision of financial intermediaries.

The picture of European banking markets in the early 1980s that emerges from this review of regulatory and economic development is one of severe fragmentation. Although national treatment applied with freedom of establishment recognised by the 1973 directive, capital controls in many countries,[244] and the threat of potential capital controls severely limited cross-border trade in banking activities. Moreover, in the early 1980s, the banking sector of most countries was very much repressed with a large set of regulations constraining its activities. Exceptions included Germany, the UK, The Netherlands and Luxembourg. The list of regulations included:

-control of interest rates;
-capital controls;
-stock exchange membership;
-foreign bank entry
-branch restrictions;
-credit ceilings
-mandatory investment requirements;and
-restrictions on insurance.

In addition, reserve requirements were put in place to facilitate monetary policy and to finance onerous regulations in several countries, such as Germany, Italy, and Portugal. The money markets were underdeveloped. Twenty years later, a "level playing field" was created, with a regulatory convergence toward a minimum set of regulations,including large exposure limits. The ending of a repressed banking system is most likely, one of the major contributors of the Single Market Programme.

[244] The UK, Germany and the Benelux countries are exceptions.

2.3. THE UNITED STATES OF AMERICA (US)

2.3.1 INTRODUCTION

This section examines and analyses the opening up of trade in banking services US laws and the Federal statutes of the United States of America.The level of opening up of banking services in the U S is related to the obligations imposed on States by Federal laws to provide, in their States law, protection against the opening up of trade in banking services. The section closes by making some recommendations to strengthen the opening up of trade in banking services under the U S.

2.3.1.1 Historical Overview

Banks are defined under the 1956 Bank Holding Company (BHC) [245] Act as institutions that both accept demand deposits and grant corporate loans.[246] There are three broad categories of private sector banks: commercial banks; thrift; and investment banks or securities houses.[247] Historically these institutions have specialised in particular types of business and their specialisation was reinforced by legislation. As loopholes in the legislation have been exploited since the early 1970s and regulations have been changed, they have increasingly encroached upon each other's territory. A dual authorisation system is in operation and there are numerous banks among the 14,700 or so banks which were operating in 1986. Around 3,300 of the banks are subsidiaries of nearly 800.BHCs.[248]

[245] Malcolm 1982: 270-272.

[246] Manvell 1999:1726-1727.

[247] Ibid.

[248] Ibid. A BHC is a holding company that owns the controlling interest in one or more banks. Federal law does not prohibit BHCs from acquiring banks across State lines. It does, restrict the activity and requires the permission of the State governments to be sought. As with branching, regulation of BHCs varies between States. The BHC movement has grown rapidly since 1970. Banks are also interrelated through chain banking, which does not use the holding company device. Instead the interrelationship results through ownership of two or more banks or through interlocking directorships or other arrangements. Most chain banking groups appear to be rather small, involving only two or three banks. The banking system is interconnected through corresponding relationships which allow banks to widen the range of services they offer.

2.3.1.2 The US Banking Legislations

The major US banking legislations are: The 1913 Federal Reserve Act creating the Federal Reserve System (FRS) to serve as the central bank of the US.[249] It was the first central bank in US history and the country's banking system had operated for a lengthy period without a central bank. The law was later refined by the 1933 Banking Act,[250] in the wake of the great Crash in 1929 and the ensuing banking crisis.[251] The 1913 Act details the principal functions of the FRS.[252] The 1929 McFadden Act permitted national banks to establish intrastate branches in order to allow them to compete with state-chartered banks that were allowed to branch state-wide.[253] It did not, however, permit national banks to cross State lines.

Inconjunction with the Douglas Amendment to the 1956 Bank Holding Company (BHC) Act,[254] the McFadden Act attempts to prohibit interstate branching by banks.[255]

The 1933 Glass-Steagall (G-S) Act,[256] which is a subsection of the 1933 Banking Act, and its amending legislation, the 1935 Banking Act, prevented the speculative use of bank credit

[249] Guenther 1971: 535.

[250] Manvell 1999: 1723. This legislation accomplished two key goals that continue to characterise the nation's banking laws today. Firstly, the legislature divorced commercial banking from investment banking by enacting the Glass-Steagall Act, a portion of the Banking Act of 1933. Secondly, it created the Federal Deposit Insurance Corporation (FDIC). The FDIC was also established to foster bank soundness by providing Federal Deposit Insurance to all national banks and qualified state-chartered commercial banks.

[251] Guenther 1971: 532-540. From 1921 to 1929, 5,714, or approximately 19% of all banks in the United States, failed.

[252] Ibid. It is required to: regulate the money supply; hold the legal reserves of member banks; meet demands for currency; effect nationwide funds transfers and promote and facilitate cheque clearing; examine and supervise member banks chartered by various States and obtain periodic reports from them; collect and interpret economic information with a bearing on credit problems; and act as fiscal agent and custodian of government funds as well as legal depository for the US Treasury and all other government departments.

[253] Ibid at 319. Branching by nationally chartered banks is governed by the McFadden Act. Enacted in 1927, it effectively incorporates the branching limitations of each State and applies State law to national banks located within that State's boundaries. Therefore, whether a national bank may engage in branch banking is a question of State law. However, whether a national bank actually is branching is a question of Federal law.

[254] Sarkis 1990: 69-70. Senator Paul Douglas of Illinois was a member of the Senate Banking Committee.

[255] Skigen and Fitsimmons 1979:61.The Act defines the term "branch" as place outside of or away from the main office where the bank carries on its business of receiving deposits, paying checks, lending money, or transacting any business carried on at the main office.

and provided for the separation of banking and securities business. It prohibited banks from acting as agents in securities transactions with brokers and dealers and from directly underwriting corporate securities.[257] The 1956 BHC Act and its amendments limit the activities of BHCs to areas of bank management and control.[258] They require divestiture of non-banking interests that have no close relationship to banking, which is defined to include deposit taking, commercial lending and the provision of payment services. BHCs are required to register with the FRS and are regulated by the provisions of its regulations. The 1919 Edge Act authorised the federal charter of corporations, known as Edge Act Corporation (EACs), for the express purpose of engaging in international or foreign banking or other international or foreign financial operations.[259] Fund raising and lending activities of EACs must be related to the financing of international trade.[260] Prior to the 1978 International Banking Act (IBA) there was no general banking legislation applying to foreign bank operations in the US. It put foreign and domestic banks on a more equal footing.[261]

2.3.2 State Geographical Barriers

Banking is unique among American commercial enterprises in that it has traditionally been severely geographically limited in its scope.[262] State branch banking laws are of three broad

[256] Manvell 1999: 1725-1727.It is the most important statute and consists of four interrelated provisions: sections 16,20, 21 and 32. Section 16 and 21 prevent commercial and investment banks from encroaching upon one another's territories. Section 16 prohibits commercial banks from engaging in certain areas of securities business, while section 21 prescribes securities firms from engaging in commercial banking activities, such as the business of deposit-taking. Congress intended these four sections to create a solid legal barrier, separating the investment and commercial industries.

[257] Ibid at 1725. During it first 30 years of existence, the Glass- Steagall Act, remained substantially untouched. Despite these efforts, the attempted to expand the banks powers ultimately failed.In effect, in 1971,the US Supreme Court in *Investment Company v Camp* reiterated the 1933 Congressional hearing subtle hazards justification for the Glass- Steagall Act separation of commercial banks and investment banks activities.

[258] Ibid.

[259] Raj 1994:30-32.

[260] Ibid. Regulation K of the FRS governs their activities and they are permitted to be established by National or State banks nationwide.

[261] Mullineux 1987:49-50.

[262] Bierman and Fraser 1988: 24; Wood 1978:51-53.

categories. State-wide branching means that commercial banks can establish branch banks throughout the State either by means of merger or de novo. This license does not mean that banks will establish an unlimited number of branch offices. In fact, there were a number of banking offices established in States with limited branching law.[263] Unit branching disallows branch banking but permits auxiliary tellers' windows.[264] An auxiliary teller's windows is a facility that only offers services similar to those performed by a bank teller and may or may not be physically disconnected from the main banking office.[265] Limited branch banking systems permit branching in compliance with geographical restrictions. Branch banks may be established by merger, de novo, or both depending on State law.[266] These States permit branches within the main bank's city, county, or banking district. Other States permit branches within a stated distance from the main bank or in contiguous counties.

2.3.3 US Branch Banking Protection

One cannot understand the U S banking industry without some Knowledge of the various statutory schemes under which banks operate.[267] There are two types of banks:[268] those with State charter and those with National charter. State banks may operate only in the State in which they received a charter; they may not branch into other States.The policy behind restricting banking operations to State boundaries grew out of the very nature of the banking business. States have a strong interest in protecting innocent depositors; examine operations, and ensuring adequate control over banks operations to avoid the trauma

[263] Bierman and Fraser 1988: 24; Wood 1978:51-53.However, State wide branch banking is not quite as liberal as it may appear because most of the States impose some minimal restraints on branching such as capital requirements, population restrictions, and limiting the number of branch offices. In Maryland and North Carolina capital requirements are based on population. Hawaii banking law permits State wide branching but limits the maximum number of branches a bank may have in the Honolulu area. This area is divided into three banking zones with a bank permitted up to four branches within each zone.

[264] Gud 1971:675-676.

[265] Ibid.

[266] Ibid. Several States with limited branch banking law have head office and branch office protection rules. For example, in New Jersey a bank cannot establish a de novo branch in a city if another bank's head office is located there. Such laws tend to encourage mergers.

[267] Malcolm 1982:266-276.

[268] Baker 1973:119-133.

caused in a community by a bank failure.[269] Thus, State legislatures, subject to Federal supremacy, may enact legislation regulating the business of banking and may confine operations by State banks to those chartered under their own particular laws and regulations. They may branch intrastate to the extent the State law allows.[270] Alaska, Arizona, California, Carolina, Connecticut, Delaware, Hawaii, Idaho, Maine, Maryland, Nevada, New Jersey, New York, North Carolina, Oregon, Rhode Island, South Carolina, South Dakota, Utah, Vermont and Washington have no restrictions on the number of branches a bank may establish.[271] While Alabama, Colorado, Illinois, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, North Dakota, Oklahoma, Texas, West Virginia and Wyoming completely prohibit branching; and Arkansas, Florida, Georgia, Indiana, Kentucky, Louisiana, Massachusetts, Michigan, Mississippi, New Hampshire, New Mexico, Ohio, Pennsylvania, Tennessee, Virginia and Wisconsin permit branching on a limited basis.[272]

Prohibition against interstate branches-unless specifically authorised by State law-have been in place since the 1920s.[273] Whereas Congress granted the States full authority to decide if banks could branch within their territories with the passage of the McFadden Act in 1927, few States authorised unlimited full-service branching until recent decades. During that time numerous States along the eastern seaboard and in the upper Midwest moderated or eliminated their restrictive branching laws.[274]The McFadden Act enabled

[269] Baker 1973:119-133.The 1920s was marked by an epidemic of bank failure.

[270] Malcolm 1982:269.

[271] Lash 1987:181.

[272] Ibid.

[273] Gud 1971: 676-677. Branch banking restrictions were not needed in the early nineteenth century because poor transportation and supervision difficulties made branch banking economically unfeasible. As transportation improved, eastern bankers, unable to branch and meet business needs, criticised the National Bank Act which lacked specific authority for national bank branching.

[274] Gud 1971: 676-677. For example, New York gradually moved from allowing limited branching within counties and special districts to state-wide branching in 1977. New Jersey preceded the Empire State with a similar rule change in 1973. New Hampshire and Virginia followed New York in 1979 and 1978, respectively, with full service branding across the state. Virginia had moved as early as 1962 to permit state-wide branching by merger and further liberalised its laws in 1978 to permit more de novo branching. Ohio authorised state-wide branching in 1979 to take effect in 1989. Arkansas moved from the prohibition of full service branching to countrywide branching in 1973. Florida allowed countrywide branching activity in the same year and then followed with state-wide branching via merger in 1978- a

national banks to establish and operate new branches within the limit of the city, town, or village in which the said association is situated if such establishment and operation are at that time permitted to State banks by the law of the State in question. The conditions upon which a national association may retain or establish and operate a branch or branches are the following: [275]

> "a national banking association may establish and operate new branches: within the limits of the city, town or village in which said association is situated, if such establishment and operation are at the time expressly authorised to State banks by the law of the State in question; and at any point within the State in which said association is situated, if such establishment and operation are at the same time authorised to Statebanksby the statute law of the State in question by language specifically granting such authority affirmatively and not merely by implication or recognition, and subject to the restrictions as to location imposed by the law of the State on State banks "

Even some States that still prohibit or restrict branching activities have moved to ease the restrictions on limited service facilities or to permit the upgrading of some limited service units to full-service capability.[276]

2.3.4 Liberalisation Legislations

A step toward liberalisation of national bank branching rules was taken in 1927 with the passage of the McFadden Act.[277] Federally chartered banks were expressly allowed to open full service branches in their home-office communities provided State law did not expressly

position also adopted by Nebraska. By 1986, 21 States and District of Columbia had acted to permit branching state-wide and another 20 allowed at least limited branching by banks operating within their borders.

[275] Ibid.

[276] Gud 1971: 676-677. For example, Texas authorised off-premises automated tellers at customer convenient locations in 1978 and then in 1983 permitted one full-service branch within a prescribed narrow radius of the home office with regulatory sanction. Minnesota authorised banks to upgrade as many as two limited service outlets to full-service branches in 1980. In 1986 there remained only nine States in which full service branching was prohibited.

[277] Malcolm 1982:270.

prohibit branch banking.[278] However, this so–called victory for national banks resulted in severe legal restrictions on future expansion plans and service offerings of many of the nation's largest banks. McFadden reaffirmed the principle of State control over territorial expansion of both State and Federally chartered banking institutions. Interstate branching was prohibited except for those few banks that had already crossed State lines or where a State expressly granted out-of-State banks the right to establish offices within its borders. Within each State's boundaries State law would henceforth control whether or not branches could be opened in the same city, country, or district where a commercial bank was headquartered. [279]

A further liberalisation step towards branching was taken in 1933 when Congress passed the Banking Act of 1933 known as Glass-Steagall.[280] The Banking Act adopted the McFadden Act position by permitting national banks to establish outside branches if such branches could be established by State banks under State law. National banks were allowed to branch anywhere within a given State, provided State law granted similar powers.[281] The main features of the Glass Banking Bill were:[282] extension of branch banking by national banks; limitations on the use of Federal credit for speculative purposes; separation of commercial loans from investment banking; divorcing of national banks from their securities trading; and more rigid controls over all banks within the national and Federal Reserve Systems.

[278] Malcolm 1982:270.The term "branch" as used in this section shall be held to include any branch bank, branch office, branch agency, additional office, or any branch place of business located in any State or territory of the U S

[279] Ibid.

[280] Ibid at 274-275.

[281] Hall 1991: 28-29. This law reflected the panicky reaction of Congress to the devastating effects of economic pressure of the 1920s and the Great Depression of the 1930s, which forced the absorption, merger, or closure of nearly half of the U S banks in the space of two decades. Many members of the congress saw branching as a way to build larger, more widely diversified and more viable banking organisations.

[282] Ibid.

Although there has been a considerable amount of deregulation since the beginning of the 1970s the G-S Act and branching restrictions remain.[283] The official interest rate deregulation followed de facto deregulation. Branching deregulation appears to be following a similar route.[284] Many States have already passed more liberal intrastate regulation concerning bank branching and mergers and acquisitions and groups of them have also passed reciprocal agreements allowing regional interstate mergers.[285] A few have opened their doors completely to out of State banks without requiring reciprocity and others have provided for freedom of entry following a fixed period in which regional interstate mergers will be permitted.[286]

2.3.4.1 Causes of Change in banking services

There are five historical powerful forces that have shaped the opening up of the banking industry in the past and will continue to dominate its future. These causes are: [287]

1. economic conditions, including the level and growth in employment, production, consumption, savings, and interest rates;
2. demographic forces, including shifts in population between rural and urban areas, changes in rates of family formations, and the age and income distribution of the population served by American banks;
3. regulation, including legislative mandates, court decision, and Federal and State supervision of bank operations and growth;
4. technological change, including innovations in the production and delivery of financial services and the processing of financial information; and
5. competition, including the number and relative sizes of both banking and bank financial institutions that are rivals for credit, deposit, and services accounts in thousands of local markets across the nation.[288]

[283] Sarkis 1990:42.

[284] Ibid.

[285] Ibid.

[286] Ibid.

[287] Rose and Peter 1987: 12-13.

[288] Ibid.

> "Over the past century the most pervasive long-term trend in American banking has been the spread of branching organisations.[289] At the turn of the century less than 1 per cent of American banks operated even a single branch office. However, the broadening of agricultural and industrial markets, coupled with the failure, merger, or absorption of thousands of small single office banking institutions in the 1920s and 1930s, gave great impetus to the spread of branch banking systems.[290] Further impetus to branching activity was provided during the decades after World War II when the suburbs grew and when businesses and households began to migrate south and west in larger numbers".[291]

Commercial banks followed with merger and branch offices where the law allowed.

2.3.4.2 Relief under State and Federal law

Interstate banking has been facilitated also by recent provisions in Federal law that allow rescue of failing banks or thrifts through mergers with larger sounder out-of-state banking organisations. The well-known mergers of Citicorp with Fidelity Savings and Bank of America with SeaFirst,[292] as well as Chase Manhattan's acquisitions of troubled Ohio thrift institutions, are cases in point. Individual states also have granted permission for entry by out-of-state banks or bank holding companies, sometimes to provide a limited range of services and usually on condition that their own banks are granted reciprocal treatment by other States.[293] A gradual phase-in of nationwide interstate banking triggered by regional branching agreements between states has received some support in Congress, especially when combined with restrictions on interstate acquisitions by the largest banking corporations and by financially weak institutions.

[289] Rose and Peter 1987: 12-13.

[290] Ibid.

[291] Ibid.

[292] Ibid at 370.

[293] Rose and Peter 1987: 12-13. Examples include Delaware and South Dakota, which recently provided an avenue for out-of-state entry to extend credit card services; Alaska, Arizona, and Maine, which sanctioned entry by out-of- office bank holding companies; and Indiana, Kentucky, Maryland, and Ohio, where entry by out-of-state bank is permitted subject to reciprocal treatment provisions.

The decades old Federal and State laws against interstate branching did not, in fact, prevent the development of a wide array of interstate banking institutions.[294] As significant as these interstate adventures have been, they have all been subject to an inherent limitation-the legal inability of interstate offices to take deposits from the general public. That is, full service banking across State lines, with limited exceptions, has not been possible legally or even technically until recently. But the barriers to interstate deposit taking are falling today as a result of reciprocal electronic transfer techniques.[295] The advent of low-fixed-cost automated tellers machines, point-of-sale terminals, and payments by computers have severely weakened the artificial barriers against geographic expansion of deposit markets. Both large and small banks have formed regional and national networks centred around strategically placed Automatic Teller Machines (ATM) facilities, offering twenty-four-hour service availability at low cost. Through financial networking, customers can access their home bank while travelling thousands of miles away and channel funds between their local demand deposit and the distant money market through various types of cash management accounts.[296]

The official interest rate deregulation followed de facto deregulation. Branching deregulation appears to be following a similar route. Many States have already passed more liberal intrastate regulation concerning bank branching and mergers and acquisitions and groups of them have also passed reciprocal agreements allowing regional interstate mergers. A few have opened their doors completely to out of State banks without requiring reciprocity and others have provided for freedom of entry following a fixed period in which regional interstate mergers will be permitted. Recognising these recent technical developments, Congress called for review of the relevance of the McFadden Act and interstate branching restrictions when the International Banking Act was passed in 1978.[297]

[294] Rose and Peter 1987: 214-215.

[295] Ibid. For example, by 1986 more than 27 States had acted to permit some form of entry into their markets by out-of-state banks.

[296] Rose and Peter 1987: 12-13.

[297] Ibid.

2.3.5 The International Banking Act of 1978

The International Banking Act of 1978 (the "Act")[298] constitutes the first comprehensive piece of Federal legislation designed to regulate the activities of foreign banks which do business in the U S.[299] The Act significantly affects the operations of existing U S agencies and branches of foreign banks and has far-reaching implications for both the U S and foreign affiliates of foreign banks which now conduct,[300] or are planning to conduct, business in the U S. Portions of the Act were amended by the Financial Institutions Regulatory and Interest Rate Control Act of 1978 ("FIRICA").[301] In addition to amending the Act, FIRICA imposes certain requirements on foreign banks doing business in the U S.[302] The Act represents the response of Congress to increase foreign banking operations in the U S over recent years. The increase in foreign banking activity in the U S generated a growing concern for the effect of their operations on the domestic banking industry. Prior to the adoption of the Act, the U S agencies and branches of foreign banks were regulated solely by the states in which they operated. The need for Federal, as well as State, regulation of foreign banks was felt for two reasons.[303] Firstly, the Federal Reserve Board thought that some level of Federal supervision over the activities of foreign banks operating in the U S was needed; the lack of Federal supervision had especially serious ramifications for implementing monetary

[298] Cruson and Werner 1989:229. The International Banking Act of 1978 is founded on the principle of national treatment.

[299] Lash 1987: 181-182.Foreign bank is defined very broadly by the Act and includes the foreign subsidiaries and affiliates of a bank.

[300] Skigen and Fitzsimmons 1979: 55-56.

[301] Ibid.The Provisions of the Act and FIRICA which affect the U S agencies and branches of foreign banks fall into four general categories: those which provide for Federal licensing of foreign bank agencies and branches as an alternative to licensing by the States; those which restrict the right of foreign banks to establish branches and acquire Federal Deposit Insurance Corporation (FDIC) insurance for the deposits of foreign bank branches; and those which extend to foreign bank agencies and branches and the affiliates of foreign banks certain Federal requirements and restrictions formerly applicable only to domestic institutions and their affiliates.

[302] Ibid. The FIRICA was signed into law on November 10, 1978. The Act defines an "agency" as any office or place of business of a foreign bank in the U S at which credit balances are maintained incidental to or arising out of the exercise of banking powers, cheques are paid and money is lent, but at which deposits from U S citizens or residents may not be accepted. While a branch is defined by the Act as any office or place of business of a foreign bank in the U S at which deposits are received.

[303] Hablutzel and Lutz 1979: 133-145.

policy.[304] Secondly, domestic banks began to feel that the absence of Federal regulations governing foreign bank activities in the U S gave the foreign banks significant advantages, like the ability to branch across states lines.[305] The International Banking Act embodies a national policy of treating foreign banks as competitive equals with their US counterparts. Under this policy foreign enterprises operating in the host country are treated as competitive equals with their domestic counterparts. "There is, at this time, no uniform national policy concerning foreign banking operations in this country. As a result, foreign banks enjoy many competitive advantages over domestic banks. The ability of foreign banks to establish and operate deposit banking facilities across State lines was thought to give them a decisive advantage over domestic banks."[306]

The Senate Report concluded, however, that the essence of banking is the ability to receive deposits, and it is in this that foreign banks do enjoy a growing significant interstate advantage over domestic banking organisations, which cannot receive deposits outside of their home state. In The McFadden Act it established the principle of parity of treatment between foreign and domestic banks in like circumstances.[307]

2.3.5.1 Section 5 of the Act

Section 5 of the Act seeks to remedy the competitive disparity between foreign and domestic banks by prohibiting a foreign bank from directly or indirectly establishing and operating a Federal or State branch outside of its home State unless the foreign bank enters into an agreement with the Federal Reserve Board to limit the deposits at the proposed branch to those which could be accepted by an E A C.[308] In addition, section 5 requires that the operation of the proposed branch be expressly permitted by the State in which it is to

[304] Hablutzel and Lutz 1979: 133-145.

[305] Ibid.

[306] Raj 1994:31.The EAC originated with a legislative proposal by Senator Walter Edge of New Jersey designed to enable domestic banks to offer international banking services without being encumbered by legal prohibitions on interstate banking.

[307] Raj 1994:31.

[308] Skigen and Fitzsimmon 1979: 62. Edge Act Corporations are federally chartered corporations organised for the purpose of engaging in international or foreign financial operations.

be operated, in the case of a Federal branch, or approved by the bank regulatory authority of the State in which it is to be operated, in the case of a State branch.[309] The home State of a foreign bank that has branches, agencies or subsidiary banks, or any combination thereof, in more than one State, in whichever of such States is so determined by election of the foreign bank, or in the absence of such election, by the Federal Reserve Board.[310]

2.3.5.2 The Statute

Except to the extent that foreign banks operating in the US are grandfathered,[311] section 5(a) (5) of the International Banking Act forbids a foreign bank, directly or indirectly,[312] from acquiring any interest in a bank located outside of the bank's home State if the acquisition would be prohibited under Section 3 (d) of the BHCA, or if the foreign bank was a bank holding company, the operation of whose banking subsidiaries are conducted under section 3(d).[313] Nor may a foreign bank, directly or indirectly, establish or operate either a Federal or State branch outside of its home State unless (1) the foreign bank agrees with the Federal Reserve Board to forego a domestic deposits business and to accept at the branch only deposit permissible for E A Cs and (2) the branch is permissible under the law of the target State.[314] Section 5(a) requires specific or express permission in the law of the target State.[315] This is incompatible with the requirement of the McFadden Act restrictions, but is enough under Section 5 (a) if the bank regulatory agency of the target State approves the entry underState law.

[309] Skigen and Fitzsimmon 1979: 62.

[310] Gud 1971: 530. See Sec 5 (c) of the Act.

[311] Skigen and Fitzsimmons1979:58. Section 8(b) of the Act provides that until December 31, 1985, foreign banks and companies may retain direct or indirect ownership or control of any voting shares of a non-banking company in the United States if such shares were owned, controlled, or held with power to vote on September 17, 1978, or may engage, until 31, 1985, in any nonbanking activities in the U S which they were engaged in on September 17, 1978.

[312] Gub 1971:530-531.

[313] Ibid.

[314] Ibid.

[315] bid.

Section 5 (b) of the IBA grandfathers from the above restrictions on interstate operations,[316] such operations commenced, or for which applications were pending, on or before July, 1979.[317] This is the date on which mark-up of the bill by the Senate Banking Committee was scheduled to be completed.Section 5 (c) permits a foreign bank to choose its home State from among those States in which the foreign bank operates at the time of enactment or as a result of entry into additional States permitted by section 5.[318] But section 5 (c) should be administered carefully by the Federal Reserve Board to ensure that flexibility afforded in choosing a home State is not used in a manipulative manner to evade the deposit limitations imposed under section 5 (a). Foreign banks with no deposit-taking operations in the U S should have their home State determined, to be the State in which they opened their initial deposit-taking office.[319]

Section 5 of the Act helps implement what has been regarded as the principle of "national treatment." [320] The section does this by restricting the interstate domestic deposit-taking capabilities of foreign banking organisations so as to reduce the advantage that they have had over domestic banks.The Senate Banking Committee observed that, this is the most appropriate policy to adopt with respect to foreign banks in the U S, and this means some measure of basic competitive equality on interstate banking. The main thrust of section 5 is to limit the acquisition of commercial banks and the establishment of deposit-taking branches by foreign banks outside their home States. Section 5 reinforced the restrictive pattern of the McFadden Act of 1927 that bars multistate branching by national and state banks and extended that pattern also to foreign bank branching.[321]

[316] Skigen and Fitzsimmon 1979:74.

[317] Ibid.

[318] Ibid.

[319] Gup 1971:529-532.

[320] Shay 1971:524-525.

[321] Ibid.

2.3.6 Conclusion

The structure and organisation of the American banking system has experienced dramatic changes in recent decades, particularly since 1960. In this period branch banking has achieved permanent legal status in about four-fifths of the States; branches increasingly have crossed State lines to follow their customers: the average banking organisation has expanded greatly in size in the wake of a record number of mergers; and conglomerate financial service organisations have proliferated in response to the changing needs of a rapidly growing, increasingly service-and customer oriented American economy.

The general policy of the US with regard to foreign banks doing business in the U S has been one of national treatment.[322] Under this policy foreign banks operating in the host country are treated as competitive equals with their domestic counterparts. There is, at this time, no uniform national policy concerning foreign banking operation in the U S. As a result, foreign banks enjoy many competitive advantages over domestic banks. The Act establishes the principle of parity of treatment between foreign and domestic banks in like circumstance. The measure finally enacted was a compromise. Although leaving foreign banks with some competitive advantage, Congress believed the legislation would adequately accommodate the controversial issues that pressed for recognition, that is, the promotion of competitive equality between domestic and foreign banks, preservation and enhancement of the ability of the State to attract foreign capital and develop international banking centres, and the need to provide the U S some leverage of secure and more equitable national treatment.

In general terms, regulators both State and Federal, should not place special statutory limitations on the geographic areas within a State where they can authorise new entry by existing banking organisations. Expansion by the branching route should be allowed throughout the States. State law should generally permit the use of automated tellers and similar electronic devices with minimum regulatory interference, rather than restricting them extensively on the theory that they are branch banks. What is there are the benefits of important innovations in computer and communications technologies and technology which can often offer the retail banking customer the convenience of a nearby twenty-four-hour

[322] Shay 1971:524-525.

facility. The public should not be denied these competitive benefits simply because their introduction may not be to the liking ofotherbanks that already have offices in a market. Law, State or Federal, should not be used to hold back beneficial innovations in technology to bank customers wherever they are living or want to operate banking services. The world in which banks operate is changing rapidly in the age of information and communication technology the legal rules under which banks operate must change too. Restrictive banking laws and regulations have achieved very little at great cost. "The fact that banking industry is highly regulated is critical to the nation's welfare and makes the play of competition not less important, but more so. This was true in 1963. It is even truer in 1973, and the challenge for us is to make real progress by 1983. Technology marches on in our electronic age. Luck and hard work, State law will be able to keep pace with the technology, and the walls built in other times for other needs will in fact, come tumbling down."

2.4 CHINA

2.4.1 Introduction

As economic globalisation has progressed, the trend towards international banking has become more obvious, and in response to changes in the overall environment and changes to systems, the Chinese banking sector has gradually been opened up.[323] During the period 1979-1982, foreign banks were permitted to establish representative offices in China, and from 1982 to 1989, various laws and regulations relating to representative offices and branches of foreign banks were implemented in the Shenzhen Special Economic Zone.[324]During the period 1990-1993, the geographical restrictions on foreign banks were relaxed.[325] Thereafter, in 1993, Shanghai's Pudong District was opened up to foreign banks, and beginning in 1994, foreign banks were allowed to set up branches in Shanghai, Shenzhen and eleven other cities.[326]

[323] Koo and Partners 2000:3.

[324] Ibid.

[325] Ibid.

[326] Asia Focus May 2007:3.

2.4.1.1 Background

China had a highly centralised, highly unified banking system which was the product of a command economy.[327] Cash was printed on command, as directed by the central planning agencies, while the People's Bank of China (PBC) issued cash as instructed by the central government; which in turn, determined how much cash would be issued by the central government to its branches at the provincial, municipal and autonomous regional levels.[328] Control over the allocation of credit was also highly centralised.[329] The funds which state-owned enterprises required for fixed asset investment and to meet the bulk of their working capital needs were provided free of charge by the Ministry of Finance, with the PBC being responsible only for providing additional working capital and loans; bank credit was thus used to meet only seasonal and extraordinary funding needs.[330]

Reforms in the banking sector in China have proceeded over 30 years against the backdrop of radical change in China's economic system. These reforms, orderly and systematic,[331] have enabled catapulting growth in the entire system. Before reforms and opening up began in 1978, China had only one bank,[332] the People's Bank of China (PBC), with multiple functions.[333]China then had a structure that included four large banks, each with a special

[327] Loechel and Packham 2010: 8.

[328] Ibid.

[329] Ibid. The main characteristics of China's banking system were: financial operation and management were highly centralised and are under the direction of the government; the PBC acted as the centre for cash, credit and settlement, functioning as national bank; the main function of banks were merely one of adjustment and the PBC had a planning function, serving as the executive, supervisory and accounting agency for the entire planned economy.

[330] Luehr 2010: 174. The provision of non-cost funding meant that state-owned enterprises were subject only to soft budget constraints, and as a result, their performance was poor.

[331] Asia Focus 2007:1-3. Looking back at China's banking reforms since the Asian Financial Crisis; we see that the Chinese government has proceeded in a sequential manner. One reform has been linked to the next, guided by careful research and design, and implemented in an organised fashion with sets of coordinated actions.

[332] Kumiko 2007: 6.

[333] Luehr 2010: 174.Within the structure of the PBC, the Bank of China (BOC) was solely responsible for foreign exchange, Agriculture and rural areas. Under the Ministry of Finance, the China Construction Bank (CCB) was set up to manage and allocate government funds to fixed capital investment according to State Economic plan.

function and separate mission: providing liquidity to industry and commerce, providing loans for agriculture and rural areas, providing foreign exchange, and providing resources for basic infrastructure.[334] In 2003, the banking law was promulgated and, for the first time, confirmed in legal form, the rights and duties of China's commercial banks, under a regulatory structure.[335] The Banking Regulatory Commission was established in the same year.[336] In 2004, the Bank of China (BOC)[337] and the China Construction Bank (CCB) became pilot cases in undertaking corporatisation reform. Commercial banks were operated as "enterprises" to an adequate degree 10 years ago. There was no clear mandate to run a bank with profit as the key objective; instead, banks were operating under the directives of government institutions. The process of enterprise reform had already begun in China at the time of the Asian Financial Crisis, but there had not yet been great progress. The concept of corporate governance had not even been broached in a preliminary fashion. Government and regulatory organisations gave no guidance in appropriate governance measures;-institutions generally proceeded with their own understanding of how to do things. In general, banks at that time, like all government institutions, lacked business objectives and lacked both motivating and retraining mechanisms for accomplishing those objectives.[338] Administrative interference in banking operations was still prevalent at that time. From 1993, China began to encourage a division of state or government and business or enterprise, and to discourage government interference in policies relating to commercial-type loans of commercial banks.[339] The central government did indeed begin to operate in

[334] Zhu ea 2009:80-86. From 1985 to 1993, these four banks underwent management reforms, turning them into enterprises in terms of operating procedures.

[335] Ibid.

[336] Ibid.

[337] Zhou 1991:115. BOC was established in 1912.

[338] Zhu ea 2009:86-90. There was sizable gap between international and Chinese laws, regulations, and rules. The gap between Chinese accounting standards and world standards was particularly large. China's standards classification at that time mainly related to the banking laws term of the loan. Standards for information disclosure of listed companies were woefully inadequate, so insider trading and share price manipulation were common. Key laws such as corporate laws were incomplete at that time.

[339] Ibid.

this direction. There were substantial differences in the way regional governments responded, however.[340]

In 2001, China finally became a member of the World Trade Organisation (WTO),[341] with its undertakings made in order to secure WTO accession due to come into effect in 2002. WTO membership will encourage the further opening up of the Chinese banking industry, thereby taking it to a new stage of development.[342]

2.4.1.2 Unfavourable Treatment of Domestic Banks with regard to Taxation

The level of corporate income tax levied on commercial banks is high and it makes it difficult for commercial banks to operate on a sound and commercial basis.[343] Further, it compares unfavourably with the tax rate for foreign banks. In terms of foreign currency operations, foreign banks are subject to a tax rate of 15 per cent, with a full tax holiday for the first year of operation and a 50 per cent tax holiday for the second year onwards.[344] Such revenue tax makes it difficult for banks to generate and retain earnings and thus to strengthen their capital bases.[345] Further, a significant tax-based disincentive still needs to be removed in

[340] Zhu ea 2009:86-90. During the Asian Financial Crisis, one of the main tasks of reform therefore was to insist that regional governments obey the demands of the central government in not applying administrative pressure to loan-making decisions.

[341] Hsu ea 2007: 23-30.

[342] Ibid.The bilateral agreements reached between China and the WTO member nations show that the main elements in the opening up of the Chinese banking industry will be as follows: foreign banks will enjoy the same rights as domestic Chinese banks in certain specified regions; non-bank financial institutions will be allowed to conduct consumer loan and auto loan business; within two years after WTO accession, foreign banks will be allowed to provide RMB services to Chinese enterprises; within five years after WTO accession, foreign banks will enjoy full access to the Chinese market; within five years after WTO accession, the restrictions on foreign banks in terms of geographic region of operation and type of customers will be abolished.

[343] Wood 2007: 84-85.

[344] Ibid.The high level of tax erodes profitability. China is one of the very few countries in the world that imposed a business tax rate on gross income for banks. The business tax rate was 8 percent (3 percent collected by the central government, 5 percent by the local government). Since then this rate has been reduced by 1 percent each year until 2003, and to date it is 5 percent.

[345] Ibid. By way of example, ironically back in 1998 when the business tax was at 8 percent, four state-owned banks alone paid RMB 11.6 billion in business tax and generated a total profit of only RMB 4. 1 billion.

order to encourage banks to increase their provisioning levels.Following the supervisory rules, banks are now required to make provisions based on the five-category loan classification system. However, at present, the tax authorities impose a cap on the tax deductibility of specific loan-loss provisions at 1 per cent. This severely discourages commercial banks to make adequate provisions that are urgently needed to accelerate loan write-offs and comply with supervisory rules. [346]

The table below demonstrates that foreign banks still enjoy special privileges.[347] Regarding tax burden, business taxes account for the bulk of the foreign bank's tax burden; however, in the special economic zones, foreign banks can benefit from a number of provisions, including business tax remission, a reduction in income tax rate by 15 per cent, and exemption from urban construction tax and education surtax.[348]

Table 3

Chinese Banks	Foreign Banks
Chinese banks pay business tax at a rate of 8% and income tax at a rate of 33%. They are also required to pay urban construction tax and education surtax (at 10% of the income tax payment).	Various levels of business tax exemption and remission are granted to foreign banks operating in the special economic zones. The income tax rate for foreign banks is 15% and they are exempt from payment of urban construction tax and education tax.

2.4.1.3 Deposit Insurance

So far, there is no deposit insurance in China, despite encouragement from the government that household deposit and savings shall be protected. [349] Deposit insurance system is designed to minimise or eliminate the risk that depositors placing funds with a bank will suffer a loss. Deposit insurance thus offers protection to the deposits of household and small business enterprises, which may represent life savings or vital transactions balances. If a deposit insurance system is in place, these households and businesses can go about their

[346] Wood 2007: 84-85.

[347] Chien-Hsum and Hui-Tzu 2004:86.

[348] Ibid.

[349] Lou 2001: 289.

business with some assurance that their funds are secure. This in turn supports the stability and smooth operation of the economy.[350] A related effect of deposit insurance that may be important in some financial systems is that it levels the playing field to a degree for large and small institutions. Under a formalised deposit insurance programme, all institutions have access to depositor protection in the amounts specified by the coverage rules. Finally, the explicit rules of a deposit insurance programme provide added certainty regarding the resolution process for failed banks. A properly balanced deposit insurance programme can provide order in winding up the affairs of a failing institution, and facilitate the establishment of an effective mechanism.[351]

China's leadership faces a substantial challenge in recapitalising its banking system.[352] In addition to the issue analysed above, a successful bank restructuring program will require a substantially strengthened central bank that can exercise effective supervision and prudential regulation of banks.[353] Ultimately, the failure to transform the banking system on a timely basis increases the possibility of a domestic banking crisis. A crisis could be triggered if domestic savers lose confidence in the government's implicit guarantee of their bank deposits.[354]

[350] Lou 2001: 289.No amount of prudential supervision can provide protection against runs that is equivalent to deposit insurance. It is easy to underestimate the value of deposit insurance when times are good. When times are bad, governments often re-evaluate the need for such arrangements. Typically, deposit insurance systems are adopted in the aftermath of severe banking crisis or when industry conditions are deteriorating and unstable. A recent IMF survey of deposit insurance systems in 60 countries indicated that 40 of these systems were instituted during the 1980s and 1990s, largely in response to actual banking problems or the perceived threat of instability. For example, in the United States, it was because of the failure of the Federal Reserve System in preventing the financial crisis of the early 1930s that the congress established the Federal Deposit Insurance Corporation in 1933.

[351] Lou 2001: 289.

[352] Ibid.

[353] Ibid. Lou argues that, "if China fails to transform its banking system, the consequences are predictable. The intermediation of funds between savers and investors by banks and other financial institutions would probably continue to be marked by the inefficiencies already apparent."

[354] Chien-Hsum and Hui-Tzu 2004:86.This loss of confidence could be triggered by a growth slowdown that obviously further weakened the domestic banking system; the prospect of a major devaluation of the Renminbi in response to an emerging current account deficit and a sharp fall in inward foreign direct investment; or a premature move to capital account convertibility or opening-up of the domestic banking market. Such a crisis would probably lead to an inflationary spiral, a dramatic curtailment of the

2.4.2 Policy Responses to Resolve Banking Problems

The establishment of the China Banking Regulatory Commission (CBRC) in 2003 was a watershed institutional development.[355] It separated critical banking supervisory and regulatory functions from the central bank and allowedthe People's Bank of China (PBC) to concentrate on increasingly complex monetary policy challenges. CBRC has since grown into a respected and increasingly effective bank supervisor/regulator with some 24,000 staff nationwide.[356]

The government has come to address the difficulties in the banking industry, which is another demonstration of the sequenced approach to reform.[357] The government makes it clear that, the commercial banks should be turned into modern banking institutions that have adequate capital, strong internal controls and operate profitably in a safe and sound manner. Selected state-owned banks are being restructured to become shareholding banks. Efforts will be made to expedite the resolution of state-owned banks' problem assets and inject capital so as to create the necessary conditions for public listings in future. No evidence so far suggests that foreign banks in China could destabilise the local banking market. The CBRC shares the view that the most important question is not who provide banking services but who can provide them more efficiently. Indeed, since the late 80's, the role of foreign banks has become increasingly important for China's banking sector.[358] They have brought in competition and helped unfold many changes in the banking sector. As the country continues to honour its WTO commitments, and eventually removes all the geographical and customer restrictions on foreign banks, the policy towards these banks will become more and more supportive.[359] The CBRC is now assisting foreign banks to become niche players in consumer lending, wealth management, asset securitisation and resolution

growth of bank credit, and a sharp recession. It would also be highly adverse for maintaining the high rate of domestic saving that has been the major source of rapid growth in the reform era.

[355] Luehr 2010:180-183. CBRC is a supervisory body with powers to regulate the evolving banking sector in China.

[356] Bottelier 2009: 57.

[357] Zhongfei 2007:623-626.

[358] Loechel and Packham 2010: 5-10.

[359] Ibid.

of problem loans. It also encourages foreign banks to have equity stake or become strategic investors in Chinese banks, big or small. The existing ceiling for foreign holding in Chinese banks is being reviewed. This will help to reach a win-win situation for both local and foreign banks and facilitate a quicker expansion of foreign banks' operations nationwide.[360]

2.4.2.1 Improvement of Bank Risk Management

The CBRC has aggressively introduced the new supervisory concepts and approaches as embodied in the New Capital Accord, or Basel II.[361] The draft capital rules state, in line with the three pillar approach of Basel II, that banks should improve on their management of credit risk. All banks should start collecting the necessary data for both borrower and facility, which serve the very basis for a more quantitative approach to measuring and managing credit risk. Over time the CBRC will consider the use of an internal rating–based approach for capital regulation when banks are ready and provide incentives for banks to improve on their sophistication in risk management accordingly.[362]

2.4.3 The Banking laws of China and the Basel Principles

The Basel principles represent the efforts of the Basel Committee to set out international standards for banking supervision and regulation.[363]If one examines the central banking laws and commercial laws of China carefully, one can find that the banking laws of China

[360] Loechel and Packham 2010: 5-10.

[361] Ibid at 18-19. The CBRC's major functions:are to formulate regulations and provisions for banking supervision; draft laws, and administered regulations and make proposals for their drafts and amendments; To approve the establishment, amendment, termination and business scope of banking institutions and their subsidiaries; to supervise banking institutions on and off the spot, and punish unlawful behaviours according to law; to examine the qualifications of senior managers of banking institutions; to compile statistics and reports of banking institutions in the whole country, copy to the People's Bank of China and publish them in accordance with government regulations; to offer opinions and proposals together with the Ministry of Finance and the People's Bank of China, with regard to how to deal with emergency risks of deposit banking institutions; and to be responsible for the routine management of supervisory boards of major state-owned banking institutions.

[362] Ibid.It is encouraging to observe that with the support of the supervisor, big banks in China have fully embraced Basel II in the interest of better risk management. Some have already designed the two dimensional rating systems with more refined risk distinction for performing loans benchmarked to probability of default.

[363] Luehr 2010: 178.

incorporate many of the Basel principles.[364] The Core principles are a set of supervisory guidelines aimed at providing a general framework for effective banking supervision in all countries. They are a reference document to be used by national supervisors and international institutions to strengthen supervisory standards in developing countries.[365]

The central banking law formally conferred on PBC the legal status of the central bank of China.[366] Although PBC became the defacto central bank of China as early as 1984, its legal status was only formally established in 1995 by the central banking law.[367] As the central bank of China the PBC is responsible for supervision of the banking industry. The objective of supervision of the banking industry is to maintain its lawful, stable and sound operations.[368]

2.4.4 Licensing and structure

The criteria applied in China are similar to those applied by authorities in other countries. Under the commercial banking law,[369] no organisation or individual shall receive money deposits from the public or do any other business of a commercial bank or use the title of "bank" without the approval of the PBC.[370]

Article 3 of the law states the lists of the businesses a commercial bank may engage in with the authorisation of the PBC.[371] Under the commercial banking law, commercial banks may

[364] Zhongfei 2007:623-624. For examples, Board and management oversight; sound capital; comprehensive assessment of risks; monitoring and reporting; internal control review; review of adequacy of risk assessment; supervisory review of compliance with minimum standards and supervisory response.

[365] Kumiko 2007:54.

[366] Lin 1991: 273.

[367] Ibid.

[368] Ibid.

[369] Luehr 2010: 188.The Commercial Banking Law deserves due credit for divorcing the government from banks' reforms, laying the groundwork for Basel II.

[370] Order of the President of the Republic of China No 45 of 1995 www.pbc.gov.cn/publish/english/964/1956/html (accessed 2010/04/04).

[371] See art. 3.

operate a range of business activities, which include taking of deposits; granting loans; handling settlements and discounting of negotiable instruments; issuing financial bonds; trading in government bonds and foreign exchange; engaging in inter-bank lending; providing letters of credit services and guarantees; acting as insurance agent, providing safe box deposit services and other activities approved by the PBC. The establishment of the commercial bank must be approved by the PBC.[372] Therefore, the permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined in the Commercial Banking Law, and the use of the word bank in names is carefully controlled. The law also sets out criteria for the establishment of commercial banks' appointment of directors and senior management and its capital base. Moreover, the transfer of significant ownership or controlling interests in commercial banks requires the approval of the PBC. These largely reflect the principles relating to licensing and structure of banks in the Basel Principles.[373] Under the Basel principles, the permissible activities of institutions that are licensed and subject to supervision as banks must clearly be defined, and the use of the word "bank" in names should be controlled as far as possible. The licensing authority must have the right to set criteria and reject applications for from entities that do not meet the standards set. The licensing process, at minimum, should consist of an assessment of the banking organisation's ownership structure, credentials of directors and senior management, its operating plan and internal controls, and its projected financial conditions, including its capital base. Banking supervisors must have the authority to review or reject any proposals to transfer any significant ownership or controlling interests in existing banks to other parties.[374]

[372] Art. 3. Without the approval of PBC, no unit or individual may use the word "bank" in its name. Before a commercial bank is established, it needs to meet various criteria under the commercial banking law. It must possess articles of association which are in conformity with the commercial Banking law and company law. It must have a sound organisational structure and management system and it must have a president, senior manager and other senior management personnel with professional and working experience relevant to their position. The minimum amount of registered capital for the establishment of a commercial bank is one billion RMB and registered capital must be paid up.

[373] Order of the President of the Republic of China No 45 of 1995 www.pbc.gov.cn/publish/english/964/1956/html (accessed 2010/04/04): 3.

[374] Ibid. art. 12.

There are a number of requirements for establishing a commercial bank.[375]

1) The articles of association must conform with the commercial banking law and company law;
2) The applicant must have the minimum amount of registered capital;[376]
3) The applicant must have a chairman of directors, general manager and other senior managerial personnel with the expertise and professional experience required by their positions;[377]
4) The applicant must have up-to-standard business sites, safety measures and other facilities relevant to the business.[378]

To ensure that the PBC monitors and supervises the structural changes of a bank, article 24 of the Commercial Banking Law requires that a bank obtain approval from the PBC in the event of any changes in:[379] its name;its registered capital;the business sites of the head office and/or its branch(es);its business scope;its shareholders, each holding more than 10 per cent of the total capital or total shares of the bank;its articles of association; and other changes specified by the PBC.[380]

2.4.5 Regulations and Requirements

Under the Commercial Banking Law, commercial banks should grant loans based on the following asset/liability ratios:[381]

1) the capital adequacy ratio must not be less than 8 per cent;

[375] Order of the President of the Republic of China No 45 of 1995 www.pbc.gov.cn/publish/english/964/1956/html (accessed 2010/04/04): 12.

[376] Ibid. art. 13.

[376] Ibid.

[377] Ibid. art.art.27.

[378] Ibid. Appropriate documentation evidencing the foregoing must be filed with the PBOC.

[379] Ibid art 4.

[380] The article also requires that when a commercial bank needs to replace its chairman of the board of directors, or general manager with a new one, the qualifications of the appointee shall be reported to the PBC for scrutiny.

[381] Ibid at 5-6.

2) the ratio of outstanding loans to the balance of deposits of a bank must not exceed 75 per cent;

3) the ratio of current assets to current liabilities must not be less than 25 per cent;

4) the ratio of total outstanding loans to one single borrower to the balance of capital of a bank must not exceed 10 per cent.

Article 40 of the Commercial Banking Law provides that a commercial bank shall not extend unsecured loans to related persons or provide related persons with secured loans on conditions more favourable than the terms of similar loans to other borrowers.[382]

2.4.5.1 Information Requirements

Under the Commercial Banking Law, commercial banks must truthfully record and completely reflect their business activities and financial situations, compile annual financial and accounting reports, and submit accounting reports to the PBC in a timely manner.[383] They should also publish their annual business reports and auditors' reports within three months of expiry of every fiscal year.[384]

2.4.6 Is China's requirements in conformity with the Basel Core Principles?

Chinese regulators followed closely the development of the Basel Accords and show consistent strong will to integrate international regulatory rules into Chinese regulatory practices with adaptation to the emerging features.[385] In 1998, the PBC published the

[382] Order of the President of the Republic of China No 45 1995. http://www.pbc.gov.cn/publish/english/964/1956/19566_html (accessed 2012/04/04) at 4.Related persons in article 39 refer to: the members of board of directors, members of the board of supervisors, managerial personnel and staff of the credit department of a commercial bank, and their close relatives; the company, enterprises or other economic organisation wherein the aforesaid persons have made investment or assumed senior managerial positions.

[383] See art. 55.

[384] Ibid.

[385] Loechel and Packham 2010:16-17. Within the CBRC, a council of international advisors was set up in 2003 to implement international best practices.

Chinese version of the Core principles for effective banking supervision.[386] Comprehensive capital adequacy came into effect in 2004 with the issuance of the Administrative Rules on Capital Adequacy Management of Commercial Banks.[387] The 2004 rulesreinforced the 4% tier one and 8% capital adequacy ratio of the 1988 Basel Accord and integrated the second pillar of supervisory review and the Third Pillar market oversight of Basel II rule to use external ratings for risk assessment calculation, introduced market risk capital requirements, established a capital adequacy supervision mechanism and obliged banks disclosure of capital ratio.[388] On the release of the Basel II Accord, the CBRC introduced timely the new capital accord in China. In 2007, the CBRC released the Basel II implementation time line in the form of the Guidance of Implementation of Basel II in the Banking Sector.[389] In 2008, the CBRC, completed the Basel II implementation in China through the release of the five set guidance:[390] Guidance on the Classification of Credit Risk Exposure in Commercial Banks' Banking Books, Guidance on the Supervision of Internal Rating Based Credit Risk Calculation of Commercial Banks, Guidance on the Risk Capital Calculation on Specialised Lending of Commercial Banks, Guidance on Credit Risk Minimisation in Risk Capital Calculation of Commercial Banks, and Guidance on Risk Capital Calculation of Operational Risk of Commercial Banks.[391]

2.4.7 New Chinese banking regulation opens the market

China's banking system has undergone significant changes in the last two decades: states banks are now functioning more like banks with specific objectives of profitability rather than before.[392] Nevertheless, China's banking industry has remained in the government's

[386] Loechel and Packham 2010:16-17.

[387] Ibid.

[388] Ibid.

[389] Ibid.The guidance divided Chinese banks into tier –one internationally active banks including the "big five" banks ICBC, ABC, BOC, CCB, BoCom; Chinese Merchant Banks and other banks. Eight Joint-stock banks were determined as tier-two banks.

[390] Ibid.

[391] Ibid. However, the implementation deadline for Basel II was extended to the end of 2011 for tier-one banks.

[392] Ibid.

hands even though banks have gained more autonomy. China's accession to the WTO will lead to significant opening of this industry to foreign participation.[393] The Chinese Banking Regulatory Commission (CBRC) has been in the process of revising the current rules and regulations governing foreign banks in the People's Republic of China (PRC) since China was admitted into the WTO in 2001.In accordance with its five year WTO commitments, China has now issued the Regulation required to fully open its banking sector to foreign banks. The Regulation, which came into effect in 2006, has had a significant impact on China's banking sector.[394]

The opening to outside competition of Chinese banking sector is being done concurrently with domestic reforms.[395] During the period 1990-1993, the geographical restrictions on foreign banks were relaxed. Thereafter, in 1993, Shanghai's Pudong District was opened up to foreign banks, and beginning in 1994, foreign banks were allowed to set up branches in Shanghai, Shenzhen and eleven other cities.[396] In 1999, geographical restrictions on foreign banks were further relaxed and the number of cities in which foreign banks were allowed to operate was expanded from twenty-three including Tianjin, and Beijing to include all major cities. The Renminibi business of foreign banks was allowed first in the Shanghai Pudong area in 1996. [397] In 1998, the PBC approved the expansion of the trial in foreign banks' operations with Renminibi currency from the shanghai pondong area to Shenzhen SEZ.[398] At the time of China's accession to the WTO, four cities, Shanghai, Tianjin, Shenzhen and Dalian, were already open for foreign banks' Renminibi business. Another five cities Guangzhou, Zhahui, Quigdao, Nanjing and Wuhah were added one year after the accession to WTO.[399] In 2003, the CBRC declared the expansion of the Renimibi business of foreign

[393] Loechel and Packham 2010:16-17.

[394] See "The Regulation".

[395] Kumiko 2007: 54-60.

[396] These are Beijing, Shenyang, Shijiazhuang, Xian, Wuhan, Chengdu, Chongqing, Hefei, Suzhou, Hangzhou and Kunming.

[397] Loechel and Packham 2010:15.

[398] bid.

[399] Ibid.

banks from the first nine cities to four more cities.[400] In 2004, the CBRC extended the RMB license cities to five more: Kunming, Beijing, Xiamen, Xi'an and Shenyang, with 18 cities opened for RMB business in foreign banks.[401]

2.4.7.1 Regulation of the People's Republic of China on Administration of foreign-funded Banks ("The Regulation")

The regulation of foreign banks was first introduced through the Administration Rules on Foreign Banks and Joint-Venture Banks in Specialised Economic Zones effective in 1985,[402] which restricted foreign banks activities mainly to foreign currency lending and settlement. The minimum requirement for registered capital for foreign banks was set at RMB 80 million or equivalent foreign currency, half of which should be paid-in capital.[403].The branch of a foreign bank should hold RMB 40 million or equivalent foreign currency as optional funds.[404] In 1990, the PBC released the Administrative Rules on Regulation of Foreign Banks and Joint Venture Banks in Shanghai,[405] which differentiate foreign banks incorporation and foreign banks branch. Three years' experience with a representative office in China was required for the set up of a foreign bank or foreign branch. The total assets requirement of the parent bank for the prior year before the application should exceed USD 10 billion and USD 20 million for foreign banks and foreign branch respectively. The registered capital for foreign banks was USD 30 million. A Foreign bank branch was required to have USD 30 million as operating funds.[406]

[400] Loechel and Packham 2010:15. Jinan, Fuzhou, Chengdu and Chongqing.

[401] Ibid. Five years after the accession the geographical restrictions of foreign banks' RMB business was fully lifted.

[402] Loechel and Packham 2010:14-16.

[403] Ibid.

[404] Ibid.

[405] Ibid.

[406] Ibid.

In 1994, the Administrative Rules of the People's Republic of China on Foreign Funded Financial Institutions came into effect, replacing the 1985 and 1990 rules.[407] The new regulation followed the structure and ratio of the 1990 rule, but increased the capital requirement of foreign banks to RMB 300 million. A foreign branch should hold at least RMB 100 million from its headquarters as operating funds. The 1994 rule reduced the required experience from three to two years with representative office but kept the minimum total assets required of USD 10 billion in the year prior to the application.[408]

The promulgation of The Regulation for the Administration of foreign-funded banks in 2006 marked the beginning of a new chapter for foreign banks in China.[409] To fulfil the WTO requirement, China opened fully the banking market and foreign banks began to enjoy national treatment without restriction in operating regions, local currency and customer type if locally incorporated.[410] A revised version of the implementation rules of foreign funded banks in the People's Republic of China replaced the 2004 rules.[411] The revised rules encouraged local incorporation of foreign banks which were regulated equally as Chinese banks.Foreign branches were allowed to accept RMB deposits of over RMB one million from private persons.Foreign banks could hold at the same time a locally incorporated bank with full licence and one foreign branch for the whole-sale business. At the same time foreign banks were granted a transitional period of five years to fulfil the 75% loan-to deposit ratio. Additionally, foreign banks should reach the 70% ratio of foreign currency deposit to total foreign assets.[412] Foreign banks can now offer commercial banking services to any customer, regardless of their nationality, everywhere in China.[413] In 2006, China State Council issued

[407] Loechel and Packham 2010:14-16.

[408] Ibid.Parallel to China's accession to the WTO negotiations, the first 11 cities were open to foreign financial institutions in 1994.

[409] Ibid.

[410] Ibid.

[411] Ibid.

[412] Ibid.

[413] The opening of the Chinese banking market however has come with significant conditions. Only those banks that choose to incorporate their operations in China will be allowed to provide a range of services

"The Regulation".[414] The Regulation, among other things, will permit foreign banks to engage in full scope local currency retail business in the PRC on the condition that they are locally incorporated and have obtained regulatory approval. The major changes reflected in the Regulations are:[415]

a. Geographic restrictions lifted: currently, foreign banks are permitted to engage in local currency business with non-local residents in 25 cities, of which 20 cities were opened in accordance with China's WTO commitments and 5 cities were opened voluntarily. Foreign banks, subject to acquisition of local currency business license, may operate freely within the boundaries of mainland China.

b. Business Scope restrictions expanded: currently, CBRC approved that foreign bank branches can engage in foreign currency business or a combination of foreign currency business and limited local currency business with foreign individuals and institutions and Chinese enterprises. The new Regulation expands the businesses that foreign branches can engage which include full-scope local currency retail business with local residents provided the foreign branch incorporates locally. Although locally incorporated banks are permitted to engage in full-scope local currency business, it is important to note that the acquisition of local currency business license remains pre-requisite need for individual banks applying for the business. Branches of locally incorporated foreign banks are automatically qualified to conduct local currency business when the head office has obtained CBRC Approval.[416]

c. Capital Requirements: As stipulated in the Regulation, the minimum operating Fund requirement for foreign bank branches will be RMB 200 million if they are to conduct foreign currency business only or RMB 300 million for conducting both RMB and foreign currency businesses. The new requirements for registered

with domestic banks. This restriction, coupled with higher minimum capital commitments, has effectively raised the costs of foreign banks wanting to enter or to expand their operation in China.

[414] The Regulations contain seven chapters: I General provisions; II Establishment and Registration; III Scope of business; IV Supervision; V Termination and liquidation; VI Legal liability; and VII Supplementary provisions.

[415] Zhongfei 2007:194-206.

[416] Ibid.

capital and operating funds for locally incorporated foreign banks will be the same as Chinese domestic banks. The registered capital requirement of a locally incorporated foreign bank and the minimum operating funds for its branches are RMB I billion and RMB 100 million, respectively.[417]

Table 5 below compares aspects of foreign banks branches and locally-incorporated foreign banks under the Regulation.[418]

	Foreign banks branches	Locally-incorporated foreign banks
Business scope	Can only take fixed deposits of more than RMB 1 million from domestic PRC .	Can conduct full-scope business including credit cards business.
Branch application for local currency	A branch needs to satisfy the "three year after commencement, two consecutive profitable years" requirement and other requirements as stipulated by the State Council, and apply individually.	Branches are qualified for full scope local currency business licence.
Organisational structure	Foreign banks who have two or more branches in China are required to designate a management branch (similar to Head Office) responsible for managing and monitoring their business operations in China. Other non-designated branches are required to report to this branch.	All existing foreign bank branches will be restructured to form under a local Head Office with the permission to keep one other branch remain under overseas parents due to credit rating consideration for conducting wholesale foreign currency transactions.
Registered Capital/operating funds	Minimum operating fund of RMB 200 million	Registered capital: RMB I billion minimum operating fund per branch.
Capital adequacy ratio	Capital adequacy is calculated and regulated at branch level.	Capital adequacy ratio is calculated and regulated at the Head Office

[417] Zhongfei 2007:194-206. Foreign banks have consistently pointed out that their branches were disadvantaged by higher capital requirements relative to domestic banks. Prior to the new regulation, foreign bank operations were required to comply with a complex schedule of minimum capital requirements. In general the Banking Regulatory Commission (CBRC) required foreign banks involved in more complex and comprehensive operations to hold more capital.

[418] Wang 2005:235.

		level.

Foreign banks are able to set up branches in China.[419] A branch of a foreign bank cannot bear independent liability to third parties.[420] In the case of insolvency, the parent foreign bank has to bear the responsibility for the debts incurred by the branch.[421] A foreign bank branch will not be conferred with legal person status.[422] As long as the branch is approved by the CBRC, it is permitted to conduct any or all of the following banking services:[423]

(a) Accepting deposits from the public;

(b) Granting short-, medium-or long-term loans;

(c) Handling notes acceptance and discounts;

(d) Trading in governmental bonds, financial bonds and foreign currency negotiable securities other than stocks;

(e) Letter of credit and guarantee services;

(f) Domestic or international account settlement;

(g) Trading in foreign exchange for their own account or for the account of customers;

(h) Foreign currency exchange;

(i) Inter-bank lending and borrowing;

(j) Bank card business;

(k) Safety deposit box services;

(l) Banking business-related credit investigation and consultancy services; and

(m) Other services approved by the PBC.

This list of the scope of business is compatible to the scope of business embodied in the Commercial Banking Law, implying that equal treatment has been granted to foreign banks in terms of the type of services that they are permitted to conduct in China.[424] Based upon the above-listed scope of business, foreign banks and branches of foreign banks are only

[419] Zhongfei 2007:194-206.

[420] Ibid.

[421] Wang 2005:230-231.

[422] Ibid.

[423] Ibid.

[424] Ibid.

allowed to carry out commercial banking activities, and are not able to engage in other financial services such as investment banking and insurance operations.[425]

2.4.8 Dissolution of Foreign Banks' Branches

Foreign banks' branches can be dissolved voluntarily or by the CBRC's compulsory measures.[426] They may be voluntarily dissolved with the approval of the CBRC, if one of the following situations occurs:[427]

(a) The duration of the existence aspredefinedby the articles of association expires or other matters leading to the dissolution predefined by the articles of association have occurred;

(b) The shareholders' meeting or board of directors resolves to dissolve the bank;

(c) Dissolution becomes necessary due to merger.

Upon the CBRC's approval of the dissolution of foreign banks' branches, they shall cease their business activities and return their financial services licenses at once.[428] The CBRC may order foreign banks to close their branches in China.[429] The winding-up of foreign banks' branches follows the same procedures as those applied to voluntary dissolution mentioned above.[430]

2.4.9 Conclusion

In practice, foreign banks currently lack the branch networks necessary to penetrate the mass market. Domestic banks have vast networks and extensive first-hand experience of operating in China and the dominance of the big Chinese banks has led to their control over supply of local currency. Although China has met its WTO commitments in the banking sector, international banks still face significant barriers to expanding their presence in China. Local incorporation requires capital of RMB 1 billion to be paid up-front and requires more

[425] Wang 2005:230-231.

[426] Ibid. 242-243.

[427] Ibid.

[428] Ibid.

[429] Ibid.

[430] Ibid.

local administration-which in turn compels foreign banks to compete for scarce pool of experienced talent. Due to their weaker branch networks in the country, foreign banks in China also face major funding constraints.They must pay higher interest rates on inter-bank borrowings and are subject to higher reserve requirements and other limitations on their foreign currency business. The competitive environment in China has prompted foreign banks to adopt different strategies according to their resources and core advantages. Fundamentally, foreign banks that wish to participate in China have two options at their disposal: buying a minority stake of up to 20 per cent in an existing institution, and thereby gaining access to retail customers through the domestic banks' existing networkor building a presence through gradual, organic growth. [431]

2.5. SOUTH AFRICA

2.5.1 Introduction

This section looks at the structure of the banking sector, and based on the Banks Act, details the foreign banks methods of entry into the South African market. South Africa in contrast to most emerging economies has a well-developed banking system, which includes several different types of banks: commercial banks, merchant banks and general banks. No formal distinction exists between each type of bank and the activities of each class often overlap. Its central bank-the South African Reserve Bankis one of the oldest central banks outside of Europe. It was established in 1921, and has played a major part in the development of the country since that time.[432]

South Africa's banking services industry is a licensed-type business.[433] Accordingly, no bank can sell its services to the general public without a license. Before such a license is granted, however, the regulatory authority has to ensure that the ultimate objectives of banking institutions do not conflict with national and consumer interests. In South Africa the regulatory authorities have three ultimate objectives, namely:[434] to ensure a safe and sound

[431] Dimon 2009:170.

[432] The Banking Council 1999: 15.

[433] Ibid.

[434] Ibid.

financial system in which the general public can trade without fear of losing their savings ; to enhance the confidence of and fairness to investors by inter alia eliminating bad business practices, possible conflicts of interests, facilitating transparency, integrity and good corporate governance; and to ensure an efficient and effective financial system in which banking services are supplied at a competitive price and the majority of the population has access to the various banking services offered.[435] South Africa's commercial banks are engaging in practically every monetary transaction that takes place in the country. This ranges from cheque processing, to the provision of cash, electronic transmission of funds and the handling of credit and debit card transactions. A substantial distribution network of branches, agencies and ATMs handles these transactions.[436] The country's banks are generally regarded as having a high degree of sophistication, belying the country's emerging market status. The soundness of the banking system was a major factor in allowing the country to escape, relatively unscathed, the worst of the 1997/98 emerging market crisis.[437]

2.5.1.1 Historical Background

The first bank in South Africa, the Bank van Leening, was established in 1793.[438] Before unification of South Africa in 1910, the law relating to commercial banking in the Cape Province was governed by Act 6 of 1891 and Act 19 of 1893; in the Orange Free State by Ordinance 20 of 1902 and in the Transvaal by Law 2 of 1893.[439] The Cape Act was promulgated to consolidate and amend the law relating to banking and to secure and regulate the circulation of bank notes. It also secured a degree of publicity for banking operations. A bank was defined as "every foreign banking company and every joint stock company engaged in the ordinary business of banking by receiving moneys on deposit and by issuing in this colony or elsewhere bills or notes payable at sight or on demand. In Natal,

[435] Falkena and Llewellyn 1999: 1-2. As a license is issued to a banking institution only if it can prove that its operations are supporting the three ultimate objectives of the authorities, it is implicit that the ultimate objectives of the regulatory authorities must also be those of the banking services industry.

[436] The Banking Association of South Africa, South African Banking Sector overview.http://www.gbd.org/downloads/South%20Africa/SARBA.pdf (accessed 04/12/2012):6.

[437] The Banking Council 1999: 15.

[438] Fourie ea 1996: 71-75.

[439] Ibid.

the Natal Bank laws 1888 to 1912 private Act 7 of 1912 consolidated all laws relating to the establishment of Natal Bank.[440] The Banking Act 38 of 1942 repealed the banking legislation in the Cape Province, Orange Free State and Transvaal as well as the previous Banks Acts of the Unions 7 of 1916 and 31 of 1920. [441]

The Banking Act 7 of 1917 was enacted to provide for the issue of bank notes of the denomination of ten shillings and for the periodic submission by banks of statements of assets and liabilities within and outside the Union.[442] The currency and Banking Act 31 of 1929 was enacted for the issue of gold certificate, to provide for the establishment of a central reserve bank for the Union, its establishment, capital, reserve fund and allocation of surpluses, powers and duties, business, prohibited business; regulate the issue of bank notes and the keeping of reserves with a view to securing greater stability in the monetary system of the Union and generally to make provision for matters incidental thereto. The Act described a bank as every person, firm or company using in its description or title "bank" or "banker" or "banking" and everyperson, firm or company, receiving or accepting deposits of money subject to withdrawal by cheque, draft or order.[443]

The Bank Act 23 of 1965, in its section 54 repealed and replaced the old Banking Act 38 of 1942.[444] In terms of the Banks Act of 1965, a major consolidating piece of legislation, "banking institution" included a commercial bank, that is a person who carries on the business of which the acceptance of bills which are eligible for discounts by the Reserve

[440] Fourie ea 1996: 71-75.

[441] Ibid.The puropose of the Banking Act 38 of 1942 was to consolidate and amend the law relating to banks and certain similar institutions. In this Act "banking institutions" included a commercial bank, a people's bank, a loan bank which carried on the business of accepting deposits of money and of granting small loans and deposit receiving institutions.

[442] Ibid.

[443] Fourie ea 1996: 71-75.

[444] Ibid.Sec 1 (1). Unless a banking institution offered the facility of accepting deposits of money withdrawable by cheque prior to 1 January 1965, it may do so only if it is a commercial bank or has obtained the written approval of the Registrar of banks.

Bank forms a substantial part, and who also accepts deposits,[445] or a saving bank, that is a person who carries on the business of accepting deposits and of whose business the granting of loans against the security of fixed property or surety bonds forms a substantial part.[446] In a major change, the Financial Institutions Amendment Act 106 of 1985 abolished the distinction between the different classes of banks and differentiated between banking institutions and discount houses only.[447] The activities of the discount houses were limited by this Act to the discounting, buying or investing in certain security.[448] However, not all banks were under this regime entitled to offer facilities and special permission to that end was necessary.[449]

The Banks Act, 1990 originally known as the Deposit-taking institutions Act 94 of 1990 goes much further and effectively does away with discount houses. It treats banks and building societies and, for that matter, all deposit-taking institutions alike.[450] The purpose of the Banks Act 94 of 1990 is to provide for the regulation and supervision of the business of public companies taking deposits from the public.[451] Its main object is to create the legal framework for the regulation and supervision of the business of accepting deposits from the public. To this end, the Act governs the establishment of financial soundness of banks, the security of the investments of depositors and the protection of the integrity of banks in the interest of the financial system. The approach of the Banks Act is said to be functional and not institutional.[452] It addresses the function of deposit taking rather than the institutions accepting deposits. The advantages of this approach are that various groups of banks are regulated by a single Act and that a more level playing field is created for the concerned

[445] See sec (xi) of the Banks Act 1965.

[446] See sec 1(xxi) of the Banks Act 1965.

[447] Fourie ea 1996: 72.

[448] See sec 22 (1) of the Banks Act 1965.

[449] See sec 29 of the Banks Act 1965.

[450] Jones and Schoeman 2006:11-12.

[451] Ibid.

[452] Ibid.

institutions, thereby eliminating past inequalities and discrepancies in the regulation of these groups.[453]

2.5.2 The Legislative Text

The Banks Act,[454] 1990 came into operation on 1st February 1991.[455] Chapter 1 deals with the interpretation and application of the Act and contains definitions of the principal concepts. Two new definitions are of overriding importance, namely "deposit" and "business of a bank". Section 1(2) gives far-reaching powers to the Minister to amend the definitions of "deposit" and "business ofa bank".[456] Registration as a bank is a prerequisite for conducting the business of a bank.[457]

A "deposit" in terms of s 1(1) made under s 1(2) is an amount of money paid by one person to another subject to an agreement in terms of which-[458]

(a) an equal amount or any part thereof will be conditionally or unconditionally repaid, with or without a premium, on demand or at specified or unspecified dates or in circumstances agreed to on or on behalf of the person making the paymentand the person receiving it; and

(b) no interest will be payable on the amount so paid or interest will be payable thereon at specified intervals or otherwise, notwithstanding that such payment is limited to a fixed amount or that a transferable or non-transferable certificate or other instrument providing for the repayment of such amount mutatis mutandis as contemplated in paragraph (a) or for

[453] Malan 1996:17.

[454] The Bank Act 1990 http://www2.resbank.co.za/internet/publication.nsf/.../BankstAct+1990.pdf (accessed 04/12/2012).

[455] Fourie ea 1996: 75-76.

[456] Ibid.The subsection provides as follows:(a) the Minister may, on the recommendation of the Registrar and after consultation with the Governor of the Reserve Bank, by regulation amend the definitions of "deposit", and "business of a bank" for the purpose of the application of any or all the provisions of this Act. Any regulation made under paragraph (a) shall be of force and effect unless and until, during the session in which the relevant list has been laid upon the table in parliament in accordance with the provisions of section 17 of the Interpretation Act, 1957, every House of parliament has by resolution disapproved of the regulation, in which event the regulation shall lapse as from a date to be specified in the resolution, but such lapsing of the regulation shall not affect the validity of anything done under such regulation before the date specified in the resolution, and nothing contained in this paragraph shall affect the power of the Minister to make a new regulation as to the subject matter of the regulation which has lapsed.

[457] A contravention of this provision is an offence.

[458] Morphet and Nkosi 1999: 145.

the payment of interest on such amount mutatis mutandis as contemplated in paragraph (b) is issued in respect of such amount.[459]

"The business of a bank" means:[460]

(a) the acceptance of deposits from the general public as a regular feature of the business in question;

(b) the soliciting of or advertising for deposits;

(c) the utilisation of the money or of the interest or other income earned on money, acceptedby way of deposit as contemplated in paragraph (a)-(i) for the granting by any person, acting as lender in his own name or through the medium of a trust or a nominee, of loans to other persons:

(i)for investment by any person, acting as investor in his own name or through the medium of a trust or a nominee; or

(ii)for the financing, wholly or to any material extent, by a person of any other business activity conducted by him in his own name or through the medium of a trust or a nominee;

(iii) the obtaining, as a regular feature of the business in question, of money through the sale of an asset, to any person other than a bank, subject to an agreement in terms of which the sellerundertakes to purchase from the buyer at a future date the asset so sold or any other asset;

(e) any other activity which the Registrar has, after consultation with the Governor of the Reserve Bank, by notice in the Gazette declared to be the business of a bank.[461]

Every banking institution registered or provisionally registered under the Act must obtain a banker's license in respect of each and every year ending on 31 December, from the receiver of revenue of the district in which its head office is situated.[462] If the Registrar is

[459] See sec 1(1) Banks Act 1990.

[460] Ibid.

[461] The Banks Act 1990 <http://www2.resbank.co.za/internet/publication.nsf/.../BankstAct+1990.pdf>(accessed 04/12/2012). In Government Notice 17895 of 27 March 1997, after consultation with the Governor of the Reserve Bank, the Registrar declared certain activities regarding specific business practices to be the business of a bank. In terms of this notice, a business practice includes: any agreement or understanding, whether legally enforceable or not, between two or more persons; or any scheme, practice or method of trading, including any method of marketing or distribution.

[462] Ibid.Sec 4(2).

satisfied that: the business proposed to be carried on is that of a banking institution of the class in respect of which registration is desired; the memorandum and articles of association of the applicant are not inconsistent with the Act and are not undesirable for any reason; and that the applicant does not propose to adopt undesirable methods; he may, provided the applicant is an incorporated and registered public company or deemed to have been incorporated under the Companies Act, register the applicant provisionally as a banking institution of the relevant class, after the payment by the applicant of a registration fee.[463] A duty of forty rands in respect of each branch of such banking institution is paid for such license to the Receiver of Revenue concerned.[464] The duty is paid before the end of January of the year for which the license is required. However, the duty in respect of any new banking institution established, or of any new branch in which business is commenced after the beginning of any year must be paid within one month after the date on which business is so commenced.[465]

2.5.3 Opening up of the South African Banking Sector to Foreign banks by the 1990 Banks Act

Banking in South Africa is regulated in terms of the Banks Act No 94 of 1990.[466] The Act is administered through the Office for Banks, which is part of the South African Reserve Bank.[467]The business of a bank is defined in section 1 of the Banks Act as,[468] the acceptance

[463] The Banks Act 1990 <http://www2.resbank.co.za/internet/publication.nsf/.../BankstAct+1990.pdf>(accessed 04/12/2012):Sec 4(4).

[464] However, the duty in respect of any new banking institution established, or of any new branch in which business is commenced on or after the first day of July in the year for which the license is required, is twenty rands, section 47 A (2) Banks Act 1990.

[465] The Banks Act 1990 http://www2.resbank.co.za/internet/publication.nsf/.../BankstAct+1990.pdf (accessed 04/12/2012). Sec 47 A(3).

[466] Fourie ea 1996:75-76.

[467] Morphet and Nkosi 1999: 145. The Head of that Office is the Registrar of Banks, who is appointed by the Reserve Bank. The Registrar has wide powers conferred upon him by the Bank Act. Banks wishing to conduct business in South Africa must be authorised to do so by the Registrar, and must comply with certain reporting requirements. For example, a bank's auditor must be approved by the Registrar, and copies of its financial statements must be sent to the Registrar. The Registrar also has wide powers to inspect or investigate the operations of banks, and furnishes banks with guidelines regarding the application and interpretation of the provisions of the Banks Act from time to time by way of a circular.

[468] The Banks Act 1990 http://www2.resbank.co.za/internet/pubication.nsf/.../BankstAct+1990.pdf (accessed 04/12/2012).

of deposits from the general public as a regular feature of the business in question, the soliciting or advertising for deposits, and any other activity which the Registrar has, after consultation with the Governor of the Reserve Bank, by notice in the Gazette declared to be the business of a bank. Before any entity or person can conduct the business of a bank in South Africa, such person or entity must first apply to the Registrar of banks.[469] Only persons who are public companies may apply for a banking license.[470]

2.5.3.1 Prudential Requirements

The prudential requirements banks must adhere to, follow very closely the guidelines set by the Basel Committee on banking supervision, and they can be reviewed under the following headings:[471]capital adequacy, liquid assets and large exposure.[472] The South African banking regulators have implemented the Basel Committee proposals to ensure that South African banks continue to comply with international standards.[473]

2.5.3.1.1 Capital Adequacy

Section 70(2) requires a bank to manage its affairs in such a way that the sum of its issued primary and secondary share capital and its primary and secondary unimpaired reserve funds in South Africa does not amount to less than R50 000 000(for institutions existing at the time of commencement of the act) or an amount which represents a prescribed percentage of the sum of amounts calculated by multiplying the average of the amounts of such different categories of assets and other risk exposure in the conduct of its business, as may be prescribed by the risk weights, expressed as percentages, for the different

[469] The Banks Act 1990 http://www2.resbank.co.za/internet/pubication.nsf/.../BankstAct+1990.pdf (accessed 04/12/2012): sec 12.

[470] Ibid. Sec 11 of the Banks Act. The Registrar considers the application and shall not grant the application unless he is satisfied: that the establishment of the proposed bank will be in the public interest; that the business the applicant proposes to conduct is that of a bank; that every person who is to be director or an executive officer of the proposed bank is, as far as can reasonably be ascertained, a fit and proper person to hold the office of such director or executive officer; that every person who is to be an executive officer of the proposed bank has sufficient experience of the management of the kind of business it is intended to conduct; and that the composition of the board of directors of the proposed bank will be appropriate having regard to the nature and scale of the business it is intended to conduct.

[471] See sec 70 (1) of the Banks Act.

[472] Jones and Schoeman 2006: 16-17.

[473] The Banking Council South Africa 1999:10.

categories of assets and risk exposures.[474] South Africa is in line with the Basel Committee in setting a solvency ratio of capital assets of 8 per cent. Following the Basel Accord the Banks Act applies a two-tier system of capital. The top tier is the bank's primary share capital, which is the capital obtained through the issue of ordinary shares or non-redeemable non-cumulative preference shares.[475] Its second tier is supplementary or secondary capital which consists of the percentage of capital obtained through the issues of subordinate cumulative preference shares, ordinary or non-cumulative preference shares issued in pursuance of the capitalisation of reserves as a result of a revaluation of asset surpluses to the extent of a prescribed percentage of 15 per cent and certain undisclosed reserves and certain categories of debt instruments like debentures.[476] The valuation of assets ranking as secondary capital must be made by an independent valuer at intervals of not more than once every financial year, in accordance with the accounting policies of the bank concerned and generally accepted accounting practice. The amount of secondary capital taken into account may not make up more than half of a bank's total qualifying capital. The following must be deducted from the total of primary and secondary capital:[477]

(a) the value of assets pledged;

(b) the book value of a bank's investment in another bank; and

(c) the permanent funding of the capital requirements of a foreign branch of the bank.

The sum of the primary and secondary share capital and primary and secondary unimpaired reserve is calculated by deducting from the total thereof certain amounts, the most important of which are the depreciation of assets and bad doubtful debts, operating and accumulated losses, established and other costs, assets pledged or encumbered, shares or

[474] See sec 70(2) of the Banks Act.

[475] See sec 70 (1) of the Banks Act.

[476] The Banks Act 1990 http://www2.resbank.co.za/internet/publication.nsf/.../BankstAct1990.pdf (accessed 04/12/2012).

[477] The Banks Act 1990 http://www2.resbank.co.za/internet/publication.nsf/.../BankstAct1990.pdf (accessed 04/12/2012).Primary and secondary unimpaired reserve funds are separately defined under s 70(1) and (4) as amended by s 45 of Act 26 of 1994.

debt instruments issued by another bank and the amount made available by the bank for the permanent funding of its foreign branches.[478]

Section 72 of the Banks Act requires that a bank hold certain of its assets in liquid form in South Africa.[479] Liquid assets include cash, treasury bills and government stock. Minimum reserve requirements are set out in Section 10A of the South African Reserve Bank Act No 90 of 1989, as well as in the Regulation relating to the Act. A bank must keep an amount equal to a certain percentage of its short term liabilities in an interest free account with the Reserve Bank.

Whereas the capital requirements of a bank, which act as a cushion to absorb losses, should the risks to which banks are exposed materialise, are measured against a bank's assets in the form of its credit granting commitments, the minimum reserve balance and liquid assets requirements do not guard against the solvency risk but against the liquidity risk facing a bank.A bank is therefore required to hold minimum reserve balances with the Reserve Bank as well as minimum liquid assets. [480]

2.5.3.1.2 Large Exposures

The Banks Act in introducing measures to supervise risk exposures takes the view that exposures to a customer should not normally exceed 10 per cent of a bank's capital base: if they do, they should be thoroughly examined and provision is made for the approval either by the board of directors or of a committee of which one director who is not an employee of the bank or a subsidiary or the holding company is a member.[481] Exposures in excess of 25 per cent of a bank's capital base should be reported to the supervising authority.[482]

[478] See sec 70(5) Banks Act.

[479] See sec 72 of the Banks Act.

[480] See sec 72 of the Banks Act.

[481] See sec 73(1) of the Banks Act.

[482] See sec 73 (2) of the Banks Act.

2.5.4 Foreign Banks doing business in South Africa

There are three ways in which a foreign bank may enter the South African banking Market.[483] The first and most obvious is to register as a bank in terms of the Banks Act, 1990.[484] This means that the bank would have to comply in all respects with the legal provisions including prudential requirements applicable to banks registered in South Africa.[485] An international financial institution conducting banking business can also, apply to the Registrar of banks to establish a representative office in South Africa.[486] A representative office is not a bank and may not conduct the business of a bank as defined in section 1 of the Banks Act in South Africa. The business of a bank has a technical meaning and consists essentially in the acceptance of deposits from the general public; the soliciting and advertising for deposits; the utilisation of the deposits for the granting of loans, the making of investments or the financing of any business. The definition of deposit is equally wide and generally amounts to the receipt of money subject to an agreement to repay it. It therefore cannot for example accept deposits from the general public, and all operations must be funded from abroad. Before granting the application, which may be granted either unconditionally or subject to such conditions as he may determine, the Registrar must be satisfied that:[487]

(i) the applicant lawfully conducts a business similar to the business of a bank in a country other than South Africa;

(ii) the regulatory authority in the country where the applicant operates complies with certain requirements; and

(iii) the establishment of a representative office in South Africa will not be detrimental to the public interest.[488]

The third and perhaps most acceptable vehicle of entry into South Africa's financial market is the establishment of a branch of the foreign bank in South Africa.[489] It is here that the

[483] Sec 34 of the Banks Act.

[484] Sec 34 of the Banks Act.

[485] Malan 1996: 8.

[486] See the Banks Act sec 34(4).

[487] Morphet and Nkosi 1999: 145-149.

[488] See sec 34 of the Banks Act.

influence of Basel is most pronounced: approval for the establishment of a branch will be given if the foreign institution, which must have been lawfully established elsewhere to engage in business similar to the business of a bank, confirms its understanding and acceptance of, and adherence to, the minimum standards in respect of consolidated supervision of banking groups and their cross-border establishment set by the Basel Committee.[490] In addition, the Registrar will have to be satisfied that the home country supervisory authority of the foreign institution accepts, is committed to and complies with the proposals, guidelines and pronouncements of the Basel Committee on Banking Supervision.[491] Moreover, the branch and the foreign institution will have to enable the home country and host country supervisory authorities to adhere at all times to the minimum standards of consolidated supervision of banking groups and their cross-border establishments set by the Basel Committee.[492] In addition, the home country supervising authority must be satisfied that proper risk management standards are maintained by the foreign institution and must inform the supervisory authorities in the Republic of material information regarding the financial soundness of the foreign bank and branch.[493]

Strict prudential requirements are set for the establishment of a branch in the Republic.[494] The bank must, among other requirements, have held net assets, as certified by its auditors and reflected in its audited financial statements, for a period of eighteen months prior to the application, amounting to US 1 billion dollars. It must also have been given an acceptable long-term investment grade debt rating by an internationally recognised rating agency. Then the endowment capital of the branch must be maintained at an amount no less than R 50 million or 8 per cent of the amount of the assets and other risk exposures of the branch, calculated in the same way as in the case of banks registered under the Banks Act, 1990. The prudential requirements the branch must comply with are, in fact, the same

[489] See sec 34 of the Banks Act.

[490] Rutova and Vokheimer 2010:84-93.

[491] Malan 1996:8-9.

[492] Ibid.

[493] Ibid.

[494] See sec 18 of the Banks Act.

as those pertaining to a fully-fledged South African bank.[495] A fit and proper test is set for the management of the branch and an executive officer has to comply with the same requirements as those set for directors and executive officers of locally registered banks.[496] Every person who is to be an executive officer of the proposed bank must have sufficient experience of the management of the kind of business it is intended to conduct; and the composition of the board of directors of the proposed branch must be appropriate having regard to the nature and scale of the business it is intended to conduct.[497] Although there is some restriction on the business activity of a branch in that it may accept unlimited deposits from legal entities but deposits in an initial amount of R 1 million only from natural persons, the intention of the legislature was clearly to treat every branch as if it were a bank and to subject it to the same regulatory and supervisory regime as the one applicable to banks.[498]

A foreign bank may therefore establish a branch in South Africa,[499] but before operating as a branch, the foreign bank must obtain the prior written authorisation of the Registrar, and may operate subject to prescribed conditions and to any further conditions which the Registrar may determine.Whichever route it followed, it should be noted that the license or authorisation must be renewed annually against payment of the prescribed fees.[500]

[495] See sec 72 Banks Act.

[496] See sec 1(1A) Banks Act.

[497] Jones and Schoeman 2006:15.

[498] See secs 1(1A) 18A, 70(2) and 72 Banks Act.

[499] The Banks Act 1990 http://www2.resbank.co.za/internet/publication.nsf/.../BankstAct1990.pdf (accessed 04/12/2012). Sec 18 A of the Banks Act (1).An institution which has been established in a country other than the Republic and which lawfully conducts in such other country a business similar to the business of a bank (herein in this section referred to as the foreign institution) may, notwithstanding the provisions of section 11(1), with the prior written authorisation of the Registrar and subject to the prescribed conditions and to such further conditions, if any, as the Registrar may determine, conduct the business of a bank by means of a branch in the Republic. (2)To obtain the authorisation of the Registrar as contemplated in subsection (1), the foreign institution concerned shall in the manner and on the form prescribed in the Regulations relating to branches lodge with the Registrar a written application which shall be accompanied by- a written statement containing the prescribed information; and the prescribed fee. (3)The Registrar may require the foreign institution applying in terms of subsection (2) to furnish him or her with- such information or documents, in addition to information and documents furnished by the foreign institution in terms of subsection (2); or such further information with regard to the nature and extent of supervision exercised or to be exercised by the responsible supervisory authority of the foreign institution's country of domicile in respect of- the proposed branch in the Republic; the foreign institution itself; or any group of institutions of which the foreign institution may form a part.

[500] Sec 35 of the Banks Act.

Following the Basel guidelines for the supervision of international banking groups,[501] the Registrar is empowered to request information concerning the foreign operations of South African banks, whether through subsidiaries, branches, agencies or other undertakings so as to supervise their world-wide activities.[502] This is in line with the approach of the Banks Act which makes possible the supervision of a group of banks by means of consolidated returns reflecting the financial information of all banks in the group as well as their subsidiaries and controlling companies, other undertakings and controlled trusts.[503] The Bank Supervision Department of the Reserve Bank is committed to consolidated cross-border supervision in accordance with the Basel standards.[504]

The South African banking industry is currently made up of localbranches of foreign banks, and foreign banks with approved local representative offices.The banks are listed in table 4below.[505]

Foreign Controlled	Local Branches of foreign banks
Albaraka Bank Limited; Habib Overseas Bank Limited; HBZ Bank Limited; Mercantile Bank Limited; The South African Bank of Athens Limited; Mutual banks and VBS Mutual bank.	Bank of Baroda; Bank Of China Limited Johannesburg Branch (trading as Bank Of China Johannesburg Branch); Bank of Taiwan South Africa Branch; Calyon (trading as Calyon Corporate and Investment Bank); China Construction Bank Corporation – Johannesburg Branch; Citibank N.A.; Deutsche Bank AG; JPMorgan Chase Bank N.A. (Johannesburg Branch); Royal Bank of Scotland (Formerly ABN Amro); Société Générale; Standard Chartered Bank – Johannesburg Branch; State Bank of India; The Hongkong and Shanghai Banking corporation.Foreign banks with approved local representative offices Asia Bank Limited; Banco BPI, SA;

[501] See Basel Committee on Banking Supervision Minimum standards for the Supervision of International Banking Groups and their Cross-border Establishment. Available at http://www.bis.org (accessed 04/12/2012).

[502] The Banks, Act http://www2.resbank.co.za/internet/publication.nsf/.../BankstAct1990.pdf (accessed 04/12/2012).sec 75(4)(a).

[503] See sec 75(4) (b) of the Banks Act.

[504] Ibid.

[505] The Banking Association of South Africa, South African Banking Sector overview.http://www.gbd.org/downloads/South%20Africa/SARBA.pdf (accessed 04/12/2012):1-2.

	Banco Espirito Santoe Comercial de Lisboa; Banco PrivadoPortuguês, S.A.; Banco Santander Totta S.A.; Bank Leumi Le-Israel BM; Bank of Cyprus Group; Bank of India; Barclays Bank Plc; Barclays InternationalLimited; BNP Paribas Johannesburg; Commerzbank AG Johannesburg; Credit Suisse AG;Credit Suisse Securities (Europe) Limited; Ecobank; Export-Import Bank of India; FairbairnPrivate Bank (Isle of Man) Limited; Fairbairn Private Bank (Jersey) Limited; First Bank of Nigeria; Fortis Bank (Nederland) N.V.; Hellenic Bank Public Company Limited; HSBC Bank International Limited; Icici Bank Limited; KfWIpex-Bank GmbH; Lloyds TSB Offshore Limited; Millenium BCP; National Bank of Egypt; NATIXIS Southern Africa Representative Office; Royal Bank of Scotland International Limited; Société Générale Representative Office for Southern Africa; Sumitomo Mitsui Banking Corporation; The Bank of New YorkNational Association; Zenith Bank; The Bank of Tokyo-Mitsubishi UFJ, Ltd; The Mauritius Commercial Bank Limited;The Representstive office for Southern and Eastern Africa of The Export-Import Bank of China; UBSAG; Unicredit Bank AG; Union Bank of Nigeria Plc; Vnesheconom bank; Wachovia Bank,N.A.; Wells Fargo Bank.

2.5.5 Conclusion

The 1990s has been a period of liberalisation and deregulation of the South African Banking markets which has led to the virtual disappearance of the traditional institutions and the blurring of boundaries between others. Building societies have been absorbed by the major banks and the few that remained have been converted into mutual banks. The different classes of banks such as merchant banks, commercial banks and discount houses disappeared with one decisive legislative measure with the passing of the Banks Act 94 of 1990 all deposit taking banks were subjected to the same regulatory regime which did away with artificial institutional boundaries and addressed the function of deposit-taking regardless of the institution involved. Most of the changes were caused by fundamental movements in the financial markets but also the independence of the central bank.

Theamendments of banking laws echo adjustments elsewhere and inspiration for the new legislation often came from Rome or Basel. The Banks Act of 1990 is evidence of the profound influence of the Basel guidelines and pronouncements. The transmission or the reception of the Basel standards for prudential supervision into South African legislation has been practically immediate and often direct and accompanied by explicit references to the Basel Principles. The soft law of Basel has indeed become positive law through the adoption of its principles in the Banks Act, 1990.[506] Foreign banks have become very active in the South African commercial, corporate and private banking sectors since the country's democratic election in 1994.Foreign banks are estimated to hold 4.3 per cent or R 31 bn(or 4.7 per cent) of the total assets of all banks doing business in South Africa. New laws and regulations make it easier for foreign banks to compete in the South African banking industry. [507]

[506] Malan 1996:39.

[507] The Banking Council 1999:15-16.

CHAPTER 3

THE CREATION OF A NEW INTERNATIONAL NORM -THE WORLD TRADE ORGANISATION'S GENERAL AGREEMENT ON TRADE IN BANKING SERVICES

3.1 Introduction

The process of bringing banking services within the realm of international trade negotiations has been long and complicated.[508] The term international trade has historically been confined to goods.[509] Trade in banking services must be supplied in proximity to the person receiving the services. However, in some cases, information and communication technology has blurred the notion of proximity.[510] Trade negotiations from the 1980s to the Uruguay Round included extensive discussions over whether there should be an international agreement concerning banking services trade and, if there was to be such an agreement, whether it should be part of GATT. [511]

The internationalisation of banking services has grown dramatically during the last three decades.[512] Since the 1960s the international scene has been characterised by an overall liberalisation of trade in banking services, brought about by changes in government regulation of the banking sector in the industrialised countries.[513] At the end of 1980, it was however recognised that mere guidance was not sufficient any longer and that a new international norm was needed. Because of the global character of these developments, mere national regulation would have been insufficient, hence the adoption of a new

[508] Jarreau 1999:9-10. Interpreting the General Agreement on trade in Services and the WTO Instruments relevant to the International Trade of Financial Services: the Lawyer's perspective.Avaliable at (http://heinonline.org) (accessed 2011/12/06).

[509] Ibid.

[510] Morrison 2001: 594-595.

[511] Ibid.

[512] Footer 1993:345.

[513] Ibid. The move towards more open, market-oriented systems has been achieved by the progressive disbandment of interest rate controls, the restoration of currency convertibility that followed the breakdown of the Bretton Woods system of fixed exchange rate in the early 1970s, and the liberalisation of capital flows in the second half of the 1980s. This move was largely forced upon the regulated sector by increased competition from the free sector in domestic markets as well as by services provided through a number of offshore banking centers.

international norm, the WTO General Agreement on Trade in Banking Services.[514]The preparation for the new international norm started in the General Agreement on Trade in Services (GATS).[515] The 1997 Financial Services Agreement was a key moment in the history of international banking integration. In the context of a legally binding international agreement, a substantial number of WTO members committed themselves to eliminate or reduce discriminatory barriers to trade in banking services. Trade in banking services[516] has become an integral part of the Multilateral Trading System, pursuant to the approval of the Uruguay Round Results of 1994 which included the General Agreement on Trade in Services (GATS).[517] Regarding trade in banking services, the institutional framework and national commitments established under the GATS, in general, and the 1997 Financial Services Agreement in particular,[518] largely defined the current field of play.[519] To understand the methodology and normative impact of this framework, there are no less than seven legal instruments to consider.[520] One of the interesting features of the GATS is that, it is only the

[514] Sauve 1994:125-127.

[515] International Legal Material 1994:1141-1181.

[516] Throughout this thesis, trade in banking services is used as defined in the GATS, which include: in providing the service, the financial institution remains outside the territory of the consumer, and the consumer remain inside his territory of residence (cross-border services); in providing the service, the financial institution remains outside the territory of the consumer, and the consumer moves outside the territory of his residence (consumption abroad); in providing the service, the financial institution establishes a commercial presence in the territory of the consumer (commercial presence) and by the presence of a natural person in the territory of any other member (presence of natural person).

[517] International legal Material 1994: 1141-1181.

[518] Stijn and Marion 2000:10.

[519] Sydney 2005:957-958.

[520] Bismuth 2010:493-494. The GATS, which is a general framework agreement governing the liberalisation of the entire services sector, including banking services; the GATS Annex on Article II Exemptions that determines the circumstances under which nations may depart from the overarching MFN principle; the GATS Annex on Financial Services that contains important provisions regarding trade in banking services and often exempts banking services from the general provisions of the GATS ; the Understanding on Commitments in Financial Services entered into by financially developed countries to undertake liberalisation commitments that in many important respects exceed the degree of liberalisation achieved under the 1997 Financial Services Agreement; the schedules of specific commitments and lists of Article II Exemptions that contain the specific commitments undertaken by individual countries in different sectors, mode of supply, and specific types of services; the Second Protocol to the GATS, so-called Financial Services Agreement that incorporates the commitments currently in force in the field of banking.

third trade agreement to address the issue of trade in banking services.[521] The first of these agreements was the Free Trade Agreement between Canada and the United States of America (FTA) of 1989.[522] The second agreement is the best-known North American Free Trade Agreement between the Government of Canada, the Government of the United Mexican States and the Government of the United States of America (NAFTA), of 1994.[523] It contains a comprehensive set of trade-liberalising rules and disciplines with respect to the banking services sector.[524] Some specific commitments to provide market access andnational treatment were made in this sector.[525] The NAFTA agreement is contained in the 1994 Agreement Establishing the World Trade Organisation.[526]

3.1.1 Background information to Trade in Banking Services

The banking services sector has figured prominently in WTO negotiations.[527] This reflects the central role it plays in the facilitation of world trade and its contribution to growth and investment in developed and developing countries.[528] Trade in banking services entered the international trade arena during the GATT multilateral trade negotiations of the Tokyo Round (1973-1979).[529] Initially, progress was limited to conducting research in the arena and

[521] Leroux 2002:413-436.

[522] Ibid.The FTA contained a specific chapter, Chapter 17, dealing with banking services. That chapter was quite limited in that it essentially consisted of an exchange of specific market access concessions between Canada and the United States and did not provide for a binding dispute settlement mechanism. These were only cautious initial steps on the matter of trade in banking services.

[523] Ibid.

[524] Ibid.

[525] Cranston 1997:435.

[526] Footer 1995:477-478. GATS constitute part of the Marrakesh Agreement which is binding on all members. GATS encompasses all services, excluding services supplied in the exercise of government authority. See GATS art. 1:3(3).

[527] Morrison 1998:54.

[528] Ibid.

[529] Jarreau 1999:12.Interpreting the General Agreement on Trade in Services and the WTO Instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. Available at (http://heinonline.org) (accessed 2011/12/06).

developing an international consensus on services.[530] Negotiating parties set the following objectives:[531]

> "to establish a multilateral framework of principles and rules for trade in services, including the elaboration of possible disciplines in individual sectors, with a view to expansion of such trade under conditions of transparency and progressive liberalisation and as a means of promoting economic growth of all trading partners and the development of developing countries. Such framework shall respect the policy objectives of national laws and regulations applying to services and shall take into account the work of relevant international organisation."

At the end of the Uruguay Round negotiations in 1993, negotiations on banking services remained largely unfinished.[532] One reason is the absence of a theory on trade in banking services and in particular the failure to reach agreement on the concept and definition of trade in services, prior to the commencement of the GATT Uruguay Round in 1986.[533] The following analysis of the negotiating history highlights some of the obvious failures that have arisen and the various reactions that have been voiced.

The inclusion of banking services in a multilateral trade agreement such as the General Agreement on Trade in services (GATS) was a major milestone.[534] Because of the special characteristics and sensitivity of the banking sector- in particular the role of banks in monetary and payment systems and the phenomenon of systematic risk, finance officials in the United States and other countries were concerned about allowing banking sector issues

[530] Footer 1993:347-348.

[531] Ibid.

[532] World Trade Organisation, Financial Services: The results of the financial services negotiations under the General Agreement on Trade in Services (GATS) <http://www.wto.org/english/tratop_e/serv_e/finance_e?finance_fiback_e.htm (accessed 01/ 10/2010):1-5.

[533] Footer 1993:346-347.

[534] Ibid. Banking includes deposit-taking and lending activities, payments, trading in monetary instruments, foreign exchange dealing, and so on. It also includes asset management, settlement and clearance services, provision and transfers of financial information, and advisory services.

to fall within the domain of the multilateral trading system.[535] The liberalisation of the banking sector has caused controversy as a result of the strength of banking institutions of advanced economies.[536] For example, banks taking advantage of a domestic market relatively closed and limited in competition may oppose liberalisation, while the possibility of cheaper capital may gain wider industry consensus in this respect. Secondly, banking services negotiations were hampered by members' prudential and regulatory concerns.[537] Members differ in their approach to the structure of the banking system, which will affect their outlook on the regulatory structure. This is because some countries will have a universal banking model, while others will segregate commercial and investment banking. Some members will have government-run banks while others will have none. Lastly, the importance of banking regulation had become a major issue in reaction to the increased number of banking crises in the major industrialised countries. By the 1980s, there had been several more banking crises and a major sovereign debt crisis involving Latin American countries that highlighted the fragility of the international banking system.[538] The absence of the original Bretton Woods rules to regulate reserve currency values and related controls of cross-border capital flows exposed the international banking system to increased systematic risk that undermined banking stability which was a key element of the international framework that gave birth to the GATT.[539] Each of these characteristics will affect how regulation is carried out. [540]

The Uruguay Round negotiating process for banking services arrangements were therefore worked out in a number of countries between trade and finance officials so that,[541] although

[535] Morrison 2001:595.

[536] Yokoi-Arai 2008:622.

[537] Ibid.

[538] Jarreau 1999:14.Interpreting the General Agreement on Trade in Services and the WTO Instrutments relevant to The International Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06)

[539] Kern 2003, The WTO and Financial Stability, The balance between liberalisation and Regulation in the GATS, http// WWW.afap.jbs.cam.ac.uk/./wp o5(accessed 21/04/2010):1.

[540] Ibid.

[541] Footer 1993: 347.The ministers were representatives of their respective governments, rather than of GATT contracting parties.

trade officials retained overall responsibility,[542] finance officials played a major role as negotiators.[543]Indeed, the Uruguay Round banking services negotiations[544] proved to be very difficult. These certainly included time pressure at the end of a lengthy and onerous negotiations process which had already been delayed well beyond its initial schedule. Progress in the banking services sector suffered not from strong opposition from developing countries against the envisaged extension of the multilateral system, but also from the novelty and technical complexity of the issues to be tackled.[545] As the round drew to a close in 1993, the hope for commitments to market opening had still not materialised. Although obtaining strong commitments to national treatment and market access for foreign direct investment in the banking sector had been a major focus of the negotiations, significant host country limitations remained. One of the most important of these involved the refusal of some emerging market economies to allow foreign banks to hold majority-ownership positions in domesticbanks or, where majority-owned was allowed to lift restrictions limiting the foreign ownership positions to less than 100 per cent.[546]

In the first set of post-Uruguay Round negotiations which took place during the first half of 1995, a number of WTO members improved their financial services commitments and /or narrowed or withdrew MFN exemptions for banking services.[547] Just before the deadline, the United States announced that the market opening concessions being offered by some

[542] Jarreau 1999:20.Interpreting the General Agreement on Trade in Services and the WTO Instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed) 2011/12/06).

[543] Footer 1993: 314-347. For example, for the United States, although the Office of the United States Trade Representative had overall responsibility for the Uruguay Round negotiations, the department of Treasury handled the negotiations for banking. For the EU, although the directorate general responsible for trade policy had overall responsibility for the Uruguay Round negotiations, the directorate general responsible for financial services handled the banking services agreement.

[544] Like those for other major service sectors such as basic telecommunications, maritime transport, and audiovisual services.

[545] Adlung and Roy 2005:4.

[546] For example, Canada.

[547] Wang 1996:93.

WTO members was still inadequate.[548] The United States therefore made binding commitments only for existing operations of foreign banking firms and took a broad MFN exemption with regard to new entry and operations of banking services. To avoid losing what had been accomplished up to that point, the EU then took the lead in trying to preserve the commitments that had already been offered in the 1994 negotiations by other WTO members. The result was the so-called interim agreement on banking services,[549] under which other countries agreed to maintain their existing offers on an MFN basis through the end of 1997 despite the minimal commitments and broad MFN exemption that had been taken by the United States.[550]

[548] Jarreau 1999:28.Interpreting the General Agreement on Trade in Services and the WTO Instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed) 2011/12/06).

[549] Morrison 1998:54. As the 1997 negotiations approached, a translantic initiative was lunched by Andrew Buxton (the chairman of Baclays Bank, UK) and Kenneth Whipple (president of Ford Financial Services, US) for a stronger private sector input, leading to a better result. They formed the financial leaders group of firms. This group provided common advice from the private sector to government negotiators (from the EU; US; Canada and Switzerland) on detailed objectives and on the value of offers as they come in.

[550] International Legal Material 1996: 35. According to the agreement, "members of the World Trade Organisation (hereinafter referred to as the "WTO") who's Schedules of Specific Commitments and lists of Exemptions from art. II of the Generall Agreement on Trade in Services concerning financial services are annexed to this protocol (hereinafter referred to as "Members concerned").

Having carried out negotiations under the terms of the Ministerial Decision on Finanacial Services at Marrakesh on 15 April 1994,

Having regard to the Second Protocol on Financial Services, and to the Decision on the application of the Annex adopted by the Council for Trade in Services on 30 June 1995,

Agree as follows:

1. A Schedule of Specific Commitments and list of Exemption from Article II concerning financial services annexed to this Protocol relating to a Member shall, upon the entry into force of this protocol for that Member, replace the financial services section of that Member.
2. This Protocol shall be open for acceptance, by signature or otherwise by the Members concerned until 30 June 1996.
3. This Protocol shall enter into force on the 30th day following the date of its acceptance by all Members concerned, those Members which accepted it before that date may, within a period of 30 days thereafter, decide on its entry into force.

This Protocol shall be deposited with the Director-General of the WTO. The Director-General of the WTO shall promptly furnish to each Member of the WTO a certified copy of this Protocol and notification of acceptance thereof pursuant to paragraph 3.

This Protocol shall be registered in accordance with the provisions of Article 102 of the Charter of the United Nations."

Banking services negotiations resumed once again in 1997, with an agreed deadline of mid-December.[551] The goal was to achieve a permanent agreement that included strengthened commitments from emerging market economies and a MFN-based commitment from the United States. The result of the 1997 banking services negotiations- that is, schedules of commitments and lists of MFN exemptions- were incorporated into the GATS by the Fifth Protocol to the GATS, which entered into force in 1999.[552] The agreement applies on a full MFN basis,[553] with few exceptions. It captures not only the new offers made in 1997, but the important commitments made, especially by developing countries, in the previous rounds in 1993 and 1995.[554] It brings banking services under international discipline for the first time and adds an essential missing piece to the GATS.[555] This agreement essentially completed the work left over after the Uruguay Round, so that the WTO is now well placed to make further advances in opening markets in the banking sector.[556]

The most important clause in the Fifth Protocol to the GATSisparagraph 1, thus all members acceding to the 1997 financial services agreement annexed their schedules of specific commitments[557] and lists of MFN exemptions to the Fifth Protocol to the GATS, and consequently, these commitments and lists become part of the contents under the framework of the GATS.[558] The Fifth Protocol to the GATS provides for the annexation of the banking services commitments agreed upon in 1997 to the Uruguay Round services schedule of commitments and for any revised lists of MFN exemptions to replace the

Done at Geneva this-day of (month) one thousand nine hundred and ninety-five, in a single copy in English, French and Spanish languages.

[551] Morrison 1998:54-55.

[552] Ibid.

[553] Ibid.

[554] Ibid. These would have been lost had the negotiations failed.

[555] Ibid.

[556] Ibid.This reflects the widespread recognition of the merits of competition and open markets in banking services.

[557] Specfic commitments available at <http://www.wto.org/wto/services/22.specm.htm>

[558] General Agreement on Trade in Services, Fifth Protocol available at .<http://www.wto.org/wto/services/S145.htm>

previous list of MFN exemptions for banking services. Seventy-one WTO members made improvement in a few cases,[559] first time banking services commitments, although the strength and scope of these commitments vary considerably. Most of the WTO members participating in the 1997 Agreement "bound" the levels of liberalisation for establishment of a commercial presence that existed as the negotiations entered their final phase in 1997. As a result of the negotiations, India, Thailand, and the United States decided to withdraw their broad MFN exemption based on reciprocity.[560] The legal significance of the Fifth Protocol is that it improved commitments regarding market access and national treatment, and reduced the scope of MFN exemptions.[561]

3.2 Interpreting the Agreement on Trade in Banking Services

The extremely complex nature of the banking services industry is typified by the diversity of services and products offered by the multiplicity of submarkets.[562] Different banking systems, and variations in the way banking products and services are provided, regulated, and supervised emerges as an important factor when negotiating trade in services generally and banking services specifically.[563] The problem therefore arises of how to define the supply of banking services. Should it be restricted to strict cross-border transactions between residents of one country and non-residents of another, irrespective of where the transaction takes place? Alternatively, should there be a broader definition whereby services are provided by foreign-owned branches, subsidiaries, and affiliates of foreign-owned enterprise, with a degree of permanent commercial presence within the importing country? The debate appears to have been settled in favour of a broader definition since the Annex on Financial Services to the GATS specifically states that the supply of banking

[559] Dilip 1998:79-81.Counting the EU as one.

[560] Hoekman..ea 2002:266.

[561] Ibid.

[562] Jarreau 1999:9.Interpreting the General Agreement on Trade in Services and the WTO Instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06).

[563] Footer 1993:353.

services under the Annex shall mean the supply of services, as defined in article 1:2 of the framework agreement, which applies to all types of services:[564]

(a) from the territory of one member into the territory of any other member;

(b) in the territory of one member to the service consumer of any other member;

(c) through the presence of service supplying entities of one member in the territory of any other member;

(d) by natural persons of one member in the territory of any other member.[565]

The GATS recognises that the effective supply of a banking service may require either that the services supplier be in a different jurisdiction from the banking services customer or on the contrary that both are located in the same jurisdiction. The GATS therefore defines trade in banking services expansively, resorting to thefour modes of supply.[566]

The Annex to GATS on banking services creates some special rules for this sector, which acknowledges the critical role played by the banking sector in fiscal accountability and economic stability.[567] The functions of a central bank or monetary authority are exempted, whether they are supplied by government or byprivate entities acting for the government.[568] Specific "services supplied in the exercise of governmental authority" are also exempted, namely, activities related to monetary or exchange rate policies and activities of public entities using the financial resources of the government.[569] These exclusions from the scope of banking services and banking service suppliers reflect the great sensitivity that GATS negotiators had with respect to governments' need to maintain

[564] Dilip 1998:79-80.

[565] Footer 1993:353. While international trade in banking services usually takes place by means of either cross-border trade or establishment-based activities, it often combines elements of both. Two main areas of activities are cross–border transactions and banking trade involving the establishment of a commercial presence-are examined separately under chapters four and five. This is because trade in banking services inevitably raises important and related issues of direct foreign investment, which have proved vital in negotiating services trade across the board.

[566] Morrison 2001:598.

[567] International Trade Center 1999:64.

[568] See GATS art.1(3) (c).

[569] International Trade Center 1999:64-65.

controlover key aspects of their banking services sectors.[570] Banking services is defined in the GATS Annex on Financial Services as:[571]

(i) acceptance of deposit and other repayable funds from the public;

(ii) lending of all types, including consumers' credit, mortgage credit, factoring and financing of commercial transactions;

(iii) all payments and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts;

(iv) guarantees and commitments;

(v) trading for own account or for account, whether on an exchange, in an over-the-counter market or otherwise, the following:

(a) money market instruments (including cheques, bills, certificates of deposit)

(b) foreign exchange;

(c) exchange rate and interest rate instruments, including products such as swaps, forward rate agreements;

(d) other negotiable instruments and financial assets, including bullion; and

(e) money broking.

The nature of trade in banking services can be seen in the four modes of supply of banking services in article 1:2 of the GATS.[572] Firstly, cross-border services (mode one):the bank is not present in the territory of the importing state but the service is delivered within the territory of the importing state.[573] The criterion for trade in mode one is the location of the bank outside the territory of the importing state and delivery is the main distinction between mode 1 and mode 2. Electronic banking across international boundaries would be an example of cross-border trade in banking services.[574] The second mode of supply under the GATS is consumption abroad (mode2): the bank is not present within the territory of the importing state and the service is delivered to the consumer outside the territory of the

[570] Morrison 2001:598. In spite of these exclusions, however, virtually all banking services which a government permits to take place in a comparative context are covered by the GATS.

[571] Sydney 2005:987-988.

[572] Yokoi-Arai 2008:621.

[573] See GATS art.1 (2) (d).

[574] Morrison 2001: 599.

consumer's residence.[575] The definition of mode 2 is consistent with the definition of mode 1, whereby the location of the delivery of the service and not the physical movement of the customer is the crucial criterion. An example of this mode is a person who travels abroad to open a bank account or complete some other banking transactions.[576] The third mode of supply is commercial presence (mode 3): the bank is commercially present within the territory of the importing state, and the service is delivered therein.[577] The notion of commercial presence covers a variety of investment vehicles, representative offices, branches, subsidiaries and entry via the purchase of an existing franchise.[578] Finally, the fourth mode of supply is temporary movement of persons (mode 4) the bank is commercially present within the territory of the importing state and the service is delivered within the territory of the state through nationals of the exporting state.[579] This mode of supply of banking services will cover any banking services, such as counselling, supplied by an individual person in the importing country.[580]This classification of trade in banking services matters, because members may choose to take different commitments under each mode of supply.[581]

3.3 Measures for the protection of Trade in Banking Services

Protectionism in banking services may be defined as the absence of equality of competition opportunities for foreign banksvis-a-vis domestic banks.[582] Under article 2 of the GATS Annex on Financial Services, a member:[583]

[575] See GATS art.1 (2) (b).

[576] Morrison 2001:599.

[577] See GATS art.1 (2) (c).

[578] Gkoutzinis 2005:894. Banks such as Citibank, JP Morgan Chase, and Deutsche Bank usually follow the first strategy, while ABN, AMRO, Commerzbank, and HSBC tend to purchase existing franchise.

[579] See GATS art.1 (2) (d). Mode 4 today accounts for less than 2 per cent of the total value of banking services.

[580] Morrison 2001: 599.

[581] Ibid.

[582] Gelb and Sagari 1990:52.

[583] Yokoi-Arai 2008:614.

> "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 provided that the regulatory measures apply similarly to domestic and overseas financial institutions, they are immune to the disciplines imposed by the GATS."

Although the prudential carve-out is wide in scope, it must be noted that the second sentence prevents its use where the otherwise inconsistent measure is being used as a means of avoiding commitments under the GATS.[584] As soon as this prudential carve-out was agreed, the financial regulators who were present in the negotiations and were previously agonising over the implications of the new framework on their regulatory discretion packed their stuff and went home.[585] The measures that fall within the ambit of this exception may not give rise to a violation of the GATS.[586] The scope of this exception, commonly referred to as the "prudential carve-out," is rather broad. Prudential reasons include the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial system.[587] The measure taken for prudential regulation shall not be used as a means of avoiding a member's specific commitment under the Agreement.[588]

[584] Morrison 2001:609. The prudential carve-out is therefore susceptible of effective control under the WTO dispute settlement provisions.

[585] Footer 1993:346-347.

[586] Ibid.

[587] Morrison 2001:53. Although this is not an exhaustive list of prudential reasons, it is highly indicative of the overall scope of the prudential carve-out. Rather, it is a concept that will evolve based in large part on the practice of States and their financial regulators and what is, at a particular point in time, considered to be prudential.

[588] Wolfrum ea 2008: 634-635. This is essentially an anti-avoidance provision, the purpose of which is to prevent the abuse of the exception for prudential measures. Although paragraph 2(a) has yet to be interpreted by a panel or the Appellate Body, it is clear that, at a minimum, it imposes on a member an obligation of good faith with respect to the adoption and application of prudential measures. The comments of the Appellate Body in US-Shrimp on the chapeau of art. XX of the GATT are instructive in this regard. The Appellate Body said in that case that the introductory clause of art. XX is but one expression of the principle of international law. Similar comments could be made in the context of the last sentence of paragraph 2(a) of the Annex.

The prudential carve-out is perhaps the most significant provision in the Annex on Financial services.[589] It allows a member to take measures for prudential reasons in the banking services sector. The prudential carve-out functions as a broad exception to the obligations under GATS, leaving domestic regulatory authorities a remarkable amount of autonomy to regulate the supply of banking services.[590] A member need not inscribe them in its schedule of commitments or its list of MFN exemptions, because prudential measures are not considered restricted on market access or national treatment in the usual sense. Both sorts of prudential reasons are, in international law, recognised exceptions for banking supervision. Institutions that set international standards and best practices are the Basel Committee on Banking Supervision.[591]

3.3.1 The Prudential Carve out

The most sensitive issue in the context of an agreement liberalising trade in banking services is the preservation of the ability of members and their national regulators to adopt and maintain measures for prudential reasons.[592]Indeed, the liberalisation of trade in this sector would prove unacceptable to any country where it will unduly restrict its ability to adopt and maintain laws and regulations for such purposes such as the protection of investors and depositors in its territory.[593] Prudential regulation is to safeguard the safety and soundness of individual financial institutions for the purpose of protecting consumers.[594]

While the main body of GATS requires that domestic regulation be fair and objective with qualitative, not quantitative, requirement, banking services can be exempted from such GATS provisions.[595] For such exceptions, the regulation must be for prudential reasons. Given the uniqueness of banking services, it was agreed that prudential consideration would

[589] Stijn and Morrison 2000:10.

[590] Footer 1995:479.

[591] Wolfrum ea 2008:634.

[592] Wang 2003:182.

[593] Footer 1995:379-380.

[594] Panourgias 2006:1-5.

[595] Yokoi-Arai 2008:623-624.

be allowed for banking regulation, and it was thus included in the Annex on Financial Services.[596] Section 2(a) of the Annex on Financial Services, in effect, allows members to apply regulatory measures that do not comply with their specific commitments.[597] Whether the measures are in fact prudential in nature or not, becomes irrelevant in the current legal structure. The WTO can use the dispute settlement mechanism to interpret the prudential requirement but there is no indication that this will take place. The paragraph permits, theoretically, members to take measures that are applied in the name of prudential concern.[598]

The Annex on Financial Services permits a departure from the MFN obligation for unilateral or mutual recognition of prudential measures.[599] This provision allows a country to recognise prudential measures of selected other countries; either unilaterally or through a negotiated agreement, without being subject to a challenge by an excluded WTO member that it being denied MFN treatment. A country must, however, be willing to accord similar recognition to measures of other WTO members that meet the same standards. In effect, the recognition provision in the Annex elaborates on the application to the banking services sector of GATS Article VII (Recognition), which allows a country to recognise standards or licensing or certification requirements of selected countries without being subject to the MFN obligation of the GATS. [600]

Regarding trade in banking services, the insulation of domestic regulatory autonomy from the formal disciplines of trade in services is almost complete.[601] Article 2 of the GATS Annex on Financial Services contains a crucial provision for the institutional reconciliation of the rival values of regulation and banking services liberalisation.[602] In dealing with the political

[596] See GATS Annex on Financial Services.

[597] Ibid.

[598] Yokoi-Arai 2008: 639.

[599] Leroux 2002:431-432.

[600] Footer 1995:468.

[601] Wolfrum ea 2008:636-638.

[602] See art. II of the GATS.

dynamics of the negotiation process, GATS negotiators had to address the reluctance of national financial supervisory authorities to implicate domestic institutions of prudential supervision in the legal process of WTO-sponsored liberalisation. They felt that there were probably enough multilateral international institutions and standard-setting bodies with a mandate to discuss the international financial regulatory and supervisory framework. On the other hand, the subject-matter of the GATS commitments was sufficiently broad to turn any domestic rule into potential GATS material, to the extent that a large number of more or less well-intentioned and non-discriminatory regulatory provisions are capable of having collateral trade effects, banking services commitments could conceivably have important ramifications for the exercise of regulatory and supervisory oversight by national authorities. For that reason, the national delegations were not prepared to compromise the complex and delicate issue of institutional and organisational structure of their regulatory and supervisory systems. As a result, the rivalry between regulation and liberalisation was settled in favour of regulatory status quo.[603]

The case for regulating international banks rests on the grounds that private lending activities emit external costs.[604] Indeed, the costs of these lending cycles are born not only by lenders, but also, and perhaps primarily, by borrowers. In the case of sovereign borrowers, this may mean entire economies. Moreover the political side-effects may be unpleasant.[605] The entry of foreign banks mainly in the form of branches raises concerns for the stability of the host country banking system and the protection of depositors. Since the branch is not a separate legal entity but merely an office of the parent bank,[606] the solvency and liquidity of branches of foreign banks is largely dependent on the financial structure and operations of the foreign parent bank. Thus, any deficiency of the home regulatory regime, which for example, allows excessive risk-taking activity by the parent bank, may adversely

[603] Wolfrum ea 2008:636-638.

[604] Ibid.

[605] Ibid.For example, in the context of under lending in mid-1983, the wall Street Journal (June 30, 1983) identified four sorts of negative political fall-out: increased government involvement in the private sector in developing nations, as banks curtail loans to private sector borrowers (which are generally the hardest hit by recession, and also the first to be cut off foreign exchange) and concentrate on the lending to government(which have guaranteed access to tax revenue and first call on foreign exchange).

[606] Krajewski 2005:92-93.

affect the sound operation of the branch. In turn, a failure of the branch may have a negative impact on the operations of credit institutions in the host country, harm depositors, and, depending on the size of the branch, lead to materialisation of systemic risk.[607] Under the GATS regime, seeking valid measures towards the stability of domestic banking system and depositor protection, the Annex on Financial Services allows measures for prudential reasons to be exempted from the GATS disciplines as long as they do not constitute means of avoiding the GATS commitments or obligations.[608]Considered as influential rules promoting regulatory harmonisation, these international standards are called upon to play an increasing role in the liberalisation of financial services, insofar as such standards usually significantly lower the likelihood of disguised or needlessly restrictive impediments to trade in banking services. In this respect, the world Trade Organisation (WTO) offers a normative framework acting like a magnet attracting external rules and by which certain international norms are used to assess domestic regulations and, more broadly, state measures. [609]

3.3.2 Measures imposed for prudential reasons

The Basel Committee's Core Principles provide a comprehensive list of prudential requirements, but widely used methods of prudential regulation are minimum capital regulations, capital adequacy ratio, legal lending limits or large exposure limits, and fit and proper requirements of management.[610]

3.3.2.1 Minimum Capital Requirement

Capital adequacy ratio is one of the most widely applied and cited methods of prudential regulation.[611] Capital adequacy ratio was standardised by the Basel Committee on Banking Supervision (Basel Committee) in 1988.[612] The Basel Committee recommended that the first

[607] Panourgias 2006: 57.

[608] Wolfram ea 2008:635.

[609] Bismuth 2010: 490-491.

[610] Yoko-Arai 2008:631-634.

[611] Ibid.

[612] Atik 2011:731-732.The 1988 Basel Accord was the first effort to systematically harmonise bank capital requirements. Weakness and gaps in the 1988 Accord led to the promogation of Basel II.

capital adequacy formula in 1988 spelling out the definition of core capital, supplementary capital, and risk weight.[613] The Capital Accord agreed that internationally active banks shall maintain a minimum of 8 per cent of their assets in capital.[614] The Capital Accord was first published as a result of increasing pressure to create a level playing field for financial institutions competing in the global market.[615] The Basel Accord addresses three basic components of capital regulation:[616] an agreed definition of Tier 1 (core) capital and a menu of Tier 2 capital; a general framework that allocates both bank assets and off-balance sheet items to risk categories while providing requisite procedure for calculating the minimum capital ratio; and a schedule for achieving a minimum ratio of total capital-to risk weighted assets and off-balance sheet items of 8 per cent.[617]Capital adequacy ratio has become the standard method of defining the strength of a financial institution. Capital acts as a cushion to absorb losses from credit risk. Capital adequacy is based on the concept that banks should have a certain amount of capital against their assets (loans).

3.3.2.2 Endowment Capital

Requirements for endowment capital are examples of measures imposed for prudential reasons.[618] Endowment capital requirements for branches constitute licensing measures which deal with capital and solvency considerations in relation to the dependence of branches on the foreign parent bank and so they would indisputably qualify as rules adopted for prudential reasons.[619]

[613] Atik 2011:731-732. Basel II and its predecessor, the Basel Accord, are premised on the concept of capital adequacy.

[614] Ibid.

[615] Ibid at 739.

[616] Ibid.

[617] Yokoi-Arai 2008: 632. Initially, capital adequacy ratio was developed from the U S CAMEL banking supervisory system. CAMEL is an acronym for Capital adequacy, Asset quality, Management, Earning and liquidity, the items it comprises. CAMEL was designed to enhance the objectivity of bank supervision, using these items to calculate a numerical index. While the supervisory method of each country is different, the items subject to monitoring would be more or less similar to CAMEL. Capital adequacy ratio is one of the main components of CAMEL.

[618] Panourgias 2006:59-60.

[619] Ibid.

3.3.2.3 Legal Lending Limits (LLL)

The legal lending limit is applied to limit the lending of a financial institution to single or connected parties.[620] When the legal lending limit is not fully complied with, the lack of diversification in its investment portfolio may result in financial difficulties when and external shock is perceived.[621] Legal lending limits are being gradually reduced to the level of 10-25 per cent of bank capital.[622] The Basel Core Principles state the maximum Legal Lending Limit (LLL) to be 25 per cent of bank capital.[623]

3.3.2.4 Fit and Proper Person Requirement

The fit and proper test usually requires that management and the board of directors are vetted to ensure that they do not have a history of badly managing a financial institution or are not persons with criminal records.[624] The experience and integrity of the CEO are often examined to ensure that only competent professionals are allowed to manage banks.[625]The Basel Committee's Core Principles of Effective Supervision state this in the Licensing principles:[626]

> "…. An evaluation of the competence, integrity and qualification of proposed management, including the board of directors, the licensing agency should obtain the necessary information about the proposed directors and senior managers to consider individually and collectively their banking experience, other business experience, personal integrity and relevant skill. This evaluation of management should involve background checks on whether previous activities, including regulatory or judicial judgements, raise doubts concerning their competence, sound

[620] Yokoi-Arai 2008:633-634.

[621] Ibid.The lack of legal lending limit is considered one of the main problems which exacerbated the Asian financial crises. Banks were lending heavily to corporates which were linked by family or political connections.

[622] Ibid.

[623] Ibid. The actual rate differs between countries, with the US at 15 per cent, EU directives at 25 per cent and Japan at 25 per cent. In some emerging economies, such as Indonesia, which have suffered from connected lending, the LLL is 10 per cent.

[624] Yokoi-Arai 2008:633-634.

[625] Sheng 1990: 13.

[626] Yoko-Arai 2008:633-634.

judgement, or honesty. It is critical that the bank's proposed management team includes a substantial number of individuals with a proven track record in banking."

3.4 The Proposals for Liberalisation of Trade in Banking Services

Given the sensitivity of the banking sector for the flow of capital and national economies, and given its importance not only to trade volume of the sector itself but also to investment in the operation of other service sectors and manufacturing industries,[627] negotiations in the Uruguay Round showed different concerns. These were reflected in various proposals which led to two Annexes on banking services and one Understanding on Commitments in banking services,[628] thus making banking services unique, and the most difficult issue to be treated under the GATS. The First Annex on Financial Services, influenced by a proposal submitted by Malaysia,[629] provides for the right of a member to take 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 services supplier, or to ensure the integrity and stability of the financial system. They shall not, however, be used as a means of avoiding the member's commitments or obligations under the GATS.[630]

3.4.1 Developed countries proposal

In the Uruguay Round negotiations, the United States and the European Union (EU) shared the goal of obtaining strong commitments to market opening in banking services from emerging economies; however, their approaches to achieving this goal differed markedly.[631] The EU's priority was to put in place a multilateral agreement that included binding commitments for banking services, even if some of the initial commitments were weak.[632] By contrast, the United States gave priority to obtaining strong initial commitments and was unwilling to allow emerging market economies to become so called free riders. The EU

[627] Wang 1996:106-112

[628] Ibid

[629] Ibid.

[630] Ibid.

[631] Ibid.

[632] Ibid.

favoured a broad agreement both in terms of general scope and sectoral coverage throughout the negotiations in order to maximize the potential for effective market access and encourage wide participation. As negotiations progressed, the EU expressed preference for an agreement with soft obligations,[633] bereft of binding obligations including national treatment, on which the US was pressing for a binding general obligation with a strong emphasis on the sectoral approach in what it termed sectoral appropriateness. This meant that progressive liberalisation on the key issue of market access should rest on respect for policy objectives and the appropriateness of regulations in each case.[634]

3.4.1.1 The United States' Proposal

3.4.1.2 Most Favoured Nation Treatment (MFN)

The United States proposal included a conditional MFN clause.[635]Its fear was that other countries would free ride on the liberalisation it had undertaken in its banking sector without opening up their own banking sectors.[636] Differential treatment of countries due to application of reciprocity requirements was inserted by the United States into its MFN exemption List.[637] The US position on MFN treatment can be traced back to the eighteenth century when the "conditional" form made its first appearance in the Treaty of Amity and Commerce concluded between France and the United States of America in 1778.[638]

"The United States announced a surprise decision in 1993, that it would not have an MFN obligation that covered new activities in banking services."[639] The argument for such a deviation was, as the U S delegation explained, that the offers of some commercially

[633] Footer 1995:458.

[634] Ibid.

[635] Rai 2007:60.

[636] Ibid. The developing countries took the opposite stand and wanted a general and unconditional MFN clause. Finally a general and unconditional MFN clause with exceptions was agreed.

[637] Wang 1996: 120-124; Schill 2009:510.

[638] Ibid. "Under the conditional form of the clause, neither party is required to extend immediately and unconditionally to the like products of the other party the advantages which it may accord to products of third countries in return for reciprocal concessions; it is obligated to extend such advantages only if and when the other party grants concessions equivalent to the concessions made by such third countries.

[639] Ibid.

important and growing markets remained inadequate in terms of market access and national treatment. "Free-ridership undermined WTO, and an MFN-based agreement required solid commitments by all parties".[640] The United States announced that it would take an MFN exemption on some aspects of banking services unless the schedules were improved. In effect this meant that the United States would discriminate among foreign banking services providers, offering more access, on a reciprocity basis, to those trading partners who opened their markets. In order to avoid such outcome, it was agreed in the Second Annex that during a period of sixty days beginning four months after the date of entry into force of the WTO Agreement, any member may improve, modify or withdraw all or part of the commitments on banking services inscribed in its schedule, notwithstanding that GATS Article XXI deals with themodification of schedules, and compensatory adjustments.[641]

3.4.1.3 National Treatment

The history of national treatment dates back to earlier centuries.[642]In the field of trade in banking services, national treatment is still a new topic. In the middle of the 1980s, the United States called for negotiations of a framework of rules for trade in services comparable to GATT rules for trade in goods, including, inter alia, the national treatment principle.[643] In 1986, an agreement was reached to negotiate services at Punta de Este, and service negotiations became part of the role of the Trade Negotiations Committee, which was responsible for conducting the negotiations in the Uruguay Round. Negotiating countries in the Uruguay Round knew that it was worth trying to examine how far these principles including national treatment could be applied to services.[644] Although some countries thought national treatment was at the heart of the services negotiations, the negotiations of national treatment for trade in services was not smooth because some

[640] Wang 1996: 120-124.

[641] Hoekman ea 2002:165-166.

[642] Wang 2003:153.National treatment in Financial Services in the GATS/WTO. http://heinonline.org (accessed 2011/12/06).

[643] Ibid.

[644] Wang 2003:153.National treatment in Financial Services in the GATS/WTO. http://heinonline.org (accessed 2011/12/06).

countries believed that national treatment might be more difficult to apply to banking services.[645] It was the United States that made the first proposal to include national treatment as a fundamental element in the framework agreement on trade in services. In 1990, the Draft Multilateral Framework for Trade in Services included a national treatment article, numbered XVII.[646] It stated as follows:[647]

> "In conformity with other relevant provisions of the framework, and as set out in their appropriate schedules, parties shall grant to services and service providers of other parties, in the application of all laws, regulations, administrative practices, and decisions of general application, treatment no less favourable than that accorded to like domestic services or service providers in like circumstances."

According to the position of the United States, national treatment should be a binding general obligation.[648]

3.4.2 The European Union's Proposal

The position of the European Union was to submit the matter of domestic regulation to the Basel Committee.[649] The EU emphasised its support for regulation that is transparent, proportionate and necessary. The EU proposed to rely on international financial standards, notably those of the Basel Committee, in order to clarify the notion of prudential measures in the Annex on Financial Services. The EU proposed using the Core Principles for Banking Supervision of the Basel Committee, stating that the objective would be to have a common understanding of the carve-out so that coverage by the carve-out would be a common understanding of the members so that itwould not be used to introduce regulatory behaviour that could become protectionist. [650]

[645] Wang 2003:153.National treatment in Financial Services in the GATS/WTO. http://heinonline.org (accessed 2011/12/06).

[646] Ibid.

[647] Ibid.

[648] Wang 2005:153-155.

[649] Footer 1995:458-459.

[650] Bismuth 2010: 506-507.

3.4.2.1 Transparency

The EU proposed that transparency can be applied in the following ways:[651] through the notifications by governments of perceived obstacles to banking trade, as well as an obligation for governments concerning all national regulations affecting the supply of banking services by foreign suppliers; the provision and publication of inquiry points through which governments could exchange information for the benefit of banks likely to be affected by existing or new regulations; and through the continuous assessment of the results of any agreement reached.[652]

3.4.3 The Developing Countries' Proposal

Developing countries argued that the rules and procedures of GATT were drafted for goods and that it was beyond the competence of GATT to address trade in banking services.[653] They contended that trade in banking services involve investment issues because of major investments in developing countries by foreign services suppliers.[654] From the very beginning of the services negotiations, developing countries consistently expressed serious concern over the liberalisation of banking services trade, because it would lead to increased balance of payments problems. They feared that domestic infant industries could not withstand foreign competition from the sophisticated multinational banks. Sharing the same or similar concerns with most of the developing countries, China co-sponsored a comprehensive legal Draft Framework with developing countries in 1990.[655]

[651] Flader 1990:687.

[652] Ibid.

[653] Jarreau 1999:12. Interpreting the General Agreement on Trade in Services and WTO Instruments relevant to International Trade of Finanancial Services: the Lawyer's Perspective.Available at (http://heinonline.org) (accessed 2011/12/06).

[654] Ibid.

[655] Bismuth 2010:506-507. In this draft agreement, they argued that the Framework would be applied to all tradable services, although trade in services would not include foreign direct investment. Once market access is available, the host country should generally grant most favoured nation and national treatment. However, they argued, progressive liberalisation would initially concentrate on concessions by developing countries, with future step-by-step liberalisation by the developing countries, depending on the extent to which their services exports would have benefited from liberalisation by the developed countries and be in conformity with their developmental and technological objectives. The Draft Framework outlined a number of measures to achieve greater participation of developing countries in services trade and expansion of their services sectors.

3.4.3.1 Transparency

Developing countries put transparency as one of the priorities among the general obligations.[656] The transparency provisions try to ensure the availability of information with respect to all laws, regulations and administrative guidelines as well as international agreements concerning trade in banking services.[657] According to the provisions, all parties to the Framework Agreement shall notify each other of specific laws and regulations intended to protect domestic banking industries.

3.4.3.2 National Treatment Principle

As far as developing countries were concerned, a general obligation of national treatment as proposed by the US in banking services trade was unacceptable.[658] Developing countries are usually concerned about national treatment. This is because of their level of development which will not permit them to provide national treatment.

Developed countries have placed a premium on increasing access to banking sectors in developing countries.[659] Developed countries' banking markets are mature, limiting banks' growth potential. In addition, developed-country banks desire entry to developing markets so as to preserve relationships with long-time clients, many of which have established operations in emerging markets. Developed countries' negotiating proposals stressed the importance of improving mode three commitments on commercial presence.[660] They requested their trading partners to remove restrictions on the right to establish or acquire existing banks, equity participation, number of operations and personnel, and other measures that impede market entry and operations. Developed countries also have proposed that developing countries improve mode 1 and mode 2 commitments, though

[656] Footer 1995:466.

[657] Ibid.

[658] Wang 2003:155. National treatment in Financial Services in the GATS/WTO.http://heinonline.org (accessed 2011/12/06).For example, Brazil directly pointed out that developing countries should not be expected to undertake the same level of market access or national treatment commitments as developed countries.

[659] Herfindahl and Brown 2007:1260-1261.

[660] Ibid.

some countries such as Australia and Switzerland have softened these requests, recognising that liberalising mode 1 trade poses difficulties for developing countries.[661] Also regarding mode1, developed countries have requested that cross-border supply not be restricted to banks with commercial presence in the host country; that is, developed countries want the right of non-establishment. A few developed countries, principally in Europe, also have urged developing countries to sign the Understanding on Financial Services,[662] a WTO document establishing a minimum acceptable level of openness in banking. Countries can sign this document on a voluntary basis, thereby removing impediments to mode 1 and mode 2. In part, developed countries interested in liberalising modes 1 and 2 because of e-banking, which they hope to market globally.[663]

3.5 Objections to Liberalisation of Trade in Banking Services

The developing countries have long recognised the importance of banking services to development.[664] While developing countries recognised the importance of banking services to development, they are apprehensive about opening up banking services trade. They fear that liberalisation may hinder economic growth and their ability to manage banking policies. They see little to gain and much to lose. Their concerns are based on three perceptions:[665]

(i) developing countries do not have a comparative advantage in trade in banking services;

(ii) their infant services industry need protection; and

(iii) liberalisation would impinge on national security and foreign direct investment in developing countries.

[661] Herfindahl and Brown 2007:1260-1261.

[662] Ibid.

[663] Ibid.

[664] Ibid.For example managerial expertise, the greatest advantage for market opening in banking services, which, come from the transfer of soft elements, such as information, and technology. In addition, general management, accounting, database processing and corporate governance have the potential to improve the entrance of foreign banking institutions. These would be beneficial to the consumer. The transfer of technology and personnel would enable local firms to innovate processes and services to cater for the local market and become competitive in their own right.

[665] Organisation for Economic Co-operation and Development 1989: 43-49.

3.5.1 Comparative advantage

The developing countries believed that they have a comparative disadvantage in banking services, and that this disadvantage means they have little to gain from the liberalisation of banking services trade.[666] They fear liberalisation would lead to exacerbating current account deficits. Developed countries with abundant physical and human capital were most likely to be banking services exporters. [667]

3.5.2 Infant industry protection

The developing countries are concerned that opening up their banking services industry to foreign competition will damage their infant industry.[668] Seeing that banking services are dominated by large, multinational firms, developing countries feel their banks are at a distinct disadvantage, lacking the capital resources and the experienced personnel to compete effectively. They argue that their nascent banking services industry require extensive protection, much like the one enjoyedbythe heavily regulated banking industry in the developed would.[669]

3.5.3 National Security

Developing countries fear opening up their banking sector to foreign competition could infringe on their national security and exacerbate existing disparities in development.[670] This fear is based on the reasonable position that the sheer financial strength, technological superiority and managerial expertise of transnational banks will cause developing states to loose potential income from trade in banking services. Thus it is argued that increased dependence on developed states will caused both financial and national security problems.[671]

[666] Organisation for Economic Co-operation and Development 1989: 43-49.

[667] Schot and Mazza 1983: 226-253.

[668] Footer 1995:472.

[669] Ibid.

[670] Flader 1990: 680.

[671] Ibid.

In general, developing countries believed that the GATT agenda is already full with the many issues left over from the Tokyo Round.[672] Their priorities include new safeguards rules and standstill measures on merchandise trade barriers. They feared that the inclusion of banking services in the new round would take the focus away from negotiations on long standing trade problems. Moreover, they were concerned that they would be drawn into trade-offs between liberalisation of trade in banking services and trade in goods, in essence paying for removal of GATT-illegal barriers with a new concession on banking services.[673] In addition to these concerns about liberalisation of trade in banking services, the developing countries thought there are four additional negotiating problems with prospective GATS talks.[674] Firstly, concern about how the most favoured nation (MFN) principle would be applied to trade agreements on banking services. They argued that the benefits of any new agreements should be to coerce those countries that have been so-called free riders to international agreements-among which number many developing countries- to contribute to the liberalisation package if they are to benefit from its new trading opportunities.[675] Secondly, developing countries concern about applying the national treatment principle to foreign services competitors, particularly in the banking industry. Since trade in banking services have many unique features and are of strategic importance in the economic, social and cultural development of a country.[676] Without forgetting their importance to a country, during preparations for the new round of multilateral trade negotiations, a large number of the participants were reticent fearing that, the inclusion of the services issue in the GATT context would create an assumption that the GATT rules should be extended to banking services thus, placing some countries in the defensive position of having to justify the legitimacy of departures from MFN or national treatment in banking services.[677] A compromise was finally reached at the Punta del Este Ministerial Meeting that lunched the

[672] Jarreau 1999:12-13.Interpreting the General Agreement on Trade in Services and the WTO Instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. Available at (http://heinonline.org) (accessed 2011/12/06).

[673] Schot and Mazza 1993: 267.

[674] Footer 1993:348-340.

[675] Ibid.

[676] Wang 1996:29-30.

[677] Ibid.

Uruguay Round in 1986.[678] Part II of the Uruguay Round Declaration carefully balanced the US initiative of including banking services in the Uruguay Round and the developing countries' dual objectives of maintaining multilateral action on trade in banking services outside the GATT, and of obtaining recognition of the priority of development objectives and the supremacy of national legislation.[679] Thus the participants separated Part II trade in services from part I trade in goods and that the Uruguay Round negotiation process on trade in banking services should be conducted in an ad hoc juridical frame work of reference outside the GATT.[680] Such legal distinction was observed and followed by the participants during the seven years of negotiations on trade in banking services which proceeded parallel to the negotiations on trade in goods.[681]

3.6 Final Text

International trade in banking services is governed by the General Agreement on Trade in Services (GATS) under the auspices of the WTO.[682] Ranking among the chief achievements of multilateral trade diplomacy at the end of the twentieth century, GATS for the first time extends internationally agreed rules and commitments, broadly comparable with those of the GATT, into a huge and still rapidly growing area of international trade in banking services.[683] WTO rules governing trade in banking services are included within three distinct instruments:[684] the GATS; the Annex on Financial Services attached to the GATS;[685] and the

[678] Footer 1993:340-348.

[679] Ibid.

[680] Ibid.

[681] Wang 1996:21-91.The Agreement Establishing the World Trade Organisation (WTO Agreement), reached in 1993, contains the GATS as Annex IB, constitutionally separate from GATT 1994 as Annex IA, and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) as Annex IC. "Although all these Agreements adopted and introduced the concept of MFN treatment, the rules and principles embodied in the legal instruments of the GATS, given the unique elements peculiar to banking services, have different implications and applications."

[682] Wang 2007:214.

[683] Ibid.

[684] Bismuth 2010:493-494.

[685] Jarreau 1999:36.Interpreting the General Agreement on Trade in services and the WTO instruments relevant to International Trade of Financial Serviices: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06).

Understanding on Commitments in Financial Services, which is optional.[686] The Annex on Financial Services contains important provisions regarding trade in banking services and often exempts banking services from the general provisions of the GATS. The Understanding on Commitments in Financial Services entered into by financially developed countries to undertake liberalisation commitments that in many important respects exceed the degree of liberalisation achieved under the General Agreement on Trade in Services.[687]The GATS also imposes a common discipline on all banking services suppliers, notably comprised of the most favoured nation treatment[688] prohibiting the discrimination among foreign suppliers and transparency obligations requiring member states to publish all relevant measures of general application which pertain to or affect the operation of the agreement.[689] The general obligations in trade in banking services are the mostfavoured nation (MFN)[690] clause and the transparency requirement.[691] MFN requires that member states must afford the same treatment to all members.[692] The obligations imposed by GATS are of two main types:[693] obligations that apply almost without qualification to banking services activities, and commitments that, although fully binding, apply only to the extent that each WTO member has negotiated their application to specified sectors and modes of supply of banking services. Members can negotiate and limit the degree of national treatment and market access under the GATS.[694] The principles of non-discrimination, MFN and national treatment, will then apply only to banking services sectors that members have listed in their schedules of commitments and only to the extent that no limitations have

[686] Bismuth 2010:493-494.The GATS constitutes the Lexgeneralis and applies to all kinds of services the Annex and the Understanding complete or modify the GATS in trade in banking services and constitute therefore the lexspecialis.

[687] International Legal Material 1994:1260-1263.

[688] See GATS art.II.

[689] See GATS art. III:1.

[690] GATS, art.II.

[691] Ibid.

[692] Wallwyn 1991:232.

[693] Morrison 2001:601.

[694] Emerson 2010:259.

been attached.[695] Members' commitments in their individual schedules can either be on a positive list or negative list approach.[696] However, regardless of their specific commitments under part III of the GATS, members are still bound by the general obligations and disciplines under part II of the GATS. Nevertheless, members are permitted to derogate from the MFN principle under the GATS by making certain exceptions.[697]

Market access and national treatment in the GATS are obligations which only apply if a WTO member specifically committed to these obligations.[698] Most favoured nation treatment on the other hand is a general obligation.[699] While specific commitments in trade in banking services are market access[700] and national treatment,[701] these are the main subjects of negotiation in banking services. National treatment requires that the same conditions of competition are applied for both domestic and foreign firms in the market,wheras market access requires that conditions of market access are stipulated appropriately.[702]

3.6.1 Most favoured nation treatment

Most favoured nation treatment clause in international agreement is designed to ensure that each party will be treated on exactly the same footing as the most favoured third country.[703] The principle allows countries to exchange commitments on a multilateral basis,

[695] Emerson 2010:259.

[696] Krajewski 2005:75.

[697] Emerson 2010:259; Shill 2009:506-509.

[698] Krajewski 2005:75.

[699] Ibid.That is it applies to all measures in the banking sector, unless a member specifically exempted a certain measure from its scope.

[700] GATS, art.XVI.

[701] GATS art.XVII.

[702] Krajewski 2005:75. Market access and national treatment are of greater importance than most favoured nation treatment.

[703] Rai 2007:59.The international law Commision of the United Nations defines MFN as, "treatment accorded by the granting state to the beneficiary state or to persons or things in determined relationship with state, no less favourable than treatment extended by granting state to a third state or persons or things in the same relationship with that third state".

safe in the knowledge that no other country with more market power will obtain more advantageous trading conditions.[704]

3.6.1.1 Nature of the Most Favoured Nation Treatment obligation of Article II: 1

Article II: 1 of the GATS prohibits discrimination between like banking services and banking service suppliers from different countries. Accordingly:[705]

> "....With respect to any measure covered by this Agreement, each member shall accord immediately and unconditionally to services and service suppliers of any other member treatment no less favourable than that it accords to like services and service suppliers of any other country".[706]

The principal purpose of the MFN treatment obligation of Article II:1 of the GATS is to ensure equality of opportunity, in casu, for banking services and banking service suppliers of all WTO members.[707] The MFN treatment of article II:1 applies both to de jure and de facto discrimination.[708] This was the ruling of the Appellate Body in *EC –Bananas III*. The Appellate Body disagreed in this case with the EC, which had argued that if the negotiators of the GATS wanted article II:1 to cover also de facto discrimination, it would have explicitly said so. The Appellate Body ruled however:[709]

> "The obligation imposed by article II is unqualified. The ordinary meaning of this provision does not exclude de facto discrimination. Moreover, if article II was not applicable to de facto discrimination, it would not be difficult and, indeed, it would not have been a good deal either regarding trade in services, than in the case of trade in goods...to devise discriminatory measures aimed at circumventing the purpose of this article."[710]

[704] Morrison 2001: 601.

[705] Wang 1996:92.

[706] See GATS art.II.1.

[707] The Law and Policy of the World Trade Organisation<http://www.phasel.nccr-trad.org/.../WTO%20-%20Chapter%204-non-discrimination.pdf> (accessed 15/05/2012): 377-378.

[708] Ibid.

[709] Ibid.

[710] Ibid. In *EC -Bananas III*, Various rules for the allocation for import licenses for bananas were at issue. According to the complainants, these rules, which on their face were origin neutral, discriminated

Thus every member undertakes under article II of the GATS to provide:[711]

1. With respect to any measure covered by the Agreement
2. Immediately, and unconditionally[712]
3. Treatment no less favourable,[713] than accorded to
4. Like banking services and banking services suppliers[714] of
5. Any other country.[715]

For a measure to be covered by the GATS, that measure must be:[716]

(i) a measure imposed by a member; and

(ii) a measure affecting trade in services.

A "measure by a member" is a very broad concept.As stated in articleI:3(a) of the GATS, a "measure by a member" is not limited to measurestaken by the central government or its authorities, they are also measures by a member within the meaning of article 1:1 of the GATS. Measures taken by non-governmental bodies are a measure by a member when these measures are taken in the exercise of power delegated by governments or authorities. A measure by a member can be a law, regulation, rule, procedure, decision or

against distributors of Latin American and non-traditional ACP bananas in favour of distributors of EC and ACP bananas.

[711] Krajewski 2005:120.

[712] Wang 1996:96-98.The term means that the beneficiary party acquires the right to MFN treatment as soon as the granting party accords to any other country favourable treatment within the scope of the subject-matter of the clause. Unconditionally: the term means that the GATS MFN treatment is, like that of GATT, extended unconditionally to all members without equivalent compensation. Some developed countries, in the negotiating process, proposed a conditional MFN approach for banking services, but developing countries-and some developed countries were concerned that a conditional MFN would limit the scope for liberalisation of trade by generating selective protection, and they would not be able to benefit from the concessions of other members if they did not provide reciprocal concessions up to a certain level of liberalisation.

[713] Ibid The GATS MFN clause requires each member, as a general obligation, to accord to any other member treatment equal to that which it grants to any other country.

[714] Ibid. These are probably the most important and controversial notions in the MFN clause, since the notion of like services and like service suppliers are directly related to the effect and value of the MFN treatment under GATS.

[715] Ibid.This term means the MFN third country in the MFN relations.

[716] The Law of and Policy of the World Trade Organisation.

http://www.phasel.nccr-trad.org/.../WTO%20%20Chapter%204-non-discrimination.pdf(accessed 15/05/012):378-379.

administrative action, but can also take any other form. A "measure by a member" within the meaning of Article I:1 can thus be a national parliamentary law as well as municipal decrees or rules adopted by professional bodies.[717]

The concept of a "measure affecting trade in services" has been clarified by the Appellate Body in the *EC-Bananas case and* later affirmed in *Canada – Autos.*[718] The EC-Bananas case concerned the European Community's banana import licencing regime, that is, measures dealing with the importation, sale and distribution of bananas.[719] The Panel, and then the Appellate Body, gave a very broad scope to the GATS, relying in particular on the use of the term "affecting" in Article 1:1. The Appellate Body stated as follows:[720]

> "In our view, the use of the term "affecting" reflects the intent of the drafters to give a broad reach to the GATS. The ordinary meaning of the word "affecting" implies a measure that has "an effect on", which indicates a broad scope of application."

In *Canada –Autos,*[721] the measure at issuein this case was an import duty exemption accorded by Canada to importsof motor vehicles by certain manufacturers.The European Communitiesand Japan, the complainants, argued that this measure was inconsistent with Article II:1 of the GATS as it accorded "less favourable treatment"to certain members' services and service suppliers than to those of other members. The Panel found that the import duty exemption was indeed inconsistent with Article II: 1 of the GATS. Canada appealed this finding of inconsistency and, in addition, as a threshold matter, appealed thePanel's finding that the measure at issue fell within the scope of Article I: 1 of the GATS.[722] According to Canada the measure at issue was not ameasure "affecting trade in

[717] The Law of and Policy of the World Trade Organisation.

http://www.phasel.nccr-trad.org/.../WTO%20%20Chapter%204-non-discrimination.pdf(accessed 15/05/012):378-379.

[718] Collins 2007:43-61.

[719] Leroux 2008: 239-240.

[720] Ibid.

[721] Ibid.

[722] Collins 2007:43-61.

services". The Appellate Body stated that two key issues must be examined to determine whether a measure is one "affecting trade in services", namely,[723] whether there is "trade in services" in the sense of article I:2;and,whether the measure in issue "affects" such trade in services.In effect, the Panel determined that the import duty exemption constituted a measure affecting trade in services within the meaning of article I:1 of the GATS by looking at whether the measure was consistent with the Agreement's substantial obligations on MFN and national treatment.[724] The question of whether there is "trade in services", is that GATS does not define a service. Article I:3(b) of the GATS, however, states that the term "services" includes:[725]

> "...any service in any sector except services supplied in the exercise of governmental authority.... "Services supplied in the exercise of governmental authority" are defined as "any service which is supplied neither on a commercial basis nor in competition with one or more service suppliers". However, in a growing number of members, some of the services that are traditionally considered to be services supplied in the exercise of governmental authority, have in recent years been subject to privatisation and may now fall within the scope of the GATS."[726]

The GATS covers measures that are "measures by a member" and are "affecting trade in banking services."[727] According to article 1:3(a), "measures by a member" include measures taken by (i) central, regional or local governments and authorities; and by (ii) non-governmental bodies in the exercise of powers delegated by central, regional or local governments or authorities. In *EC-Bananas III,* the WTO Panel concluded that a measure affects trade in banking services when it modifies the conditions of competition in the supply of a banking service.[728] According to the Appellate Body in that case, measures

[723] Collins 2007:43-61.

[724] Panizzon ea 2008:241.

[725] The Law and Policy of the World Trade Organisation.http://www.phase.nccr-trad.org/../WTO%20-%20Chapter%204-non-discrimination.pdf (accessed 15/05/2012) 377-378.

[726] Ibid.

[727] Emerson 2010:269-270.

[728] Ibid.

affecting trade in banking services as provided by for in article I:1 and,are not necessarily measures regulating or governing trade in banking services nor measures taken in respect of trade in banking services. Rather any measure bearing upon conditions of competition in supply of banking services, regardless of whether the measure directly governs or indirectly affects the supply of the banking service is deemed to fall under the scope of the agreement.[729]

The interpretation given to the wording "treatment no less favourabe" was first adopted in the 1989 Panel Report in the United States-section 337 of the Tariff Act of 1930,[730]that examined the consistency with GATT articles III and XX of section 337 of the US Act that provides for the enforcement of patent infringement claims in relation only to imported goods alleged to infringe a US patent.[731] The panel, in turning to review the wording "treatment no less favourable," decided that, although this expression is taken up in various places throughout the GATT and in later agreements negotiated under the GATT framework, for example , the Tokyo Round Codes, it remained unqualified. It then went on to qualify the expression as including "affecting equality of opportunities for imported products in respect of the application of laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation and distribution."

In the panel's view this phrase set a "minimum permissible standard" as a basis.[732] Secondly, theBananas Panel interpreted the word treatment no less favourable in GATS article II:1 by referring to paragraph 2 and 3 of GATS article XVII and noted that:[733]

[729] Emerson 2010:269-270.

[730] Footer 1995:473-474.

[731] Ibid; Schill 2009:554.

[732] Footer 1995:473-474. This standard did not preclude the application to imported products of different formal legal requirements provided they accorded imported products more favourable treatment. Likewise, in situation where "application of formally identical legal provisions" would bring about less favourable treatment to imported products, the application "of different legal provisions to imported products to ensure that the treatment accorded them is in fact "no less favourable" is warranted. Both these considerations find a counterpart in the additional qualification that has been added to article XVII of the GATS at para. 2 and 3, where formally identical or formally different treatments are permissible, provided they do not alter the terms of competition in favour of domestic services or service suppliers.

[733] Werner 1999:343-344.

> "the standard of less favourable treatment in paragraph 1 of article XVII is meant to provide for no less favourable conditions of competition regardless of whether that is achieve through the application of formally identical or formally different measures. Paragraph 2 and 3 of article XVII serve the purpose of codifying this interpretation, and in our view, do not impose new obligations on members additional to those contained in paragraph 1. In essence the treatment, no less favourable standard of article XVI:1 is clarified and reinforced in the language of paragraph 2 and 3. The absence of similar language in article II is not in our view, a justification for giving a different ordinary meaning in terms of article 31(1) of the Vienna Convention to words "treatment no less favourable"which are identical to both articles II:1 and XVII:1"

Based on this reasoning, the Panel found that, the obligation in article II: 1 of GATS to extend "treatment no less favourable" should be interpreted to include providing no less favourable conditions of competition.This finding is of particular significance since it essentially reads paragraph 2 and 3 of the GATS national treatment clause into the GATS MFN clause, although GATS article II does not mirror the language of GATS article XVII in full.[734]

The MFN treatment under GATS does not depend on the specific commitments made by the members.[735] Its coverage is not limited to the commitments a member has undertaken for market access and national treatment.[736] Unconditional MFN treatment means that the GATS does not lay down any conditions in order for a member to be able to claim the most favourednation treatment.MFN and national treatment are similar to a certain extent, because they both contain non-discrimination principles. This could be seen by the analysis of the Panel and the Appellate Body in *EC-Bananas,* where claims under articles II and XVII were considered together.[737] "Any other country" means that a WTO member should not

[734] Werner 1999:343-344.

[735] Rai 2007:61.

[736] Ibid.Art. II of the GATS covers any measure covered by the Agreement which may be "in the form of law, regulation, rule, procedure, decision, administrative act or any other form".

[737] Krajewski 2005: 120-121.

get less favourable treatment than is granted to any other country, whether a WTO member or not.[738]

This principal MFN clause of the GATS is divided into two aspects:[739] the scope of MFN effect, in other words, to what subject matters it applies; and the obligation of the members under this clause, that is,what it obliges and requires members to do. The GATS refers to treatment no less favourable when defining the MFN Standard.[740] Article II of the GATS states that, with respect to all measures covered by the Agreement, each member shall accord immediately and unconditionally to services and service suppliers of any other member treatment no less favourable than that which it accords to like services and service suppliers of any other country. According to paragraph 2, however, a member may maintain a measure inconsistent with paragraph 1, provided that such a measure is listed in, and meets the conditions of, the annex to the article. The annex states that the MFN exception should not apply for more than 10 years.[741] However, many WTO members indicated in their lists of article II exemptions that a number of measures are intended to last indefinitely.[742] The GATS therefore allows member countries to make any exception to MFN that they can negotiate. The only constraint is that exceptions need to be made at the time of the entering into force of the GATS. The exceptions also continue to be subject to negotiations in subsequent rounds. Member countries therefore know at least the extent to which exceptions exist when the agreement becomes effective, and they can be sure that

[738] Krajewski 2005 at 72.

[739] Ibid at 120-121.

[740] Ibid. The MFN standard means that a host country must extend to investors from one foreign country the same treatment it accords to investors from any other foreign country in like cases. It potentially applies to all kinds of investment activities, such as the operation, maintenance, use, sale or liquidation of an investment. Regarding the admission and establishment of an investment, international MFN commitments are less frequent, although there is a certain movement towards an extension of the rule in this direction. This comprehensive coverage ensures that investors are protected even if the investment-related activities change or expand during the lifetime of their investments. Moreover, the standard can be invoked with regard to any investment-related legislation. In principle, one can distinguish several types of MFN clauses. They can be unilateral or reciprocal, conditional or unconditional, limited (by territory, time, or substantive scope) or unlimited. The MFN standard (with exceptions) usually applies in the areas of trade, investment, foreign exchange, intellectual property, diplomatic immunities, and the recognition of foreign judicial awards.

[741] Krajewski 2005:120.

[742] Ibid.

no additional exceptions will be made in future. The explanation for this approach towards MFN exceptions is that the scope of the GATS is very broad. It covers, in general, any measure of a member country affecting trade in banking services, including a service providedthrough "commercial presence" that is, foreign direct investment. Thus the scope of MFN provision is equally broad. Member countries may therefore not always apply the clause to the fullest extent possible. Moreover, the GATS' focus is not on investment protection per se in the same way as the pertinent bilateral and regional agreements.[743]

3.6.1.2 Generalisation of Most Favoured Nation Treatment

Application of article II of the GATS will result in generalising the advantages, favours, and specific commitments granted by each member to all other countries in the multilateral context.[744] Each member will be an MFN granting party vis-a-vis other members.[745] Once a country becomes a WTO member, its MFN relations with all other members are immediately established. The economic effect of one GATS MFN clause is equal to, or even more efficient than that of numerous MFN clauses signed among members bilaterally.[746]The MFN obligation would act, for example, to prevent Country A from entering into a reciprocal agreement with Country B to grant each other special treatment with respect to the number of banking services suppliers that may operate in each others' market, without according such advantageous treatment to Country C.[747] The generalisation of MFN treatment under the GATS is manifested in the following conditions:[748]

(a) each member shall extend the specific commitments on market access and national treatment immediately and unconditionally to all other members;

(b) each member shall extend all advantages, favours, privileges and immunities beyond the national schedule which it accords to services and service suppliers of

[743] United Nations 1999:4-25.

[744] Krajewski 2008: 120.

[745] Wang 1996:104.

[746] Footer 1995:464-466.

[747] Morrison 2001: 602.

[748] Ibid.

any other member, to like services and service suppliers of all other members immediately and unconditionally;

(c) each member shall extend all advantages, favours, privileges and immunities which it accords to services and services suppliers of any non-member country, to like services and service suppliers of all other members immediately and unconditionally;[749]

(d) each member may or may not extend GATS benefits to any non-member country with which it has signed a bilateral MFN agreement. Whether to extend the GATS benefits to a non-member depends on the terms of the bilateral MFN clause.

Under the GATS, MFN treatment is a general obligation that applies to all measures, positive or negative, affecting trade in banking services not only to the measures which are subject to binding commitments under national schedules, but also to all other measures, beyond the national schedules, affecting trade inbanking services under its regulatory regime. In that sense, the MFN obligation provides for a significant degree of liberalisation by committing members to non-discriminatory treatment of all other members with respect to the existing level of market access and national treatment.[750]

3.6.1.2.1 Limiting Article

Article 1:3(b) of the GATS states that a service within the scope of the agreement includes any service in any sector except services supplied in the exercise of governmental authority.[751]It should be noted that the GATS specifies two limitations to the scope of the Agreement, thus limiting the coverage of MFN treatment correspondingly as follows:[752] services supplied in the exercise of governmental authority, meaning any service which is supplied neither on a commercial basis nor in competition with one or more service suppliers.[753] Secondly, the GATS obligation to grant MFN treatment applies on a general

[749] Rai 2007: 60. Unconditional MFN principle does not allow the value of bilateral trade concessions to be eliminated by a most favoured trade concession to a third country competing for the same market.

[750] Wang 1996:104.

[751] Leroux 2002:429.

[752] Werner 1999:321-322.

[753] See GATS art.1:3 (b).

basis to all services sectors and with respect to all modes of supply unless MFN exemptions have been scheduled in a member's list of MFN exemptions in accordance with the terms, conditions and requirements on the Annex II exemptions. Therefore, in a dispute it is necessary to ascertain, first, whether a member has scheduled exemptions from the obligation to accord MFN treatment in its national list of MFN exemptions with respect to the particular sector or mode of supply at issue. Lastly, article II of the Annex on Finanacial Services contains a built-in exception permitting members to establish prudential regulatory measures in order to ensure the overall intergrity of the banking system.[754] The prudential measure is based upon goodfaith and should not be abused.[755] This view is based on article II (a) which states that prudential measures exceptions "shall not be used as a means of avoiding the member's commitments or obligations under GATS". In the light of these limitations, the prudential measures exception will likely not encompass price restrictions on particular banking services aimed at protecting consumers as was the case in Canada's prohibition of automated bank machine service charges as a violation of the GATS.[756]

The US was unwilling to allow the countries with closed markets in the banking sector to enjoy the fruits of market access and national treatment in a sector that the US has liberalised.[757] The contention of the developing countries was once a country has decided to open its market it should not be closed against some countries.[758] The US was apprehensive that countries enjoying the fruits of liberalisation in other markets without opening their markets would not face any pressure to reciprocate and open up their markets. Finally what emerged was a general MFN obligation with exemptions. Rules for these exemptions are given in the annex to article II and they could in principle remain in force up to 10 years however, their continuation would depend on the outcome of future negotiations.[759]

[754] Collins 2007:41.

[755] Ibid.

[756] Ibid at 30-46.

[757] Rai 2007: 74-75.

[758] Ibid.

[759] Ibid.

3.6.1.2.2 Transparency

The obligation of transparency contained in article III of the GATS requires that each member publishes all measures of general application affecting trade in banking services, and informs other members promptly of any changes in measures affecting trade in banking services covered by its specific commitments.[760] Indeed a major obstacle to doing business in a foreign country often involves a lack of information regarding the relevant laws and regulations of a particular jurisdiction.[761] This problem has particular importance for trade in banking services because many relevant trade restrictions take the form of domestic regulations. Sufficient information about potentially relevant rules and regulations is critical to the effective implementation of trade agreements. To address this, GATS sets forth a transparency principle in its preamble and in Article III.[762] Article III requires that members publish promptly all measures pertaining to or affecting the operation of the GATS. Article VI: 4(a) provides a mandate for WTO members to negotiate domestic regulatory disciplines to ensure transparent criteria for qualification requirements and licensing procedures. There is an obligation to notify the Council for Trade in Services at least annually of all legal or regulatory changes that significantly affect trade in the banking sector where specific commitments have been made. State's laws and regulations should be transparent setting forth clear standards so that foreign banks can discern exactly what conditions must be fulfilled in order to conduct banking trade in the host country.[763] To improve compliance obligations, article III requires member countries to establish enquiry points for dissemination of trade related laws and regulations to other WTO members on request.[764] Governments must establish these enquiry or contact points in order to respond to banking trade related questions posed by suppliers of banking services in other countries. As a general matter and similar to the MFN obligation, there are no exceptions or exemptions available to WTO members to comply with the obligation of transparency under article III.[765]

[760] Morrison 2001: 602.

[761] Ibid.

[762] Footer 1995: 455-466.

[763] Ibid.

[764] Ibid.

[765] See art. III of the GATS.

3.6.2 National Treatment

In the sectors inscribed in its schedules and subject to conditions, qualifications and limitations set out therein, a member must accord treatment no less favourable, to banking services and banking service suppliers of any other member, in respect of all measures affecting the supply of banking services, than that it accords to its own like banking servicesand banking service suppliers.[766] Article XVII of the GATS sets out a three-tier test of consistency with the GATS. This requires the examination of whether:[767]

(i) the measure at issue affects trade in services;

(ii) the domestic banking services and banking service suppliers are like services or service suppliers; and

(iii) the foreign banking services or banking service suppliers are granted treatment less favourable.

3.6.2.1 Nature of National Treatment under Trade in Banking Services

National Treatment under the GATS is not a general principle, but rather an obligation subject to a member's specific commitments which belongs to part III of GATS (specific commitments).[768] It is one of the two aspects of non-discriminatory treatment.[769]The fundamental purpose of national treatment is to ensure equal treatment between a host country and foreign countries.[770] Article XVII of the agreement requires each WTO member to accord to service suppliers of any other member, in respect of all measures affecting the

[766] See GATS art.XVII.

[767] The Law and Policy of the World Trade Organisation

http://www.phasel.nccr-trad.org/../WTO%20-%20Chapter%204-non-discrimination.pdf.(accessed 15/05/2012):422-423.

[768] Guojan 2010: 88. As a consequence, during negotiations on liberalisation, measures inconsistent with national treatment will be either eliminated, or scheduled as specific commitments.

[769] Wang 2003:1. National Treatment in Financial Services in the context of the GATS/WTO.

http://heinonline.org>

(accessed 2011/12/06).The other is most favoured nation treatment.

[770] Ibid.

supply of banking services, treatment "no less favourable" than that it accords to its own like banking service suppliers:[771]

(1) In the sectors inscribed in its schedule, and subject to any conditions qualifications set out therein, each member shall accord to services and service suppliers of any other member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.

(2) A member may meet the requirement of paragraph 1 by according to banking services and banking service suppliers of any other member, eitherformally identical treatment or formally different treatment to that it accords to its own like bankingservices and bankingservice suppliers.

(3) Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of banking services orbanking service suppliers of the member compared to like banking services or banking service suppliers of any other member.

Paragraph 1 is the key rule of national treatment in trade in banking services.[772] Firstly, the scope of national treatment is limited to those sectors inscribed in each member's schedule. This means that national treatment is not applicable to the banking service sectors not covered by a member's schedule, which means a member of the WTO may take discriminatory measures against banking services and banking service suppliers of any other member in those reserved sectors without violation of the national treatment rule embodied in GATS Article XVII.[773] Secondly, even for those sectors inscribed in each member's schedule, national treatment is not necessary or fully applicable because national treatment may be limited through any conditions and qualifications set out in the schedule. Thirdly, the beneficiaries of national treatment are both banking services and banking service suppliers originating from or related to any other member.[774] Fourthly, the measures related to national treatment are "all measures affecting the supply of banking services".

[771] Werner 1999:334-335.

[772] Wang 2003:159. National treatment in Financial Services in the GATS/WTO.http://heinonline.org (accessed 2011/12/06).

[773] Ibid. Reservation on national treatment came from the Uruguay Round negotiations on trade in services, at the behest of developing countries.

[774] Ibid.

"Measure" means any measure apply by a member in its territory, whether in the form of a law, regulation, rule, procedure, decision, administrative action, or any other form.[775] Fifthly, the comparable domestic counterparts of beneficiaries of national treatment are a member's own "like services and service suppliers".[776]

A WTO member grants full national treatment in a given sector and mode of supply when it accords in that sector and mode no less favourable treatment to banking service suppliers of other members than those accorded to its own like services and service suppliers.[777] The national treatment standard does not require formally identical treatment of domestic and foreign suppliers: formally different measures can result in effective equality of treatment; just as formally identical measures can in some cases result in less favourable treatment of foreign suppliers.[778] Paragraph 1 of article XVII (National Treatment) sets out the basic obligation in generic terms: "in the sector inscribed in its schedule, and subject to any conditions and qualifications set out therein, each member shall accord to services and service suppliers of other members, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers."[779] The notion of "treatment no less favourable" is interpreted by paragraphs 2 and 3 of article XVII.[780]"A member may meet the requirement of paragraph 1 by according to services and service suppliers of any other member, either formally identical treatment or formally different treatment to that it accords to its own like services and service suppliers"[781]. "Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or

[775] Wang 2003:159. National treatment in Financial Services in the GATS/WTO.http://heinonline.org (accessed 2011/12/06).

[776] Ibid.

[777] See GATS art.XVII.

[778] Footer 1995: 473-474.

[779] Guojan 2010: 77.

[780] Krajewski 2005:96.

[781] Ibid.

service suppliers of the member compared to like servicesor service suppliers of any other member."[782]

Article XVII paragraphs 2 and 3 gives some preliminary answers to what is meant by less favourable treatment:[783] Paragraph 2 national treatment applies to formally identical treatment and formally different treatment. Paragraph 3 states that both types of treatment shall be considered to be less favourable if they modify the conditions of competition in favour of domestic banking services or service suppliers.[784] Article XVII:2 and XVII:3of GATS also answer the question whether national treatment covers only de jure discrimination or also de facto discrimination. Since national treatment extends to formally identical treatment, it clearly covers both types of discrimination.[785] GATS article XVII covers both de jure and de facto discrimination, for example, a member who has taken a national treatment commitment with respect to the supply of banking services through branches cannot apply the same measures to both domestic and like foreign banks, if the effect of the measure on the like foreign bank results in altering the conditions of competition in favour of the domestic bank.[786] Thus de jure discrimination is easily identified through comparison of treatments between domestic and foreign banking service suppliers. The issue arises in de facto discrimination. According to paragraph 2 of article XVII, formally identical treatment might result in "less favourable treatment", that is de facto discrimination, whereas formally different treatment can result in "no less favourable treatment". Therefore, the possible permutations include:[787]

(i) Formally identical treatment results in no less favourable treatment;

(ii) Formally identical treatment results in less favourable treatment;

(iii) Formally different treatment results in no less favourable treatment; and

[782] Krajewski 2005:96.

[783] Ibid.

[784] Ibid at 107.

[785] Ibid at 106.

[786] Morrison 2001: 605.

[787] Wang 2003:161-162. National treatment in Financial Services in the GATS/WTO.http://heinonline.org (accessed 2011/12/06).

(iv) Formally different treatment results in less favourable treatment.

In the above four permutations, (i) and (ii) are compatible with the national treatment rule of GATS, but not (iii) and (iv).[788]

Paragraph 3 of article XVII goes further to try to provide a criterion to determine what measures will accord "less favourable" treatment to foreign banking service suppliers.[789] The criterion is whether the formally identical or formally different treatment modifies the conditions of competition. Moreover, "no less favourable" treatment in the GATS implies that foreign banking services and banking service suppliers could not be accorded more favourable treatment than that accorded to domestic banking services and banking service suppliers by a member. From this perspective, "no less favourable" is more favourable than "the same" or "as favourable as" for foreign banking services and banking service suppliers.[790]

3.6.2.2 Exceptions to National Treatment relating to Trade in Banking Services

The exception issue in banking services is outstanding. In addition to the limitations on national treatment listed in the schedules of specific commitments, WTO members also have other legal rights to refuse national treatment to foreign banks and banking service suppliers. In the case of banking services, WTO members may take advantage of several types of exceptions to avoid granting national treatment obligation under some circumstances.[791] Firstly, balance of payment safeguard is the most important paragraph of article XII, It reads:[792]

[788] The law and Policy of the World Trade Organisation.

http://www.phasel.nccr-trad.org/../WTO%20-%20Chapter%204-non-discrimination.pdf(accessed 15/05/2012):441.The latter would obviously be the case if the different treatment would be in favour of foreign banking services or service suppliers but it may also be that a formally different treatment has no impact on the conditions of competition.

[789] Ibid.

[790] Wang 2003:162.National Treatment under the GATS/WTO.http://heinonline.org (accessed 2011/12/06).

[791] Ibid.

[792] Ibid.

> "in the event of serious balance of payments and external financial difficulties or threat thereof, a member may adopt or maintain restrictions on trade inservices on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitment..."

The purpose of this article is to safeguard the balance of payment position of WTO members.[793] Secondly, government precurement is absolutely free from the GATS national treatment obligation.[794] The condition of the exception on government procurement is that the procurement must be for a government purpose,[795] not for a commercial purpose.[796] Thirdly, GATS article XIV (d) reads as follows:[797]

> "subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustified discrimination between countries where like conditions prevail, or disguised restriction on trade in services, nothing in this Agreemnent shall be construed to prevent the adoption or enforcement by any member of measures inconsistent with article XVII, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other members".

GATS article XIV (d) is particularly directed against GATS article XVII in the case of differential direct tax measures against foreign banks and will not violate national treatment.[798] Lastly, Prudential Carve-out is important because of the significance of banking regulations for members. It is viewed as necessary to have a special and clear rule relating to prudential

[793] Wang 2003:162.National Treatment under the GATS/WTO.http://heinonline.org (accessed 2011/12/06).

[794] Ibid. GATS art. XIII:1 purports to exclude government procurement from the national treatment principle. However, Section 2 of the Understanding on Commitments in Financial Services indicates that art. XIII notwithstanding, a party must provide national treatment to foreign service providers in the context of the purchase or acquisition of financial services by public entities of the party.

[795] Ibid at 179-180.

[796] GATS art. XII states that: art. II; XVI and XVII shall not apply to laws, regulations or requirements governing the procurement by government agencies of services purchased for governmental purposes and not with a view to commercial resale or with a view to use in the supply of services for commercial sale.

[797] Leroux 20002:424.

[798] See GATS art.XIV.

regulation, that is paragraph 2(a) of the Annex on Financial Services.[799]According to the prudential carve-out, a member may take discriminatory measures against foreign banking services and banking service suppliers in order to protect domestic investors, depositors, policy holdersor to ensure the integrity and stability of the banking system.[800] In contrast to those limitations listed in a schedule as limitations because of their legal exceptions specified by paragraph 2 of the Annex on Financial Services, they shall not necessarily bound financial service commitments. However, some members still like to list prudential measures in their schedules. This seemingly unnecessary act, in practice, may have unexpected results. When a dispute arises as to whether a measure is prudential or not, the member who had listed such measure in the schedule may rely on the listing as a defense to a possible claim. A list including broad prudential measures may frustrate other members' arguments as to whether such a measure is prudential or not. Nevertheless, no matter how many measures have been listed in the schedule, there may still be some prudential measures not predicted and not listed in the schedule. Therefore, prudential carve-out is always an effective tool to evade national treatment obligations for trade in banking services under the GATS.[801]

3.6.3 Market Access

3.6.3.1 Market Access, definition and coverage

Market access is one of the fundamental concepts of the GATS and signifies the commitments of WTO members to open up their borders to trade in banking services.[802] Market access should be clearly distinguished from that of national treatment. Market access is the policy instrument by which governments exercise their discretionary powers as to which foreign banks will be granted access to their domestic markets. The principle of national treatment comes into play once access has been granted and concerns the continuing treatment that the supplier of the banking services can expect to receive from

[799] Wang 2003:182.National Treatment under the GATS/WTO. http://heinonline.org (accessed 2011/12/06).

[800] See paragragh 2(a) of the Annex on Financial Services.

[801] Wang 2005:180-182.

[802] Arup 2008: 193-198.

the authorities of the importing country.[803]It is set forth in article XVI of the GATS.[804] The provision reads as follows:[805]

> "With respect to market access through the modes of supply identified in article 1, each member shall accord services and service suppliers of any other member treatment no less favourable than that provided for under its terms, limitations and conditions agreed and specified in its schedule".

The Panel in the *US-Gambling case* interpreted article XVI by making two important findings:[806] Firstly, the Panel stated that, based on the ordinary meaning of the terms, article XVI:1 makes clear that members are bound by the terms, limitations and conditions contained in the market access column of their respective schedules. Secondly, it was concluded that, the types of measures listed in article XVI:2 is an exhaustive list of the restrictions prohibited by article XVI, in particular by the first paragraph of article XVI. The Panel adopted the narrow interpretation of article XVI:1 and found that, the list of restrictions in article XVI:2 is an exhaustive list including the restrictions on market access that are covered by article XVI under the Vienna Convention on the Law on Treaties, however, it was not highly authoritative because it did not thoroughly consider all the factors of interpretation.[807]

The commitment on market access is meant to provide disciplines against members' applying quantitative restrictions on imports of banking services from other members.[808] In

[803] Footer 1995:472.

[804] Ibid.

[805] See GATS art.XVI.

[806] Goco 2006:743.

[807] Raj 1994:246-247. The Panel framed its interpretation of article XVI by stating that the context of the first para. of article XVI includes the second paragraph of article XVI, and went on to apply art. 31 VCLT to the second para.of article XVI. It examined the ordinary meaning of article XVI: 2 as follows: On the basis of the ordinary meaning of terms contained in article XVI:2, the purpose of the second paragraph of article XVI is to define the types of limitations and measures which shall not be maintained or adopted in scheduled sectors or sub-sectors, unless otherwise indicated in the relevant member's schedule. Para. 2 also informs members of the manner in which they should schedule such limitations and measures.

[808] Morrison 2001:601.

the banking services sector, article XVI:2 of the GATS states the types of market access obligations that can be limited by inclusion in the schedule. This includes: [809]

(a) limitation on the number of banking service suppliers, whether in the form of numerical quotas, monopolies, exclusive suppliers or the requirement of an economic needs test;

(b) limitations on the total value of banking service transactions or assets in the form of numerical quotas or the requirement of an economic needs test;[810]

(c) limitations on the total number of natural persons that may be employed in a bankingservices sector or that a banking service supplier may employ and who are necessary for, and directly related to, the supply of a specific service in the form of numerical quotas or the requirement of an economic needs test;

(d) limitations on the total number of banking service operations or on the total quantity ofbanking service output expressed in terms of designated numerical units in the form of quotas or the requirements of an economic needs test;

(e) measures which restrict specific types of legal entity or joint venture through which abanking service supplier may supply a service; and

(f) limitations on the participation of foreign capital in terms of a maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment.[811]

The Panel in the *US-Gambling Case* also found that the words "terms, limitations, and conditions on market access" in article XX:1 correspond directly with the types of measures listed in article XVI:2:[812]

> "This language, particularly the use of the word "limitations" denoted the limitations identified in article XVI:2 (a), (b), (c), (d) and (f). The words "terms"

[809] Krajewski 2005:81.

[810] Ibid at 81-90.Limitations of foreign bank assets to a certain percentage of total domestic assets of all banks would fall under the scope of this subparagraph.

[811] Ibid at 81.

[812] Goco 2006:743-744.

> and "conditions" refer to the "measures" contemplated by article XVI:2(e) and the chapeau of article XVI:2."

The Panel therefore found that the word "limitation" in article XVI:1 refers only to the two types of measures listed in article XVI:2, save paragraph (e).[813] Thus, the Panel found that the words "terms" and "conditions"in article XVI:1 refer to "measures which restrict or require specific types of legal entity through which a banking service supplier may supply a banking service, as provided in article XVI:2(e).[814]These measures comprise four types of quantitative restrictions above, paragraps (a) and (d) as well as limitations on forms of legal entities paragraph (e) and on foreign equity participation paragraph (f). The list is exhaustive, in the sense that a member is regarded as granting full market access in a given sector and mode of supply when it does not maintain any of these measures.[815]

The various restrictions on numerical quotas and economic needs test are required to ensure that the judgment on the issuance of bank licences and /or other decisions cannot be based on an economic needs test.[816] It must be as a result of whether the bank has fulfilled the predetermined criteria for entry, for example, based on minimum capital requirements. Members can state the number of licences they respectively issue annually or the number of expatriates they will permit per year.[817] Market access prevents members from making commitments that are based on an economic needs test.[818] This is a negative list, in that commitments must be made to conform to the requirements in article XVI. Commitments that do not come under the ambit of market access and national treatment can also be negotiated and included in the schedule as additional commitments.[819] In order to achieve market access, article XVI:2 (b) prohibits limitations on the total value of service

[813] Goco 2006:743-744.

[814] Ibid.

[815] Guojan 2010:76.

[816] Yokoi-Arai 2008:620.

[817] Ibid.

[818] See GATS art.XVI.

[819] See GATS art.XVIII.

transactions or assets in the form of numerical quotas or requirement of an economic needs test.[820]

3.6.3.2 Market Access and Progressive Liberalisation

The progressive liberalisation of access to banking markets for foreign banks is an important manifestation of the anti-protectionist foundation of the GATS.[821] No country should be allowed to exclude banks from certain countries while granting preferred access to banks from other countries unless there are compelling prudential reasons to do so.[822] Every country should be encouraged to reduce non-tariff barriers to foreign bank entry to an acceptable minimum based on prudential laws and regulations. These general ideas are aimed at facilitating the free flow of capital across borders by ensuring that institutions that transfer funds and trade financial instruments and foreign currencies will be free to establish offices in any member country.[823] The GATS appears to accept these general ideals. It envisions successive rounds of negotiations whereby each round results in the reduction of non-tarriff barriers to trade in banking services. There are no preset ground rules for these rounds. In each round, negotiators determine neither how the negotiations will be conducted noris.there any prescribed time period between rounds or for a particular round. In sum, the process of progressively liberalising the access of foreign banks to the markets of the GATS members is loose and informal.[824] In each round, the members make commitments with respect to banking. These commitments are memorialised in schedules which are annexed to and become a part of the GATS.[825] The commitments involve specific promises made by a member about the degree to which banks from other members will have access to the member's market. Naturally, no rational member will make a promise

[820] See GATS art. XVI: 2(b).

[821] Raj 1994:246-247. The foundation of anti-protectionism should be conceived of in terms of three specific manifestations: the most favoured nation principle, the principle of national treatment, and the progressive liberalisation of market access.

[822] Ibid.Such as safety and soundness.

[823] Raj 1994:246-247.

[824] Ibid.

[825] See GATS art. XX: 1.

without obtaining a promise of equal or greater value.[826] The meaning of a commitment to increase market access is substantially elaborated in article XVI: 2 of the GATS.[827] This important provision identifies in detail six measures a member is not permitted to take once it has made market access commitments, unless its schedule expressly permits such measures. Interesting, any of these rules can be challenged not only under article XVI, as violation of a specific market access commitment, but also as a violation of article XVII, concerning national treatment.[828] These six measures are: firstly, limitations on the number of foreign banking service providers are prohibited.[829] Quotas, monopolies, exclusive banking service providers, or economic needs tests are expressly barred. Secondly, limitations on the total value of banking service transactions, again regardless of the form of the measure, are not permitted.[830] Establishing a cap on the income or profits earned by foreign banks would violate this prohibition. Thirdly, it is impermissible to limit the total number or total quantity of banking services output by using quotas or an economic needs test.[831] A measure which precluded foreign banks from lending more than 1 billion dollars or from obtaining more than ten per cent share of the market for loans to companies with assets of less than 1 billion dollars would be a quota for the quantity of service output and, therefore, would violate this prohibition. Fourthly, a limitation on the number of individuals who may be employed in a particular banking services sector or that a banking service provider may not employ is prohibited. Fifthly, a member cannot adopt a measure which restricts or requires a banking service supplier to provide a banking service through a specific type of legal entity.[832] Lastly, limitations on the participation of foreign capital through caps on the percentage of foreign shareholding or the total value of foreign investment are barred.[833]

[826] Raj 1994:247.

[827] Ibid.

[828] Ibid at 248.

[829] See GATS art. XVI: 2(a).

[830] See GATS art. XVI: 2(b).

[831] See GATS art. XVI: 2(c).

[832] See GATS art. XVI:2 (e).

[833] See GATS art.XVI:2(f).

3.6.4 National Treatment and Market Access

From the structure of the GATS, market access and national treatment are in the same part of the GATS, that is, part III dealing with specific commitments, which means that market access is not a general obligation under the GATS.[834] Part III of the GATS[835] requires that specific commitments be made by members in relation to market access and national treatment. Schedules of commitments state the specific condition of market access and national treatment that members grant for each sector.Specific commitments are subject to negotiation and then listed in the schedule of each member. Progressive liberalisation is an objective of the GATS as set out in Part IV. This is achieved by amending and modifying the schedule to allow greater liberalisation in successive rounds.[836] These clauses prevent members from taking measures that are regressive or trying to retain the status quo.[837]

In each member's schedule, there are three columns, market access column, national treatment column and additional commitments column.[838] The column of additional commitments does not belong to or overlap with the market access and national treatment columns. On the one hand, any sector or sub-sector that a member agrees to open shall be inscribed in the column. In other words, if a sector or a sub-sector does not appear in the schedule, it will be presumed that the member does not open the sector or sub-sector. This approach is called positive approach, or "bottom-up"approach.[839] On the other hand, any limitation on market access and national treatment with respect to a specific sector or sub-sector shall be inscribed in the corresponding columns, in addition to the horizontal commitment applying to trade in banking services in all scheduled banking services sectors unless otherwise specified. Otherwise, it will be deemed that there is no limitation on market access or national treatment for the sector or sub-sector. Such approach is called

[834] Wang 2003:165. National treatment in Financial Services in the GATS/WTO.http://heinonline.org (accessed 2011/12/06).

[835] Ibid.

[836] See GATS art. XIX:1.

[837] Footer 1995:461.

[838] Morrison 2001: 606.

[839] Ibid.

negative approach,[840] or "top-down approach".[841] A schedule is a combination of positive approach and negative approach, called the hybrid approach.[842] For each sector or sub-sector, the limitation shall be expressed in order of four modes of supply, that is, cross-border supply, consumption abroad, commercial presence, and presence of natural persons.[843] It is also necessary to identify the mode of services supply, as defined in GATS article 1:2, in respect of which the member complained against has entered into specific commitments on market access and/or national treatment. In cases where it is technically not feasible to supply a given services transaction through a certain mode, members usually will not enter into or inscribe "not applicable" in their schedule. What was relevant for purposes of the *Bananas case* was that the EC had scheduled commitments concerning wholesale trade in services with respect to the first and third mode of supply.[844]While the cross-border supply of wholesale trade in serviceswasneither technically impossible nor economically insignificant, however as trade in services was involved, the *Bananas case*centered around wholesale services supply through commercial presence. Although the complainants claimed that services as well as service suppliers were subject to less favourable treatment under the EC banana regulations at issue, it was not entirely clear whether this argumentation related to cross-border supply as well as supply through commercial presence, or exclusively to the latter, mode 3. In essence, this problem derives from the fact that the GATS non-discrimination clause refers to services and service suppliers, which does not exactly match the terminology and the definitions used for describing the modes of supply in GATS article 1(2) a and c. The Panel and the Appellate Body findings refer to service suppliers, which will imply coverage of supply through commercial presence only since in the case of supply across borders only foreign services are direct beneficiaries of GATS rights. This is so because a member's GATS obligations extend to service suppliers located outside that member's territory only as far as the service

[840] Fausten 2003:118.

[841] Stijn and Marison 2000:10-11.

[842] Morrison 2001: 606.

[843] Gkoutzinis 2005: 881.For trade in banking services the two important modes are cross border and commercial presence.

[844] Werner 1999:323. That is across borders mode 1 and through commercial presence mode 3.

supplied across borders by such suppliers are affected, although from an economic perspective a services supplier located abroad must necessarily be involved in cross-border supply of a service per se.[845]

The market access obligations reduce barriers to entry of foreign banks,[846] namely limitations on the number of foreign banks,[847] the total value of service transactions or assets, the total number of service operations or the total quantity of service output, the total number of employees, the type of legal entity or joint venture through which a foreign bank operates, and foreign equity participation. The national treatment principle prohibits measures that discriminate against "like" banks and banking services of other members and distort the conditions of competition in favour of domestic banks. Article VI asks for reasonable, objective and impartial administration of measures affecting trade in banking services and aims to prevent the use of qualification requirements and procedures, technical standards and licensing requirements as barriers to entry of foreign banks.[848]

3.6.6 Schedules of Specific Commitments

Market access, national treatment and additional commitments are inscribed in each WTO member's schedule with respect to the banking services sector.[849] During the negotiations, members were required to specify the sectors and activities in which they intended to undertake specific commitments. These were listed in country schedules appended to the agreement.[850] Part III of the agreement comprises article XVI (market access), XVII (national treatment), and XVIII (additional commitments).[851] These three articles of the Agreement are the core of the agreement as far as specific sectoral commitments are concerned. Having established that signatories will accord services and service suppliers treatment

[845] Werner 1999:323.

[846] Krajewski 2005: 82-84.

[847] The term "foreign bank" is used here to mean banks of any other member country.

[848] See GATS art.VI.

[849] Morrison 2001:605.

[850] Dilip 1998:95.

[851] Ibid.

atleast as favourable as that provided for in the schedules, the article goes on to define six types of market access restrictions that may not be adopted in respect of sectors where market access commitments are undertaken "unless specified in its schedule".[852] That is, market access discipline will apply to scheduled commitments unless a reservation is registered to the contrary. Limitations on market access should be scheduled in terms of one or more of the six measures specified in article XVI, paragraph 2. Article XVI can be treated as exhaustive, in the sense that the six types of market access restrictions defined in it are the only limitations on market access that members are permitted to include in their schedules.[853]

Article XVII contains the national treatment principle of the agreement.[854] The approach adopted here is similar to that of market access, that is, national treatment is applicable only to scheduled commitments, and only if reservations are not made to the contrary. It is something to be granted, denied or qualified, depending on the sector and signatory concerned.[855] Members' inscriptions of market access and national treatment limitations for each service sector or sub-sector inscribed should be made for each of the four modes of supplying banking services. Article 1 defines the modes of supplying banking services as: cross-border; consumption abroad; commercial presence and presence of natural persons.[856] Each sector or sub-sector commitment should, therefore, consist of eight entries: four addressing any limitations on market access and four addressing any

[852] Dilip 1998:95.

[853] Ibid. Accoring to Dilip, "If market access and national treatment were general obligations, a negative list of exceptions or "top-down" approach could be used for scheduling. Under this approach all non-conforming measures could be listed as limitations in a country's schedule of commitments. By non-conforming measures we mean measures that do not conform to the principle of market access and national treatment. Consequently, market access and national treatment would have applied to all sectors not listed in a country's schedule of commitment. For instance, in banking sector if a member wishes to prohibit further expansion of foreign or deposit accumulation by foreign banks in the domestic market, and wishes to do so without violating its GATS obligations, all it needs to do is inscribe these wishes to do so without violating its GATS obligations".

[854] Leroux 2002:423.

[855] Ibid.

[856] Jareau 1999:44. Interpreting the General Agreement on Trade in Services and the WTO instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06).

limitations on national treatment.[857] In addition to part II, the Annex on Financial Services provides for specific commitments as opposed to general obligations. The Annex deals with the specificities of the banking services and takes into account the sector-specific characteristics of banking services. The most significant sector-specific provision relates to prudential measures in domestic regulation. Since the start of the negotiations on financial services during the Uruguay Round, negotiators recognised the need to maintain measures protecting domestic prudential regulations as well as investors and depositors. Therefore, paragraph 2(a) had to be added to the Annex.[858] These measures need not be inscribed in the schedules of specific commitments of members regardless of whether they are in conformity with Article XVI (market access) and XVII (national treatment) so long as they constitute prudential measures as defined in the same Annex.[859]

A WTO member is only bound to market access and national treatment in those sectors which it committed to the obligations in its schedule of specific commitments.[860] The schedules are annexed to the GATS and form an integral part of the agreement.[861]They are hence legally binding on respective WTO members.An Important feature of scheduling is that WTO members can commit themselves to specific disciplines at different levels.[862] Articles XVI, XVII and XX stipulate that WTO members can schedule "terms, limitations, qualifications and conditions" of market access and national treatment obligations.[863]

Free trade effectively allows foreign banks to enter the domestic market by way of specific commitments made by the host country.These specific commitments in the schedule are

[857] Jareau 1999:44. Interpreting the General Agreement on Trade in Services and the WTO instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06).

[858] Leroux 2002:430.

[859] Ibid.

[860] Krajewski 2005:76.

[861] GATS art. XX: 3.

[862] Krajewski 2005:77-78.

[863] Ibid.

laid out in article XX. This articulates the commitments, together with article XVI. Each schedule should articulate:[864]

"Each member shall set out in a schedule the specific commitment it takes under Part III of this Agreement." The sectors where such agreement is undertaken shall specify:[865]

(a) terms, limitations and conditions on market access;

(b) conditions and qualifications on national treatment;

(c) undertakings relating to additional commitments;

(d) where appropriate, the time frame for implementation of such commitments; and

(e) the date of entry into force of such commitments. It is noted that the schedule of commitments is an integral part of GATS.[866]

Measures inconsistent with Article XVI shall be inscribed in the column relating to article XVI.[867] In this case the inscription will be considered provided there is a condition or qualification to Article XVII as well.When read together, article XX,(schedules of specific commitments), XVI, (market access), and XVII, (national treatment), suggest that WTO members must be regarded as having made commitments only in those banking services sectors identified in their schedules.[868] Article XX (1) provides, in part, that each member shall set out in a schedule the specific commitments it undertakes under Part III of the Agreement. Article XVI (1) refers to each member's market access commitments specified in its schedule, and article XVII (1) mandates that each WTO member provide national treatment in the sectors inscribed in its schedules. Although article XVII only refers to sectors, a fair reading of the three articles together comfirms that a WTO member should not be assumed to have made commitments, unless it is specifically inscribed in its schedule of specific commitments.[869]

[864] See GATS art. XX: 1.

[865] GATS art XX.

[866] See GATS art.XX.

[867] Leroux 2002:422-423.

[868] Krajeswki 2008: 76-80.

[869] Jareau 1999:43. Interpreting the General Agreement on Trade in Services and the WTO instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06).

Standard terminologies areused to identify market access and national treatment limitations, but they are not entirely uniform.[870] If a member intends to include no limitations on market access or national treatment for a particular sector or sub-sector, the word "NONE" is entered in the respective limitations column for the mode of supply being addressed. If a member inscribes banking sector in its schedule but intends to retain the option to maintain or introduce measures that limit market access or national treatment for any or all of the modes of supply, "UNBOUND" is entered."UNBOUND" must be inscribed for each mode of supply in the respective market access and national treatment columns, as is applicable.[871] The following standard terms have been used in the schedule columns under market access or national treatment.[872]

None this means that there are no limitations on foreign banking services or foreign banking service suppliers that are inconsistent with the relevant market access or national treatment provisions of the GATS.

Text The text states the limitation(s) for the particular mode of supply.

Unbound This means that measures inconsistent with the market access or national treatment provisions of the GATS may exist or be introduced.

The terminology employed in article XX, XVI, and XVII indicates that only those limitations on market access and national treatment that are specifically inscribed in the member's schedule may be maintained or introduced.[873] This position does not apply if a member inscribed "UNBOUND". Article XX which addresses both market access and national treatment limitations, addresses the limitations those members may specify in their schedule. Article XVI (2) identifies the measures which a member shall not maintain or

[870] Jareau 1999:43. Interpreting the General Agreement on Trade in Services and the WTO instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06).

[871] Stijn and Marion 2000:11.

[872] Jareau 1999:45.Interpreting the General Agreement on Trade in Services and the WTO instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06). "UNBOUND" is entered if a schedule commitment is not technically feasible through a particular mode of supply. An explanatory footnote would be made containing information explaining why a scheduled commitment is considered not technically feasible.

[873] Hoekman ea 2002:260-261.

adopt unless otherwise specified in its schedule. Article XVII mandates national treatment for the banking services and banking service suppliers of other WTO members subject to any conditions and qualifications set out in the members' schedule. [874]

The treatment of banking services under the WTO system involve an additional complexity that is likely a by-product of the limited result achieved using the positive list approach to sectoral coverage –the willingness of the WTO membership to engage in sectoral services negotiations outside the framework of a formal negotiating round of trade negotiations. The agreement on trade in banking services is an example of this type of agreement. A WTO member's GATS schedule can always be amended to increase the number of commitments schedules by simply adding to existing positive lists.[875] Therefore recording the results of such sector specific negotiations is relatively simple. This is done by amending the member's schedule to add the newly negotiated commitments.[876]

3.6.6.1 Interpretation of Specific commitments in a member's Schedule

Pursuant to article XX: 3 of the GATS, the schedule of a member forms an integral part of the GATS. Hence, the rules of interpretation that apply with respect to a schedule are the same as those applicable to the rest of the Agreement. This means that the schedule of a member, and the specific commitments contained therein, must be interpreted in accordance with articles 31 and 32 of the Vienna Convention on the Law of Treaties.[877] This position was firmly adopted in the *US-Gambling case*.[878] Accordingly, the specific commitments of a member, like any other treaty term, must be interpreted in good faith, in accordance with the ordinary meaning of the member's scheduled entries taken in their

[874] Jareau 1999:45.Interpreting the General Agreement on Trade in Services and the WTO instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06) .A fair interpretation of these articles suggests that if any limitations on market access or national treatment are not specifically inscribed in the member's schedule, any attempt by the member to impose such limitations would violate the GATS.

[875] Sciarra 1998:925.

[876] Ibid. This aspect of the GATS makes the schedules somewhat of a moving target but new commitments will result in additions to only a specific part of each WTO member's schedule, which should be readily identifiable.

[877] Leroux 2008: 242-243.

[878] Ibid.

context and understood in the light of the object and purpose of the GATS and the WTO Agreement more generally.[879] The determination in this case is that while a member's schedule only binds that member, it represents a common agreement among all WTO members. Hence, the task of ascertaining the meaning of a commitment in a schedule involves identifying the common intention of members.[880]

3.7 Legal structure of Banking services - Documents under the GATS/WTO

3.7.1 The Annex on Financial Services

The GATS',[881] specific sectoral commitments, are contained in special schedules, and the provisions surrounding them are called annexes.[882] In general, the annexes are attempts to extend the general rules of the GATS to the specificity of sectoral regulations, whereas the schedules set out the obligations of governments, spread across a scheduling matrix bounded by sub-sectors and by what are called modes.[883] Modes are scheduling conventions that caused governments to list limitations on free access by how the banking service is supplied acrossborders.[884]

The Annex on Financial Services is one of the eight annexes to the main text of GATS, which are an integral part of the GATS.[885] Both the GATS and the Annex on Financial Services are applicable to each WTO member.The Annex on Financial Services contains five Paragraphs:[886] Paragraph 1 is "Scope and Definition", further interpreting GATS article 1 in the context of banking services. Paragraph 2 is "Domestic Regulation". Paragraphy 3 is "Recognition", which is the application of GATS article VII to banking services. Paragraph 4 is "Dispute Settlement", providing that panels for disputes on banking matters shall have the

[879] Leroux 2008: 242-243.

[880] Panizzon ea 2008:242-243.

[881] Lang 2000: 806.

[882] Ibid.

[883] Ibid.

[884] Lang 2000: 806.

[885] Wang 2003:173.National Treatment under the GATS/WTO.http://heinonline.org (accessed 2011/12/06).

[886] Leroux 2002: 428-430.

necessary expertise relevant to the specific banking service at issue in the dispute. Paragraph 5, "Definition", includes three definitions: "financial services", financial service suppliers, and "public entity".[887]

3.7.1.1 Scope

The Annex applies to "measures affecting the supply of banking services".[888] In the *EC Bananas case*[889] the EC argued that its common market organisation for bananas regulates the importation of goods and not the provision of services and, accordingly, cannot constitute "measures affecting trade in services" within the meaning of the GATS. The Appellate Body agreed with the Panel that the ordinary meaning of the term "affecting" does not convey any notion of limiting the scope of the GATS to certain types of measures or to a certain regulatory domain.[890] The Panel and the AppellateBody shared the view that a broad interpretation of the term "affecting" was also called for because the GATS defined the supply of a service as including the production, distribution, marketing, sale and delivery of a service. This was the first attempt to transplant the principles andprocedures of the General Agreement on Trariffs and Trade (GATT) to GATS, however, it was impossible to transplant the basic principles of GATT to GATS in all their full Vigour.[891] The objective of the GATS then was the liberalisation of trade in banking services between WTO members.[892] For this purpose four different modes of banking service supply are distinguished.[893] The supply of banking services means the supply of those services through the four modes of supply identified in article 1:2 of the GATS, that is:[894]

(a) from the territory of a member into the territory of another member;

[887] Van Empel and Morner 2000:40-41.

[888] Ibid.

[889] Ibid.

[890] Ibid.

[891] Ibid.

[892] Ibid.

[893] Ibid.

[894] The Law of the World Trade Organisation.<http://www.phasel.nccr-trade.org/../WTO%20-%20chapter%204non-discrimination.pdf>(accessed 15/05.2012):379-380.

(b) in the territory of a member to the service consumer of another member;

(c) by the service supplier of a member, through commercial presence in the territory of another member; and

(d) by the service supplier of a member, through presence of a natural person in the territory of another member.

Banking service supplier is broadly defined.[895] According to the Annex, it means any natural person or juristic person of a member wishing to supply or supplying banking services, excluding a public entity.[896] Thus, in order to be a banking services supplier under the GATS, for the purpose of the application of the MFN treatment obligation, the person or a member does not, in principle, need to be already engaged in the supply of banking services in the territory of that member.[897]

True to GATT model, GATS provides a few basic principles[898] to apply from the start, as well as gradual liberalisation through multilateral negotiations between WTO members.[899] The basic principles are the most favoured nation treatment (MFN); the obligation of legislative and regulatory transparency; and the availability of national remedies.[900] As for the negotiations, the essential point of reference for each member of the arrangement is its "Schedule"-in which it commits itself to a certain level of liberalisation in terms of market access and national treatment.[901] This, in itself, contributes to transparency, one of the major aims of GATS, while the schedules will be the object of future negotiations aimed at further narrowing barriers between WTO members.[902] Again, following the GATT model,

[895] Leroux 2002:428.

[896] See GATS Annex para. 5(b).

[897] See GATS art.1:3 (c). A "public entity" which is excluded from the definition of banking services supplier, means a government, a central bank or monetary authority of a member, or an entity owned or controlled by a member, that is principally engaged in carrying out government functions or activities for governmental purposes, not including an entity principally engaged in supplying banking services on commercial terms.

[898] Van Empel and Morner 2000:41.

[899] Ibid.

[900] Ibid.

[901] Ibid.

[902] Ibid.

these negotiations essentially have a multilateral dimension through the MFN principle, extending any concession made to one single WTO member to all other members. The result is the phenomenon of a series of bilateral bargaining exercises between single member states, or restricted groups of members, within the overall "rounds" involving all members.[903]

3.7.1.2 Normative Rules

Virtually everynormative provision of the GATS is interesting and even novel.[904] Through domestic regulation[905] GATS establishes for the first time a framework of rules governing trade in banking services.[906]

3.7.1.2.1 Domestic Regulation

a) Domestic regulation reads as follows:

> "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 the financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform to the provisions of the Agreement, they shall not be used as a means of avoiding the member's commitments or obligations under the Agreement;[907]
>
> b) Nothing in the Agreement shall be construed to require a member to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities".[908]

[903] Van Empel and Morner 2000:41.

[904] Lang 2000: 806.

[905] See art. VI of the GATS.

[906] Charles 2000:811.

[907] Leroux 2002:430-431.

[908] Ibid.

A measure that falls within the ambit of this exception may not give rise to a violation of the GATS.[909] The words"notwithstanding any other provisions of the Agreement" indicate that the exception applies in respect of any obligation under the GATS. The scope of this exception, commonly referred to as the prudential carve-out, is rather broad.[910] While the main body of GATS requires that domestic regulation is fair and objective with qualitative, not quatitative, requirements, banking services can be exempted from such GATS provisions. For such exceptions, the regulation must be for prudential or investor protection purposes. If a member is exposed to serious balance of payment and external financial difficulties or a threat of it, the member may adopt or maintain restrictions on trade in banking services even when specific commitments have been made.[911] Given the uniqueness of trade in banking services, it was agreed that prudential consideration would be given for banking regulation, and was thus included in the Annex on Financial Services.[912] Even though a measure is taken for prudential reasons, thus is a priori covered by the exception, it "shall not be used as a means of avoiding a member's commitments or obligations under the Agreement", for instance its specific commitments in the banking services sector.[913] This is essentially an "anti-avoidance" provision, the purpose of which is to prevent the abuse of the exception for prudential measures.[914] Although practice on point varies, a member need not inscribe them in its schedule of commitments or its list of MFN exemptions, because prudential measures are not considered restrictive on market access or national treatment in the usual sense. Guidance for the content of prudential

[909] Leroux 2002:430-431.

[910] See GATS art. VI. The main body of GATS on domestic regulation requires that "all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner". Article VI: 4 states that where there are qualification requirements and procedures, technical standards and licensing requirements, will not constitute unnecessary barriers to trade in services...".

[911] See GATS art. XII:1.

[912] Yokoi Arai 2008:638.

[913] See GATS Annex par. 2(a).

[914] Leroux 2002:430-432. Although paragraph 2(a) has yet to be interpreted by a panel or the Appellate Body, it is clear that, it imposes on a member an obligation of good faith with respect to the adoption and application of prudential measures. The comments of the Appellate Body in the *US-Shrimp case on* the chapeau of article XX of the GATT are instructive in this regard. The Appellate Body said in this case that, the introductory clause of article XX is but one expression of the principle of good faith, which is at once a general principle of law and a general principle of international law.

measures can be drawn from other financial sectors and the respective institutions that set international banking standards and best practices like the Basel Committee on Banking Supervision.[915]

3.7.2 Recognition

Paragraph 3 of the Annex specifies that a member may recognise prudential measures of another country- WTO member or not such recognition may be accorded unilaterally or pursuant to an agreement or arrangement between the host member and another country.[916] "That allows a member, for instance, to deny a branch license to the bank of another member, while granting branch licences to banks of other members, if such differential treatment is based on the fact that the former member does not supervise the activities of the banks established in its territory".[917] Such selective recognition of adequacy of prudential measures taken by other members would not lead to a breach of the MFN treatment obligation.[918] Recognition of prudential measures may be achieved through harmonisation or otherwise and may be either unilateral or by agreement or arrangement with the other country. Such selective recognition of adequacy of other countries' prudential measures is a permissible form of MFN exemption.[919]

3.7.3 The Present State of the Prudential Carve -out

Section 2(a) of the Annex on Financial services, in effect, allows members to apply regulatory measures that do not comply with their specific commitments.[920] Whether the

[915] Leroux 2002:430-431.

[916] Ibid.

[917] Ibid.

[918] Ibid. Leroux argues that, the "Uruguay Round participants specified, however, that where a member recognises the prudential measures of another country, it must afford, depending on the circumstances, an adequate opportunity for other interested members to negotiate their accession to the agreement or arrangement, to negotiate a comparable agreement or arrangement or to demonstrate that their prudential measures should also be recognised unilaterally. Thus, whenever a member recognises, in one form or another, the prudential measures of another member, any other interested member must be afforded the opportunity to show that its own prudential measures also are worthy of the same recognition".

[919] Ibid.

[920] Yokoi-Arai 2008:639.

measures are in fact prudential in nature or not, becomes irrelevant in the current legal structure. The WTO can use the dispute settlement mechanism to interpret the prudential requirement but there is no indication that this will take place, the paragraph permits, theoretically, members to take measures that applied in the name of prudential concern.[921]

3.7.4 Dispute settlement

The Annex specifies that when a panel is constituted for the purpose of resolving a dispute related to prudential issues or other banking matters, it shall have the necessary expertise relevant to the specific banking service at issue.[922] This reflects the view of the negotiators that, because of the complexity of its regulation and its importance for the entire economy of a country, the banking sector is unique and thus it must be ensured that panels dealing with banking sector disputes have expertise in that area.[923]

3.7.5 The Understanding on Commitments in Financial Services

For trade in banking services, however, there is a unique additional element, namely, the Understanding on Commitments in Financial Services, which was used by most of the OECD countries in scheduling commitments to supplement the provisions of the GATS framework agreement.[924] The Understanding imposes a strict discipline and provides that:[925]

> "Each member shall endeavour to remove or to limit any significant adverse effects on banking service suppliers of any other member of:[926]
>
> (a) non-discriminatory measures that prevent banking servicesuppliers from offering in the member's territory, in the form determined by the member, all the banking services permitted by the member;
>
> (b) non-discriminatory measures that limit the expansion of activities of banking services suppliers into the entire territory of the member;

[921] Yokoi-Arai 2008:639

[922] See para. 3 (c) of the Annex.

[923] Leroux 2002: 432.

[924] Stijn and Marion 2000:11.

[925] Wolfrum ea 2008: 646.

[926] Leroux 2002:438-439.

(c) measures of a member, when such a member applies the same measures to the supply of banking services of any other member with concentrated activities in the provision;

(d) other measures that, although respecting the provisions of the Agreement, affect adversely the ability of banking service suppliers of any other member to operate, compete or enter the member's market; provided that any action taken under this paragraph would not unfairly discriminate against banking service suppliers of the member taking such action."[927]

There are four parts in the Understanding on Commitments in Financial Services (the Understanding).[928] Paragraph A is "Standstill," paragraph B is "Market access"; paragraph C "National treatment", and paragraph D is "Definitions".[929] The Understanding requires a higher degree of banking services liberalisation than the GATS that is why it was impossible to be accepted as an integral part of the GATS by consensus.[930] WTO members are not required to adhere to "the Understanding" as they must to the dictates of the GATS.[931] Thus, "the Understanding" is only binding on those interested members who have inscribed this Understanding in their schedules subject to conditions and qualifications.[932] If a member inscribes the Understanding in its schedule, it is binding on the member, and all other WTO members can obtain the benefits of the Understanding through the MFN

[927] International Legal Material 1994:1260-1263. Art. 10 of the Understanding on Commitment on trade in Financial Services, imposes a soft obligation since it provides that member states shall endeavour to remove or limit....indicating that WTO Courts would hardly consider it binding. However, it suggests that states should not adopt measures that, although non-discriminatory, affect the competitive capacity of foreign providers.

[928] Wang 2003:174. National Treatment in the GATS/WTO.http://heinonline.org (acessed 2011/12/06).

[929] Ibid.Part B includes eight paragraphs: Monopoly Rights; Financial Services Purchase by Public Entities; Cross-border Trade; Commercial Presence; New Financial Services; Transfer of Information and Processing of Information; Temporary Entry of Personnel and Non-discriminatory Measures.Wang 2003:174. National Treatment in the GATS/WTO.http://heinonline.org (acessed 2011/12/06).

[930] Jarreau 1999:39-40.Interpreting the General Agreement on Trade in services and the WTO instruments relevant to international Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06).

[931] Footer 1993:351.

[932] Ibid.

treatment.[933] In other words the legal status of the Understanding depends on a member's voluntary act.[934] The aim of the Understanding is to expand the trade liberalising reach of the GATS framework agreement and Annex on Financial Services, and the member's schedules of specific commitments.[935] The Understanding offers greater predictability to trade in banking services than the GATS by further refining the market access and and national treatment obligations.[936]

The Understanding allows members to opt for a higher and more robust set of market access and national treatment commitments that would grant non-discriminatory access to all foreign banking services providers of WTO member states.[937] It has been adopted by mostly developed countries. The members had adopted the Understanding by cross-referencing. The Understanding is not part of the GATS, but is part of the Final Act of the Uruguay Round.[938] It is an optional document that sets out a blueprint for making commitments on banking services.[939] It goes beyond market access commitments to specify disciplines on government non-discriminatory measures. Participants in the Uruguay Round have been enabled to take on specific commitments with respect to banking services under the Understanding on Commitment in Financial Services on the basis of an alternative approach to that covered by the provisions of Part III of the GATS It was agreed that this approach could be applied subject to the following understanding:[940]

(i) it does not conflict with the provisions of the Agreement;

[933] Wang 2003:175.National Treatment in the GATS/WTO.http://heinonline.org (acessed 2011/12/06). For example, in the head note of Japan's Schedule of specific Commitments (banking serices sector), there is a special statement: "In addition to part III of this agreement (the GATS) and the Annex on Financial Services, Japan undertakes its specific commitments with respect to banking services under this agreement in accordance with the Understanding on Commitments in Financial Services. Thus, the obligations under the Understanding are incurred in the sectors of Financial Services additionally to those covered by the provisions of Part III of this Agreement and the Annex on Financial Services".

[934] Wang 2005:174.

[935] Ibid.

[936] Ibid.

[937] Footer 1993:351-352.

[938] Ibid.

[939] Ibid.

[940] Peuker 2000: 194.

(ii) it does not prejudice the right of any member to schedule its specific commitments in accordance with the approach under Part III of the Agreement;

(iii) resulting specific commitments shall apply on a most favoured nation basis;

(iv) no presumption has been created as to the degree of liberalisation to which a member is committing itself under the Agreement.

Interested members, on the basis of the negotiations, and subject to conditions and qualifications where specified, have inscribed in their schedule specific commitments conforming to the approach set out below.[941]

A. Standstill

The Understanding includes a "standstill rule" on existing non-conforming measures,[942] which prohibits parties from adopting any law or regulation that would increase the level of non-conformity of its listed measures.[943] The Importance of the Standstill relates to the depth of commitments undertaken by parties as it involves freezing the existing regulatory regime by undertaking a commitment not to take measures more non-conforming in future.[944]

B. Market Access

Market access provisions refer to the conditions under which a foreign banking services supplier is allowed to enter and operate within a domestic market, and typically list a set of specific measures that a party cannot maintain or adopt without reserving them.[945]

(i) Commercial Presence

Each member shall grant banking service suppliers of any other member the right to establish or expand within its territory and the acquisition of existing enterprise, a commercial presence.[946]

[941] Wolfrum ea 2008:647-648.

[942] Leroux 2002:433. It means that conditions, limitations or qualifications that a member adhering to the Understanding wishes to inscribe in its schedule can only reflect non-conforming measures that exist at the time of its adherence to the understanding.

[943] Goncalves and Stephanou 2007:27.

[944] Ibid.

[945] Goncalves and Stephanou 2007:27.

[946] Wolfrum ea 2008:655.

Section B(5) requires a member to grant other members' banking service suppliers the right to establish or expand a commercial presence in the granting member's territory.It should be noted that expansion includes acquisition of existing enterprises. The broader definition of "commercial presence" for purposes of the Understandinghas made this provision highly significant, in terms of retail banking.[947]

(ii) New Financial Services

> "A member shall permit banking service suppliers of any other member established in its territory to offer in its territory any new banking service."[948]

Paragraph B(7) grants a banking service supplier established in the territory of another member the right to offer any new banking service, meaning one that is already offered in the territory of another member but not yet in the territory in question.[949] This provision preserves the competitive advantage of innovative banking institutions in foreign and more traditional markets by preventing the host member from inhibiting innovation.[950] Thus, for instance, if an international bank is already offering an innovative financial service in its home country, a host country cannot refuse to authorise that service simply because its domestic banks do not yet offer the same service and would thus be at a comparative disadvantage.[951]

(iii) other non-discriminatory measures

[947] Wolfrum ea 2008:655. This right of market access granted to foreign service suppliers is, in turn, limited by the subsequent paragraph B (6). This latter provision explicitly permits a member to impose terms, conditions and procedures for authorisation of such establishment or expansion of a commercial presence; however, the imposition of such measures may not "circumvent" either the basic obligation in section B(5) or other GATS obligations.

[948] Goncalves and Stephanou 2007: 656-658. The purpose of this provision is to allow innovative products introduced by banks in their own countries, and approved by their home countries, to be introduced and sold abroad.

[949] Ibid at 657-658.The Understanding also defines a "new financial service", a term which appears in paragraph (7). A new financial service is one which no financial service supplier yet supplies in a particular member's territory, but which is already being supplied in another member's territory. Thus, as defined in the Understanding, the term does not denote a service that has not yet been offered anywhere.

[950] Leroux 2002:437.

[951] Goncalves and Stephanou 2007: 655-666.However, as always, the prudential carve-out may be invoked if the disadvantage is drastic enough to necessitate prudential measures, for example, to protect investors or policy holders.

The Understanding contains a best efforts obligation relating to certain types of measures that,[952] although possibly consistent with other obligations of the Understanding and the GATS, may nevertheless have adverse effects on the liberalisation of trade in banking services. Paragraph B.10 of the Understanding provides that a member shall endeavour to remove or to limit any significant adverse effects on financial service suppliers of other members of: [953]

(i) Non-discriminatory measures that prevent financial service suppliers from offering in the member's territory, in the form determined by the member, all the financial services permitted by the member. These measures are those that prevent a financial institution, for instance a bank, to provide a whole range of financial services such as banking services. Although the measures generally are not discriminatory, they segment a member's financial market and limit competition among different types of financial institutions.

(ii) Non-discriminatory measures that limit the expansion of the activities of financial service suppliers into the entire territory of the member. These measures typically are those that prevent or limit the ability of a financial institution, foreign or domestic, to establish subsidiaries or branches throughout the territory of a member;

(iii) Measures of a member, when that member applies the same measures to the supply of both banking and securities services, and a financial service supplier of another member concentrates its activities in the provision of securities services.

(iv) Other measures that, although respecting the provisions of the Agreement, affect adversely the ability of financial service suppliers of other members tooperate, compete or enter the member's market. This is an obligation of a residual nature that on its face has a fairly broad scope.[954]

[952] Leroux 2002:438-439.

[953] Ibid.

[954] Wolfrum ea 2008:660-661. The obligation contained in paragraph B.10 only applies, however, to the extent that any action taken by a member would not unfairly discriminate against its own financial service suppliers.

3.8 Second Protocol to the GATS

Upon signature of the GATS,[955] a deadline was established for member countries to submit changes to their lists of specific commitments and exceptions to the MFN principle.[956] This Second Protocol provides that, all signatory countries provide lists of exceptions and of specific commitments of those countries accepting the Second Protocol before June 1996 will automatically be replaced by new ones, annexed to the Protocol.The Second Protocol to the GATS is the main document of the 1995 interim agreement. Its function was toreplace the old schedules of specific commitments and lists of MFN exemptions made at the end of the Uruguay Round with the new ones made in July 1995. This was only related to the GATS and does not generally relate to other respects of financial services.[957]

Accordly the Protocol, firstly, the fact that the Uruguay Round, concluded at Marrakech in 1994, brought banking services within this sophisiticated international framework for the first time, can be considered a notable success.[958] After all, the intangible character of banking services, and the much closer identification of the product with the producer than is normally the case for tangible goods, renders hazardous any automatic transplantation of rules originally applying to goodsonly. It is no surprise, therefore, that, in the first round, not all GATT-principles were transplanted in full to this new domain.[959] Secondly, a major inroad in the system is the fact that the cornerstone of the GATT-negotiation techniques, the MFN-principle is, in relation to GATS, subject to exemption.[960] If made at the time of entry into effect of GATS, these exemptions were accepted until 2005, and could even be extended beyond, within the framework of future negotiations.[961] Thirdly, national treatment is treated as a mere negotiable right within the framework of the GATS-in contrast to the

[955] Aguirre 1995:1062.

[956] Ibid.

[957] Wang 2003:175.Nation Treatment in the GATS/WTO. http://heinonline.org (accessed 2011/12/06).

[958] Van Empel 2000:41-42.

[959] Ibid.

[960] Ibid.

[961] Ibid.It is submitted that the extent, to which this loophole will be closed, will prove the litmus-test for the GATS-system as such.

situation within the GATT.[962] It should be stressed that the GATS does not mandate deregulation of banking services in any way. Moreover, it may be mentioned that the prudential carve-out is not subject to this GATS-negotiation-mechanism.It would appear, therefore, that GATS essentially accepts, as a point of reference for each WTO member state, the status quo in terms of the substance of national regulation of banking services. Although transparency and the availability of judicial remedies are, of course, important improvements, it deserves to be pointed out that harmonisation of such regulations between member states is not the aim. Finally, attention should be drawn to the institutional aspects of theGATS.[963] Part V of the GATS provides for the establishment of a Council for Trade in Services, with a view to administering the agreement, while the GATS is also embraced by the WTO system of dispute settlement and enforcement.[964] The practical experience of the first few years of the WTO has proved dispute settlement and enforcement a reality to be taken seriously.

Table 4: GATS Framework on trade in Banking Services.[965]

Modes of supply	**Financial services Annex**	**Schedules of Commitments**
Cross-border supply Consumption abroad Temporary presence of natural persons General obligations and disciplines Most favoured nation principle Transparency Recognition of service suppliers Restrictions to safeguard the balance of payments Specific commitments Market access National Treatment Additional commitments	Coverage and definition of Financial Services Prudential carve-out Financial services expertise in dispute settlement Recognition of prudential measures	Hybrid list approach Scheduling by sector/sub-sector and by mode of supply Market access and national treatment

[962] Van Empel 2000:41-42.

[963] Van Empel and Morner 2000:42.

[964] Ibid.

[965] Stijn and Morrion 2000:9.

Like any international agreement, the GATS essentially comprises a framework of rules and schedules of commitments from the member countries regarding market opening and schedules of commitments from the member countries regarding market opening or market access.[966] These rules are based on the concepts developed and applied in the context of the GATS and the WTO.[967] The MFN principle and transparency form the foundation of the GATS as well. Not all the governments were willing to apply the MFN principle across the board, therefore Article II, Paragraph 2, permits members exemptions which could be expressed at the time of the initial GATS commitments. These exemptions are subject to review.[968] The second reason for countries, particularly the large ones like the US, asking for exemptions was the concern regarding "free riders".[969] "Free riders," in the eyes of the US negotiators, will be those WTO members who make weak or no commitments to open their banking services markets.[970] Large exporters of banking services like the US felt that by granting MFN access to their markets, they would be losing the opportunity to exchange their relatively open access for further liberalisation in the markets of their trade partners. In other words, the larger exporters thought that by granting MFN access they would lose the opportunity to ask for reciprocity from their trading partners.[971]

3.9 Conclusion

The opening up of markets and expansion of trade in banking services, the range and quality of banking services come closer to international norm. "Opening up trade in banking services leads to both static and dynamic gains".[972] Foreign investment in banking services

[966] Van Empel 2000:41-42.

[967] Ibid.

[968] Ibid. The first such review shall take place no more than five years after the entry into force of the agreement. The Council for Trade in services (CTS) in a review shall determine the date of any such review and examine whether the conditions which created the need for the exemptions still prevail. Thus, in principle, the exemptions cannot be of a permanent nature but are to be of a limited duration.

[969] Jareau 1999:27. Interpreting the General Agreement on Trade in Services and the WTO instruments relevant to the International Trade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06).

[970] Ibid.

[971] Ibid.

[972] Dilip 1998:84-85.

leads to improvement in the standard of functioning of domestic banking systems. There are two direct and indirect channels of benefit:[973]

(i) Firstly, foreign trade and investment in banking services provides better access to foreign capital which in turn contributes to financing a higher level of investment.

(ii) Secondly, they also result in expansion and strengthening of the domestic banking infrastructure, which in turn promotes improvement in regulation and supervision.[974]

GATS has enabled liberalisation of banking services to take place on a multilateral basis. The first round of negotiations for banking services, the Uruguay Round, could be further improved to achieve greater liberalisation. This has been the objective of the Doha Round which began in 2000.[975] The structure of the GATS is complex and multilayered. It is imperative to understand that the schedule of commitments of each member is crucial to the substance of the banking services. The text of GATS will not lead to a comprehensive understanding of GATS' impact schedules on commitments Unless members attain greater liberalisation and realise mutual benefit.The Annex is important because it includes a "prudential carve-out" clause that recognises the right of WTO members to introduce and maintain prudential measures "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". Such a right is not absolute under the GATS, as such measures are subject to dispute settlement if they are used as disguised restrictions.[976] The Annex provides no definition or indicative list of prudential measures, affording domestic banking regulators broad discretion in their choice of prudential conduct so long as measures are not applied for protectionist purposes. The prudential carve-out has come to signify the difficulties of negotiating commitments without being inhibited by

[973] Dilip 1998:84-85

[974] Ibid.

[975] Morrison 2003: 613.While the Uruguay round resulted in the commitment by 102 members in banking services, greater liberalisation is being requested by the US, the EU, Canada, Australia and Switzerland.

[976] Goncalves and Stephanou 2007:10.

prudential concerns of banking regulators and has dominated the pitfalls of the Fifth Protocol.[977] The Fifth Protocol has had a positive impact on the opening up of trade in banking services. It states the general obligation of GATS, and requires members to clarify their specific commitments on market access and national treatment. Significantly, it has contributed to the duty of members to disclose the substance of their requirements for foreign parties to operate in their markets.[978]

[977] Wolfrum ea 2008:643.

[978] See the Fifth Protocol to the General Agreement on Trade in Services (Financial Services Agreement).

CHAPTER 4

TRADE IN BANKING SERVICES INVOLVING ESTABLISHMENT OF A COMMERCIAL PRESENCE

4.1 Introduction

The third mode of supply is commercial presence (mode 3)- the bank is commercially present within the territory of the importing state, and the service is delivered therein.[979] The notion of commercial presence covers a variety of investment vehicles,[980] representative offices (legal entities of the host country), branches (legal entities of the home country), subsidiaries (legal entities of the host country over which the bank has direct or indirect control), associates (legal entities of the host country over which the bank holds a minority interest), and correspondents.[981] Foreign banks' entry can take one of four forms:[982] entry via branches; representative offices; agencies or subsidiaries and entry via the purchase of an existing franchise.[983] Mode 3 is the predominant mode because of international banking, and is likely to remain so for some time.[984] It is predominant because proximity to customers remains an advantage in banking, especially in the retail sector, which focuses on individual consumers and small businesses.[985]"In addition, from a prudential perspective, it is preferred that banks participating in a foreign market be physically present in that market so that safety and soundness can be assured by domestic regulators".[986] Retail customers are presumed to be among the least sophisticated of banking services consumers, so they are afforded greater protection.[987] Regarding mode 3 commitments of a member, GATS mandates that the member is thereby committed to

[979] Morrison 2001:599.

[980] Gkoutzinis 2005:894.

[981] Ibid.

[982] Ibid.

[983] Banks such as Citibank, JP Morgan Chase, and Deutsche Bank usually follow the first strategy, while ABM, AMRO, Commerz bank, and HSBC tend to purchase existing franchises.

[984] Herfindahl and Brown 2007:1270.

[985] Ibid.

[986] Ibid.

[987] Ibid.

allow related transfer of capital into its territory.[988] Only capital inflow, but not capital outflow, is allowed under this provision.[989]

The supply of banking services through the commercial presence of foreign banks in the territory of any other member is the preeminent article dealing with establishment of foreign banks.[990] On the trade side it is directly concerned with some of the key issues in negotiating services, namely, market access, national treatment, and progressive liberalisation.[991] At the same time it cannot be separated from the question of foreign direct investment.[992] For establishment of commercial presence important barriers that need to be addressed include restrictions on foreign ownership positions in host country banks and restrictions on entry through the branch organisation.[993] Banking is understood as commercial banking, mainly the activities of institutions under which they take repayable funds, for example, deposits, from the public and grant loans for their own account.[994] The GATS has provided an exemption for measures which have a rational connection to prudential reasons, that is, reasons relating to depositor protection and systematic stability.[995] This mode of banking entails more risks for the safety and soundness of the banking system, as it enhances the interdependence of banking jurisdiction and subsequent systematic risk.[996] As far as financial stability is concerned, GATS is of special interest because it provides for free trade through the commercial presence of a foreign bank in the territory of another member. Of primary concern are the transmission of regulatory

[988] Wang 2007:216.

[989] Ibid.

[990] Footer 1993:358-359.

[991] Footer 1995:472-474. All three are the subject of separate, specific commitments under the GATS.

[992] Footer 1993:359.

[993] Ibid.

[994] Goncalves and Stephanou 2007: 10. According to Goncalves and Stephanou, it is this type of intermediation that presents special problems for the protection of depositors and stability of the banking system. This set out the rationale for regulating banking, which then provides justification for special exceptions in trade in banking services under the WTO.

[995] See GATS, Annex on Financial Services art. 2(a).

[996] Barth 2001:305-306.

deficienciesthrough the presence of banks in multiple jurisdictions and the inadequacies of decentralised banking regulation and supervision to deal with internationally active banks.[997] The economic role of commercial presence, which is estimated to account for half of all trade covered by the GATS, is reflected to a certain extent in the absence of non-binding schedules under this mode.[998] Mode 3 commitments may be viewed as a key element to attract investment.[999]

The financial wave after 1990 has involved significant foreign direct Investment in banking in the form of bank expansion across borders, especially in commercial banking.[1000] While foreign bank participation significantly increased in both Sub-sahara Africa and Latin America countries over the past 20 years.[1001] A result of the general trend towards globalisation and consolidation was that the five largest banking groups controlled more than 16% of global banking assets in 2008, which is more than double their market share in 1998.[1002] A small number of countries dominated cross-border banking in the form of commercial presence: France, Germany, the UK, the US, Switzerland and the Netherlands.[1003]

4.2 Advantages of Commercial Presence

A key benefit to commercial presence arises from its effects on risk diversification.[1004] "The assets of foreign banks will be less exposed to country specific shocks. This reduces their likelihood of failure as well as the likelihood of them ending up in a situation where they are constrained in their lending".[1005] In addition, the presence of foreign banks in a country can

[997] Panourgias 2006:50.

[998] Adung and Roy 2005:12.

[999] Ibid.

[1000] Allen ea 2011:1.

[1001] Ibid.

[1002] Ibid.

[1003] Ibid.

[1004] Ibid at 5.

[1005] Ibid.

also carry a stabilising force, since when domestic banks are hit by a shock, foreign banks can substitute for them in the lending market.[1006] Foreign banks may also be more efficient and foreign banks that enter developing markets tend to have more advanced risk-management systems.[1007] The spread of best practices may then benefit domestic banks as well, further enhancing stability.[1008] In times of local financial crisis, international banks in contrast to local banks can refinance their lending activities with funds provided by the parent bank abroad.[1009]

Secondly, commercial presence of foreign banks can enhance the performance of their domestic counterparts through the mechanisms of competition and technology transfer.[1010] Banking services were monopolised by a limited number of suppliers in most countries before liberalisation.[1011] The entry of foreign banking suppliers will help domestic banks to reduce cost, improve management, and become more efficient in order to survive. Foreign banks by bringing superior technical expertise into the domestic market, can tremendously improve the soundness of the local banking system. In China's experience, by the first quarter of 2005,[1012] foreign banks had established 214 operating entities in the form of branches, subsidiaries and 244 representative offices. Foreign banks in China offer over 100 banking services products , tripling the number of services provided by Chinese commercial banks. As the China Banking Regulatory Commission (CBRC), China's regulator of financial institutions admits:[1013]

> "China's experience showsthat the presence of foreign banks has not only brought into China advanced and modern banking operation and management expertise, but

[1006] Allen ea 2011:1-2.

[1007] Ibid.

[1008] Ibid at 2.

[1009] Dietrich ea 2010:44.

[1010] Wang 2007:227.

[1011] bid.

[1012] Ibid.

[1013] Ibid.

> also motivated the local banks to improve on their service quality and sharpen their competitive edge through reforms and cooperation with their foreign counterparts."

Thirdly, liberalising entry for foreign banks may have important benefits:[1014] Firstly, intergration of banking systems and financial stability, the opening up of banking markets and in particular, the increased presence of foreign banks in domestic markets entails welfare benefits. Free trade will bring about considerable macroeconomic and consumer benefits. Foreign banks entry is likely to lead to a more competitive environment with benefits for the consumer due to cost savings and new financial services and products, and to enhance the efficiency of the financial system through better resource allocation across sectors, countries and time. Moreover, national regulators have an additional incentive to develop prudential macroeconomic policies to ensure the stability of the domestic system and deal with competition pressures.[1015] Broad-based liberalisation in the banking sector put pressure on the regulator to introduce adequate prudential regulation and supervision of banks, and on the monetary authorities to replace administrative controls with market-based, indirect policy instruments.[1016] Secondly, the ability to establish a commercial presence in another country can be of prime importance in the banking services sector.[1017] Indeed, the supply of certain types of banking services such as retail banking services will prove much more difficult, if not sometimes impossible,without a commercial presence in the territory of the host member.The negotiators of the understanding thus included in the latter specific obligations with regard to commercial presence. In paragraph B 5 of the Understanding, they specified that a member must grant banking service suppliers of other members the right to establish or expand within its territory, including through the acquisition of existing enterprises, a commercial presence.[1018] As noted above, "commercial

[1014] Stijn and Jansen 2000: 148-150.

[1015] Panourgias 2006:17-18, "Macro-prudential Supervision means arrangements for monitoring and dealing with the systemic stability aspects of the operations of financial institutions as well as of economic and financial systems development. Such arrangements include information gathering from financial institutions and assessment of risks for systemic stability, analysis of macroeconomic conditions and financial markets, fine-tuning of individual capital requirements, regulation of payment systems and management of liquidity crises and bank insolvencies".

[1016] Wang 2007:227-228.The regulator can also benefit from interacting with more sophisticated banks and regulators.

[1017] Wolfrum ea 2008:656-657.

[1018] Ibid.

presence" has a very broad scope. It includes subsidiaries, branches, agencies and representative offices.[1019] The obligation has a broad scope. Indeed, it gives a foreign banking services supplier the right to establish a commercial presence as well as the right to expand such a commercial presence,through the acquisition of other institutions. It does not prevent, however, a member from imposing terms, conditions and procedures for the authorisation of the establishment and expansion of a commercial presence, provided they do not circumventthe member's obligation to grant a right to establish and expand a commercial presence and are consistent with the other obligations under the GATS, for instance the national treatment obligation contained in Article XVII.[1020]

Fourthly, information technology will enable as well the restructuring of the activities of banks.[1021] Processing and transactions related activities could be centralised. For administrative purposes, banks would have to focus on finding skilled personnel as one of the main location decisions. Smaller branches and representative offices, especially those located in dense banking regions, could be closed and clients served from regional centers.[1022] The higher degree of information and communication technology also allows a greater degree of control of foreign activities.[1023] Country specific differences aside, banks could in theory monitor and consolidate their foreign activities with higher frequency. This would suggest that monitoring costs were lowered, raising internalisation advantages of international activities. Viewed from this angle, information technology might have been an enabler for asset seeking strategies.[1024]

Fifthly, commercial presence can increase the pressure to strengthen the regulatory and supervisory framework.[1025] Foreign banks can help to make information on the best

[1019] Wolfrum ea 2008:656-657.

[1020] Leroux 2002:436.

[1021] Slager 1984:41.

[1022] Ibid.

[1023] Ibid.

[1024] Slager 1984:41.

[1025] Kono and Schuknechi 2000:148-149-150.

practices available. Enhanced peer pressure may induce banking institutions to observe and report on each other's situation. Reliable ratings are more likely to be developed. This makes inadequate risk management, and inappropriate interventions into banking activities less likely, and the pressure to improve regulation and supervision will increase.[1026] Skill and technology transfer from abroad can further help to strengthen banking institutions and supervision.[1027]

Sixthly, commercial presence helps market development.[1028] The development of new services and deepening of markets is easier when services providers have information about local markets needs/potentials. "Foreign banks are more likely to operate as market makers, or as liquidity providers, when they have a commercial presence and a considerable base of local business. Deeper and more developed markets, in turn, are less likely to experience volatility and investors are more willing to engage in long-term commitments".[1029] The presence of foreigners can also help spread risk more broadly, resulting in better risk management and diversification, and head offices abroad can operate as lenders of last resort.[1030]

Seventhly, commitments to mode 3 liberalisation only require the liberalisation of capital inflows related to commercial presence, whereas, mode 1 requires liberalisation of both inflows and outflows.[1031] In principle, countries can, therefore, benefit from the institutional building effect of commercial presence with only limited commitments to capital account liberalisation.[1032] In line with the fundamental approach to economic development,

[1026] Kono and Schuknechi 2000:148-149-150

[1027] Ibid.

[1028] Ibid.

[1029] Ibid.

[1030] Ibid.

[1031] Gelb and Sagari 1990:7.

[1032] Ibid. If a country allows new entry of foreign banking service providers but prohibits them from raising domestic capital, it forces banking institutions to seek international capital for their business transactions. This restriction, then, increases capital inflow, on short term lending if it coincides with lack of information on borrowers' credit-worthiness and underdeveloped financial markets.

countries may ease restrictions on foreign banks' entry as a means of encouraging capital inflows in the belief that these capital inflows will promote capital formation and economic growth.[1033] These foreign banks may stimulate inflows of capital, including funds to establish their own capital bases if they are subsidiaries; they may also act as a conduit for foreign funds, especially if the international standing of indigenous banks is inadequate to sustain correspondent relationships; and they will be able to supply banking services that would otherwise have to be imported.[1034] Commercial presence also results in less of a bias towards short-term lending than cross-border trade in banking services.[1035] Commercial presence facilitates the assessment of credit-worthiness and, hence, financial institutions are more willing to accept long-term commitments.This is particularly important when transparency is limited, as commercial presence can help banks generate their own information. Commercial presence is also more likely to result in a balanced and efficient financing structure as it can help reduce the likelihood of excessive capital inflows.[1036]

Lastly, efficiency[1037] and competition is likely to increase. Another important contribution of foreign banks is on-the-job management training.[1038] Managers of indigenous banks in developing countries are increasingly drawn from the ranks of host country nationals who have risen to executive level in foreign banks. The experience of these nationals combines exposure to modern banking techniques with understanding of the local market. In the long run, this infusion of skills might be the most important spinoff to the entry of foreign banks, especially given the difficulty that most developing country banks would now face in trying to establish in developed markets.[1039] Reducing impediments to foreign bank entry may improve access to international capital markets; easing restrictions on foreign bank entry

[1033] Gelb and Sagari 1990:7.For example, Korea and Austrialia specifically emphasized that one of the policy objectives sought in opening up to foreign banks was to enhance contact with the international financial community and thereby increase capital inflows.

[1034] Ibid.

[1035] Kono and Schuknecht 2000:150.

[1036] Stijn and Marion 2000:148-150.

[1037] Kono and Shuknecht 2000:150.

[1038] Gelb and Sagari 1990:17-18.

[1039] Ibid.

should improve the quality and availability of financial services noted above by stimulating competition and contestability of domestic financial markets and by facilitating the application of more modern banking skills, management, and technology in the domestic market;and openness to foreign banks may stimulate improvements in both domestic financial policy and financial infrastructure, which in turn will promote domestic financial development.[1040] Foreign banks can also make a significant dynamic contribution to the development of domestic banking markets.[1041] They can introduce modern, sophisticated banking techniques and systems more quickly than many indigenous institutions can develop them.[1042] Foreign banks frequently innovate.[1043] For example, they have introduced a banker's acceptances market in Spain, credit cards and ATM's in some countries, and so on.[1044] In some countries, such as Kenya, foreign banks have established venture capital affiliates.[1045]

Foreign presence in the banking sector is highly concentrated in developed countries, which share similar levels of institutional quality.[1046] A bank is foreign owned if 50 percent or more of the shares of the bank is owned by foreigners. The source country of the foreign owner is determined by looking at the shareholder. The country with the highest percentage of shares is appointed as the source country.[1047] Experiences from the 1994-95, financial crises in Latin America and the 1997-98 banking crises in Asia show that foreign banks played an important role in the recovery of many economies during the post-crisis phase.[1048] Foreign banks are better capitalised and are subject to a more stringent supervisory system; therefore they are better equiped to recapitalise the weaker banks in the crisis-stricken

[1040] Gelb and Sagari 1990:17-18.

[1041] bid.

[1042] Ibid.

[1043] Ibid.

[1044] Ibid.

[1045] Ibid.

[1046] Stijn ea 1998:2-6.

[1047] Ibid.

[1048] Dilip 1998:93.

economies.[1049] In Mexico and Venezuela foreign banks emerged key as players in recapitalising and restructuring banks during the post-crisis period.[1050]

4.3 Definition of Commercial Presence

"GATS Article 1(2) (c) defines trade in services as including the supply of a service by a service supplier of one member, through the commercial presence in the territory of any other member".[1051] Article XXVIII (d) of the GATS defines "commercial presence" as any type of business or professional establishment,[1052] including through (i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or a representative office, within the territory of a member for the purpose of supplying a service.[1053] The Understanding defines commercial presence as "wholly or partly-owned subsidiaries, joint ventures, partnerships, sole proprietorships, franchising operations, branches, agencies, representative offices or other organisations."[1054] The Understanding is more comprehensive in the definition, allowing foreign banks to enter a market in more diverse or capital like forms.[1055] As a consequence, the GATS covers forms of establishment which correspond to the notion of foreign direct investment.[1056]

Paragraph B (5) of the Understanding requires a member to grant other members' financial services suppliers the right to establish or expand a commercial presence in the granting

[1049] Dilip 1998:93.

[1050] Ibid.

[1051] Wang 2007:214.

[1052] Fausten 2003:116-117.

[1053] Panourgias 2006:53.

[1054] Jarreau 1999:59-60.Interpreting the General Agreement on Trade in Services and the WTO Instruments relevant to the internationalTrade of Financial Services: the Lawyer's perspective. (http://heinonline.org) (accessed 2011/12/06).

[1055] Ibid. "The EU insisted that commercial presence should be permitted in the legal form of members' choice. Generally, establishment via local incorporation is more costly than branching. Local incorporation frequently requires higher minimum capital, and regulatory monitoring would be stricter. The local incorporation will need to meet the various regulatory requirements on a single entity basis rather than on a group basis".

[1056] World Trade Organisation 1996:70.

member's territory.[1057] It should be noted that expansion includes acquisitions of existing enterprises.[1058] However, this right may be made subject to such conditions and authorisation procedures as the granting country deems appropriate.[1059] Thus, when a member grants the right of establishment, it is committing only that it will not completely restrict the right of establishment or discriminate among member countries.[1060] This is a broader definition of commercial presence for the purpose of the Understanding; this provision is highly significant, particularly in terms of retail banking. This mode of financial service supply can be roughly equated with foreign direct investment.[1061] This right of market access granted to foreign financial services suppliers is, in turn limited by the subsequent paragraph, paragraph B(6).[1062] This latter provision explicitly permits a member to impose terms, conditions, and procedures for authorisation of such establishment or expansion of a commercial presence; however, the imposition of such measures may not circumvent either the basic obligation in paragraph B (5) or other GATS obligations. The vague term prudential is also used in paragraph B (8).[1063] Interpretation of the term should also take into account the term avoid, as used in, for example, the prudential carve-out in paragraph 2 of the Annex on Financial Services. [1064]

All WTO members have established specific commitments under the GATS in relation to this mode of supply.[1065] These commitments bind governments to guarantee conditions of market access in respect of the mode and sector indicated in schedules of specific

[1057] Wolfrum ea 2008:656-657.

[1058] Aguirre 1996:1061.

[1059] Ibid.

[1060] Ibid.

[1061] Ibid.

[1062] Wolfrum ea 2008:657.

[1063] Ibid.

[1064] Diectrich ea 2010:18-19. The term "prudential" as used in this thesis includes arrangements addressing both the financial condition of individual banks and the stability of the relevant banking system and extends to both ex ante and ex post arrangements. It covers licensing rules, capital adequacy requirements, payments systems regulation, deposit gurantee schemes, and lender of last resort arrangements as well as arrangements relating to supervisory cooperation.

[1065] Ibid.

commitments.[1066] In the absence of specifications to the contrary, members guarantee both the right of market entry and the right to national treatment in scheduled sectors. A schedule must indicate under this mode of supply whether a member intends to grant full market access and /or national treatment, no market access and/or national treatment, or condition market access and/or national treatment. Some measures of market access or national treatment must be granted in at least one mode of supply in order for a member to include a particular services sector in its schedule of specific commitments. A list of six conditions that may be imposed on market access is contained in article XVI.[1067] Four of these relate to quantitative limitations that may apply to foreign services or a service supplier may supply a service and limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or total value of individual or aggregate foreign investment.[1068]

4.4 Forms of Commercial Presence

Banks have a wide range of organisational forms to choose from when establishing a presence in a foreign country, with different control aspects:[1069] diffused interest (representative office) and dominant equity interest (agency, subsidiary and branch). The choice of organisational form suggests that bank size, regulation, the relationship with clients, the extent of other foreign activities and relative costs are all issues raised above to explain organisational forms.[1070] The organisational form chosen by the bank in the foreign country might be a good indicator of the level of commitment in the host country, since it reflects the banks' willingness to make a costly and long term investment.[1071] The choice between the various organisational forms depends on a number of factors:[1072] Firstly, the foreign regulatory and legal structure influences the choice of organisational form to a large

[1066] Diectrich ea 2010:18-19.

[1067] Ibid.

[1068] Ibid.

[1069] Slager 1984:63-64.

[1070] Ibid.

[1071] Ibid.

[1072] Ibid.

degree. From the viewpoint of the home country, restrictions on the type of organisational form usually come from the considerations relating to problems with supervision and monitoring banks' positions in a foreign country. Specific requirements may determine the choice of organisational form. For example, minimum capital requirements have to be met, perhaps different from home country banks' capital requirements. Foreign taxation may also be an important factor in the choice of organisational form: the tax treatment of directly controlled foreign branches can differ from the tax treatment of foreign bank subsidiaries.[1073] The legal liability structure in the host country also influences the choice of organisational form. Secondly, entry barriers in combination with the type of activity the bank wants to undertake are instrumental for the choice of organisational forms. Host country may impose entry barriers with a view to retaining effective control over, and protecting the local banking system. Where limited entry restrictions apply, they are usually modulated to take account of the possible benefits to be derived from certain types of foreign banking presence.[1074] Thirdly, decisions about the structure and organisation of a foreign network are primarily based on a bank's overall strategy, in particular with regard to its involvement in trade-related business, global funding policies, the servicing of multinational customers and the extent of involvement in local currency business.[1075] Given the choice of organisation form, the change of organisational form also has an important signalling effect to the customers in the home country. Signaling may be more important for relatively large banks. It is to be expected that banks with more assets tend to establish relatively more subsidiaries and/or branches since they have the capital and therefore the opportunity to commit to such responsibility.[1076]

The decision for a particular organisational form can also be influenced by relative costs on a firm level.[1077] Major costs are rents, salaries and communication costs. If the banking activity in the foreign country tends to require extensive face-to-face communication,

[1073] Slager 1984:63-64.

[1074] Ibid.

[1075] Ibid.

[1076] Ibid.

[1077] Ibid.

communication costs tend to be disapportionally high if conducted from the head office for all but very large transactions.[1078] Banks seeking to gain market share for smaller transactions may have little choice but to establish subsidiaries or branches instead of representative offices, unless they are very close to the host market.[1079]

Historically, the establishment of branches and subsidiaries by international banks followed closely the location of major international clients and the finance of trade.[1080] On the other hand, a representative office is a cost-effective way to explore a new geographical market before setting up more extensive operations.[1081] Over the last two decades, many countries liberalised bank activities that traditionally had been heavily regulated and protected from competition.[1082] As part of this process, foreign banks, which had previously played only a maginal role, have established a substantial presence in the banking systems of several middle-income and developing countries.[1083] That presence has taken a variety of forms, ranging from the acquisition of domestic institutions with extensive branch networks to the establishment of isolated representative offices aimed at serving niche market segments.[1084] Financial liberalisation of this kind proceeds on the premise that the gains to domestic

[1078] Slager 1984:63-64.

[1079] Ibid.

[1080] Geld and Sagari 1990:4.

[1081] Petrochiolos 1989:51.

[1082] Ceruti ea 2005:1-2

[1083] Ibid.

[1084] Ibid, "there are at least two sets of reasons for which policy makers, bank users, and bankers should care about how foreign banks operate in host markets. First, the organisational form of foreign bank operations may affect the competitive structure of the local banking systems, threatening the profits and market share of domestic banks and affecting the price and quality of banking services in the host country. For example foreign subsidiaries with extensive networks are in direct competition with local commercial banks for retail clients, while single-branch foreign banks or representative offices concentrate, instead, on segments such as wholesale and investment banking, which are typically undeveloped in the host countries. Secondly, branches and subsidiaries typically involve different levels of parent bank responsibility and financial support. While subsidiaries are separate entities from their parent banks, under most circumstances, parent banks are responsible for the liabilities of their branches. This can have implications not only for the parent bank but also for local regulators, who care about the stability of the host-country, and for local depositors, who care about the safety of their savings".

market participation from foreign entry overshadow any losses to domestic banking institutions.[1085]

Attitude towards licensing foreign banks vary widely across developing countries.[1086] Some totally exclude foreign banks; others permit representative offices but not branches. The Bahamas, Bahrain, Hong Kong, Panama and Singapore view exports of banking services as a source of employment and foreign exchange, and in few, usually small, developing countries foreign banks account for nearly all banking assets.[1087] The foreign banks operating in Botswana hold all commercial banking assets, although there are several smaller indigenous non-bank intermediaries that take deposits, make loans or both.[1088] In Malaysia,[1089] sixteen foreign banks account for one quarter of the banking assets. In the Philippines, Chile and Kenya the share of foreign banks is also appreciable.[1090] In Nigeria foreign shareholdings in banks have been tightly limited to create a class of co-owned enterprises; in Tanzania, a foreign-owned banking system is nationalised.[1091] Foreign banks are less likely than domestic banks to have an extensive branch network. This implies that they are usually more dependent on wholesale funds or on funds from abroad and that they are more likely to provide services to large clients in the main urban centers than to small farmers.[1092] The cost structure of foreign banking affiliates may therefore differ significantly from that of indigenous banks.[1093]

[1085] Ceruti ea 2005: 1-2. Specifically, foreign banks may (i) improve the quality and availability of financial services in the domestic financial market by increased bank competition, and enabling the application of more modern banking skills and technology, (ii) serve to stimulate the development of the underlying bank supervisory and legal framework, and (iii) enhance a country's access to international capital.

[1086] Gelb and Sagari 1990:4-5.

[1087] Ibid.

[1088] bid.

[1089] Ibid.Which has traditionally had an open policy towards the banking system.

[1090] Ibid.

[1091] Ibid.

[1092] Ibid.

[1093] Ibid.

4.4.1 Subsidiaries

A subsidiary is a legal entity of the host country; it is a separate wholly or majority owned by the transnational bank parent.[1094] Unlike branches, subsidiaries are separately incorporated under the laws of the host country and are therefore similar to domestically owned banks. Subsidiaries of foreign banks have their own capital, which is within the regulatory and supervisory jurisdiction of the host country authorities. Because subsidiaries are part of a multinational organisation, however, a host country might still be concerned with the condition of a parent bank and the extent to which it might serve as a source of strength by standing ready to inject capital into its host country subsidiary.[1095]

When a foreign bank operates through a subsidiary, the subsidiary is subject to the safety and soundness regime of the host country.[1096] The host country can ensure the safety and soundness of the foreign subsidiary through the same techniques it applies to domestic banks, such as capital requirements and loan limits.[1097] The host country will not necessarily be concerned with the safety and soundness of the foreign parent of the host country subsidiary. The bankruptcy of the parent may result in a transfer of the ownership of the subsidiary, but will not necessarily affect the safety and soundness of the subsidiary. The subsidiary can continue to operate even though its parent is bankrupt. This was true in the *BCCI case* where subsidiary US banks, continued to operate even though the BCCI bank owners were in insolvency proceedings.[1098] But some countries, most notably the US, are concerned with the safety and soundness of the foreign parents of subsidiaries.[1099] This concern is based on the source of strength doctrine.[1100] Under this doctrine, the host country looks to the foreign parent to supply capital to the subsidiary if the subsidiarybecomes weak. The basic idea is that the strength of the parent determines

[1094] Kaufman 1991:57-80.

[1095] Ibid.

[1096] Ibid.

[1097] Ibid.

[1098] Ibid.

[1099] Ibid.

[1100] Ibid.

whether it will be able to save its subsidiary from difficulty by injecting additional capital.[1101] The safety and soundness of the foreign parent is not, however, within the regulatory control of the host country. For example, the safety and soundness of a UK banking parent of a US bank is largely determined by the United Kingdom, not the United States. The United Kingdom determines the capital requirements and loan limits of its banks. And if one of its banks gets into trouble, the United Kingdom determines whether and how to rescue it. And if the foreign parent is not a bank, it may be entirely unregulated by the home country.[1102]

4.4.2 Branches

In general, the objective to build a branch network has been to assist foreign clients, finance activities more cheaply or to evade home country regulation.[1103]The entry of foreign banks mainly in the form of branches raises concerns for the stability of the host country'sbanking system and the protection of depositors.[1104] Since the branch is not a separate legal entity but merely an office of the parent bank,[1105] the solvency and liquidity of branches of foreign banks is largely dependent on the financial structure and the operations of the foreign parent bank. Thus, any deficiency of the home regulatory regime, which for example, may have a negative impact on the operations of the credit institutions in the host country, harm depositors, and depending on the size of the branch, lead to realisation of systemic risk.[1106] Even though a branch is an integral part of a foreign bank and not separately capitalised, some countries that permit branch entry imposed branch capital-equivalency requirements.[1107] These can take the form of endowment capital requirements. Because such measures are widely regarded as prudential, most countries that impose these requirements have not listed them as limitations on market access or national treatment in

[1101] Kaufman 1991:57-80.

[1102] Ibid.

[1103] Slager 1984:67.

[1104] Panourgias 2006: 57.

[1105] Kaufman 1991:79.

[1106] Panourgias 2006:57.Systemic risk in the case of branches relates mostly to problems in the payment system.

[1107] Ibid.

their schedules of commitments. Some host countries, however, take an additional step that effectively negates the economic benefits associated with the branch form of organisation-namely calculating lending and other operating limits based on branch capital-equivalency requirements. Since domestic banks operate on the basis of their consolidated worldwide capital, national treatment would require allowing branches to operate on the basis of the foreign bank's consolidated worldwidecapital.[1108]

4.4.2.1 Competitive Markets

Branches can operate on the basis of the consolidated capital of the foreign bank and are often a more efficient method of doing business than operating through subsidiaries. Permitting branch entry is important in promoting competition among foreign and domestic banks in a host country market.[1109] This consideration suggests that, for competitive purposes, branches should be allowed to enter under home country rules; that is, if the home country authorises a bank to establish a foreign branch, the host country would be required to accept that decision.[1110]

4.4.2.2 Safety and Soundness

When a foreign bank operates abroad through branches, the host country is more at the mercy of the home country.[1111] The branch is but an office of a bank located in another country. If the foreign bank fails, so do its branches abroad.[1112] The viability of the branches is largely determined by the efficacy of the supervision by the bank's home country.[1113] This is because it is more difficulty for the host country to deal with the systemic risk problems, particularly prudential concerns regarding entry of foreign branches cannot be allayed by

[1108] Panourgias 2006:57.A U S government study concluded that, although restrictions might need to be applied to address specific prudential concerns in problem cases, general application of such restrictions would have the effect of denying a foreign bank the economic benefits of the branch form of organisation.

[1109] Sydney and Hal 1991:8.

[1110] Ibid.

[1111] Kaufman 1991:79.

[1112] Ibid.

[1113] Ibid.

non-discrimatory application of host country laws.[1114] Allowing entry by a foreign branch is inherently different from permitting a domestic bank to open a branch. Branching by a domestic bank is predicated on initial approval for the establishment of the bank itself, and establishment of a branch is merely incremental. Moreover, domestic banks are subject to domestic regulations for safety and soundness, wheras a foreign bank establishing a branch is not. The host country therefore needs to assure itself on this point in permitting entry for a foreign branch.[1115] When home countries are responsible, both countries are in the position to determine the safety and soundness of the entire operation, and matters can easily fall between the cracks.[1116] Affiliated banks can use intra-affiliate transactions to disguise bad loans. Where multiple regulators are responsible for the safety and soundness of a bank, no one is really accountable.[1117]

Table 5 below is a summary of the important advantages and disadvantages of branches and Subsidiaries of foreign banks.[1118]

Branches	**Subsidiaries**
Subject to additional oversight by foreign supervisors on a consolidated basis with the parent under the Basel accord	Stand alone entities with their own capital and are supervised on a consolidated basis by the parent's supervisory authority only when the subsidiary is part of a holding company or a universal bank.
They are more likely to obtain financial support from the head quarters.	Reputed international banks, however, closely monitor the activities of their subsidiaries so as to preserve the parent's good name and solid standing.

[1114] Sydney and Hal 1991:19-20.

[1115] Ibid.

[1116] Kaufman 1991:78.

[1117] Ibid.

[1118] Analil 2005:478.

They may be subject to more rigorous accounting disclosure and reporting requirements.	Subsidiaries will be covered by ratings of their host country under the proposed Basel accord and therefore are likely to have high cost funds.
They are less likely to engage in connected lending.	Able to better regulate, supervise, and ring fence in period of distress.
Under the Proposed Basel Capital Accord, branches of banks are subject to lower capital weight and therefore will be able to obtain cheaper funds.	
In the case of branch failure, foreign creditors would generally have an advantage over domestic creditors	

4.4.3 Agencies

A foreign bank may operate through agencies.[1119] These are host country offices of the foreign bank that can make loans and receive deposits or maintain credit balances. Agencies have more authority in that they may accept predetermined payments in connection with international trade or deliver undisbursed portions of loans made by the parent bank. However deposit taking is strictly prohibited. Essentially no credit decisions are made by agencies. Agencies may only execute credit decisions made by the parent.[1120]

4.4.4 Representative Offices

Of the four general forms of business organisation through which a bank may conduct overseas operations, the representative office is the most restricted form.[1121] Representative offices may not accept deposits, make loans, or conduct any banking services. They are simply points of contact between parent banks and their clients.[1122]

[1119] Petrochilos 1989:51.

[1120] Ibid.

[1121] Ibid.

[1122] Ibid.

Branches, agencies or representative offices and subsidiaries are different types of legal entities.[1123] The terms "branches'" "agency" "representative offices" or "subsidiaries" are not defined in GATS law. However, some guidance for a general distinction can be drawn from article XXVIII (d) of the GATS, which holds that commercial presence includes:[1124]

(i) The constitution, acquisition or maintenance of a juridical person, or

(ii) The creation or maintenance of a branch or a representative office.

Based on this distinction, a subsidiary can be defined as an independent legal entity established under the laws of the host country and is owned or controlled by a foreign services supplier.[1125] A branch or representative office is generally not a legal person under the host country's law. However, it is on a permanent basis and consumers will engage exclusively with the branch or representative office and not with the company.[1126]

The distinction between a legal person established under the host country's laws and a dependent branch or office has important implications from a regulatory point of view.[1127] This is especially apparent in the banking sector. A subsidiary is subject to the same rules as domestic banks in terms of controlling the level of deposits or limits on financial transactions. A subsidiary is also isolated to a certain extent from problems arising with the parent institution in the home market. Therefore, the failure of the parent bank is less likely to affect the stability of the host country's financial market. A branch of a foreign bank makes it more difficult for the regulator to deal with systemic risk problems arising from the situation of the parent bank. Consequently, a country may wish to limit foreign presence to subsidiaries and prohibit the provision of a banking service through a branch or representative office for prudential reasons.[1128] Subsidiaries and branches are different legal types, because a subsidiary is an independent legal entity, wheras a branch is a dependent

[1123] See GATS art. XVI: 2 (e).

[1124] Krajewski 2003:92-93.

[1125] Ibid.

[1126] Ibid.

[1127] Ibid.

[1128] Ibid.

commercial presence of a legal entity.[1129] Therefore, a restriction to limit foreign presence in the banking sector to subsidiaries is a restriction concerning the type of legal entity and would fall into the ambit of article XVI: 2(e) of the GATS. Such a restriction would need to be scheduled if the particular WTO member wanted to grant market access in the relevant subsector, but maintain this restriction.[1130]

4.5 Prudential Carve -out

The GATS addresses prudential implications from its liberalisation dynamics through the prudential carve-out.[1131] They are broad justification bases and this provision is not qualified by the necessity or other proportionality requirement. It could be argued that the requirement that measures under this provision be "for prudential" imposes at least a requirement of simple means-ends rationality, but it does not impose a least-trade-restrictive alternative requirement, as might result from a "necessity" qualifier, nor does this provision contain a reasonableness requirement, as does the co-ordinate provision of the NAFTA.[1132] Interestingly, here, the necessary qualifier is already included in the prohibition of article VI (5) of the GATS which prohibits requirements that are more burdensome than "necessary to ensure the quality of the service."[1133] Thus, the intent is clearly that even "unnecessary" prudential regulation is to be protected from scrutiny. Only financial regulation so unnnecssary that it lacks "prudential reasons" is subject to discipline.[1134]

4.5.1 Prudential Carve -out and Branches

Under the GATS regime, seeking valid measures towards the stability of the domestic banking system and depositors protection,[1135] the Annex on Financial Services allows

[1129] Krajewski 2003:92-93.

[1130] Ibid.

[1131] See GATS art.2 (a) of the Annex on Financial Services.

[1132] Trachtman 1997:87.

[1133] Ibid.

[1134] Ibid.

[1135] Panourgias 2006:57-58.

measures for prudential reasons to be exempted from the GATS disciplines as long as they do not constitute a means of avoiding the GATS commitments or obligations.[1136] Some of the difficulties in dealing with barriers that may fall within the prudential carve-out are illustrated by the treatment of direct branches of foreign banks.[1137] The list of barriers to market access in GATS article XVI include restrictions on the type of legal entity through which services may be supplied.[1138] This is consistent with the consensus that an overall prohibition on branch entry is not a legitimate prudential measure. However, even though a branch is an integral part of a foreign bank and not separately capitalised,[1139] some countries that permit branch entry impose branch capital-equivalency requirements. These can take the form of endowment capital requirements or asset pledge requirements. Because such measures are widely regarded as prudential, most countries that imposed these requirements have not listed them as limitations on market access or national treatment in their schedules of commitments.[1140]

Endowment capital requirements for branchesconstitute licensing measures, which deal with capital and solvency considerations in relation to the dependence of branches of foreign parent banks and so they would indisputably qualify as rules for prudential reasons.[1141] Let us assume that a member state of the EU requires banks authorisation in non-EU, WTO member countries to supply their branches with a minimum endowment capital. Assume also that this requirement is not listed as an MFN exemption under the GATS Annex on article II exemptions or inscribed as an exemption in the EU schedule of specific commitments under the GATS.[1142] The endowment capital requirement violates the MFN and the national treatment principles unless an exemption is made.[1143] The MFN and

[1136] Panourgias 2006:57-58..

[1137] Sydney 2005:965-966.

[1138] Ibid.

[1139] Kaufman 1991:75-76.

[1140] Sydney 2005:965.

[1141] Ibid.

[1142] Ibid.

[1143] Sydney 2005:965.

national treatment principles require respectively that like service suppliers of a WTO member are not treated by the host country less favourably than like service suppliers of any other country nor treated less favourably than like service suppliers of the host country.[1144] A national regulatory measure only violates article XVII of the GATS if it treats foreign services and service suppliers less favourably than domestic ones. Article XVII paragraphs 2 and 3 gives some preliminary answers to what is meant by less favourable treatment.[1145] Paragraph 2 holds that national treatment applies to formally identical treatment and formally different treatment. Paragraph 3 states that both types of treatment shall be considered to be less favourable if they modify the conditions of competition in favour of domestic services suppliers.[1146]Article XVII of the GATS applies to services and service suppliers. It has been pointed out that the inclusion of service suppliers in these provisions reflects the fact that the service provider itself may be part of the continuing nature of the service.[1147]Broadening the scope of non-discrimination to like service suppliers was necessary because many national regulatory policies apply to the supplier rather than the service.[1148]

Departure from the national treatment principle could be grounded in article 2(a) of the Annex on Financial Services.[1149] For the exemption to be granted discriminatory capital requirements, shall not be used as a means of avoiding the member's commitments or obligations under the Agreement, that is, the member will have to meet a simple means-ends rationality test. This means that measures should rationally serve a legitimate end and should not constitute an intentional attempt to avoid GATS commitments or obligations. The loose discipline of the means-ends rationality test is likely to allow an exemption for prudential measures irrespective of their effectiveness. The means-ends rationality test does not ask for the measure to be necessary for the attainment of the regulatory

[1144] Panourgias 2006: 59-60.

[1145] Ibid.

[1146] Krajewski 2003:103-107.

[1147] Ibid.

[1148] Ibid.

[1149] Panourgrias 2006: 661-62.

consideration at issue. This is only a requirement for the measure to have a rational link here to legitimate prudential concerns. The legitimate prudential concern here is the financial stability implications from the dependence of the branch on the foreign parent bank.[1150] Endowment capital addresses these concerns, for example, by helping the branch to meet its obligations from participating in a payment or settlement system, or by providing capital cushion to domestic depositors in case of failure.[1151]

4.5.2 Prudential Carve -out and Subsidiaries

A subsidiary is normally subject to the host country laws and regulation, since it is a separate legal entity incorporated in the host country jurisdiction.[1152] Thus, departure from the national treatment principle will be difficult to justify on the basis of regulatory considerations, prudential or otherwise.[1153] Depositors enjoy the full protection of the host deposit insurance schemes and of the host insolvency regime.[1154] Insolvency of the parent bank does not entail insolvency of the subsidiary bank, and hence, interstate systemic risk will be limited.[1155] Also the host country is likely to use its lender of last resort to prevent the failure of the subsidiary bank.[1156] Therefore, measures for prudentialreasonsmight not sustain even lax means–ends test of the prudential carve-out.[1157]

The activity of a foreign subsidiary raises some special concerns, which may justify its discriminatory treatment by the host regulator:[1158] Firstly, the source of strength doctrine

[1150] Panourgrias 2006: 661-62.

[1151] Ibid. According to the Basel Standards a GATS scrutiny of the endowment capital requirement might be different if both home and host country has adopted the Basel Concordat. The capital standards and surpervision arrangements for international banking operations prescribed therein may be deemed adequate to deal with the prudential aspects of foreign branch activity.

[1152] Ibid at 92.

[1153] Ibid.

[1154] Ibid.

[1155] Kaufman 1991:75.

[1156] Ibid.

[1157] Pourgias 2006: 91-92.

[1158] Ibid.

and the parent-subsidiary relationship cause host country regulatorydeficiences to be of concern. Under the source of strength doctrine the host country looks to the foreign parent to supply capital to the subsidiary if the subsidiary becomes weak. The basic ideal is that, the strength of the parent determines whether it will be able to save its subsidiary from difficulty by injecting additional capital. In addition, the host country may be concerned that the weak foreign parent may try to loot a local subsidiary through non-market affiliate transactions, for example, purchasing its assets at low market prices.To the extent that the subsidiary looks to the parent bank for capital support or that affiliate transactions are not always at arm's length, regulation of the parent becomes of interest for the host country regulator. Similar concerns arise if problems in the parent bank put the financial health of the subsidiary at risk. The host country might not be able to ring-fence the subsidiary's asset, especially if the subsidiary's activities are to a large extent outsourced to the host country.[1159] Secondly, there may be problems in the supervision of the subsidiary when the home country authority in charge of consolidated supervision for the parent bank is not the same as the home country authority in charge of consolidated supervision for the banking group that owns or controls the parent bank.[1160] In addition, supervision problems arise when the subsidiary has a sister bank operation under the same ownership in another jurisdiction without, however, one bank being a subsidiary of the other.[1161] Therefore, trade-restrictive measures in respect of subsidiaries of foreign banks may also be exempted from the GATS commitments or obligation in order to attain the relevant regulatory objectives.[1162]

4.6 Fundamental Principles of Commercial Presence

The GATS launch in 1995 is considered to be the major outcome of the Uruguay Round.[1163] The Agreement establishes a catalogue of rules and disciplines addressing commercial

[1159] Pourgias 2006: 91-92.

[1160] Ibid.

[1161] Ibid.

[1162] bid.

[1163] Collin 2007:47-48.

presence in trade in banking services.[1164] These rules and disciplines are targeted towards liberalising trade in banking services; thereby paralleling the objectives of GATT which were meant for goods trade only.The GATS introduces the following key principles: MFN, market access and national treatment.[1165]

The other two main principles, market access and national treatment principles can be limited, since their application is conditional upon the listing of a specific service sector in a member's schedule of commitments.[1166]Thus, host country regulation and supervision of foreign banks is potentially subject to the trade discipline of GATS principles. The MFN principle requires that banks and banking services of any other member must not be treated less favourably than "like"banking services of any other country.[1167] The market access obligations reduce barriers to entry of foreign banks,[1168] namely limitations on the number of foreign banks, the total value of services transactions or assets, the total number of service operations or the total quantity of service output, the total number of employees, the type of legal entity or joint venture through which a foreign bank operates, and foreign equity participation. The national treatment principle prohibits measures that discriminate against like banks and banking service suppliers of other members and distort the conditions of competition in favour of domestic banks.[1169] Article VI provides for reasonable, objective and impartial administration of measures affecting trade in banking services which aims to prevent the use of qualification requirements and procedures, technical standards and licensing requirements as a barrier to entry of foreign banks.[1170]

[1164] Collin 2007:47-48.

[1165] Egger and Lanz 2008:166-1667.

[1166] Panourgias 2006:50.

[1167] See GATS art.II.

[1168] Panourgias 2006:53.

[1169] Ibid.

[1170] See GATS art VI.

The legal commitment of MFN raises a number of interpretative difficulties.[1171] The first difficulty is whether the concept of like services and service suppliers is given a narrow or wide scope. The wider the definition of like services, the more measures will fall within the scope of the MFN clause, with potential benefits for international trade. Under the WTO law, the notion of like services is a wide one –to the extent that the service suppliers concern supply the same services, they should be consider for the purposes of article II. The second difficulty relates to the definition of the notion of "treatment of less favourable".Is it limited to de jure discrimination, or is it extended to de facto as well? The answer is that article II prohibits both de jure and de facto discrimination.[1172] De facto discrimination is when formally different measures result in equality treatment; just as formally identical measures can in some cases result in less favourable treatment of foreign suppliers.

4.6.1 Market Access

The principle of market access should be clearly distinguished from that of national treatment.[1173] Market access is the policy instrument by which governments exercise their discretionary powers as to which foreign banks will be granted access to their domestic markets.[1174] The principle of national treatment comes into play once access has been granted and concerns the continuing treatment that the supplier of the banking services can expect to receive from the authorities of the importing country.[1175] Banking is characterised by a number of sub-markets, and the granting of market access to foreign banks may only apply to some of those sub-markets. In other countries where a relatively high degree of liberalisation has already been achieved, the emphasis is more on the need to maintain

[1171] Gkoutzinis 2005:898.

[1172] Ibid. The motto of the GATS is "favour one, favour all." Members cannot afford privileges to services or firms originating in other countries without affording the same treatment to all other members. MFN means treating one's trading partners equally on the principle of non-discrimination. Under GATS, if a country allows foreign competition in the banking sector, equal opportunities in this sector should be given to service providers from all other WTO members.

[1173] Footer 1995:472.

[1174] Footer 1993:360.

[1175] Ibid.

control over the process in order to take account of the overriding importance of prudential consideration, monetary policies, and national development objectives.[1176]

The chosen method in article XVI of the GATS is not to define market access as an obligation, but instead to seek an implicit approach, as suggested by the wording in paragraph 1, which states that "each member shall accord services and service suppliers of any other member treatment no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its schedule."[1177] If a member lists a specific banking sector, that sector is unrestricted except for those limitations and conditions that it has listed pertaining to mode 3 supply. However, such limitations may not include certain measures such as the placing of ceilings on the number of natural persons who may be employed or on the amount of foreign capital that may be invested in the banking services industry.[1178]

As for OECD countries, the establishment of foreign banks has become widely accepted throughout the member countries.[1179] The way was already opened by the inclusion of an obligation to liberalise foreign banks establishment in the OECD The current Invisible Operations of 1989 contains new provisions that strengthen liberalisation obligations for non-residents wishing to establish branches, agencies, and so on in the banking sector. Throughout the negotiations on banking services, the OECD member states have tended to favour an approach to market access that is broad in character, the so-called "negative approach" to commitments on market access.[1180] The Understanding takes up the commercial presence aspect of market access at sub-paragraph 5.[1181] It requires that each member, on the basis of the Understanding, grant to a banking service supplier the right of

[1176] Footer 1993:360.

[1177] Ibid.

[1178] Ibid.

[1179] Ibid.

[1180] Ibid.

[1181] Ibid.

establishment or expansion in its territory, thereby further qualifying the specific commitments contained in article XVI:1 of the GATS.[1182]

4.6.2 National Treatment

The issue here is the treatment accorded by host country regulatory authorities to foreign banking affiliates.[1183] The GATS contains specific obligations meaning that they are only engaged if a member has made specific commitments in that sector.[1184] This operates once a bank obtains market access. It commits members to treat foreign banks in the same way as domestic banks, although, as with market access, under the GATS, members can make treatment subject to conditions and qualifications. The approach to national treatment of the OECD countries is embodied in the Understanding, attached to GATS, but with no legal force. It is designed to obtain more ambitious liberalisation commitments, although it seems that almost the same degree of liberalisation could be obtained under the general approach.[1185]

The transfer of banking skills and know-how is often one of the crucial considerations for developing countries when granting foreign banks market access and subsequent national treatment.[1186] A common proviso of many of them is regulation relating to the hiring and training of local staff by foreign banks. Clearly, national rules that discriminate between foreign and domestic providers of banking services constitute barriers to free trade. The principle of national treatment, which applies host country rules to foreign and domestic banks on a non-discriminatory basis, is meant to ensure equality of competitive opportunity by eliminating such discriminatory barriers. In the *Canada-Autos case*,[1187] a private member's bill in 2007 proposed changes to the Bank Act which will prohibit banks charging

[1182] Footer 1993:360This obligation can be made subject to terms and condition under para.6.

[1183] Gelb and Sagari 1990:3-4.

[1184] Collins 2007:51. These highly qualified rules embraces national treatment, which as has been described as the "core" of GATS, and market access.

[1185] Cranston 1997:436.

[1186] Footer 1993:363.

[1187] Collins 2007:44-52.

for the electronic transfer of funds through any automatic banking machine in Canada.[1188] Canada's schedule of commitments lists financial services and does not contain any restrictions such as those regarding machine services charges and consequently the GATS specific obligations apply and must be considered when any measure is taken that may affect the international provision of these services. Canada's current exemptions under its scheduled commitments involve primarily constraints of foreign ownership of banking institutions. An absolute withdrawal fee prohibition could contravene the national treatment obligation of article XVII because there may be greater costs faced by new comers to the automated cash services relative to incumbents.[1189]

It is generally understood that national treatment must be applied de facto as well as de jure.[1190] For example, the OECD national treatment instrument defines national treatment under host country laws, regulations and administrative practices as no less favourable than than accorded in like situations to domestic enterprises. The expression no less favourable acknowledges that exact national treatment cannot always be achieved and that any adjustment should favour the foreign bank.[1191]

4.6.3 Most Favoured Nation

The economic rationale of the MFN principle is to create a level playing field for all foreign investors by prohibiting discrimination between investors from different member states.[1192] It aims at enabling equal competition among investors by prohibiting the imposition of different transactions costs based on the national origin of the investors.[1193] The two outstanding issues confronting the MFN principle, where banking services are supplied

[1188] Collins 2007:44-52.An initial difficulty rests with the ambiguity of this statutory amendment, the text reads as follows: A bank shall not make a charge, to its customers or to the public, for the electronic transfer of funds or the communication of account information through the use of automated banking machine, whether the machine is owned or operated by the bank or by another person.

[1189] Collins 2007:44-52.

[1190] See art. XVII: 2 and XVII: 3 of the GATS.

[1191] Sydney and Hal 1991:20.

[1192] Chill: 2009:503.

[1193] Ibid.

through a commercial presence are:[1194] the compatibility of MFN treatment with procedures that place a ceiling on the total number of entries into a particular market; and the eligibility of receiving the benefits of concessions under GATS through application of the MFN principle.In the first case, the permitted level of commercial presence for foreign banks is an issue. Application of unconditional MFN treatment is problematic because the granting of market access is bank specific rather than aimed at particular countries.[1195] This specificity runs counter to the fundamental MFN principle as enshrined in multilateral trading relations.[1196] In the second case, the eligibility to receive the benefit of concessions under the GATS in accordance with MFN principle is already running into difficulties.[1197] As anticipated, many countries, particularly developing countries, have chosen to include extensive limitations and conditions with regard to market access and national treatment in their offers submitted during the negotiations on commitments. Some of those offers have been prefaced with reservations concerning a right to modify the contents in light of the number of offers made by other parties to negotiations and the degree to which they are equivalent and mutually acceptable.[1198]

The MFN obligation does not apply, in the case of banking services where there is recognition of prudential measures.[1199] The Annex on Financial Services permits a departure from the MFN obligation for unilateral or mutual recognition of prudential measures. This provision allows a country to recognise prudential measures of other countries, either unilaterally or through a negotiated arrangement or agreement, without being subject to a challenge by an excluded WTO member that it is being denied MFN treatment. A country must, however, be willing to accord similar recognition to measures of other WTO members that meet the same standards. In effect, the recognition provision in the Annex elaborates on the application to the banking services sector of GATS article VII (Recognition), which

[1194] Footer 1993:363-364.

[1195] Ibid.

[1196] Ibid.

[1197] Ibid.

[1198] Ibid.

[1199] Collins 2007:48.

allows a country to recognise standards or licensing or certification requirements of selected countries without being subject to the MFN obligation of the GATS.[1200] The recognition provision in the Annex on Financial Services does not contain a requirement for prior notification to the Council on Trade in Services.[1201]

4.7 Foreign Direct Investment and Commercial Presence

Article 1:2 (c) is of the supply of a banking service by means of a commercial presence "by a banking service supplier of one member, through commercial presence in the territory of any other member" where a banking service provider crosses a border in order to render a banking service to the recipient who remains in his country.[1202] It is usually envisaged in these circumstances that the banking service is sold abroad through a legal entity, thus requiring a commercial presence, for example a foreign branch or affiliate in the case of banking. This situation raises issues involving the right of establishment and the application of national treatment, and thus is often inseparable from basic issues relating to FDI.[1203] The establishment of commercial presence raises important and related issues of FDI, which have proven vital in negotiating trade in banking services across the board.[1204]

Liberalisation of capital movement is distinct frombut closely related to liberalisation of trade in banking services.[1205] Establishment of a commercial presence in a host country by a foreign service supplier involves both trade in services under the GATS and international capital transactions.[1206] For example, a GATS commitment to liberalise banking services trade by allowing foreign banks to establish wholly owned subsidiaries is essentially a commitment to allow foreign direct investment that involves the acquisition of one hundred

[1200] See GATS art.VII.

[1201] Macrory ea 2005:966.

[1202] Footer 1995:464.

[1203] Ibid.

[1204] Footer 1993:353.

[1205] Sydney 2005:962-963.

[1206] Ibid.

percent of the shares of existing or de novo host country banks.[1207] In theory it is possible that, once established, a subsidiary of a foreign bank could conduct its ongoing activities without engaging in additional international capital transactions; however, its activities would need to be limited to transactions with host country residents involving domestic banking.Boththe establishment and operation of branches of foreign banks, which are not incorporated in the host country,[1208] almost alwaysinvolve international capital transactions between the bank's head office and the branch.[1209] The transactions include foreign direct investment.[1210]

In General, it is difficult to realise fully the benefit of liberalisation of trade in banking services without the freedom of capital movements.[1211] Banking services trade absolutely requires, however, the liberalisation of only those capital movements that are necessary for trade transaction to occur.[1212] GATS article XI prohibits WTO members from imposing restrictions on capital transactions or associated payments and transfers that would be inconsistent with their specific commitments to market access and must allow inward capital movements that are related to a banking service supplied through a commercial presence.[1213] The bottom line is that if a country makes a commitment to liberalise trade with respect to a banking service involving a commercial presence in the GATS, it is also making a commitment to liberalise most capital movements associated with the total trade liberalisation commitments. The country is not however, making an across-the-board commitment to freedom of capital movements.[1214] Liberalisation of inward direct

[1207] Sydney 2005:962-963.

[1208] Ibid.

[1209] Ibid. Generally, establishment via local incorporation is more costly than branching. Local incorporation frequently requires higher minimum capital, and regulatory monitoring would be stricter. The local incorporation will need to meet the various regulatory requirements on a single-entity basis rather than on a group basis. In many Asian countries, foreign banks are required to gain licences as a local incorporation.

[1210] Macrory ea 2005:962-963.

[1211] Footer 1993:356.

[1212] Ibid.

[1213] Wang 2007:216.

[1214] Ibid.

investment in the banking sector would be required to achieve liberalisation of banking services trade through commercial presence. In fact developing countries have often chosen to liberalise inward direct investment through their commitments in mode 3 (commercial presence) while restricting cross-border capital movement by relatively limiting commitments in mode 1 (cross-border supply). Regarding commercial presence, the GATS rules require the liberalisation of capital inflows which are related to the supply of the service, without specifying in more detail whether this refers only to capital inflows related to service provision.[1215]

The GATS has produced substantive and legally binding norms for the regulation of FDI in the banking sector.[1216] As commercial presence constitutes one of the modes of trade in the banking sector, foreign direct investment in the banking sector is subject to the trade disciplines of the GATS.[1217] The GATS achieved liberalisation of foreign direct investment without focussing on FDIs.[1218] Interestingly, the GATS has instituted FDI liberalisation in the banking sector, a sector of interest to the national regulator due to its importance for monetary policy, economic financing and the conduct of payment as well as due to systemtic risk from banking activities.[1219] The GATS liberalisation of FDI in banking is of interest here for its effect on the stability of the international banking system.[1220] Liberalisation results in deeper interdependence of the national banking system and so potentially exacerbates the effect of negative externalities originating in jurisdictions with deficient financial supervision system.[1221] The GATS addresses this concern through the prudential carve-out. [1222]

[1215] Masamichi and Ludger 2000:142.

[1216] Panourgias 2006:29.

[1217] Ibid.

[1218] Ibid.

[1219] Ibid.

[1220] Ibid.

[1221] Ibid

[1222] Ibid.

4.7.1 Definition of Foreign Direct Investment in Banking

Foreign direct investment can be defined as investment in a bank located in one country but effectively controlled by residents of another country.[1223] The IMF provides a definition of control as:[1224]

> "Control of a bank in country Y by residents of country X is inferred (1);50 percent or more of the voting stock is owned by residents of country X, or (2) 25 percent or more of the voting shares is concerntrated in the hands of a single holder or organised group of holder in X, or (3) residents of X are known in fact to have a controlling interest in the bank's policy".

Secondly, IMF defines foreign direct investment as:

> "investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy....the lasting interest implies the existence of a long-term relationship between the direct investor and foreign enterprise and a significant degree of influence by the management of the enterprise."[1225]

The GATS has provided a multilateral binding framework for FDI in the banking sector, at the same time negotiators of the Agreement on Trade Related Investment Measures (TRIMS), another WTO agreement, avoided negotiating FDI rules.[1226] The most important multilateral regulatory effort towards world economic integration results in FDI liberalisation in the financial sector, and in particular in the banking sector, a very dynamic sector, but also regulation-intensive and subject to systematic risks, without its focus being on FDI.[1227]

4.7.2 Determinants of Foreign Direct Investment Localisation in the Banking Sector

The decision to invest abroad can be related to one or more of the following factors:[1228]

[1223] Panourgias 2006:29.

[1224] Ibid.

[1225] Kant 1996:3.

[1226] Panourgias 2006:28.

[1227] Ibid.

[1228] Brewer 1995:12-13.

(i) Size of the host country market, as given by the level of gross domestic product. As soon as the size of the market of a particular country has grown to a level warranting the exploitation of economies of scale, then this country can become the target for inflow of foreign direct investment.

(ii) Economic and political stability of the host country. Foreign banks prefer those countries where the banking sector is relatively more developed and stable, and where there are large interest rate margins to exploit.[1229]

(iii) Economic and cultural relations between the host and the foreign country are also possible to foresee a positive relationship between FDI in the banking sector and geographical distance. As the distance from the host to the foreign country increases, in fact, foreign banks may need a physical presence in the host market in order to provide adequate services to their clients. Foreign banks can decide to follow their clients into new markets, in order to maintain and strengthen their customer relationship.

(iv) Features of the local banking sector. FDI is expected to be positively related to the stability, efficiencies, and potential profitability of the host banking sector.

(v) Host country's attitude to foreign banks. A positive attitude towards foreign banks (low taxes, no discrimination, and free entry) should be attractive for FDI.

The likely improvement of human capital due to foreign banks' presence is particularly important to developing and transitional economies,[1230] where the skills required for the banking business are usually scarce, especially during the first years of transition. As for increased competition, it should be borne in mind that, at the beginning of transition, the creation of a two-tier banking system produced domestic oligopolistic market structures in almost all transitional economies.[1231] The entry of foreign banks may, therefore, significantly reduce the market power of domestic banks in some segments of the market. Moreover; benefits may also arise in the field of financial regulation. FDI can affect regulatory policies, and indirectly improve the efficiency of the legal and regulatory framework by facilitatingthe

[1229] Papi and Revoltella 2000: 437-457.

[1230] Ibid.Examples of TEs are: Czech Republic; Estonia; Hungary; Latvia; Lithuania; Poland;and Romania.

[1231] Ibid.

adoption of regulation and supervision standards. Lastly, foreign intervention can increase the financial strength of foreign banks through the capitalisation of domestic institutions, and help to resolve internal difficulties through the acquisition of problem banks.[1232]

Foreign direct investment helps to open up domestic banking markets, and this process feeds back into the composition of foreign investment flows.[1233] Foreign banks reduce lending margins and restrictive business practices by domestic banks. Improvements in the quality and extent of intermediation activity promote allocative efficiency in the host country.[1234] Easing of credit conditions helps to increase liquidity in stock markets.[1235] The realisation of these benefits depends on internal opening, that is, on the liberalisation of domestic banking markets. Restrictive controls and quantitative prescriptions for credit allocation need to be replaced by transparent regulations, and legal and governance institutions that protect and support contractual arrangements.[1236] In general terms, external opening to the global banking market encourages the process of internal opening. This process centers on the development of institutions and business practices that improve the efficiency of the financial system.[1237]

4.8 Foreign Banks in Developing Countries

Generally, banks begin to operate internationally so that they can penetrate local markets, and serve domestic corporate clients.[1238] One of the major motivating factors for international expansion is to gain direct access to the host country's market. Perhaps, indigenous banks are not competitive in lending activities, either in terms of loan pricing or

[1232] Papi and Revoltella 2000: 437-457. The banking environment in the TEs is special for several reasons. Firstly, in most TEs the government maintains a pervasive presence in the banking sector. Secondly, poor financial and legal infrastructures are a common feature of TEs. Thirdly, in the initial stage of transition there are relatively narrow sets of potential business clients, although some markets have highly promising prospects in the medium and long-term.

[1233] Hazel 1994:12-13.

[1234] Ibid.

[1235] Ibid.

[1236] Ibid.

[1237] Fausten 2003:12.

[1238] Petrochilos 1989:45-46.

services. Alternatively, host country banks may not realise their full potential in deposit-taking.[1239]

Spurred by financial liberalisation policies removing barriers to entry across geographic areas and markets and facing increased economic and financial incentives, the presence of foreign-owned banks in the form of branches and subsidiaries increased sharply in many countries during the 1990s.[1240] Accross the globe, observers have found that increased foreign banks participation has generally improved the efficiency of and helped strengthen host countries' financial systems, including by facilitating the privatisation of state banks and broadening access to financial services.[1241] Developing countries have participated in this trend. Entry through takeover of existing, often state-owned or nationalised banks have been especially high in developing countries.[1242]

4.8.1 Determinants of Foreign banks entry in Developing Countries

Banks go abroad to serve their domestic customers who have gone abroad.[1243] Domestic banks in developing countries are poorly equiped to serve the branches set up by entering firms. Thus, clients setting up activities in foregn countries only trigger an incentive for banks to internationalise if the financial innovation and sophistication in the foreign country lags behind that of the home country.[1244] A second rationale is that banksfollow their domestic customers abroad to reduce the likelihood that they might lose their business to host country banks.[1245] This likelihood increases if the financial sophistication of the host country is greater than that of the home country. If so, one would expect the services and

[1239] Petrochilos 1989:45-46.

[1240] Ibid.In Tanzania for example, the share of foreign-owned banks in total banks is 30 percent.

[1241] Stijn and Jong-Kun 2006:109.

[1242] Ibid.

[1243] Slager 1984:47.

[1244] Ibid.

[1245] Ibid.

organisation of the foreign operations of the bank to be similar to that of the home country, since it merely serves as an extension.[1246]

The main driving force pushing industrialized country banks into developing countries has been the search for profits.[1247] Banks have also followed their corporate customers that have started foreign operations. However, banks cannot expand abroad unless destination countries let them in, which many developing countries have opened up to foreign banks and removed rules that restricted foreign ownership. Between 1995 and 1997, years in which an interim and final World Trade Organisation agreement on financial Services was negotiated, countries generally opened up further.[1248] Among middle to high-income countries, countries in Africa committed more to opening up than those in Asia and Latin America, with an average index value of 0.452, respectively.[1249] This suggests that some countries with less developed financial systems viewed the potential gains from internationalisation as so large that they wanted to open fully. [1250]

Geographical promiximity are important factors to explain why a bank decides to undertake activities in a foreign country.[1251] A common language, administrative system and culture are an enormous help for banks wishing to enter these markets. The presence of British banks in the 1970s in Africa can be explained by the former presence of British colonies there, with a similar case of French banks in Central Africa and South East Asia or Spanish banks in South America.[1252] These cultural and historical determinants offer several advantages when banks are internationalising:[1253] Firstly, banks can commercialise the same products with similar marketing techniques, lower entry and sales costs of new banking

[1246] Slager 1984:47.

[1247] Ibid.

[1248] Stijn and Jong-Kun 2006:109-121.

[1249] Ibid.

[1250] Ibid.

[1251] Slager 1984:52.

[1252] Ibid.

[1253] Ibid.

services. The use of the same language facilitates the transfer of know how and could help the process of integration within the organisation, when foreign expansion is achieved by acquiring local banks.[1254] Foreign banks have also introduced improved risk management practices and imported supervision from parent country regulators, thereby helping to strengthen banking systems.[1255] Permitting foreign banks to enter the market is often accompanied by less entrance requirements and clarification of their content. This is to ensure that all parties are on equal footing, and will be judged on the same criteria. It also corresponds to the specific commitments of GATS national treatment. This assists in ruling out arbitrary decisions, encouraging regulatory rules to be better drafted, disclosed and scrutinised.[1256]

4.9 Why Foreign Bank Penetration is low in Developed Nations

Foreign banks control only about 10 percent of banking assets in most developed nations.[1257] While there are some exceptions, foreign banks' penetration is generally quite low in developed nations, particularly when compared to most developing nations.[1258] The relatively low foreign penetration in developed nations may be surprising. Most of the developed nations have removed explicit governmental regulatory barriers to foreign banks entry. In addition, improvements in information processing, telecommunications, and financial technologies have facilitated greater reach across borders by allowing banks to manage information flows from more locations, and to evaluate and manage risks at lower cost without geographic proximity. The low foreign shares in developed nations relative to developing nations may also be surprising since developing nations more often have high explicit barriers to foreign entry. Developing nations often present particular difficulties as well in processing soft information about local conditions and for dealing with cultural and market differences for banks headquartered in developed nations.[1259] In many cases,

[1254] Slager 1984:52.

[1255] Yokoi-Arai 2008:617.

[1256] Ibid.

[1257] Berger 2006:125-126.

[1258] Ibid at 125-133.

[1259] Ibid.

developing nations also have significant market shares for state-owned banks that may crowd out foreign competition with subsidised services and laxed enforcement of loan repayments.[1260] The focus here is to determine why foreign banks have often been so unsuccessful in penetrating banking markets in developed nations, and generally been much in and expanding in many of the developing nations:[1261]

(i) One potential comparative advantage for developed nations' banks is that their organisations may be able to diversify and absorb risks across nations and regions of the world. This may raise profits and lower costs by providing superior financial stability for which customers may be willing to pay, reducing other costs of risk management, lowering the organisation's cost of capital or allowing the institution to invest in some higher risk-higherexpected return investment.

(ii) In terms of abilities to serve specific types of customers, the multinational presence of foreign banks may help these institutions serve multinational corporations by providing services in multiple nations. Some banking organisations engage in the following of their customer strategy by setting up offices in nations in which their home-nation corporate customers have foreign affiliates.[1262]

(iii) Foreign banks headquartered in developed nations may have additional advantage over domestic banks in developing nations. These may include managerial expertise and experience, access to capital, ability to make larger loans, a seasoned labour force, and market power over suppliers. These banks also likely have advantages in the use of lending technologies based on hard information that is quantitative and verifiable-such as credit scoring or lending based on financial statements or easily valued fixed assets pledged as collateral-given their experience and economies of scale in processing information.[1263]

(iv) Foreign ownership has advantages, including the fact that foreign banks have easier access to capital and financial expertise from beyond their borders.

[1260] Berger 2006:125-126.

[1261] Ibid.

[1262] Ibid at 125-133.

[1263] Ibid.

Outside ownership can bring sources of capital from abroad to cash-starved business in a less developed economy and can smooth out regional variations in wealth and financial opportunity. The levelling effect of capital investment can be expected to reduce the difference between relatively poor and wealthy regions, especially important in a country such as developing countries which fervently desire to enjoy the living standards of western countries.[1264]

(v) Developing countries suffer many disadvantages, often including troublesome operational inefficient and low-quality assets. They often lack experienced personnel and realiable sources of information on the performance of potential borrowers, and in many cases they have inherited low-quality loans from past years. The question remains: is the development of an efficient and responsive banking system which promotes economic growth in a society best obtained through rapid external liberalisation, in other words, opening the market to foreign competititors? The Hungarian experience would suggest that foreign investment in the banking sector of a transition economy does indeed, improve these goals, at least in part. The bad loan problem has improved, bank services are much better, and in fact, technology and product offering are at or near Western European levels. The foreign banks in Hungary are now well integrated into the international financial systems. This means there is little difference nowadays between the products and services at a bank in Hungary and a branch of the same bank in Austria, for example.[1265]

(vi) Lack of technology: developing countries lack information technology used in banking, which can be termed as banking technology. The information technology revolution has brought about a fundamental transformation. No other sector has been affected by advances in technology as much as in banking;it has become the most important factor for dealing with the intensifying competition and rapid proliferation of banking innovations. The proliferation of Automated Teller machines (ATM), networking of these ATMs and Shared payment network based ATM is a feature that has been welcomed by

[1264] Akbar and Brad 2004: 100.

[1265] Ibid.

the banking system, and anywhere banking all of which have a high level of technology embedded in the systems offering these services.[1266]

4.10 Conclusion

In sub-saharan Africa, the experience of increased foreign participation in the domestic banking sector to date has shown such benefits as improved quality, pricing and supply of banking services and risk management, especially in poorer developing countries where the banking system is inefficient and unreliable, the entry of foreign banks will make domestic banks more efficient and avoid the high economic cost of inefficiency that prevent development, trade and investment.[1267]

Many industrialised and some developing countries allow for free entry of foreign banking service suppliers without any adverse effects on the conduct of monetary policy or soundness of the banking system.[1268] There are some countries such as New Zealand where the banking system is entirely owned and run by foreign banks.[1269] This has not had any adverse effect on monetary policy.[1270] Some basic prudential regulatory measures should be adopted before opening up a market to foreign financial services suppliers.As principle-based regulation threatens to overburden inexperienced regulators and supervisors and may allow for too much political discretion, developing countries should introduce prudential measures like capital requirements and leverage restrictions. Moreover, an independent supervisory agency should be established that is also responsible for a timely and reliable disclosure of information on banking services suppliers. Existing regulations that hamper markets and which are not sufficiently justified by other policy objectives should be abolished. This includes, but is not limited to, interest rate ceilings, credit targets, and use-of-funds regulations. State-ownership of banks should be reduced continuously and confined to those financial service, which cannot or are unlikely to be provided privately. In

[1266] Analil 2005: 473-474.

[1267] Vander Critical Issues in the Financial Sector <http://www.wto.org/english/forums_e/ngo_e/posp42_somo_doc (acessed 08/07/2011).

[1268] Ibid.

[1269] Dilip 1998:92-93.

[1270] Ibid.

order to promote incentives and competition, public deposit insurance systems and other means of public support for banks should be limited. Only small and/or poor bank customers should benefit from insurance systems, not sophisticated investors. The process of liberalisation has to be accompanied by easing the restrictions on international capital flows, not only for financial services providers but – since banks tend to follow their customers – for non-financial firms as well. For liberalisation to be successful, it is crucial that it starts by allowing the supply of simple financial products like deposit-taking, lending, payment and money transmission services, financial leasing, guarantees and commitments, and the insurance of standard risks to life and property.[1271] In order to follow these guidelines derived from economic considerations, developing countries must be able to actively influence and shape the financial services liberalisation process with respect to both timing and the services involved. Whether or not this is possible will depend on political realities, the policy space provided by international law, and the path and stance of economic development and of legal and economic institutions. Furthermore it is important to recognise, as already indicated, that there is no single blueprint for successful liberalisation as developing countries differ with respect to these dimensions. Gradual differences and the time it may take to address open issues can have an impact on the success of liberalisation.[1272]

The decision of banks on their mode of foreign market operation is closely related to non-financial firms' decisions to serve a foreign market by establishing a foreign representation.[1273] In particular banks tend to serve markets through subsidiaries if they have a strict productivity margin over competing banks that supply financial services across borders.This productivity margin is necessary because subsidiaries structures have a comparative disadvantage with respect to their ability to settle country specific liquidity shocks.[1274] There is also evidence that countries regulatory framework, political risk and

[1271] Dilip 1998: 92-93.

[1272] Ibid.

[1273] Dietrich ea 2010:43-44.

[1274] Ibid.

economic risk influence the mode of foreign market entry of international banks.[1275] In particular it is found that banks are more likely to establish a branch network if there is regulation that treat branches preferencially, if taxes are high, and if political risk is more important than economic risk.[1276] The reason for the latter effect is that, in contrast to branch network, the limited liability associated with a subsidiary structure allows the international bank to protect against country specific economic risk while being more prone to the risk of expropriation often associated with political risk.[1277]

[1275] Dietrich ea 2010: 43-44.

[1276] Ibid.

[1277] Ibid.

CHAPTER 5

CROSS-BORDER TRADE IN BANKING SERVICES (MODE 1)

5.1 Introduction

Cross-border trade in banking services (mode 1) –is when the bank is not present in the territory of the importing state and the service is delivered within the territory of the importing state.[1278] The criterion for trade in mode 1 is the location of the bank outside the territory of the importing state and the delivery of the service within that territory. Hence, defining the place where the service is delivered is a crucial criterion for the distinction between mode 1 and mode 2:[1279]

(i) Firstly, under mode 1, the supplier is not present within the territory of the importing state;

(ii) The service is delivered within the territory of the importing state;
The distinction between mode 1 and 2 is problematic because it presupposes that the location where the service is provided is evident;

(iii) The distinction has a trade perspective (scope and scale of GATS commitments related to mode of supply) and a regulatory perspective (the territory in which a service is delivered is relevant for the exercise of regulatory jurisdiction); and

(iv) Movement of capital depends on type of services for example, lending, acceptance of deposits.[1280]

In the arm's-length scenario where banks could provide an arm's length service directly to customers across borders without any domestic presence,[1281] a foreign bank could bypass domestic banks and collect funds directly from domestic savers, provide them with payment instruments (credit cards and even cheques), and arrange loans using telephone and computer technology.[1282]

[1278] Gkouzinis 2005:894-895.

[1279] Ibid.Given that the location where the service is provided is not clear in many cases of cross-border trade in banking services, for example, in the case of electronic finance, the distinction between modes one and two is particularly problematic and constitutes one of the open technical questions of the current financial services negotiations in Doha.

[1280] Ibid.

[1281] Gallagher 2005:100.

[1282] Hanson ea 2003: 759.

Banking services interact with a broad range of economic activities and agents play an important role in the credit, monetary, and payment systems.[1283] They have close relationships with public policy, and their operation is strongly influenced by the regulatory environment and by other aspects of the economy. The issue of opening up to international trade is consequently complex.[1284] The supply of a banking service from the territory of one member country into another, as defined in subparagraph (a),of the GATS would cover such activities as current transactions.[1285] In the case of cross-border transactions of mode 1 the crucial point, from the view of trade in banking services, is the extent to which controls over external payments have been relaxed.[1286] Indeed many of these may not be considered as current transactions, but as capital transactions instead.[1287] This first mode of trade in banking services, which involves international exchange of financial flows, and essentially, the liberalisation of capital account, allows agents in one country to enjoy financial services provided by institutions in other countries.[1288] Trade in banking services is defined as the provision of banking services by a bank in one country to a consumer of those services in certain degree of proximity. The supplier and the purchaser is usually more important for services than goods. It has generally been viewed within the context of the removal of exchange controls or capital account liberalisation.[1289]

5.1.1 Capital Account Liberalisation

Capital account liberalisation removes controls on the movement of capital in and out of the country and does away with restrictions on convertibility of currency.[1290]Cross-border trade in banking services has generally been viewed within the context of the liberalisation of

[1283] Gelb and Sagari 1990:3.

[1284] Ibid.

[1285] Hanson ea 2003:759.For example, external payments and other foreign exchange activity, and also the provision of financing facilities.

[1286] Ibid.

[1287] Ibid.

[1288] Daiana and Radu 2002:1-3.

[1289] Ibid.

[1290] Hoekman ea 2002:299.

capital movement.[1291] Issues relating to the movement ofcapital among countries have become central to the International Monetary Fund's (IMF) role, as embodied in its Articles of Agreement in the IMF system.[1292] A wave of capital account liberalisation swept across the world in the 1990s.[1293] This trend emboldened the Interim Committee of theIMF to recommend in 1997 that Fund members amend their Articles of Agreement to take on a new formal commitment to capital account openness.[1294] During the last biennial review of its surveillance activities concluded in 1995, the IMF's Executive Board agreed that financial markets and capital account issues deserved more attention by the IMF and amended the 1977 surveillance decision to take into account more explicitly the role of capital flows.[1295] The rationale for this proposal was simple, like free trade, international capital mobility increases aggregate welfare by facilitating the efficient allocation of investment irrespective of political boundaries.[1296]

In many developing countries, capital controls are used to limit short-term capital inflows.[1297] Although the tools of capital controls are wide-range and diversified, they can be broadly categorised into two types:[1298] administrative or direct control and market-based or indirect controls. Measures of the first type restrict capital transactions and/or the associated payments and transfer of funds through outright prohibition, explicit quantitative limits, or an approval procedure.[1299] Market-based controlling measures often discourage capital movements and the associated transactions by making them more costly to undertake through various forms such as dual exchange rate regimes or taxation of

[1291] Gelb and Sagari 1990:2.

[1292] Quirk and Ewen 1995:1; Lee 1999:37-38.

[1293] Brune ea.The Political Economy of Capital Account Liberalisation http://www.capitalcontrols_apsa_01.pdf (accessed 03/08/2011): 1-2.

[1294] Ibid.

[1295] Ibid.

[1296] Ibid.

[1297] Wang 2007:213.

[1298] Ibid.

[1299] Ibid.

international capital flows.[1300] When a country removes the restrictions on cross-border capital movement, it can be said that this country has undertaken capital account liberalisation, which can be defined as the freedom from prohibitions on transactions in the capital and financial accounts of the balance of payments.[1301] It is associated with changes in ownership of foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on or by the rest of the world. Capital account liberalisation can be, and is coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions, which are prudential in nature.[1302] Capital flows involve the cross-border movement of capital.[1303] Capital inflows occur when there is a receipt of payment from foreigners, including an increase in foreign assets in the country or a reduction in the country's assets abroad.[1304] Capital outflows on the other hand, takesthe form of either an increase of assets held abroad or a reduction in foreign assets in the country, both involving a payment to foreigners.[1305] In the country's balance of payment statement, those credit and debit items arising from the inflow and outflow of capital in the course of international receipts and payments, including direct investment, loans and securities investment, are recorded under the "capital account", as opposed to the "current account" which records the transaction items recurrent in the course of international exchange of services as well as unilateral transfers.[1306]

Under the GATS, mode 1 related market access commitments by a WTO member would require that member allow cross-border movement of capital only if the capital flow is "an

[1300] Gelb and Sagari 1990:2.

[1301] Benu.Conference on Capital Account Liberalisation: A developing Country Perspective http://www.odi.org.uk/resources/download/522.pdf (accessed 02/07/2011):2.

[1302] Wang 2007:212.

[1303] bid.

[1304] Ibid.

[1305] Ibid.

[1306] Ibid.

essential part of the service itself".[1307] That is to say, the capital should only be used to operate the liberalised service, but cannot be the subject matter of the said service.[1308]In the most general form the liberalisation of banking services trade under the GATS envisages that signatories will remove capital account restrictions to permit cross-border supply of banking services. GATS requires the removal of capital account restrictions in order to facilitate cross-border trade. Thus, in principle, by facilitating the international flow of capital, GATS ensures that investment flows internationally to those enterprises where it will be most productive in terms of risk and returns, in the new world trading regime.[1309] Some developing countries like the Gulf States of Bahrain, Kuwait, Qatar and United Arab Emirates and the African States of Ghana, Uganda and South Africa have fairly liberal regimes regarding cross-border supply of banking services with no restrictions on capital flows.[1310]

In the context of the opening up of trade in banking services, liberalisation of capital account has generated a good deal of policy debate. There are several reasons why it may be desirable to liberalise capital account rapidly:[1311]

(i) To discourage oreliminate the "black" market in foreign exchange;

(ii) To create an environment conducive to the establishment of a competitive and efficient domestic financial system;

(iii) To liberalise domestic interest rate policies and bring them in line with the international rates; and

(iv) Capital account liberalisation in the context of appropriate macroeconomic policies can effectively reduce capital flight.

Although these views stand to reason, a consensus is developing around the view that capital account liberalisation should not be introduced prematurely and that it must be

[1307] Dietrich ea 2010:11.

[1308] Wang 2007:215.

[1309] Ibid.Thus, in theory, freer capital flows are an opportunity for producers to attract the new investment necessary for development, and an opportunity for domestic savers to invest in projects anywhere in the world.

[1310] Hanson ea 2003:757.

[1311] Dilip 1998:91-92.

carefully sequenced.[1312] Poorly timed liberalisation always runs the risk of reintroduction of capital controls. However, capital account liberalisation and opening up of the financial sector are two distinct issues.[1313] In recent years, particularly following the crises in East Asia, Russia and Brazil, the opening up of the capital account has been a subject of intense debate with an emerging consensus on the need to manage the risks posed by rapid and large flows of short-term capital.[1314] Meanwhile, some of the poorer countries have already taken significant steps to liberalise their capital accounts but are now faced with the problem of trying to manage capital flows in a liberalised environment.[1315] The GATS focuses on the latter not the former. It seeks improvements in the terms and conditions of market access and non-discriminatory treatment or national treatment for foreign suppliers of banking services. The GATS not only allows members to maintain prudential regulations to ensure stability of their financial systems but also maintain the temporary restrictions on trade in banking services due to balance of payments reasons.[1316]

5.2 Preconditions for Capital Account Liberalisation

The premature capital account liberalisation was the direct cause of various financial crises including the 1997-1998 Asian crises.[1317] It is highly advisable that countries delay capital account liberalisation or maintain capital controls so that they can put in place effective domestic regulatory framework..[1318] However, banking services liberalisation should not be retarded by these factors.[1319]

[1312] Dilip 1998:91-92.

[1313] Wang 2007:211-212.

[1314] Ibid.

[1315] Benu.Conference on Capital Account Liberalisation: A Developing Country Perspective June 21, 2000, http://www.odi.org.uk/resources/download/3522.pdf (acessed 01/08/2011) at 1.

[1316] Dilip 1998: 91-92.

[1317] Wang 2007:211.

[1318] Ibid.

[1319] Ibid.

In order to reap the fruit of liberalising banking markets, firstly, countries have to open for substantial international capital flows,[1320] accompanied with sound measures for prudential regulation and whole-hearted efforts to stibilise macroeconomic performance and financial stability.[1321] Secondly, to fully reap the benefit of liberalisation a country should also aim at improving macroeconomic stability, in particular fiscal discipline.[1322] By stabilising expectations through rule-based macroeconomic policies,[1323] countries will reduce the risk associated with currency mismatches.[1324] Finance is all about trust and credit and macroeconomic stability enhances trustworthiness and credibility.[1325] It is important to note that rule-based macroeconomic policies do not imply complete surrender of fiscal or monetary autonomy. Instead, flexible rules allow for sufficient policy space and make macroeconomic policy on banking policy.[1326]

The second factor refers to prudential regulation.[1327] Opening borders for international capital flows can lead to surges in capital inflow.A major problem here could be that it may fuel excess credit expansion leading to bubbles that will later bust or to exchange rate appreciations that prepare the ground for future currency crisis.[1328] Accordingly, prudential measures are needed to convince international investors that their funds will be properly invested so that bubbles do not emerge.[1329] In terms of macroeconomic policies and, fiscal consolidation, an independent monetary policy based on indirect policy tools and flexibility in exchange rate management, are allimportant conditions for liberalisation effort. For

[1320] Dietrich ea 2010:40.

[1321] Ibid.

[1322] Ibid at 47.

[1323] Ibid. Monetary and fiscal.

[1324] Ibid at 40. An economy is subject to a currency mismatch if its real wealth strongly depends on exchange rate.

[1325] Ibid.

[1326] Ibid at 40-47.

[1327] Ibid.

[1328] Ibid.

[1329] Ibid.

banks, key issues in prudential regulation related to cross-border banking include:[1330] regulation of the specific and inter-related risks that arise from international capital flows, notably liquidity risk, market risk and credit risk; capital adequacy standards, which are intended to enhance the resilience of banks in the face of wide varities of risks:[1331]

(i) Capital Adequacy Standards are important in the presence of international capital flows. Indeed, the adoption of the 1988 Basel Capital Accord was, to a considerable extent, a response to the expansion of banks' cross-border activities.[1332] Firstly, by establishing minimum levels of capital for internationally active banks and assigning explicit risk weightings to all types of assets, the Accord has helped to ensure that banks hold sufficient capital against risks, including those arising from cross-border exposures. Secondly, by standardising the measurement ofcapital ratios, both with respect to the numerator and denominator, the Accord has promoted greater market transparency and regulatory arbitrage that could potentially lead to financial system instability and sharp reversals in capital flows.[1333]

(ii) Regulation of specific Risks:[1334] Prudential policies may entail specific and detailed controls on the transactions that banks are allowed to enter into and the positions they are allowed to hold. This type of regulation relies heavily on defined prudential ratios, for example the relationship between open foreign currency positions and capital, or the ratio of liquid assets to liquid liabilities. A traditional method for the regulation of liquidity risk is the imposition of a minimum ratio of liquid assets to current liabilities, or liquid asset ratio that banks would normally be required to meet within a set time period. Liquid assets are cash and short-term interbank.

[1330] Mathieson and Rojas-Suarez 1993:40-42.

[1331] Ibid.

[1332] bid.

[1333] ibid.

[1334] Ibid.

The early contributions were based on the experience of Argentina, Chile and Uruguay in the late 1970s, and they emphasised the importance of achieving macroeconomic stabilisation, financial liberalisation, and trade liberalisation before opening the capital account.[1335] The literature then shifted toward advocating the big-bang approach in the early 1990s,[1336] particularly in the context of transitional economies, arguing that the lack of credibility in the reform made it more appropriate to act quickly. In extending the big-bang approach to non-transitional contexts, some argued that the best route to an efficient financial sector was to liberalise the capital account quickly, as it would allow market discipline to operate on the banking system.[1337]

Moving toward capital account liberalisation, governments must also ensure that inflation, the current account balance and foreign exchange reserves are maintained at acceptable levels.[1338] The inflation objective can be aided by the creation of a strong, independent central bank that is relatively insulated from populist pressures emanating from the political process.[1339] Liberalisation of capital flows for financial firms fosters the internationalisation of banking business.[1340] But it is only a necessary but not a sufficient condition for international banks to enter a foreign market. Since banks tend to follow their customers first, a further necessary condition is to allow non-financial firms to establish local subsidiaries, implying that once international banks have entered, they will start to serve the local market.[1341] On the other hand, having liberalised capital account without opening domestic banking markets to foreign suppliers will also be insufficient.The reason is that there is also a need for infrastructure that makes sure that the international capital will be

[1335] Masahiro and Takagi 2008:7.

[1336] Ibid.

[1337] Ibid.

[1338] Ibid. Any one of these variables can prompt a financial crisis if it is allowed to move seriously out of line and undermine confidence in the currency.

[1339] Ibid.

[1340] Dietricht ea 2010:43.

[1341] Ibid.

channelled to its most productive use.[1342] The third factor is macroeconomic stability.[1343] A major drawback of international cash flows is the possibility of a sudden stop or even reversals in international capital flows. This is particularly problematic when international investors tend to withdraw funds exactly in those times when external funding is hard to obtain.Macroenomic stability is crucial here as it reduces uncertainty, stabilises expectations and thus exchange rates and minimises the probability that international investors have reasons to speculate against a currency and to withdraw their investment at once.[1344]

5.2.1 Benefits of Capital Account Liberalisation

Advocates for capital account liberalisation have argued that the free movement of capital around the globe enhances economic growth and paves the way for poor countries' development.[1345] According to this theory, if capital flows are unrestricted then resources will be allocated efficiently and move from rich countries where yields are low due to capital abundance to countries where capital scarcity promises high returns on investment. Consequently increased credit availability in developing economies would enhance domestic production and consumption and lead to economic growth, which would contribute to poverty reduction. Free capital movement is presumed to increase investment stability by allowing poor countries to diversify their income sources and thus become more independent of donors.[1346] Capital account liberalisation enables international capital mobility,[1347] which, according to economists, will generate some classic benefits generally because free capital movements permit a more efficient global allocation of savings and direct resources toward their most productive uses.[1348] Specifically, capital mobility brings about the following major benefits:[1349] firstly, as a tool of efficient allocation of resources,

[1342] Dietricht ea 2010:43.

[1343] Ibid at 40.

[1344] Ibid at 43.

[1345] Allendorf 2010:2; Gallagher ea 2005:98-99.

[1346] Ibid at 3.

[1347] Dietrich ea 2010:40.

[1348] Ibid.

[1349] Wang 2007: 216-217.

capital flow representsmoney that flow between two countries-that allows a country that has excess savings in a given period to transfer these savings to another country which has excess investment opportunities.[1350] Secondly, capital movement enables risk diversification. By holding claims on foreign countries, households and firms can diversify risks associated with disturbances that impinge on the home country alone. Thirdly, capital inflows in many cases is associated with gains from foreign direct investment, which might bring with it technology know-how, managerial expertise, and access to market.[1351] Fourthly, capital account liberalisation can promote dynamic efficiency in the banking sector. Increased competition from abroad will force domestic banks to become more efficient.[1352]

The basic argument that a country should not have controls on capital accounts is analogous to the argument for free trade in goods and services.[1353] Free capital movement facilitates an efficient global allocation of savings and helps channel resources into their most productive uses, thus increases economic growth and welfare. To put it more specifically, free capital movement will (1) increase consumer's welfare by providing more international investment opportunities; (2) expand the opportunities for portfolio diversification and thereby provide investors in both industrial and developing countries with the potential to achieve higher risk-adjusted rates of return. Moreover, individuals should be free to dispose of their own wealth and income as they see fit, provided that doing so does not harm others. The second reason is that barriers to free capital flows do not work anyway. In modern financial markets, financial instruments are highly fungible and markets are able to avoid capital controls when they have a strong incentive to do so.[1354]

[1350] Wang 2007: 216-217.

[1351] Ibid.

[1352] Mathieson and Rojas-Suarez 1993:20.

[1353] Carsson. Go with Flow? Capital Account Liberalisation http://www.brettonwoodssprojects.org (accessed 2011/07/09):5-7.

[1354] Ibid.

5.2.2 Capital Movements

This is the relaxation on the normal limits placed on residents opening bank accounts abroad.[1355] Developing countries turn to deposits in offshore accounts. Explanations are probably best related to:[1356]

(a) the differences in return and risk between the small and large countries; and

(b) the differences in residents' responses to these incentives. Viewing offshore deposits, sometimes called capital flight, as the product of rational economic choice.

In this light, differences in the pattern of deposits can be related to the following:[1357] Firstly, physical security is an obvious factor that may affect the risk-adjusted rate of return and the pattern of deposit holdings. Many of the smaller countries have recently experienced civil wars or insurrections. In such circumstances, onshore deposits are likely to be relatively low and offshore deposits relatively high. Secondly, a market-related factor that could explain small countries' large offshore deposits and small onshore deposits might be the greater importance of international activities in small countries' economies. Residents engaged in international trade may find that keeping funds both offshore and onshore is convenient. Residents who work offshore may keep deposits both where they work and where they are citizens. Hence a large share of offshore-related activities by residents of small countries than large countries would be consistent with more offshore deposits.[1358] Thirdly, the greater importance of large companies in small countries' economies; especially those engaged may deposit offshore to receive services that they need for their businesses. Lastly, one explanation of the large offshore deposits of small countries is that, to the extent that these countries attempt to repress domestic interest rates, there are more leakages into offshore deposits than in developed countries.[1359]

[1355] Hanson ea 2003:100-102.

[1356] Ibid.

[1357] Ibid.

[1358] Ibid.

[1359] Ibid.

Openness is probably an explanation for the developing countries' lower ratio of onshore deposits and higher ratio of offshore deposits compared with large countries.[1360] This openness means that residents of developing countries not only want offshore deposits, but can more easily avoid any repression of deposit rates, either by the banks themselves or by policymakers, than residents of developed countries.[1361]

Article VIII, paragraph 2(a) of the IMF Agreement prohibits the introduction by members of exchange restrictions on making of payments and transfers for current transactions, except as otherwise authorised by the IMF.[1362] The concept of payments for current transactions as defined in article XXX (d) (1) of the IMF Agreement covers:[1363]

(i) Payments for services, including financial services, and

(ii) The provision of trade finance facilities.

The IMF Agreement, article XXX (d) states that:[1364] payments for current transactions means payments which are not for the purpose of transferring capital, and includes without limitation: all payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities. For those IMF members complying fully with the requirements of article VII,[1365] paragraph 2(a), relating to the prohibitions on interference with international payments are confined to the financial aspects namely, exchange controls of current transactions and not to the underlying transactions themselves.[1366]

Capital transfers are not caught by the obligations of convertibility under the IMF Agreement.[1367] Thus under article VI, paragraph 3 " members are free to control or not to

[1360] Hanson ea 2003:100-102.

[1361] Ibid.

[1362] Footer 1993:355-357.

[1363] Ibid.

[1364] Ibid.

[1365] Mathieson and Rojas –Suarez 1993:9.

[1366] Footer 1993:355-356.

[1367] Ibid.

control these transfers, provided that any controls that are employed do not impede payments and transfers for current transactions."[1368]

Article VI of the IMF Agreement states in Full that:[1369]

> "Members may exercise such controls as necessary to regulate international capital movements, but no member may excercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfer of funds in settlement of commitments, except as provided in article VII, section 3(b) and in article XIV, section 2."

Those countries that utilise the exception of article XIV, paragraph 2 to impose restrictions on payments and transfers for current transactions also maximise the use of the available restrictions on capital transactions. Once these restrictions are lifted and the balance of payments situation improves and the transaction made to full implementation, article VIII, paragraph 2(a), may not be reintroduced, except under article VIII with the IMF approval.[1370]

5.2.3 Payments and Transfers

Article XI of the GATS contains obligations on payments and transfers that, needless to say, are important in the context of a trade agreement on banking services that covers cross-border activities.[1371]Article XI first provides that a member may not apply restrictions on international transfers and payments for current transactions relating to its specific commitments.[1372] This is yet another obligation that finds application only where a member

[1368] Footer 1993:355-356. Even so, no member may exercise controls on capital payments, which likewise place restrictions on payments for current transactions or which unduly delay the transfer of funds in settlement of outstanding commitments. However, this rule has two permitted exceptions laid out in article VI, paragraph 3. Firstly, article VII, paragraph 3 (b) allows the member in question, in the event of the scarcity of a member's currency and subsequent to consultations with the Fund, to impose limitations on the freedom of exchange operations in the scarce currency as a temporary measure. Secondly, and more commonly, art. XIV, section 2 of the Fund Agreement, permits a member, if it so desires, and without prior authorisation from the Fund, to maintain for balance of payments reasons exchange restrictions on payment transfers for current transactions that are in effect at the time it becomes a member.

[1369] Ibid.

[1370] Ibid.

[1371] Leroux 2002:421.

[1372] Sydney 2005:963.

has taken specific commitments.[1373] The concept of payments for current transactions covers payments for banking services. It does not cover payments for the purpose of transferring capital.[1374] While any agreement on trade in banking services could have serious implications for countries' regimes for controlling external capital movements, articleXI: 2 of the GATS is a compromise.[1375] The rights and obligtions of IMF members, as to the use of exchange controls and restrictions in conformity with the Fund Agreement, take precedence over provisions of the GATS, with the proviso that restrictions shall not be imposed on any capital transactions inconsistent with specific commitments concluded under the GATS.[1376] The bottom line is that if a country makes commitments to liberalise trade with respect to a particular financial services under the GATS, it is also making a commitment to liberalise most capital movements associated with the trade liberalisation commitment.[1377] The country is not, however, making an across-the-board commitment to freedom of capital movements. The GATS provisions dealing with capital movements, like GATS specific commitments to liberalise trade in banking services, are subject to balance – of-payment safe-guards.[1378] Both the capital movements and balance-of-payment safeguards are consistent with the provisions of the GATS refered to and are consistent with the IMF's responsibilities in these areas.[1379]

GATS does not aim at the overall liberalisation of international payments and transfers.[1380] However, it provides for a conditional obligation according to which WTO members must not restrict current transactions and capital transactions that have been made in relation to

[1373] Sydney 2005:963.

[1374] Leroux 2000:421.

[1375] Footer 1993:56; Dukgeun 2000:13.

[1376] The choice of wording is unfortunate, article XI:2 would have been better if drafted to read "without prejudice to the obligations of IMF members under the Fund Agreement", Footer 1993:56.

[1377] Sydney 2005:963.

[1378] Ibid.

[1379] Ibid.

[1380] Dietrich ea 2010:12.

services in respect of which a member has undertaken specific commitments.[1381] No member may exercise controls on capital payments, which likewise place restrictions on payments for current transactions or which unduly delay the transfer of funds in settlement of outstanding commitments.[1382] Except under article XII,[1383] the GATS does not allow members to apply restrictions on international transfers and payments for current transactions relating to specific commitments.[1384] "If a member is committed to cross-border supply of banking services the associated movement of capital is to be accepted as its natural counterpart. Although such provisions apply to trade in all services, they are particularly relevant in the context of banking services. A commitment to liberalise market access in banking services would be virtually worthless without a commitment obligation to liberalise associated capital flows. When external financial difficulties cause serious balance of payments pressures, a member is permitted to introduce restrictions of temporary nature on trade in banking services".[1385] This implies restrictions on international payments or transfers as well. Article XII stipulates conditions so that these measures are not recklessly applied.[1386]

Article XII deals with restrictions to safeguard the balance of payments and reads :[1387]

1. In the event of serious balance of payments or threat of balance of payments, a member may adopt or maintain restrictions on trade on which it has undertaken specific commitments, including on payments for transactions related to such commitments. It is recognised that particular pressures on balance of payments of a member in the process of economic development or economic transition may necessitate the use of restrictions.

[1381] Dietrich ea 2010:12.

[1382] Footer 1993:355.

[1383] Restrictions, to safeguard the balance of payments.

[1384] See GATS art.XI (1).

[1385] Dilip 1998:96.

[1386] Ibid.

[1387] Ibid.

Article XI of the GATS takes into account the relevance of capital flows for the provision of some services and seeks to ensure that capital restrictions are not used to reverse liberalisation commitments in cases where the flow of capital is necessary for trade in banking services.[1388] Article XI of the GATS affirms that the GATS does not affect the rights and obligations of the members of the IMF under the articles of Agreement of the Fund, including the use of exchange actions that are in conformity with the articles of Agreement.[1389] The article is intended to gurantee the primacy of IMF rules in this area.[1390] Members shall not impose restrictions on any capital transactions inconsistently with their specific services commitments regarding such transactions.[1391] Obligations as to the liberalisation of cross-border transactions in the WTO are linked to the commitments to market access included in a country's schedule and are designed to prevent their frustration in practice through restrictions on capital transactions necessary for their fulfilment.[1392] However, the decoupling in the GATS of market opening for banking services from liberalisation of capital account transactions generally leaves space for connections in practice. To ensure effective implementation of such commitments the country will be obliged to undertake comprehensive liberalisation of capital transactions.[1393] A country whose commitments were made through the Understanding would also be making an open-ended commitment to the liberalisation of such transactions required by its obligations to permit banking service suppliers of any other member established in its territory to offer its territory any new financial services.[1394] Members of the GATS are not to impose restrictions on any transactions inconsistent with their specific commitments, except under article XII, or at the request of the IMF.[1395] Before invoking these measures, a member is obliged to consult the other members and the IMF. The latter plays a crucial role in determining

[1388] Dietrich ea 2010:12.

[1389] Gkoutzinis 2005:897.

[1390] Cornford 2004:11.

[1391] Gkoutzinis 2005:897.

[1392] Cornford 2004:11.

[1393] Ibid.

[1394] Ibid.

[1395] Ibid.

whether these measures are legal or extra-legal. Also, for consultations with the GATS members, the statistical data and other facts prepared by the IMF relating to the balance of payments and foreign exchange reserves situations will be accepted as the basis of discussion.[1396]

The provisions of GATS article XI: I on market access, in part III of the Agreement, are further reinforced by a note and supplementary provision that states that where a member has undertaken a specific commitment on market access, with respect to the supply of cross-border banking services, and the cross-border movement of capital is an essential component of the service itself, that member is committed to allowing such movement of capital.[1397]

5.3 Capital Account Liberalisation Issues

5.3.1 Capital Account Liberalisation and Real Exchange Rate

Capital account liberalisation has been at the forefront of discussion on the optimal sequencing of stabilisation and banking reform.[1398] The case for the late dismantling of capital controls emphasises the role played by the real exchange rate. Relaxation of capital controls would induce capital inflows that result in a real exchange rate appreciation which, in turn, removes protection from the tradable sector just when banking trade reform requires real exchange rate depreciation.[1399] The case for late external banking reform is strengthened when a country undertakes major stabilisation and liberalisation in one big reform, inducing a sudden attempt of foreign lenders to increase their claims on reform economy.[1400] Those who opt for capital account first sequence of structural reform want to reduce structural adjustment costs by relying on foreign capital during the transition. They also point to political constraints and vested interests which resist reform and think of early

[1396] Dilip 1998:96.

[1397] Dietrich ea 2010:12.

[1398] Fischer and Reisen 1993:41.

[1399] Ibid.

[1400] Ibid.

capital inflows as an important ally for the groups interested in liberalisation.[1401] The real exchange rate has many guises; among them are:[1402]

(1) The nominal exchange rate multiplied by a foreign price index and divided by a domestic price index;

(2) The domestic price level of tradable goods as deflated by domestic price level of no tradable; and

(3) the ratio of nominal exchange rate to wage index.

If the foreign price index corresponds to the internal price level of tradables, and if the domestic price level follows the price level of nontradable, the real exchange rate as defined by (1) changes in the same way as defined in (2). Likewise, (3) can be seen to approximate (2), given that the nominal exchange rate is the predominant variable in determining the domestic price of goods traded on the world market, and that the wage level is the principal component of the price of nontradables. In discussing the real exchange rate experiences of countries opening up their capital account we will use definition (1) because it comes closest to many policy makers' concerns about external competiveness and because it is easy to determine for a large number of countries.[1403]

The fear that capital account liberalisation would entail a real appreciation of the exchange rate may have been nourished by the way several economists have modelled capital account liberalisation.[1404] Usually, capital controls have been assumed to act as a tax on capital inflows. That modelling practice can be justified as long as:[1405] controls on capital inflows are more effective than controls on capital outflows; and only to those countries that open their capital account to generate government revenues. However, these assumptions are insufficient to maintain that liberalising the capital account will appreciate the real exchange rate. The domestic currency will appreciate in real terms only to the extent that the liberalisation-induced capital inflow increases the net financial transfer to

[1401] Fischer and Reisen 1993:41.

[1402] Ibid.

[1403] Ibid.

[1404] Ibid.

[1405] Ibid.

the economy from abroad, and that this net transfer is partly spent on no tradable. By contrast, if the increased resource transfer is used to build up foreign assets abroad, the real exchange rate is likely to be quite immune to the new capital inflows.[1406] The monetary authorities may also enjoy some short-term monetary independence after liberalisation of capital flows so that they can shield the domestic currency from capital inflows by way of open-market operations or intervention on the foreign exchange market.[1407]

5.4.1 Capital Inflows

A natural consequence of the opening up of the market in banking services is increased capital inflows.[1408] Banking market opening also renders reverse capital flows easier. If loss of market confidence leads to a reverse flow of capital, domestic banking institutions are weakened, which in turn magnifies the adverse effects of poor macroeconomic and regulatory policies. Capital flows portrays international mobility of capital as a mechanism of growth.[1409] Capitalflows relax contraints on resource mobilisation, convey technological and organisational knowledge, and catalyse institutional change.[1410] The task for policy is thus to encourage funds to flow from capital rich to capital poor economies. In developing economies, where the depth of the financial markets is limited, such capital outflows can have a highly destabilising effect on the financial markets and subsequently over the economy in general. Foreign investors are known for herding behaviour which can soon cause a crisis-like situation in the economy. Furthermore, speculative pressure aggravates the situation and can eventually precipitate the crisis. However, it is apparent that outward capital movements are reactive. They are not proactive and occur in response to imbalances

[1406] Fischer and Reisen 1993:41.

[1407] Ibid at 43.

[1408] Eichengreen 2004:13.Capital inflows are defined as the increase in net international indebtness of private and public sectors and are measured-albeit imprecisely-by surplus in capital account of the balance of payment.

[1409] Ibid.

[1410] Ibid.

in economic and financial variables.[1411] This strengthens the case for (a) following sound macroeconomic policies and (b) having a strong prudential regulatory system in place.[1412] The main conclusions on capital account liberalisation are:[1413]

(i) The forces leading to globalisation and moves towards greater liberalisation of capital account transactions are irreversible. Capital account liberalisation is not a choice. It is part of prudential policy to work out an orderly opening of the capital account instead of reforming under duress once a crisis has hit the economy. Many capital control regimes in developing countries also failed to prevent balance of payments predicament from developing and inhibiting access to international financing and diversification.[1414]

(ii) While liberalisation is generally beneficial, it also heightens a country's vulnerability to reversals in capital flows that can precipitate severe currency and balance of payments crisis.[1415]

(iii) The risks inherent in capital account liberalisation thus justify a gradual approach to liberalisation. Gradualism also allows time for the learning curve in developing countries. It is important that countries focus on the pre-conditions for liberalisation. Especially fiscal policy, right mix of instruments to manage capital flows, exchange rate policy and bank supervision.[1416]

(iv) Liberalisation of the controls on current account combined with a relatively closed capital account leads to the loss of capital through leads and lags in the current account. Some restrictions on the current account are needed in the transition phase to give the country time to reform without dealing with the problem of capital flight through this channel. The decision to open up the capital account because of pressure introduced by the opening of the current

[1411] Dilip 1998:91.

[1412] Ibid.

[1413] Benu.Conference on Capital Account Liberalisation: A Developing Country Perspective June 21, 2000, Http://www.odi.org.uk/resources/download/3522.pdf (accessed 01/08/2011):13.

[1414] Ibid.

[1415] Ibid.

[1416] Ibid.

account is a poor policy decision. The volume of capital lost through leads and lags, it must be mentioned, is likely to be less significant through an open account under unsuitable conditions.[1417]

(v) Capital account liberalisation requires that central banks have effective regulatory, supervisory, enforcement and informational structures in place. Liberalisation must not be seen to require authorities to retreat from these essential functions.[1418]

(vi) The need to regulate short-term flows arises from the inability of financial systems in developing countries to intermediate capital from short end to the long end and cannot therefore bear the risk of financial intermediation. The management and monitoring of short-term inflows must be a central concern.[1419]

(vii) The composition of capital flows must also be closely monitored. FDI flows are in general more costly but also more stable and beneficial to development. At the other end of the spectrum, short-term borrowing is highly volatile and more likely to underwrite consumption rather than productive investment.[1420]

(viii) Capital controls must be viewed pragmatically. A distinction must be made between capital control and prudence. Many controls are inefficient and ineffective. However, a distinction must be drawn between these controls and controls that serve a prudential function. In particular, authorities wishing to limit exposure to sudden capital reversals must consider some quantitative restrictions and controls on short-term flows. Price controls on short-term flows are only effective in the short-run in altering maturity transformation and provide monetary autonomy in the short-run, they cannot be used to insulate monetary and exchange rate policy. Controls must be carefully targeted to where they are more effective and must make distinctions between various classes of

[1417] Benu.Conference on Capital Account Liberalisation: A Developing Country Perspective June 21, 2000, Http://www.odi.org.uk/resources/download/3522.pdf (accessed 01/08/2011):13.

[1418] Ibid.

[1419] Ibid.

[1420] Ibid.

agents. In the transition phase, depending upon conditions both price controls and prudential limits can be used. Efficient administrative machinery is needed for their effectiveness. Controls must not, however, be used to put off essential reforms directed at the banking sector.[1421]

(ix) Foreign currency deposits in domestic banking systems are a source of instability in the transition phase and central banks should make it a priority to reduce their level and enact regulations to discourage them.[1422]

(x) Countries experience suggest there are three strategies for opening the capital account and that it is practical and feasible to be at different points along the spectrum leading to a fully convertible capital account: Opening first the inflow side and later liberalising outflows. After liberalisation of inflows and outflow management of the open capital account with the aid of price instruments that are designed to alter the maturity structure of inflows and their impact on monetary and exchange rate policy.[1423] The experience of Malaysia points to the importance of overall supportive policies to make this control work and, a big-bang approach that simultaneously liberalises controls on inflows and outflows.[1424]

5.5.1 Meaning and rationale of Cross-border Banking

Cross-border trade in banking services are those services offered by a bank located in one country to customers in another country without establishing an office in the customer's country, the host country.[1425] In general, the liberalisation of cross-border banking services has concentrated on removing exchange controls.[1426] Under the GATS, a member is free to

[1421] Benu.Conference on Capital Account Liberalisation: A Developing Country Perspective June 21, 2000, Http://www.odi.org.uk/resources/download/3522.pdf (accessed 01/08/2011):13.

[1422] Ibid.

[1423] Wang 2007:219.An approach followed by Malaysia.

[1424] Ibid. An approach followed by Argentina.

[1425] Ibid at 215-221.

[1426] Ibid.In recent years, however, increased attention has been given to barriers in such areas as portfolio management and investment advice.

make specific commitments or not with respect to cross-border trade in banking services.[1427] However, under the Understanding, a member commits to granting a certain level of access to its market for the supply of banking services through the cross-border mode of supply.[1428] The absence of more significant obligations in respect of cross-border mode of supply is duelargely to the fact that cross-border banking service suppliers are not directly subject to the supervision and regulatory powers of the host member's financial regulator.[1429]

In the interest of promoting competitive markets,[1430] host countries should allow cross-border provision of banking services under home country rules without imposing any restrictions. This practice would permit host country consumers access to a broader range of services and a large number of service providers.On the other hand, broader powers, lower capital requirements, subsidies, and other advantages offered by foreign governments may make for "unfair" competition in the context of cross-border services. The Basel risk-based capital accord partially addresses this concern by setting minimum capital requirements for banks in countries party to that agreement.[1431] "However, if the only consideration were maximising the welfare of host country consumers, it might be preferable to allow them to benefit from, for example, more favourable pricing by foreign banks, even in the absence of additional harmonisation. In any event, for large business customers, host country limitations on the provision of banking services would be largely ineffective since such customers have easy access to banking offices located abroad. Thus, the conclusion is that the goal of competitive markets can best be promoted by applying home country rules."[1432]

[1427] Dietrich ea 2010:11.

[1428] See GATS art.1:2 (a).

[1429] Leroux 2002:435.

[1430] Key and Hal 1991:8-10.

[1431] Ibid.

[1432] Ibid.

A host country has minimal concern with systematic risk in the provision of cross-border banking services.[1433] The risk for individual domestic banks of holding deposits with foreign banks can be addressed by regulating such exposure directly rather than by imposing restraints on foreign banks. Cross-border services do not directly involve a foreign bank in the payment system of the host country, nor is the failure of a foreign bank likely to trigger imitative runs on domestic banks. If such a runs were to occur, they would, in any case, have little relation to the foreign bank's provision of cross-border services. Thus, home country rules should apply with respect to systematic risk.[1434]

5.5.2 Closing the loopholes

5.5.3 Preseving National Regulatory space and flexibility on Capial Account regulation

To offset the negative impact of liberalisation, it is important for national governments to preserve some regulatory space and flexibilities in their own hands.[1435] For example, individual governments need to keep the power to regulate and restrict if necessary short-term capital flows as well as the herding behaviour. This is worth reminding because national governments are often under international pressure to take a more liberal approach to deal with the problems they face. In this regard, the experiences of both Malaysia and China in dealing with the Asian crisis provide valuable lessons.[1436] Although it was suggested that Korea and Thailand, received the IMF's reform package almost in full, recovered in parallel from the crisis, using a time technique, the Malaysia policy produced faster economic recovery, less significant declines in employment and real wages, and more rapid turnaround in stock market.[1437] In 1998, a year after the start of the crisis, Malaysia altered its policies by imposing capital control and other financial measures, including significant reduction of interest rates to provide the supply of funds, reduction of statutory reserve requirements to increase liquidity, expanded government spending, and a fixed exchange rate. In terms of financial regulations, it introduced measures including shutting

[1433] Key and Hal 1991:8-10.

[1434] Ibid.

[1435] Wang 2007:2.21-222.

[1436] Hood 2001:1-5.

[1437] Ibid.

down offshore trading of the Malaysian currency, the ringgit, coupled with restrictions on capital flows, particularly short-term capital flows for foreigners and local citizens.[1438] One of the lessons to be learnt from Malaysia's experience is that, having policy space and flexibility is important to developing countries in order to offset the negative aspects of one-size-fit-all policies of some international organisations.[1439]

China's experience during the crisis is also an example supporting national regulatory space and flexibility.[1440] As the Chinese experience shows, apart from the strong surplus in current accounts as well as the medium and long-term nature of its external debts, China's regulatory measures implemented to restrict capital flow before and during the crisis - played a significant role in minimising the risk posed by the crisis to China. China is unlikely to experience a crisis like that of Mexico in 1994-1995 or that of several southeast Asian countries and Korea in 1997 because of five reasons, most of which are related to government control on the pace and sequence of financial liberalisation and domestic financial regulation.[1441] First, and foremost, China's capital account was strictly controlled-namely China's currency, the renminbi, is not convertible for capital account transactions. Therefore, the possibility of moving funds out of China in the expectation of a crisis is very limited.[1442] Secondly for two decades, foreign direct investment had been the predominant form of capital flow into China. Direct investors differ fundamentally from financial investors since they invest with long term horizon and their investments are illiquid. Thirdly, a majority of surpluses for a number of years prior to the crisis eliminate the need to finance trade deficit with foreign capital inflow. Fourthly, China had recorded trade surpluses for a number of years prior to the crisis, eliminating the need to finance trade deficit with foreign capital inflow. Finally, prior to the crisis, China had amassed huge foreign exchange reserves,

[1438] Wang 2007:220-232. It is not to say that all the measures taken by Malaysia during the crisis were appropriate. However, those measures taken by Malaysia during the crisis were economic situation and helped the country recover from the crisis.

[1439] Ibid.

[1440] Ibid.

[1441] Ibid.

[1442] Ibid. This restriction also closed substantially the door of China's domestic stock market to foreigners, meaning that they were not able to trade in renminbi-denominated shares on China's stock exchange.

enough to finance a full year of imports.[1443] It is important to stress that the preserved regulatory space should not be abused. It should however be used only when the maximum gains can be realised and the risks can be minimised.[1444]

Economic theory aside, experience has demonstrated that liberalising capital account before the home country financial system has been strengthened, can contribute to serious economic problems.[1445] Recognising these possibilities, the IMF's policy-setting committee-the Interim committee-and subsequently the finance ministers and central bank governors of the Group of Seven Industrial Nations, stressed that a country opening its capital account must do so in an orderly, gradual and well-sequenced manner.[1446] If the said space is used to implement restrictive regulations, the national government concerned should be wisely advised to know the delicate point where it should relinquish those restrictions. In the Malaysia case, the government made changes in controls a few months after they were implemented.[1447] In 1999, Malaysia unilaterally relaxed its regulation restricting offshore banks' capacity to lend in local currency, thus allowing some of them to grant medium-to long-term financing denominated in ringgit to specific groups of resident companies. Restrictions in other aspects were also albeit to a limited extent liberalised thereafter. In the case of China, it employed the time saved by the restrictive measures to introduce prudential and risk management regulations in the financial sector, laying the foundation for a more market-related financial regulatory framework.[1448] China's banking sector was also significantly opened after the crisis, to a large extent as a result of its WTO accession.[1449]

[1443] Wang 2007:220-232.

[1444] Ibid. For example, fear of the herding effect should be used also as an excuse to delay the introduction of competition at least from the domestic private sector.

[1445] Furubotn and Richter 1990:2-3.

[1446] Ibid.

[1447] Hood 2001: 2-3.

[1448] Wang 2007:222-223.

[1449] Ibid.

5.5.4 Pace and Sequencing of Liberalisation of Capital Account

Having mentioned the usefulness of regulatory space and flexibility, it is still important to stress that efforts to preserve national regulatory space can never be made for the sake of preserving that space.[1450] The key points are that the pace and sequence of liberalisation should be carefully designed and that appropriate regulatory space should be preserved for the national government involved.[1451]

The pace of reform refers to the time lapse from the initiation of the reforming measures to the point that they are made operational and accepted in general.[1452] The sequencing of reforms means the order in which either macroeconomic policy actions or specific reforms are introduced. In respect to the pace of reform, there are two suggested strategies:[1453] shock therapy or big-bang and gradualism or incrementalism. The former strategy allows introduction of all market-opening measures simultaneously. It has several benefits. As all the measures are adopted rapidly, the danger of leaving the process half-way through, common in developing economies, is reduced. An interesting example is that of India where reforms and market opening was started slowly in 1991.[1454] After some time the pace became slower, and by mid 1998 the whole exercise was still incomplete. The big-bang strategy gives regulators little time to organise and obstruct the opening up process.[1455] The advantage associated with the gradualist approach is that it provides time to adjust to new conditions. The gradualist approach also provides time for raising the level of credibility of the opening up process and the government's commitments to it. [1456]

[1450] Wang 2007:222-223.

[1451] Ibid.

[1452] Ibid.

[1453] Ibid.

[1454] Ibid.

[1455] Dilip 1998:93-94.

[1456] Ibid.

The sequencing of reforms is never an easy job.[1457] There are two important reasons for sequencing. Firstly, there are limitations on any government's time, focus and resources and thus priority must be decided.[1458] Secondly, maximum economic and social benefits as well as minimum economic and social risks relating to the liberalisation of one area can only be achieved after the liberalisation in another area was completed. Appropriate sequencing of reforms can be realised without gradualism.[1459] In terms of the sequencing relating to capital account liberalisation, it is generally agreed that capital account be preceded by domestic institutional reform, trade liberalisation and domestic macroeconomic stabilisation.[1460]

5.5.5 Sequencing matters

The observation that all of today's high-income countries have removed their controls is consonant with the view that capital account liberalisation is a corollary of economic development and maturation.[1461] The sequencing of capital account liberalisation is an important but complicated issue.[1462] Countries vary greatly in their levels of economic and financial development, in their institutional structures, in their legal systems and business practices, and their capacity to manage change in a host of areas relevant for financial liberalisation.[1463] So a country with a fully liberalised domestic financial system, that had firmly put in place the safeguards necessary to ensure its successful operations, could proceed almost immediately and in confidence to full capital account liberalisation.[1464] Alternatively, maintaining tight restrictions on virtually all forms of international financial flows until the domestic financial system is fully and successfully liberalised is generally not

[1457] Wang 2007:221-224.

[1458] Ibid.

[1459] Ibid.

[1460] Wang 2007:223-224.Indonesia liberalised its capital account prematurely before trade-related current account liberalisation, which contributed heavily to the country's loss during the Asian crisis.

[1461] Eichengreen 2004:13.

[1462] Ibid.

[1463] Ibid.

[1464] Ibid This advice, however, generally applies to countries mainly the industrial countries that already have quite liberal policies toward international capital.

advisable.[1465] For countries that are still in the process of opening the capital account, how best and how fast to proceed remains an unresolved issue. There is no presumption that the resource requirements of implementing a quick transition are either smaller or larger than those of managing a long transition process or administering capital controls. Developing effective regulatory frameworks takes time, but a lengthy process may create wrong incentives and distortions. There are also political considerations. A big-bang approach may be appropriate if a prolonged transition is likely to create resistance from vested interests or if different elements of the existing system are so dependent upon each other that a piecemeal reform is not possible without creating significant distortions. A gradualist approach, on the other hand, may be more appropriate if it takes time to build consensus or if a slower process is more conducive to minimising the adjustment.[1466] The case of India and Uganda are examples of the gradualist and big-bang approaches.[1467] India pursued an incremental and phased liberalisation process in the aftermath of the 1991 balance of payments crisis.[1468] Within a broad liberalisation process, emphasis was placed upon introducing a market-determined exchange rate, containing the fiscal deficit, reforming the system of industrial licenses, placing bonds on the current account deficit and liberalising current account transactions. Capital account transactions remain tightly controlled and monitored. Non debt-creating flows were encouraged and short-term commercial borrowing remained restricted while capital outflows were only gradually liberalised.The Uganda Capital account regime has been less evidence than its Indian counterpart, allowing, for example, both residents and non-residents to hold foreign exchange denominated accounts in the domestic banking system.[1469] Uganda has been successful in attracting

[1465] Eichengreen 2004:13. International and domestic liberalisation can reinforce one another and can benefit from parallel development. In countries where entrenched interests and policy inhibit reform, external pressures created by the opening of capital markets can provide the needed impetus.

[1466] Ibid.

[1467] Benu Conference on Capital Account Liberalisation: A Developing Country Perspective Http://www.odi.org.uk/resources/download/3522.pdf (accessed 01/08/2011): 3-4.

[1468] Eichengreen 2004:13.

[1469] Ibid.

foreign capital inflows primarily in the form of foreign direct investment, which is more stable than either portfolio or loan flows.[1470]

Foreign Direct Investment (FDI) should be liberalised because,[1471] firstly, FDI is the form of foreign investment that most plausibly comes packaged with managerial and technological expertise.[1472] "It is the form of foreign investment least likely to aggravate weaknesses in the domestic banking system. It is less footless than portfolio capital and less likely to flee in a creditor panic. All these point to the wisdom of liberalising inward FDI early in the capital account opening process".[1473] The case for liberalising FDI early in the process of opening the capital account extends to the banking system.[1474] Entry by international banks is a way of upgrading management and its risk-management capacity in particular. Insofar as home country regulation applies, opening the banking sector to foreign investment should raise the average quality of prudential supervision. Insofar as international banks are better capitalised, they are unlikely to engage in excessive risk taking.[1475] For all these reasons, permitting early entry by foreign banks can contribute to the upgrading of domestic financial arrangement that should be a pre-condition for further capital account liberalisation.[1476]

Secondly, liberalise stock and bond markets first,[1477] make foreign investment in securities pose fewer risks than short-term foreign deposits, because bank deposits are a contractual obligation to repay at a particular time. The withdrawals of foreign deposits can jeopadise the stability of the banking system.[1478] When foreign investors liquidate their positions in

[1470] Eichengreen 2004:13.

[1471] Ibid at 297-298.

[1472] Ibid.

[1473] Ibid.

[1474] Ibid.

[1475] Ibid.

[1476] Ibid.

[1477] Ibid.

[1478] Ibid.

stock and bond markets, in contrast, their actions simply show up in the prices of securities. In reality, a stock or bond market crash can damage the balance sheet position of banks and others who themselves hold stocks and bonds. It can make life difficult for entities, including the government, with funding needs and for whom the prices of their liabilities are an important signal of credit worthiness.[1479]

Lastly, regarding the liberalisation of capital outflows, the main concern arises when the restrictions to be removed are supported either by significant macreconomic imbalances or a distorted financial system.[1480] If an overvalued exchange rate has been maintained with the help of restrictions on capital outflows, then the government must be prepared to adjust the exchange rate when the restrictions are removed. Similarly, if policies have kept interest rates for savers artificially low, markets participants must be prepared for a rise in rates. To avoid such costly accidents, countries should liberalise outflows after they have reduced macroeconomic imbalances and financial distortions to manageableproportions.[1481]

In many Asian economies,[1482] the countries have managed to keep their interest rates positive. The banking systems are deep, with the ratio of credit to GDP above 50 percent.[1483] For Hong Kong and Singapore, this ratio is above 250 percent.[1484] Many have gradually liberalised their capital accounts and have enjoyed access to international capital markets.[1485] Chile followed the widely recommended sequence of liberalising the current account first and the capital account later. Domestic reform began by allowing non-bank intermediaries to operate without interest controls. Then decontrol of interest rates was

[1479] Eichengreen 2004: 297-298.

[1480] Furubotn and Richter 1990: 7-8.

[1481] Ibid.

[1482] Dilip 1998:103.

[1483] Ibid.

[1484] Ibid.

[1485] Ibid.

gradually extended to commercial banks. Also state banks were returned to the private sector.[1486]

5.5.6 Exchange Rates

In an effort to create an open but stable international economy, the Bretton Woods planners married trade liberalisation with fixed exchange rates.[1487] It is often forgotten, however, that the IMF's founding Articles of Agreement explicitly allowed member states to impose restrictions on capital account transactions.[1488] Those who constructed the new international order believed that capital controls served two important functions – reducing volatility in international capital movements and allowing governments to run independent macroeconomic policies.[1489] Taxes on short-term financial transactions have often been viewed as a means of limiting short-term capital flows that can lead to a sharp change in a country's foreign exchange reserves or contribute to excessive exchange rate volatility.[1490] These flows are thought to be driven by investors who ignore fundamentals and conduct transactions on the basis of rumours, trading strategies, or uncertainties about the sustainability of macroeconomic or exchange rate policies.[1491] It has therefore been argued that the authorities should limit speculative capital flows rather than alter financial and macroeconomic policies designed to achieve medium-term objectives.[1492]

5.5.7 Use of Capital Controls

Some countries with an otherwise open capital account have made use of direct controls on inflows.[1493] These recent controls have typically taken the form of Unremunerated Reserve Requirements (URRs) that mandate a certain percentage of inflows to be deposited with the

[1486] Fisher 2002:1-4.

[1487] Ibid.

[1488] Mathieson and Rojas-Suarez 1993:4-5.

[1489] Fisher 2002:1-4.

[1490] Mathieson and Rojas-Suaarez 1993:4.

[1491] Ibid.

[1492] Ibid.

[1493] Masahiro and Takagi 2008:8-9.

central bank for a given period of time. These controls also tend to be temporary as the countries have been the beneficiaries of substantial capital inflows in the past and no longer have the option of isolating themselves permanently from the rest of the world. The controls are lifted when the triggering situation ceases to exist.[1494] Controls can be on inflows or outflows.[1495] "Inflows controls are most commonly used in the context of a speculative bubble. They free the authorities from the need for large scale sterilisation to counter inflationary pressures created by the inflows, and they mitigate the distortionary effect that exchange rate appreciation will have on external trade and production. In addition, large inflows of short term capital distort the maturity structure of debt and strain the capacity of the domestic financial system to intermediate efficiently."[1496] This problem is most acute when regulatory and supervisory systems are weak.[1497] Controls on outflows are more commonly associated with a speculative collapse and currency crisis as was the case in Malaysia, Spain and Thailand. [1498]In these countries the capital account had previously been largely liberalised. The controls were adopted because of strong speculative pressure against declining currency reserves. Domestic interest rates had already been raised to levels that were further weakening by depressed domestic demand.[1499]

5.5.8 Macroeconomic and structural measures to manage capital inflows

If capital inflows are driven largely by economic fundamentals, authorities must sooner or later accept the inevitablility of allowing the real exchange rate to appreciate.[1500] In fact,

[1494] Masahiro and Takagi 2008:8-9. URRs are different from the conventional controls at least in three respects. Firstly, URRs are designed for a country with an otherwise open capital account to manage-not prevent-capital inflows. Secondly, they work on capital inflows was.not through administrative means but through the prices of international investors. Thirdly, the amount of tax on capital inflows is negatively related to the length of investment. Hence, URRs are more effective on short-term flows than long-term flows that are believed to be driven more by fundamental economic factors. For these reasons, URRs are considered to be less distortionary and abrasive, and have received sympathy even from some advocates of free capital mobility.

[1495] Ibid.

[1496] Ibid.

[1497] Ibid.Controls was used in this context in Malaysia 1994, Chile 1991-98 and Thailand 1995-97.

[1498] Hood 2001:2.

[1499] Ibid.

[1500] Masahiro and Takagi 2008:11-12.

real exchange rate appreciation is the only sustainable response to permanent increase in capital inflows and a fundamental re-evaluation of domestic relative to foreign assets.[1501] Exchange rate appreciation is also the most effective response to large capital inflows, regardless of the cause of the inflows, because it avoids the myriad of limitations and side-effects attendant to other policy response. This is how most industrial countries respond to large inflows.[1502]

5.5.9 Structural Measures

Structural or microeconomic measures to deal with surges in capital inflows are many, but three of them are the most common:[1503] Firstly, financial sector reform, including improving the system of prudential supervision and developing capital markets. This is meant to minimise any negative impact should a crisis occur. If banks are well capitalised and diversified, they are more likely to be resilient to potential capital flow reversals and associated macroeconomic shocks. Having an alternative to bank finance promotes greater risk diversification in the economy. Thus, financial sector reform may help minimise the banking stability risk of capital inflows. This is a long process however, because a well supervised banking sector connot be produced overnight. Secondly, there are two motives for easing restrictions on capital outflows.[1504] The first is to subject domestic banking markets to greater competition and to allow residents to diversify their risk; thirdly, to reduce net capital inflows by encouraging outflows.[1505]

5.5.9.1 Macroeconomic measures

In general, three types of macroeconomic measures are available to countries facing surges in capital inflows, if they are not willing to allow the norminal exchange rate to appreciate:[1506] firstly, sterilisation has been the most commonly used instrument. Narrowly

[1501] Masahiro and Takagi 2008:11-12.

[1502] Ibid.

[1503] Ibid.

[1504] Ibid.

[1505] Ibid.

[1506] Ibid.

defined, sterilisation involves the exchange of domestic bonds to foreign assets, often through open market operations, designed to neutralise the increase base money arising from purchases of foreign currency. In a number of emerging market economies where the market for government debt is not well developed, the central banks have often created their own debt instruments for this purpose.[1507] Through sterilised intervention, countries experiencing surges in capital inflows can maintain the nominal exchange rate while also preventing the capital inflow from increasing the balance of base money.[1508]

More broadly, sterilisation can be any measure such as raising reserve requirements;[1509] central bank borrowing from commercial banks; and shifting of government deposits from commercial banks to the central bank that attempts to offset the growth of monetary aggregates coming from reserve inflows. Secondly, greater exchange rate flexibility is another possible response. It is meant to introduce two-way risks and thereby discourage speculative capital inflows. This usually involves, in the context of a tightly manage float, introducing a wider band of fluctuation. The effectiveness of this instrument depends on how much authorities are willing to allow the exchange rate to move. If the fluctuation band is set large, the potential for large nominal appreciation would also be limited. If the band is set small, the potential for large nominal appreciation would also become great. Thirdly, fiscal tightening is the reason for surge in capital inflows because it involves a reduction in the absorption of real resources by the public sector to offset the domestic impact of resources transfers from abroad. To the extent that it is a real response, it should work to contain inflationary pressure and to prevent a real appreciation of the currency. In addition, fiscal tightening could reduce pressure on interest rates, thus directly reducing incentives

[1507] Masahiro and Takagi 2008:11-12.

[1508] Ibid, "Sterilised intervention works only if two conditions are met. Firstly, domestic and foreign assets must be imperfect substitutes, such that the exchange of one type of asset for the other alters the relative rates of return. Secondly, the interest cost of operation must be manageable, as sterilization typically carries quasi-fiscal costs that arise from the exchange of high-yielding domestic debt for low-yielding foreign assets. There is a broad consensus that the first condition does not hold between industrial country assets and therefore the effectiveness of sterilized intervention is limited at best for industrial countries. Between industrial country assets and emerging market assets, however, substitutability may be sufficiently low to allow sterilized intervention to have some effectiveness, though available evidence is mixed at best. On the other hand, the interest rate differential rises as substitutability declines, so that greater effectiveness can also mean more limited sustainability",

[1509] Ibid.

for interest rate-induced capital inflows, as well as restrain appreciating pressure by limiting the increase in the relative price of non-tradable goods.[1510]

5.5.10 Overview of Capital Account Liberalisation

The post World War II international monetary system was based on the notion that unfettered international capital flows were not welfare–enhancing.[1511] The idea that free capital mobility is incompatible with a free trading system was well accepted in academicand the mainstream policymaking community when the international monetary Fund (IMF) was established.[1512] Consequently, the IMF's Articles of Agreement granted member countries the right to maintain controls over capital transactions, though not on current transactions.[1513] It was only in the context of extensive trade liberalisation that the majority of industrial countries began to liberalise capital flows as giving a degree of substitutability between current and capital transactions, capital controls became less effective and more distortionary. More recently, an increasing number of emerging markets and developing countries have followed suit.[1514]

The traditional policy regime in many developing countries has been to restrict cross-border movements through often elaborate systems of controls and regulations.[1515] The objective of these restrictions is to retain domestic saving in the economy for domestic investment and to insulate the economy from external shocks.[1516] In the 1980s and 1990s, a confluence of events, including diminishing levels of foreign aid, the expansion and integration of global capital markets and the collapse of the socialist bloc in Europe, served to undermine this

[1510] Masahiro and Takagi 2008:11-12.

[1511] Mathieson and Rojas-Suarez 1993:4.

[1512] Ibid.

[1513] Jacques 1998:47-50.

[1514] Masahiro and Takagi 2008:2.

[1515] Mathieson and Rojas-Suarez 1993:4.

[1516] Ibid.

policy regime.[1517] Some developing countries in Sub-Saharan Africa became aware that domestic savings were very low making their retention a relatively low priority to retain and that a more open capital account enabled them to access desperately needed resources. This may have been the case in Uganda and elsewhere in Sub-Saharan Africa, but liberalisation of the capital account without fulfilling the pre-conditions is problematic and domestic savings are needed, together with foreign savings, for sustainable growth.[1518]

The case for capital account liberalisation was authoritatively put forward by Stanley Fischer, the former Deputy Managing Director of the International Monetary Fund, in the following terms:[1519]

> "that the benefits of liberalising the capital account outweigh the potential costs; - that countries need to prepare well for capital account liberalisation: economic policies and institutions, particularly the financial system, need to be adapted to operate in a world of liberalised capital markets; and - that an amendment of the IMF's Articles of Agreement is the best way of ensuringthat capital account liberalisation is carried out in an orderly, non-disruptive way, that minimizes the risks that premature liberalisation could pose for an economy and its policymakers."

Fischer suggests that, at a theoretical level, capital account liberalisation would lead to global economic efficiency through allocation of world savings to those who are able to use them most productively, and would thereby increase social welfare.[1520] Citizens of countries with free capital movements would be able to diversify their portfolios and thereby increase their risk-adjusted rates of return. It would enable corporations in these countries to raise capital in international markets at a lower cost. It is suggested, moreover, that such liberalisation leads to further development of a country's financial system which in turn is

[1517] Benu Conference on Capital Account Liberalisation A developing Country perspective, http://www.odi.org.uk/resources/download/3522.pdf>(accessed 01/08/2011):2.

[1518] Ibid.

[1519] Carlsson .Go with the Flows?: Capital Account Liberalisation http://www.brettonwoodsprojects.org (accessed 07/09/2011): 8-10.

[1520] Ibid.

thought to enhance productivity in the real economy by facilitating transactions and by better allocation of resources.[1521]

5.12 Conclusion

The degree of capital account liberalisation can determine the potential gains and benefits of liberalisation of trade in banking services.[1522] Some degree of free capital movement is required for effective and efficient liberalisation, especially regarding the cross-border provision of banking services offered by a banking service supplier.[1523] Countries should be very careful in liberalising their capital account and certainly they should not do so at the short end without effective regulatory regimes and strong macro-economic policies.[1524]The general political framework for successful liberalisation requires stable political conditions, adherence to the rule of law, particularly with respect to property rights, and an efficient means of reducing corruption. Otherwise, capital flows will remain thin, limited to the political establishment, and prone to corruption.Moreover, cross-border trade in banking services, whether in a developed or developing country, needs regulatory and supervisory governmental structures in order to function. Thus, cross-border trade in banking services liberalisation has to go hand in hand with the introduction and establishment of regulatory and supervisory structures. Whether in a given situation regulatory and supervisory measures have to be adopted first, before liberalising the market for financial services, cannot be determined and assessed in abstract terms. This will depend essentially on the general legal situation in a given country. A country with a well-functioning legal system in terms of the key essentials of a legal order (property rights, rules on liability, etc.) and an effective judicial system may open up its markets more quickly, without much risk for market stability, than those countries with problems in this regard. The final points of "sequencing" must thus always be determined on a case-by-case basis.

[1521] Carlsson .Go with the Flows?: Capital Account Liberalisation http://www.brettonwoodsprojects.org (accessed 07/09/2011): 8-10.

[1522] Stijn and Marison 2000:9-10.

[1523] Ibid.

[1524] Age and Bryan: 2003:46.

When these legal and economic institutions are developed and working effectively, countries should start liberalising market access for foreign banks with regard to core banking services – in contrast to Orthodox economists views that there is risks attached to capital account liberalisation. Markets sometimes overreact or react late or react too fast. However, capital movements are mostly appropriate: currency crises do not blow up out of a clear blue sky, but rather start as rational reactions to policy mistakes or external shocks. The problem is that once started, they may sometimes go too far. In general, capital markets serve as an important discipline on government macro-economic and other policies which improves overall economic performance by rewarding good policies and penalising bad ones.[1525]

[1525] Wang 2007: 225-237.

CHAPTER 6

CONCLUSIONS, RECOMMENDATIONS AND LAW REFORM PROPOSALS

6.1 Introduction

The General Agreement on Trade in Services (GATS) is the first multilateral trade agreement to cover trade in banking services.[1526] Its creation was one of the major achievements of the Uruguay Round of trade negotiations, which took place from 1986 to 1993. This was almost half a century after the entry into force of the General Agreement on Tariffs and Trade (GATT) of 1947,[1527] the GATS' counterpart in merchandise trade.[1528] According to the negotiations, firstly, given the continued momentum of world services trade, the need for internationally recognised rules was increasingly pressing.[1529] Secondly, given the substantial increase in volume of banking trade, liberalising it by bringing multilateral disciplines to bear on this sector was an important Uruguay Round goal for developed countries. The Second Annex on Financial Services to the GATS and the Decision on Financial Services adopted at the end of the Uruguay Round provided for extended negotiations to be held during a six-month period following the entry into force of the GATS.[1530] As a result of the negotiations, a new and improved set of commitments in financial services under the GATS was agreed in 1997.[1531]

The general argument in favour of banking trade liberalisation is that it allows the expansion of the size of markets, allowing the global economy to take further advantage of economies of scale, and it enhances global efficiency in production and exchange. A broad group of countries, including the most important financial markets, made commitments to guarantee a certain level of market access to foreign banking service suppliers in the WTO.[1532] Thus,

[1526] Kennedy 1999: 30.

[1527] Cho 1995: 143-144.

[1528] Understanding the WTO- Services: rules for growth and investment <http://stream.hq.unu.edu/presentations/wtoenglish/e-doc/english/thewto_e/whatis_e/tif...(accessed 2009/10/03). s

[1529] WTO Secretariat 2005:1.

[1530] Leroux 2002:426. That is, up to the end of June 1995; Bhagirath 1998:111-112.

[1531] Booysen 1999:139.

[1532] See chapter 3.

banking trade liberalisation must be managed carefully to ensure that developing countries benefit from it and are not left worse off.[1533] It is important for countries with significant barriers in place to make commitments that go beyond current practice, unlike the last round where the current levels of liberalisation were the ceiling and not the floor for almost all scheduled commitments. Liberalising trade in banking services allows member countries to become more integrated into international capital markets and to more effectively access investment capital. The decision was taken at the last moment, with respect to the Annex on Financial Services to adopt a separate Understanding on Commitments in Financial Services. This appended document, which has already been referred toin chapter 3, redefines certain specific commitments on an alternative basis.

Liberalisation can be understood as a process introducing greater market openness and a competitive market environment.[1534] Such process requires the removal of obstacles to market entry and competition. GATS aims at the liberalisation of trade in banking services, just like WTO law in general aims at the liberalisation of trade. GATS defines trade in banking services broadly and the distinction between domestic and international supply of banking services often only depends on the nationality of the service suppliers or consumers.[1535] Liberalisation of trade in banking services can be based on three general approaches: non-discrimination, mutual recognition or harmonisation. As was pointed out in chapter 3, non-discrimination requires that different banking services and banking services suppliers are treated no less favourably than like foreign or domestic banking services suppliers. However, non-discrimination does not require a country to accept regulatory standards applied by other countries. Mutual recognition requires this acceptance. Mutual recognition refers to the agreement between sovereign states whereby they agree to the transfer of regulatory authority from the host country where the transaction takes place to the home country from which a banking service originates.[1536] It reflects the general principle that if a service can be provided lawfully in one jurisdiction, it

[1533] See Chapter 4.

[1534] Ibid.

[1535] See chapter 3.

[1536] Ibid.

can circulate in any other participating country without having to comply with the laws of these other jurisdictions. Under the system of mutual recognition, a banking service which is supplied in accordance with the regulatory requirements of one country can also be supplied in another country without fulfilling the regulatory standards of the host country. The GATS recognises the right of every state to choose its level of regulation but at the same time imposes the requirement to apply its domestic regulation in a non-discriminatory way between foreign suppliers.[1537] However, derogation from the most favoured nation treatment is possible through article VII of the GATS enabling, but not requiring, any member state to adopt mutual recognition measures on the basis of which it considers for a specific service the domestic regulation of another State as equivalent to its own.[1538] In the field of prudential regulation, this option is laid down in the Annex:[1539]

> "A member may recognise prudential measures of any other country in determining how the member's measures relating to financial services shall be applied. Such recognition, which may be achieved through harmonisation or otherwise, may be based upon an agreement with the country concerned or may be accorded autonomously."

Mutual recognition measures exempt the beneficiary foreign supplier from the limitations to market access and national treatment included in the specific commitments.[1540] The mutual recognition process may therefore have a potentially discriminatory effect when it is granted to some states and refused to others despite both having an equivalent level of regulation. In order to prevent abuses likely to constitute disguised restrictions to trade in banking services, the GATS contains a "best-endeavour" provision inducing member states to extend the benefit of mutual recognition measures at the request of excluded members when domestic regulations are deemed to be equivalent. The Annex provides indeed:[1541]

[1537] See chapter 3 para 6.

[1538] See GATS art.VII.

[1539] See art. 3(a) of the Annex on Financial Services.

[1540] See chapter 3.

[1541] Art. 3(b) of the Annex on Financial Services.

> "A member that is a party to such an agreement or arrangement referred to in subparagraph (a), whether future or existing, shall afford adequate opportunity for other interested members to negotiate their accession to such agreement or arrangements, or to negotiate comparable ones with it, under circumstances in which there would be equivalent regulation, oversight, implementation of such regulation, and if appropriate, procedure concerning the sharing of information between the parties to the agreement or arrangement. Where a member accords recognition autonomously, it shall afford adequate opportunity for any other member to demonstrate that such circumstances exist."

Mutual recognition is a hybrid of negative and positive integration.[1542] It goes beyond the mere elimination of barriers in that it pursues liberalisation through the equivalence of national regulatory perspectives and the measured and safe allocation of regulatory responsibility. In parallel, it is not a typical model of positive integration in the replacement of national rules by common standards if not strictly required. It is an instrument of regulation because the division of responsibility among participating jurisdictions has a clear normative element; it is also a means of deregulation because a disturbing layer of national control is abolished.[1543] Ideally, services lawfully provided in one jurisdiction may freely circulate across national borders. Hence, mutual recognition secures market openness and promotes the values of trade in banking liberalisation by reducing structural barriers while simultaneously avoiding the excessive policy and transaction costs of full harmonisation and uniformity.[1544]

Finally, under a system of harmonisation or standardisation, an international body would set certain standards, with which services would have to comply with.[1545] The Annex on Financial Services remains silent on the potential standards and standard-setting institutions

[1542] See chapter 3 para 6.

[1543] Gkoutzinis 2005:889.

[1544] Ibid.

[1545] See Chapter 1.

for the assessment of domestic measures.[1546] In the absence of indications in the *lex specialis*, the relevant provisions are to be found in the GATS, the *lex generalis*.[1547] It provides that, in order to determine whether the domestic regulations are based on objective and transparent criteria, account shall be taken of international standards of relevant international organisations. Similarly, the GATS provides in the matter of mutual recognition procedures that:[1548]

> "In appropriate cases, members shall work in cooperation with relevant international and non-governmental organisations towards the establishment and adoption of common international standards and criteria for the recognition of common international standards for the practice of relevant services trades and professions".

The GATS does not refer to any international institution likely to fulfil this purpose, and with good reason, this agreement applies to all kinds of services. The expression "relevant international organisations" is defined as "international bodies whose membership is open to the relevant bodies of at least all members of the WTO".[1549] The opening up of the membership of these institutions is thereby the only condition for the recognition of the relevant international standards. However, the GATS imposes no procedural conditions pertaining to the adoption of standards by consensus allowing the recognition of standards adopted by a majority vote outside the WTO and, consequently, the circumvention of the consensus-based functioning of the organisation.[1550] Whereas the standards of the Basel Committee are in favour with a majority of authors to serve as relevant rules within the framework of the liberalisation of banking services,[1551] articles VI and VII of the GATS seem to prevent such a connection.

[1546] Bismuth 2010: 500-501.

[1547] Ibid.

[1548] Ibid.

[1549] Lee 1998: 34-35.

[1550] See GATS art. VI:5.

[1551] For example, Gkoutzinis proposing the intergration of the Standards of the Basel Committee.

The conclusion is that, while the Basel Committee's norms are not considered as "international standards of relevant international organisations" under the GATS, this has not prevented the development of an institutional practice within the WTO members to accept all international financial standards and therefore bypassing the limitations included in the GATS. This extension manifests itself within the WTO Committee on Trade in Financial Services (CTFS) whose role is to administer the relevant agreements and commitments of member states in the matter of financial services.Moreover, since no dispute has yet precisely defined the relevance of international financial standards, other institutional mechanisms within the WTO through which the legality of member states' measures is assessed reveal a tendency for the integration of all international standards, notably those of the Basel Committee, in the practice of the organisation.

The GATS could provide for a more certain outcome of banking trade and regulation synthesis through incorporating the Basel standards in its system. Such incorporation could be effected, for example, through amendments to the Annex on Financial Services and could require that adoption of the Basel standards by the home country be a precondition for the application to host country regulation of the disciplines of market access, national treatment and MFN. Moreover, incorporation of the Basel standards into the GATS system will supply a mechanism for realising the harmonisation function of the Basel process. The GATS members are expected to adopt the Basel standards so that banking institutions incorporated in their jurisdictions can take advantage of trade commitments and avoid discriminatory treatment. This should be more efficient than current alternatives for effecting harmonisation of banking regulation at the international level and ensuring sustainable globalisation of banking. Finally, harmonisation at the international level may consist of harmonisation of banking regulation and supervision in close relation to reduction of barriers to banking services trade. It could be a treaty-based harmonisation model, similar but more advanced than the incorporation of the Basel standards in the GATS as proposed above and resembling the processes towards EU internal banking market. Despite being a provision highly difficult to put into practice, the recourse to international standards would facilitate the comparison between two sets of domestic regulations when they are based on a common, the expression "equivalent regulation" used in the Annex and "harmonisation" used in Article VII:1 of the GATS playing the same role. Again international standards are use as tools for a state claiming the benefit of mutual recognition.[1552]

Non-discrimination is the most generic tool of liberalisation.[1553] Its rationale is simple: if a particular banking services provided in one country is treated in a certain way there is no compelling reason why the same or a similar banking service should be treated differently, simply because the latter services were produced in another country. As a general principle non-discrimination, however, ignores differences between domestic and foreign suppliers, such as differences of economic power. Also non-discrimination raises the difficult question, when two banking services are actually the same or at least similar so that they should not be treated differently. Traditionally, non-discrimination in its two forms of most favoured nation treatment and national treatment has been the liberalisation tool of the multilateral trading system.[1554] Mutual recognition and harmonisation are more advanced instruments of liberalisation, which require a greater degree of economic and political integration. Mutual recognition requires a minimum standard of regulatory cohesion between different systems, which exists more frequently at the regional than at the global level. Harmonisation requires institutions based on common and shared economic, social or technical understandings. Even though international harmonization organizations exist at the global level, their standards are usually voluntary.[1555] Binding harmonisation can usually be found at the regional level more frequently than at the global level.[1556] Mutual recognition and harmonisation are hence instruments of liberalisation used by countries with similar political, economic and social systems. The GATS contains some aspects of mutual recognition and harmonisation. It should be noted that all three instruments of liberalisation can have overlapping aspects and that non-discrimination could in fact also require recognition or standardisation.[1557]

[1552] Bismuth 2010:497.

[1553] See Chapter 3.

[1554] See Chapter 3.

[1555] See chapter 1.

[1556] See chapter 2 para 2.

[1557] See chapter 3.

It was pointed out in chapter 4 that, there is one characteristic of banking services trade policy that is special, and is influencing the way that trade in banking services itself is model.[1558] That characteristic is the formal recognition within the WTO of commercial presence as a method by which banking services are traded.[1559] What is special is that, although there has been little progress in achieving multilateral or plurilateral agreement on liberalising barriers to FDI generally, there has been progress in setting up a multilateral mechanism to liberalise FDI in banking services. That mechanism is the GATS under the WTO. The GATS is set up to liberalise trade in banking services, and it formally recognizes commercial presence, along with cross-border banking as two important methods by which banking services are traded.[1560]

The argument in chapter 5 of sequencing capital account and current account liberalization shows that, the current account should be liberalised before the capital account. The argument is that the responsiveness of financial flows to capital account liberalisation typically would lead to an unwarranted real appreciation of the real exchange rate and an incorrect allocation of investment between tradeables and non-tradables. However, this argument, neglects the points that:

(i) Whenever capital account liberalisation occurs it would tend to cause a real exchange rate appreciation; and

(ii) The amount of resources available to an economy would be greater if the capital account was liberalised earlier.

The recognition that current account liberalisation can take place at varying speeds also suggests some undesired interactions can occur between the current and capital account.[1561] In particular, a slow current account liberalisation may require a compensating real devaluation over a number of years. The implied upward pressure on the real interest rate via the capital account may discourage domestic investment. This suggests that the

[1558] See chapter 4.

[1559] Ibid.

[1560] See chapters 4 and 5.

[1561] See chapter 5.

economic response to slow cross-border banking trade liberalisation and the exchange rate policy during the period of cross-border banking trade liberalisation should be taken into account with the capital as well as the current account.[1562] Liberalising the capital account before strengthening the domestic financial system certainly creates an environment conducive to serious economic problems and, potentially, financial crises. At the same time, reducing the barriers to the movement of savings has been a boon to economic development worldwide.[1563] And powerful and irreversible changes in information technology have made highly mobile capital a fact in life. The solution to reconciling these considerations is not to revert to restrictions on capital flows, but to liberalise controls in an orderly, well-sequenced way, accompanied by sound macroeconomic policies, strengthen domestic banking systems, and improve transparency through disclosure of timely financial and economic information.[1564] According to these safeguards measures, liberalisation becomes not only inevitable but clearly beneficial.[1565]

The study concludes that, one area where progress remains to be made is cross-border trade in banking services.[1566] Even where members have adhered to the Understanding, their obligations and commitments in that respect remain limited, especially in relation to cross-border banking services. This is in large part due to regulatory concerns of members' financial regulators. The prudential carve-out may be of limited help in this regard as the issue relates to the enforcement of prudential regulation in respect of banking services suppliers located in another jurisdiction where a members' financial regulator does not have authority.

Finally, an important question relates to the subject-matter of the GATS banking services framework or what sort of laws, rules and regulations are subject to liberalisation commitments on market access, non-discrimination, regulatory transparency and so

[1562] Furubotn and Richer 1990: 6-7.

[1563] Ibid.

[1564] Ibid at 20.

[1565] Ibid.

[1566] See chapter 5.

forth.[1567] According to article 1 of the GATS, the Agreement applies to "measures by members affecting trade in services". Measures by members means measures taken by central, regional, or local governments and authorities, as well as those taken by non-governmental bodies in the exercise of powers delegated by central, regional or local governments or authorities. The WTO Panel in *EC-Bananas III* defined the scope of application of the GATS in the following terms:[1568] "The scope of the GATS encompasses any measures of a member to the extent it affects the supply of a service regardless of whether such measure directly governs the supply of a service or whether it regulates other matters but nevertheless affects trade in services". The Appellate Body upheld this and held that the use of the term "affecting" reflects the intent of the drafters to give a broad reach to the GATS. The ordinary meaning of the word "affecting" implies a measure that has "an effect on", which indicates a broad scope. In accordance with the definition, the liberalisation commitments undertaken in the WTO cover all measures taken by governments or regulatory authorities provided that, firstly, there is trade in banking services, and secondly, the measures affect such trade.[1569]

6.1.1 International Trade in Banking Services

Overall, the conclusion reached in this thesis is that, it has become clear that regulatory diversity in domestic prudential, monetary, and investor protection standards has remained largely outside the scope of the normative effects of the GATS commitments despite its collateral economic effects on international banking operations.[1570] The specific obligations of market access and national treatment undertaken by WTO members under the GATS do not address the indirect effects of regulatory diversity.[1571] Provided that there is no direct discrimination against foreign banks, the general provisions of the GATS-as reinforced by the explicit exemption afforded to national prudential and investors protection measures by the Annex on Financial Services-impose no disciplines and constraints on the exercise of

[1567] See chapter 3.

[1568] Ibid.

[1569] Gkoutzinis 2005:897.

[1570] Ibid at 913.

[1571] See GATS arts XVI and XVII.

regulatory rule-making and enforcement powers by national authorities. Secondly, banking services liberalisation under the GATS is one part of the larger process of achieving international contestability of markets and strengthening domestic financial systems, including prudential regulation and supervision. As the GATS explicitly recognises, liberalisation of trade in banking services is an ongoing process.[1572] In the banking services sector, this process is being driven not only by market forces and new technologies but also by growing recognition among policy-makers, particularly in emerging markets economies, that banking market opening can both benefit host country consumers of banking services.[1573]

6.2 Recommendations

6.2.1 Recommendations relating to the Prudential Carve -out

The financial crises of recent years have led to greatly increased attention to prudential regulation of the banking sector.[1574] Strengthening such regulations has been attributed to the key role played by international financial reforms. The GATS recognises governments' needs for considerable freedom of action for prudential measures to protect investors, depositors, policy holders and other persons covered by financial services supplier's fiduciary responsibilities, or to ensure the financial system intergrity and stability.[1575] However, the scope and character of measures permitted under this heading are not specified. Indeed the allowance of recourse to dispute settlement concerning a country's prudential measures is probably an indication of the difficulty which negotiators of the GATS faced when spelling out the measures which are or are not permissible under the prudential carve-out of the Annex on Financial Services.[1576] One set of questions under this heading is likely to be measures taken as part of restructuring of the banking sector in the aftermath of financial crisis such as that which broke out in Asia in 1997.[1577] Such restructuring can take

[1572] Sydney 2005:981-984.

[1573] Ibid.

[1574] Cornford 2004:14-15.

[1575] See chapter 3 para 3.

[1576] Ibid.

[1577] Ibid.

place over an extended period of time, thus posing the question of whether all the actions involved can be classified as being covered by reference to the system of intergrity and stability. A greater recourse to financial standards developed by organisations such as the Basel Committee on Banking Supervision (BCBS) is recommended. These standards could serve as a basis for a definition of exceptional measures which may be taken for prudential reasons regardless of other provisions of the GATS.

The prudential carve-out is perhaps the most significant provision in the Annex on Financial Services.[1578] Supplementing the exception clauses of the GATS, such as article XII or article XIV,[1579] it allows a member to take measures for prudential reasons in the banking services sector. The prudential carve-out is a broad exception to the GATS obligations, leaving domestic regulatory authorities a remarkable amount of autonomy to regulate the supply of banking services in their respective countries. Although practice on this point varies, a member need not inscribe them in its schedule of commitments or its list of MFN exemptions, because prudential measures are not considered restrictions on market access or national treatment in the usual sense. Paragragh 2 of the Annex on Financial Services lists two sortsofexceptions,[1580] namely, to protect investors, depositors, policy holders or persons to whom a fiduciary duty is owed and to ensure the integrity and stability of the financial system. Paragraph 2 (2) of the Annex on Financial Services limits the extent to which a member can employ domestic regulations for prudential reasons: it forbids the use of such prudential measures as a means of "avoiding" commitments or obligations under the GATS. This relates not only to the central WTO principles of MFN, market access, and national treatment, but also to important disciplines on the application of domestic regulation, such as article VI:1-2, which provides for reasonableness and objectivity in administration as well as judicial, abitral, or administrative review. The interpretation of the term "avoiding" should take into account the rich case law on the chapeau of article XX of the GATT 1994, as it performs a similar function is recommended.

[1578] See chapter 3 para 3.

[1579] See GATS art.XII or XVI.

[1580] See chapter 3.

6.2.1.1.1 Recommendation to National Treatment

National treatment and the principles that go beyond it can be understood in terms of three basic components that can be applied separately or in combination: host country rules; home country rules; and harmonised rules that apply in both countries.[1581] For example, national treatment requires the non-discriminatory application of host country rules to foreign banks. The public policy question is what basic principle or combination of principles, host-country rules, or harmonised rules-should govern trade in banking services. I will recommend that no single rule is appropriate for the provision of all trade in banking services. The choice of a rule depends on the interaction between two factors: the manner in which the service is provided and the public policy goals underlying the regulation of trade in banking services. A bank located in one country can provide services to customers in another country in three principal ways: cross-border supply that is, without establishing a commercial presence in the host country; through branches established in the host country; or through subsidiaries, which must be separately incorporated in the host country. Countries generally have four principal policy objectives that affect their regulation of such services: promoting competitive markets, ensuring the safety and soundness of banks, protecting against systemic risk, and ensuring adequate protection of consumers. In regulating the international provision of banking services, countries must choose from among the basic principles the ones more likely to promote policy, given the forms in which trade in banking services are provided. I will recommend that ensuring safety and soundness and competitive markets when services are provided by branches of foreign banks require harmonised rules, home country rules where harmonisation is not deemed necessary and home country enforcement. This is the EC approach under the Second Banking Directive. Competition, particularly with regard to geographical location and permissible activities, would be enhanced by this approach.

6.2.3 Recommendations relating to the overlap between Market Access and National Treatment

Under article XX of the GATS, upon the conclusion of banking services negotiations, members' market access and national treatment undertakings must be recorded in national

[1581] See chapter 3.

schedules, which are attached to, and form an integral part of the GATS.[1582] In their schedules, members first outline the sectors and sub-sectors in which they commit themselves to liberalisation. Then, under each sector or sub-sector, and for each of the four modes of supply, they may list any measure inconsistent with article XVI or XVII, but which they intend to maintain. The scheduling of banking services commitments combine positive and negative approaches undertaking obligations: there is no liberalisation obligation unless a sector or subsector is positively included in the schedule; but, once it is, a member cannot therein maintain measures inconsistent with articles XVI or XVII, unless these are listed.[1583] Depending on the level to which a member has listed market access and national treatment, for each commitment, and with respect to each mode of supply, three major possible levels of commitments are foreseen:[1584]

1. Full commitment: the entry "NONE" will be used to indicate that the member does not seek in any way to limit market access or national treatment in a given sector and mode of supply through measures inconsistent with article XVI and XVII.[1585]
2. Commitments with limitations: the member must describe in the appropriate column the measures to be maintained which are inconsistent with articles XVI or XVII.[1586]
3. No commitments: the entry "unbound" will be use to indicate that the member remains free in a given sector and mode of supply to introduce or maintain measures inconsistent with articles XVI or XVII.[1587]

The overlap between articles XVI and XVII causes some confusion with respect to the scheduling of those discriminatory market access restrictions that are inconsistent with both articles XVI and XVII. The Committee on Trade in Services should recommend a technical review of the GATS provisions to the WTO.

[1582] See chapter 3 para.6.

[1583] Guojun 2010: 81.

[1584] Ibid.

[1585] Ibid.

[1586] Ibid.

[1587] Ibid.

6.2.4 Recommendations relating to liberalisation provision

The GATS Agreement in the Uruguay Round stopped short of requiring full reciprocity in access, opting instead for less stringent market access and national treatment requirements Full reciprocity will require that foreign banks be allowed the same degree of market access in the domestic market as permitted to domestic banks in foreign markets. This provision would have effectively forced countries to liberalise their banking markets to a common standard. I will recommend that members should reconsider this provision.

6.3 Regional Trade in Banking Services

In the study for the sake of brevity, the examination of regional trade in banking services was limited to the banking law of the European Union.[1588] This approach was informed by the realisation that trade in services in the European Union is similar to that of the WTO. An examination of trade in services in the EU and of the GATS could contribute to the understanding of the liberalisation framework. While it is acknowledged that important differences remain in the overall structure and the constitutional mandates of the two constructs, a juxta position of the EU and GATS banking services liberalisation systems can inform possible GATS reforms.[1589]

In terms of trade in banking services in the European Union, the conclusion reached, in the thesis is that the European Union builds liberalisation of trade in banking services on the unique constitutional structure and its powerful administrative, legislative and adjudicative institutions. The liberalisation process has been gradual, starting with the constitutional principles enshrined in the Treaty of Rome, continuing with the jurisprudence of the European court of Justice (ECJ) and the commitments of the Second Banking Directive. In fact the Treaty of Rome laid the foundations for the internal banking market by prescribing the freedom of establishment, the freedom to provide banking services and movement of capital. It was the ECJ decisions and the Second Banking Directive that provided the powerful legal instruments towards a European banking market without barriers, discrimination, on the basis of essential harmonisation, mutual recognition and home

[1588] See chapter 2 para. 2.

[1589] See chapter 2 part 2.1.

country supervision. The Second Banking Directive established the single banking license eliminating barriers, like host country authorisation and endowment capital requirement, to cross-border bank branching and provison of banking services. Without creating a European banking license, the Second Banking Directive has allowed credit institutions authorisation in member states to open branches in another member state by simply complying with a notification requirement while they are subject to home country prudential supervision. The Court has ruled that both discriminatory and non-discriminatory measures can be in contravention of the fundamental internal market freedom. Building on the *Dassonville* and Cassie *de Dijon* cases on the free movement of goods,[1590] the ECJ has extended the trade discipline of freedoms of establishment and of provision of services to non-discriminatory measures.

The study concludes that, the EU Second Banking Directive is a Centerpiece of EU banking legislation for the post-1992 era. The conclusion is that, firstly, branches of EU banks throughout the community under this directive should be authorised and supervised by the home country. Secondly, the directive, however, specifies certain conditions that an EU bank must meet in order to establish branches without host country licensing. Lastly, the directive acknowledges the public interest exception to the principle of home country control.

6.4 Conclusion

The ultimate goal of opening up trade in banking services, as shown in the study, rest with the GATS. The GATS provides a useful multilateral framework for doing so, offering sufficient flexibility for countries to pursue an appropriate banking services trade liberalisation strategy, and yet take a more prudent approach towards capital account liberalisation when warranted. GATS commitments allowing the commercial presence of foreign banks, and liberalising a broad range of instruments, should be considered. Such liberalisation requires only limited liberalisation of capital flows in the GATS context.[1591]

[1590] See chapter 2 para. 2.

[1591] Stijn and Marion 2000: 142.

Secondly, such liberalisation should also allow for necessary degree of prudential regulation and supervision, and provide safeguard mechanisms against financial crisis.[1592]

In this respect, the GATS should strive to strike equitable balances which recognise systems of prudential supervision and regulations. These measures are frequently necessary before banking systems can operate on a market basis, but they cannot beeffectedimmediately. The opening of borders to foreign competition, while it is an important and necessary part of liberalisation, must proceed in line with wide ranging domestic reforms, which, in many developing countries, must proceed at a moderate pace.

[1592] Stijn and Marion 200:142.

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SUMMARY

This thesis has investigated the deregulation of trade in Banking Services in developing countries. It has investigated the deregulation of trade in banking services by an analysis of trade in banking services under the European Union, the United States of America, China and South Africa. The objective was to analyse the liberation process that has taken place in these countries and evaluate it in the context of negotiations on multilateral liberalisation of banking services within the World Trade Organisation framework. In particular, has the path adopted by these countries represented the best case of successful extensive deregulation in the banking services industries of developing countries? It is worth understanding whether this route could represent a blueprint for opening up markets in developing countries. Hence the sequence of deregulation and problems faced by these countries in deregulating their markets are here studied in order to provide insight in the areas that are likely to be most difficult to open internationally and are expected to lift impediments to multilateral negotiations. The thesis cover the traditional services provided by banks, such as acceptance of money transmission services. The thesis also focus on the principles for regulating the liberalisation provision of trade in banking services because of the unique character of such services and because, despite the increasing liberalisation of trade in banking services, national regulatory systems still differ substantially. Attempts made by the Basel Committee with its Core Principles for effective banking regulation and supervision was discussed to see whether or not this attempt has assisted toward ensuring that all banks are supervised according to common principles. It has been established that harmonisation of prudential and supervisory regulations are warranted where entry is restricted by differences among national regulations. However this should be done without preventing the host state from retaining the right to regulate foreign banks' activities in the host state only to the extent that such regulation is necessary for the protection of public interest. The host state may also intervene in those matters expressly reserve to it, notably liquidity, monetary and advertising. Lastly, an in-depth examination of the World Trade Organisation legal text was done in an attempt to extract the legal principle relevant to the deregulation of trade in banking services in developing countries. It was attempted to determine the most common issues between host countries and home countries, and to compare it. Their usual plea is for international harmonisation of national regulatory regimes, so as to coordinate their efforts, create a level playing field, and prevents a competitive race to the bottom among national regulators that ultimately harm the participants in these markets and the reluctance of the World Trade Organisation to prevent this.

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OPSOMMING

In hierdieproefskrif is die deregulering van handel in bankdienste in ontwikkelendelandeondersoek. Hierideondersoek is gedoendeurhandel in bankdienste in die EuropeseUnie, die Verenigde State van Amerika, China en Suid-Afrikateanaliseer. Die doel was om die liberaliseringsproseswat in hierdielandeplaasgevind het, teanaliseer en omditteevalueer in die konteks van die onderhandelingeoormultilateraleliberalisering van bankdienstebinne die Wêreldhandelsorganisasie-raamwerk. In besonder is gevra of die pad wathierdielandegevolg het die bestekeusevirsuksesvolleuitgebreidederegulasie in die bankdienstesektorverteenwoordig.Dit is van belangomteverstaan of hierdiewerkswyse 'n bloudrukdaarkanstelvir die oopstelling vanmarkte in ontwikkelendelande. Derhalwe is die proses van deregulering en die problemewat in hierdielandeondervind is, bestudeerominsigtevind in daardiegebiedewatwaarskynlik die moeilikstesalweesominternasionaalooptestel en watverwag word omhindernissevirmultilateraleonderhandelingteverwyder. Die proefskrifhandel met die tradisioneledienstewatdeurbankegelewer word, soosgeldoordragtransaksies. Die proefskriffokusook op die beginselsvir die regulering van liberaliseringsbepalings van handel in bankdienste as gevolg van die uniekekarakter van sodanigedienste en omdat, ten spyte van die toenemendeliberalisering van bankdienste, die onderskeienasionaleregulatoriesestelsels steeds wesenlik van mekaarverskil. Poginsdeur die Basel Komitee met die uitreiking van hulKernbeginselsvireffektiewebankregulering en oorsig is ookbespreek ten eindetebepaal of hierdiepogingbygedra het omteversekerdatallebankebeheer word ooreenkomstighierdiegemenebeginsels.Daar is vasgesteldat die harmonisering van prudentiale en oorsigregulasiesnoodsaaklik is waartoegangbeperk word deurverskilletussennasionalestelsels. Ditmoetegtergedoen word met behoud van die gasheerland se regombuitelandsebanke se aktiwiteite in die gasheerlandtereguleertot die mate watsodanigereguleringnodig is vir die beskerming van die openbarebelang. Die gasheerland mag ookoptree ten aansien van daardieaangleenthedewatuitdruklikbinnesybevoegdhedeval, naamliklikwiditeit, geld en advertensies. Laastens is 'n in-diepteondersoekgedoenna die Wêreldhandelsorganisasie se regsbronne in 'n pogingom die regsbeginsels vas testelwat relevant souwees tot die deregulering van bankdienste in ontwikkelendelande. Daar is gepoogom vas testelwat die meesalgemegeskilpunte in die geskilletussengasheerlande en die buitelandsebanke se eielandeis en omdittevergelyk.Diealgemenepleidooi isvir die internasionaleharmonisering van nasionale regimes ten eindepogingstekoordineer;om 'n gelykespeelvelddaartestel; en omonnodigekompetisietussenreguleerderstevoorkom,aangesiendit die deelnemers in hierdiemarktemag benadeel.

KEY WORDS

The World Trade Organisation

The General Agreement on Trade in Services

The prudential Carve –out

Most favoured nation treatment principle

National treatment principle

Market Access

The Annex on Financial Services

The Understanding on Commitment in Financial Services

Commercial presence

Cross border trade