Financial Services in the WTO:
LICENSE TO CASH IN?
A Civil-Societal Critique of the Liberalization of Financial Services in the GATS Negotiations
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List of Abbreviations

BdB  Association of German Banks
GDP  Gross domestic product
DSU  Disputes Settlement Understanding: arbitration procedure of the WTO
ESF  European Service Forum
FSI  Financial Services Industry
FLWG Financial Leaders' Working Group
FSAP Financial Service Action Plan of the EU
FSF  Forum for Finance Stability
GATT General Agreement on Trade and Tariffs
GATS General Agreement on Trade in Services
IMF  International Monetary Fund
LDC  Least Developed Countries
OECD Organization for Economic Cooperation and Development
USCSI US Coalition of Service Industries
WTO  World Trade Organization

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Summary

Due to the stiff competition among the large financial service providers and the acute symptoms of crisis in the industry, there is strong interest on the part of the industrialised countries in opening up new markets. The EU and the USA therefore have a major interest in using the negotiations on the liberalization of financial services in the context of the GATS to open the way for an expansion offensive by their very competitive companies.

In this context, this paper will initially provide a summary of the most important segments of the financial service industry, and their economic function. Thereafter, we will outline some basic trends, such as the trend towards one-stop banking, the significance of so-called "innovative instruments" as derivatives, mergers, the high degree of concentration in the industry, the role of investment banking, and the role of pension and insurance funds.

Then, we will discuss quantitative aspects such as the share of financial services in the GDPs and the export volumes of selected national economies, with reference to the largest companies in the industry, both globally and in Europe, as well as the most important lobbying associations and networks. This will demonstrate that the financial service industry has very great influence on the formulation of policy by both national governments and the WTO.

In Chapter 2, the most important "rules of the game" of the WTO and the GATS are explained, together with an overview of the history of the financial service agreement and the current state of negotiations. The requests of the North and the EU are then analyzed. The fact that the EU is submitting opening requests involving financial services to 94 countries (out of a total of 109) demonstrates the high priority of place that the financial services have for the EU. The main emphasis of the content of these opening requests for the EU is on the opening of the pension and insurance markets, on the abolition of limitations on holdings by foreign capital, and on the liberalization of the movement of capital – all areas considered sensitive in terms of development policy. The interests of the EU are demonstrated with reference to particular countries – Malaysia, Chile, Thailand and South Africa.

Chapter 3 examines the dangers to the stability of the international financial system as well as to the national financial systems of the developing countries that would emerge if the requests of the EU were fulfilled. It is pointed out, for instance, that single GATS regulations could be used to block or to deter stability-oriented measures. Thus, the introduction of a foreign currency transaction tax might be interpreted as a trade barrier.

Flows of capital which bring with them the danger of instability and can burden the balance of payments are being generated by the increased presence of service providers from the industrialised countries in the markets of the South, as well as by certain practices, such as credits in foreign currencies or the repatriation of profits. Attempts to regulate these capital flows can easily run against of GATS regulations. In addition, the requirements upon local control and supervisory authorities who are often already overtaxed in many developing countries, is growing.

The paper identifies a contradiction between the logjam of reform of the international financial system and the high pressure for liberalization which the GATS exerts on developing countries. The increasingly oligarchic structure is also considered a problem in some market segments. The expansion of the financial service industry to the insurance and pension sectors is also viewed as a sensitive issue from a development perspective. The danger here is that poorer sections of the population will have reduced access – or none at all – to services of vital importance. It is pointed out that the foreign enterprises incline towards “cherry-picking”, and therefore do not exert a positive influence on development and poverty alleviation. On the contrary, some requests for liberalization have the effect of obviating sensible development policy regulations, e.g., the obligation for all banks active in Malaysia to provide a certain quota of economical housing loans for the underprivileged. The risk of increased capital flight is also increased by the growing presence of foreign financial service providers.
Even if impulses for innovation are generated by particular aspects of the liberalization of financial services, which result in positive effects, a sufficiently efficient regulation and supervision system will be required to ensure that effect in fact develops. The example of China is taken here to demonstrate such trends empirically.

The paper concludes that, in view of the unsolved problems of the international financial architecture and the notorious weakness of many national financial systems, the GATS tends to increase instability. There is the danger that liberalization will lead to a bottom-up redistribution of resources, and that the asymmetry which already exists in any case between the North and the South will be deepened.

Therefore, the request is that overhasty liberalization should not be carried out, but that an impact assessment first be undertaken, which should include such issues as financial stability, development policy, social and distribution risks, and problems of consumer protection. For the poorest countries, capacity-building measures must have priority. Pressure, and also the undermining of existing regulations which support the stability of the financial system and serve development policy goals, or help combat poverty, must cease. Instead, concepts must be developed for using financial services to support development and poverty alleviation. A priority must be placed on such human services as health and retirement insurance as well as on enabling access of poorer segments of society to financial resources.
Financial Services

License to Cash In?

Introduction

With the spectacular breakdown of the ministerial conference in Seattle at the end of 1999, the WTO, which had been founded only in 1995, fell into a crisis from which it has not fully recovered to this day. It was primarily the discontent of many developing countries about the poor results which the liberalization of world trade had brought them up to that time which caused the meeting to break up, along with differences between the two “big players” in world trade, the EU and the USA. The promise that the wave of liberalization would “raise all ships” – the big steamers and the little boats alike – had proven to be empty. The big winners had been, with few exceptions, the industrialised countries.

In response, the Ministerial Conference of Doha in 2002 proclaimed the new round of negotiations as a “development round”. However, nothing on the original agenda was changed. For the big players, liberalization of the service trade under the GATS is the focal point.

Under the “services” category, the financial services segment is one of the top priorities for both the USA and the EU. There are several reasons for this:

1. the financial services constitute the economic infrastructure of the international financial markets, which in turn form the economic power centre of the globalization process;
2. the industrial countries have an even bigger competitive advantage over the South than in other areas and therefore greater possibilities for expansion
3. the financial service markets in the North have already been liberalized to a large extent in the last twenty years. This has intensified competition so that new markets must be opened up now;
4. the high degree of concentration puts the financial industry under pressure to develop new potentials for growth;
5. the bursting of the speculation bubble 2001, the so-called “accounting scandals” of renowned corporations and the downturn at the stock exchange, still not yet finished to this day (summers 2003) has led to insolvencies, unemployment and other manifestations of crisis, as well as to a heavy fall of profits and a drastic austerity programmes.

In view of such strong interests in an expansion towards new markets there is the danger that other interests, like development, environment, social and consumer protection are put aside. A counterbalance against the one-sided interests of the financial service industry is necessary.

The crisis of Seattle had, however, a third component: the protests of social movements, non-governmental organizations and unions. In Seattle, for the first time, the movement for an alternative to neoliberal globalization stepped into the limelight of world opinion. Since then, public attention has increasingly focused on the WTO, while an increasingly informed critique by civil society groups, responsible politicians, academia and the media has emerged.

The financial service sector, on the other hand, has received too little attention to date. With this working paper, a more extensive civilian society view of the liberalization of financial services is presented for the first time. We are aware that this is an initial effort, with the goal of developing the basics and initial critical questions, a kind of “capacity building”, for ourselves. We see it as a “work in progress”, to be deepened and expanded further. We hope that other stakeholders in the civil society community, too, will be stimulated to take a closer look at the issue.

Berlin, August 2003

Peter Wahl
(Member of WEED Executive Board)
1. The Structure of the Financial Services Industry

by Isabel Lipke

“This sector is like a nervous system. It sends signals to the muscles of industry, and directs capital and investment to those projects which promise the greatest profit.”

former U.S. Treasury Secretary Lloyd Bentsen

1.1. What Are Financial Services?

Financial services are part of the extremely dynamic service sector – also known as the “tertiary sector” – which is the most important sector of the economies of the industrialized countries today. In those countries with the highest income, the share of services in the gross domestic product (GDP) is 65%; in some cases, such as the USA, it is far above 70%. Meanwhile, in the USA, 80% of employed persons work in the service sector. In the emerging markets, too, services already account for more than half (56%) of GDP, while in the countries with the lowest income, the share is only 38% (WTO 2003). Consequently, it would theoretically be more accurate to call the industrialized countries “service countries” instead.

Despite the great importance of services, there is to this day no uniform definition of the term “services.” Usually, the following criteria are given:

- simultaneity of consumption and production,
- lack of transportation and storage capacity,
- non-materiality,
- a high share of material and human capital.

Of course, these criteria do not always all have to apply at the same time. The international trade in services made its breakthrough during the eighties. From the beginning of the seventies until the nineties, it increased by 1,200% (Duwendag 1999: p. 257). In 2001, almost $1.5 trillion were earned by the export of services worldwide. The share of services in overall world trade has now grown to 30%. The increase of the economic significance of services reflects the general change in the world economy, the extensive technologization during the 20th century, the take-off into the information age. Technological progress, particularly the modern communications technologies, have always allowed new service industries to arise, and have contributed to increasing the “tradability” of services across national boundaries. The “biggest player” in the international service trade is the EU.

Beyond his quantitative significance, the service sector is of particular importance qualitatively, as well. It includes subsectors of the material and social infrastructure that cross macroeconomic boundaries, among them telecommunications, audio-visual services, (including television, the press and news agencies) education, health and other social-support systems of vital importance. One of these economically vital sectors is the financial service industry. It is only through its services, that the financial industry makes trade in goods and other services possible (Eckert, 1997). An intact financial service sector is therefore rightly viewed as the nervous system of a national economy, and constitutes the prerequisite for a target and yield-oriented distribution of available financial resources. The term “financial services” generally covers all services offered by credit institutions, insurance companies, financial intermediaries (secondary financial institutions) and other non-banks. Particularly, all traditional forms of banking and insurance services are included. Thus, an international commercial

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1 These are institutions which mediate between supply and demand on the money (short-term) and capital markets (in the long run), e.g. stock exchanges, (stock exchange securities include shares, loans, investment-fund shares etc.), capital investment and insurance companies, savings and loan associations etc.
bank, for example, can offer up to 250 different banking services ("retail products"). Initially, financial services – like other services, and unlike goods (Tamirisa, 1999) – are regarded as invisible, intangible and non-storable products which are traded through the intermediary of goods, people, information or money.

As in the case of other services, financial services are not always clearly assignable either. This applies, for instance, to foreign direct investments (FDI). The question of the extent to which foreign direct investments should be counted as part of trade in financial services in the statistics, is controversial.

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**BOX 1**

**Financial Services under GATS**

**Insurance and insurance-related services**

1. Direct insurance, including:
   a) life insurance, e.g. capital life insurance,
   b) non-life insurance, e.g. accident, liability, or private health insurance;
2. Reinsurance and retransfers or retrocessions;
3. Insurance agency services, including brokers’ services;
4. Supporting (auxiliary) services, such as consultant services, insurance statistics, etc.
5. Risk assessment and evaluation and services involving claim adjustment.

**Bank services and other financial services**

1. The acceptance of deposits and other repayable public funds;
2. All types of credit issuance, incl. consumer loans and mortgages, export loan factoring (demand purchase), and the financing of trading companies;
3. Financial leasing (this includes rental or lease of such durable capital goods as machines and buildings);
4. All payment and financial transfer services, (including credit and debit card and bank exchange services, issuance of travelers' checks, bankers' drafts and bills of exchange);
5. Bank sureties, guarantees, obligations;
6. Stock brokerage, off-market trading etc. including:
   - money market instruments, (incl. bills of exchange and checks),
   - foreign-exchange dealings,
   - derivatives (e.g. options, futures), swaps,
   - exchange-rate and interest instruments (e.g. swaps, forwards),
   - transferable securities (e.g. stocks),
   other tradable instruments, finances and investment in valuables (e.g., gold bars);
7. Participation in the issuing/ distribution of securities, incl. drawing and placing, in representation of public or private interests, as well as the provision of necessary services;
8. Money and foreign exchange dealings;
9. Capital management, such as portfolio, cash and pension-fund management, all forms of collective investment management as well as tutelary, custodial or trust services;
10. Compensation and offsetting services for financial capital, including securities, derivatives and other tradable instruments;
11. Provision and transfer of financial information, data processing and software from suppliers of other financial services;
12. Consulting, agency and other supporting financial services for all the activities listed above.
In order to avoid disputes on the definition of services, the WTO has carried out a listing of financial services which are the subject of the GATS negotiations. Financial services are accordingly divided into four major categories:

- **Insurance services**: Direct insurance (life and property insurance), reinsurance, insurance provision, and auxiliary services like insurance statistics;
- **Banking services**: Acceptance of deposits, loan and payments;
- **Securities services**: Asset management, trade with and participation in the issue of securities, invoicing and clearing services;
- **Other services**: Provision of financial information and consultation services.

Thus, virtually all national and international financial operations fall under this classification (see detailed list in Box 1). The list makes no claim to completeness. It can be supplemented with further categories by the negotiation parties at any time.

### 1.2. Which Purposes do the Individual Financial Services Fulfill?

Together with the telecommunications and information sectors, the financial services area is part of the infrastructure of a modern economy. Tele-communications and information technology, and financial services are mutually determinant and supporting. How else, if not by means of the innovations in information and communications technology, could non-cash commercial traffic, the millions of salary and checking accounts, all the remote-sales transactions, inter-bank commercial traffic, electronic floor trading, etc. be possible? Thanks to telecommunications technology, all these operations take place in real time and at very low transaction costs. Due to their immaterial nature, financial services are particularly well-suited for transactions in remote sales. With the IT revolution, the international volume of trade in financial services (particularly at the so-called “new” financial products) has also increased, as has product diversification.

Financial services are not only the nervous system of economic activity; the financial transactions which can only take place due to the services provided by the financial sector form the essential basis for macroeconomic operations. A few central fields of activity of the financial service providers exemplify the economic function of the sector:

#### Financial Intermediaries

Financial intermediaries include all market participants who offer services between providers and the recipients of money or capital in the broadest sense. They may be individuals or such financial service institutions as banks or stock exchanges, insurance or investment companies, leasing or factoring company. Basically, the term covers all players on the capital markets who act as agents in any form whatsoever.

One area of responsibility is oriented toward the mediation of financial need and potential financial investment, i.e. the funds of investors are accepted against the promise of later repayment (investment service), and provided to recipients, again against a promise of later repayment. This service includes:

**I. Agency Services, including**

1.) Primarily the bringing together of provider and recipient, and the conclusion of business between them; such agents include financial brokers, credit agents but also insurance institutions or agents/brokers (e.g. reinsurance institutions);

An example of such an agency service is the issuance and placement of short-term credit instruments (e.g. euro-notes);

2.) The transfer of already existing claims or obligations from a previous provider (recipient) to a new provider (recipient);
the agents in this case are securities firms, securities dealers, e.g. reinsurance brokers and companies; an example is the revolving trade in promissory note loans.

Since the original providers (or recipients) have a multi-level agency system available to them, due to the passing on of claims and obligations, the network of relationships between the contracting parties is often very difficult to elucidate.

II. Information services, such as stock exchange services, rating agencies, securities issuers, evidence centers (institutions which collect information about money and borrowers and pass it on to donors on request, e.g. the SCHUFA in Germany).

III. Risk-Assumption or Risk-Transfer Services ... and hence also liability services, such as all kinds of credit insurance, (e.g. credit sureties, leasing sureties) and factoring. The services of financial intermediaries are viewed by investors as opportunity-enhancing. The existence of the market intermediaries is also seen as an indicator of the stage of development of the market itself: the more intermediaries, the more highly developed the markets. Financial intermediaries are legally independent, and receive not salaries but so-called acquisition commissions.

Other Financial Services

I. Factoring
Factoring means nothing more than the continuous purchase of short-term receivables. With the assumption of the receivable, the factor also assumes the risk of failure and of liability (the del credere risk). Before assumption of the del credere risk, a credit standing and respectability investigation of the receivable seller (client) is carried out; this means the level of the receivable must be beyond reproach, the receivable itself must be free of any claims by third parties. Collection companies are an example. They insure that due receivables (usually after multiple reminder and non-payment of invoices and charges) are returned as fast as possible to their customers. Thus, they do not assume the failure or liability risk. This form of receivables assumption is therefore also described as recourse factoring. As a fee, one receives a proportional share of the amount collected, which is in turn charged to the debtor.

II. Reinsurance, Retransfers, Retrocessions
Reinsurance exchanges (typical in Great Britain) or reinsurance brokers (typically in Germany) are among the financial intermediaries in the broadest sense. Insurance companies can in turn reinsure themselves through other insurance companies. These reinsurance companies then assume the obligations which the insurance companies have taken on through their actual insurance policies (primary or direct insurance) – the future-based protection promise toward the policyholder. Covered by reinsurance are both the risk from the direct insurance (cession) and that from the reinsurance (retrocession). Almost all primary insurance companies pass on a part of their risk in this way. Furthermore, reinsurance companies cover risks of further reinsurance by other insurance companies. In this way, a variety of insurance companies are involved in the risks. The reinsurance stock exchange is the place where insurance companies are traded. Reinsurance companies are regarded as particularly dependant on the assessment of the rating agencies, since the primary insurance companies judge the credit standing of the reinsurance companies on the basis of these classifications.

III. Brokerage services
The main activity of the broker is handling the trade in securities, funds and foreign exchange. When acting as a business agent, he either acts on the part of a third party or as a commission agent (middleman) in his own name, but with the money of others. Current developments are, however, increasingly moving him away from the classic broker’s position –

3 “Revolving” means the extension or renewal of loans.
4 Rating agencies are responsible for the credit standing classification of countries, financial institutes, and monetary and capital market securities in certain classification systems. Leading rating agencies are Standard & Poor’s (New York), Moody’s investor Service (New York), and International Banking Credit Analysis Ltd. (London).
one in which he does not execute any trading activity of his own – and toward that of the so-called broker-dealer, who holds risk positions of his own. The broker gets a brokerage (or commission) for his services.

IV. Portfolio management/ investments
A securities portfolio (securities package) means a mixture of different types of investments (stocks, securities, federal bonds, bills of exchange, etc.). The mixture serves the purpose of spreading the risk. Portfolio management means the optimum planning and choice of securities (investments) for the purpose of an ongoing optimization among companies, investment trusts and banks. The attempt is also made with the aid of mathematical statistics to take into account the risks of single investments, in addition to yields (returns). The main function of portfolio management is to spread the risk (risk diversification) in the interest of long-term profit securing.

Portfolio investments, unlike direct investments, are short-term capital investments which serve mainly speculative interests. Profits are made by the continual use of exchange and interest-rate differences. They involve all cross-border purchases of tradable monetary and pension-fund-market securities as well as those stock purchases by which the foreign investor does not gain a controlling influence on the business policy of the issuing company (i.e. they must be less than 10% of corporate capital). Portfolio investments have fallen into disrepute since the Asian economic crisis as so-called “hot money,” because they were one of the main triggers of the crisis. After 1998, their share has hence declined dramatically from 22% in 1994 to approx. 2% in 1998

V. Investment banking
The customers of the investment banks or investment companies are large corporations, governments and the owners of large amounts of capital. Unlike commercial banks, which traditionally handle deposit and credit transactions, investment banks operate mainly on the security markets, i.e. they issue no loans, but rather their area of activity involves mainly consulting services concerning the issue of securities and capital investments, as well as the trade in securities in their own name or on the part of others (thus, investment banks could also be described as financial intermediaries). They support governments and corporations in procuring financing on the capital market or through the new issue of shares and loans. This support service extends from consultation on the setting of the issue price of new shares through the composition of a bank consortium, the placement of securities on the markets, to the assumption of the placement risk by making an obligation to purchase securities not sold. All in all, they are responsible for investing and utilizing public and private funds as profitably as possible. Their area of operations thus extends into the area of asset management (overlapping of asset and portfolio management). Market research, consulting and risk management (fund management) are also among the services of the investment banks. However, investment banks also handle currency-hedging transactions for transnational companies, including the trade in derivatives.

As can be seen from this description, the areas of operation of the dominant players – financial intermediaries, brokers, investment bankers, fund and portfolio managers (also called institutional investors or investors) – overlap increasingly. Since the boundaries of their fields of activity are becoming blurred or hard to differentiate, it has become much more difficult for outsiders to get a picture of the structures and power relations, and hence to assign responsibilities within them. Supervisory authorities, too, have had to contend with this problem.

1.3. Basic Trends in the Financial Service sector
The financial service sector has experienced great changes within the last two decades. A decisive trigger for its extremely dynamic growth was the end, in 1973, of the post-war order of the international financial system, with its fixed dollar-tied exchange rates, which had been established in 1944 at Bretton Woods. With the release of the exchange rates between the major currencies, a wave of liberalization and deregulation in the financial sector set in, lead-
ing to the rise of the global financial markets as we know them today. Under the new conditions, the financial service industry experienced an enormous upswing, and became itself a driving force behind the dynamics of the financial markets. This process was characterized by some basic trends, including on the one hand a high degree of concentration, and on the other, numerous new products and institutions.

### 1.3.1 Expansion, Merger, Concentration and “Innovative” Products

The expansion and internationalization of banks and other financial service providers have been observable since the 1960s. It was at that time that the Euromarkets, for example, were created, to circumvent national regulation. While German banks were, during the fifties, still largely devoted to reconstruction, they began, during the sixties, to follow their customers, the multinational companies, abroad. At that time, corporations involved in cross-border activities were already initiating international mergers. With the rapid development of international financial business during the seventies, new fields of activity for internationally oriented companies arose. With the addition of the foreign exchange trade, the “new” financial centers in London, New York, Tokyo, Hong Kong, Frankfurt, etc. emerged. In addition, the international credit trade became an important and rapidly growing area of business.

But commercial banks, too, are no longer only involved in their original areas of operation, but have, through diversification of their service and financial product range, and through mergers and takeovers, increasingly tried to expand into other, more lucrative areas. The trend is toward one-stop banking. Up to 75% of the sales volume of the big banks (to a large extent, these are now one-stop financial groups) are now achieved by the trading activities in the investment banking sector.

Another trend is the “securitization” – the confirmation of the securities – or the securities-like (i.e., equivalent in terms of classification by the rating agencies) underlaying of credit and deposit positions, as a rule in the form of short-term credit instruments, which was used at the beginning of the eighties in the course of the deregulation of the national money and capital markets (securitization or asset-backed securitization means the confirmation in writing of bank assets and sale of the receivables to investors).5

The significance of the investment sector or investment banking has taken place approximately simultaneously with the growth of the financial markets. On the one hand, ordinary commercial banks have increasingly devoted themselves to this profitable line of business. The significance of financial services has increased additionally in the context of the heavy increase in the indebtedness of public households as well as the privatization, which has taken place in waves for approx. two decades (Huffschmid 2002). The financial services industry is therefore among the big winners of globalization.

Nevertheless, the financial markets of the EU member states still were regarded as highly regulated. Thus, numerous financial service providers, such as the German savings banks, are still in public ownership, despite the fact that privatization was moving ahead in neighboring European countries. Important steps in the direction of an unregulated capital markets in the ’90s included:

- the creation of the European single market in 1992, which is the basis for the liberalization of financial services in the euro zone, and
- the reduction of virtually all barriers to the circulation of capital in the EU; and
- the harmonization of bank law and
- the introduction of the “European passport,” which regulated establishment law for financial service subsidiaries and branch offices within the EU.

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5 Securitzation makes it possible, for example, for credit institutions to avoid the incorporation of extensive loans in their own portfolios, or to liquefy loans already paid. This means, among other things, that credit institutions can relieve their balance sheets and thus better meet local equity-capital requirements.
Thus, it was no coincidence that another concentration wave based on mergers and take-overs, as well as a further increase in the supply of on- and off-market financial products ensued. The sales – the daily trade in stock-market interest derivatives – was over $2 trillion in 2001, for example (see Chart 1). This sum was double the sales volume attained during the mid-'90s in the stock-market interest derivative trade. The off-market derivative trade (also called “over-the-counter,” or OTC) has risen to $0.8 trillion (Bundesbank, Monthly Report, January 2003), more than tripling during the same period. The growing derivative trade is a product of unregulated financial markets. If derivatives are used as speculative instruments – and this is the case 90% of the time – it has destabilizing results and triggers currency and financial crises.

Since the international financial markets are given considerable control and steering functions, with regard to all other macroeconomic areas, their weaknesses and systemic risks are viewed as especially dangerous to stability. Thus, for example, the Bank for International Settlements (BIS) noted that with an increasing degree of concentration of the banks, the systemic risks grew, as did the distortion of market rates and, ultimately, turns into the misallocation of capital.

Another example of the concentration processes is the worldwide unofficial trade in derivatives and foreign exchange, almost 50% of which is concluded at only two financial centers, London and New York. Almost 90% of the nominal circulation of foreign currency derivatives are held by only three U.S. banks; the concentration in the market for interest and credit derivatives (86% and 94%, respectively) is similar. About three quarters of exchange transactions worldwide are concluded by merely thirty dealers (BIS 2002: p. 131).

A glance at the share of overall worldwide capital holdings in the hands of a few banks and funds (e.g. pension funds), makes the empowerment of the markets and the oligopolization trend even clearer. On the other hand, this could be used to make directive power of supervisory and regulative authorities more efficient, since the number of players is very limited.

Another trend is the strong development of wealth and asset management in the banks. This is an indicator of the major increase in large fortunes (World Bank 2000) which is on the one hand an expression of increasing social polarization which took place worldwide within the last two decades, and on the other hand due to the so-called “heir generation.”

These circumstances have in any case already further strengthened the influential role of banks and insurance service providers. The financial service providers and banks – and primarily the investment banks such as Citigroup, Deutsche Bank, Credit Suisse, First Boston, Goldman Sachs, Morgan Stanley, JP Morgan, or Merill Lynch – have thus at the same time secured a leading role in the process of economic globalization.

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6 The BIS is the association of the central banks of the OECD countries. Its office is in Basel.

7 Recently, the M&A activities of investment banks have been considerably reduced because of the bursting of the stock-market bubble and the world economic situation. By contrast, the trade in and the sale of loans has become particularly profitable. The three largest investment banks of the USA (Lehman Brothers, Morgan Stanley, Bear Stearns) have chalked up record profits in this trade.

8 Heir generation means that the today 30 years old generation inherits the assets of their parents acquired in the post war period. According to the WGZ bank study, in addition to the relatively steady increase of the overall assets in cash and securities, an disproportionate growth of the very wealthy segment is evident. Approximately 350,000 persons (< 0.5% of the total population) in Germany have approx. 55% ($2 trillion) of the all monetary capital in Germany.
Derivatives

The market in derivatives, which twenty-five years ago was of only marginal significance, developed during the nineties to one of the fastest-growing segments of the financial markets. Derivatives are an extended form of financial futures. The essential feature of derivatives is that their assessment is based on an underlying value, such as stocks, loans, foreign currency, interest rates or some other derivative. The basic forms are futures, options and forwards. Depending on the contractual content, financial futures can be broken down into conditional (options) and unconditional (futures and forwards), as well as into bank products (non-standardized OTC products) and stock exchange products (standardized OTC products.) The classification into conditional and unconditional financial futures is connected with the performance of the contract. In the case of unconditional financial futures, the performance of a contract is not connected to any condition; it is unconditional. By contrast, in the case of options – i.e., conditional financial futures – conditional fulfillment pertains, namely if the right of option is exercised.

There is another difference, that between the standardization and the non-standardization of the products. The standardized ones are equipping with uniform features and are tradable on the stock exchange; the others are individual products, which are traded “over of the counter” — or OTC. The trade in OTC products is considerably more extensive than market trading. OTC derivatives are traded essentially without supervision. However, they, too, are now offered by large financial institutes in standardized form.

Options: In options trading, a party purchases, by payment of an “options” bonus, the right of option of buying or delivering the agreed-upon product (e.g. a share of stock) at a previously fixed price within a particular period or at a particular point in time. The counterpart has the obligation to deliver or buy, respectively, the underlying (product).

Futures: The purchaser of a future contract undertakes to buy at a future date an underlying product (e.g. oil) at a previously fixed price. Analogously, the seller obliges himself to deliver the product at the agreed-upon terms and conditions.

According to the BIS, only a very small part of the derivative business (just 0.7%) is nowadays done in real (material) derivatives, such as raw materials or goods.

Artificial (synthetic) products include e.g. indices, interest rates, differences between short and long-term returns or rates. The non-transferable ones include currencies, loans, shares and all possible types of short-term securities, claims to payments of interest, etc.

The central economic function of derivative instruments consists in the isolated assessment, packaging and passing on of market-price risks. The basic principle is the idea of insurance. In principle, the risk transfer can also be achieved by means of traditional financial instruments, such as classic future exchange transactions. The use of derivatives, as opposed “normal” risk-transfer operations and techniques, makes possible control of the individual risk position with a low commitment of funds, because no acquisition, sale or exchange of the underlying assets (capital) is necessary. They are merely arithmetical reference quantities.
1.3.2. Institutional Investors
Institutional investors (or financial intermediaries, like insurance companies, pension funds, investment funds or investment companies) are a new, strategically important group of players on the financial markets. They demonstrate very clearly the problem of the concentration of large amounts of capital in very few hands. Their decisions on inflows of capital and drains have far-reaching economic effects. They therefore are increasingly courted by state and private capital recipients, and increasingly included in the political-economic decision-making process.

Certainly, like banks, institutional investors collect savings deposits, but they do not pass them on to companies and governments in the form of loans and thus contribute to the creation of productive capital, but rather invest in bond issues and stocks, or put together a mixture (portfolio) of assets (portfolio investments).

The significance of institutional investors for national economies gets even clearer if one places the assets managed by them in relationship to gross domestic product. They account for 38% of GDP in Germany. In the USA, institutionally invested assets to some extent amount to more than one and a half times the value of the GDP (Lütz, 2002: 160).

Chart 1:
**Distribution of Institutional Investors by Country of Origin 1998**
(cf. Lütz, 2002)

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>50%</td>
</tr>
<tr>
<td>Japan</td>
<td>14%</td>
</tr>
<tr>
<td>Great Britain</td>
<td>9%</td>
</tr>
<tr>
<td>France</td>
<td>6%</td>
</tr>
<tr>
<td>Germany</td>
<td>5%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>3%</td>
</tr>
<tr>
<td>Canada</td>
<td>2%</td>
</tr>
<tr>
<td>Luxemburg</td>
<td>.2%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>2%</td>
</tr>
<tr>
<td>Other</td>
<td>7%</td>
</tr>
</tbody>
</table>

1.3.3. Private Pension Funds – Unsafe Pensions
Due to the demographic development in the industrial countries, a broad discussion about the future of the public pension systems which are based on the “intergenerational contract” concept and financed by payments, has broken out. The providers of private retirement plans have a major stake in this discussion. For them, opening up to private utilization, at least partially, the gigantic sums of money which move through the public pension funds is extremely attractive. An example of this is the Allianz Group, which, as a result of the partial privatization of the German pension system in the so-called “Riester Reform” has already reached a market share of over 20% of the “Riester products” (Schulte-Noelle, Henning, 2001).

However, the optimistic idea that commercial pension funds would bring about a solution to the demographic problem, has since been considerably deflated. The burst of the speculative

---

9 This is the system whereby the current working generations pays into a fund which is then immediately used to support the retired generation
10 Named after former German Social Affairs Minister Walter (?) Riester (1998-2002), who introduced publicly-supported, privatized add-ons to the German old-age pension system.
bubble in 2001, after almost a decade of apparently irreversibly high-flying stock exchange quotations has brought the supporters of private retirement provisions back down to earth. In the USA, thousands have lost their pensions, and millions of privately insured people the world over have seen their payments drop considerably. The pension insurance companies, which once seemed so solid, have obviously miscalculated, and are now facing drastic losses. The German insurance companies, too, have now been caught up in the results of the crash. At Mannheimer Versicherung, the Capital Life Insurance Division, which is frequently used for retirement provisions, is already bankrupt. Only thanks to a safety-net fund (“Protector”) recently founded by the industry, can the legal minimum of services at least be guaranteed to the policy-holders. The crisis is not over yet, though. The rating agency Fitch estimates that €45 -50 billion in latent liabilities have piled up with German insurance companies (Frankfurter Rundschau, June 27th 2003). And this in spite of the fact that there have already been experiences with this sort of thing. For example, in the USA and in the Netherlands in the ‘70ies and ‘80ies, it was demonstrated that capital-market financed pensions are not at all larger or safer than allocation-financed ones. Besides the high capital market risk, there is a problem inherent in the system for the mass of wage-earning policy-holders. On the one hand, high salaries are necessary in order to be able to afford sufficient private insurance protection in the first place; on the other hand, if they rise too high, the returns on the private funds will drop. This is in accordance with the neoliberal logic: Expenses (i.e., salaries) down, share prices up.

Moreover, regardless of crisis-type developments, the gigantic financial masses which are moved around by the pension funds in “normal” times also contribute to increasing the volatility of the financial markets. Particularly developing countries are thus placed at a disadvantage, since they are frequently forced to use their currency reserves to stabilize their foreign trade earnings and their debt service, creating a permanent redistribution effect from the weak currencies to the strong currencies (Beck et al., 2003).

The privatization of the retirement-pension system not only further strengthens the economic power of the financial-services industry, but also increases its influence on basic sociopolitical conditions, as the social situation of the pensioners. The experience with the private pension systems in the United States and Great Britain demonstrates, that the pensions are getting unstable, the polarization between wealthy seniors and poor pensioners is increasing, the old age poverty is rising.

1.4. Quantitative Dimensions of the Service Economy

According to the European Service Forum, sales volume generated by the service account for approx. 60-70% of the total GDP of the OECD countries. This sector now provides more than 60% of the jobs (approx. 110 million), i.e. almost two out of three employees work in the service sector.

By contrast, financial services account for only a little over 5% of GDP in most OECD countries. In Switzerland which, along with Luxemburg, has a reputation as Europe's “banking country”, the financial services share of GDP is approx. 15%(Panitchpakdi, 2002).

Some countries in comparison

Ireland is outside the range of the EU average. Exports of financial services (not counting insurance services) were 13% ($2.62 billion) in 2001, imports came to 5% ($1.62 billion). Luxemburg, Switzerland and Great Britain are also all outside of this range. In Switzerland, financial services exports were already 17% of the overall services trade in 1990 (not counting insurance services, where the share was 5%). By 2000, the proportional share of finan-

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11 General Assembly of The Swiss Bankers Association: From Doha to Cancun and Beyond.

12 There are different types of statistical recording of insurance services, e.g. in the statistics of the balance of payments insurance services are listed separately. In this paper they are always included in financial services.)
cial services in the overall volume of services exports had almost doubled to 32%. Trade in financial services now provide Switzerland a trade surplus of almost $8 billion. In addition, the surpluses in insurance services, which are listed separately in the statistics, amounted to $1.2 billion. The overall volume of services exports increased by approximately 50% during the same period – from $18.8 billion to $27.5 billion.

In Luxemburg, trade in financial services – both export and import (not counting insurance services) – is very extensive. Financial services exports account for more than 60% of overall services exports. The import share is about 10% less than that, approx. 50%; in absolute terms, that means approx. $12.1 billion for exports and $7.3 billion for imports. The EU average also is far exceeded by Great Britain, with 17% in 2001. This reflects the fact that London is the largest international financial center worldwide. In Germany, financial service exports have increased over ten years from 1% in 1990 to 5% in 2000, an increase of 500%. By contrast, the imports of 1% are not particularly significant. The export share of insurance services is 2%, or $1.6 billion in absolute figures. Germany thus surpasses Ireland in absolute terms; there, however, the share of the insurance benefits in overall exports is 7%. In the USA, financial services exports are only 6%; in Japan, 4% of exports ($2.7 billion).

At first glance, the shares of the financial service trade look relatively modest. But apart from the qualitative significance of financial services, the growth rates are enormous, as the 500 per cent increase of the German exports indicate. Moreover, it must be taken into account that the liberalization which has already taken place has led companies to expand worldwide, by means of subsidiaries, corporate holdings, takeovers etc. The sales volumes of the subsidiaries no longer appear in the foreign trade statistics. This explains, for example, why Germany, with one of the world's biggest banks, the Deutsche Bank, and Europe's largest insurance conglomerate, the Allianz Group, does not leave much of a trace in the trade balances. For the most part, the important financial transactions are concluded with the aid of the foreign branch offices (direct investments), no longer in the home country.

Direct investments thus play a major role. Counting them as part of financial services – and that means all of them, not only the direct investments of the banks and insurance companies connected with the foundations of these foreign branch offices and subsidiaries (Mode 3 of the GATS; see Box 1) – considerably more impressive figures can be obtained. The share of foreign direct investments, apart from the international capital flows in the mid- to late nineties, has increased most strongly in comparison with trade in goods or production. Thus, foreign investments increased by almost 28% every year between the eighties and the nineties. At the end of eighties, the trade in services was 20% of world trade, compared with 30% today; half of that is accounted for by direct investments. And the major portion of this was in turn accounted for by financial services, both as regards the import and the export of direct investments. The direct investments of the industrial countries in the financial service sector increased from $63 billion to $356 billion between 1980 and 1990; this corresponds to an approximate average annual increase of 18%. By contrast, the rate of increase was more than 20%, i.e. the investments in industrial countries have increased in the same period from $28 billion to $187 billion. (UNCTAD: 2003).

1.5. The Big Players of the Financial Service Industry
The financial service industry is highly marked by big corporations. The largest financial service provider worldwide is the US financial holding company Citigroup – formerly Citicorp – since its merger with the Traveler’s Group Inc. (financial services provider for travel insurance companies). The Group encompasses the Citibank as well as various other banks and insurance companies, including one of the largest investment banks, Salomon Smith Barney (SSB), and also VISA. The major mergers and takeovers took place during the nineties, during the phase of the overall consolidation of the financial service providers. The companies

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13 E.g. see the Allianz home page, www.Allianz.de
14 By comparison: world production increased during the same time period by 9.8%, and world trade by 11.1% (WTO: 2001).
Financial Services

License to Cash In?

and subsidiaries belonging to the Citigroup can be found worldwide – in over 100 countries, naturally including the emerging markets, mostly in the East Asian area. In the overall worldwide corporate ranking, Citigroup now occupies fifth place (according to the criterion of market capitalization), surpassed only by Microsoft, General Electric, Exxon Mobil and Wal Mart Stores. In spite of all the international mergers, most of the investment banks – and the largest ones – are located in or operate from the USA. In the European ranking, the Allianz Group is in the top seven, surpassed, for instance by the oil majors Totalfina and BP, and the automobile manufacturers Daimler Chrysler and Volkswagen.

In the overall European ranking of the 500 largest companies, Allianz occupies fifth place, and is thus Europe’s largest financial services provider – not only in the insurance service sector, the Group’s traditional line of business, but also in asset management and other financial services. The Allianz Group includes over 700 companies, subsidiaries or partial ownerships on all continents. Just the approximately 400 funds (money market, pension and stock) managed by Adam (Allianz Dresdener Asset Management) speak for themselves. Allianz describes itself as one of the largest investors worldwide, with approx. €1 trillion in assets under management. The second largest European insurer, Axa, also a one-stop banking company, also intends to expand its banking transactions, and thus to double the number of its bank customers, create new distribution channels for traditional products, and extend its product range by expanding into home-building, consumer credit and savings accounts (Financial Times Germany, June 18th, ’03).

The Netherlands has a relatively high concentration of capital, compared with other European countries. Approx. 80% of all of bank assets are in the hands of only five banking service providers. As the followings tables show, this has a favorable effect on their return on investment and profit figures.

By contrast, a fairly heterogeneous market structure exists in Germany. Banking capital is relatively scattered. Only 17% of capital assets are held by the top five banks, although Germany, too, saw significant mergers and takeovers during the late nineties, the banks complained of low profitability due to a lack of positive returns of scale, and to not making use of synergy effects. In fact, the market share of the largest German banks is relatively low (Deutsche Bank 7.4%, HypoVereinsbank 3%), due to the large number of suppliers. Nevertheless, as the rankings, the balance sheets, the number of private customers, etc., show, their international competitiveness has not been affected – despite all their repeated complaints (“diet” for the banks).

Chart 2:

<table>
<thead>
<tr>
<th>Share of the 5 biggest banks of total capital (assets)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands</td>
</tr>
<tr>
<td>Austria</td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>Germany</td>
</tr>
</tbody>
</table>

0% 20% 40% 60% 80% 100%

15 Deutsche Bank/Banker Trust, Alliance/Dresdener Bank/Investment Bank Water Stone (USA),

16 See WGZ study: “Banken – die Fastenkur geht weiter” [The banks sill on a diet.]
Table 1:
The Biggest Insurance and Bank Service Providers Worldwide

<table>
<thead>
<tr>
<th>Bank</th>
<th>Country</th>
<th>Market Capitalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup</td>
<td>U.S.</td>
<td>283</td>
</tr>
<tr>
<td>AIG (American International Group)</td>
<td>U.S.</td>
<td>220</td>
</tr>
<tr>
<td>HSBC (Hong Kong &amp; Shanghai Banking Corp.)</td>
<td>GB</td>
<td>134</td>
</tr>
<tr>
<td>Allianz Group</td>
<td>Ger.</td>
<td>77</td>
</tr>
<tr>
<td>ING Groep</td>
<td>NL/ USA</td>
<td>74</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>Switz.</td>
<td>63</td>
</tr>
<tr>
<td>AXA</td>
<td>Ger.</td>
<td>.59</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>Ger.</td>
<td>57</td>
</tr>
<tr>
<td>Aegon (10th-largest insurer worldwide)</td>
<td>NL</td>
<td>47</td>
</tr>
<tr>
<td>Generali Holding Vienna AG</td>
<td>Austr./It.</td>
<td>43</td>
</tr>
<tr>
<td>Zurich</td>
<td>Switz.</td>
<td>3</td>
</tr>
</tbody>
</table>

Table 2:
...and in Europe

<table>
<thead>
<tr>
<th>Bank</th>
<th>Country</th>
<th>Capitalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Union Bank of Switzerland (UBS)</td>
<td>Switz.</td>
<td>127.3</td>
</tr>
<tr>
<td>HSBC</td>
<td>GB</td>
<td>129.6</td>
</tr>
<tr>
<td>Alliance</td>
<td>Ger.</td>
<td>77</td>
</tr>
<tr>
<td>Royal Bank of Scotland</td>
<td>GB</td>
<td>67.6</td>
</tr>
<tr>
<td>Halifax Bank of Scotland (HBOS)</td>
<td>GB</td>
<td>58.9</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>Ger.</td>
<td>48.6</td>
</tr>
<tr>
<td>Lloyds TSB</td>
<td>GB</td>
<td>40.2</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>Fr.</td>
<td>36.3</td>
</tr>
<tr>
<td>Crédit Agricole/ Crédit Lyonnais (CA/CL)</td>
<td>Fr.</td>
<td>33.2</td>
</tr>
<tr>
<td>Santander Central Hispano (s)</td>
<td>Sp.</td>
<td>32.3</td>
</tr>
<tr>
<td>Banco Bilbao Viscaya Argentina (BBVA)</td>
<td>Sp.</td>
<td>31.</td>
</tr>
</tbody>
</table>

Source: Financial Times Germany 2001, Allianz and own research

\[^17\] Market capitalization means the stock-exchange value of an enterprise, or its market price. It is calculated from the number of all shares multiplied by the stock-exchange quotation.
Table 3:
The Biggest Insurance Service Providers in the European Corporate Ranking

<table>
<thead>
<tr>
<th>Rank</th>
<th>Name</th>
<th>Country</th>
<th>Sales volume, million €</th>
<th>Rate of Exchange</th>
<th>Profit</th>
<th>Market value, million €</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>Alliance</td>
<td>Ger.</td>
<td>92232</td>
<td>-71.06</td>
<td>-1167</td>
<td>25548.8</td>
</tr>
<tr>
<td>6</td>
<td>ING Groep</td>
<td>NL</td>
<td>90172.9</td>
<td>-49.83</td>
<td>4499.99</td>
<td>28574.9</td>
</tr>
<tr>
<td>12</td>
<td>Axa</td>
<td>Fr.</td>
<td>64507</td>
<td>-42.6</td>
<td>949</td>
<td>23244.6</td>
</tr>
<tr>
<td>16</td>
<td>Generali</td>
<td>It.</td>
<td>55122.2</td>
<td>-23.09</td>
<td>-754.49</td>
<td>26088.1</td>
</tr>
<tr>
<td>21</td>
<td>Aviva</td>
<td>GB</td>
<td>50045</td>
<td>-42.76</td>
<td>-821</td>
<td>13777</td>
</tr>
<tr>
<td>22</td>
<td>Münchner</td>
<td>Ger.</td>
<td>48781</td>
<td>-66.65</td>
<td>1081</td>
<td>16026.4</td>
</tr>
<tr>
<td>29</td>
<td>Zurich Financial</td>
<td>Switz.</td>
<td>45122.4</td>
<td>-53.79</td>
<td>-3642.25</td>
<td>14085.1</td>
</tr>
<tr>
<td>42</td>
<td>Prudential</td>
<td>GB</td>
<td>36409.9</td>
<td>-48.56</td>
<td>688.86</td>
<td>11277.4</td>
</tr>
<tr>
<td>46</td>
<td>Legal &amp; General</td>
<td>GB</td>
<td>34581.1</td>
<td>-46.24</td>
<td>-648.97</td>
<td>7915.08</td>
</tr>
<tr>
<td>69</td>
<td>Swiss Re</td>
<td>Switz.</td>
<td>26205.6</td>
<td>-53.18</td>
<td>-62.71</td>
<td>17554.5</td>
</tr>
<tr>
<td>78</td>
<td>CNP Assurances</td>
<td>Fr.</td>
<td>22688.9</td>
<td>-7.28</td>
<td>571.1</td>
<td>5445.23</td>
</tr>
<tr>
<td>90</td>
<td>Royal &amp; Sun Alliance</td>
<td>GB</td>
<td>20060</td>
<td>-62.84</td>
<td>-1445</td>
<td>2447.5</td>
</tr>
<tr>
<td>99</td>
<td>Allianz Leben</td>
<td>Ger.</td>
<td>17739.4</td>
<td>-48</td>
<td>175</td>
<td>3412.5</td>
</tr>
<tr>
<td>101</td>
<td>AGF</td>
<td>Fr.</td>
<td>17149</td>
<td>-43.79</td>
<td>268</td>
<td>5967.9</td>
</tr>
<tr>
<td>102</td>
<td>Aegon</td>
<td>NL</td>
<td>17088</td>
<td>-63.92</td>
<td>1547</td>
<td>13134.8</td>
</tr>
<tr>
<td>108</td>
<td>RAS</td>
<td>It.</td>
<td>16568</td>
<td>-9.25</td>
<td>911</td>
<td>9004.78</td>
</tr>
<tr>
<td>113</td>
<td>Swiss Life</td>
<td>Switz.</td>
<td>15926</td>
<td>-72.78</td>
<td>-1167.54</td>
<td>1168.43</td>
</tr>
<tr>
<td>128</td>
<td>Old Mutual</td>
<td>GB</td>
<td>14191.5</td>
<td>-33.62</td>
<td>240.87</td>
<td>4754.92</td>
</tr>
<tr>
<td>136</td>
<td>Ergo Versicherung</td>
<td>Ger.</td>
<td>13199.8</td>
<td>-56.54</td>
<td>-1124.8</td>
<td>7398.21</td>
</tr>
<tr>
<td>138</td>
<td>Aachener &amp; Münchner</td>
<td>Ger.</td>
<td>13098.6</td>
<td>-59.39</td>
<td>-235.1</td>
<td>2646.42</td>
</tr>
<tr>
<td>168</td>
<td>Skandia</td>
<td>Swed.</td>
<td>10278.8</td>
<td>-53.93</td>
<td>-470.07</td>
<td>2680.76</td>
</tr>
<tr>
<td>190</td>
<td>Hannover Rück</td>
<td>Ger.</td>
<td>8860.21</td>
<td>-6.12</td>
<td>267.17</td>
<td>2517.52</td>
</tr>
<tr>
<td>201</td>
<td>Axa Colonia Group</td>
<td>Ger.</td>
<td>8306</td>
<td>-49.35</td>
<td>3.77</td>
<td>996.25</td>
</tr>
<tr>
<td>245</td>
<td>Baloise</td>
<td>Switz.</td>
<td>6599.77</td>
<td>-68.67</td>
<td>443.06</td>
<td>1562.33</td>
</tr>
<tr>
<td>Rank</td>
<td>Bank</td>
<td>Country</td>
<td>Sales Volume</td>
<td>Employee</td>
<td>Profit</td>
<td>Market Value</td>
</tr>
<tr>
<td>------</td>
<td>----------------</td>
<td>---------</td>
<td>--------------</td>
<td>----------</td>
<td>--------</td>
<td>--------------</td>
</tr>
<tr>
<td>19</td>
<td>Fortis</td>
<td>Belg.</td>
<td>51775.6</td>
<td>65,989</td>
<td>532</td>
<td>19534.3</td>
</tr>
<tr>
<td>25</td>
<td>Deutsche Bank</td>
<td>Ger.</td>
<td>46795</td>
<td>70,882</td>
<td>397</td>
<td>30159.9</td>
</tr>
<tr>
<td>27</td>
<td>UBS</td>
<td>Switz.</td>
<td>46590.8</td>
<td>69,061</td>
<td>2436.4</td>
<td>57891.2</td>
</tr>
<tr>
<td>32</td>
<td>HSBC Holdings</td>
<td>GB</td>
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Source: *Handelsblatt* and own research
1.6. The Lobby of the Financial Service Industry

The financial service providers have a lobby which is strong and efficient, with which they influence the political decision-making process and public opinion. They include the representatives of the most influential financial service industries, with the highest sales volumes of the economically and financially strongest countries. One of the most important lobby associations is the Financial Leaders Group (FLG), whose members are leading financial services representative from Canada, the European Union, Hong Kong, Japan, Switzerland and the USA. It was founded principally to promote the position of its members in the negotiations for financial services agreements in the WTO. Without the pressure from this powerful lobby, there probably would have been no agreement on the deregulation of financial services.

The most influential national group in Financial Leaders’ Working Group (it is now called FLWG instead of FLG) is the US Coalition of Service Industries (USCSI). As early as the mid-seventies, it tried with the help of the most important American financial service providers, American International Group (AIG), American Express, Citicorp and other influential service representatives, to obtain access to highly-regulated financial markets outside the USA, primarily in Southeast Asia – and met with intense resistance on the part of the developing countries and emerging markets. At its initiative, the issue of trade in services was for the first time placed on the international agenda in 1986, at the beginning of the Uruguay Round.

The USCSI was founded in 1982 under the chairmanship of the vice-president of American Express, Harry Freeman. Between 1982 and 1985, the coalition cooperated closely with US trade representatives and tried, through intensive lobby, to win Congress members to a stronger stand on trade liberalization (Wesselius 2002: 6).

The result of this lobbying was a real symbiosis between the Trade Desk of the government and the representatives of the service industry. The USCSI was given privileged access to all decision-making processes relevant to trade policy, via the Industry Sectoral Advisory Committee on Services – ISAC. During the negotiations of the Uruguay Round, the USCSI became the most important support of the official negotiators. The conclusion of the Uruguay Round could therefore also be regarded as a victory for the service industry.

At that time, financial services were not yet a component of the liberalization negotiations. The first progress was made in 1997. During the preparations for the next round of negotiations, GATS 2000, the cooperation of the two parties was intensified. There was a business-government dialogue between the government and the service industry regarding future expansion aims. At a joint conference of the USCSI and the Department of Commerce, the goals, such as increased market access and the implementation of additional regulatory and supervisory standards, were discussed, and the excellent and close cooperation between the USCSI and the Trade Ministry was praised. In 1997, the negotiations on the financial services agreement as an additional protocol to the GATS were concluded. A so-called interim agreement which was signed by the EU and its fifteen member nations and another approximately thirty countries had been reached in 1995. A temporary result of the untiring lobbying effort was the implementation of the final agreement in 1999, which even liberalization proponents regard as far-reaching, since it covers 95% of all international financial services in the banking, security and insurance sectors

The European Service Forum (ESF) is the counterpart to the USCSI. The ESF, founded in 1999, was the reaction of the Europeans to the success of the American lobby, for the Euro-

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19 The former WTO president, Renato Ruggiero, also held this opinion. Also see www.wto.org/English/news_e/pres97_e/fsdg.htm
20 Also see the home page of the USCSI and the FLG, and GATSwatch or Erik Wesselius, e.g. Behind GATS 2002. Corporate Power at Work (WESSELIUS 2002); or: Driving the GATS Juggernaut (WESSELIUS 2003)
peans could see from the American example what unity might achieve through pressure and influence. The ESF works together closely with the European Commission and follows the current GATS negotiations intensively “to define the offensive, and the defensive, trade interests of the community, and to advise the Commission” (Barth, 2000: 290). This effort has been highly successful: In 1999, with no public participation, a Financial Services Action Plan (FSAP) was approved, for implementation in the WTO. This is the EU Commission’s road-map for the GATS negotiations on financial services. The FSAP is based on the consultations of the Financial Services Policy Group (FSPG), which consist of the personal representatives of the Ministers of Finance and the European Central Bank. It contains, among other things, suggestions for the creation for an integrated financial service market, for the modernization of supervisory law, etc.

In the face of the active lobby of the competition in the USA and Europe, Japan, too, could wait no longer. The task of the influencing policy has now been assumed by the Japan Service Network.
2. The Financial Service Agreement In the WTO
by Isabel Lipke

2.1. The Structure of the GATS, Its Essential Rules and Method
The World Trade Organization (WTO) is the most important international institution in the process of the economic globalization, next to the International Monetary Fund (IMF) and the World Bank. The goal of the WTO is the worldwide opening of all markets by multilateral liberalization agreements. The doctrine of free trade, according to which liberalization means growth, and growth, in turn, means prosperity, is the ideological basis of WTO policy.

While until the foundation of the WTO in 1995, only trade in goods was the object of multilateral agreements (GATT), agricultural trade, intellectual property (trips agreement), trade-related investments (TRIMS agreements) and services (GATS agreements) have now also been integrated into the multilateral trade regime.

Due to its main principles, reciprocity, most-favored-nation clause, and non-discrimination, the WTO has developed a strong liberalization dynamic. Since it has a dispute settlement procedure, as the only multilateral economy organization which can authorize economic sanctions, it has a strong capability to intervene in the economy and social policy of its member countries.

The WTO Agreement on Financial Services is a component of the General Agreement on Trade in Services (GATS), which regulates the services trade in general.

In 1986, financial services became the object of multilateral negotiations for the first time with the beginning of the Uruguay Round (1986 - 1993, 8th World Trade Round of the General Agreement on Tariffs and Trade [GATT]). At that time however, there still was resistance on the part of developing countries to the liberalization of financial services, so that at the end...
of the Uruguay Round, there was no agreement on the integration of a financial services component into the WTO treaty framework.

When the WTO took up its work in 1995, and the GATS went into effect, there was merely an interim agreement, under which the liberalization requirements in banking, insurance and the securities sector lagged far behind the expectations of the industrial countries. During two follow-up rounds of negotiations, the North was able, thanks to far-reaching concessions by the developing countries, to achieve a considerably better result, so that finally, on December 12th, 1997, an agreement on financial services was successfully concluded, and went into effect upon ratification in 1999.

The results of the negotiation include the “Fifth Protocol to GATS” and national obligation lists (in which market access and national treatment obligations are listed); and lists of exemptions from most-favored-nation treatment requirements in the financial service sector (so-called Appendices).

The general principles and general regulations of the GATS also apply to financial services. These include:

- Most-favored-nation clauses, reciprocity and the non-discrimination principle;
- The classification of services according to mode of supply (four modes; see Box 4)
- The exception for services which are rendered “in exercise of sovereign power” (Article I); the activities of central banks, supervisory or currency authorities are listed in this regard in the Appendix to the GATS;
- The dispute arbitration procedure (DSU = Disputes Settlement Understanding);
- The so-called prudential carve out clause, i.e. the right to supervisory legal measures; and
- Other exemption rules, like the exclusion of the most-favored-nation treatment for regional economic integrations (Article V).27
- Stand-still agreements, under which the level of liberalization already arrived at is defined as the further basis for negotiation (irreversibility.)

**BOX 4  The Four Modes of the Provision(Supply) of Services**

**Mode I: Cross-border trade**
Example: A Swiss bank offers the facilities of numbered accounts abroad.

**Mode II: Consumption abroad**
Example: A Luxemburg bank provides a French company with a loan with which the latter concludes an investment in France.

**Mode III: Commercial presence**
Example: A German insurance company opens a branch office in Brazil.

**Mode IV: Cross-border movement of individuals**
Example: The manager of an American portfolio fund works in the German branch office for a year, or a prospective foreign exchange dealer from Hong Kong does a one-year internship in London.

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27 This exception is of importance for the EU, since it prevents trade advantages which apply within the EU from being automatically granted to third-party countries.
Unlike the usual method under the GATS, in which the so-called bottom-up principle (positive-list approach) applies for the process of negotiation, this Understanding on Commitments in Financial Services provides for a negative-list principle. The clause for the distribution of new financial products (GATS Part 3, Article XVI), the goal of which is to authorize the sale of any financial product by foreign branch offices (e.g. derivatives), if they are already allowed in the home country is important.

A country makes only those commitments which it specifically includes in the corresponding list. By contrast, the negative lists approach provides that an entire sector is in principle automatically subject to the agreement. Exceptions must be specified in a negative list.

---

**BOX 5 Central Regulations under the GATS**

**Part I:** Scope and definition

**Part II:** General obligations
- Article II: Most-favored-nation treatment
- Article III: Transparency
- Article IV: Economic integration
- Article VI: National regulation
- Article XI: Payment and money transfer system
- Article XII: Measures in case of balance-of-payments deficits

**Part III:** Specific obligations
- Article XVI: Market access
- Article XXI: Native treatment

**Part VI:** Progressive liberalization
- Article XIX: Negotiation of specific obligations
- Article XXI: Change of the country lists

**Part V:** Institutional regulations
- Article XXIII: Conflict resolution and Implementation

**Part VI:** Concluding stipulations

**Important appendices:**
- Appendix to Article II: most-favored-nation treatment exceptions
- Appendix on financial services
- Second appendix on financial services
- Appendix on telecommunications services
- Appendix on negotiations re telecommunications infrastructure
- Lists of concrete concessions and on most-favored-nation treatment exceptions
2.2 The Development of the Financial Service Agreement to Date

The sectoral financial service agreement regulates 95% of all international financial services in banking, insurance and the securities area. When it came into force in 1999, the WTO had 132 members. Of these, 102 made liberalization proposals, including seventy-seven developing countries and emerging markets and all twenty-five industrialized countries. The imbalance between these two country groups is particularly evident in the area of financial services, e.g. approx. 80% of cross-border credit transactions are accounted for by only seven OECD countries (Werner, p. 49).29

The common point of departure for further negotiations from 2000 on is the Understanding on Commitments in Financial Services, which all industrialized countries have (voluntarily) accepted as the basis. Some developing and emerging markets have also joined up; they, too, have recognized the Understanding as a basis.30

The agreement provides significant improvements for foreign suppliers of financial services and broader possibilities for commercial branch office and the expansion of their business activities. It involves the reduction of restrictions on corporate legal forms, obstacles and limitations on majority ownership, corporate control by foreign companies and other obstacles to expansion. “Investment obstacles” (such as necessity tests) are to be discontinued in the future; the same is true on bans on and restrictions of commercial branch offices (see Box 3, “Non-Tariff Trade Barriers”).

The Understanding permits grandfathering, or the safeguarding of the status quo for already existing branch offices and investments, activities and rights. New regulations may therefore not be more restrictive than those already existing or those provided for under multinational or bilateral negotiations which have been discontinued.

Furthermore the Understanding covers so-called non-discriminatory trade barriers which can occur due to differing supervisory legal standards. These resulting disadvantages are to be avoided in the future, by more transparency and by a harmonization of regulations.

Although the lobby of the financial service providers complains that the agreement does not go far enough, particularly due to too-few concessions on the part of the developing and emerging market, supporters of free trade also note: “By means of the Multilateral Financial Service Agreement, it has been possible to multilaterally consolidate a historically uniquely high deregulation standard (Werner, 1999, p. 102). Werner comes to this conclusion due to the “breathtaking” development of liberalization of the financial sector during the past two decades, which, with the aid of agreements valid under international law has now been confirmed and thus made irreversible. Moreover, the importance of the agreement is, in his view, that it stipulates that deregulation proceed further (esp. under GATS, Part 4).

Parallel to the regular negotiations, the above mentioned Financial Service Action Plan which is to implement a fully integrated European financial market by 2005, was approved by the EU in 1999. The background is that liberalization of financial services is far advanced in the EU countries, compared with other nations. The Action Plan, which originally contained forty-two measures of which twenty-six have already been concluded, encompassed the further integration of the securities markets, a four step concept for the further liberalization of the securities services, and adoption of a definite stipulation on the application of international principles for accounting (Young: 2003).

Trade in services takes place mainly in Mode 3 – Commercial Presence, followed by Mode 1 Cross-Border Supply. Thus, industrialized countries have made concessions for Mode 3 on 95% of all financial services listed in the framework agreement. Among other things this has to do with the twenty-five-year deregulation experience in the financial sector upon which the industrial countries can look back. Moreover, these two forms of performance (Modes 1 and

29 Germany, France, Great Britain, Italy, Japan, Switzerland and the USA; cf. Werner, Welf: Das WTO-Finanzdienstleistungsabkommen [The WTO Financial Services Agreement], p. 43.
30 Bulgaria, the Czech Republic, Slovakia, Nigeria, Turkey and Sri Lanka.
3) are the ones where the highest-volume deals are done. By contrast, the sales made under
the other two modes, Modes 2 and 4 Border Crossings by natural persons, are low. The bulk
of major-client business is with international and foreign branch offices; moreover the busi-
ness relationships of the financial companies with one another is maintained and promoted in
this way (Werner: 36).

The reason that Mode 3 Commercial Presence is a more attractive alternative than Mode 1
International Trade is that it permits companies to lower transaction costs and circumvent
restrictions which – still – hamper cross-border trade in financial services. Corporate pres-
ence under Mode 3 moreover conforms with the inclination of consumers who prefer to use
the products of local companies (Home Country Biases, TAMIRISA 1999). This applies in
special measure to insurance services, for which it is assumed that local companies are par-
ticularly subject to supervisory obligations and state control. The attractiveness of Mode 3 is
additionally enhanced by the fact that commercial presence in the target country provides a
good point of departure for the securing of market shares there.

However, if capital flows are not to have any damaging effect (e.g., financial crises), or if their
optimum allocation is to be ensured, control instruments (capital movement control in the
broadest sense) – and specifically national control instruments and their unconditional interna-
tional acceptance – are absolutely needed, at least as long as there are no international
standards based on the principle of equal rights, for both developing and industrialized coun-
tries. The definition of the focus for Modes 3 and 1 can also be seen in the bilateral agreements
which are increasingly being drafted parallel to the negotiations in the WTO.32

2.3. The Contentious Issue of “Sovereign Power”
One of the great controversies in the discussion around the GATS refers to the status of pub-
lic services. In Part I of the GATS – Scope and Definition, it is specified under the heading
“sovereign power” that services rendered in the exercise of sovereign power are to be ex-
empted from the GATS. Interpretations differ as to what falls under this clause. A similar
clause is found in the Appendix to the Financial Services – which gives the appearance of
being precise. To be found under Item (i) are the activities of central banks or currency au-
thorities, and (ii) activities concerning the areas of social security and public retirement
systems. Services which fall under these areas are to be exempted from deregulation meas-
ures.34

However, doubts do arise about the unambiguity of the exceptions if one takes a look at the
EU requests in these areas, e.g. to emerging markets like Malaysia (see Capter 2.4.2.). If for
example, one were to interpret the insurance of foreign exchange market stability as a public
service which is provided by the sovereign in favor of the economic public interest, then all
measures which serve this aim fall under it, including capital movement controls, taxation etc.
If single instruments like holdings restrictions by foreign banks or insurance companies, are
isolated from this public good foreign exchange market stability, then the EU definitely wants

31 For even if local companies have long since been taken over by foreign ones, this is not immediately obvious to the
consumer.

32 The regulation standards of the BIS, Basel I, were drafted by the richest countries, the G 10.

33 See e.g. the various statements of the USCSI on the bilateral agreements with Singapore and Chile. www.uscsi.org

34 See Appendix to Financial Services (GATS), 1 B)

……service supplied in the exercise of governmental authority" means the following

(i) activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or
exchange rate policies;

(ii) activities forming part of a statutory system of social security or public retirement plans; and

(iii) other activities conducted by a public entity for the account or with the guarantee or using the financial ressources of
the Government
to see them opened up. Article xi/part 2 of the GATS—International Payment Transactions, offers the opening here, because, given corresponding sector-specific obligations, it restricts the possibility of regulating capital flows nationally. This means nothing else but that capital movement controls are to be hamstrung or made altogether impossible.

2.4. The New Round of Negotiations: Interests and Requests of the North

In the present round of trade negotiations, the EU has addressed “Requests” (demands for opening) to a total of 109 countries. This includes requests to 84 countries in the area of financial services; thirty of these are poor developing countries (Low-Income Countries, or LICs). As this high number of Requests indicates, financial services are, along with telecommunications and water, a major object of EU interest. The EU is very competitive here, and itself demonstrates a high level of liberalization; both factors are prerequisites for going into the offensive in this area.

In addition, the stock-market crash and the drop in stock prices which has followed, the financial industry has its back to the wall. It hopes that an export offensive will contribute to overcoming the crisis.

The Understanding on Commitments in Financial Services is the basis for the new market-opening requests. This basis is regarded as a floor, or minimum demand. The basic goal is that the Understanding be recognized as the basis for further negotiations; the poorest developing countries (Least Developed Countries, or LDCs) are to be called upon to adopt the classification of the Appendix on financial services, inasmuch as they have not already done so.

The Association of German Banks (BdB) has formulated its liberalization goals clearly in a lobby paper (cf. Unkelbach 2003, BdB). According to this paper, there is a particularly high interest in Mode 3 in the area of the bank services, i.e., the establishment of companies and corporate subsidiaries, as well as the associated foundation and activity rights. In connection with this, Mode 4 is of importance—i.e., the request to be able to dispatch specially qualified employees to target countries with little red tape. Restrictions on highly qualified employees (executives such as managers or managing directors) are to be discontinued, or at least reduced, in the future. The reduction of the still stringent restrictions is also a goal under Mode 1—International Trade, which, according to the BdB, is subject to too-strict restrictions due to provisions of supervisory law.

In Mode 2, the consumption of bank services by non-EU foreigners (i.e., foreigners from third-party countries), the opening obligations are welcome. Otherwise, the trading partners of the EU are being called upon to drop the restrictions in those sectors of the banking, insurance and securities services where partial concessions have already been made which are, however, restricted (“bound”), or where only partial liberalization has been achieved. Preferably, the individual sectors are to be completely opened.


36 EC Requests to Argentina or Malaysia: General EC Request: “Undertake commitments in accordance with the Understanding on Commitment in Financial Services.” See GATSwatch: EC Requests
Table 5:

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2.4.2 Requests of the EU on Some Select Emerging Markets

As the list of the target countries of EU liberalization requests shows, all emerging markets are included. In view of the size and potential profitability of these markets, they are particularly high on the list of targets of the EU offensive, as the following cursory examples indicate:

**Malaysia**

Prior to the Asian economic crisis, Malaysia had pursued the opening of its financial sector very carefully, and had, during the financial crisis, instituted capital movement controls often frowned upon by the IMF and other free-market fundamentalists (see Box 6), in order to regulate the trade in its currency and to protect itself from destabilizing inflows of capital. The EU’s “wish-list” on the opening of the banking, insurance and securities services subsectors, is long. In all areas, the request is that the Understanding be accepted as the basis. For the banking sector, the EU requests to accept the regulation against risky loans of the native country if it has signed the Basle accord.

Furthermore, it is requested that foreign banks, too, be allowed to issue, purchase and sell travelers’ checks. In addition, the reduction of the access restrictions for foreign financial services providers to the local currency market is requested. This amounts to a request for capital movement control, and opens up the possibilities for currency speculation. The Malaysian insurance sector is also the target of liberalization requests. The request here is for the re-
moval of all shareholding limitations for foreign companies, at present 51%.[37] In 1997 Malaysia had imposed this ceiling against heavy pressure, with the justification that without it, foreign insurance companies would roll over the home market with mergers and drive out local suppliers. Nevertheless, the German insurer Allianz has since then managed to penetrate the Malaysian insurance market through the take-over of a national supplier. According to its own statements, Allianz has taken over the fourth-largest Malaysian insurance company, Malaysia British Assurance Berhad, and now has a majority share of 98.5% (Allianz press conference on financial statements, April 2002).

Moreover, the issuance of new licenses for insurance companies is requested. Another highly problematic demand is the request to cancel all quotas for cheap housing credits, because they are considered as “trade barrier”.

**Chile**

The goal for Chile is to eliminate all still existing restrictions (controls) on the circulation of capital. Regarding market access for Modes 1, 2 and 3, for instance, the request is that the Chilean Central Bank lift the limitations on payments and transfers.[38] Furthermore, the country is to eliminate the legally stipulated taxation of foreign transfers, limited to a certain percentage.[39] Another request concerns direct investments, maturity period of which Chile has fixed at at least two years, in order to restrict short-term inflows of capital (portfolio investments); this restriction, too, should be lifted. The Forum for Financial Stability (FSF), which had been set up after the Asian economic crisis with the cooperation of the most important players in the financial community (including the IMF, the World Bank and the finance ministries of the industrialized countries) to suggest reforms in the international financial system, in its first interim report identified short-term investments as a particular stability risk (FSF: 2000).

Furthermore, as in the case of Malaysia, all services involving the management of pension funds, principally for Mode 3, are on the list.

**Thailand**

The EU request upon Thailand is also interesting. The country is to grant banks with offshore licenses access to the local financial market. The offshore banking industry, the core business of which is capital flight, tax evasion and money-laundering, is also a major stability risk for the international financial system, as the FSF also stated. The EU request contradicts all declarations on reducing risks in the international financial system in the interest of the developing countries, which were primarily based on the bitter experiences of Thailand, with its still-insufficient bank supervision system, in the Asian economic crisis.

**South Africa**

Yet South Africa did not liberalize its capital movement completely. E.g. insurance and pension funds in South Africa are only allowed to purchase foreign shares (stocks) up to 15% of the asset. The EU requested from South Africa to open its pension funds. But what happens, if a foreign pension fund wants to purchase a larger share of foreign assets to guarantee its profitability?

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[37] The request for abolition of native capital majority ownership appears in the requests to almost all developing countries.

[38] … or at least supervisory-law measures according to the prudential regulation clause, which allows countries sensible regulation.

[39] “Eliminate restrictions on payments and transfers; prior authorisation by the Central Bank before transferring dividends from Chile abroad.” See GATSwatch, EC Request to Malaysia. In view of the fact that Chile’s minimum reserves requirements (cash deposit requirements) on inflows of capital for the purpose of foreign exchange rate stabilization were generally recognized during the nineties, this demand appears very dubious (See Bank for International Settlement – BIS).
BOX 6

**Capital Movement Controls** are a means for regulating the inflows and outflow of capital. The encompass various measures, including:

- Restriction on the borrowing of national companies on international financial markets;
- Shutdown of secondary markets (and hence OTC trading); only trade on the stock exchange is permitted;
- Restrictions, control and direction of the trade with the local currency e.g. by upper limits for export and import of the currency;
- Restrictions on provision of credit to foreign companies;
- Regulations on the transfer between foreign accounts (transfers between foreign accounts are subject to authorization);
- Cash deposit requirements, i.e. foreign investors must deposit a certain percentage of the transferred capital at the central bank or currency authority.

“Capital movement” means circulation of capital between countries with different currencies. Due to the effects of the circulation of capital on the balance of payments (every country has such a fictitious balance, covering export and import of goods, services, capital etc.) and hence on the currency stability of a country, the circulation of capital is frequently subject to regulation.

2.5. No Requests of Third-Party Countries upon the EU

To date, there are no known requests of third party countries upon the EU in the area of financial services. This is logical, in view of the fact that the EU market is already largely decontrolled in any case. However, as statements by the Association of German Banks at a hearing of the German Bundestag on GATS indicate, the banking industry would be happy to open up the not yet decontrolled areas on the basis of reciprocity. The requests to the EU involve principally Mode 3, i.e., the movement of natural persons. The profile of offers and requests shows generally, however, that the financial service sector is not an area of primary interest to the developing countries.

This is not really surprising, because with few exceptions, its financial services industry is weak, while the OECD countries are very strong competition in this area. The complete profile of Offers and Requests of the EU shows that what is at issue is to initiate an expansion offensive via the GATS based on:

(a) the great competitive power of the European financial service providers,

(b) growing competitive pressure, and

(c) the crisis-plagued developments on the financial markets.

Development policy interests, such as the legitimate protection needs of vulnerable national economies, with their often very insufficient supervision and regulation mechanisms, are just as unimportant as questions of system stability of the international financial architecture. On the basis of purely managerial considerations, corporate interests are taken as the basis of the negotiation strategy of the EU.

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40 Statement of the BdB, Committee Bulletin 15 (9) 353, German Bundestag
With this strategy, the already existing asymmetry between the North and South – in the financial service sector as elsewhere – is deepened. The result will be a redistribution effect in favor of the North. The efforts for stability-oriented reforms on the financial markets would be contravened. The stability risks for developing countries would increase.

**BOX 7  Bilateral Trade Agreements, the Fast Alternative to the WTO:**

**The USA and its Bilateral Agreements with Chile and Singapore.**

The USA is particularly competitive in the financial service sector, and has for years produced trade-balance surpluses in this sector, while its foreign trade otherwise runs a very serious deficit. In 2001, the surplus in trade in financial services ran to $6.3 billion.

Given this fact, the USA has a special interest in the elimination of trade barriers by its trading partners. In order to move this process along, the superpower depends less on the relatively time-consuming and complicated negotiations in the context of the WTO, than on parallel negotiations for bilateral treaties, which will improve the expansion possibilities of its own financial service providers.

Since the beginning of 2003, bilateral agreements with Chile and Singapore have covered the liberalization of the essentially important circulation of capital restrictions, which are so strongly disputed in GATS.* Thus, the elimination of the restrictions on market entrance and native treatment, which have to date only been demanded, but not achieved, multilaterally, have already been abolished bilaterally.

* See USCSI: *So-called Free Trade Agreements for Singapore and Chile*
3. POTENTIAL RISKS OF LIBERALISATION OF FINANCIAL SERVICES

by Myriam Vander Stichele

3.1. Potential Consequences for the International Financial Markets

The negotiations on liberalisation on financial services have generally not involved officials from the ministries and regulatory agencies working on reforms of the international financial system ("financial architecture"); rather, they have been conducted largely by the ministries responsible for trade, and ultimately by the EU Commission. They in turn have formulated their negotiating positions on the basis of detailed requests from the big FSI companies (see Chapter 1.6).

Hence, there is a deficit in concern for the GATS in precisely those institutions which have competence regarding issues of national and international finance, while trade-policy interests dominate one-sidedly. This applies both to industrial countries and to developing countries.

3.1.1. The Controversial Interpretations of “Prudential Regulation”

Formally, the GATS does not prevent any country from taking prudential measures to protect depositors, investors etc. or to ensure the integrity and stability of the financial system. As is stated in the Annex, however, such measures should not be used to avoid commitments or obligations under the GATS agreement. In other words, if a WTO member challenges a measure of another WTO member as being not a prudential measure, but rather a way to avoid a GATS obligations, a WTO panel must decide whether that is the case or not. Thus, central banks and other regulators loose their freedom to impose the prudential regulations they see as necessary. China, for instance, has imposed regulations which it considers prudential, e.g. regarding capitalisation requirements and setting up branches by foreign financial service providers, which are already being questioned by the EU and other WTO members as constituting unnecessary barriers to trade, or as violations of the principle of national treatment (WTO, 2002).

This raises the question of the danger of a chilling effect on regulations. If, for instance, some countries did not consider a currency tax ("Tobin tax") a prudential measure, they could accuse another WTO member which imposed such a tax of applying restrictions on international transfers in current transactions (if related to committed financial sectors), which would be a breach of Art. XI obligations.

3.1.2. Increasing Instability

According to the World Bank, IMF and Western countries, deregulation liberalisation of financial services strengthens the financial sector of a country and allows more stable – i.e., less volatile - sources of funds, provided that appropriate regulatory and legal frameworks and adequate supervision are in place, and that a well-sequenced policy of domestic reform of the financial sector and of capital account liberalisation is undertaken. In such cases, liberalisation might even improve the national regulatory framework, because foreign financial service banks could bring in new expertise, including the prudential standards of their home countries, and thus strengthen competitive disciplines. Increased competition due to the entrance of foreign banks can lead to cheaper and better consumer services, which are seen as crucial for economic growth.

However, as experience with the recent financial crises has indicated, deregulation of financial flows, e.g. for investments and loans through capital-account liberalisation, has increased the risk of a financial crisis in countries that failed to develop a strong regulatory and
supervisory framework prior to liberalisation. Foreign banks can contribute to a financial crisis by imprudent short-term lending policies, and by “herding behaviour,” as was the case in the Asian financial crisis. It is now recognised that, under the conditions of globalisation, the stability of the national and international financial systems relies on the scale and sequencing of financial reforms, and that a gradual and considered approach to the deregulation of financial services and financial flows is needed to make financial liberalisation beneficial for the economy (id21, 2002).

That the presence of foreign banks and insurance companies also carries with it some particular risks of financial instability, is less recognised. As the World Bank puts it: Access to financial services is what matters for development, not who provides it (World Bank, 2001).

One way that foreign banks tend to import instability is by lending in foreign currencies. This leads to inflows but also outflows for the repayment of loans, and pressure on foreign exchange reserves, particularly if those loans are short-term. In China for instance, experience of the early phases of liberalisation has shown that foreign banks have become one of the important channels for bringing in foreign capital, by loans in foreign exchange, amongst other avenues. Because this increases the rate of inflow and outflow of international capital, it can dramatically increase the exchange between the local and foreign currencies. Consequently, the balance of payments deficit can increase, and with it the risk of financial instability. These increased capital fluctuations have come on top of China’s dramatic increase in its service trade deficit, which has had a further negative impact on the country’s balance of payments. This has had a major impact on China’s monetary policy, and has strained the macro-regulatory mechanisms of its financial system.

Another way that foreign financial services can bring about pressure on the balance of payments of countries is when foreign financial services increase the outflow of capital by offering services that involve allocating money abroad, such as credit risk mitigation systems, or the purchase of securities abroad.

The GATS plays a role in the risks associated with the financial flows related to foreign financial service providers. GATS Art. XI does not allow countries to restrict international transfers and payments for current transactions which are related to services in sectors which they have liberalised under the Agreement (i.e. commitments already entered into). That means, in effect, that a country cannot prevent profit repatriation by foreign service providers in sectors in which a country has made commitments. Thus, if a country has liberalised the financial sectors, foreign banks and insurance companies can transfer their profits abroad without reinvesting them in the country.

Moreover, Art. XI has a special effect in relation to financial services provided by foreign banks, insurers and asset managers established in countries which have deregulated these services under GATS (Mode 3), in cases where these financial service providers view financial inflows and outflows as essential to their services, i.e., lending in foreign currency (see China), buying securities abroad to balance the risks in pension fund management, increasing the return of asset management services for local clients, or providing derivatives and using international credit risk mitigation mechanisms.

If such capital flows reach significant volumes, they can increase financial instability in the country itself, but also import financial crises from abroad. Footnote 8 of the GATS (WTO; 2003 b) agreement commits a country to allowing inflows of capital related to sectors which it has deregulated under GATS. In principle, countries can regulate the outflow of capital, but many countries have already deregulated capital flows. Moreover, capital flow restrictions as mentioned above related to foreign financial service providers present in the country might be seen as a breach of Art. XI. So far, this is a little discussed area about which experts yet have no clear answer.

Discussions have recently started in the WTO on the deregulation of financial services that do not have a presence in the country (Mode 1 and e-financing through e-mail and the Internet), but rather provide their services from abroad(WTO, 2003 b). Liberalisation of such cross
border financial services can have a destabilising effect because they are typically in foreign currency and involve cross-border financial flows through such financial “products” such as lending of all types, and asset and portfolio management provided by foreign service providers. Footnote 8 of GATS Article XVI (“Market Access”) states that if a country makes a market access commitment in Mode 1 of a sector, it also commits itself to allowing cross-border movement of capital that constitutes an essential part of the service itself. In the view of Brazil, this footnote could be tantamount to capital account liberalisation, i.e., the deregulation of major transfers of money for loans, even if a country has not fully liberalised its capital account system. Such cross-border capital transfers could affect the balance of payments and the whole financial stability of a country.

The GATS Understanding on Commitments in Financial Services requires countries to make only very limited commitments in Mode 1, while the Annex on Financial Services covers a much broader range of financial services, such as lending of all types. The European Union, the US and other western countries downplay the importance of the impact of opening up Mode 1 in financial services, but little research has been done to date on this issue. The impact of e-financing for cross-border capital movements and consumer protection is still being discussed by the supervisory authorities. The EU has made requests to open up Mode 1 to the US for selling derivative products, and to many developing countries, as is required in the GATS Understanding (MAT insurance, reinsurance, and provision and transfer of financial information).

The increased inflows and outflows of foreign capital that might result from the liberalisation of financial services need careful monitoring and management by the financial authorities, especially in small countries where swift flows can have a major impact.

WTO members are allowed to not apply Art. XI, provided they do not thereby restrict trade and commitments made. Art. XII allows countries to restrict their market opening commitments in the financial sector (or other sectors), and the international transfer of money related to it, in case of serious balance of payment problems. A country that invokes these restrictions, however, needs to fulfil a number of conditions, including the criteria of non-discrimination and least-harmful affects upon foreign service providers, consistence with the Articles of the IMF, and time limitation of the measures. The country also must undertake consultations with WTO members; ultimately, the assessment of the IMF of the financial situation of the country determines whether the restriction measures are to be allowed.

Art. 2 on domestic and prudential regulation in the GATS Annex on Financial Services also allows a country to take prudential measures against foreign exchange exposure. As explained, the Article states that such measures should not be used to avoid commitments or obligations under the GATS agreement. However, the conditions attached to the prudential carve-out measures may cause countries to avoid taking measures which, while contravening GATS commitments, are nevertheless the most effective for dealing with financial instability.

3.1.3. Insufficient Consideration of National Regulation

At the national level, not all countries are prepared to face the risks of greater liberalisation of financial services. For instance, sudden intensification of competition may encourage short-sighted panic responses by previously protected domestic financial institutions (Eichengreen, 1999, p. 46-48). For in the negotiations, virtually no concrete link is made between the existing state of a country’s financial system or its needs for a functional regulatory framework and supervisory system on the one hand, and the requests or offers of financial service providers on the other. For one thing, the regulatory authorities will have to han-

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41 Namely MAT (maritime shipping, commercial aviation, space launching and freight) insurance, reinsurance, insurance of goods in international transit, and the provision of financial information and advice.
The EU requests do not address the capacity of countries to deal with these increased risks. For instance, the EU has asked China to open itself up for derivative products and investment fund management, instruments which involve a significant speculative component. China has gradually reformed its regulatory framework to adapt to international practice, but admits that its regulatory authority still falls behind that of the developed countries, the homes of the foreign banks. It recognises that the tremendous changes due to entrance of foreign banks and their impact on domestic banks increase the risk of instability and make regulation even more difficult to enact than it already is in a country like China – and add costs to the financial administration. Although the IMF has a programme in place to monitor the reforms and the strength of financial-sector regulation and supervision, it is, as the US representative put it during a WTO meeting of the WTO’s Working Group on Financial Services, up to the negotiators of each country concerned to deal with the issue themselves (WTO, 2003 b). The EU claims that the regulatory and supervisory issues will be discussed during the bilateral negotiations – i.e. far from public eyes, when the pressure to liberalise is the highest priority. How will the EU deal with the IMF’s assessment that the regulatory system in Thailand is not yet efficient enough and that further liberalisation entails systemic risks for that country?

The IMF and others have recognised that considerable and costly capacity building is often required to educate regulators, supervisors, legislators and the judiciary in order to create the appropriate framework for financial services. Although the operation of foreign banks is under the supervision of the authorities of the home country, which might have ample experience in monitoring their operations, these authorities are mainly interested in avoiding bankruptcy of the bank. This means that they are less concerned with the needs of the country in which their banks operate. Also, this means that regulators and supervisors of countries in which foreign banks operate might not have all the information they need, although cooperation between home and host country supervisory authorities does exist.

3.1.4. Liberalisation of Financial Services in the Fast Lane - Reform of the International Financial System Stalled

At the international level, the current GATS negotiations on financial services are taking place at a time when the reform of the financial system announced after the Asian financial crisis has bogged down. At the spring meeting of the IMF in 2003, the discussion of an insolvency regulation for sovereign debtors (states), which had originally been proposed by the U.S. vice-director of the IMF, Ann Kruger, was removed from the agenda. Merely a so-called “collective action clause” was accepted. The German federal government had, as recently as the autumn of 2002 in its post-election coalition agreement, declared itself in favour of an insolvency procedure for sovereign debtors.

Proposals for reform involving improved supervision and stricter regulation of offshore centres and tax havens have largely fallen by the wayside. Some countries with tax havens have not yet reformed their systems. A considerable amount of money from drug-trafficking, the illegal arms trade and other criminal operations is laundered in this manner. International measures to control the risks stemming from the highly speculative hedge funds, which are increasingly active in times of low value of stocks are still very weak. Whether the new standards for risk management in lending established by the BIS ("Basel 2"), will in fact fulfil their much-lauded promise, remains to be seen. Indeed, Basel 2 could actually increase the ten-
dency of international banks to take more risks in their lending and investment activities. Only the next crisis will tell.

An important issue in the reform of the financial system is improved transparency by banks operating internationally. Publishing more information increases “market discipline” in the financial markets because investors and customers can assess the bank’s state of affairs and act accordingly; in addition it opens up more opportunities to supervisory authorities to play their role. A review of fifty-four international banks in 2001 showed that they disclosed only 63% of the items considered important by the Basel Committee of Banking Supervision (the association of all major supervisory authorities). While that was an improvement over the previous years, it was still far from sufficient. In particular, information about their techniques for mitigating credit risks (including more speculative credit derivatives) was lacking, which makes it difficult to monitor from the outside their practices and expertise for avoiding bad loans, a major source of instability. Ironically, while GATS makes greater transparency of governments on service regulation a priority, it does not address the lack of transparency of service providers operating internationally, which poses many problems for host country authorities, particularly in the financial sector.

Liberalisation of financial services which is not embedded in a new financial architecture that serves the needs of the poor and of sustainable development is a dangerous strategy that increases the overall instability of a globalised economic system.

3.1.5. Increasing Concentration Processes in Financial Services

A recurring request in the EU requests, even to many developing countries, is that countries give up their restrictions on full foreign ownership of banks, and their legal requirements that foreign banks only participate through joint ventures. The argument is that full ownership results in better allocation of resources than in financial service companies which must have local elements. However, increased full foreign ownership of banks would raise many questions. For instance, how is the presence of foreign financial service providers to lead to a transfer of know-how to local banks, given the fact that foreign banks tend to attract more experienced personnel from domestic banks and other foreign banks in the host country (see China’s experience, below) than they lose personnel to those local banks? What would be the consequences of having 80% of private financial assets in the hands of foreign financial service providers, as is the case of Mexico?

A major issue related to the full ownership request by the EU is the continuing consolidation and concentration of the financial service sector. Analysts predict that there will be only five to ten top banks in the world in ten years’ time (Vander Stichele, 1999) Citigroup once declared that it wanted to have one billion customers in ten years. Allowing more international banks to fully own banks in an increasing number of countries is likely to increase this trend towards world wide concentration of financial services in the hands of a few big players. This involves the risk of creating banks which are too difficult to monitor and “too big to fail” – i.e., to be allowed to fail – when things go wrong. The government then has to step in as the “insurer of last resort” – “socialising” the losses, while profits are privatised.

Such a high concentration of economic power leaves governments – which have to borrow – and customers too little choice, which can unnecessarily increase prices. During the first phase of competition, prices might fall, but later, when only a few players dominate the sector, tacit price-fixing may drive them back up. These are not hypothetical questions; rather, such secret price-fixing has occurred repeatedly, even if it only seldom comes to light, as it did recently in Germany. Authorities reported that the insurance companies Allianz, Gerling, HDI, Axa, Aachener, Münchener, Gothaer and Victoria, engaged in illegal price-fixing to the detriment of their industrial customers. Allianz board member Hagemann has now admitted: “There were informal contact groups.”

46 Frankfurter Rundschau, 31.7.2003
Consolidation is, ironically, a response by the financial industry to increased competition, in order to increase profits. The EU requests for more market opening in financial services (through full ownership and otherwise) and the GATS liberalisation of financial services in general have increased this worldwide competition. Strong competition among financial services leads to difficult dilemmas. On the one hand, it may enhance the efficiency and lending of the banks with the resulting benefits of lower prices for consumers and the whole economy. On the other hand, more competition may tempt banks to engage in too-risky lending – as was the case in the Asian financial crisis – and other practices that destabilise the banking industry, which has very costly repercussions for the economy.

These issues are increasingly being discussed at top governmental levels. According to a recent finding (Canoy et al., 2001), many forms of competition do not endanger financial stability, and in cases where competition does affect financial stability, the appropriate safeguard is sound prudential regulation or good corporate governance, rather than limiting competition. This means, however, that the functional regulatory and supervisory authorities have to be in place and efficient, in order to guarantee fair competition, which is not always the case in many developing countries. Governments thus have to be cautious when liberalising financial services, in cases where national and international instruments designed to deal with the risks of greater competition are not in place.

Due to increasing competition and pressure to step up profitability, as well as to successful requests by the financial sector for more deregulation, ever more international banks tend to be integrated banks i.e. active in a number of types of financial services (e.g. banking, insurance and securities). More competition among banks due to GATS might increase this tendency. However, while increased integrated banking brings with it such benefits as reduced costs, more product diversity and cross-subsidisation of the different activities within the financial company, it also involves such risks as conflicts of interests between the different services (as seen at the major investment banks), more concentration of economic – and hence political – power, the greater difficulty for the authorities in monitoring integrated banks, and the necessity of providing “safety nets” for those activities of a financial service company which go beyond banking (Claessens/Klingebiel, 2001, p. 19-44).

3.1.6. The impact of the EU’s request for liberalising pension fund management

The EU has made requests to many developing countries to liberalise their pension fund management services. Such expansion of European pension fund services to the rest of the world could introduce imprudent practices in other parts of the world. Pension fund management has increasingly relied on buying shares to provide the necessary returns on capital to finance current and future pensions. When share value decreased dramatically and pension funds lost money, it became clear how risky this strategy had been and how it could endanger the provision of pensions by these privatised systems. For instance, the Dutch pension funds and their managers invested 46% of their capital funds in shares on the national and international stock markets as of June 2002. In 2003, it was revealed that many pension funds could not fulfil their obligations any longer, as the return on investments over the previous three years had been 30% less (i.e. around €135 billion less!) than expected by the fund managers: in May 2003, one in five pension funds had mismanaged the funds used to cover future pension payments. The pension fund supervisory authorities had to intervene to force pension funds to come up with strategies to ensure all future payment obligations. Now, new income is generated by increased contributions by employees and employers – decreasing workers’ income and companies’ profits – or by lowering payments to pensioners. At the same time, some pension funds are restructuring or merging, decreasing their numbers. In the UK, pension funds face similar problems.

Experience in Latin American countries shows that the benefits of pension reform and privatisation have been overestimated, and that the administrative costs are high (Queisser/Reisen, 1997). The question is whether European and other foreign pension fund man-

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47 See for instance recent World Bank research on bank concentration and competition.
agers will be cheaper and make additional pension insurance available to more poor workers. Moreover, new pension funds raise new regulatory questions for which there are not always any answers yet, and require regulatory capacity which, as already mentioned, is not always available, especially in developing countries.

Even in developing countries, pension funds are buying national and international shares to diversify their risks and achieve a guaranteed return on capital. However, the uniformity of the investment portfolios of many pension funds can undermine the risk-diverting strategies. Moreover, the purchase of international shares has caused great instability in the financial system, because pension funds have billions of dollars to invest. It has helped to create the bubble of high share prices and rapid decrease in share values, once prices started falling, and pension funds have tried to limit damage by reorganising their portfolios. It could also mean that pension funds in the South would be buying more shares and bonds in the North, thus increasing the flow of capital from the South to the North.

The linkage of pensions to the international capital market raises basic, long-term questions. In effect, the purchase of shares in slowly-ageing countries such as the “emerging markets” by funds in such fast-ageing countries as those of the OECD is a strategy designed to maintain high returns on capital for more and more pensions, since the return on capital will decrease in OECD countries as the share of non-working segment of the population rises. However, research shows that such strategies only slightly attenuate but do not reverse the consequences of ageing populations (MacKellar/Reisen, 1998: p.35). The capital flows to slowly ageing countries nevertheless have an important effect on the distribution of wealth: they benefit especially the working population of the slowly ageing countries of the south – as long as there is no crash. In the fast ageing countries, they benefit the rich elderly with well-funded pension systems, while hurting the poor pensioners who rely on payroll-tax financed pension systems.

At a time when there is increasing social protest unrest (Spring 2003) in countries like France and Italy against privatization of pension funds, it would be politically inadvisable for the EU to put pressure on developing countries to allow European companies to impose such a pension system there.

3.2. Specific Risks of Liberalization for the Developing Countries

In the literature, many arguments can be found in favour of, as well as against the presence of foreign banks (Bies, 2003)

The arguments put forward by those in favour of liberalisation are:

- reduction in overhead expenses and profit-taking by domestic banks due to increased competition by foreign banks;
- increased efficiency and diversity of financial services;
- spill-over effects of foreign bank entry, such as the introduction of new financial services and of modern and more efficient banking techniques, and the improvement of domestic bank management;
- improvement in bank regulation and supervision due to the entry of new financial service providers and new financial services;
- less interference by government in the financial sector, to cover up bad practices;
- training by foreign banks, resulting in more experienced personnel in the financial sector of a country;
- the presence of foreign banks stimulates domestic investment in the host countries;
- foreign banks may attract (other) foreign direct investments and enhance a country’s access to international capital;
• well capitalised foreign banks may be able and willing to keep lending to domestic firms during adverse economic conditions, while domestic banks would probably reduce the credit supply;

• foreign bank entry leads to better lending terms (lower interest rates, lower fees, longer maturities) for all but larger firms.

The arguments put forward for those opposing foreign entry are:

• domestic banks are not able to cope with increased competition, and may stop operating, which can cause disruptions and political concerns about increased foreign control of the financial market;

• trying to cope with increased competition from the foreign banks and implementing new techniques may raise costs for local banks in the short term, which they would then finance by raising their profit margins, in turn leading to price increases for consumers;

• foreign banks get higher interest margins;

• foreign banks entry into the market of loans to corporations does not decrease the margins and profits in the personal loan market;

• foreign banks will not provide additional credit during an economic downturn in a host country;

• foreign banks will leave the country when the profitability is too low, which can undermine stability in financial services;

• changes in economic conditions in the foreign bank’s home country may have a negative effect on bank activity in the local market;

• foreign banks only provide credit to large and often foreign-owned (multinational) firms, and tend to lend less to small firms;

• domestic supervisory and monetary authorities often fear that their influence on banks’ behaviour may diminish as supervision of foreign banks is done by the authorities of the home country.

In the following, some concrete experiences of developing countries are described, in order to examine the real impact that further liberalisation of financial services might have under GATS.

The experience of 80 countries between 1988 and 1995 shows that foreign banks in developing countries tend to have greater profits, higher interest rates and higher tax payments than domestic banks (while in developed countries this is the case for domestic banks). Also, competitiveness is increased much more by a large number of entrants than by a few with large market shares (Huizinga et al., 1998).

In Latin America, which has high foreign bank presence, research shows that the argument for increased efficiency of domestic banks through lower overhead expenses and less profit taking only holds true for countries at the lower end of the economic development scale (e.g. Peru, Colombia, Ecuador and Bolivia), but not for the more developed countries such as Brazil (Bies, 2003). The research also shows that foreign bank entry can have positive effects on the credit stability of domestic banking systems. However, before opening up, the less economically developed countries should consolidate and strengthen the domestic banking system in order to be able to face international competition. These findings confirm a case study of the Dutch bank ABN Amro in Brazil, which showed that it was not more efficient than domestic banks which had experienced – and survived – many financial crises (Vander Stichele, 2002). ABN Amro’s higher profitability, like that of other foreign banks, was due to a large extent to Central Bank policies and its status as a foreign bank, which many people trust, even if they have to pay more.
3.2.1. Effects of Liberalisation on Emerging Markets

The financial sector in "emerging markets" and higher-income developing countries are a major target of the EU requests, although the EU has also addressed financial service requests to 20 least developed countries and 30 low-income countries. The financial sectors of emerging markets was already a major target of the North during the previous GATS negotiations. Because the US was not satisfied with the initial offers for market opening in financial services by the emerging market countries of Southeast Asia, the financial service agreement could not be completed until after the Uruguay Round was over. In 1997, the Asian financial crisis did not stop the Western negotiators on financial services, and especially the US, from requesting further liberalisation. The US abused the need for external rescue packages by the countries in financial crisis to pressure them to open their markets even more; the WTO took the position that liberalisation of financial services would tend to help avoid future financial crises.

China has, in the course of its negotiations for accession to the WTO and during the current GATS negotiations, become a major target for financial services providers. China’s opening up to foreign banking and insurance companies promises more profits for big internationally operating banks.

In China, the experience of liberalising financial services to date – full opening has still not taken place - reflects experiences in other countries.

(a) Positive:

- Foreign banks are improving the functioning of the financial system: they are promoting the competitiveness of domestic banks and bringing in new experience in risk management, internal controlling, incentive mechanisms, business innovation and accounting.

- There have been increased foreign capital inflows, and an improvement of the investment environment.

- After entering the Shanghai market, a major US insurance group (American International Group) introduced a recognised insurance marketing system, stimulated the domestic insurance market, strengthened the idea of customer-oriented service among Chinese insurance companies, and promoted the development of the personal life insurance market.

- Foreign financial service companies provide more advanced services and financial innovations to consumers in China.

(b) Negative:

- “Cherry picking”: Domestic banks loose especially rich clients (“high end consumers”) to foreign banks. Since such rich clients provide most of the profit for a bank (according to Chinese statistics: 80% of the profits come from the richest 20% of the clients), domestic banks are losing profitable clients and are left with the less profitable ones, which can further undermine their capability to compete with foreign banks, which in turn are not interested in serving poorer clients.

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49 This phenomenon is being used in many countries, for instance in Turkey (see: M. Karatas & M. Broadbent, Foreign banks in emerging markets: a Turkish success story, in id21 Society & economy, 29 April 2003 (www.id21.org/society/s7amk1g1.html) : Turkey is not considered to be typical of emerging markets because foreign banks only control 2% of domestic banking operations (in Poland they control 36%) and 40% is still in hands of large public banks. Twenty-one foreign banks are operating in the country. The most successful foreign bank has first served multinational and government clients and was able to survive the financial crisis in Turkey (high inflation, volatile market) through adaptive and aggressive strategies and by segmenting the market amongst others to financing of the many privatisation projects, focusing on corporate banking and credit cards, limiting its physical distribution network and careful selection of clients and sectors to which it provides services. In other words, foreign banks have the ability carefully select the most profitable sectors and clients and are not interested in full expansion all over the country, increasing the unequal development between the different Turkish regions.
• Brain drain: Domestic banks are losing many capable senior executives and key personnel. This leads to a lack of experienced executives in domestic banks and further undermines the swift development and improvement of these banks.

• Widening the gap: The imbalance of economic development between the eastern and western regions of China in widening further as more foreign investments – and their banking services – flow to the more developed eastern part of the country.

(c) Challenges:
• The entrance of foreign insurance companies has shown a dramatic expansion of these companies in a short period of time. Foreign banks have developed their activities very fast. This makes it difficult for Chinese companies to meet the fierce competition, while the supervisory and regulatory authorities have trouble keeping abreast of the developments and their risks.

• GATS has also provided for China’s insurance companies the opportunity to establish abroad, but Chinese financial services lack the competitive edge (and still need a lot of restructuring) to expand abroad to the extent that foreign financial services are capable of entering the Chinese market. This adds to a deficit in service trade, and to balance-of-payments problems.

• China needed to introduce new regulatory bodies for supervising the insurance and securities sectors, alongside those regulating and supervising the banking sector. (Note that Western regulators and supervisors have come to the conclusion that these regulatory bodies are not adequate, but need to be integrated, as financial institutions are increasingly involved in banking, insurance and securities at the same time);

• Loans issued in foreign exchange have rapidly become an important channel for capital inflows into the country, providing capital for domestic enterprises, but also increasing foreign exchange and capital flow instability (see above), which requires careful macro-regulatory management of the financial system and monetary policy by the authorities. Transaction techniques have become more complicated, and China’s financial institutions are experiencing tremendous changes which increase the risk of instability. China admits that its administrative capacity of the regulatory authority still falls far behind that of many developed countries and that continuous reform and improvement is needed, which adds to the difficulties and costs of administering the financial system.

3.2.2. Consequences for Other Developing Countries
Especially in poorer developing countries, the banking system is considered inefficient and unreliable, which carries with it a high economic cost and prevents economic development, trade and investment. Therefore, it is claimed, the entry of foreign banks makes domestic banks more efficient by more competitive banking markets. However, “more efficient” also means “less profit”, and less profitability and greater competition can also lead to more risky lending practices by smaller local banks (Huizinga et al., 1998). Also, volatility risks are greater for smaller economies, which are more vulnerable to capital movements.

In Sub-Saharan Africa, experience of increased foreign participation in the domestic banking sector to date has shown such benefits as improved quality, pricing and supply of financial services and in risk management, accounting and transparency as well as increased competition (Murinde/ Tefula, 2002). On the other hand the costs have included increased exposure to capital flight, which destabilises domestic bank credit: Foreign banks withdraw quickly from the domestic market in face of a financial crisis. Moreover, they are not necessarily better capitalised than local banks – although better capitalisation is often claimed as an advantage they enjoy, making them more resistant to financial crises – nor do they have fewer bad performing loans. They use their financial power and international status to focus on the most lucrative transactions (“cherry-picking”). The presence of foreign banks increases loans by
both domestic and foreign banks, but the variability of the loan supply decreases. Foreign banks can out-compete locally owned banks in smaller economies because they can recover their high set-up costs from profitable operations elsewhere. And they can expand rapidly: in Tanzania, liberalisation for foreign banks increased their presence from 5% before 1980 (when policies were restrictive) to 76% in 2002.

Also, the insurance sector in Africa has so far remained underdeveloped and without the necessary backing from governments. Lack of capacity and expertise has prevented the sector from starting viable commercial relations among African countries and making them fully prepared for international competition at home and on international markets.

This means that the EU request for eliminating restrictions on the full foreign ownership in small or poor developing countries can easily lead to domination by foreign banks. Dominance by foreign banks makes these countries vulnerable to strategies of financial companies which leave the country when profits decline and make it more difficult for the authorities to manage the financial system. This was illustrated in Kenya when foreign banks formed a cartel that fixed high interest rates, which resulted in high costs for the consumers and the economy. Moreover, the question as to how profits are to be reinvested in the country remains unanswered, as GATS Art. XI forbids a restriction on the transfer of profits.

3.2.3. Undermining Poverty Eradication

The request of micro-credit organisations for financial services for the poorest populations segments is of great significance in development policy. So-called micro-credits of just a few hundred dollars have proven an effective instrument for development.

Yet foreign banks have little interest in providing credit to poorer clients, or managing their finances. Their “cherry-picking” policies, especially in the poorer countries, are oriented towards the richer market segments; this leaves the poorest, who are most in need of better financing, to other initiatives such as micro-financing.

According to the World Bank, the entry of foreign banks results in the spread of better lending techniques, so that small borrowers gain new access to financing, and to a greater diversity of financial products and allocation of capital, which stimulates the economy (World Bank, 2001). By this logic, there should be no reason for countries to restrict foreign banks to take deposits from small depositors as has been the case in South Africa. But South Africa is atypical. A more typical case is Ghana, where a British bank has been asking payment for deposits below a certain amount.

The situation is also similar for foreign health insurance companies, as was researched in Kenya (SOMO/WEMOS, 2003). These companies tailor their services to the wealthy city-dwellers who are already able to pay their hospital bills. They charge high premiums, unaffordable to poor patients. They refuse to accept patients who suffer from illnesses such as HIV/AIDS. This is in sharp contrast to the government’s public health insurance system, which is obligated to accept all patients. During the previous GATS negotiations, Kenya agreed to liberalise its financial services without fully realising that it was also subjecting the health insurance sector to the GATS rules. Article XVI prohibits governments from taking six specific kinds of measures to place limitations on companies, such as restricting the number of service suppliers. During the negotiations, the Kenyan government could have reserved the right to impose a universal service requirement for foreign insurers only, but did not do so. The government can now require foreign companies to insure poor and vulnerable (HIV-positive or terminal) patients only if it also sets the same requirement for Kenya-based insurers, according to the GATS principle of non-discrimination and national treatment (Article XVII). Whether countries will impose universal service obligation is another matter, as it is considered to have an unfavourable impact on the banks’ profitability and stability.

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50 Africa’s insurance industry needs assistance in Addis Tribune, 7 June 2002
51 J. Marchetti (WTO Economic Affairs Officer, Trade in Services Division), letter of 25th June 2003.
The EU requests are addressing measures that support poverty alleviation. For instance, the EU considers the requirement applied to all banks in Malaysia to provide quotas for low-cost housing as a limitation that should be scheduled. This means that measures to provide poorer families with the financial resources needed for housing are not considered falling under the “right to regulate”, but rather as a trade barrier that must be exempted from the GATS agreement, and ultimately eliminated.
4. Conclusions and Proposals of Civil Society

In view of our analysis, the following conclusions emerge: The GATS negotiations for the liberalization of financial services generally and the requests of the EU in particular:

- ignore the risks to the stability of the financial systems in the developing countries;
- ignore the epidemic and domino effects which crises in a developing country can have on other developing countries;
- overtax the regulation and supervisory authorities in numerous developing countries;
- take no account of the issue of poverty alleviation, and in many cases even undermine such efforts;
- do not provide viable offers to the great mass of the poor in such central development-policy areas as health and old-age care;
- lead to redistribution effects to the benefit of the middle class and the elites in the developing countries;
- overtax the negotiating capacities of many developing countries, especially those of the poorest;
- concentrate on the interests of the highly competitive financial service providers of the industrialised countries;
- are being used to compensate, by means of a liberalization offensive, for the results of the crisis brought upon the industry by the bursting of the speculation bubble in 2001;
- are in glaring contradiction to the public claim that the new round of negotiations is a "development round;"
- in the final analysis deepen the asymmetry already existing between the North and the South.

As a result, the following demands should be made to the EU and the WTO:

1. No rush to liberalization. What is necessary prior to any deregulation is an impact assessment of the liberalization of financial services, which would examine aspects of financial stability, development policy, dangers to social and distribution policies, and issues of consumer protection.
2. For the poorest category of countries, capacity-building measures to strengthen local financial service providers as well as regulative and supervisory structures should have priority.
3. No pressure should be put on developing countries to undermine existing regulations which serve the stability of the financial system, development policy goals, or poverty alleviation.
4. Concepts must be developed for harnessing the financial service industry to the needs of development and poverty alleviation. Services for securing the livelihood of the poorer segments of society, such as health and retirement insurance, as well as for providing them with access to financial resources, should have priority.
5. The discussion of financial services must be brought out of its experts’ niche and made public and transparent.
6. Before further steps for the liberalization of financial services are requested by developing countries the North should make substantial concessions to the South, for instance in Mode 4 of the GATS, but also in the area of agriculture (e.g. The negotiations should not be overburdened by such new Schuknecht et al. 2003). topics as competition, investments etc..

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