Unclassified **DAFFE/MAI(96)25**

Organisation for Economic Co-operation and Development
Organisation de Coopération et de Développement Economiques

29 August 1996

Negotiating Group on the Multilateral Agreement on Investment (MAI)

THE TREATMENT OF FINANCIAL MATTERS IN THE MAI

(Note by the Chairman)

This document was issued during the MAI negotiations which took place between 1995 and 1998.
All available documentation can be found on the OECD website: www.oecd.org/daf/investment

THE TREATMENT OF FINANCIAL MATTERS IN THE MAI

(Note by the Chairman)

I. Issues

1. The MAI is to be a comprehensive multilateral agreement setting high standards of liberalisation and protection for international investment in all economic sectors, including the financial sector.

2. The financial sector represents a large and growing share of national economies. The financial system --institutions and markets -- plays a critical and unique role in the determination and allocation of domestic saving, the financing of the overall economy and the payments and settlement system.

3. The treatment of financial services in the MAI gives rise to a number of important issues from the perspectives of regulators as well as services providers in the financial services sector. Some issues may require solutions that are unique to the financial sector; others may require solutions that are important for liberalisation of the sector and might have broader application.

4. A key issue for financial services concerns the treatment of *prudential measures* in the MAI. The interface of prudential measures with the MAI basic obligations and other provisions such as dispute settlement mechanisms or denial-of-benefits clauses[1] are of particular relevance for financial services. In view of the special nature of financial services, there is a need to ensure that the application of National Treatment and MFN obligations does not prevent the legitimate exercise of prudential oversight aiming at protecting users of financial services and ensuring the stability and integrity of the financial system. Another issue includes the extent to which government entities may require a carve out to conduct monetary policy, to limit transfers for prudential reasons and for central banks to limit their exposure as lenders of last resort. At the same time, there is a need to ensure that the invocation of prudential considerations does not lead to abuse and denial of market access to sound foreign investors.

5. Another issue relates to the treatment under the National Treatment obligation of formally non-discriminatory rules which may amount to restricting *effective market access*. In the context of financial services, "market needs" tests are typical examples of such rules. Incorporation requirements prevent the establishment of direct branches by non-resident institutions which, in the context of financial services, is an especially important form of foreign investment[2]. Dotation capital requirements for branches may discourage their establishment and limit their operations. Another issue is whether established foreign financial institutions would have the right to introduce new services already provided in their home markets but not available in the host country's markets, which may be due to the host country's regulations. Effective market access may also be affected by the existence of exchange controls which, although formally applied on a National Treatment basis, may seriously limit business opportunities for, or bear more heavily on, established foreign financial institutions as the latter are often oriented towards international operations. The issue of a balance-of-payments derogation clause under the MAI may be examined in this perspective.

6. A third issue relates to the treatment of *selective recognition and harmonisation arrangements* under the MFN obligation. Although it is not specific to financial services, it is an important issue as there is an increasing number of instances where host countries recognise, generally on the basis of bilateral or regional mutual recognition arrangements, the prudential standards of other countries and agree to waive

some or all of their licensing requirements with respect to financial institutions originating from these other countries.

7. A fourth issue concerns the definition of investment and how it relates to *capital market transactions*. This issue is under discussion by the Drafting Group N° 3 with respect to the definition of an investment and the coverage of the agreement. There is agreement to work on a broad definition of investment which includes portfolio investment. Financial market participants have an interest in the outcome of this discussion as financial institutions are the main channel for portfolio investment abroad.

8. Other issues that may need to be addressed include, for example, whether the application of *transparency requirements* to the investment approval process is sufficient to support liberalisation in financial services, and whether there is a need for provisions allowing financial firms to transfer data and to have access to payments systems and membership in stock exchanges or other markets.

9. The following section highlights a number of examples where issues unique to, or important for, financial services have been dealt with in investment provisions of several existing international agreements.

II. Existing disciplines

10. Relevant articles from existing agreements are available in DAFFE/MAI/RD(96)33. They are briefly described below.

11. The **GATS** contains an Annex on Financial Services which provides for the right of Members to take prudential measures which may not conform to commitments to provide market access, national treatment or MFN but stipulates that this right should not be used for the purpose of escaping from these obligations. The Annex also provides that a Member may recognise prudential measures of any other country in determining how the member's measures relating to financial services shall be applied. At the same time, it provides for an obligation to afford third countries adequate opportunity to negotiate their accession to recognition arrangements[3]. Also, panels for disputes on prudential issues and other financial matters shall have the necessary expertise relevant to the specific financial service under dispute. The Annex finally contains a non-exclusive list of what should be considered financial services.

12. The GATS also contains an Understanding on Commitments in Financial Services (which results from an initiative by OECD countries). Its application is optional. Members do not formally "adhere" to it, but may use it without further formality as an "alternative approach" to scheduling specific commitments on financial services. The Understanding aims at pushing further liberalisation with respect to financial services. Application of the approach must not conflict with the provisions of the Agreement. The MFN obligation and commitments to National Treatment of the GATS will apply for the benefit of all Members, including those who have not adhered to the Understanding. The main characteristics of the Understanding are:

- an explicit standstill obligation;

- a top-down approach, through the formulation of ideal standards of liberalisation from which Members are expected to take only limited reservations.

13. The **Code of Liberalisation of Capital Movements** contains no special provisions with respect to investment in the financial sectors. Article 5, however, provides that controls and formalities to prevent

evasion of laws and regulations are permitted but that they must not be more extensive than appropriate. Article 5 is applicable to prudential measures.

14. It can be noted that the Capital Movements Code covers all cross-border capital operations (both payments and underlying transactions), including capital inflows and capital outflows, irrespective of their maturity and of their currency of denomination. In particular, it covers the freedom for non-residents to make portfolio investment in domestic securities (including purchases of government debt securities, money market securities and collective investment securities), extend trade and short-term credits, engage in foreign exchange, derivatives and deposit account operations which are not linked with an underlying direct investment -- all areas which represent key business activities for financial institutions.

15. The **Code of Liberalisation of Current Invisible Operations** covers *inter alia* trade in insurance, banking and financial services on a cross-border supply basis or through branching. It contains a prudential provision somewhat similar to that of the GATS Annex on Financial Services[4]. It is complemented by a provision aiming at avoiding abuse, again in the same spirit as that of the GATS Annex on Financial Services.

16. Furthermore, Annexes I and II to Annex A of the Current Invisibles Code contain detailed provisions as to what should be considered acceptable requirements for the establishment and operation of branches by foreign insurers and non-resident investors in banking and financial sectors[5]. These annexes use the notion of "equivalent" treatment rather than "national" treatment. They also include provisions on representation and representative offices, and as far as banking and financial services are concerned, provisions preventing the imposition of nationality requirements on established financial institutions for membership in private professional associations, self-regulatory bodies, securities exchange or markets or other private associations.

17. **NAFTA** contains a special chapter (Fourteen) on financial services which establishes separate rules for both cross-border trade and investment in financial services. Its investment provisions are modelled on the rest of the Agreement. The financial services chapter has also been drafted to be compatible with the GATS. National treatment and most-favoured nation treatment remain the core principles. The concept of National treatment includes that of "equality of competitive opportunity" which means that financial institutions of another NAFTA country should not be disadvantaged vis-à-vis domestic institutions. The chapter also guarantees the right to market access in another Party but a Party may impose an incorporation, residency or information requirement provided it does not impair the substance of the benefits of the Agreement.

18. At the same time, the financial services chapter preserves the right of regulators to enact reasonable prudential measures. This provision may not be invoked, however, to nullify obligations under NAFTA on performance requirements with respect to investment or transfers.

19. Finally, financial services are subject to the dispute settlement mechanism of the whole agreement (Chapter Twenty) but with certain specificities. When Parties agree that a matter is financial, the panel must be comprised entirely of financial services experts, drawn from a pre-agreed roster of 15 financial experts. When the issue is both financial and non-financial, mixed panels are established. Any retaliatory action resulting from a decision of the panel must be confined to the financial services sector.

20. The **Energy Charter** contains in its Article 9(4) b) a prudential provision very close to that of the GATS Annex on Financial Services.

21. **Bilateral investment protection agreements** generally do not have special provisions relating to financial sectors and most cover only post-establishment issues. U.S bilateral investment treaties, which contain liberalisation obligations in addition to protection obligations, provide for sectoral exceptions, including for the financial sector.

III. The MAI

22. In light of the preceding considerations, Delegates may wish to consider whether the MAI should include specific provisions for financial services.

a) Should a prudential provision be introduced ?

b) Do the other issues important for or specific to financial services such as those identified above need to be addressed under the agreement?

c) Do Delegates believe that all those financial issues could be adequately addressed within the normal framework of the on-going work of existing drafting groups?

d) Should a special Expert Group be created to deal with issues relating to financial services matters? Should the mandate include the drafting of appropriate texts and should the Group be required to deliver its final report at the December meeting of the Negotiating Group?

Notes

[1] Such clauses would allow a Party to deny the benefits of the agreement to enterprises of another Party which do not undertake substantial business in the territory of this Party. In this respect, it can be noted that following a number of frauds and financial scandals, recent regulatory initiatives have been in the direction of a tightening by the host countries of the conditions for a foreign parent company to establish a commercial presence. For instance, recent amendments to EC Directives on credit institutions, insurance companies, investment companies, etc.. include inter alia a requirement that the parent company has both its head office and its registered office in the same country. Also, in 1992, the Basel Committee on Banking Supervision agreed on a set of "Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments" which inter alia establish a number of principles to be followed by bank supervisors in their determination whether to consent to the creation of a banking institution by a foreign bank.

[2] It must be noted that identical treatment is made difficult to apply to branches by the fact that no strictly comparable circumstances exist in the host country, contrary to the establishment of incorporated entities such as subsidiaries. (Whether a branch should be included in the definition of an investor under the MAI is also an issue, currently dealt with by the Drafting Group 3.)

[3] It may also be noted that, irrespective of the specific question of financial services, Article VI of the GATS provides safeguards against formally non-discriminatory domestic regulations concerning qualification, licensing requirements, etc. which may not be based on objective and transparent criteria, may be more burdensome than necessary or be in themselves a restriction on the supply of services. Also, Article VII allows Members to recognise selectively qualifications obtained, requirements met or licences granted in one or several other Member countries. While this Article might be view as an exception to MFN, at the same time it introduces a right for third countries to try and demonstrate that their licensing requirements, etc. are equivalent to those of the beneficiaries of recognition arrangements. In the context of investment in financial sectors, this provision may be important for the establishment of direct branches by financial institutions established abroad.

[4] It can be noted that the prudential provision applies to banking and financial services only, excluding insurance services. Whether it should be applied to insurance services is currently a subject of discussion and different points of view within the CMIT/Insurance Committee Joint Working Group, as part of its on-going overall review of the Code provisions on insurance. Also, the Current Invisibles Code's prudential provision applies to the establishment and operation of direct branches by non-resident investors, not to subsidiaries.

[5] Such as a maximum period of 6 months to process an application, minimum permitted shares of real estate in insurance companies' portfolio, maximum financial requirements in cases of establishment of several branches.