LIBERALIZATION OF FINANCIAL SERVICES UNDER THE WTO

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Introduction

In the past three decades, worldwide financial systems have been characterized by a consolidated trend of steady and continuous liberalization of domestic markets. This has implied a shift from highly regulated financial markets to more open systems, based on prudential regulation, reduced direct intervention by the state in the credit allocation decisions, privatized financial intermediaries, increased level of competition, and encouraged entry of foreign providers of financial services.[1]

The natural by-product of financial liberalization has been an explosion in the international provision of financial services, involving the cross-border supply of financial transactions and the cross-border transfer of capital. Given the wide-spread diffusion of international financial services, the need for international agreements as to how the financial business should be conducted has consequently arisen. One such international agreement is represented by the General Agreement on Trade and Services (GATS). GATS stands on the principle that opening markets is the way forward to greater world prosperity. It came into force in 1995 and set international rules aimed at removing barriers in services generally. It applies to all services sectors, including financial services, encouraging the opening of markets for trade and investments. As was pointed out by the European Commission in 1999, the GATS is not just something that exists between Governments. It is first and foremost an instrument for the benefit of business.[2]

Services cover economic activities ranging widely from banking, Insurance and telecommunications to recreation, cultural and sporting services.[3] Trade in services is

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[1]Paola Bongini, "The EU Experience In Financial Services Liberalization: A Model For Gats Negotiations?", SUERF – The European Money and Finance Forum, Vienna 2003, http://www.suerf.org/download/studies/study20032.pdf.

[2] www.gatswatch.org.

[3] The intangible nature of services distinguishes them from goods and this difference also influences the modes in which international trade transactions in services take place. While international trade in goods involves the physical movement of goods from one country to another, only relatively few service transactions involve cross-border movements. For most service transactions, proximity between the service provider and the consumer is necessary. Such proximity can be obtained either by establishing a

growing and currently accounts for over 20% of all international trade. The General Agreement on Trade in Services, which was negotiated in the Uruguay Round, has created a framework for bringing this trade under international discipline.

The GATS rules cover investments as well as trade, requiring transparency and non-discrimination between suppliers. These general rules represent a starting point for reducing trade as well as non-trade barriers, but need to be supplemented by specific commitments in service sectors. These sectoral commitments determine market access, i.e. how foreign firms get into a market, and national treatment, i.e. whether they are treated the same as local firms within the market.[4]

Its provisions apply to all the modes in which international trade in services takes place, viz:

- Cross-border movement of services products;
- The establishment of a commercial presence in the country where the service is provided;
- Temporary movement of natural persons to another country to provide a service there; and
- The movement of consumers to the country of importation.

Main Provisions of GATS

The General Agreement on Trade in Services is a framework text which lays down a set of general principles that apply to trade in services. The following are the main principles enumerated in the Agreement:[5]

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commercial presence in the importing country (e.g. opening a branch) or through the movement of natural persons for a temporary period (e.g. a lawyer or architect moving to another country). In the case of few service activities, consumers may have to move to the country of importation (e.g. tourism, where tourists travel to another country).

[4] Talal Abu-Ghazaleh, " Liberalization of Financial Services within WTO", (2002), http://www.tagorg.com

[5] "MFN-the non-discrimination principle means treating one's trading partners equally. It guarantees equal opportunities for suppliers from all WTO Members. However, it does not require any degree of market openness. The MFN principle applies to non-scheduled as well as to scheduled services. At the entry into force of the GATS Members were able to take exemptions, in principle limited to 10 years' duration, allowing them to grant differential treatment to certain trading partners. Newly acceding countries have the same right"…www.wto.org

Most Favoured Nation (MFN) and national treatment

These two basic principles, which apply to trade in goods, now also apply to trade in services. However, they have been modified to take into account the special characteristics of trade in services. Thus the Agreement requires countries to apply MFN treatment by not discriminating between service products and service providers of different countries. The national treatment principle requires the member countries to treat Foreign Service products and service providers at par with the national products and providers. The Agreement, however, does not as in the case of trade in goods, impose this as an obligation to be applied across the board in all service sectors but requires countries to indicate in their schedules of concessions the sectors in which, and the conditions subject to which, such treatment would be extended.

Transparency requirements

In order to ensure that foreign service providers are fully aware of the regulations, which apply to trade in services, countries are required to publish all relevant laws and regulations. Each country is further required to establish an enquiry point from which other member countries can obtain information on laws and regulations in the service sector.

Developed countries are in addition required to establish contact points from which service providers in developing countries can obtain information on, inter alia, the availability of service technology and the commercial and technical aspects of the supply of services.

Increasing participation of developing countries

The Agreement recognizes that as service industries in developing countries are not fully developed, they may have to maintain higher levels of protection. It therefore provides that they should have the flexibility, when making liberalization commitments, to open fewer sectors to import competition and to impose certain restrictions on foreign suppliers wishing to invest or establish a branch or a subsidiary. The conditions imposed can be aimed at securing transfer of technology or at achieving other developmental objectives. The Agreement further imposes on countries obligations, inter alia, not to apply restrictions on international transfers and payments (except when they are in balance-of-payments difficulties) in sectors where they have made specific liberalization commitments.

Financial Services

Financial services fall into two board categories: insurance and banking, both of which cover a range of activities. Insurance includes life and non-life insurance, reinsurance intermediation, and auxiliary insurance services. Banking comprises all the traditional services such as acceptance of deposits, lending in foreign exchange, derivatives, securities underwriting, provision and transfer of financial information, and advisory and other auxiliary financial services.[6]

Negotiations on the financial services agreement commences in the Uruguay Round. Negotiations in this sector continued after the completion of the Uruguay Round as it was considered that the progress achieved in the round was far from satisfactory, the renewed negotiations held in two stages were completed in December 1997.[7]

The negotiations on Financial Services were a part of the agenda in the Cancun Ministerial Meeting in 2004. This round of negotiations failed as a result of disagreements mainly between industrialized and developing countries, over various issues like, the relationship between trade and investment, the interaction between trade and investment, transparency in government procurement, and trade facilitation (customs procedures), and did not involve financial services as such. The difficulties at Cancun nonetheless reflect factors, which help to explain the more general wariness of many developing countries towards several of the negotiating initiatives coming from

[6] Supra n, 4.

[7] The 1997 agreement reflected some of the major concerns of the developed nations. These included expanded market access and the removal from countries commitments of limitations affecting several different financial activities (horizontal limitations). Emphasis was also laid on the need for greater regulatory transparency in the treatment of foreign banks.

the major developed countries. These factors include placing the major burden of structural adjustments required for liberalization on developing countries and exerting negotiating pressure on such countries regarding what for them are politically sensitive or controversial subjects, while keeping off the table subjects which could be a source of domestic political problems within developed countries.[8] The disagreements between the developed and developing countries led to the unwillingness of the developing countries to accept negotiating agendas involving financial services. Thus there was no further development on the financial services agreement.

The Benefits of Financial Services Trade

Trade in financial services has various benefits. International openness improves the efficiency and institutional development of financial sectors through increased competition, skill and technology transfer, better risk management and risk diversion across borders, transparency and information. It encourages the use of more efficient financial instruments, and raises pressure on governments to create an adequate regulatory and supervisory environment. Open financial services trade improves the intermediation of resources between sectors, across countries and over time, and enhances financial stability. However, it is significant to note that there cannot and should not be any indiscriminate promotion of financial services. This is especially relevant for developing countries. These countries have to achieve the dual objectives of promoting economic growth along with attaining equity in their domestic economies. This end can be achieved by effecting proper regulation over the economy and economic activities.

Liberalization of Financial Services in India: With Special Emphasis on Banking

For India, the last couple of decades have been one of the most important periods in the economic history. We have witnessed significant changes to the structure, composition

[8] Andrew Cornford, "The Wto Negotiations On Financial Services: Current Issues And Future Directions".. http://www.unctad.org/en/docs/osgdp20046_en.pdf-andrew

and operation of the economy and financial markets and integration with the global markets.[9] These changes have also paved the way for further financial market development and integration, financial globalization and acceleration of the process of deregulation of the financial services industry in the 21st century.[10] As a result of which, the banking industry has witnessed an increase in the role of multinational banks in Indian banking.

An apt example of this is the Central Government notification dated 5th March 2004, which stipulated that foreign banks could set up 100 per cent subsidiaries in India. Foreign banks have also been permitted to acquire up to 74 per cent stake in existing private bank to set up a subsidiary.[11] However, the foreign entity has to choose only one among the three alternatives of having a branch network or a wholly-owned subsidiary or a private banking subsidiary with aggregate foreign holding of up to 74 per cent.

The privatization of banks in the nation and increasing foreign investment in the banking sectors has obtained diverse responses.

It has been argued that when domestic or foreign investors acquire a large shareholding in any bank and exercising proportionate voting rights, it creates potential problems not only of excessive concentration in the banking sector, but can also expose the economy to more intensive financial crises at the slightest hint of panic.

Banks are the principal risk carriers in the economic system, since they take in relatively small deposits that are liquid and make relatively large investments that are not so liquid and typically can have substantial income and capital risk. Any tendency to divert a substantial share of these deposits into activities in which the promoter or board is

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[9] The global markets have also experience significant transformation as, the emergence of flexible exchange rates, further trade liberalization in goods and services, increases in the level of FDI, trade liberalization in financial services, deregulation of financial markets both in developed and in a number of emerging countries, deregulation of the financial institutions and issues related to their supervision, securitization, macroeconomic coordination and global financial stability, consolidation of financial institutions, increased mergers and acquisitions, the gradual integration of stock markets around the world, internalization of the securities markets and an increase in the role of corporate governance in national and international investment strategies.

[10] "Changes in the World's Financial Markets in the last 30 Years and its Implications for the Future", Journal of Banking and Finance… ideas.repec.org/s/eee/jbfina.html

[11] "Foreign Banks allowed 100 pc Subsidiaries", Business Line, Saturday, March 6, 2004.

interested or into investment that are risky but promise quick returns can increase fragility and lead to failure.[12] This can become a problem when private banks find that they are not in a position to pay their depositors and therefore fail. In such cases, if small depositors are to be rescued and the life savings of ordinary people who put their trust in the bank are to be recovered, the bank has to be bailed out by the central bank.

In such a situation, it is probably more important for the government and the central bank to think of strategies that would ensure that such instances are prevented, rather than resolving them after the event through mechanisms such as forced mergers. Increased participation of foreign banks will lead a proportional increase in the responsibility of the Reserve Bank.

There are other tendencies which foreign banks show that are undesirable. Foreign Banks tend to concentrate in the most profitable and high value-added segments of the market, and on certain types of lending such as credit cards in urban markets, rather than pursue any development agenda.[13]

RBI Guidelines on Bank Ownership

Subsequent to the March 5, 2004 notification issued by the ministry of commerce and industry, a comprehensive set of policy guidelines on ownership of private banks was issued by the Reserve Bank of India on July 2, 2004. These guidelines stated among other things that no single entity or group of related entities would be allowed to hold shares or exercise control, directly or indirectly, in any private sector bank in excess of 10 per cent of paid-up capital. The guidelines sought to define the ceiling as applicable on aggregate foreign investment in private banks from all sources (FDI, Foreign Institutional Investors, Non-Resident Indians), and in the interest of diversified ownership, the percentage of FDI by a single entity or group of related entities was restricted to 10 per cent.

[12] Jayati Ghosh, "FDI in Banks: The RBI Suggests Restraint", People's Democracy, Volume XXIX, No.11, March 13, 2005…www. pd.cpim.org/

[13] Foreign Banks have not always been regarded as beneficial for the national economy. A leading example is the curb on the participation of foreign banks by the Central Bank of South Korea. South Korea received billions of dollars of overseas investment in its financial industry since the country's 1997-98 financial crisis. However, in the central bank's view, foreign-owned banks were undermining the economy by focusing lending on consumers. It said: "Such a tendency could lead to lower corporate lending . . . and therefore weaken the country's economic growth."

The guidelines allowed for an acquisition equal to or in excess of 5 per cent, so long as it was based on the RBI's permission. The guidelines stated: "In deciding whether or not to grant acknowledgement, the RBI may take into account all matters that it considers relevant to the application, including ensuring that shareholders whose aggregate holdings are above the specified thresholds meet the fitness and proprietary tests."[14]

An outstanding feature of the RBI guidelines is the recommendation of diversified ownership of banks. RBI's Report on Trend and Progress of Banking in India, 2003-04 (Chapter VIII: Perspectives) states[15], "The concentrated shareholding in banks controlling substantial amount of public funds poses the risk of concentration of ownership given the moral hazard problem and linkages of owners with businesses. Corporate governance in banks has therefore, become a major issue. Diversified ownership becomes a necessary postulate so as to provide balancing stakes." It further states that "…in the interest of diversified ownership of banks, the Reserve Bank intends to ensure that no single entity or group of related entities have shareholding or control, directly or indirectly, in any bank in excess of 10 per cent of the paid up capital of the private sector banks. Any higher levels of acquisition will be with the prior approval of the Reserve Bank and in accordance with the guidelines notified on February 3, 2004."

In the first phase, the RBI has made it clear that the acquisition by foreigners of shareholding in Indian private sector banks can only relate to certain very specified banks who are in very bad shape already.[16]

Therefore, *until 2009, foreign acquisition of Indian banks is to be limited to those that are anyway about to collapse and have been vetted by the RBI for restructuring.* Thereafter, "In the second phase, after a review is made with regard to the extent of penetration of foreign investment in Indian banks and functioning of foreign banks,

[14] These fitness and proprietary tests include the integrity, reputation and track record of the applicant in financial matters, compliance with tax laws, history of criminal proceedings if any, the source of funds for the acquisition etc. Where the applicant is a body corporate, the fit and proper criteria involves its track record of reputation for operating in a manner that is consistent with the standards of good corporate governance, financial strength and integrity. More rigorous fit and proper tests were suggested where acquisition or investment takes the shareholding of the applicant to a level of 10 per cent or more.

[15] "Left Parties Note to the UPA Government- On the Proposal to Enhance the FDI Cap in Banking", People's Democracy, Volume XXIX, No. 8, February 20, 2005…www. pd.cpim.org/ -

[16] The guidelines state that "In order to allow Indian Banks sufficient time to prepare themselves for global competition, initially entry of foreign banks will be permitted only in private sector banks that are identified by RBI for restructuring. In such banks, foreign banks would be allowed to acquire a controlling stake in a phased manner."

foreign banks may be permitted, subject to regulatory approvals and such conditions as may be prescribed, to enter into merger and acquisition transactions with any private sector bank in India subject to the overall investment limit of 74 per cent."[17]

Thus we see that through the medium of the detailed guidelines the RBI has attempted to minimize the fear of monopolies by any foreign banks over the Indian banking industry. This objective has been achieved by applying regulatory measures to monitor the investment and lending activities of foreign banks. Another step in this direction is the imposition of a mandatory requirement on private and foreign banks according to which they have to target 18 percent of the advances towards farm lending. Shortfalls in farm lending entail penalties under current RBI guidelines. These guidelines prescribe that the shortfalls would have to be parked either with the Small Industries Development Bank of India or with the Rural Infrastructure Development Fund at bank rate of 6 per cent.[18]

Another commendable regulatory measure of the RBI are the recent guidelines for the `Protected Disclosure Scheme' for private and foreign banks.[19] The primary aim of the Reserve Bank in issuing these guidelines is that the disclosure scheme would prompt more people, like employees of the bank, customers, stakeholders, or NGOs, to point out irregularities without fear. For the purposes of protecting the identity of the complainant a detailed, facilitator procedure has been evolved.[20]

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[17] Supra n, 12.
[18] C. Shivkumar, "PSBs courted on farm loans — Private, foreign banks behind targets", Business Line, Friday, January 13, 2006. However, in the year 2006 both the private and foreign banks were falling short of the targets. Traditionally, private sector and foreign banks have concentrated exclusively on large corporates for building up their respective asset base. Few foreign and new generation private banks were prepared to bear the administrative costs of disbursing large volumes of small-ticket loans. Instead, most of them preferred to be in the less administratively cumbersome sectors such as retail and corporate lending, including lending in foreign currencies.
[19] Guidelines were issued on January 25, 2006.

[20] As per the procedure outlined by the apex bank, the complaint should be sent in a closed envelope to the Department of Banking Supervision. The name of the complainant should be attached with the complaint; in case of employees, the designation, department and institution and place of posting should be mentioned. After verifying the identity of the complainant in the case of employees, the RBI may investigate the matter further or call for response from the Chairman or Chief Executive of the bank concerned. The apex bank will recommend appropriate action including action against the official concerned, steps for redressing losses caused to the bank, and initiation of criminal proceedings. On the other hand, if the RBI finds that the complaint is motivated, action can be taken against the complainant.

Thus, now all the private and foreign bask are require to frame a `Protected Disclosures Scheme' approved by their boards of directors in line with this broad framework.[21]

Thus, we see that the apex bank has, through detailed guidelines attempted to regulate the activities of foreign banks in the nation. This is extremely essential as banks are the principal risk carriers in the system, taking in small deposits that are liquid and making relatively large investments that are illiquid and can be characterised by substantial income and capital risk. Keeping in mind the core functions performed by banks and the role that they play in a nation's economy, there is a need of not only issuing regulatory guidelines but evolving National Banking Policy Resolution, with the main objective of providing efficient and prompt banking services to all the people in all parts of the country*. A National Banking Policy is recommended, keeping in mind the following considerations.*

Regional Imbalances

In view of increased participation and proliferation of foreign banks there is probability of regional imbalance in the establishment of the banking network. Already banking sector reforms since 1992, with an emphasis on profit and sophistication, have unwittingly forced the banks to move away from the small client and from the rural and semi-urban areas.[22] Concentration of banks in urban areas is not feasible as seventy-two per cent of Indian population reside in rural areas. Their main vocation is agriculture and

[21] "Foreign, pvt banks staff can now blow the whistle — RBI issues norms for `Protected Disclosure Scheme", Business Line, Thursday, January 26, 2006.

[22] Between March 1991 and March 2000 the credit-deposit ratio has continuously declined from 60 per cent to 39.3 per cent in rural areas and 35.3 per cent in semi-urban areas. The number of borrowal accounts between March 1992 and March 2000 declined from 65.9 million to 52.7 million. In the subsequent two years the number of accounts increased by about three million, mainly due to retail banking – car loans, home loans, vehicle loans, consumption loans, etc, in the urban areas! Public sector banks closed more than 3,000 branches in rural and semi-urban areas during the reforms period. The differential rate of interest scheme of lending at 4 per cent to the weaker sections of the society is being ironically implemented by the banks to provide funds at the cheapest rate to the dominant corporate sector. Bankers are vying with each other to rush to the doors of the rich corporates to pour funds into their vaults at the rate of interest dictated by the latter. The poor have been left high and dry. .. P N Joshi, "Needed- A National Banking Policy", Economic and Political Weekly, July 9, 2005

agro-based services. Most of the young in the workforce would naturally be in the rural areas. If financial services are wittingly or unwittingly withdrawn from the rural sector, then economic activity, including modernization of agriculture, would suffer. Banks are the major financial intermediaries to lubricate the wheels of trade, industry and agriculture.

In a welfare-oriented economy, the basic objective of banking should be the provision of efficient, courteous and prompt banking services to all sections of the society in different parts of the country.

Importance of Local Banks

To achieve the laudable objective of mass banking emphasis should be laid on the objective of providing efficient and prompt banking services to all the people in all parts of the country. There should be a proper banking structure to include three to four global banks, 10-12 national banks, 200-250 regionally focused local private banks, some foreign banks and 400-500 urban cooperative banks along with a network of primary cooperative societies at the village level.

Thanks to the technological revolution, it is possible to establish a ‘correspondent relationship’ from the primary credit society at the village level to the global bank at the metro through the channels of local, regional and national banks. A network of linkages will help even the customer of a credit society to access the global market.[23]

Threat of Extinction

In India, today, there are 20 old private sector banks and 10 new private sector banks. The new private sector banks have a strong capital base and they are capable of raising fresh capital on their own nationally or internationally. The twenty old private sector banks have slender capital bases. The Reserve Bank of India has advised the 20 old private sector banks to indicate a plan of action for raising their capital base to Rs 300

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[23] As in the United States where along with multinational banks like Citibank, Bank of America, etc, there are more than 8,000 efficiently functioning and locally focused small banks, which are the most sought-after units by the average American.

crore. Reaching this limit could prove to be a cumbersome task for some of the old private sector banks. This might either lead to the closure of these private sector banks or they might involuntarily fall prey to foreign banks. Thus, eventually, these old private sector banks, which have been functioning, to provide banking services to the local people, including the weaker sections on an informal basis may become extinct. The locals will not have their own bank, which they could enter confidently, and converse in the local language.[24] The interests of a large section of the society should not be sacrificed in the wake of achieving the objective of strengthening the capital base.

Conclusion

There are certain basic objectives on which the Indian banking system is structures. The government had undertaken Nationalization of banks in 1969 with the aim of fulfilling these objectives like- giving effect to the program for attaining a socialistic patter of society and decentralizing the credits to enable certain sectors- like agriculture to obtain liberal banking facilities. The government also wanted to change the urban centric profile of banking in India and keep a safeguard over public money deposited in the banks.

However, in the era of globalization significant changes have taken place in the operating environments of banks and financial institutions. The Government has undertaken certain international commitment which are required to be honored. In some cases the government has gone beyond its international commitments in order to expedite the process of foreign banks establishing their presence in India.[25] These measures are commendable as they will aid in increasing the capital base and investment in the country. Thus, what we need is an effective regulatory regime to strike a balance between the varied sections of the society.

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[24] Due to their presence in a particular area over a period of time the banks have been able to encourage savings and deposits. The extinction of such banks may not thus be to the advantage of the local people.

[25] As by the notification issued on January 3, 2006, the Government and the RBI have agreed to allow foreign banks to open 20 branches a year in the country. The government is committed to allowing only 12 branches of foreign banks a year. In practice, however, it has been allowing as many as 17-18 branches…. KG Narendranath, "Foreign banks will get to open 20 branches a year", The Financial Express, Wednesday, January 04, 2006.