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General introduction

> Although Europe was not at the root of the current financial crisis, it has nevertheless both contributed to it and been hit severely by it. Global economic and financial integration has by now reached a level where no country or region can any longer insulate itself from developments elsewhere in the world.
>
> Report by the High-Level Group on Financial Supervision in the EU Chaired by Jacques de Larosière, Brussels, 25 February 2009, para. 219

1. The global financial crisis started in 2007 and struck with full force in autumn 2008. At the time of concluding this book, the world is still suffering from its consequences. The crisis has shown that the interconnectedness of the global economy implies that problems that occur in banks in one state may quickly spill over to banks in other states and eventually to the real economy worldwide. While in the last decade of the twentieth century many governments gradually removed regulatory restrictions on banking activities and thus increased competition in their markets for banking services, the global financial crisis made policymakers again realize that opening up the market for banking services to foreign competition implies also serious risks for financial stability. Nonetheless, policymakers, academics and commentators disagree on how much and what type of regulation is appropriate in the banking sector. It seems that much depends on personal beliefs in the ability of regulation to modify behaviour of market participants. Still, except for some more radical voices, there appears to exist also a general recognition that competition in the banking sector has also brought benefits in the form of increased efficiency in the channelling of funds from savers to investors.

2. At the level of the European Union (EU) as well as at the international level (more particularly, within the World Trade Organization (WTO)), states have accepted that competition between banks from different

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countries will improve efficiency and thus lead to a higher degree of welfare for society. They have developed legal rules to remove barriers to trade in banking services. Nonetheless, such legal obligations also affect the possible ways in which states can regulate and supervise the access of foreign banks to the domestic market and the way in which they can carry out activities. Hence they limit the extent to which countries can pursue domestic policy goals.

The interaction of EU and WTO law

3. The system of legal rules developed within the EU and the WTO both address the same question: how to intensify cross-border competition in the market for goods and services while at the same time taking into account the domestic policy concerns that underlie regulation of these markets. It is therefore no surprise that comparative studies of the systems of the EU and the WTO are quite common.[1] In November 2009, the former Director-General of the WTO, Pascal Lamy, called for the drawing of lessons for global governance from European integration.[2] As a political statement, this certainly has merit. However, a comparative legal analysis of these two projects of trade liberalization should be approached carefully. Although many questions with regard to identifying protectionist measures are the same for both the EU and the WTO, and it is thus interesting to compare the different approaches taken in answering these questions, the political, economic and legal contexts of the EU and the WTO are very different. The

[1] See for instance K. Byttebier and S. Fares, 'The EU Liberalisation of Financial Services: The EC Obligations in Comparison to the GATS Commitments', in K. Byttebier and K. Van der Borght (eds.) *WTO Obligations and Opportunities: Challenges of Implementation* (London: Cameron May, 2007) 85–119; F. Ortino, *Basic Legal Instruments for the Liberalization of Trade: A Comparative Analysis of EC and WTO Law* (Oxford: Hart, 2004); L. Panourgias, *Banking Regulation and World Trade Law* (Oxford: Hart, 2006); M. Pallemaerts, *EU and WTO Law: How Tight is the Legal Straitjacket for Environmental Product Regulation?* (Brussels: VUB Press, 2006); G. Van Calster, *International and EU Trade Law: The Environmental Challenge* (London: Cameron May, 2000); A. Von Bogdandy, P. Mavroidis and Y. Mény (eds.), *European Integration and International Co-ordination. Studies in Transnational Economic Law in Honour of Claus-Dieter Ehlermann* (The Hague: Kluwer Law International, 2002); J. Weiler (ed.), *The EU, the WTO and the NAFTA: Towards a Common Law of International Trade?* (Oxford University Press, 2001); and J. Wiers, *Trade and Environment in the EC and the WTO: A Legal Analysis* (Groningen: Europa Law Publishing, 2002).

[2] P. Lamy, 'Global Governance – Lessons from Europe', speech made at Bocconi University, Milan, 9 November 2009, available at www.wto.org/english/news_e/sppl_e/sppl142_e.htm.

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international process for intensifying competition in banking can never go as far as the European project. In a regional process like the European Union, transaction costs linked to cooperation are lower than in an international process like the WTO. Since the Treaty of Rome of 1957 (Treaty establishing the European Economic Community – EEC Treaty), the EU has combined liberalization (negative integration) with re-regulation of the banking sector by means of the approximation of laws (positive integration). At the international level, liberalization and possible regulatory convergence are spread over different international bodies. The WTO has, as at the time of writing, never engaged in regulatory convergence for trade in services and it is unlikely that this will happen soon. However, some non-binding convergence of banking regulations has been produced by the Basel Committee on Banking Supervision.

4. The situation of the EU and its member states in the WTO merits specific attention. The EU promotes a preferential trade integration project, while at the same time being a fully fledged WTO member, along with its own member states. Like any other WTO member, the EU has to comply with the obligations it has assumed on the basis of the General Agreement on Trade in Services (GATS). When regulating and supervising their market for banking services with regard to activities used by third-country banks, EU member states have to comply with their obligations under EU law as well as those under the GATS. Moreover, the EU aims at progressively abolishing restrictions on international trade and foreign direct investment.[3] When exercising its competences in respect of banking services provided by banks from third countries in the EU, the EU has to respect its obligations under the GATS. In *Poulsen*, the Court of Justice of the European Union (CJEU) famously stated that 'the European Community must respect international law in the exercise of its powers'.[4] This is certainly the case when the EU is itself party to an international agreement such as the GATS. This creates a specific legal reality that has not been fully examined.

[3] Art. 206 of the Treaty on the Functioning of the European Union (TFEU) provides that the EU 'shall contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and on foreign direct investment, and the lowering of customs and other barriers'.

[4] CJEU, Case C-286/90 *Poulsen and Diva Navigation*, [1992] ECR I-6019, para. 9. See also CJEU, Case C-53/96 *Hermès International* v. *FHT Marketing Choice*, [1998] ECR I-3603, para. 28; CJEU, Case C-162/96 *Racke* v. *Hauptzollamt Mainz*, [1998] ECR I-3655, para. 45; and CJEU, Joined Cases C-402/05 P and 415/05 P, *Kadi and Al Barakaat* v. *Council and Commission*, [2008] ECR I-6351, para. 223.

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5. Some authors have paid attention to these issues in the past. In a 1994 study, Eeckhout carried out a legal analysis of the European internal market and international trade. He included the competence of the European Communities to regulate trade in services with third countries in his analysis, and devoted a chapter to financial services. In several instances, the study also refers to the GATS. However, because the study was published shortly before the conclusion of the Uruguay Round and thus before the entry into force of the WTO Agreements, the focus is mainly on the EU law aspects of the external dimension of the internal market in services. Eeckhout notes, however, that 'this draft GATS will often be referred to, because if it enters into force, *it will play an important role in defining the external dimension of the internal market in services*'.[5] Further, in a book chapter published in 2002, Cremona noted,

> The challenge for the unified Community market, and the Community's own external economic policy, is in presenting and justifying to its trading partners its own regulatory policy choices, whether these are development-based preferences or environmental or public health priorities.[footnote omitted] *The additional element, which we are not specifically addressing here, is that this process is carried out against a background, not only of existing bilateral and regional treaty obligations, but also in the context of a developing world trading system which is itself exploring methods for reconciling these potentially conflicting goals.*[6]

6. Still, this does not mean that there are no other elements in primary and secondary EU law that affect third-country banks. For instance, the implications of the obligation imposed on national supervisors to evaluate the *equivalence* of consolidated supervision by third-country supervisors is one of the many issues that persist. Further, the entry into force of the Lisbon Treaty on 1 December 2009 implied important modifications to the competence of the EU in the field of the common commercial policy. What is more, in 2013, significant steps were taken towards the creation of a 'banking union'. Questions arise with regard to the implications for the competence of the EU to regulate activities of third-country banks in the EU. Further, the case law with regard to the WTO Agreements in general, and the GATS in particular, has developed through reports by the WTO panels and the Appellate Body and now

[5] P. Eeckhout, *The European Internal Market and International Trade: A Legal Analysis* (Oxford: Clarendon Press, 1994) 13 (emphasis added).

[6] M. Cremona, 'The External Dimension of the Single Market: Building (on) the Foundations', in C. Barnard and J. Scott (eds.), *The Law of the Single EU Market. Unpacking the Premises* (Oxford University Press, 2002) 351–93, at 389 (emphasis added).

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provides some clearer insights into the implications of the GATS obligations for the competence of WTO members to regulate and supervise their market in banking services. This merits a fresh analysis.

7. The present book addresses the following central question: to what extent does the combined application of the EU law and the GATS restrict the leeway the EU and its member states have with regard to the regulation and supervision of their market for banking services?

The balance between efficiency through competition and stability through regulation

8. Policymakers at the national or regional level that want to define their approach to the liberalization of trade in banking services have to balance two objectives. On the one hand, they consider the objective of achieving more *efficiency* through *competition* between foreign and domestic banks. On the other hand, they consider the objective of ensuring financial *stability* by means of the *regulation and supervision* of their market for banking services. The international and European projects for liberalizing trade in banking services determine the leeway policymakers have to do so. Depending on the extent to which the obligations in WTO law and EU law restrict the possibility of regulating banks and making supervisory assessments, the balance may tilt more towards efficiency or more towards stability. The experience of the global crisis shows what dramatic consequences may follow if policymakers get the balance wrong. It is thus important to know to what degree the interaction between WTO law and EU law influences the possibility of performing this balancing exercise.

9. To the extent the GATS or EU law limit the leeway of policymakers in national governments in designing their regulatory approaches and making the supervisory decisions they consider appropriate, financial stability may be threatened, unless measures for ensuring financial stability are adopted at a higher (European or international) level. At the same time, if the GATS or EU law do not limit the possibility for WTO members or EU member states to create barriers to trade in banking services at all, the objective of increased efficiency in the banking sector may be threatened.

The structure of this book

10. The book consists of three parts. In Part I, the policy concerns underlying the regulation and liberalization of the market for banking

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services are examined. We examine why regulation is required to address market failures in the market for banking services. Next, we consider the economic arguments that support the case for competition in the market for banking services.

11. In Part II, we examine the *international approach to the liberalization of trade in banking services*. The focus is mainly on the legally binding obligations contained in the GATS, but, where it is useful, we pay attention to the Basel standards and principles. We draw conclusions with regard to the limitations imposed by the GATS on the right of WTO members to regulate and supervise their markets for banking services. One cannot fully understand how foreign banks can carry out activities in a host market when considering only the *general rules* that apply to these banks. These rules often leave a margin of appreciation to the competent authorities in these host territories to apply these rules and make *supervisory assessments*. Therefore the analysis in Part II is broadly divided into the right to regulate and the right to supervise the banking sector.

12. This distinction between regulation and supervision reappears in Part III of the book. In it, we examine the *European approach to the liberalization of international trade in banking services and its interaction with the GATS*. We make an analysis of the right of the member states and the EU to regulate and supervise the provision of banking services by third-country banks in the EU. This analysis focuses on one specific form in which third-country banks can operate in the EU: through the establishment of credit institutions in the EU that are subsidiaries of the third-country bank.

13. The banking sector is, certainly after the global financial crisis, subject to a body of legal rules that undergoes constant modifications. The state of the law as described here is up to date as at 1 March 2014.

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PART I

Policy concerns underlying the regulation and liberalization of banking

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Introduction to Part I

> It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity.
>
> Charles Dickens, *A Tale of Two Cities*, 1859

> It's human nature, unless somebody can find a way to change human nature, we will have more crises and none of them will look like this because no two crises have anything in common, except human nature.
>
> Alan Greenspan, interviewed as part of BBC2, *Love of Money* series, broadcast on 10, 17 and 24 September 2009

> Economics teaches us that when there is huge uncertainty about catastrophic risks, it is dangerous to rely too much on the price mechanism to get incentives right. Unfortunately, economists know much less about how to adapt regulation over time to complex systems with constantly evolving risks, much less how to design regulatory resilient institutions. Until these problems are better understood, we may be doomed to a world of regulation that perpetually overshoots or undershoots its goals.
>
> Kenneth Rogoff, 'The BP Oil Spill's Lessons for Regulation', 1 June 2010, www.project-syndicate.org

14. In Part I we examine the policy concerns underlying the regulation and liberalization of banking. Several studies have tried to identify the degree of competition that is desirable without compromising stability. However, authors disagree greatly on this question. It appears that, to a considerable extent, the trade-off between efficiency and stability is a matter of belief and even ideology.

15. Part I consists of five chapters. Following this introductory chapter, Chapter 2 discusses the role of banks as intermediaries and thus the reasons why banks have been created. In the next two chapters, the economic theory underpinning the regulation and supervision of banking services, on the one

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hand, and the liberalization of trade in banking services, on the other hand, are discussed.

16. We explain in Chapter 3 that the specific nature of the banking services market gives rise to specific *market failures*. It is far from clear what types of regulation are appropriate to remedy such market failures. Economists have paid much attention to *market-based regulation*, whereby many of them argue that regulation should attempt to encourage the exercise of market discipline on banks. However, the global financial crisis has caused this market-based approach to be much questioned.

17. In Chapter 4, we explain that the liberalization of trade in banking services takes place over different stages. First, liberalization may mean that policymakers decide to deregulate the market for banking services. This implies that national regulatory restrictions on permitted banking activities are reduced. Second, liberalization may also involve the opening up of the national market to foreign banking, either in the form of cross-border banking or through commercial presence. In this book, we focus on this second stage of liberalization: the 'internationalization' of the market for banking services. Economic studies that consider whether the liberalization of trade in banking services increases welfare often arrive at different conclusions. However, these studies do agree that international liberalization of trade in banking services has benefits, provided that it is accompanied by adequate prudential regulation. Chapter 5 concludes Part I.

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