

## Chapter 12

# Financial Services in Free Trade Agreements: The Case of Switzerland

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### I. TRADE DISCIPLINES ON TRADE IN SERVICES

It is commonly understood that the main aim of trade disciplines in multilateral and bilateral trade agreements is to gradually open up foreign markets' services sectors and to provide new market access opportunities for services suppliers of the contracting parties. Another central feature of trade agreements and their disciplines, however, is often not at the centre of discussions: trade disciplines as an instrument to avoid protectionist moves. To a certain extent, the essence of trade agreements is to provide a predictable regulatory environment. Disciplines on trade in services are no different in that respect. Whether set out in a multilateral or bilateral framework, they ensure that business operators benefit from a stable legal environment and a rule-based level playing field.

While new market access issues are usually the focus of free trade negotiations in times when the global economy is faring well, more attention is devoted to

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aspects of predictability and legal certainty in times of economic downturn. The current economic and financial crisis is no exception. Although market access negotiations still form the core of free trade negotiations, the results are also increasingly valued for their instrumental role in preventing protectionist temptations.

The current economic and financial turmoil has led to a much greater role for public-sector engineering of the economies, while the financial sector is at the centre of legislative activity. Governments are increasingly engaged in the financial sector and regulatory proposals abound. Although such regulatory developments are by and large of no particular consequence from a trade-law perspective, and are generally viewed as necessary to adjust and redress the system, it may never be ruled out that, alas, protectionist voices manage to make themselves heard in the course of the domestic legislative process.

While the reports on the financial and economic crisis and trade-related developments published by the World Trade Organization (WTO) Secretariat in the framework of the Trade Policy Review Body<sup>1</sup> do not conclude that the crisis has triggered any generalized backlash in the services area towards protectionism, they nonetheless point out that a few WTO Members have taken measures in some sectors which may have restrictive effects on trade. With respect to measures taken in the financial sector, the WTO Secretariat cautions in its second report that the various government interventions (mainly bailout measures and the establishment or expansion of guarantee schemes) may lead to a situation, where:

uncompetitive or even insolvent financial institutions may be kept in operation at the expense of their foreign competitors [...]. Under current circumstances, this may be viewed as secondary to the objective of reducing systemic risk, but as that risk recedes it is important that financial markets return to competitive conditions (albeit under stricter regulation than in the past) in which sound institutions can prosper without facing unfair competition.<sup>2</sup>

Trade agreements on trade in services are instrumental in ensuring that a level playing field for foreign competitors exists in conformity with the multilateral and bilateral disciplines set out therein. Trade disciplines ensure that the regulation deemed necessary by governments complies with these rules (mainly with respect to most-favoured-nation treatment, national treatment and market access). Thus, in times of regulatory reorientation, a certain degree of predictability regarding trading conditions for foreign operators is maintained.

1. World Trade Organization, Reports to the TPRB from the Director-General on the Financial and Economic Crisis and Trade-related Developments. Reports are contained in the WTO documents JOB (09)/2 (26 Jan. 2009), WT/TPR/OV/W/1 (20 Apr. 2009) and JOB(09)/62.

2. World Trade Organization, WT/TPR/OV/W/1, 18.

## II. SWITZERLAND'S OBJECTIVES AND APPROACH TO FTAS

In line with the above, Switzerland is pursuing its free trade strategy not only with the aim of providing new market access opportunities, but also of establishing a legal framework for its financial services suppliers which is predictable in the long term.

Switzerland is taking an ambitious stance regarding free trade agreements (FTAs) as it is closely integrated into the world economy and its economic structure is characterized by a pronounced outward orientation. Switzerland's prosperity therefore depends, to a large extent, on international trade in goods and services as well as on cross-border investment activities. Consequently, its aim is to capture a substantial part of its trade flows under the disciplines of bilateral FTAs. Such agreements with free trade partners are negotiated in the context of the European Free Trade Association (EFTA) or alone. They may either be so-called 'comprehensive agreements', covering all trade issues including trade in services, or classic agreements essentially covering trade in goods.

According to the foreign economic strategy of the Swiss Federal Council, the selection of prospective free trade partners is based on four main criteria:

- (1) the current and potential economic importance of a partner;
- (2) the extent of existing or potential discrimination that may result from the conclusion of FTAs between the prospective partner and important competitors of Switzerland;
- (3) the willingness of the partner to enter into negotiations, and the corresponding prospects for success; and
- (4) political considerations (e.g., the expected contribution of a FTA towards the economic stabilization and development of a possible partner or in general; the compatibility with Swiss foreign policy objectives).

Based on these principles, Switzerland has concluded FTAs, mainly in the framework of EFTA, which contain a comprehensive chapter on trade in services with the following partners: Mexico, Singapore, Chile, South Korea, Colombia, Japan (on a bilateral basis) and with the Cooperation Council for the Arab States of the Gulf (GCC). Negotiation activities on comprehensive FTAs, which include trade in services, are currently taking place with India and Ukraine.

The cornerstone of Switzerland's policy in terms of services negotiations is to aim at establishing a broad and comprehensive set of legally binding rights and obligations based on the General Agreement on Trade in Services (GATS), not excluding a priori any services sector or mode of supply.

There are several reasons for taking the GATS as a point of departure. Firstly, as Switzerland is a Member of the GATS and has thus integrated the GATS into its national law, making sure that FTAs use basically the same structure, concepts, definitions and provisions is the most efficient way to ensure the required homogeneity of the national legal framework. This is even more crucial for a strongly monist country like Switzerland. Second, as the GATS is the only common good

shared by all potential partners around the world, taking it as a basis represents the most efficient way of realizing every country's endeavour, that is, to end up with a set of bilateral agreements that do not differ too fundamentally from each other. A minimum degree of consistency and homogeneity of international agreements in a given sector is always desirable, and the method Switzerland chose to achieve this aim is to stick to a GATS approach. Thirdly, and this follows on from the two previous points, with the vast majority of potential partners a GATS-based approach is easier to negotiate, and thus saves resources.

That is why the Chapter on Trade in Services – which is by and large a translation of the GATS into a bilateral setting – is complemented by a number of specific annexes. Given the importance of the financial sector in Switzerland for trade in services, an annex on financial services constitutes a standard part of such a package. In addition, similar to the GATS, parties to the agreement undertake specific commitments in the various services sectors. Financial services are thus treated as part of a broader services package, consisting of a chapter, annexes and lists of commitments.

### III. THE ANNEX ON FINANCIAL SERVICES

Needless to say, in terms of financial services, Switzerland aims for a comprehensive set of legally binding rights and obligations. Firstly, the current Swiss model texts are based on a broad definition of what is meant by 'financial services', covering not only 'all' insurance and banking services, but also 'other financial services' which effectively makes that definition open-ended and encompasses both existing and so-called 'new' financial services. The definition is accompanied by a list of 'activities' which are 'included' – again a term in line with the open-ended nature of the definition – in the concept of financial services. All those terms correspond literally to the wording of the definition contained in the GATS Annex on Financial Services. The definition is relevant in two respects. Firstly, it determines the scope of application of the provisions of the Swiss model Annex on Financial Services (hereinafter 'the Annex'). Secondly, in case a party uses the broad term of financial services as a basis for inscribing its specific commitments, the scope of the financial services commitments corresponds to these broad definitions. The specific commitments of Switzerland rely on the broad definition of financial services.

Similar to GATS, the Annex contains definitions of what constitutes a 'financial service supplier', 'public entity' and of 'services supplied in the exercise of governmental authority' to the effect of accommodating the need for flexibility in respect of government activities of central banks and monetary authorities, as well as in respect of monetary and exchange rate policies and statutory systems of social security.

A first material provision of the Annex relates to market access for new financial services. This provision builds upon a similar provision on new financial services contained in the GATS Understanding on Commitments in Financial

Services. It states that each party shall permit financial service suppliers established in its territory to offer new financial services. Thus, this provision does not apply to cross-border trade.

Another provision pertains to national treatment and transposes the relevant provision of the GATS Understanding on Commitments in Financial Services into a bilateral setting. It states that parties shall grant national treatment in terms of access to payment and clearing systems operated by public entities and to official funding and refinancing facilities. Again, this is not meant to apply on a cross-border basis. National treatment shall equally be ensured in relation to participation in self-regulatory bodies, securities or futures exchanges or markets, clearing agencies and any other organization or association.

Transparency is key in the financial sector. The Annex therefore contains an extensive provision for the purpose of guaranteeing a minimum level of transparency, mainly by establishing a consultation framework to implement objective and transparent regulatory processes. The same provision states that the competent authorities of the parties shall make available requirements and procedures for completing applications relating to the supply of financial services. Finally, parties shall make available the period of time normally required to reach a decision concerning an application for a license.

But transparency in itself is not sufficient. The next step is very logically to move to proper so-called domestic regulation. With both transparency disciplines and provisions on domestic regulations, it is expected to allow market players to be able to obtain the full benefit of any market access or national treatment commitments granted by the parties. In addition to the domestic regulation provisions stipulated in the main services chapter, the Annex contains an article on expeditious application procedures that imposes a number of obligations in this respect. The application of expeditious and transparent procedural requirements is essential for doing business in financial markets, where time-to-market is often said to be the most important factor in acquiring market shares. However, reliable information about the timing of the application procedure may be even more important to the financial service supplier: internal business plans as well as related strategic decisions which may involve organizational as well as financial resources depend to a large extent on the timing of the issuance of an application. The article on expeditious application procedures therefore focuses on access to information regarding the application process and on the timely issuance of the application. At the beginning, the article stipulates that the competent authorities of the parties shall process expeditiously applications relating to the supply of financial services. Then, if that authority requires additional information from the applicant it shall notify the latter without undue delay. It is thus ensured that the applicant is informed about the missing elements if the applicant initially submits an incomplete file. Another provision states that the authority shall provide information concerning the status of the application. The information on the status is important to the extent that applicants may use this information to adapt their internal organizational arrangements and business schedule accordingly. It goes without saying that the Annex provides further that the authority shall notify the applicant of the

outcome of the application promptly after the decision is taken, and if that decision is negative, the reason for the denial shall be made known to the applicant. Knowing the reason for denial enables the applicant to modify the deficiencies indicated and to consider a new application process as well as the costs involved. The last provision relates to the specific cases where a license is required for the supply of a financial service and stipulates that a license will be granted if the requirements are met, again in an expeditious manner.

Still in terms of domestic regulation, an article of the Annex contains the universally known 'prudential carve-out' and the provision on confidentiality. Those two issues are addressed in virtually all agreements, in particular in paragraph 2 of the GATS Annex on Financial Services. Of course, the carve-out is not a totally open-ended one, as it is recognized that prudential policy does not (or should not) undermine basic trade obligations. Prudential measures must be designed on the basis of prudential parameters where the quality of the supervision applied in the jurisdiction of origin of the service and service supplier, assessed in objective terms, does play a role, but they are not meant to discriminate between financial institutes merely on the grounds of their nationality. It is perfectly possible to design and implement a prudential policy that is both efficient and effective from the supervisors' perspective and does not have detrimental effects on trade. The reality is that an effective prudential policy is in fact trade supportive, not least because confidence in the stability of the system is key to generating business. That is why most players concur that prudential measures, in that sense, should remain within reasonable limits.

An additional paragraph relates to the importance of the Basel Committee's 'Core Principles for Effective Banking Supervision', the standards and principles of the International Association of Insurance Supervisors and the International Organization of Securities Commissions' 'Objectives and Principles of Securities Regulation' and urges the parties, in line with the commitment of Switzerland to establish international standards in financial services and to endeavour to implement the existing standards. Switzerland is very active in international financial forums and is keen to promote the work done there.

Recognition of equivalent standards and regulations is one of the most widespread instruments of cooperation between financial regulatory authorities. The lack of recognition of others' regulatory standards and regulations may be a huge impediment to trade in financial services, as compliance with the different regulatory norms and standards may, from a services suppliers' perspective, for instance lead to huge costs in terms of organization and capital. Thus, unilateral and/or mutual recognition of supervisory rules and regulations may greatly facilitate trade in financial services. Moreover, arrangements on recognition may also enable the supervisory authorities to engage in enhanced cooperation and facilitate the exchange of information with respect to the supervision of financial services suppliers operating on a cross-border basis and in different jurisdictions. While recognition may certainly be granted outside a FTA (which is most often the case, see for instance the agreement on direct insurance between Switzerland and the European Community), FTAs could provide a suitable framework for such

arrangements. To date, Switzerland has not yet concluded any recognition agreements in the field of financial services in the framework of a FTA. Nonetheless, free trade negotiations as well as the conclusion of an agreement would provide momentum, as well as an appropriate platform, to establish preferential market access through the conclusion of recognition arrangements. Thus, an article of the Annex translates in a bilateral setting the provision on recognition set out in paragraph 3 of the GATS Annex on Financial Services. The crux of that article is to ensure that parties afford each other adequate opportunities to negotiate recognition agreements. The Annex thus becomes an efficient vehicle for advancing in terms of mutual recognition.

The last article of the Annex covers the issue of the transfer and processing of information. This provision, deriving from the GATS Understanding on Financial Services, aims at ensuring an unhindered flow of information.

Many countries are used to establishing a sub-committee on trade in financial services under their FTAs. In contrast, Switzerland generally does not seek to establish a sub-committee on financial services in its Annex, although it has been open to such an organ in past negotiations depending on the market size of the financial sector of its free trade partner. From an institutional perspective, Switzerland's overall stance is to leave the management of the FTA on issues related to financial services to the Joint Committee established for the management of the entire agreement.

In short, by addressing issues of market access and national treatment as well as issues of transparency, domestic regulation and recognition, the Annex covers most, if not all, trade relevant aspects of the financial sector. Of course, it is far from being a Swiss specialty. On the contrary, most FTAs actually contain provisions of that kind. In Switzerland's view, the Annex constitutes an indispensable foundation on which to build specific commitments, to which we now turn.

#### IV. SPECIFIC COMMITMENTS AND MFN

Specific commitments are obligations undertaken in respect of market access and national treatment provisions. Such obligations are contained in separate lists that are country-specific: each party is bound by its own list. The listing technique may be based on a positive method, similar to the GATS Schedules of specific commitments, or on a negative method, as was the case for example, in the agreement between Switzerland and Japan. Such lists, whether positive or negative, cover all services sectors and all modes of supply, and thus encompass the entire range of financial services.

The four modes of supply for which commitments are undertaken are defined as in the GATS. Mode 1 refers to cross-border trade and covers activities such as selling credit card services to customers residing in the other party.

Mode 2 covers consumption abroad, for instance if an insurance company contacts a reinsurer residing in the other party to reinsure its risks. Mode 2 commitments do not allow for solicitation.

Setting up and operating a commercial presence in the other party falls under Mode 3. This is the case of subsidiaries, branches and representative offices of a financial institute of a party established in the other party.

Mode 4 – that is, movement of natural persons – has become a prominent topic of the Doha Round negotiations. This mode relates to the temporary entry and stay of a number of categories of natural persons such as business visitors, intra-corporate transferees, or contractual service suppliers.

Of course, in terms of a ‘reality check’, all modes matter, as no business plan could be uni-modal.

Parties to a FTA may under certain conditions make exemptions to the most-favoured-nation (MFN) obligation. The purpose of such exemptions is to allow a party to discriminate in favour of its preferential partner over non-parties.

#### A. SWITZERLAND’S INTERESTS

Switzerland’s market interests in the financial sector are focused on a limited number of financial activities. In the insurance business, Switzerland’s main worldwide activity is reinsurance. But also some types of primary insurances are present, for instance large-risk insurances, such as those for industrial complexes. In the banking business, asset management is by far the most prominent activity. Other activities, particularly in relation to the issuance and placement of securities and other types of debt instruments also play a substantial role in Swiss exports. Last but not least, the whole array of ‘softer’ activities such as the provision of financial information, financial software, research and advisory services are of importance. In a nutshell, Swiss institutes have long specialized in niches where outstanding competence can make all the difference, and where the quality, reliability and reputation of the provider are more decisive than the price. In effect, the primary customers of the activities enumerated above are expected to be other financial institutes, or more generally other large companies. Clearly, mass products and retail banking are not where Switzerland sees its competitive advantages, neither in trade in goods, nor in trade in services. So much as to the sectors where Switzerland would put its focus. Of course, the actual line taken in a negotiation will depend on the state of play in the market of the negotiating partner. There is no point in insisting on full-scale commitments on reinsurance in a country where there are no local insurance companies as potential clients to begin with.

In sectors that Switzerland retains for pursuing negotiations on specific commitments, the weight is normally put equally on all modes of supply. This, among other reasons, is mainly due to the sophisticated nature of the sectors that Switzerland targets. These businesses rely on skills that are relatively scarce, and where in many foreign markets the number of clients is quite selective. The highest level of competence and expertise can only be delivered if there is a substantial degree of centralization in the production process. This is in contrast to ‘mass products’ requiring a lower level of skill, for instance currency exchange or credit cards

services, where a company may perfectly – and perhaps more appropriately – achieve worldwide supply channels through commercial presence.

Furthermore, Switzerland considers that MFN exemptions in the financial sector are not appropriate and aims therefore at their elimination when negotiating trade agreements.

#### B. SWITZERLAND’S SPECIFIC COMMITMENTS IN FTAs

In its specific commitments on financial services, Switzerland is binding a level of market access in FTAs which usually goes beyond the level granted in the GATS. The specific commitments may be based on a positive list approach (GATS approach) or, as in the case of the Free Trade and Economic Partnership Agreement between Switzerland and Japan, on a negative list approach. Following a broad-based definition of financial services, it covers all financial services, including insurance, banking and other financial services in all modes of supply. In the banking sector, Switzerland is undertaking a far-reaching commitment on Mode 1 (cross-border supply) which reflects its open regulatory regime for foreign financial products supplied on a cross-border basis.

The reciprocity rule contained in Swiss banking legislation is not applied to GATS and free trade partners, so that Switzerland has no MFN exemption in the financial sector.

#### V. CONCLUSION AND EVALUATION

Switzerland has now reached a point where the number of its FTAs covering financial services is great enough, and the partner countries diversified enough, to allow certain conclusions to be drawn. Both in terms of disciplines (the Annex) and commitments, the legal framework established by FTAs goes beyond that of the GATS and grants additional legal certainty on a number of specific and important issues. Against that background, the outcome obtained and the basis used to negotiate are seen as satisfactory from a financial industry perspective and by the competent agencies involved. Of course, the question often raised is how much further the original texts from the GATS should be revised, reworked and strengthened. But given that FTAs represent a parallel set of rules applicable to the same trade flow already falling within the scope of the GATS, departing too much from the latter is a delicate issue. The balance achieved in the Swiss experience is that Switzerland maintains the foundation of the GATS and builds upon it, while modernizing and upgrading the fittings. This approach has proved to be sufficiently convincing for regulators in both parties to the FTAs to feel comfortable with the various sets of parallel trade rules, while the business sector of both parties sees real added value.

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## About the Editors

To gain from trade, modern economies rely on a stable financial system. In many countries around the world, the benefits of finance are taken for granted. Financial stability comes to the forefront only in times of crisis. The global financial crisis of 2008 and 2009 exposed some of the regulatory and market failures of a more and more globally organized financial system and led to far-reaching discussions about a broad range of academic and policy issues on the regulation of financial services.

Against this background, this edited volume brings outstanding expertise and provides insightful perspectives from nineteen authors with diverse backgrounds, including officials from international organizations, national regulators, and commercial banking, as well as academics in law, economics, political economy, and finance. The authors not only shed light on the causes of the financial turmoil, but also present thoughtful proposals that contribute to the future policy debate, and discuss opportunities that financial services can offer in funding activities which raise standards of living through initiatives in microfinance, renewable energy, and food distribution.

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