The financial services chapter: Inflating bank profits at the expense of citizens

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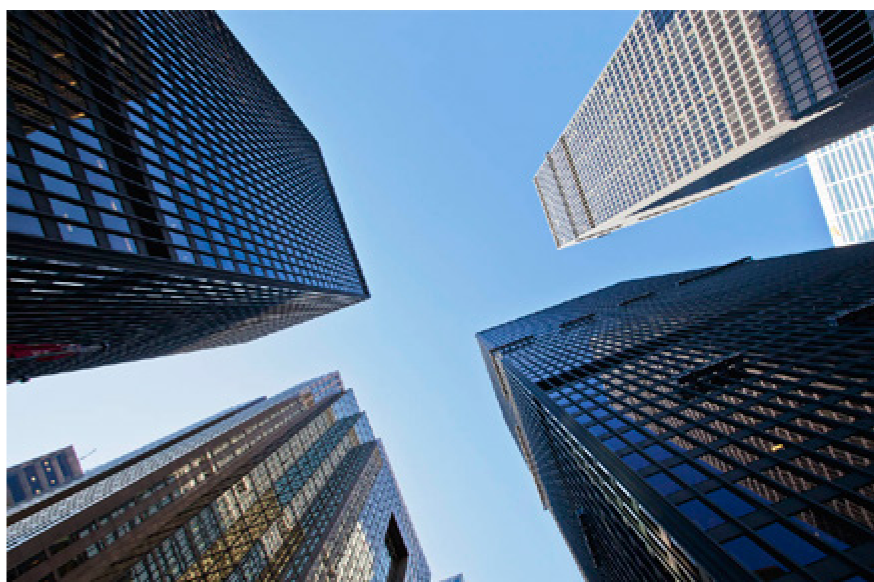
Canada weathered the financial crisis of 2007-08 better than many other countries and regions, including the European Union (EU). According to the International Monetary Fund (IMF) and other experts, this was because Canada had much stricter regulations and supervision, and its domestic banking and financial sector is less open to foreign investment and competition.[1] The six largest Canadian banks, for example, control over 90 per cent of the country's banking assets and are protected from foreign takeovers via mergers and acquisitions.



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Despite these lessons, the financial services chapter of the EU–Canada Comprehensive Economic and Trade Agreement (CETA) would ensure a wider opening of the financial sector and the financial markets in Canada and the EU. CETA will not only allow more cross-border financial services (e.g. advice on portfolio investments), but also facilitate more investments (including takeovers) in each other's financial sectors (e.g. the establishment of bank branches). Advocates of free trade hail the enhanced investment competition between EU-based and Canadian banks and other financial service suppliers. A clear downside is that it makes the financial systems in both Canada and the EU more interconnected and vulnerable to external shocks and contagion.

Obligations found elsewhere in CETA further enhance the risk of rapid spillovers and financial instability in times of crisis. For example, the agreement's final provisions require the Parties (Canada and the EU) to authorise any payments and transfers on their current accounts (Article 30.4), and create an obligation to consult

1 See for instance Giovanni Aversa (editor), *'Canada's financial system among federal regulation and economic crisis. Strengths and vulnerabilities'*, E-encyclopedia of banking, stock exchange and finance, Assonebb (http://www.bankpedia.org/index.php/en/89-english/c/23915-canadas-financial-system-among-federal-regulation-and-economic-crisis-strengths-and-vulnerabilities-encyclopedia); and Chrystia Freeland, *'What Toronto can teach New York and London'*, Financial Times, 29 January 2010.

with a view to liberalising transfers of very large amounts money and investment payments, i.e. capital and financial accounts (Article 30.5). CETA also imposes many conditions on measures taken by a country in financial difficulty to restrict payments and movement of capital (see Articles 28.4, 28.5 in the exceptions chapter), even when the recent crisis clearly proved the importance of curbing speculative capital flows as a means to prevent financial crises.

In general we can say the increased competition envisioned in CETA ensures that the financial industry, in order to capture markets, will display more risk-taking behaviour, sell more high-risk financial products, and reduce services to less affluent clients. The CETA dynamic thus runs counter to post-crisis attempts to reform the financial sector, remove the key causes of financial instability, reduce risk-taking behaviour, shrink the size of the financial sector (i.e. *'too big to fail'*), and ensure better protection of consumers and the economy as a whole.

Meanwhile, the CETA text restricts the ability of governments, parliaments and other public institutions to regulate finance in the public interest, whether to prevent a financial crisis and/or reform the financial sector, except in cases where Canada or the EU have made specific exemptions from treaty rules. The agreement would also expand the rights of foreign investors to challenge financial regulations through investor–state dispute settlement, and apply unprecedented and controversial restrictions to non-discriminatory domestic regulation, such as licensing requirements in the financial services sector.

KEY PROVISIONS

'Market access' rules in CETA's financial services chapter (Article 13.6) prohibit financial regulators from taking measures that would limit the participation of foreign capital in a domestic bank or other domestic financial company, or from limiting the number of financial service providers of the other party, the total value of their financial transactions or the total number of their service operations. Taken at face value, such rules contradict measures that need to be taken to reduce bubbles in the financial sector and trim *'too big to fail'* banks and insurance companies (to avoid more costly bailouts with taxpayer money). Interestingly, though regulators are generally prohibited by CETA from requiring financial services to be supplied through specific types of legal entities, it remains permissible *'where under the laws of the Party the range of financial services supplied by the financial institution may not be supplied through a single entity'* (Article 13.6.3 [b]). This clarification may allow for the separation of speculative and basic retail banking operations, which is being considered by the EU and other regulators as a way to curb future financial crises and bailouts.[2]

CETA defines which laws and other measures are to be allowed as prudential measures to regulate the financial sector (Article 13.16, referred to as the *'prudential carveout'*). The definition deviates somewhat from other free trade agreements (FTAs) in that prudential measures are not only those protecting investors, clients and financial stability, but importantly also include interventions to ensure the integrity and responsibility of a financial institution. Moreover, Annex 13B of the financial services chapter lists a number of guarantees to ensure that prudential regulations are not unduly restricted by CETA. While this additional protection for financial regulation is unprecedented in a trade and investment agreement with the EU, it remains to be seen what its practical scope will be. Additionally, it does not

2 It is unclear how far the CETA caveat will hold, as it is not included in the Trade in Services Agreement (TiSA) currently being negotiated behind closed doors between the EU, Canada and 21 other WTO member countries, and which covers mostly the same financial services .

seem likely this improved language will be included in the Trade in Services Agreement (TiSA), where both the EU and Canada are negotiating on the same financial services.

CETA circumscribes how licensing and qualification requirements and procedures may be applied, and it will make it more difficult for regulators and supervisors to act and react by stipulating such rules must be established in advance and in the most objective and simplest way for financial service providers and investors (Article 12.3, applicable to the financial sector by means of Article 13.2.6). Licensing and qualifications are important, not only to guarantee the integrity of the scandal-riddled financial sector, but also to deal with new products and future regulatory challenges relating, inter alia, to technical and digital innovations (called fintech).

Within three years of CETA coming into force, the EU and Canada will have to negotiate rules restricting performance requirements for investments in the financial industry. If no agreement is reached within that period, the performance requirements applicable to investments in general (i.e. those mentioned in Article 8.5 of the investment chapter) will automatically apply. These would greatly restrict government policy space to regulate foreign financial investors (e.g. foreign banks and foreign hedge fund managers) to ensure beneficial impacts on the domestic economy. Importantly, the Article 8.5 performance requirements prohibit regulators from restricting the sale of a good or service (e.g. money transfers) by relating them to the volume or value of financial services exports or foreign exchange earnings. Allowing such freedom for services and capital movements in the financial sector can become very financially destabilizing because they can exhaust the financial reserves of a country (current and capital accounts) and increase pressures to devalue the currency.

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Market opening in CETA takes place through *'schedules'* in which parties list the subsectors or measures they wish to exclude from liberalisation and deregulation. This *'negative list'* approach to making commitments, which is quite new for the EU, implies that all financial service sectors are to be opened up unless they have been explicitly excluded. The EU should be aware of (the impact of) all the financial services it has liberalized.

Negative listing has the effect of automatically subjecting new financial services (i.e. services or sectors developed after CETA is signed) to competition from foreign financial services suppliers and investors without knowing what the effect might be. Article 13.14 creates some space for government regulation of new services—e.g. the parties *'may determine the institutional and juridical form through which the new financial service may be supplied and may require authorisation for the supply of the service'*—but it is quite limited. Where the negative impacts of a service (e.g. a risky investment or fintech product that results in customers losing money) become apparent only at a later stage, or when unforeseen consequences should materialise, CETA leaves very little scope

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to reverse market access schedules (Article 30.2).

Such guarantees that markets will remain open are a big win for investors, who want the certainty they can reduce their costs by preempting future regulation and that they will be able continue their presence. Many Canadian provinces have included exemptions from foreign takeovers, and guarantees that provincial laws will remain applicable to the foreign financial industry, in order to ensure that financial services are adapted to local circumstances. Europe, on the other hand, has included few, if any, guarantees of this nature.

NEW INDUSTRY PRIVILEGES, FEWER DATA PROTECTIONS

CETA provides no assurances of better financial services to businesses and the general public or sufficient financing for the much-needed transition to a more socially and environmentally sustainable society in Canada and the EU. CETA does, however, stand to substantially increase the profitability of the financial industry by extending the ways and instruments at its disposal to protect its interests. Consider the following new privileges CETA would extend to the EU and Canadian financial sectors:

➜ General investment protections—including to *'fair and equitable treatment and full protection and security'*, compensation for losses and particular expropriations, permission to transfer all money related to the investment, etc.—will be fully applicable to the financial sector (Article 13.2.3).[3]

➜ The option to sue the government under the investor–state dispute settlement (ISDS) process (the *'Investment Court System'*) if a financial service provider or an investor thereof deems a regulation or other measure to be in breach of the abovementioned investment protections. Belgium, Greece and Cyprus have already faced investment claims over measures taken to address the impacts of the financial crisis. Interestingly, suing a government over losses arising from existing and new prudential financial regulations appears to be somewhat more difficult than in other FTAs. Specifically, an investor–state challenge to financial regulation can be declined at the outset by decision of a Canada–EU Financial Services Committee (to be instituted under CETA) or, failing this, the CETA Joint Committee (Articles 13.1–6 and 13.16, Annex 13B). However, where Canada and the EU fail to reach consensus in these bodies, or the procedures are not respected within the periods as determined by CETA, regulatory measures remain open to challenge.

➜ Some government bonds, referred to as *'public debt'*, are also subject to ISDS.

3 Article 13.20 states: *'The CETA Joint Committee may establish a list of at least 15 individuals, chosen on the basis of objectivity, reliability, and sound judgement, who are willing and able to serve as arbitrators'*, and, *'The arbitrators included on the list must have expertise or experience in financial services law or regulation or in the practice thereof, which may include the regulation of financial service suppliers.'* Given the novelty of these reforms to the ISDS process, it is far from clear how this will affect arbitration related to financial services.

Annex 8B excludes claims in relation to bonds that are not being paid out (in full) as a result of a *'restructuring'* of the debt if at least 75 per cent of the bond holders have consented to such a debt reduction process. By implication, in other circumstances where governments confronted with a financial crisis act to reduce public debt to protect public interests, bond holders may bring claims for full repayment under ISDS—at the expense of the taxpayer. Some hedge funds, referred to as vulture funds, specialise in exploiting defaults on government debt and refuse to consent in a debt reduction.

➔ In addition to ISDS, financial services suppliers and investors are protected by state-to-state dispute settlement for breach of other articles in the agreement.

While financial services firms and investors are generously protected by CETA's investment rules, the privacy of their clients and the general public is not. Article 13.15 states the EU and Canada should maintain *'adequate'* safeguards to protect privacy and that the transfer of personal information related to financial information should happen in accordance with the laws where the transfer originates. However, CETA also requires each party to *'permit a financial institution or a cross-border financial service supplier of the other Party to transfer information in electronic or other form, into and out of its territory, for data processing where such processing is required in its ordinary course of business'*. This raises many questions in the context of current data protection discussions, for example with respect to the Privacy Shield framework for EU–US personal data transfers.

For instance, what are *'adequate'* safeguards? Who will check whether the data transfer only happens for processing and for ordinary business purposes? How will the EU verify that personal information will be protected in Canada in the same way as required by the EU or vice versa? Financial and personal data are a highly attractive target for hackers, intelligence agencies and marketers, which means that strong safeguards are needed to protect them. The financial industry has already demonstrated its opposition to restrictive laws aimed at the protection and localisation of personal financial data because of the alleged impediment to flexibility and the cost involved.[4]

CURBING THE RIGHT TO REFORM

Last but not least, CETA also provides the financial sector with the means to directly influence democratic decision-making around prospective financial legislation and regulation. The EU and Canada have agreed they shall, *'to the extent possible'*, provide the financial sector and other stakeholders a reasonable opportunity to comment on a law, regulation, procedure or other measure that a country or the EU is proposing to adopt regarding the financial sector (Article 13.11). The financial sector has considerable resources at its disposal. And, based on its response to post-crisis financial reforms, its lobbyists have demonstrated they can seriously undermine financial legislation aimed at protecting people, governmental budgets and the economy from abusive practices and financial instability or crises. There are no provisions in CETA that guarantee comments received during the regulatory development stage will be balanced against inputs or arguments from outside the financial sector, and that the public interest will be prioritised.

In Annex 13C, the EU and Canada commit to establish dialogues on regulations that relate to international standards and

4 For example, the US financial industry lobbied vigorously against the US government's position to permit the localisation of financial data in the TPP, and threatened not to support the treaty if the right to freely transfer all data, including financial data, was not assured. The TiSA negotiations also discuss the transfer of financial data, and not just for processing purposes.

cross-border financial stability. Missing are strong frameworks for permanent co-operation between supervisors to swiftly detect risky behavior, prevent abusive practices, protect customers, pinpoint financially unstable situations, and act immediately and in unison in times of financial crisis. The impacts of the 2008 financial crisis were so much more severe in Europe than in Canada in part because the EU had a much more open, liberalised financial sector with incomplete regulations and supervision, and insufficient frameworks to cooperate in times of crisis. With the EU already dragging its feet on needed reforms, ratifying CETA would make them all the more difficult to realise or to put in place the appropriate mechanisms to cooperate with Canada to handle the next financial crisis.