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REGIONAL COMPREHENSIVE ECONOMIC PARTNERSHIP

WORKING GROUP ON INVESTMENT (ASEAN CAUCUS)

PAPER: THE IMPORTANCE OF PRUDENTIAL MEASURES ELEMENT IN RCEP AGREEMENT AND THE CROSS CUTTING ISSUES BETWEEN SERVICES AND INVESTMENT CHAPTER

Submitted by: Indonesia

Taking into account deliberations at 8th RCEP-WGI in Kyoto, June 2015 (referred to paragraph 7 of the Summary of Discussion), Indonesia submit the following paper to assist further consideration of the inclusion of prudential measures element in RCEP agreement and may be considered as a cross cutting issues due to the linkage between Services and Investment Chapter.

I. Introduction

1. In the small open economy characterized by growing importance of financial systems, capital movement in/out of the country in the context of investment majorly facilitated by the use of financial services especially banking services. In the other hand, opening financial market to foreign financial firms can itself contribute to strengthening domestic financial system through the creation of more competitive and efficient host-country markets.[1]
2. The measures to promote competitive markets must be completed by measures to ensure the stability of the financial system and to provide adequate protection for consumers of financial services. At the same time, adequate prudential regulations played an important role in achieving the maximum benefits of liberalization while minimizing the risk.[2] Such risks sometimes caused a systemic effect. Hence, prudential regulations needed to ensure such risks are well-managed and authorities have full discretion in implementing policy space to take measures to ensure the integrity and stability of country's financial system as a whole.
3. The purpose of this paper is to inform AMS the importance of Prudential Measures element in RCEP Agreement and its linkage between services and investment chapter.

II. The Essence of Prudential Measures

Financial Stability

4. Prudential Measures are closely related with macroprudential and microprudential policy to maintain financial stability and anticipate potential systemic risks. Apart from monetary policy which aims at ensuring price stability for goods and services in supporting real sector, prudential policy is conducted to tame the financial sector in asset market segments showing signs of exuberance or where imbalances could be forming[3].

[1] Key, GATS 2000: Issues for the Financial Services Negotiations, p.6.
[2] Key, GATS 2000: Issues for the Financial Services Negotiations, p.7.
[3] Speech by Vítor Constâncio, Vice-President of the ECB, Warwick Economics Summit, 13 February 2015

5. There are no official definition of financial system stability, but in several reference, financial stability could be expressed in a condition of financial system:[4]

   a. Efficiently facilitating allocation of resources from time to time, from depositors to investor, and allocation of economic resources as a whole,

   b. Could identify/assess and manage financial risks,

   c. Could efficiently absorbs turmoils in financial and economic sectors.

   In general, financial system stability is financial resiliency towards economic shock, where intermediary function, payment system, and distribution of risks are running well. To achieve those purposes, there are 4 (four) beneficial factors: i) stable macroeconomic situation, ii) well-managed financial institution, iii) effective supervision of financial institution, and iv) safe, sound, and effective payment system.

6. Stable financial system will:

   a. Create trusts and conducive environment for depositors and investors to put funds in financial institutions, and guarantee financial services consumer's interest.

   b. Promote efficient financial intermediary function which lead to investment and economic growth

   c. Promote market mechanism and efficient allocation of economic resources

Prudential Measures in GATS

7. The importance of maintaining the health and soundness of the banking and other financial services industry had encouraged the establishment of the rule of prudential carved-outs in the GATS Annex on Financial Services. Essentially this provision gives the financial services authority including banking authority to apply prudential measures for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system, even though it was contrary to market access or national treatment or MFN obligations commitments. However, prudential measures may not be used as a means of avoiding the member's commitments or obligations under the Agreement.[5]

8. WTO/GATS recognise the Prudential Measures as prudential carved-out principle which incorporated in its Annex on Financial Services (AFS). The common language and element of prudential measures element is as follows:

   (a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investor, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform to the provision of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement."

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[4] Schinasi (2006).
[5] Key, *supra* note 4.

(b) Nothing in the Agreement shall be construed to require a Member to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities.

The first sentence of paragraph (a) is the so-called prudential carve-out which authorizes a Member to take prudential regulatory measures that may restrict financial service trade[6]. The second sentence of paragraph (a) qualifies the first sentence, providing that such measures allowed by the first sentence shall not be used as a means of avoiding the Member's commitments or obligations under the GATS.[7]

9. Prudential carve-out principle is the way for the competent authorities of the WTO members to, in a good faith, conduct prudential safeguard measures to maintain sustainability and integrity of financial system. Prudential carve-out allow member countries to partake in liberalization process of their financial services while ensuring that the liberalization process does not, in any way, pose serious threat to the financial system. However, as made clear by GATS, the carve out, is by no means an avenue to avoid commitment or obligations.

The Role of Authority in Implementing Prudential Measures

10. WTO members are all aware of the unique nature of financial services compared to other services sector. The main unique characteristics is the trust of business actors and individuals which allows their funds to be managed in financial services, and high level of interconnectedness which may caused potential systemic risks to the economy. This basic nature of trust and its inherent risks leads to the needs of prudentiality in delivering financial services. Its compliance also continuously being monitored by relevant authority to ensure financial services intermediary function are well managed and could delivers positive contribution to the economy.

11. In maintaining financial resilient and stability, monitoring of potential crisis risks symptoms is necessary as well as regular dangerous potential risks projection. Financial system stability is a form of public policy which generally is a result of responsibilities from all relevant stakeholders:

    a. Financial authority (government, financial services authority, central bank, financial deposit insurance, etc.)

    b. Financial business actor (banks, capital market, non-bank financial institutions)

    c. Public (particularly financial services consumer)

12. In general, relevant authority has financial system stability function to analyze and assess potential risks and propose recommendation for necessary policy to be implemented as part of financial stability measures.

    i.e central bank is responsible to ensure state's financial system stability. This function is quickly and effectively conducted by mitigating economic instability through instruments introduced by central bank that can lower the liquidity pressure and recovering market sentiments. Liquidity pressure can be eased by open market operation or other liquidity injection instruments such through lender of the last resort function/discount window.

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[6] WTO Secretariat, Guide to the Uruguay Round Agreements 176 (Kluwer Law international 1999)

[7] Ibid.

Central bank can also imposed adjustable bank's reserve requirement or through interest rates policies.

III. The Importance of Prudential Measures in RCEP Agreement and Its Linkage Between Services and Investment Chapter.

The Importance of Prudential Measures in RCEP Agreement

13. RCEP establishing an open trade and investment environment in the region to facilitate the expansion of regional trade and investment and contribute to global economic growth and development. To achieve a modern, comprehensive, high-quality and mutually beneficial economic partnership, RCEP should include meaningful provision to support and encourage participants in achieving the maximum benefits of liberalization while minimizing the risk.

14. Prudential Measures play an important role in achieving the maximum benefits of liberalization while minimizing the risk and need to be addressed in RCEP Agreement. The main reason Prudential Measures need to be incorporated in RCEP Agreement, as follows:

    a. Prudential regulation has become a major policy issues in recent years due to increasing globalisation of financial markets that has been facilitated by deregulation and liberalisation of the provision of financial services and accompanying capital flows. Recent global financial crisis have highlighted the importance of adopting sound prudential regulatory regimes to enhance financial stability.

    b. Investment in a country, by nature, seeks future higher asset value than the present. Without proper prudential regulation of financial market, volatility of asset value may deteriorate real values of investment. Hence, the ability of authorities for taking prudential regulation shall be seen as an effort to maintain investor's interest in terms of asset values which also have beneficial outcome not only for financial market stability but also investor's values of investment.

    c. Taking into account of vulnerability risk became an integral part of financial sector, investment in financial sectors that presence through Mode 3 (commercial presence) need to be protected from the risks that leave financial instability and potentially lead to financial systemic affect.

    d. Prudential Measures is a space for the authorities to implement the various policies and rules for prudential purposes.

15. Prudential Measures has been addressed in some FTA agreements and are placed under services/investment chapter, sub-title 'Domestic Regulation' or 'Prudential Measures'.

Linkage of Prudential Measures Between Services and Investment

16. 'Prudential Measures' commonly introduced in free trade agreement negotiations as a part of trade in services obligations especially in financial services.

17. In the FTA / CEPA, the service sector or the presence of foreign services providers in a host country performed through the opening of market access of commercial presence (Mode 3). In this context, it can be said that investment in the financial services sector performed through the opening of Mode 3 services supply (commercial presence). As a

result investment in a financial services business in the territory of an FTA party could be subject to disciplines of both the services and-investment chapters of the FTA.

18. As mentioned above, since financial services has a unique/characteristic and highly regulated sector, Prudential Measures has been adopted in financial services sector as stated as prudential carve-out (AFS). In this context, when the authorities applied Prudential Measures in order to maintain a sound and stable financial sector, the action will take effect to the financial sector in both disciplines, services as well as investment.

19. In the absence of prudential carve-out principle which covers investment related chapter and only covers in services related chapter in FTA, a measures taken by authority related to prudentiality will potentially being subject to dispute by other parties (investor/state). The authorities may face risk of being alleged for expropriation and later be obliged to compensate investor for prudential measures implemented. For example, authorities is risked for being claimed by investor for revoking license of financial institution after failure to meet the minimum prudential standard set.

20. Based on above consideration and referring to text from cross-border investment agreement, both in terms of FTA or bilateral investment treaties, there are possibility to place prudential carve-out principle in investment.

IV. Indonesia Cases Involving Prudential Measures Provision (ICSID and UNCITRAL)

21. ICSID Case No. ARB/11/13 (Rafat Ali Rizvi vs. Republic of Indonesia)

    Claimant requested arbitration using **'UK & North Ireland – Indonesia Bilateral Investment Treaty'** to ICSID for prudential measures taken by Indonesia (Respondent) in the form of bail-out to Bank Century. ICSID later dismissed Claimant's argument by accept Respondent's jurisdictional objection that Claimant's investment was not granted admission in accordance with the Foreign Capital Investment Law of Indonesia, as required by BIT.

22. UNCITRAL Case (Hesham Al Warraq vs. Republic of Indonesia)

    Claimant submitted arbitration using **Organization of Islamic Cooperation (OIC) Investment Agreement** to UNCITRAL for prudential measures taken by Indonesia (Respondent) in the form of bail-out to Bank Century. UNCITRAL later dismissed unlawful expropriation claims by Claimants and decided that Respondent did not expropriate the Claimants investment since there are no deprivation of Claimants ownership or actual control of investment. Further, the bailout is deemed lawful and conducted by competent legal authority.

V. Comparison of Prudential Carve-Out Element Placement in Some FTA/BIT Agreement

There are some examples of prudential carved-out principle placement in FTA/CEPA and Bilateral Investment Treaties (BITs). In general, some FTAs/BITs placed prudential carved-out principle under financial services annex of services chapter, and some others placed in investment chapter main text, as follows:

Options	Modality	Description
1	IJEPA Style	Incorporated as main text in Investment Chapter

2	GATS Style	Incorporated under Annex on Financial Services Chapter
3	ACIA/AK-FTA/AIFTA Style	Incorporated as General Exception with text on GATS Annex on Financial Services will prevail, *mutatis mutandis*, when related to financial services
4	Ongoing AJCEP	Incorporated either in Investment Chapter main text and/or Annex on Financial Services under Services Chapter, subject to legal scrubbing.
Other Bilateral Investment Treaty (BIT) Models		
5	US-BIT Model	Incorporated as main text in Financial Services Chapter
6	India BIT Model	Incorporated as General Exception with specific text related prudential carve out as a measures to ensure stability of financial system, banks, and financial instititons
7	Canada FIPA Model 2004	Incorporated as General Exceptions with specific matters on Prudential Measures (including monetary and credit policies, and exchange rate policies)

23. In the context of it's linkage to services obligations, addressing prudential measures in investment obligations is deemed necessary. State's ability to set, monitor, and implement measures with regard to prudential standard is also essential protection to investor by ensuring economic and financial system stability and integrity as a whole, and for this reason, Indonesia views that carving out prudential measures from expropriation is deemed necessary.

24. There are some possibilities to put prudential measures element in investment chapter

    a. By non-applying prudential measures in Article of Scope, and/or

    b. By non-applying prudential measures in Article of Expropriation, and/or

    c. By introducing Prudential Exception as part of Article of General Exception, or

    d. By introducing prudential exception in whole RCEP Agreement General Exception.

VI. Conclusion

25. Prudential Measures play an important role to ensure risks in the financial sector are well-managed and authorities have full discretion in implementing policy space to take measures to ensure the integrity and stability of country's financial system. As the result financial stability could bring positive impact to the investment climate.

26. To achieve a modern, comprehensive, high-quality and mutually beneficial economic partnership, RCEP should include Prudential Measures provision to support and encourage participants in achieving the maximum benefits of liberalization while minimizing the risk.

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