NATIONAL TREATMENT PRINCIPLE IN GATS:
A Study of Vietnam's Insurance Services Market

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Foreword

This book is a product of Dr. Vu Nhu Thang's three-year research as a Ph.D candidate at the Graduate School of International Development, Nagoya University.

Vietnam acceded to the World Trade Organization (WTO) in January 2007 and it marked a milestone in the history of its Doi Moi and the process of its entry into the global economy. While, as the 150th member of the WTO, Vietnam now can enjoy the benefit of non-discriminatory access to other members' markets and, if any dispute, can take advantage of the WTO dispute settlement mechanism, it is also obliged to implement a lot of commitments it made upon accession, including tariff rate reduction, liberalization of service markets and improvement of intellectual property protection.

Among others, the author focuses on the issues surrounding liberalization of the insurance market in Vietnam after the WTO accession, especially the national treatment principle of General Agreement on Trade in Services (GATS) and the so-called prudential exception in its Annex on Financial Services. In spite of their importance, WTO case law has not yet been so sufficiently developed on their interpretation as to give clear guidance to negotiators, legislators and other practitioners who are involved with service negotiations as well as domestic implementations of service commitments. Against such a background, PART I tries to clarify interpretations of the national treatment principle in GATS as well as the prudential exception by transplanting the interpretation of the national treatment principle in GATT and by relying on the interpretative approach adopted by panels and the Appellate Body in the WTO dispute settlement cases. I believe it is the first comprehensive and systematic research on these issues and is an invaluable contribution to our understanding of the GATS obligations not only in service sectors in general but also in financial services in particular.

Based on the achievement in PART I, PART II goes on to introduce the history of Vietnam's insurance market, analyze Vietnam's relevant commitments, and discuss what challenges it will face and how it should tackle them. PART II also offers a very concrete roadmap for reforms of insurance regulations, especially for introduction of necessary prudential regulations. Given the fact that the Vietnamese Government will start to discuss amendment of Insurance Law this year and that the National Assembly plans to discuss it in 2009-2010, this book comes at a most opportune time and I am sure it can supply useful and reliable guidelines in the legislating process. Since the author has returned to the Ministry of Finance, which is directly in charge of such reforms, this is also a must-read book not only for Vietnamese but also for foreign businesses who would like to know which direction Vietnamese regulations on insurance markets will take.

For three years, I have been enjoying advising, discussing with and learning from the author. I am very proud of being involved in education and capacity building process of such a talented young person who is now one of distinguished WTO law experts.

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I greatly appreciate *Fordham Journal of Corporate and Financial Law, Manchester Journal of International Economic Law, Forum of International Development Studies,* and *Vietnam Law and Legal Forum* for allowing me to incorporate my published articles in this book. I also wish to acknowledge the kind acceptance of the Center for Asian Legal Exchange, Nagoya University to publish my doctoral thesis as a CALE book.

Last but not least, I owe my deep gratitude to my beloved parents for their greatest and warmest encouragement; my dearest wife, Hien Anh, for her understating, patience, sacrifice, everlasting love and constant faith in me; and my lovely daughter and son, Hien Minh and Quoc Minh, for their naïve inspiration and emotional support.

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List of Abbreviations

ACP	: African, Caribbean and Pacific countries
BIDV	: Bank for Investment and Development of Vietnam
c.i.f.	: cost, insurance, and freight
COMECON	: Council for Mutual Economic Assistance
CPC	: Central Product Classification
CVA	: Canadian Value Added
DSU	: Understanding in Rules and Procedures Governing the Settlement of Disputes
EC	: European Communities
EEC	: European Economic Community
EU	: European Union
EUR	: Euro
GATS	: General Agreement on Trade in Services
GATT	: General Agreement on Tariffs and Trade
GDP	: Gross Domestic Products
GNS	: Group of Negotiations on Services
IAIS	: International Association of Insurance Supervisors
ICP	: Insurance Core Principle
MFN	: Most-Favoured-Nation
MOF	: Bo Tai chinh (Ministry of Finance) (Vietnam)
MTN	: Multilateral Trade Negotiations
NAIC	: National Association of Insurance Commissioners
OECD	: Organization for Economic Cooperation and Development
RBC	: Risk-based capital
SC	: schedule of commitments
SEACEN	: Southeast Asia Central Banks
SOE	: State-owned enterprise
The Annex	: Annex on Financial Services, GATS
UN	: United Nations
UNCTAD	: United Nations Conference on Trade and Development
US	: United States
US$	: United States dollars
US-VN BTA	: Bilateral Trade Agreement between the United States and Vietnam
VND	: Vietnamese currency (Dong)
WTO	: World Trade Organization

Executive Summary

The birth of the General Agreement on Trade in Services (GATS), after eight years of negotiations under the Uruguay Round, has reflected the endeavour by contracting parties of the General Agreement on Tariffs and Trade (GATT) to extend the multilateral trading system from goods to include services. Certain GATT principles and obligations are reworded to apply to the service realm, including the national treatment principle. GATS Article XVII on National Treatment deals with discriminatory measures concerning the level playing field between domestic and foreign services and service suppliers.

While national treatment in the context of trade in goods has been substantially explored and interpreted, the jurisprudence on interpretation of this principle in GATS is less developed. As both GATT and GATS are subject to a single dispute settlement mechanism under the WTO, there is clear rationale for transplanting GATT jurisprudence to the service sector. Furthermore, the language of national treatment articles in GATT and GATS shares a number of similarities, including likeness and the standard of "no less favourable treatment". However, the fundamental nature of intangibility and non-storability of services, which is different from goods, has made the interpretation of national treatment principle more complicated in the context of services.

The problems of uncertainty in interpretation of the national treatment principle in GATS would cause concerns over the liberalization of services in general and insurance services sector in particular by Members of the World Trade Organization (WTO). In contrast, the incorporation of the Annex on Financial Services, which covers the prudential exception to other obligations under GATS, including the national treatment principle, is proved to keep the right balance between liberalization and flexibility of Members in regulating domestic markets. A clear understanding of the prudential exception would contribute to facilitating on-going negotiations on liberalization of financial services, including insurance services, by offering a way of balancing between rights and obligations of WTO Members, and providing a proper space for Members in introducing prudential regulations without prejudice to the predictability and transparency of the multilateral trading system.

Therefore, the interpretation of the national treatment principle in the context of insurance services is proposed to follow a two-stage approach to determine, *firstly* whether a measure adopted by WTO Members accords less favourable treatment to foreign services and service suppliers than the domestic like counterparts, and *secondly* whether that less favourable treatment, if found, could be justified under the prudential exception. Three important understandings on the application of the national treatment principle in the insurance services sector have been found.

First, the GATS national treatment principle is the object of both negotiations for liberalization and dispute settlement mechanism. A WTO Member, therefore, is obliged to respect the national treatment obligation as far as that Member inscribes which service sectors and/or sub-sectors in its schedule as well as levels of commitment. However, the scope of the national treatment principle in GATS addresses all discriminatory measures which do not fall within the scope of Article XVI on Market Access between foreign services and service suppliers, on the one hand and domestic counterparts, on the other hand.

Second, similar to GATT national treatment in, the national treatment principle in GATS consists of three core elements for interpretation, namely "measures" affecting the

supply of services, "like" services and service suppliers, and "no less favourable" treatment. The WTO jurisprudence shows that the first element is broadly interpreted to encompass all measures directly and indirectly affecting trade in services. The possibilities of transplanting GATT jurisprudence on interpretation of likeness to GATS would lead the second element to a broad scope of likeness due to the uncertainty in criteria for comparing foreign and domestic services and service suppliers. The third element addresses a broad scope of discrimination, both *de jure* and *de facto*. In parallel with a broad approach to the interpretation of "measures" subject to GATS, the combination of uncertainty in interpretation of likeness and broad coverage of "no less favourable" treatment would lead to a high possibility for Members to violate national treatment in the context of services.

Third, to justify a measure which is found to violate the national treatment principle affecting trade in financial services, including insurance services, a WTO Member is required to satisfy a three-layer examination under the prudential exception. Under the first layer, that measure must fall within the scope of the "prudential reasons" which could be understood to address the solvency situation of insurers to fulfill their obligations towards policyholders and other relevant persons, and towards the stability and integrity of the financial system as a whole. The second layer is to examine the connection between that measure and prudential objectives through a "primarily aimed at" test. Under the third layer, that WTO Member must prove that the application of the WTO-inconsistent measure does not constitute disguised restrictions on trade in insurance services. Accordingly, when a measure is found discriminatory against foreign insurance services and service suppliers compared to domestic "like" counterparts in the context of the national treatment principle, by an objective assessment, it would (i) not constitute a violation of this principle if it falls under the scope of "prudential reasons" and qualifies the anti-avoidance provision; or (ii) constitute a violation of the national treatment principle if that measure does not fall within the scope of "prudential reasons" or the application of that measure is proved to constitute a disguised restriction on trade in insurance services.

As a WTO Member from January, 2007, in the insurance services sector, Vietnam undertakes direct insurance, reinsurance and retrocession, insurance intermediation, and services auxiliary to insurance for liberalization under the multilateral trading system. The full national treatment is inscribed in Modes 1, 2, and 3, and commitments with limitations in Mode 4. It means that, with respect to all measures affecting trade in insurance services under the meaning of GATS Article XVII, Vietnam is obliged to accord insurance services and service suppliers of any other WTO Member treatment no less favourable than it accords to its own like insurance services and service suppliers. While several inconsistent measures have been eliminated by the government right after the WTO accession, Vietnam is obliged to refrain from introducing any new measures which might constitute either *de jure* or *de facto* against foreign insurance services and service suppliers.

However, the uncertainty in criteria for determining likeness of services and service suppliers under the meaning of GATS Article XVII might raise several possible violations of Vietnam's commitments on the national treatment obligation. Specifically, insurance brokerage and agency services could be regarded as like services if only criterion of service classification is taken into account for comparison. Similarly, the likeness might be established among those services auxiliary to insurance, such as consultancy, actuarial, risk assessment and claim settlement. Accordingly, any different treatment, either *de jure* or *de facto*, against foreign services and service suppliers could be challenged by other WTO Members.

An overall evaluation of Vietnam's commitments under the WTO accession shows that Vietnam's insurance services sector has become more liberal to foreign participation and competition. Liberalization of insurance services under the WTO could offer some opportunities for further development of Vietnam's insurance market. Nevertheless, some threats of fierce competition and underdeveloped regulation should not be ignored, especially given weaknesses in both insurance companies *per se* and the whole financial system. In order to mitigate negative impacts of such threats, as well as maximize benefits of liberalization of the insurance services sector under GATS, more complex regulations should be enhanced in order to ensure the solvency of insurance companies for consumer protection as well as for the systemic stability.

Under GATS, Vietnam is entitled to introduce prudential regulations to address the solvency situation of insurance companies. Prudential regulations also exist in the Law on Insurance Business of Vietnam. Compared to other jurisdictions, for example the EU, US and Japan, there are some problems in the current solvency system. *First*, while the technical provisions are properly regulated, the existing rules on actuary would not well support compliance with the regulations on technical provisions established by insurance companies. *Second*, existing regulations would simplify the credit risk and liquidity risk of those assets that can represent the solvency margin. Reinsurance risk is not appropriately addressed by the current regulations. In addition, what appear to be missing in the solvency regulations are concrete remedial measures corresponding to different quantitative solvency control levels in order to recover the solvency of a financially problematic insurance company. *Third*, investment rules seem to overlook the concentration risk in respect to assets held by insurance companies. *Fourth*, while insurance intermediation might significantly affect the solvency of an insurer, several specific measures addressing the credit risk of insurance brokerage companies as well as agents seem not to be strictly concretized. *Last*, regulatory weaknesses also exist in the supervision of insurance holding companies.

Therefore, future solvency regulations should include: (i) enhancement of the actuarial role to support compliance with regulations on technical provisions; (ii) clear identification of permissible assets for calculating the solvency margin; (iii) incorporation of the reinsurance risk into the determination of solvency margin of insurers; (iv) inclusion of claims criterion for calculating the minimum solvency margin of non-life insurers; (v) more detailed quantitative solvency control levels to enable an early intervention by the supervisory authority in financially difficult insurers; (vi) concrete remedial measures corresponding to each solvency control level; (vii) establishment of a policyholder protection fund; (viii) introduction of more concrete quantitative limitations on maximum investment on each category of assets; (ix) limited relaxation on investment abroad from the technical provisions of insurers; (x) a more detailed requirement on the professional indemnity insurance to be kept by insurance brokerage companies; (xi) a pre-determined specific amount to be deposited by insurance agents; and (xii) concrete requirements on calculation of the adjusted solvency margin of an insurance holding company as well as group-wide information disclosure. All legal enhancements could protect the interests of consumers as well as improve public confidence, and consequently ensure the stability of Vietnam's insurance services sector after its accession to the WTO.

During the introduction of the above-said new prudential regulations, Vietnam should refrain from any discriminatory measures, either *de jure* or *de facto*, against foreign insurance services and service suppliers. Nevertheless, some measures might be found in violation of GATS Article XVII due to uncertainty in the interpretation of the national treatment

obligation. In such a circumstance, it would be safe if Vietnam could prove that those new regulations and measures in the insurance sector are "primarily aimed at" the solvency of insurance companies in the meaning of paragraph 2(a) of the Annex on Financial Services. In addition, Vietnam must ensure that the introduction and application of future solvency regulations are in a manner of, *inter alia*, flexibility, consistency, necessity and transparency, in order to avoid the possibility of violating the anti-avoidance provision under the prudential exception.

INTRODUCTION

Insurance plays a crucial role in the economy (Skipper; and Outreville). By transferring risk to insurers, consumers are able to mitigate financial losses due to the occurrence of certain events. Insurance, especially life insurance, could be an important channel for mobilization of savings, which is then transferred to investment. By collecting premiums when issuing insurance policies, insurers are required to invest the funds in order to be able to satisfy future claims. Therefore, insurers, especially life-insurers who are involved in long-term insurance contracts, would be active institutional investors.[1] They would contribute to the efficiency of financial system by (i) reducing transaction costs, (ii) increasing liquidity, and (iii) facilitating economies of scale in investment.[2] In addition, financial systems would also be enhanced by different risk management techniques offered by insurers such as risk pricing, risk pooling and reduction.[3]

Trade in insurance can make various contributions to the development of domestic markets. International spread of extremely large commercial risks, such as oil refineries and offshore rigs, satellites, jumbo jets, is necessary (Skipper; Feketekuty). At the multilateral level, trade in insurance services is governed by the General Agreement on Trade in Services (hereinafter GATS) since 1995.

The birth of GATS, after eight years of negotiations under the Uruguay Round, has reflected the endeavour by contracting parties of the General Agreement on Tariffs and Trade (hereinafter GATT) to extend the multilateral trading system from goods to include services. Certain GATT principles and obligations are reworded to apply to the service realm, including the national treatment principle. GATS provides a set of multilateral rules to address both discriminatory and non-discriminatory restrictions, which affect trade in services in general and insurance services in particular.

The national treatment principle deals with discriminatory measures concerning the level playing field between domestic and foreign services and service suppliers. In contrast to trade in goods, most restrictions on trade in services reside in national regulations (Feketekuty; Trebilcock and Howse). Since liberalization of trade in services ultimately requires the removal of those restrictions, the national treatment principle may be considered as one of the fundamental rules governing the multilateral trading system.

However, the application of the national treatment principle is conditional upon schedules of specific commitments by Members of the World Trade Organization (hereinafter WTO). In other words, furthering trade in services largely depends on negotiations regarding the undertaking of commitments on national treatment by WTO Members, which follows the progressive liberalization approach. Contrary to GATT, where the national treatment obligation is generally applied without making any prior commitment, the inclusion of the

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[1] Carter, Robert. 1990. Obstacles to International Trade in Insurance. In Edward P.M. Gardener, ed., *The Future of Financial Systems and Services. Essays in Honour of Jack Revell*, Macmillan, London, p. 206. Reprinted in Mervyn K. Lewis ed. 1999. The Globalization of Financial Services. UK: Edward Elgar Publishing Limited, pp. 85-101.

[2] Skipper, Harold D. Jr. 1997. Foreign Insurers in Emerging Markets: Issues and Concern. Washington, D.C.: International Insurance Foundation (Occasional Paper No. 1), pp. 10-13.

[3] *Id.* pp. 13-14.

national treatment principle in specific obligations is a distinguishing feature of GATS. This indicates that GATS national treatment does not apply automatically to all service sectors, but only applies to scheduled sectors and/or sub-sectors that a Member specifically lists in its commitments.

Moreover, the scope of national treatment in GATS addresses not only trade but also investment since GATS encompasses the supply of services, *inter alia*, through commercial presence of foreign service suppliers. Accordingly, understanding the national treatment principle is necessary for dispute settlement procedures as well as scheduling national commitments on specific sectors or sub-sectors. As predicted by Hoekman, interpretation of countries' schedules would constitute "the main part" of the panel process, in addition to fundamental principles.[4]

While national treatment in the context of trade in goods has been substantially explored and interpreted, the jurisprudence on interpretation of this principle in GATS is less developed. As both GATT and GATS are subject to a single dispute settlement mechanism under the WTO, there is clear rationale for transplanting GATT jurisprudence to the realm of services. Furthermore, the language of national treatment articles in GATT and GATS shares a number of similarities, including likeness and the standard of "no less favourable" treatment. Interpretation of the national treatment principle in GATS, including transplant of GATT jurisprudence to GATS, has been discussed among scholars and practitioners (Mattoo; Krajewski; Zdouc). However, the fundamental nature of intangibility and non-storability of services (Feketekuty; Nicolaides), different from goods, makes the interpretation of the national treatment principle more complicated in the context of services.

With regard to liberalization of the insurance sector by WTO Members, in addition to the national treatment principle in the legal text of GATS and their schedules of specific commitments, the applicability of multilateral rules to this complicated sector is also governed by the Annex on Financial Services (hereinafter the Annex), which constitutes an integral part of GATS under Article XXIX. Under this Annex, government is not limited in introducing prudential measures for consumer protection and systemic concern. The Annex also defines financial services to cover all banking and other financial services, and all insurance and insurance related services, which consist of: (i) direct insurance (life and non-life); (ii) reinsurance and retrocession; (iii) insurance intermediation, such as brokerage and agency; and (iv) services auxiliary to insurance, such as consultancy, actuarial, risk assessment and claim settlement services.

Literature review shows that liberalization in services in general and insurance services in particular requires careful regulation, including increasing the strength and quality of certain regulations, and introducing new rules that facilitate the transition to a more open system (Krajewski; Gamberale and Mattoo; and Skipper). A more liberal insurance sector, therefore, will require a more complex and effective regulatory and supervisory framework. When applying the national treatment principle to liberalization of the insurance services sector, as noted earlier, the Annex allows WTO Members to take prudential measures in regulating their financial systems, regardless of other obligations and commitments in GATS. Paragraph 2(a) of this Annex has been characterized as the "prudential exception",[5] and

[4] Hoekman, Bernard. 1994. General Agreement on Trade in Services. In OECD, *The New World Trading System: Readings*. Paris: OECD, pp. 180-181.

[5] Whether paragraph 2(a) of the Annex constitutes a "prudential exception" in the financial services sector, including insurance services, shall be discussed in Chapter Three.

discussed among scholars (Key; Nicolaidis and Trachtman; Trachtman; Leroux; Mattoo; Dobson and Jacquet; and Panourgias) with regard to three factors, namely the concept of "prudential reasons", connection between the prudential objectives and measures, and the anti-avoidance provision. However, these discussions have not yet incorporated sufficient analysis in the light of WTO jurisprudence, especially on interpretation approach. The issue of interpretation seems to be more difficult because there has been no WTO case so far relating to financial services in general and insurance services specifically. Accordingly, these uncertainties would discourage Members from undertaking commitments on national treatment for further liberalization of trade in financial services, including insurance services.

Panourgias generally observed that the literature offers very limited clarification with regard to the term "prudential" as it applies to the financial sector.[6] The need for clarifying this "prudential exception", especially the concept of "prudential reasons", has become an issue of debate in the agenda of the Committee on Trade in Financial Services, and no agreement has been reached.[7] Moreover, as the scope and character of prudential measures are not specified, it is difficult to explain whether measures are permissible or not under the "prudential exception" during the on-going round of negotiations.[8] Therefore, a clear understanding of the "prudential exception" would contribute to facilitating on-going negotiations on liberalization of financial services, including insurance services, by offering a way of balancing between rights and obligations of WTO Members, and providing a proper space for Members in introducing prudential regulations without prejudice to the predictability and transparency of the multilateral trading system.

In the case of Vietnam, in 1986, the VI Congress of the Communist Party launched a fundamental economic reform program - called *doi moi* (Renovation) - that marked the country's transition from a centrally planned economy to a market-driven economy with a socialist orientation. Key elements of this reform include (i) state-owned enterprise reform and private sector development, (ii) external trade and foreign investment, and (iii) liberalization of financial market. Along with the domestic economic reform, at the bilateral level, Vietnam has established and fostered economic relationships with other countries in order to facilitate foreign trade relations and integration into the world economy. The road towards a membership of the WTO has been marked by observatory status in GATT since June 1994. Vietnam became the 150th Member of the WTO in January, 2007.

Concerning the insurance services sector, Vietnam's commitments on liberalization of insurance services at the multilateral level are relatively liberal to competition by foreign insurance services and service suppliers. Especially, commitments in insurance services seem to be more liberal than those in banking and securities services.[9] Those commitments under

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[6] Panourgias, Lazaros E. 2006. Banking Regulation and World Trade Law: GATS, EU and Prudential Institution Building. Oxford and Portland, Oregon: Hart Publishing, pp. 11-15.

[7] Committee on Trade in Financial Services, Reports of the Meetings held on 28 September 2004 (WTO Doc. No. S/FIN/M/46, 29 October 2004); 25 June 2004 (WTO Doc. No. S/FIN/M/45, 19 July 2004); 9 October 2000 (WTO Doc. No. S/FIN/M/28, 20 November 2000); 13 July 2000 (WTO Doc. No. S/FIN/M/27, 23 August 2000); and 25 May 2000 (WTO Doc. No. S/FIN/M/26, 29 June 2000).

[8] Cornford, Andrew. 2004. The WTO Negotiations on Financial Services: Current Issues and Future Directions. Geneva: UNCTAD (Discussion Papers No. 172), p. 15.

[9] *See* Vietnam – Schedule of Specific Commitments, GATS /SC/142, 19 March 2007, pp. 42-47.

While Vietnam undertakes full national treatment with regard to Modes 1, 2 and 3 in insurance services sector, it inscribes Unbound in both market access and national treatment columns on cross-border supply of banking and securities services, except for information transfer and advisory services. In addition, in the banking

Vietnam's schedule of specific commitments are legally binding to Vietnam, and require it to accord foreign insurance services and service suppliers no less favourable treatment than domestic counterparts under the meaning of GATS Article XVII on National Treatment. In addition, Vietnam shall permit direct branches of foreign non-life insurers from 2012 in conformity with prudential regulations.[10] As a WTO Member, under GATS, Vietnam is entitled to introduce prudential regulations to address the solvency situation of insurance companies in order to ensure consumer protection and the stability of the whole financial system.

However, as mentioned earlier, the interpretation of the national treatment principle in the context of services, including insurance services and the "prudential exception" is less developed. On the one hand, this problem might create difficulties for practitioners and legislators in Vietnam in regulating the insurance market pursuant to prudential objectives. On the other hand, this problem might make Vietnam more vulnerable to violation of the GATS national treatment obligation. Accordingly, understanding on the national treatment principle is needed for Vietnam's implementation of its commitments on liberalization of the insurance services sector under the multilateral framework.

Therefore, the object of this study is to answer, considering the above issues, three questions:

- How could the national treatment principle in GATS be understood and interpreted?
- What are the special factors in interpretation of the national treatment principle in the financial services sector generally and in the insurance sector particularly?
- Based on the understanding of the GATS national treatment principle, what should be done by Vietnam to comply with national treatment while regulating its insurance services market with a vision of ensuring consumer protection as well as the stability and integrity of the financial system?

In order to answer these questions, the study is divided into two parts. Part One on general aspects of the national treatment principle in insurance services covers four chapters. Part Two on Vietnam's insurance services market consists of three chapters. The final chapter is conclusions.

Chapter One includes a theoretical explanation on the concept of insurance as well as the role of insurance services and trade in insurance services in economic development. Based on a historical approach, this chapter also presents the inclusion of insurance services into the multilateral framework. This chapter points out that, at the conclusion of the Uruguay Round in 1994, the liberalization of insurance services under GATS was only agreed on rules and special factors of this sector as provided in the Annex, but not specific commitments by WTO Members.

Chapter Two starts with some remarks on the national treatment principle in GATS. This chapter argues that in relation with Article XVI on market access, the scope of the national treatment principle in GATS would address all discriminatory measures which do not fall within the realm of Article XVI.

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sector, under Mode 3, Vietnam still reserves several limitations on the national treatment principle concerning conditions for establishment of branches of foreign banks, joint-venture banks, and wholly foreign owned banks.

[10] *Id.* p. 38. *See also* WTO. Report of the Working Party on the Accession of Vietnam, WT/ACC/VNM/48, 27 October 2006, para. 494.

Based on reviewing GATT jurisprudence in interpretation of the national treatment obligation, this chapter demonstrates that although there are a number of similarities between the language of GATT Article III and GATS Article XVII, the transplant to GATS raises the high possibility of violation of the national treatment principle. The chapter argues that this problem results from both the broad scope of likeness, on the one hand, and the broad coverage of discrimination, on the other hand. A justification based on national legitimate policy objectives is submitted to balance this broad obligation. However, as this principle is interpreted in an objective manner, irrespective of national regulatory aims, the inclusion of regulatory objectives into this principle is proved to be unacceptable. Looking at different available approaches to reducing the uncertainty in likeness and limiting the broad scope of "no less favourable" treatment, the chapter comes up with a two-stage approach for the confirmation of breach of this principle whereby Article XVII should be read in connection with Article XIV on general exceptions, which provides a proper space for legitimate national policy objectives.

Chapter Three explores the application of the national treatment principle to insurance services. The Annex, which is only applicable to the financial services sector, is proposed to provide a proper space for WTO Members to pursue their prudential objectives, and to constitute a second stage in the two-stage approach towards the application of the national treatment principle to financial services in general and insurance services in particular.

By exploring some interpretative issues on the applicability of this "prudential exception" to trade in insurance services, this chapter argues that for a WTO Member to exercise the "prudential exception", the Member is required to provide evidence that a measure which is inconsistent with GATS obligations satisfies a three-layer examination. First, that measure must be concerned with preservation of the solvency of insurance service suppliers to fulfill their obligations towards policyholders and other relevant persons, as well as towards the stability and integrity of the financial system as a whole. Second, a degree of connection between that measure and prudential objectives must be demonstrated through a "primarily aimed at" test. The third layer is to ensure that the application of that measure does not constitute disguised restrictions on trade in insurance services. This understanding of GATS "prudential exception" would maintain the balance between the rights of a Member to regulate its insurance services sector and the rights of other Members to rely on the performance of that Member's obligations and commitments with regard to liberalization of trade in insurance services.

The agreement on liberalization of financial services sector, including insurance services, was achieved by the end of 1997, rather than at the time of conclusion of the Uruguay Round. Therefore, Chapter Four provides a brief history of the post-Uruguay Round negotiations on this sector. The main part of this chapter reviews specific commitments on insurance services by the EC, US, Japan and China, in order to reexamine the interpretation of the national treatment principle in Chapter Two with regard to the scope of national treatment and criteria for examination of likeness among insurance services and service suppliers. An example of China's measure on the minimum capital requirement of branches of foreign non-life insurance companies is analyzed and tested through the application of the two-stage approach, framed in Chapters Two and Three, towards interpretation of the national treatment principle in the insurance sector.

This chapter points out that the examination of the schedules of specific commitments by the selected WTO Members reconfirms that the scope of application of the national

treatment principle applies to those discriminatory measures that are excluded from the realm of Article XVI on Market Access. In addition, the determination of likeness in Article XVII would be uncertain if only the criterion of services classification is taken into account.

As the first chapter in Part Two, Chapter Five provides descriptive backgrounds on Vietnam's economic development after the introduction of doi moi in 1986. The main part of this chapter presents an overview on Vietnam's insurance services market and its regulatory framework throughout three periods: pre-1993, 1994-2000, and post-2001. This chapter points out that foreign participation has made a contribution to Vietnam's economic development as well as the insurance sector after doi moi. Moreover, a clear tendency towards a level playing filed for all insurers, regardless of ownership and origin, has been introduced over a period of time.

Chapter Six starts with a summary of Vietnam's commitments on insurance services in the WTO. The chapter observes that, in general, Vietnam's commitments on liberalization of insurance services are liberal to foreign participation and competition. While liberalization of insurance services under the WTO could offer some opportunities for further development of Vietnam's insurance services market, concomitant challenges of fierce competition should not be ignored. The chapter also raises some issues on compliance with Vietnam's commitments on insurance services with respect to the national treatment obligation in the Vietnam Insurance Law, namely the scope of insurance sub-sectors, measures affecting trade in insurance services, likeness, and the standard of "no less favourable" treatment.

Chapter Seven analyzes the current solvency regulations under the Vietnam Insurance Law. Based on experience of the US, EU and Japan, this chapter points out several problems concerning compliance with regulations on technical provisions, assets representing the solvency margin, reinsurance risk, concrete remedial measures corresponding to different quantitative solvency control levels, investment rules, credit risk of insurance intermediation, and supervision of insurance holding companies. The interpretation of the national treatment principle in GATS based on the two-stage approach in the insurance services sector shall shed light on providing feasible suggestions for further enhancement of Vietnam's prudential regulations.

During the introduction of new prudential regulations, Vietnam is required to refrain from according any discriminatory measures against foreign insurance services and insurers. However, some measures might be found in violation of GATS Article XVII due to the uncertainty in the interpretation of the national treatment obligation. The chapter, therefore, offers different possibilities for justification under the "prudential exception".

Finally, the concluding chapter draws on the analysis and findings presented in the previous chapters with respect to the applicability of the national treatment principle in insurance services as well as suggestions for further enhancement of the Vietnam Insurance Law.

For the purpose of discussing and analyzing these issues, this study focuses particularly on jurisprudence, as developed in the WTO dispute settlement mechanism, in examination of the national treatment principle in GATS, and in its application to the insurance sector. Several cases in both GATT and WTO jurisprudence with regard to national treatment and exceptions are described and analyzed. The understanding on the national treatment principle shall be supported by examining the practice of scheduling commitments

of WTO Members.[11] The selected WTO Members are the European Community (hereinafter EC), Japan, the US, and China, who acceded to the WTO after the conclusion of GATS. In addition, the study shall present a comparative study between Vietnam's prudential regulations in the insurance sector and those of other jurisdictions, for example, the US, EU and Japan. Consideration of Vietnam's insurance sector shall be centered on the period since adoption of the doi moi policy. Although many other factors may affect trade in insurance services, such as administrative issues, taxation, labour or land law, the study limits its scope to specific problems in the Law on Insurance Business of Vietnam[12] (hereinafter Vietnam Insurance Law) with regard to the national treatment and prudential measures.

The selection of those above-said WTO Members for analysis is based on at least the following three considerations.

First, the EC, US and Japan submitted their commitments during the Uruguay Round, and revised their schedules in the Second and Fifth Protocols in 1995 and 1997, respectively. In addition, these countries are the most developed insurance markets in the world. The US is the world's largest insurance market with gross insurance premiums of US$ 1.06 trillion in 2003.[13] The EU (15) and Japan are the second largest insurance markets in the world, just behind the US.[14]

Second, China acceded to the WTO in 2001, after the completion of negotiations on financial services, including insurance services. Vietnam may learn some lessons from China's compliance with its commitments in liberalization of insurance services. By including China's case, the selected countries cover both the existing WTO Members present during the negotiation on financial services and a newly acceded WTO Member. This would provide a clear understanding on making commitments on the national treatment principle and offer better interpretation for the application of this principle in scheduling practices.

Third, as insurance markets of the EC, Japan and the US are well developed, their insurance laws might provide good lessons for Vietnam in reviewing current solvency regulations in the Vietnam Insurance Law. In regard to the US, because the insurance industry is regulated at the state level rather than federal level, model laws which have been developed by the National Association of Insurance Commissioners (hereinafter NAIC)[15] and can be adopted by states, shall be examined.[16] Among state laws, New York Insurance Law,

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[11] GATS, Art. XVII (1) and XX (1), (3).

[12] Law on Insurance Business (Dec. 9, 2000) has become effective since 1 April 2001 (Vietnam).

[13] Trade Policy Review – The United States, Report by the Secretariat, WT/TPR/S/160/Rev.1, 20 June 2006, p. 95.

[14] Trade Policy Review – European Communities, Report by the Secretariat, WT/TPR/S/136, 23 June 2004, p. 120.

[15] The NAIC, which was established in 1871, is an organization of the state chief insurance regulatory officials with a view to coordinating supervision and regulation. The coordinated activities include maintenance of database, analysis of financial conditions of insurers, design of uniform statutory financial statements and accounting rules for insurers.

See OECD. 2002. Insurance Solvency Supervision: OECD Country Profiles. Paris: OECD, pp. 295-96.

[16] *See* Goddard, William. 2003. The Revolution of the Times: Recent Changes in U.K. Insurance Insolvency Laws and the Implications of Those Changes Viewed from a U.S. Perspective. *Connecticut Insurance Law Journal*, 10, pp. 160-161. *See also* Skeel, David A. Jr. 1998. The Law and Finance of Bank and Insurance Insolvency Regulation. *Texas Law Review* 76, p. 731.

The system of state regulations over insurance markets was developed from the Civil War when the Supreme Court ruled that insurance regulation did not fall in the federal authority, and was legalized by the McCarran-Ferguson Act of 1945.

nevertheless, shall be referred to as an example when appropriate because New York is a major insurance market and home of many of the largest insurers.[17] Further, New York Insurance Law is recognized as the most well-equipped and sophisticated insurance legislation in the US.[18]

Moreover, most foreign insurance companies conducting insurance business in Vietnam are from the US, EU and Japan. These countries, therefore, could be potential complainants against Vietnam with regard to the national treatment and prudential regulations on insurance services. Studying the experience of those countries in regulating their insurance markets may enable Vietnam to reduce the possibility of invoking complaints by those countries under the WTO framework.

[17] Macey, Jonathan R. and Geoffrey P. Miller. 1993. The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation. *New York University Law Review* 68, p. 73.

[18] Chang, Kuan-Chun. 2003. The Supervision of Financial Conglomerates in China in the Post WTO Era – The Challenges of Risk Concentration and Risk Contagion. *University of Miami International and Comparative Law Review* 11, p. 17.

PART ONE

GENERAL ASPECTS OF THE NATIONAL TREATMENT PRINCIPLE IN INSURANCE SERVICES

CHAPTER ONE
Insurance Services under the World Trade Organization

The national treatment principle is one of the key rules to liberalize trade in services in general and insurance services in particular at the multilateral framework. However, before analyzing this principle in detail, this chapter shall provide a general background on insurance and international trade in insurance services. Using a historical approach, the chapter also describes the inclusion of insurance services into the framework of WTO.

1. A background on insurance and international trade in insurance services

1.1 Concept of insurance

Insurance is characterized by Carter as a "means" of transferring risk from consumers having exposure to possible financial losses as a consequence of occurrence of uncertain events, to insurers, by paying a premium.[19] Outreville defined insurance, from the consumer's point of view as "a mechanism (or a service) for the transfer" of risks of financial losses to the insurer; and from the insurer's point of view as a "pooling mechanism", where the insurer pools together a large number of risks in order to reduce the risk accrued to the insurer from supplying insurance services.[20] Skipper considered insurance as *both a risk-shifting and risk-sharing device*:

> For a consideration (premium), an individual or organization (the insured) is guaranteed to be reimbursed by the insuring organization (the insurer) if a covered event occurs.[21]

Specifically, based on the law of large numbers, the insurer provides insurance for a sufficient quantity of similar risks with a reasonable probability of losses.[22] In addition, the insurer may manage risk by spreading it over other insurers through co-insurance mechanism or purchase of reinsurance.[23]

For further clarity, it is necessary to see other ways of classifying insurance based on different criteria.

(1) Social and private insurance: Skipper distinguished social insurance, which emphasizes social equity such as income redistribution (retirement, disability, unemployment benefits), where participation is compulsory and financed by taxes, on the one hand, and private insurance which is provided on individual interest, on the other hand.[24] Outreville

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[19] Carter (1990), p. 205.

[20] Outreville, J. Francois. 1998. Theory and Practice of Insurance. Dordrecht/Boston/London: Kluwer Academic Publishers, p. 131.

[21] Skipper, Harold D. Jr. 2002. Liberalization of Insurance Markets: Issues and Concerns. In Robert E. Litan et al. eds., *Open Doors: Foreign Participation in Financial System in Developing Countries*. Washington, D.C.: Brookings Institution Press, pp. 105-106.

[22] *Id.* p. 106.

[23] Carter, Robert L. and Gerard M. Dickinson. 1992. Obstacles to the Liberalization of Trade in Insurance. Great Britain: Harvester Wheatsheaf (Thames Essay No. 58), p. 15.

[24] Skipper (2002), p. 106.

clarified that, while social insurance, which is compulsory and determined by law, involves fundamental risks that could not be afforded by consumers, private insurance operates on a voluntary basis to cover particular risks.[25] Between the two types are health insurance and workmen's compensation that can be provided by either government or private sector or both combined.[26]

(2) Life and non-life insurance: Birds and Hird classified those two types by their difference in the nature of uncertainty. In life insurance, the risk of death is certain (that is why life insurance contracts are understood as contracts for contingency insurance) whereas it is not the case in non-life insurance, where contracts are called contracts for indemnity.[27] To be more exact, Skipper defined life insurance as insurance on the person (life and/or personal insurance) and non-life insurance to protect property (non-life or property/casualty or general insurance).[28]

(3) Direct or primary insurance and reinsurance: Skipper mentioned that while the former is sold to the public or non-insurance commercial and industrial organizations, direct insurers, to hedge their own portfolios, purchase the latter, which may also be called wholesale insurance.[29]

(4) Retail and corporate insurance are classified by Skipper based on the nature of consumers of the insurance contracts. Consumers can be individuals in retail insurance (home-owners insurance, automobile, individual life, retail non-life personal lines insurance) or businesses and other organizations in corporate insurance (product liability, business interruption, group life insurance or commercial lines insurance).[30] As information asymmetry is greater in retail insurance, more stringent supervision by government should be recognized in this area.[31]

(5) First and third party insurance: According to Birds and Hird, first party insurance is where consumers insure their own life or property such as life insurance, property insurance, while third party insurance is a situation where consumers insure against their potential legal liability to pay for damages to another, such as public liability, product liability.[32]

In addition, there are other activities such as insurance brokerage, loss adjusting, and risk management consultancy, which are directly complementary to insurance.[33] Those activities are provided by different entities, such as insurance brokers, loss adjusters and consultants.

1.2 Rationale of insurance regulation

[25] Outreville (1998), p. 199.
[26] Skipper (2002), p. 106.
[27] Birds, John and Norma J. Hird. 2001. Birds' Modern Insurance Law. London: Sweet & Maxwell (Fifth edition), pp. 9-10.
[28] Skipper (2002), pp. 106-107.
[29] *Id.* pp. 107-108.
[30] *Id.* p. 107.
[31] *Id.* p. 107.
[32] Birds and Hird (2001), pp. 8-9.
[33] Carter and Dickinson (1992), p. 14.

Scholars have agreed that although the underlying rationale for financial regulation is to address problems of market imperfections, there is a significant difference between banking and non-banking financial services. More specifically, the ultimate concern in regulation of banks is systemic issues, whereas this concern is less significant in regulation of non-banking financial services.[34] As the nature of banking business is to involve the transformation of liquid liabilities to illiquid assets, the problem of asset-liability mismatch would result in bank runs.[35] A failure of a bank would cause panicking consumers to withdraw their deposits from other sound banks, and then make them insolvent because those sound banks could not convert their illiquid to liquid assets in a short period of time in order to finance their liquid liabilities. In addition, this contagion effect is more problematic because banks are closely interconnected through clearing and payment systems.[36] The disruption of the payment system, *per se*, may also be a fundamental source of systemic risk, as it would lead to panic behaviour of consumers.[37] Therefore, the main concern in banking regulation is to address the systematic risk when cost of a bank failure does not limit to that bank itself, but leads to the insolvency of other banks due to the contagion effect.

In theory, the potential of systemic risk might exist in the insurance sector through reinsurance activities where the failure of the re-insurer would lead to direct insurers' failures.[38] In addition, in the international context, as a domestic re-insurer may retrocede a part of surplus or catastrophic risks to foreign re-insurers, any simultaneous postponement of providing those services by foreign re-insurers in the international insurance market would lead to adverse effects on domestic primary insurers and consumers.[39] As pointed out by several scholars, however, the empirical evidence has shown that this systemic risk does not exist in the non-life insurance sector.[40] In other words, the failure of a non-life insurer would hardly constitute an insolvency of other non-life insurers.[41] On the other hand, instances of systemic risk could be found in life insurance where the failure of the two largest US life insurers in 1991 – Executive Life and Mutual Benefit Life – led to the downgrades in ratings of many other life insurers and increased concern that policy holders initiated runs on other low rated life insurers.[42]

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[34] Goodhart, Charles et al. 1998. Financial Regulation: Why, how and where now? London: Routledge, pp. 10-11.

[35] *Id.* pp. 8-9.

[36] *Id.* pp. 10-11.

[37] Herring, Richard J. and Robert E. Litan. 1995. Financial Regulation in the Global Economy. Washington, D.C.: The Brookings Institution, pp. 50-52.

[38] Skipper, Harold D. Jr. 1996. International Trade in Insurance. In Claude E. Barfield, ed., *Harmonization versus Competition: International Financial Markets*. Washington, D.C.: The AEI Press, pp. 188-190.

[39] Herring and Litan (1995), pp. 73-74.

[40] *See* Skipper (1996), pp. 188-190. *See also* Harrington, Scott E. 1991. Public Policy and Property-Liability Insurance. In Richard W. Kopcke and Richard E. Randall, eds., *The Financial Condition and Regulation of Insurance Companies*. Boston: Federal Reserve Bank, p. 241.

[41] *See* Skipper, Harold D. Jr. 1987. Protectionism in the Provision of International Insurance Services. *The Journal of Risk and Insurance* 54(1), p. 80. *See also* Carter and Dickinson (1992), pp. 36-37.

A typical example is the suspension of London insurers and re-insurers with regard to Argentine commercial vessels and aircraft during the Falkland Islands conflict. However, this threat is unlikely to be severe due to high availability of alternative insurers and re-insurers in the international insurance market, and the fact that those insurance policies were arranged through Argentine state-owned National Reinsurance Institute, which had access to other sources of reinsurance.

[42] Gart, Alan. 1994. Regulation, Deregulation, Re-regulation – The Future of the Banking, Insurance, and Securities Industries. U.S.A.: John Wiley & Sons, pp. 190-205.

The literature seems to be in agreement that, in contrast to banks, the systemic risk in the insurance sector is less problematic. The main rationale for insurance regulation might be consumer protection due to imperfect information (Mayer; Skipper; Spencer; and Goodhart et al.). The problem of asymmetric information occurs in the insurance sector and can be called a "two-way information asymmetry".[43] On the one hand, it is very difficult for insurers to properly assess a consumer's risk and differentiate between high-risk and low-risk consumers because consumers hold information as monopolists and try not to disclose their private information. This situation leads to both adverse selection and moral hazard problems.[44]

On the other hand, although proper operations of a competitive market must be based on well-informed consumers with regard to evaluation of services and service suppliers, consumers find it difficult to access information on the soundness of insurance companies.[45] In other words, insurers possess more information about their financial condition and insurance products than consumers, especially individuals and small businesses, who are not in position to evaluate and judge such conditions. In principle, while this problem could be addressed by the adequate dissemination of information, it seems to be too expensive and difficult to equip the necessary information to different individual consumers.[46] Consequently, consumer protection considerations would correct this information asymmetry and minimize loss to consumers from insolvent insurers. Therefore, unlike banks, it appears that the insurance industry has only minimal exposure to systemic risks, while consumer protection issues are more important in the insurance sector.

In addition to the problem of information asymmetry, Mayer (2001) stressed two additional market failures, which may raise concerns on consumer protection in the insurance sector, namely market manipulation (due to problems of private information and dominant positions in a market) and contract failure through poor enforcement.[47] The problem of monopoly and oligopoly may arise in financial services when government imposes restrictions on new entrants, and when there are only one or few service suppliers in a market.[48] In the insurance market, there may be some explicit or implicit collusion with regard to pricing, or different national tax regimes, and licensing requirements.[49]

For example, in November 1992, Pennsylvania insurance regulators blocked 100,000 customers from withdrawing their money out of Fidelity Mutual Life Insurance Company in order to avoid a run on this insurer.

[43] Spencer, Peter D. 2000. The Structure and Regulation of Financial Markets. Oxford: Oxford University Press, pp. 66-67.

[44] *See* Skipper (1996), pp. 191-192.

For example, a consumer, who is more knowledgeable than the insurer about his/her own health conditions, can use this secret information for his/her best interests and against the interests of the insurer. Accordingly, the adverse selection occurs when low-risk consumers may be charged with high premium and high-risk consumers charged with low premium. Moral hazard occurs when with their advantageous position regarding information, consumers are discouraged from entering into loss prevention and risk management.

[45] Gamberale, Carlo and Aaditya Mattoo. 2002. Domestic Regulations and Liberalization of Trade in Services. In Bernard Hoekman, Aaditya Mattoo, and Philip English, eds., *Development, Trade and the WTO - A Handbook*. Washington, D.C.: World Bank, pp. 291-293.

[46] *Id.*

[47] Mayer, Colin. 2001. Regulatory Principles and the Financial Services and Markets Act 2000. In Eilis Ferran and Charles Goodhart eds., *Regulating Financial Services and Markets in the Twenty First Century*. Oxford: Hart Publishing, pp. 29-31.

[48] White, Lawrence J. 1996. Competition versus Harmonization – An Overview of International Regulation of Financial Services. In Claude E. Barfield ed., *Harmonization versus Competition: International Financial Markets*. Washington, D. C.: The AEI Press Publisher, p. 12.

[49] Skipper (1996), pp. 185-188.

The problem of contract enforcement could be considerable in the insurance sector because the nature of insurance is to recover financial losses due to the occurrence of certain events. There may be a situation where the insurer, without being subject to strict information disclosure on financial conditions or adhering to capital requirement standards, would tend to misuse the collected premiums for purposes other than satisfying claim payments.[50] Any delay or failure of payment would constitute a loss to consumers.

1.3 International trade in insurance services

The literature shares a lack of consensus on the definition of services in general (Trebilcock and Howse; Drake and Nicolaidis). However, the term "insurance" is always quoted as an example to define the term "services".[51] As a service, insurance also shares the general nature of services, namely intangibility[52] and non-storability.[53] Therefore, the production and consumption of insurance services seem to occur concurrently, and they require a close connection between suppliers and consumers of services.

Trade in insurance is to encompass both cross-border trade and investment in importing countries (Feketekuty; Carter; Carter and Dickinson; and Skipper). Due to the invisible nature of services, where the sale of service requires substantial inputs in importing countries, trade in services can not limit itself as pure trade as in case of goods, but must extend to include other activities associated with international movement of people, information, and goods as well as the use of facilities in importing countries.[54]Accordingly, two distinct channels of supplying insurance internationally are cross-border trade, which involves the supply of insurance by a foreign insurer located in one country to a domestic consumer of another country across national borders, and establishment of the presence of a foreign insurer through branches, representative offices, subsidies or other forms, to supply insurance in the consumer's country.[55]

International trade in insurance services can make various contributions to development of domestic markets. As noted by Skipper, because no one country's market could offer the necessary cover for extremely large commercial risks, such as oil refineries and offshore rigs, satellites, and jumbo jets, an international spread of such large risks is required.[56] Accordingly, insurance and trade in insurance would not only ensure the financial stability of individuals, families, and organizations, but also enable business facilitation through greater stability in business transactions.[57] Moreover, there is a potential inflow of

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[50] Herring and Litan. (1995), p. 62.

[51] Drake, William J. and Kalypso Nicolaidis. 1992. Ideas, Interests, and Institutionalization: "Trade in Services" and the Uruguay Round. *International Organization*, 46(1), pp. 42-43. *See also* Aghatise, Esohe. 1990. Services and the Development Process: Legal Aspects of Changing economic Determinants. *Journal of World Trade* 24(5), p. 103.

[52] Feketekuty, Geza. 1988. International Trade in Services: An Overview and Blueprint for Negotiations. Cambridge, Massachusetts: Ballinger Publishing Company, pp. 27-36.

[53] Nicolaides, Phedon. 1989. Economic Aspects of Services: Implications for GATT Agreement. *Journal of World Trade* 23(1), p. 106.

[54] Feketekuty (1988), pp. 87-88.

[55] Carter (1990), p. 206.

[56] Skipper (1996), pp. 168-169.

[57] Skipper (1997), pp. 9-10.

funds to cover damage due to claim settlement and reduction of economic uncertainty, as well as a surplus return of investment to pay life insurance policies.[58]

From the view of consumer's choice, involvement in cross-border trade satisfies their own interests such as cost savings (lower price or higher quality of services), highly specialized services (for example, only Lloyd's of London is able to provide liability insurance on a mega tanker), or high connection with international transaction (export insurance).[59] Concerning establishment of the presence of a foreign insurer, according to Carter and Dickinson, there are at least three reasons in favour of this channel in the context of insurance, namely (i) acquiring precise information and knowledge, (ii) supporting marketing purposes, especially in personal insurance, and (iii) offering services to the exporting country's consumers who travel to the importing country.[60]

International trade in insurance services, nevertheless, is also subject to restrictions. Some literature (Feketekuty; Trebilcock and Howse) has showed that restrictions on trade in services generally exist in domestic regulations, but not in transparent form at the national border gate like tariffs on trade in goods.[61] As cross-border transactions of services are intangible, an easy way to control foreign services and service suppliers is to regulate local sale or consumption of imported services.[62] Those restrictions may be either discriminatory or non-discriminatory, or both.[63] An example of discriminatory restrictions is to prohibit a foreign insurer from providing life insurance policies, or only allowing domestic insurers to supply insurance policies for car registration.[64] Non-discriminatory restrictions may exist in a case of lack of transparency due to incompleteness of laws and regulations and/or non-participation of interested parties in designing proposed laws and regulations.[65]

In sum, international trade in insurance services could play a significant role in development of a domestic insurance market. On the one hand, furthering trade in insurance services requires removal of anticompetitive regulations, which pose unnecessary restrictions on competition. On the other hand, as described earlier, as the most underlying rationale for insurance regulation is to protect consumers against market imperfections, trade in insurance services still needs domestic regulation. The next section shall examine how the two objectives could be reconciled in the multilateral trading system.

2. The inclusion of insurance services into the World Trade Organization

2.1 Before the Uruguay Round

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[58] Carter and Dickinson (1992), pp. 33-35.

[59] Feketekuty (1988), pp. 16-17.

[60] Carter and Dickinson (1992), p. 17.

[61] Feketekuty (1988), pp. 30-34; Trebilcock, Michael J. and Robert Howse. 2005. The Regulation of International Trade. London and New York: Routledge (Third Edition), pp. 351-53.

[62] Feketekuty (1988), pp. 30-35.

[63] *Id.* pp. 131-133.

[64] Feketekuty, Geza. 2000. Assessing and Improving the Architecture of GATS. In Pierre Sauve and Robert M. Stern eds., *GATS 2000: New Directions in Services Trade Liberalization*. Washington, D.C.: Brookings Institution Press, pp. 90-91.

[65] Skipper, Harold D. Jr. 2001a. Liberalization of Insurance Markets: Issues and Concerns. In OECD, *Policy Issues in Insurance: Insurance Regulation, Liberalization and Financial Convergence – Insurance and Pensions*. Paris: OECD, pp. 95-96.

While GATT, which covers trade in goods and tariff reduction, has had a relatively long history since 1947, services have been addressed comprehensively on a multilateral basis only since the Uruguay Round negotiations (1986-1994) with a view to elimination or reduction of restrictions on trade in services.

The initial step of introduction of services into the multilateral trade negotiations occurred as early as 1954 when contracting parties of GATT considered the proposal on applying the non-discriminatory principle to transport insurance because Article VII of GATT on Valuation for Customs Purposes would include insurance costs of imported products.[66] This consideration came up with a Recommendation on "Freedom of Contract in Transport Insurance" in 1959, whereby countries were recommended, but not legally bound, in designing national policies in transport insurance, to refrain from application of any measures that "would have restrictive effect on international trade".[67]

However, due to the lack of availability of statistics on trade in services as well as the disconnection between trade in goods and services, there was no significant progress in negotiations, except for research activities on trade in services, which continued until the end of the Tokyo Round (1973-1979).[68] In addition, developing countries, led by Brazil and India, opposed the inclusion of trade in services negotiation into the GATT agenda for a number of reasons: (i) GATT rules were not appropriate for services, (ii) other issues, such as agriculture and safeguard were more important than services, and (iii) there was a reluctance and concern on opening service markets.[69]

There were, nevertheless, three main driving forces to include trade in services into multilateral negotiations. *Firstly*, the rapid growth of international trade in services resulted from technological advances, especially in electronics and computers, in the 1960s.[70] The total global trade in services increased sharply from US$ 358 billion in 1980 to US$ 931 billion in 1992, with the average annual growth of 8.3 per cent.[71] The increasing growth of services' share in international trade gave incentive to extend trade liberalization in goods to services through GATT.[72] *Secondly*, in the US, domestic pressure stemmed from both services industries (such as insurance, financial services, travel, and tourism) and the enforcement of the Trade and Tariff Act 1984, which requires the elimination or reduction of barriers and distortions to trade in services as an objective in bilateral and multilateral

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[66] Footer, Mary E. and Carol George. 2005. The General Agreement on Trade in Services. In Patrick F. J. Macrory, Arthur E. Appleton and Michael G. Plummer, eds., *The World Trade Organization: Legal, Economic and Political Analysis*. New York: Springer (Volume I), p. 803.

[67] Freedom of Contract in Transport Insurance: GATT Recommendation of 27 May 1959. Reprinted in Carter and Dickinson (1992), pp. 153-154.

[68] Footer and George (2005), pp. 803-804.

[69] Jarreau, J. Steven. 1999. Interpreting the General Agreement on Trade in Services and the WTO Instruments Relevant to the International Trade of Financial Services: The Lawyer's Perspective. *North Carolina Journal of International Law & Commercial Regulation* 25, pp. 12-13.

[70] Reyna, Jimmie V. 1993. Services. In Terence P. Stewart, ed., *The GATT Uruguay Round: A Negotiating History (1986-1992)*. Deventer: Kluwer Law and Taxation Publishers (Volume II: Commentary), p. 2342.

[71] Hoekman, Bernard. 2002. Assessing the General Agreement on Trade in Services. In Kym Anderson and Bernard Hoekman, eds., *The Global Trading System*. London-New York: I. B. Tauris Publishers (Volume 3), Table 4.1, p. 138.

[72] Dobson, Wendy and Pierre Jacquet. 1998. Financial Services Liberalization in the WTO. Washington. D.C.: Institute for International Economics, p. 71.

negotiations.[73] *Thirdly*, in 1979, the US successfully convinced other members of the Organization for Economic Cooperation and Development (hereinafter OECD) to conduct a study of trade in services in order to define areas for follow-up negotiations.[74] The proposal of the US in 1982 to include a study of trade in services into a new round of multilateral trade negotiation led to a compromise on voluntarily undertaking national studies of trade in services and exchange of information.[75]

Before the Uruguay Round started, there was a prolonged and fierce debate on whether to include trade in services in negotiations between developed and developing countries.[76] While the former supported the inclusion of services in multilateral negotiations, the latter concerned the appropriateness of the GATT framework with respect to services. Even until the last meeting of the Preparatory Committee, in charge of preparing the groundwork for new multilateral negotiations, held in July 1986, there was no solution for the inclusion of trade in services in the next round.[77] Nevertheless, services were finally included in the Uruguay Round agenda under the Ministerial Declaration adopted at Punta del Este:

> Ministers also decide, as part of the Multilateral Trade Negotiations, to launch negotiations on trade in services.
>
> Negotiations in this area shall aim to establish a multilateral framework of principles and rules for trade in services, including elaboration of possible disciplines for individual sectors, with a view to expansion of such trade under conditions of transparency and progressive liberalization and as a means of promoting economic growth of all trading partners and the development of developing countries. Such framework shall respect policy objectives of national laws and regulations applying to services and shall take into account the work of relevant international organizations.
>
> GATT procedures and practices shall apply to these negotiations.[78]

A Group of Negotiations on Services was established under the Ministerial Declaration in order to deal with negotiations in services, which comprised a five-element agenda: (i) definition of services and collection of statistical data on trade in services, (ii) determination of broad concepts underlying principles and rules applicable to trade in services, (iii) definition of the scope and the multilateral framework for trade in services, (iv) determination of existing international disciplines and arrangements relevant to trade in services, and (v) identification of measures and practices which facilitate or are detrimental to trade in services.[79]

2.2 The Uruguay Round

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[73] Reyna (1993), p. 2343.

[74] Feketekuty (1988), pp. 191-192.

[75] Ministerial Declaration, adopted on 29 November 1982, GATT Doc. No. L/5424.

[76] Reyna (1993), pp. 2354-2356.

[77] *Id.* pp. 2356-2358.

[78] GATT. The Ministerial Declaration on the Uruguay Round, September 1986, Part II. Reprinted in Terence P. Stewart, ed., *The GATT Uruguay Round: A Negotiating History (1986-1992)*. Deventer: Kluwer Law and Taxation Publishers (Volume II: Commentary), p. 10.

[79] GATT. The Decision by the Group of Negotiations on Services on the programme for the initial phase of negotiations on trade in services, 28 January 1987. Reprinted in Terence P. Stewart, ed., 1993. *The GATT Uruguay Round: A Negotiating History (1986-1992)*. Deventer: Kluwer Law and Taxation Publishers (Volume III: Documents), pp. 24-25.

The early negotiations reflected enormously different views of negotiating parties on four fundamental issues: (i) the comprehensive coverage of all service sectors under the framework agreement or any sector exemption for future negotiations; (ii) the transplant of GATT structure as well as principles, rules and concepts on trade in goods to a new framework; (iii) definition of services, speed of liberalization and exemption from multilateral principles; and (iv) the concern on facilitating participation of developing countries in the world trading system.[80] Those different views resulted from different goals of the four major trading partners, namely the US, EC, Japan, and developing countries.

While the US followed liberalization of trade in services in general with protection in some service sectors, such as maritime and air transportation, Japan's interests were mainly in some specific sectors such as transport, tourism and financial services.[81] The EC's goals were to pursue a comprehensive coverage of service sectors to support better market access, including investment in supply of services.[82]

Concerns of developing countries were mainly on: (i) the prospects as well as the potential impact of the future multilateral framework on trade in services, (ii) the risk of reducing autonomy and limiting flexibility in pursuing macroeconomic and development policies, and (iii) consideration for infant industry protection.[83] Therefore, developing countries strongly motioned for a separation of services from GATT negotiations on goods.[84]

In the Mid-term Meeting, held in December 1988 and April 1989, the Ministers agreed that "work should proceed, without excluding any sector of trade in services on *a priori* basis, with a view to reach agreement on the sectoral coverage under the multilateral framework."[85] However, there was no consensus on a general agreement on trade in services separate from GATT until Switzerland and New Zealand proposed overall structures of a "General Agreement on Trade in Services" in 18-22 September 1989.[86] Sector-specific discussions on financial services, including insurance, under the Uruguay Round began from September 1989, and the negotiators agreed to establish additional working groups to deal with individual service sectors, including financial services, in May 1990.[87]

Several meetings of the Working Group on Financial Services were held in the second half of 1990 in order to clarify the applicability of the general agreement in financial services sector, including insurance. Some delegations, for example, India, Brazil, Egypt, Pakistan, were concerned about the inclusion of the Annex on Financial Services into the general framework, while others (for example, the EC, Yugoslavia, the US, Nordic countries, Japan, Canada) expressed the necessity for this sectoral annex.[88] In particular, negotiators called for preserving the rights of national authorities to regulate financial services including insurance

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[80] Reyna (1993), p. 2360.

[81] Footer and George (2005), p. 811.

[82] *Id.* pp. 814-815.

[83] *Id.* pp. 817-818.

[84] Randhawa, P. S. 1987. Punta del Este and After: Negotiations on Trade in Services and the Uruguay Round. *Journal of World Trade Law* 21(4), p. 164.

[85] GATT. Mid-term Meeting document 5-9 December 1988 and 5-8 April 1989, Part II, para. 5. Reprinted in Terence P. Stewart, ed., 1993. *The GATT Uruguay Round: A Negotiating History (1986-1992)*. Deventer: Kluwer Law and Taxation Publishers (Volume III: Documents), p. 61.

[86] News of the Uruguay Round, 16 October 1989, Sec. "Services ... 18-22 September", GATT Doc. No. NUR 031.

[87] Reyna (1993), pp. 2372-2373.

[88] *See* Note on the Meeting of 19-20 October 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/4, 30 November 1990, paras. 2-12.

for prudential objectives because these rights were regarded as essential for liberalizing this sector under the multilateral trading framework.[89]

A draft text of GATS, consisting of thirty-five full-drafted articles, was submitted by the Group of Negotiations on Services at the Ministerial Meeting in Brussels in December 1990. Although eight other annexes were identified and developed, the annex on the financial services sector was left blank due to lack of agreement on its scope and content.[90] The main reason was the different interests of the EC and US with respect to financial services. While the EC strongly supported an agreement including financial services, the US was reluctant to extend the scope of the final agreement to this important sector.[91]

Moreover, there were also several unsolved problems in the framework of GATS concerning the applicability of the most-favoured-nation (hereinafter MFN) treatment as a general obligation and any sectoral exemption from this principle, the scope of exceptions, and balance of payment provision.[92] The concern of the US was on the problem of free riders of the MFN principle because while national treatment and market access obligations were negotiated on a sectoral basis, unconditional MFN would extend the commitments to all other Members.[93]

Until another draft of the multilateral framework agreement on services was announced in December 1991 by the Chairman of the Negotiation Committee,[94] massive efforts were made to bring service negotiations back on track. The parties concentrated mostly on three important areas, namely the overall framework, initial commitments, and sectoral annexes.[95] This draft consisted of thirty-five articles and the fully drafted five annexes in the fields of MFN exemptions, telecommunications, movement of natural persons, financial services, and air transport services.[96] An annex on financial services, which dealt with insurance services and banking services, including securities, was incorporated in the draft text of agreement in December 1991, and mainly as it is now in the final agreement. Specifically, the drafted annex included a provision allowing parties to pursue prudential

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[89] EC (Note on the Meeting of 18-22 September 1989, the Group of Negotiations on Services, GATT Doc. No. MTN.GNS/25, 23 October 1989, para. 98); the US (Note on the Meeting of 18-22 September 1989, the Group of Negotiations on Services, GATT Doc. No. MTN.GNS/25, 23 October 1989, para. 75; Note on the Meeting of 11-13 June 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/1, 5 July 1990, para. 86; Communication from the United States, GATT Doc. No. MTN.GNS/FIN/W/2, 12 July 1990); Canada, Japan, India, and Switzerland (Note on the Meeting of 11-13 June 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/1, 5 July 1990, paras. 79, 80, 81, and 87, respectively); and SEACEN (Southeast Asia Central Banks, comprising India, Korea, Nepal, Malaysia, Myanmar, Philippines, Singapore, Sri Lanka, and Thailand) (Communication from the Delegation of Malaysia, GATT Doc. No. MTN.GNS/FIN/W/3, 12 September 1990).

[90] Draft Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, 3 December 1990, GATT Doc. No. MTN.TNC/W/35/Rev.1, Annex II.

[91] Jarreau (1999), pp. 23-24.

[92] Draft Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, 3 December 1990, GATT Doc. No. MTN.TNC/W/35/Rev.1, Annex II, Commentary, paras. 2, 3, 6 and 7.

[93] Drake and Nicolaidis (1992), pp. 42-43. *See also* Aghatise (1990), p. 86.

[94] Draft Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, December 1991. Reprinted in Terence P. Stewart, ed., 1993. *The GATT Uruguay Round: A Negotiating History (1986-1992)*. Deventer: Kluwer Law and Taxation Publishers (Volume III: Documents), pp. 795-850.

[95] Reyna (1993), pp. 2396-2411.

[96] In comparison with the second draft, this third draft did not contain annexes on maritime transport services, inland waterway transport services, road transport services, basic telecommunication services, and audio visual services.

objectives in regulating their financial services, including insurance services.[97] The incorporation of the annex on financial services would imply a balance between the liberalization of financial services under the multilateral framework and the concerns over the stability of financial markets as well as consumer protection.

Nevertheless, there was no progress in negotiations during 1992 and the first half of 1993 because of different views with regard to market access negotiations and agricultural subsidies. Additionally, uncertainty over the application of the MFN treatment, mainly from the US proposal on undertaking specific MFN exemptions in various service industries, led to reluctance by many parties to schedule initial commitments.[98] The proposal of the US partly resulted from the fact that commitments in financial services made by some countries (including Japan and developing countries in Asia and Latin America) did not satisfy the US expectation on opening financial services markets.[99]

This deadlock, however, was solved by the meeting of the Group of Seven held in Tokyo in July 1993, where the leaders stressed the top priority in conclusion of the Uruguay Round, which could be achieved through "comparable market opening measures by other participants" and constructive negotiations on all subjects.[100] GATS was formally adopted by the Trade Negotiation Committee in the Final Act of the Uruguay Round Multilateral Trade Negotiations in December 1993,[101] and then incorporated as Annex 1B into the Agreement Establishing the World Trade Organization (hereinafter WTO agreement) approved by the ministerial meeting at Marrakesh on 15 April 1994.[102]

2.3 Trade in insurance services under GATS

(i) Scope of insurance services

The Annex on Financial Services of GATS defines a financial service as "any service of a financial nature offered by a financial service supplier of a [WTO] Member" and specifies that "financial services include all insurance and insurance related services, and all banking and other financial services (excluding insurance)", up to sixteen sub-sectors of financial services.[103] Insurance and insurance related services consist of:

(i) Direct insurance (life and non-life);
(ii) Reinsurance and retrocession,
(iii) Insurance intermediation, such as brokerage and agency; and

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[97] Draft Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, December 1991. Reprinted in Terence P. Stewart, ed., 1993. *The GATT Uruguay Round: A Negotiating History (1986-1992)*. Deventer: Kluwer Law and Taxation Publishers (Volume III: Documents), p. 829.

[98] Reyna, Jimmie V. 1999. Services. In Terence P. Stewart, ed., *The GATT Uruguay Round: A Negotiating History (1986-1994)*. The Hague: Kluwer Law International (Volume IV: The End Game (Part I)), p. 793.

[99] Jarreau (1999), p. 24.

[100] Tokyo Summit Economic Declaration, A Strengthened Commitment to Jobs and Growth, GATT Doc. No. MTN.TNC/W/114, 13 July 1993, para. 7.

[101] Thirty-Sixth Meeting of the Trade Negotiations Committee on 15 December 1993, GATT Doc. No. MTN.TNC/40, 21 December 1993, para. 7.

[102] The Agreement Establishing the World Trade Organization, Marrakesh, 15 April 1994.

[103] GATS, the Annex, para. 5 (a).

(iv) Insurance-related services, such as consultancy, actuarial, risk assessment and claim settlement services.[104]

However, those insurance and insurance-related services must not be services supplied in the exercise of government authority.[105] The Annex provides some details on "services supplied in the exercise of governmental authority" applicable in the financial sector, which are excluded from the scope of GATS as follows:

(i) activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies;
(ii) activities forming part of a statutory system of social security or public retirement plans; and
(iii) other activities conducted by a public entity for the account or with the guarantee or using the financial resources of the Government. [106]

If a Member allows any of the activities referred to in the two last categories to be conducted by its financial service suppliers in competition with a public entity or a financial service supplier, those activities shall be subject to the scope of GATS and the Annex.[107]

(ii) Modes of supply

Under GATS, trade in insurance services is defined through four modes of supply.[108] Table 1 provides a summary on the distinctions among four modes of supply.

Table 1: Modes of supply

Supplier Presence	Other Criteria	Mode
Service supplier not present within the territory of the Member	1. Service delivered within the territory of the Member, from the territory of another Member	1. Cross-border supply
	2. Service delivered outside the territory of the Member, in the territory of another Member, to a service consumer of the Member	2. Consumption abroad
Service supplier present within the territory of the Member	3. Service delivered within the territory of the Member, through the commercial presence of the supplier	3. Commercial presence
	4. Service delivered within the territory of the Member, with supplier present as a natural person	4. Presence of natural person

Source: Reproduced from Scheduling of Initial Commitments in Trade in Services, Explanatory Note, GATT Doc. No. MTN.GNS/W/164, 3 September 1993, para. 18.

Mode 1 deals with supply of a service from the territory of one Member into the territory of any other Member (cross-border supply), which is similar to international trade in goods in that a service product crosses a national frontier, and both the consumer and the supplier remain in their respective territories when the product is delivered. Under this mode,

104 *Id.*
105 GATS, Art. I:3 (b).
106 GATS, the Annex, para. 1 (b).
107 *Id.* para. 1 (c).
108 GATS, Art. I:2 and the Annex, para. 1 (a).

for example, consumers in one country are allowed to purchase insurance policies from financial institutions located abroad supplying services across the border.

Mode 2 addresses the supply of services in the territory of one Member to the service consumer of any other Member, which involves consumption abroad with the movement of consumers to the territory of suppliers, for example the purchase of personal accident insurance by consumers while traveling abroad. The distinction between Mode 1 and Mode 2 is services provided to non-residents "from" the country of the service supplier (Mode 1) and services supplied "in" the country of the service supplier (Mode 2), which requires the movement of consumers.

Mode 3 allows the commercial presence of a supplier of one country in the territory of another country. By including this mode in supplying services, GATS extends its scope to include investment. Commercial presence is defined to encompass "any type of business or professional establishment", which is undertaken through creation or acquisition, for example juridical person, branch or representative office.[109] In addition, in order to be eligible for commercial presence, this juridical person must be owned or controlled by the entity located in the exporting country.[110]

Mode 4 covers the supply of services through presence of natural persons of one Member in the territory of another Member. Natural person is to cover both nationals as well as permanent residents of WTO Members,[111] who are either service suppliers or employees of service suppliers seeking to supply services abroad.[112] Supplying services through this mode involves the movement of natural persons of the service supplier across the border of WTO Members.

(iii) Outline of GATS

GATS consists of three levels: (i) a set of general concepts, principles and rules that applies to measures affecting trade in services; (ii) specific commitments that apply to those service sectors and/or sub-sectors listed in WTO Members' schedules; and (iii) eight annexes that take into account sectoral specificities and allow for temporary exemption to the MFN obligation.

The framework agreement, which consists of thirty two articles (including Articles III bis, V bis and XIV bis) divided into six parts,[113] set out general concepts, rules and obligations that apply to measures affecting trade in services. GATS deals with both discriminatory and non-discriminatory restrictions on trade in services in general. A number of rules address exclusively either discriminatory or non-discriminatory restrictions, whereas

[109] GATS, Art. XXVIII (d).

[110] GATS, Art. XXVIII (n) provides that, "owned" refers to ownership of more than 50 per cent of the equity interest of a company, and "controlled" means the power to name a majority of its directors or otherwise to legally direct its actions.

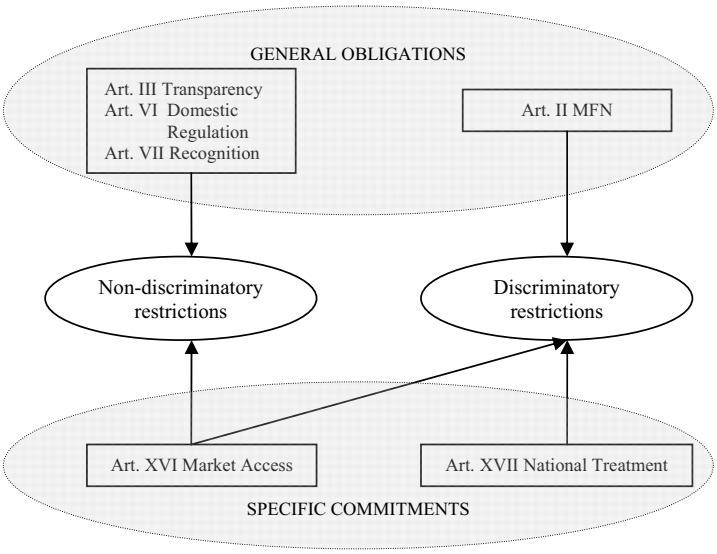
[111] GATS, Art. XXVIII (k) provides that permanent residents are covered provided the Member concerned (1) does not have nationals, or (2) accords substantially the same treatment to permanent residents as to nationals.

[112] GATS, Annex on Movement of Natural Persons Supplying Services under the Agreement, para. 1.

[113] The General Agreement on Trade in Services: Part I – Scope and Definition, Part II – General Obligations and Disciplines, Part III – Specific Commitments, Part IV – Progressive Liberalization, Part V – Institutional Provisions, and Part VI – Final Provisions.

some others concern both types of restrictions. Figure 1 describes several main rules and obligations of GATS dealing with trade restrictions in services.

Figure 1: Outline of GATS rules



There are several fundamental rules in GATS Part Two on General Obligations and Disciplines addressing the problem of non-discriminatory restrictions on trade in services, such as Article III on transparency regarding relevant domestic policy measures; Article VI on domestic regulation, designed to ensure that regulatory measures affecting service trade are administered in a reasonably objective and impartial way; and Article VII concerning recognition of education or experience obtained, requirements met, or licenses or certificates granted in other WTO Members.

Although discriminatory restrictions are dealt with by MFN and national treatment in Articles II and XVII, respectively, only MFN is a general obligation. MFN obligation requires a WTO Member to accord immediately and unconditionally to services and service suppliers of any other Member treatment "no less favourable" than that it provides to "like" services and service suppliers of any other country. While the national treatment and market access principles fall under GATS Part Three on Specific Commitments, only the latter extends its scope to all measures that restrict either domestic or foreign services and service suppliers from getting access to a market, whether on a discriminatory or non-discriminatory basis.

In addition, other articles relevant to this study are Article X, which permits emergency safeguard measures in specific circumstances; Article XII, which allows for the application of restrictions on trade in services, including payments and transfers, in the event of serious balance of payments and external financial difficulties; and Article XIV, which provides exceptions as necessary to protect public order, human health, or secure compliance with laws and regulations.

At the end of the Uruguay Round, Members presented their schedules of specific commitments with regard to liberalizing service sectors. However, the disagreement of the US over financial services, including insurance services could not be resolved at the time of conclusion of the Uruguay Round and led to the Second Annex on Financial Services. This second annex allows Members a period of up to six months after the date of entry into force of the WTO agreement, to (i) list measures relating to financial services inconsistent with the MFN, and (ii) improve, modify or withdraw any specific commitment in their schedules on financial services.[114] Consequently, the agreement on liberalization of the financial services sector, including insurance services, was achieved by the end of 1997, rather than at the time of conclusion of the Uruguay Round.

Besides the two annexes on financial services and the annex on MFN exemption mentioned earlier, other annexes address the movement of natural persons supplying services, air transport services, negotiations on maritime transport services, telecommunications, and negotiation on basic telecommunications.

3. Concluding remarks

GATS provides a set of multilateral rules to deal with both discriminatory and non-discriminatory restrictions, which affect trade in services in general, and insurance services in particular. The right to introduce prudential regulations, which is governed by the Annex, is vital for incorporating insurance services into the multilateral trading system. The inclusion of insurance services into the multilateral framework, however, was agreed on regarding only rules and specific factors of this sector provided in the Annex at the conclusion of the Uruguay Round. WTO Members continued negotiations on specific commitments on liberalization of insurance services in the following several years. Accordingly, the applicability of the national treatment principle in insurance services shall be analyzed in detail in the next three chapters relating to the framework of GATS, the Annex, and schedules of specific commitments.

[114] GATS, Second Annex on Financial Services.

CHAPTER TWO
Interpretation of the National Treatment Principle in GATS

Chapter Two starts with some remarks on the national treatment principle in GATS, and then identifies the scope of this principle. This chapter also reviews GATT jurisprudence in interpretation of the national treatment obligation. The main part of this chapter examines possibilities of interpretation of the national treatment principle in GATS, and frames a two-stage approach for such interpretation with a view to balancing liberalization of services under WTO and legitimate national policy objectives.

1. Remarks about the national treatment principle in GATS

The national treatment principle is incorporated in GATS Part III on Specific Commitments. Article XVII requires an importing country to treat foreign services and service suppliers of any other Member no less favourably than its own "like" services and service suppliers.[115] The inclusion of the national treatment principle in specific obligations, not general obligations like GATT, is a distinguishing feature of GATS, and implies that the national treatment obligation does not apply automatically to all service sectors. Instead, it applies to scheduled sectors and/or sub-sectors that a Member specifically lists in its commitments, and is also subject to any limitations indicated in each of the four modes of supply.

This progressive liberalization has been criticized as the main structural weakness of GATS, as national treatment is an object of negotiation rather than a general obligation.[116] It has been noted that the more Members exclude various sectors and sub-sectors from their schedules or inscribe limitations on national treatment in scheduled sectors, the less effective GATS will be in liberalization.[117] In the words of Snape and Boswoth, this approach "inhibits liberalization" because it gives incentives to governments to liberalize only sectors or sub-sectors subject to the least harm to their countries.[118]

Although the national treatment principle by itself is to deal only with some degree of trade liberalization – discrimination between foreign and domestic source of supply, but not among foreign services and service suppliers, the importance of the national treatment principle in facilitating progressive liberalization in services in general and insurance services in specific could be summarized by five attributes.

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[115] GATS, Art. XVII:1.

[116] Sauve, Pierre. 1995. Assessing the General Agreement on Trade in Services: *Half-Full or Half-Empty? Journal of World Trade* 29(4), p. 32. *See also* Hoekman, Bernard. 1994. General Agreement on Trade in Services. In OECD, *The New World Trading System: Readings*. Paris: OECD, pp. 180-181.

[117] Hoekman, Bernard and Pierre Sauve. 1994. Liberalizing Trade in Services., Washington, D.C.: World Bank (Discussion Papers 243), p. 33.

[118] Snape, Richard H. and Malcolm Boswoth. 1996. Advancing Services Negotiations. In Jeffrey J. Schott, ed., *The World Trading System: Challenges Ahead.* Washington, D.C.: Institute for International Economics, p. 191.

First, the primary concern of the national treatment is to address domestic law and regulations of Members with regard to treatment of foreigners.[119] As mentioned in Chapter One, section 1.3, most restrictions on trade in services are embedded in national domestic regulations. At the time of negotiating a framework agreement, it was recognized that national treatment in the service sector has significance because most services were subject to heavy domestic regulation, monopolization or state control.[120] National treatment of foreign services and service suppliers, therefore, is a necessary condition to ensure a level playing field for foreign and domestic suppliers.

In addition, the scope of GATS seems to be broad in terms of measures affecting trade in services. It covers not only measures in different forms, such as laws, regulations, rules, procedures, decisions, administrative actions, but also regulations issued by different authorities, including central, regional or local governments, as well as non-governmental bodies exercising delegated governmental functions.[121] It has been said that national treatment would enhance further liberalization because restrictions on trade in services have been clearly identifiable and subject to subsequent negotiations.[122]

Second, during the negotiation of GATS, many countries, including the EC and developing countries, were in favour of future negotiations and implementation of the national treatment obligation on a progressive basis rather than general obligation.[123] According to Hoekman, this was considered a trade-off with the extension of trade in services to all four modes of supply, which was supported by the US.[124] The adoption of a positive listing approach, whereby WTO Members opt to inscribe specific sectors and sub-sectors in the multilateral commitments, mainly resulted from efforts of developing countries in lessening the demands on liberalization from developed countries.[125]

The inclusion of national treatment in the specific commitments also recognizes the Member's choice in specifying sector and mode of supply, and implies reduction of multilateral rules and exceptions for different service sectors.[126] Therefore, the application of the national treatment principle takes a long-term approach, and further liberalization in services largely depends on negotiations with regard to making commitments on national treatment.

Third, by making multilateral commitments on national treatment, Members would bind themselves to current as well as future liberalization, which constitute, at least, increased

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[119] UNCTAD. 1999. National Treatment. New York and Geneva: UN, pp. 7-13.

[120] Reyna (1993), pp. 2376.

[121] GATS, Art. I (3) (a).

[122] Drake and Nicolaidis (1992), p. 93.

[123] During the Uruguay Round negotiations, some GATT contracting parties, including Australia, New Zealand, Japan, Switzerland, the US, supported an "automatic national treatment", whereby national treatment is obligatory once market access is granted. However, other parties, including Thailand, Singapore, India, Mexico, Peru, and EC, were in favour of accepting the national treatment as an object of progressive negotiations.

See Note on the Meeting of 17-21 July 1989 of the Group of Negotiations on Services, GATT Doc. No. MTN.GNS/24, 28 August 1989, paras. 202-218; Note on the Meeting of 11-13 June 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/1, 5 July 1990, paras. 46-53. *See also* Reyna (1993), pp. 2375-2377.

[124] Hoekman (1994), p. 179.

[125] Dobson and Jacquet (1998), p. 75.

[126] Drake and Nicolaidis (1992), p. 90.

predictability of the existing applicable policies.[127] Although lack of commitment does not imply prohibition on supply of services, the absence of such commitment, nevertheless, means no guarantee of stability of such liberal trade in services.[128]

Commitments on national treatment would provide more transparency and stronger attitudes towards foreign investors, and thus make the country more competitive for foreign investment.[129] In other words, although limitations on national treatment may exist in Members' schedules of specific commitments, they may offer some certainty and security towards foreign services and service suppliers. Furthermore, those limitations are only applicable to existing discriminatory measures, and any limitations on national treatment not inscribed into Members' schedules would be found to be illegal later.[130] Therefore, by making commitments on national treatment, governments could liberalize their service markets under controllable sequencing.

Fourth, by reference to mode 3, GATS covers investment for supplying services. The scope of national treatment in investment seems to be wider than that in trade because the investment involves a wide range of activities in importing countries, including know-how technology, local production and distribution, capital financing and provision of services.[131] In the context of GATS, economic activities are not limited only to "internal sale, offering of sale, purchase, transportation, distribution or use" as stipulated in GATT Article III, they encompass also "production" of services in other countries as provided in GATS Article XXVIII (b). Therefore, making commitments on national treatment would require a "no less favourable" treatment not only between foreign and domestic like services, but also between domestic and foreign service suppliers, who provide services through commercial presence.

Last, understanding the national treatment principle is necessary for both scheduling national commitments on specific sectors or sub-sectors, and dispute settlement procedures. Failure to implement specific commitments would lead to an obligation to compensate other WTO Members who are denied from benefit.[132] As noted earlier, examination of countries' schedules would be "the main part" of the panel process, in addition to interpretation of fundamental principles.[133]

2. Similarities between GATT and GATS with respect to national treatment[134]

2.1 Similarities

[127] Sorsa, Piritta. 1997. The GATS Agreement in Fianncial Services – A Modest Start to Multilateral Liberalization. New York: IMF (Working Paper WP/97/55), pp. 11-12.

[128] WTO. Undated. Market Access: Unfinished Business – Post-Uruguay Round Inventory and Issues. Geneva: WTO (Special Studies 6), p. 101.

[129] Kono, Masamichi et al. 1997. Opening Markets in Financial Services and the Role of the GATS. Geneva: WTO (Special Studies), p. 5.

[130] Drake and Nicolaidis (1992), p. 93.

[131] UNCTAD (1999), p. 9.

[132] Mattoo, Aaditya. 1999. Financial Services and the World Trade Organization: Liberalization Commitments of the Developing and Transition Economies. Washington D.C.: World Bank (Working Paper 2184), pp. 29-30.

[133] Hoekman (1994), pp. 180-181.

[134] This section draws in part from Vu Nhu Thang. 2006a. Interpreting GATS National Treatment Principle: Possibilities and Problems of Transplant from GATT. *Forum of International Development Studies* 32, pp. 173-194.

GATT national treatment requires Members to refrain from applying any law, regulation and requirement as well as internal taxes and charges, which may affect internal sale, offering for sale, purchase, transportation, distribution or use, on a discriminatory basis between imported and like domestic products. This fundamental obligation is specified in Article III on National Treatment on Internal Taxation and Regulation, paragraphs (1), (2) and (4):

> 1. The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.
>
> 2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.
>
> 4. The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use. The provisions of this paragraph shall not prevent the application of differential internal transportation charges which are based exclusively on the economic operation of the means of transport and not on the nationality of the product.[135]

Similarly, GATS Article XVII on National Treatment requires a Member to treat foreign services and service suppliers no less favourably than its like domestic services and service suppliers:

> 1. In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.
>
> 2. A Member may meet the requirement of paragraph 1 by according to services and service suppliers of any other Member, either formally identical treatment or formally different treatment to that it accords to its own like services and service suppliers.
>
> 3. Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member.[136]

Although Article III applies to goods and Article XVII deals with services, the text of the Article XVII:1 has more similarities to Article III:4 rather than Article III:2 of GATT, in that it refers only to "like" services and service suppliers, but not to "directly competitive or substitutable" services. In addition, the structure of Article XVII is completely different from that of Article III:2, which consists of two separate sentences. However, as Article XVII covers all the measures affecting supply of services regardless of fiscal or non-fiscal measures, it seems to be similar to the combination of both Article III:2 and 4. In general, GATT Article

[135] GATT, Art. III. (Asterisks omitted)
[136] GATS, Art. XVII. (Footnote omitted)

III and GATS Article XVII share three elements, in which Members are required to, (i) with respect to all laws, regulations and requirements affecting internal sale, offering for sale, purchase, transportation, distribution or use (or all measures affecting supply of services), (ii) accord to foreign goods (or services and service suppliers) no less favourable treatment, and (iii) than that accorded to like domestic goods (or services and service suppliers).

2.2 Possibilities of transplant

In the context of services, the practice of panels and the Appellate Body indicate that GATT jurisprudence on interpretation of Article III may be relevant to examining the meaning of GATS Article XVII.

Firstly, GATS and GATT fall within the same framework of the WTO Agreement, in which the former constitutes Annex 1B and the latter constitutes Annex 1A. Article XVI:1 of the WTO Agreement reads:

> Except as otherwise provided under this Agreement or the Multilateral Trade Agreements, the WTO shall be guided by the decisions, procedures and customary practices followed by the CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947.[137]

Although this does not indicate a clear and exact legal obligation to follow those decisions, procedures and customary practices developed in GATT, it is likely to suggest that GATT provisions and jurisprudence relating thereto, including the national treatment, would be relevant for interpretation of GATS provisions. Furthermore, as mentioned in Chapter One, section 2.1, the Ministerial Declaration of the Uruguay Round expressly indicated that GATT practices were relevant to negotiating a multilateral framework on services. In addition, the negotiating history shows a clear expression that some GATT principles and obligations are applicable to the service realm, including transparency, MFN, and national treatment.[138]

Secondly, the Appellate Body in *EC – Bananas* provided a general approach to GATS in that GATT jurisprudence could be relevant for the interpretation of analogous provisions in GATS.[139] The Appellate Body has compared GATT Article III and GATS Article XVII when ruling that the aims and effects test is not applicable to GATS Article XVII because there is no comparable provision similar to Article III:1 of the GATT as the grounds for this test.[140]

Thirdly, the Appellate Body also confirmed the conclusions of previous panels in GATT on Article III as a strong support for its interpretation of the word "affecting" in the context of GATS Article XVII when scope of a measure in question is to be defined.[141]

Lastly, the Panel in *Korea – Beef* recalled that the main purpose of Article III:4 is to ensure "the effective equality of opportunities" with regard to the application of laws,

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[137] WTO Agreement, Art. XVI:1

[138] Note on the Meeting of 15-17 September 1987 of the Group of Negotiations on Services, GATT Doc. No. MTN.GNS/10, 15 October 1987, paras. 11-19.

[139] Appellate Body Report, *European Communities – Regime for the Importation, Sale and Distribution of Bananas* [hereinafter *EC – Bananas*], WT/DS27/AB/R, adopted on 25 September 1997, para. 231 reasons that:

> …The Panel would have been on safer ground had it compared the MFN obligation in Article II of the GATS with the MFN and MFN-type obligations in the GATT 1994…

[140] *Id.* para. 241.

[141] *Id.* para. 220.

regulations and requirements, and this is also applicable to Article XVII:3 of GATS, which explicitly provides that formally identical legal provisions would cause less favourable treatment to imported products.[142]

However, there are some differences between GATT and GATS, which may significantly limit the transplant of GATT jurisprudence to GATS. First, GATT covers trade in goods whereas GATS applies to the supply of services. The fundamental nature of intangibility and non-storability of services make the interpretation of the national treatment principle of GATS more complicated and difficult than that of GATT. Second, as noted in section 2.1 of this chapter, the structure of GATS Article XVII is different to that of GATT Article III. In addition, textual differences also exist between GATT and GATS. While GATT Article III specifically refers to goods "imported into the territory of any other contracting party", GATS Article XVII seems to address *all* discriminatory measures between domestic and foreign services and service suppliers. Third, as GATS covers investment for supplying services, the scope of the national treatment principle extends not only to services but also to service suppliers. Finally, GATS Article XVII is a negotiable obligation, which make schedules of specific commitments of WTO Members become an integral part of the national treatment principle.

Although legal evidences apparently demonstrate possibilities for transplanting GATT jurisprudence to service sectors, the examination and interpretation of the GATS national treatment principle should carefully take into account such limitations.

3. Provision and case law of GATT

3.1 Internal taxation and regulation affecting trade in goods

The first element of the national treatment obligation under GATT is whether a measure in question falls under the scope of Article III. While Article III:2 deals with all kinds of internal taxes and other internal charges, which discriminate between imported and like (or directly comparative or substitutable) domestic products, Article III:4 deals with all kinds of laws, regulations, and requirements, which have no fiscal nature, affecting internal sale, offering for sale, purchase, transportation, distribution or use of imported products.

With regard to measures covered by Article III:4, both panels and Appellate Body have clarified their scope through a number of cases.

First, measures which affect internal sale, offering for sale, purchase, transportation, distribution or use of imported products must be governmental. The Appellate Body in *Korea – Beef* has stated that Article III:4 covers only the *governmental* intervention that affects the conditions of competition between imported and like domestic products.[143] Therefore, a dual or parallel system of beef distribution in the Korean market is not covered by the scope of this Article as far as it purely resulted from the cost and benefit calculation of private

[142] Panel Report, *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef* [hereinafter *Korea – Beef*], WT/DS161/R, WT/DS169/R, adopted on 10 January 2001, para. 624.

[143] Appellate Body Report, *Korea – Beef*, para. 149. (Original emphasis)

entrepreneurs.[144] This indicates that any measure bearing non-governmental nature or functions would not fall within the scope of Article III:4.

Second, the scope of "laws, regulations and requirements" encompasses both mandatory or compulsory rules, and voluntary but enforceable measures as well. In *Canada – FIRA*, the US contended that the written undertakings obtained by the government of Canada under the Canadian Foreign Investment Review Act, obliging foreign investors to purchase goods of Canadian origin or from Canadian sources, would be inconsistent with Article III:4.[145] The Panel, in examining whether those purchase undertakings constituted "laws, regulations and requirements" within the meaning of Article III:4, found that the word "requirements" could cover the existing purchase undertakings.[146] The reasoning of the Panel is that those written purchase undertakings would be a criterion for governmental approval of investment projects, and they could be legally enforced.[147] This broad interpretation was repeated in *EEC – Regulation on Imports of Parts and Components*, where Japan contended that the acceptance of undertaking to limit the use of imported parts and materials would constitute a "requirement" within the context of Article III:4.[148] The Panel considered that grants of an advantage depending on the acceptance of undertakings by EEC enterprises to limit the use of Japan-original parts and material constitute a "requirement" inconsistent with Article III:4.[149]

Third, measures cover both substantive and procedural norms. In *US – Section 337*, Section 337 was used as a means for the enforcement of the US patent law at the border under the investigations and proceedings conducted by the US International Trade Commission subject to the Administrative Procedure Act, while litigation under the US patent law was brought before federal district courts and subject to procedures of the Federal Rules of Civil Procedure.[150] The Panel concluded that the procedures under Section 337 were covered by the scope of "laws, regulations and requirements affecting the internal sale of imported products" because (i) there is no distinction of laws, regulations and requirements in substance and procedure under the text of Article III:4, and (ii) the substantive provisions would be ineffective if there was a lack of the procedural provisions for enforcement.[151]

Last, measures include those directly regulating the provision of products, and those that govern other matters but indirectly affect the conditions of competition. In *Italian Discrimination against Imported Agricultural Machinery*,[152] the Italian government set up a revolving fund allowing the Ministry of Agriculture and Forestry to provide special credit terms for the purchase of Italian agricultural machinery, but not imported tractors and other agricultural machinery. According to the Panel, the implication of the word "affecting" means that Article III:4 encompasses both laws and regulations which directly governed the

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[144] *Id.*

[145] Panel Report, *Canada – Administration of the Foreign Investment Review Act* [hereinafter *Canada – FIRA*], L/5504 – 30S/140, adopted on 7 February 1984.

[146] *Id.* para. 5.4.

[147] *Id.* para. 5.4.

[148] Panel Report, *EEC – Regulation on Imports of Parts and Components*, L/6657 – 37S/132, adopted on 16 May 1990.

[149] *Id.* para. 5.21.

[150] Panel Report, *United States – Section 337 of the Tariff Act of 1930* [hereinafter *US – Section 337*], L/6439 – 36S/345, adopted on 7 November 1989.

[151] *Id.* para. 5.10.

[152] Panel Report, *Italian Discrimination against Imported Agricultural Machinery*, L/33 – 7S/60, adopted on 23 October 1958.

conditions of sale or purchase, as well as any law and regulation which might "adversely modify the conditions of competition between the domestic and imported products in the internal market".[153]

The term "internal taxes or other internal charges" as mentioned in Article III:2 is not limited only to taxes and charges themselves, but other measures that could lead to cost burdens on the products. According to the Panel in *Argentina – Bovine Hides*, those measures which are covered by Article III:2 must satisfy three conditions: (i) constituting taxes or other charges of any kind, (ii) constituting internal measures and (iii) applying, directly or indirectly, to imported and domestic products.[154] In Argentine regulations, goods that are definitively imported into Argentine territory are subject to (i) an additional amount, under Resolution 3431, in addition to the ordinary value added tax due on that import transaction, and this pre-payment of value added tax may be credited on the subsequent re-sale of goods in cases where the importer is a registered taxpayer;[155] and (ii) a certain amount, under Resolution 3543, on account of the annual tax on income and this pre-payment of income tax can be credited against the amount that is due by the importer in the same fiscal period.[156] The Panel found that, although Resolutions 3431 and 3543 were mechanisms for the collection of the value added tax and income tax, they impose fiscal and payment obligations on importers, which qualify as tax measures under Article III:2.[157] Therefore, the term "taxes or other charges of any kind" would cover other measures, including "tax administration" measures that constitute an internal charge applicable to products.[158]

In summary, GATT jurisprudence has developed a broad approach to interpretation of the scope of "laws, regulations and requirements" as well as "internal taxes or other internal charges of any kind" to cover all measures, which potentially modify conditions of competition among foreign and domestic products. This practice would bring about more significance on how likeness and the standard of "no less favourable" treatment are interpreted.

3.2 Likeness

The second element in the national treatment obligation is whether imported and domestic products are alike. The text of Article III has offered three approaches to interpreting likeness in dispute settlement, namely (i) Article III:2, first sentence, (ii) Article III:2, second sentence in connection with Ad Article III, paragraph 2 and Article III:1, and (iii) Article III:4.

(i) Narrow interpretation in the first sentence of Article III:2

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153 *Id.* para. 12.

154 Panel Report, *Argentina – Measures Affecting the Export of Bovine Hides and the Import of Finished Leather* [hereinafter *Argentina – Bovine Hides*], WT/DS155/R, adopted on 16 February 2001, para. 11.139.

155 *Id.* para. 6.6.

156 *Id.* para. 6.16.

157 *Id.* para. 11.143.

158 *Id.* para. 11.144.

The first sentence of Article III:2 requires that no internal taxes or other internal charges of any kinds shall be imposed on imported products in excess of those applied to like domestic products. The panels and Appellate Body have opportunities to examine likeness in different cases, where they followed the narrow interpretation to this term. The word "like" products (in the French text: "products similaires") is not limited to "identical" or "equal" products, but it extends to products with similar qualities.[159] Further, the Panel in *Japan – Alcoholic Beverages* viewed that the term "like" should be used in a narrow understanding on a case-by-case basis though products are not required to be identical in all respects,[160] and this view has been upheld by the Appellate Body.[161]

Both panels and Appellate Body have adhered to the following basic approach, which includes three criteria set out by the Report of the Working Party on *Border Tax Adjustments*[162] in interpreting likeness in a narrow way: (i) the products' end-uses in a given market; (ii) consumers' tastes and habits, which change from country to country; and (iii) products' properties, nature and quality. The fourth criterion is a uniform tariff classification of products, which can be a relevant to confirming likeness.[163] Under this narrow interpretation, the term "like" products requires two products to share "essentially the same physical characteristics" even though the commonality of end-uses is a necessary, but not sufficient, criterion to confirm likeness.[164] Consequently, the Panel in *Japan – Alcoholic Beverages* found that vodka and shochu are like products as (i) their end-uses are identical;[165] (ii) there is no evidence from the traditional Japanese consumers' habits to regard vodka as an unlike product;[166] (iii) they shared most physical characteristics; and (iv) they were currently classified in the same heading in the Japanese tariffs and covered by the same Japanese tariff binding.[167] The Appellate Body upheld the reasoning and this conclusion although it pointed out that the reliance on tariff bindings would be risky because there is a major difference between tariff classification nomenclature and tariff bindings made by Members.[168]

A different interpretation was adopted by the Panel in *US – Malt Beverages*, where the Panel found that likeness of products should be determined "not only in the light of criteria as the products' physical characteristics, but also in light of the purpose of Article III".[169] This means that the Panel expressly referred to Article III:1, which provided that internal taxes and other internal charges should not be applied to imported or domestic products so as to afford protection to domestic production, when it interpreted likeness in the first sentence of Article

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[159] Panel Report, *Japan – Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, L/6216 – 34S/83, adopted on 10 November 1987, para. 5.5.

[160] Panel Report, *Japan – Taxes on Alcoholic Beverages* [hereinafter *Japan – Alcoholic Beverages*], WT/DS8/R, WT/DS10/R, WT/DS11/R, adopted on 1 November 1996, para. 6.21.

[161] Appellate Body Report, *Japan – Alcoholic Beverages*, p. 19.

[162] GATT. Report of the Working Party on *Border Tax Adjustments*, (L/3464), adopted on 2 December 1970, para. 18.

[163] Panel Report, *EEC – Measures on Animal Feed Proteins*, L/4599 – 25S/49, adopted on 14 March 1978, para. 4.2; Panel Report, *Japan – Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages,* L/6216 – 34S/83, adopted on 10 November 1987, para. 5.6.

[164] Panel Report, *Japan – Alcoholic Beverages*, para. 6.22.

[165] Panel Report, *Japan – Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, L/6216 – 34S/83, adopted on 10 November 1987, para. 5.7.

[166] *Id.*

[167] Panel Report, *Japan – Alcoholic Beverages*, para. 6.23.

[168] Appellate Body Report, *Japan – Alcoholic Beverages*, p. 23.

[169] Panel Report, *United States – Measures Affecting Alcoholic and Malt Beverages* [hereinafter *US – Malt Beverages*], DS23/R – 39S/206, adopted on 19 June 1992, para. 5.71.

III:2. The main reason for this approach was, according to the Panel, that the determination of likeness in the context of Article III should respect the "regulatory authority and domestic policy options of contracting parties".[170] This is referred to as "aims and effects" test for determination of likeness. The next and last panel which introduced this interpretation in its report, but not adopted, was the Panel in *US – Taxes on Automobiles*. This Panel considered that Article III:2 and 4 must be read in the light of the central purpose as stated in Article III:1, which did not prohibit fiscal and regulatory distinctions applied so as to achieve other policy goals.[171]

However, the Panel in *Japan – Alcoholic Beverages* has strongly rejected this "aims and effects" test, which was upheld by the Appellate Body,[172] in determination of the likeness based mainly on three reasons. First, the ground for this test is based on the words "so as to afford protection to domestic production" which is found in Article III:1, while there is no similar wording in the first sentence of Article III:2.[173] Therefore, it would be unacceptable to consider "so as to afford protection to domestic production" as a criterion in interpreting the term "like" products in the context of the first sentence of Article III:2. Second, the adoption of the "aims and effects" test would cause a burden upon complainants to show both the aim and effect of a particular measure.[174] This situation becomes more complicated when different aims are involved, and there is no agreement on which aim or aims are decisive for this test. Further, it seems to be infeasible for complainants to have access to the legislative history of other Members in examining the aims of legislations. Third, if the "aims and effects" test were applied in interpretation of the first sentence of Article III:2, this would nullify the list of exceptions in Article XX of GATT as this test leads to non-exhaustive grounds for derogation of the obligations in Article III.[175]

(ii) Broad interpretation of likeness with reference to "directly competitive or substitutable products"

The scope of products for comparison in the second sentence of Article III:2 is clarified by Ad Article III paragraph 2, which refers to "directly competitive or substitutable products".[176] However, in contrast to the word "like", the term "directly competitive or substitutable" does not require that two products must share similar physical characteristics.[177] "Market place" requirement was established as a basis for comparison, in addition to physical characteristics, common end-uses, and tariff classification, by the Panel in *Japan – Alcoholic Beverages* and upheld by the Appellate Body.[178] In other words, competition in a relevant

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[170] *Id.* para. 5.72.
[171] Panel Report, *United States – Taxes on Automobiles,* DS31/R, 11 October 1994, unadopted, para. 5.7.
[172] Appellate Body Report, *Japan – Alcoholic Beverages*, p. 21.
[173] Panel Report, *Japan – Alcoholic Beverages*, para. 6.16.
[174] *Id.*
[175] *Id.* para. 6.17.
[176] GATT ***Ad Article III*** *Paragraph* 2 reads:
> A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.

[177] Panel Report, *Japan – Alcoholic Beverages*, para. 6.22.
[178] Appellate Body Report, *Japan – Alcoholic Beverages*, p. 26.

market should be used as one means in evaluating whether products are directly competitive or substitutable. This requirement shall be assessed based on many factors, including the elasticity of substitution.

Therefore, in assessing whether products are "directly competitive or substitutable", the Panel found that, in addition to other factors, the decisive criterion is whether those products have common end-uses as showed by an elasticity of substitution.[179] This analysis was upheld by the Appellate Body.[180] Elasticity of substitution, according to the Panel, was evidenced by the fact that foreign produced whisky and shochu were competing for the same market,[181] and by the cross-price elasticity of demand because a change in demand for one product would sensitively lead to changes in price of the other product.[182]

In addition, in *Korea – Alcoholic Beverages*, the Panel put more emphasis on the word "directly" based on the reasoning that at some levels, there would be at least an indirect competition among products and services. The examination of whether two products or groups of products have a direct competitive relationship would be evidenced by whether consumers consider or are able to consider those two products or groups of products as "alternative ways of satisfying a particular need or taste", including comparisons of their physical characteristics, end-uses, channels of distribution and prices.[183] The Appellate Body agreed with the Panel that the *nature, or quality* of competition, and not its *quantity*, must be emphasized in determination of whether products are "directly competitive or substitutable".[184] Accordingly, the Panel concluded that the imported (whiskies, brandies, cognac, rum, gin, vodka, tequila, liqueurs and ad-mixtures) and domestic (soju, both diluted and distilled) products are directly competitive or substitutable based on evidence on the physical characteristics, end-uses, channels of distribution and pricing.[185]

However, because the second sentence of Article III:2 specifically refers to Article III:1, the second test must be confirmed concerning whether the internal measures applicable to "directly competitive or substitutable" products are to afford protection to domestic products. This test requires a separate examination of protective "purpose".[186] The structure of Article III indicates that this test is only applicable to the second sentence of Article III:2, but not the first sentence of Article III:2 nor Article III:4. In *Canada – Periodicals*, the protective purpose in introducing Part V.1 of the Excise Tax Act was clearly mentioned in several statements of Canada's explicit policy objectives to afford protection to the production of Canadian periodicals.[187]

Nevertheless, as the protective purpose of a measure is sometimes difficult to confirm, the assessment of whether a measure "affords protection to domestic production" is additionally evidenced by protective application through the examination of "the design, the

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[179] Panel Report, *Japan – Alcoholic Beverages*, para. 6.22.

[180] Appellate Body Report, *Japan – Alcoholic Beverages*, p. 26.

[181] Panel Report, *Japan – Alcoholic Beverages*, para. 6.30.

[182] *Id.* para 6.31.

[183] Panel Report, *Korea – Taxes on Alcoholic Beverages* [hereinafter *Korea – Alcoholic Beverages*], WT/DS75/R, WT/DS84/R, adopted on 17 February 1999, paras. 10.40 and 10.43.

[184] Appellate Body Report, *Korea – Alcoholic Beverages*, WT/DS75/AB/R, WT/DS84/AB/R, adopted on 17 February 1999, para. 133. (Original emphasis)

[185] Panel Report, *Korea – Alcoholic Beverages*, para. 10.98.

[186] Appellate Body Report, *Japan – Alcoholic Beverages*, p. 28.

[187] Appellate Body Report, *Canada – Certain Measures Concerning Periodicals* [hereinafter *Canada – Periodicals*], WT/DS31/AB/R, adopted on 30 July 1997, pp. 33-34.

architecture, and the revealing structure" of that measure.[188] This would indicate an objective examination based on the appearance of measures in question. Consequently, the Appellate Body in *Japan – Alcoholic Beverages* upheld the Panel's finding that the Liquor Tax Law had been applied "so as to afford protection" by noting the correct reasoning of the Panel that domestically produced shochu is isolated from foreign competition because, on the one hand, foreign-produced shochu will face difficulties in penetrating the Japanese market and, on the other hand, the equality of competitive conditions between shochu and the rest of "white" and "brown" spirits is not ensured.[189]

Following the same approach, the Appellate Body in *Korea – Alcoholic Beverages* upheld the Panel's finding that the Korean measures afford protection to domestic production on the grounds of (i) large differences in levels of taxation under the Korean tax law, (ii) discrimination in the design, architecture and structure of the Korean alcoholic beverages tax laws, and (iii) the practical situation that most imported products were subject to a higher tax burden than domestic products.[190]

(iii) Broad interpretation of likeness in Article III:4

Based on the reasoning of the textual difference between Article III:2, which consists of two separate sentences, and Article III:4, which applies only to "like products", the Appellate Body in *EC – Asbestos* have followed a contextual interpretation of the meaning of the word "like" in Article III:4.[191] Accordingly, likeness in Article III:4 must be interpreted differently from the narrow meaning in the first sentence of Article III:2, and calls for taking into account the proper scope and meaning of Article III:1, which means "to ensure that internal measures not be applied to imported or domestic products so as to afford protection to domestic production".[192] By this interpretation, the scope of products would be enlarged, at maximum, equal to the combined product scope of the two sentences under Article III:2, and consequently, the determination of likeness under Article III:4 must be based on "the nature and extent of a competitive relationship between and among products".[193]

In determining the competitive relationship between products, two criteria, namely products' end-uses and customers' tastes and habits, are fundamental and relevant in assessment of likeness.[194] While the products' end-uses criterion will testify "the extent to which products are capable of performing the same, or similar, functions", the customers' tastes and habits criterion will examine "the extent to which consumers are willing to use the products to perform these functions".[195] Therefore, the Appellate Body reversed the Panel's conclusion on the likeness between chrysotile fibres, on the one hand and polyvinyl alcohol, cellulose and glass fibres, on the other hand, because of different "properties, nature and

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[188] Appellate Body Report, *Japan – Alcoholic Beverages*, p. 30.
[189] *Id.* pp. 31-32.
[190] Appellate Body Report, *Korea – Alcoholic Beverages*, para. 150.
[191] Appellate Body Report, *European Communities – Measures Affecting Asbestos and Asbestos-containing Products* [hereinafter *EC – Asbestos*], WT/DS135/AB/R, adopted on 5 April 2001, paras. 93-94.
[192] *Id.* para. 98.
[193] *Id.* para. 99.
[194] *Id.* para. 117.
[195] *Id.* para. 117.

quality" of those products, their difference in tariff classification, different end-uses, and lack of evidence on consumers' tastes and habits.[196]

With respect to the likeness of chrysotile-fibre products and fibro-cement products, the Appellate Body reversed the conclusion of their likeness because there was no examination of evidence on consumers' tastes and habits, although they are in the same tariff classification.[197]

As noted earlier, the "aims and effects" test was introduced in *US – Malt Beverages* for determining likeness of products based on the argument that under the light of Article III:1, two products can not be regarded as like products as long as there is no protective purpose in the differentiation between them. In the context of Article III:4, the Panel found that low alcohol content beer and high alcohol content beer are not like products because there was no evidence that the choice of the particular level of alcohol content has the protective purpose or effect.[198] However, the Appellate Body in *EC – Bananas* rejected the determination of likeness in reference to "so as to afford protection to domestic production" as Article III:4 did not mention Article III:1.[199] It indicates that, for the purpose of Article III:4 it is sufficient to confirm likeness of products on an objective assessment, regardless of regulatory purpose of internal measures concerned.

Another legal issue is whether the way of producing products could be taken into account in assessing likeness of two products. In *US – Restriction on Imports of Tuna*, the Panel concluded that the US is under obligation to treat Mexican tuna no less favourably than that accorded to the US tuna regardless of vessel type because Article III:4 called for the comparison of products as a product, not according to process or production method.[200]

In sum, the structure of Article III provides three different approaches for interpretation of likeness between foreign and domestic products. Although the word "like" is analogous between the first sentence of Article III:2 and Article III:4, the former is interpreted in a narrow way, which requires, among other criteria, essential similarities in physical characteristics.

The second approach is to refer to "directly competitive or substitutable" products articulated by the second sentence of Article III:2, which covers examining the elasticity of substitutability among products as well as the willingness of consumers to use alternative products, and revealing protective purpose of a measure. In contrast, the interpretation of both the first sentence of Article III:2 and Article III:4 would follow an objective assessment of likeness regardless of regulatory purposes.

However, it is recognized by the Appellate Body that it is inappropriate to separate likeness in Article III:4 from the general purpose of Article III:1. Therefore, the third approach provided in Article III:4 is to have a broader meaning that covers the competitive relationship among products concerned, which is substantially evidenced by two criteria of products' end-uses and consumers' tastes and habits.

3.3 "No less favourable" treatment

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196 *Id.* paras. 125-126.
197 *Id.* paras. 130-131.
198 Panel Report, *US – Malt Beverages*, paras. 5.74-75.
199 Appellate Body Report, *EC – Bananas*, para. 216.
200 Panel Report, *United States – Restriction on Imports of Tuna*, DS 21/R – 39S/155, dated 3 September 1991 (unadopted), para. 5.15. (Original emphasis)

When measures are found under the scope of Article III and the likeness between imported and domestic products is confirmed, a WTO Member will violate the national treatment obligation if it accords imported products a less favourable treatment than that accorded to domestic counterparts. The standard of Article III:4 requires Members, upon the custom clearance of foreign goods, to ensure "effective equality of opportunities for imported products in respect of the application of laws, regulations, and requirements affecting internal sale, offering for sale, purchase, transportation, distribution or use of products". [201] In other words, this standard sets the obligation that domestic measures must be origin-neutral with respect to imports and domestic products. Since the interpretation of the term "like" products in the light of Article III:1 may lead to a relatively broad scope of likeness under Article III:4, this element of "no less favourable" treatment must be satisfied before a measure can be held to be inconsistent with Article III:4.[202] It has been suggested that the Appellate Body would desire to balance the broad scope of likeness by focusing on "no less favourable" treatment as another condition in Article III:4.[203]

One legal issue is whether Article III:1 should be taken into account in interpretation of this standard. As mentioned earlier, the Appellate Body in *EC – Bananas* clearly rejected the inclusion of Article III:1 in the interpretation of Article III:4 based on the ground that Article III:4 does not specifically refer to Article III:1. It would mean that, similar to the second element of likeness, the standard of "no less favourable" treatment must be also assessed in an objective manner regardless of legislative purposes or aims.[204]

According to the Appellate Body in *EC – Asbestos*, the term "no less favourable" treatment should be understood and interpreted in the light of the general principle set out in Article III:1, that internal laws, regulations and requirements "should not be applied to imported or domestic products so as to afford protection to domestic production".[205] This, nevertheless, does not mean that a separate test should be introduced in examination of the standard of "no less favourable" treatment in Article III:4. This implies that the protective purposes of a measure concerned should be revealed, and they would be a relevant factor in the examination of this standard. In different cases, *Korea – Beef* and *Dominican Republic – Cigarettes*, the Appellate Body clarified that the standard of "no less favourable" treatment must be determined through examination of whether the measure at issue modifies conditions of competition or not in the relevant market to the detriment of imported products.[206]

Another legal issue is that this standard does not allow offsetting the treatment accorded to the like product in question with the treatment granted to another like product. The argument of "balancing more favourable treatment of some imported products against less favourable treatment of other imported products" is rejected in *US – Section 337* because it may lead to the situation of more favourable treatment in one case as a justification for less

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[201] Panel Report, *US – Section 337*, para. 5.11.

[202] Appellate Body Report, *EC – Asbestos*, para. 100.

[203] Ehring, Lothar. 2002. De Facto Discrimination in World Trade Law: National and Most-Favoured-Nation Treatment – or Equal Treatment? *Journal of World Trade* 36(5), p. 944.

[204] *Id.* p. 946.

[205] Appellate Body Report, *EC – Asbestos*, para. 100.

[206] Appellate Body Report, *Korea – Beef*, para. 137; Appellate Body Report, *Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes* [hereinafter *Dominican Republic – Cigarettes*], WT/DS302/AB/R, adopted on 19 May 2005, para. 93.

favourable treatment in another case, which would make the conditions of competition between domestic and imported products more uncertain.[207]

From GATT jurisprudence, there are two types of requirements under the standard of "no less favourable" treatment. The first requirement relates to a situation where any different legal requirement applicable to imported products must accord no less favourable treatment to those imported products. In this situation, a different treatment between imported and like domestic products does not constitute a violation of the standard as long as this treatment is not less favourable with regard to imported products.

In *Canada – FIRA*, the Panel found that the different treatment led to the modification of conditions of competition in favour of domestic products because written undertakings by foreign investors to buy Canada-original goods were subject to no qualification, and accordingly eliminated "the possibility of purchasing available imported products".[208] Even though purchase undertakings were conditional on Canada-original goods being "available", "competitively available", or "reasonably available" in the market, treatment of imported goods was also found less favourable as those undertakings would constitute a preference to the domestic products.[209] Regarding undertakings to buy products from Canadian suppliers, although these requirements, even when subject to qualification of "competitive availability" or "reasonable availability", may have little influence on the choice of purchasing domestic or imported products, this would exclude the possibility of purchasing imported goods directly from foreign suppliers and entail giving preference to Canadian sources.[210]

The second requirement covers a situation whereby although domestic measures are origin-neutral, they may have a discriminatory effect against imported products. In this situation, Members are also required to refrain from application of formally identical regulation, which may, in practice, lead to less favourable treatment to imported products.[211] In *Korea – Beef*, despite upholding the Panel's conclusion that under the Korean dual retail system, imported beef is treated less favourably than domestic beef, the Appellate Body re-examined the "no less favourable" treatment of the imported beef on the ground of assessing whether the dual retail system, modifies the *conditions of competition* in the Korean market to the detriment of imported products.[212] The reasoning of the Appellate Body was that by introducing the dual system of distribution for beef, which required small retailers to opt for selling either domestic or imported beef, the vast majority of individual retailers selected the domestic beef, and the effect of this measure was the dramatic reduction of retailers for imported beef, that limited the access to normal retail distribution system and the competitive conditions for imported beef.[213]

In sum, the core requirement of the third element of "no less favourable" treatment under Article III:4 is to prohibit both formally identical and different legal treatment, which actually modifies conditions of competition in favour of domestic products. This standard is examined on objective grounds irrespective of national regulatory purposes.

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[207] Panel Report, *US – Section 337*, para. 5.14.
[208] Panel Report, *Canada – FIRA*, para. 5.8.
[209] *Id.* paras. 5.8-9.
[210] *Id.* paras. 5.10-11.
[211] Panel Report, *US – Section 337*, para. 5.11.
[212] Appellate Body Report, *Korea – Beef*, para. 144. (Original emphasis)
[213] *Id.* paras. 145-146.

4. National treatment principle in GATS: Interpretative issues[214]

The previous section has reviewed GATT jurisprudence in interpreting the national treatment obligation. After determining the applicable scope of the national treatment principle in GATS, the transplant of jurisprudence from GATT to GATS with regard to three fundamental elements of this principle, namely scope of measures, likeness, and the standard of "no less favorable" treatment, shall be examined in detail.

4.1 Defining the scope of application of the national treatment principle

Clearly defining the scope of the national treatment principle is important for both understanding this principle and scheduling national commitments in liberalization of services. However, the scope of GATS Article XVII seems to be less predictable as it only requires WTO Members to accord no less favourable treatment to foreign services and service suppliers, rather than expressly indicating whether such foreign services and service suppliers enter the domestic market or not. This is more complicated as far as Article XVI on Market Access is concerned.[215]

One interpretation, which is based on the GATT approach, is that the scope of Article XVII is limited to the post-entry stage of foreign services and service suppliers. As noted in section 3 of this chapter, the wording of Article III of GATT extends the national treatment obligation to foreign goods only at the post-entry stage because it clearly refers to "the products of the territory of any contracting party imported into the territory of any other contracting party".[216] It would mean that the national treatment obligation in GATS is triggered upon the entrance of foreign services and service suppliers into domestic market. This interpretation is probably supported by the text of Article XVI:2 (f) that calls for refraining from limitations on the participation of foreign capital, which can be regarded as relating to establishment, either in terms of a percentage limit on foreign shareholding or on

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[214] This section draws in part from Vu Nhu Thang (2006a), pp. 173-194.

[215] Instead of defining the term "market access", Article XVI provides a list of restrictive measures, which Member countries, having undertaken commitments in a particular sector, are required to refrain from applying less favourable treatment to services and service suppliers of other Members. There are six types of limitations which are prohibited by GATS, namely: (a) limitations on the number of suppliers; (b) limitations on the total value of service transactions or assets; (c) limitation on the total number of service operations or on the total quantity of service output; (d) limitations on the total number of natural persons that may be employed; (e) measures which restrict or require specific types of legal entity or joint venture; and (f) limitations on the participation of foreign capital, either in terms of a percentage limit on foreign shareholding or on the total value of foreign investment, either in the aggregate or by a single entity. The first four sub-paragraphs of Article XVI:2 deal with "quantitative" measures on market access, whereas Article XVI:2 (e) concerns restrictive measures applicable to specific forms of establishment, and Article XVI:2 (f) covers restrictions on the foreign capital participation. Moreover, those restrictions are referred to a maximum limitation, but not minimum requirements. While the first five sub-paragraphs deal with both discriminatory measures (prohibition of foreign services and service suppliers) and non-discriminatory measures (prohibition of both foreign and domestic services and suppliers), the last sub-paragraph addresses exclusively discriminatory restrictions against foreign participation.

See also Scheduling of Initial Commitments in Trade in Services, Explanatory Note, GATT Doc. No. MTN.GNS/W/164, 3 September 1993, para. 5.

[216] Emphasis added.

the total value of foreign investment, either in the aggregate or by a single entity.[217] In other words, the national treatment is applied only after commercial presence of foreign service suppliers is established. However, as far as the text of Article XVII:1, which indicates "all measures" that might discriminate foreign services and service suppliers, is concerned, this interpretation proves to be less persuasive.

Another possible interpretation is that the national treatment principle extends to both pre (the right to establish) and post-entry of foreign services and service suppliers. Taking into account four modes of supply in services as described in Chapter One, section 2.3, the scope of the national treatment principle applies not only to services (similar to foreign goods as provided in Article III of GATT), but also to service suppliers (similar to investment). In investment agreements, the national treatment obligation may apply to either post-establishment or both pre and post-establishment.[218] The text Article XVII:1 seems to support this argument of both pre and post-entry stages because it extends to "all measures", which could be interpreted to include measures affecting establishment of commercial presence under Mode 3, and there is no clear distinction between frontier and internal measures.[219] Pauwelyn goes further to underscore that as Article XVII could cover both internal regulations and market access restrictions, *all* Article XVI measures fall within the scope of Article XVII.[220] It would indicate that national treatment overrides market access.

While Article XVI (f) exclusively deals with discrimination against foreign counterparts, the other five limitations and measures apply to both foreign and domestic services and service suppliers. This means that Article XVI deals with not only discriminatory but also non-discriminatory measures relating to the entrance into a domestic market. Therefore, the interpretation suggesting that national treatment overrides market access apparently restrains the scope of Article XVI to only non-discriminatory measures.[221] Moreover, this interpretation disregards the scope of Article XVI:2, which also addresses foreign service suppliers' right to establish a commercial presence.

The scope of application of the national treatment principle would be more complicated as far as quantitative and discriminatory measures are concerned. As the text of Article XVII:1 indicates all measures, it may be interpreted to cover all restrictions, regardless of quantitative or non-quantitative discriminatory nature. However, the first four limitations under Article XVI:2 exclusively relate to "quantitative" measures, both discriminatory and

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[217] Mattoo, Aaditya. 1997. National Treatment in the GATS: Corner-Stone or Pandora's Box? *Journal of World Trade* 31, p. 117.

[218] The typical example of the pre and post-entry national treatment obligation can be found in the North American Free Trade Agreement. Article 1405 on National Treatment reads:

> 1. Each Party shall accord to investors of another Party treatment no less favorable than that it accords to its own investors, in like circumstances, with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of financial institutions and investments in financial institutions in its territory.
>
> 2. Each Party shall accord to financial institutions of another Party and to investments of investors of another Party in financial institutions treatment no less favorable than that it accords to its own financial institutions and to investments of its own investors in financial institutions, in like circumstances, with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of financial institutions and investments.

Available at http://www.nafta_sec_alena .org – Last visited 5 October 2005.

[219] Mattoo (1997), p. 115.

[220] Pauwelyn, Joost. 2005. Rien ne Va Plus? Distinguishing domestic regulation from market access in GATT and GATS. *World Trade Review* 4(2), p. 149. (Original emphasis)

[221] Mattoo (1997), p. 116.

non-discriminatory, on market access. According to Feketekuty, both Articles XVI and XVII may address quantitative limitations on foreign services and service suppliers.[222]

Although the argument that the national treatment principle extends to both pre (the right to establish) and post-entry of foreign services and service suppliers has strong support from the text of Article XVII, it would be inappropriate because this interpretation disregards the scope of Article XVI. To be more specific, a definition of the scope of Article XVII, which makes any sub-heading of Article XVI:2 redundant, would be unacceptable. Consequently, the interpretation of the scope of Article XVII must take into account Article XVI.

Due to the complicated combination of Article XVI:2, which deals with restrictions on pre-entry stage on the one hand, and on both quantitative ((a), (b), (c), (d), and (f)), and non-quantitative ((e)) nature, on the other hand, an alternative reading of Article XVII is to exclude all discriminatory and quantitative measures, which belong to the domain of Article XVI, from the scope of the national treatment principle. It would mean that as the market access article only deals with six types of limitations, Article XVII would encompass any discriminatory measures, both non-quantitative and quantitative, other than such limitations covered by Article XVI:2. Moreover, the scope of Article XVII would also extend to pre-entry stage as far as discriminatory measures do not fall under the ambit of Article XVI:2.[223] Accordingly, all discriminatory measures, which fall within the overlapping area between Articles XVI and XVII, shall be governed by Article XVI.

The interpretation, which excludes all measures under Article XVI from the scope of Article XVII, nevertheless, apparently implies a hierarchy between Article XVI and XVII. However, Article XX:2 provides that any measures inconsistent with both Articles XVI and XVII shall be inscribed in the column relating to Article XVI. This would mean that the hierarchy between Article XVI and XVII has been established by GATS, whereby the national treatment principle shall apply to all measures, which are excluded from the domain of Article XVI, but not in the reverse way. According to Markus, Article XX:2 deals not only with scheduling commitments but also the substance of the relationship between market access and national treatment, that strongly support a *lex specialis* relationship between Article XVI and XVII.[224] This interpretation would clarify the scope of the national treatment principle, whereby discriminatory measures falling within the ambit of the market access article are excluded from Article XVII.[225]

During the negotiations of a multilateral framework on services, many contracting parties to GATT expressed the view that the scope of the national treatment principle would

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[222] Feketekuty (2000), p. 95.

[223] There seems to be no clear distinction between pre and post entry stages in Article XVII. Some quantitative and discriminatory restrictions, but not maximum measures, which may also affect the rights of establishment of foreign service suppliers, shall not be addressed by Article XVI. For example, while both foreign and domestic suppliers are allowed to supply services to a domestic market, foreign suppliers may pay higher minimum capital requirements than domestic counterparts.

See Scheduling of Initial Commitments in Trade in Services, Explanatory Note, MTN.GNS/W/164, 3 September 1993, para. 5.

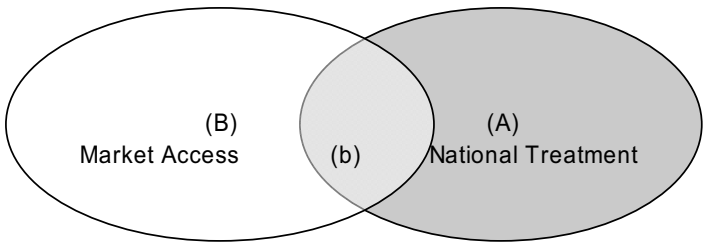
[224] Krajewski, Markus. 2003. National Regulation and Trade Liberalization in Services: The Legal Impact of the General Agreement on Trade in Services (GATS) on National Regulatory Autonomy. The Hague/London/New York: Kluwer Law International, p. 115.

[225] Low, Patrick and Aaditya Mattoo. 2000. Is There a Better Way? Alternative Approaches to Liberalization under GATS. In Pierre Sauve and Robert M. Stern eds., *GATS 2000: New Directions in Services Trade Liberalization*. Washington, D.C.: Brookings Institution Press, pp. 450-451.

mean that upon entry into the domestic market of other Members, services and service suppliers would be treated in the same way as domestic counterparts in respect of all measures.[226] Furthermore, the Ministers in the Mid-term Meeting also stated that "national treatment means that the services exports and/or exporters of any signatory are accorded *in the market* of any other signatory".[227] This expressly indicates that the scope of the national treatment principle only applies to those discriminatory measures which are not governed by Article XVI on Market Access.

Figure 2 illustrates the effective scope of application of the national treatment principle in relation to Article XVI on Market Access. Area (A) represents all discriminatory measures under the broad interpretation of the term "all measures" under Article XVII. Area (B) encompasses all discriminatory and non-discriminatory measures, which are governed by Article XVI:2. The overlapping area between Articles XVI and XVII is named (b), which deals with those discriminatory measures under Article XVI:2 (a)-(d), (e) joint venture, and (f). Accordingly, the scope of the national treatment principle has been equal to the area of [(A) – (b)], where (b) = six types of discriminatory limitations and measures.

Figure 2: Scope of application of the national treatment principle



Source: Reproduced from the Council for Trade in Services, WTO Doc. No. S/C/W/237, dated 24 March 2004

4.2 Broad scope of measures affecting trade in services

[226] Note on the Meeting of 15-17 September 1987 of the Group of Negotiations on Services, GATT Doc. No. MTN.GNS/10, 15 October 1987, paras. 11-19.

Although different views on automatic or negotiable national treatment, the negotiators agreed that the application of the national treatment should follow the application of the market access. Views of negotiators were recorded: Australia and New Zealand (Note on the Meeting of 19-23 September 1988 of the Group of Negotiations on Services, GATT Doc. No. MTN.GNS/17, 18 October 1988, para. 13); Singapore, Switzerland, Peru, EC and Nordic countries (Note on the Meeting of 17-21 July 1989 of the Group of Negotiations on Services, GATT Doc. No. MTN.GNS/24, 28 August 1989, paras. 201, 203, 205, 210, and 246); India and Brazil (Note on the Meeting of 23-25 October 1989 of the Group of Negotiations on Services, GATT Doc. No. MTN.GNS/26, 17 November 1989, paras. 48 and 121, respectively); the SEACEN, Note on the Meeting of 13-15 September 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/3, 16 October 1990, para. 4.

[227] Mid-term Meeting in Montreal on 5-9 December 1988 and in Geneva on 5-8 April 1989, GATT Doc. No. MTN.TNC/11, 21 April 1989, Part II, para. 7(c).

In GATS context, a measure is defined to have extensive coverage, which encompasses law, regulation, rule, procedure, decision, administrative action, or any other form.[228] Specifically, Article XVII also prohibits Members from application for any different treatment in imposition or collection of direct taxes on foreign services or service suppliers.[229] It would suggest that this broad scope of the term "measure", regardless of fiscal or non-fiscal measures, encompasses both, internal taxes or other internal charges as stipulated in GATT Article III:2, and law, regulations and requirements as mentioned in GATT Article III:4. Given the broad scope of this term and GATT jurisprudence of interpretation of Article III, the coverage of measures under GATS Article XVII would include, but not be limited to, any measure bearing governmental nature, substantive and procedural, compulsory and voluntary but legally enforceable, and taxes *per se* and tax administration measures causing financial burden on foreign services and service suppliers.

The GATS case on *EC – Bananas* concerned Council Regulation (EEC) 404/93 (Title IV) regulating banana trade with third countries, establishing three categories of imports: (i) traditional imports from twelve African, Caribbean and Pacific (hereinafter ACP) countries; (ii) non-traditional imports from ACP countries; and (iii) imports from third (non-ACP) countries.[230] While imports of bananas from the twelve traditional ACP countries enjoy duty-free up to the maximum quantity fixed for each ACP country,[231] imports of non-traditional ACP bananas and bananas from third countries are subject to a tariff quota.[232] Imports of bananas from both traditional ACP and non-traditional ACP/third-country are subject to licensing procedures.[233] The allocation of import licenses for third-country bananas and non-traditional ACP bananas are based on a number of rules, including (i) operator category rules;[234] (ii) activity function rules;[235] and (iii) export certificates.[236] In addition, operators who "include or directly represent" a producer adversely affected by a tropical storm and are

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[228] GATS, Art. XXVIII (a).

[229] GATS, Art. XIV on General Exception, paragraph (d) reads that:

> Members may adopt or enforce measures inconsistent with Article XVII, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members. (Footnote omitted)

[230] Panel Report, *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/R/USA, adopted on 25 September 1997, para. III.7.

[231] *Id.* para. III.8.

[232] *Id.* para. III.9.

[233] *Id.* para. III.16.

[234] *Id.* para. III.21.

Under the EC's operator category rules, import licenses are distributed among three categories of operators based on quantities of bananas marketed during the latest three year period: (i) entitlement of Category A - operators that have marketed third-country and/or non-traditional ACP bananas – is 66.5 per cent; (ii) entitlement of Category B - operators that have marketed EC and/or traditional ACP bananas – is 30 per cent; and (iii) entitlement of Category C - operators who started marketing bananas other than EC and/or traditional ACP bananas as from 1992 or thereafter ("newcomer category") – is 3.5 per cent.

[235] *Id.* para. III.22.

Under the EC's activity functions, the operator Categories A and B are further subdivided into three types of qualifying entities, and fixed percentages of the licenses required for the importation originating in third countries or non-traditional ACP countries at in-quota tariff rates are allocated to (i) "primary importer" with 57 per cent, "secondary importer or customs clearer" with 15 per cent, and "ripener" with 28 per cent.

[236] *Id.* paras. III.25 and 7.378.

Pursuant to the Framework Agreement on Bananas (BFA), supplying countries that have country allocations may deliver special export certificates for up to 70 per cent of their allocations. According to Article 3 of Regulation 478/95, Category A and C operators are subject to the EC's requirement to match import licences with BFA export certificates, whereas Category B operators are not subject to a similar requirement.

consequently unable to supply the EC market, are eligible for hurricane licenses, which allow importation of bananas from any source.[237]

The Panel found that in the context of GATS, the term "measures affecting trade in services" is construed as broadly as any measure affecting the supply of a service, either directly regulating the supply of a service or governing other matters that affect trade in services.[238] Based on this reasoning, the EC measures implementing operator category rules, activity function rules, export certificates, and hurricane licenses constitute measures affecting the supply of services under Article XVII:1.[239] The Appellate Body upheld this broad interpretation of the Panel and its conclusion that measures within the EC banana import licensing regime fell within the scope of GATS, based on three grounds:[240] (i) the ordinary meaning of the word "affecting" would cover any measure having "an effect on", and this would imply "a broad scope of application"; (ii) the previous panels in GATT also followed this broad interpretation with regard to Article III; and (iii) while GATS Article XXVIII (c) provides three examples of "measures by Members affecting trade in services", it does not limit the meaning of the term "affecting".

In sum, the term "measures affecting trade in services" has been broadly interpreted by WTO case law.

4.3 Uncertainty in determining likeness

(i) Like services

Because the structure of GATS Article XVII:1, as described earlier, is different to GATT Article III:2, which consists of two separate sentences, the first and second approaches to interpreting likeness in Article III:2 would apparently be irrelevant. In addition, as noted earlier, the word "like" in the first sentence of Article III:2 requires that two products must share mostly the same physical characteristics. However, in case of services, the consensus among scholars is that physical characteristics (properties, nature and quality) of products are not a relevant criterion.[241] Arguably, the main reason, as presented in Chapter One, section 1.3, is the intangibility and non-storability of services. Therefore, the fundamental grounds of "physical characteristics" for comparison of likeness in a narrow meaning do not exist in the context of services. Furthermore, there is no similar wording in Article XVII with regard to both "directly competitive or substitutive services" and "so as to afford protection to domestic production" as grounds for the second approach of interpretation.

On the other hand, the structure and language of GATS Article XVII:1 are very similar to GATT Article III:4 as both the former and latter refer to the terms "like" and "no

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[237] *Id.* para. III.28.
[238] *Id.* para. 7.285.
[239] *Id.* paras. 7.316, 7.358, 7.377, and 7.391.
[240] Appellate Body Report, *EC – Bananas*, para. 220.
[241] Zdouc, Werner. 2004. WTO Dispute Settlement Practice Relating to the General Agreement on Trade in Services. In Federico Ortino and Ernst-Ulrich Petersmann eds., *The WTO Dispute Settlement System 1995-2003*. The Hague/London/New York: Kluwer Law International (Vol. 18), pp. 395-397. *See also* Mattoo (1997), pp. 127-128.

less favourable" treatment. With reference to GATT jurisprudence on likeness under Article III:4, it requires that, in examination of competitive relationship among services, all evidence relating to all four criteria should be assessed and weighted, and more emphasis should be placed on products' end-uses and consumers' tastes and habits.

The first criterion of products' end-uses seems to be the most suitable one for assessing likeness in the context of services.[242] This would clarify the extent to which services are able to carry out the same functions. In other words, two services providing different functions would be regarded as unlike, such as life insurance and property insurance, because the former involves risks occur to the physical body of persons, and the latter concerns risks to assets.

However, there is no clarity on the threshold for the extent of similarity in functions. It is arguable that similarity would cover a range from just one similar function to almost all similar functions. While the first extreme would lead to a broad scope of likeness, the second extreme would narrow down the scope of likeness. In case of the latter extreme, because services are required to share commonality in almost all end-uses, it is submitted that this extreme would suggest an elasticity of substitution, whereby any change in price of a service would result in a change in demand for the other service. Unlike GATT Article III:2, second sentence, where the introduction of elasticity of substitution is in conjunction with the assessment of protective aim to limit the scope of likeness, this criterion in GATS Article XVII:1, as discussed latter, operates independently from regulatory purpose. Consequently, it leads to a broad scope of likeness.

The second criterion is consumers' tastes and habits, which indicates the extent to which consumers are willing to purchase those services. However, the weakness of this criterion is that consumers' tastes and habits may be relevant in determination of service likeness especially in "standardized service transaction", but less appropriate to services which require a high degree of co-production and interrelation between suppliers and consumers in order to satisfy particular customers' needs and preferences.[243]

As noted earlier, the third criterion of physical characteristics is inappropriate for comparing services. Similar to GATT tariff classification in case of goods, service classification could be used as the fourth criterion in assessment of likeness. With a view to increasing clarity, it was recommended that the WTO Secretariat's revised Services Sectoral Classification List (hereinafter WTO Classification) should be used as grounds for undertaking commitments in services in Members' schedules.[244] This WTO Classification identifies each sector and sub-sector corresponding to the United Nations Central Product Classification (hereinafter UN CPC) numbers.[245] But the main weakness of this criterion, as shown by GATT jurisprudence, is that the classification list could be used as an indicative, but not decisive, criterion in confirming likeness.[246] Services classification, nevertheless, has

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[242] *See* Zdouc (2004), p. 395; Mattoo (1997), p. 128.

[243] Zdouc (2004), p. 396.

[244] Scheduling of Initial Commitments in Trade in Services, Explanatory Note, MTN.GNS/W/164, 3 September 1993, para. 16.

[245] GATT. Services Sectoral Classification List, GATT Doc. No. MTN.GNS/W/120, 10 July 1991.

[246] Panel Report, *Japan – Alcoholic Beverages*, para. 6.22; Appellate Body Report, *Japan – Alcoholic Beverages*, p. 23; Appellate Body Report, *EC – Asbestos*, paras. 130-131.

the merit of excluding likeness when two services fall into different sectors or sub-sectors, though two services which fall into one sector or sub-sector may not be alike.[247]

In addition, there are a number of other concerns on the status of services classification. *Firstly*, the sectoral classification in the WTO Classification is not exactly identical to the UN CPC.[248] *Secondly*, the UN CPC has been developed by the United Nations for statistical purposes and not necessarily based on competitive relationships of services.[249] In contrast, the tariff classification test in GATT Article III is more relevant in determining likeness, as the Harmonized System is designed to collect taxes and charges at the border. *Thirdly*, the UN CPC and WTO Classification are not legally binding on Members.[250] As Members are allowed to schedule their specific commitments on national treatment subject to conditions and qualifications, this may make the comparison on bindings more complicated due to differences in understanding and classification lists.[251]

On the contrary, the approach of both the Panel and Appellate Body in *EC – Bananas* to likeness seems to simplify this concern by relying on service classification list, rather than either the criteria of products' end-uses or consumers' tastes and habits. The Panel reasoned that since the EC followed a services classification, which is largely based on the UN CPC, for making their commitments, and specifically inscribed CPC 622 in scheduling commitments on "wholesale trade services", the interpretation of the EC's commitment in wholesale services should be based on UN CPC description.[252] Based on this reasoning, the Panel found that because the "wholesale trade services" are classified in the UN CPC in a category of the broader sector of "distributive trade services" described in a head-note to section 6, the distribution of bananas falls within the scope of category CPC 622 "wholesale trade services".[253] Therefore, the Panel concluded that when supplied in connection with wholesale services, wholesale transactions, on the one hand, and different subordinated services, on the other hand, are "like" as specified in the head-note to section 6 of the UN CPC, regardless of origin of bananas.[254]

The scope of likeness would remain broad as the Appellate Body strictly follows the objective interpretation of likeness, regardless of national regulatory aims or purposes. In *EC – Bananas*, the EC justified its licensing for bananas, including the operator category rules, the activity function rules and the special hurricane license rules, on the ground of pursuing "entirely legitimate policies" and not being "discriminatory in design and effect".[255] The Appellate Body, nevertheless, ruled out the "aims and effects" test in GATS because words comparable to "should not be applied to imported or domestic products so as to afford protection to domestic production", as a basis for this test, are not found in the context of GATS.[256]

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[247] Krajewski (2003), p. 102.

[248] For example, the WTO Secretariat has pointed out four main differences between the WTO classification and UN CPC with regard to insurance services. *See* section 4.1 of Chapter Four.

[249] Krajewski (2003), p. 101.

[250] *Id.*

[251] Zdouc (2004), p. 397.

[252] Panel Report, *EC – Bananas*, para. 7.289.

[253] *Id.* paras. 7.290-7.293.

[254] *Id.* para. 7.322.

[255] Appellate Body Report, *EC – Bananas*, para. 240.

[256] *Id.* para. 241.

In summary, the transplant of interpretation of GATT Article III to GATS Article XVII with regard to the second element suggests a broad scope of likeness due to the uncertainty in criteria for comparison and an objective assessment thereof. As the national treatment principle in GATS is an object of negotiations, this uncertainty in determining likeness would constitute a disincentive to WTO Members in undertaking commitments on services liberalization.

(ii) Likeness with reference to service suppliers and modes of supply

The concern of likeness in the context of services would be more complicated when service suppliers and modes of supply are involved, as there is no GATT jurisprudence on both matters.

The text of GATS Article XVII suggests that like services and like service suppliers should be read concurrently, and therefore domestic measures could be considered in violation of the national treatment principle when they treat like services less favourably even if service suppliers were unlike. According to this interpretation, for the purpose of comparison, it is sufficient to determine likeness of services, regardless of whether service suppliers are like or unlike. In other words, likeness of service suppliers is not taken into account when determining likeness as a whole. The Panel in *EC – Bananas* seems to have followed this straightforward and broad interpretation in concluding that to the extent that entities provide like services, they are like service suppliers,[257] and as this reasoning was not appealed, the Appellate Body did not visit this matter.

However, there are some concerns with this interpretation. *Firstly*, as discussed earlier, the approach to evaluating likeness of services as the ground for assessment of service supplier is uncertain because the determination of likeness of services is only based on the criterion of service classification. In other words, the uncertainty of "like services" would lead to a broad coverage of likeness in services, consequently in service suppliers. *Secondly*, there would be a broad scope of "like" service suppliers, as this approach does not make a distinction between present and potential service suppliers, nor between natural and legal persons.[258] *Thirdly*, while basing determination of likeness in the context of GATS Article XVII only on likeness of services would facilitate liberalization, it might put pressure on domestic regulation.[259] *Fourthly*, it would invalidate likeness of service suppliers as the text of Article XVII refers to like service "and" service suppliers.

A stricter interpretation is proposed by Trachtman to separate the evaluation of treatment of services from the evaluation of treatment of service providers. Following this interpretation, there is no violation of the national treatment principle if like services are treated differently based on the justification of different treatment with respect to different service providers.[260] Accordingly, in order to determine likeness as a whole for the purpose of

[257] Panel Report, *EC – Bananas*, para. 7.322.
[258] Zdouc (2004), pp. 399-400.
[259] Krajewski (2003), p. 104.
[260] Trachtman, Joel P. 2003. Lessons for the GATS from Existing WTO Rules on Domestic Regulation. In Aaditya Mattoo and Pierre Sauve, eds., *Domestic Regulation and Service Trade Liberalization*. Washington D.C.: World Bank, Oxford University Press, pp. 62-64.

Article XVII, the necessary step is to assess whether services are alike, and if they are, then the sufficient step is to assess whether service suppliers are alike.

This stricter interpretation has a number of advantages, including support from negotiating history. *Firstly*, this approach is consistent with Article 31(1) of the *Vienna Convention*, which calls for the interpretation in "good faith", and the ordinary meaning being given to terms of treaty.[261] *Secondly*, this stricter interpretation would narrow down the scope of likeness in Article XVII, and then respect the regulatory autonomy of Members.[262] *Thirdly*, as described in Chapter One, section 1.3, the distinct nature of services is intangibility and non-storability, and services are produced and consumed at the same time. Although under GATT context, the process or production method seems to be not subject to the realm of Article III, it has been argued that, in case of services, it would not be necessary and sometimes impossible, to separate a service from specific service supplier.[263] As far as the process of supplying services is concerned, this would constitute a relevant factor in determining the actual characteristics of final service as a service product.[264] *Fourthly*, the negotiating history suggested that there is "inseparability" between service supplier and service itself in the concept of national treatment.[265]

However, the stricter interpretation, for its part, leads to another legal issue of how likeness of service suppliers is appraised. Following the four-criterion test in determination of likeness of service suppliers, it has been suggested that the most appropriate criterion might be the physical characteristics, though it is difficult to find the extent to which suppliers have to share the same or similar characteristics or quality, such as size of company, and qualification of staff.[266] Further, this criterion would imply a non-exhaustive list of characteristics for comparison. Zdouc also proposed that likeness of service suppliers must be based on the combination of service-related and supplier-related factors.[267]

Although this, to some extent, might limit the broad scope of likeness of service suppliers, the inherent problem is still unsolved due to the uncertainty of a set of supplier-related factors. It is submitted that, as described earlier, a relevant factor for determination of like service suppliers might be the process of supplying services. Furthermore, in *Canada – Autos*, the Panel concluded that Intermeccania (Canadian manufacturer) could not be considered as a supplier of wholesale trade services of vehicles under the meaning of UN CPC entry "6111 sale of motor vehicles, including automobiles and other road vehicles", because it manufactures and sells directly to consumers a small number of vehicles per year.[268] It would suggest that market place of the service supplier, including trading volume and customer network, is also relevant for determination of likeness of service suppliers.

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[261] Vienna Convention of the Law of the Treaties, done at Vienna, 23 May 1969 [hereinafter *Vienna Convention*], Art. 31(1).

[262] Krajewski (2003), p. 57.

[263] *Id.* p. 106.

[264] Nicolaidis, Kalypso and Joel P. Trachtman. 2000. From Policed Regulation to Managed Recognition in GATS. In Pierre Sauve and Robert M. Stern eds., *GATS 2000 – New Directions in Services Trade Liberalization*, Washington D.C.: The Brookings Institution, pp. 252-253.

[265] Draft Glossary of Terms, GATT Doc. No. MTN.GNS/W/43, 8 July 1988, NATIONAL TREATMENT.

[266] Zdouc (2004), pp. 397-398.

[267] *Id.* p. 401.

[268] Panel Report, *Canada – Certain Measures Affecting the Automotive Industry* [hereinafter *Canada – Autos*], WT/DS139/R, WT/DS 142/R, adopted on 19 June 2000, para. 10.285.

The second issue is whether modes of supply should be taken into account when likeness is assessed. As described in Chapter One, section 2.3, supply of services is exercised through four modes of supply, namely: (i) cross-border supply, (ii) consumption abroad, (iii) commercial presences, and (iv) movement of natural persons. Mattoo argued that in order to ensure the integrity of this principle, and better protection for foreign service suppliers, the national treatment principle should be read independently from modes of supply.[269] This would, for determination of likeness in Article XVII, mean that it is not required to examine the different modes through which services are supplied. In addition, as noted earlier, the Panel in *EC – Bananas* confirmed the likeness of services based on the same sub-sector of the CPC, and the likeness of service suppliers on the ground of the likeness of services. This would imply that modes of supply are not a relevant factor in determination of likeness in the context of Article XVII.

This interpretation, nevertheless, would lead to a broad scope of likeness in Article XVII, and challenge any domestic regulation, which differentiates among modes of service supply. Zdouc and Krajewski share the view that the reference to modes of supply would limit the broad scope of likeness.[270] Moreover, the guidance on scheduling of initial commitments in trade in services clearly explained that levels of commitments in Article XVII should specify sector/sub-sector and mode of supply, and then when a Member has made a commitment on national treatment in Mode 1, this commitment alone does not extend to Mode 4.[271] Therefore, in a scheduled sector or sub-sector, there would be a case that Members make full commitments on a mode of supply, but no commitment on other modes of supply. This would indicate the intention of WTO Members to treat services and service suppliers differently under different modes of supply with regard to national treatment. If likeness was determined throughout all modes of supply, the meaning of commitments specified by modes of supply would be undermined.

In sum, the most relevant criterion for comparison of service suppliers is physical characteristics. However, a lack of clarity on extent of similarity among service suppliers would mean that likeness of services in GATS Article XVII remains uncertain. It is submitted that, among other factors, the process of supplying services and market place of the service supplier should be included for comparison.

4.4 Broad coverage of "no less favourable" treatment

The third element in the national treatment principle is the standard of "no less favourable" treatment. When measures are found under the scope of Article XVII and the likeness between foreign and domestic services and service suppliers is confirmed, a WTO Member violates the national treatment obligation if it accords foreign services and service suppliers less favourable treatment than what is accorded to domestic counterparts. Because the interpretation of the term "like services and service suppliers" is broad, it is submitted that the third element must be qualified in order to balance against the second element. There are three important aspects in interpretation of this standard.

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[269] Mattoo (1997), p. 120.

[270] Zdouc (2004), p. 402; Krajewski (2003), p. 102.

[271] Scheduling of Initial Commitments in Trade in Services, Explanatory Note, MTN.GNS/W/164, 3 September 1993, paras. 19 and 21.

Firstly, Article XVII:2 codifies GATT jurisprudence on the "no less favourable" standard in goods, which covers both formally identical and different treatment. Moreover, Article XVII:3 codifies the core requirement under the GATT "no less favourable" standard in goods, which prohibits measures modifying conditions of competition. Consequently, either formally identical or different treatment modifying conditions of competition in favour of domestic services or service suppliers, or at the expense of foreign services or service suppliers, shall not be allowed. Therefore, the language of this Article is to prohibit both *de jure* and *de facto* discriminations.[272]

In examination of "no less favourable" treatment, the Panel in *EC – Bananas* followed a two-step approach to examine (i) whether a measure constitutes formally identical or different treatment among foreign and domestic origin under Article XVII:2, and (ii) whether the application of these formally identical or different treatments modifies conditions of competition for foreign services or service suppliers under the meaning of Article XVII:3. In the first step, all four types of rules, namely operator category rules, activity function rules, export certificates, and regulations on the issuance of hurricane licenses are considered not discriminatory against foreign like service and service suppliers on the basis of their origin, and thus arguably accords formally identical treatment to services and service suppliers regardless of their origin, nationality, ownership or control.[273]

However, in the second step, the Panel concluded that while all four types of rules operate in a non-discriminatory basis, in practice, they create less favourable conditions of competition for like service suppliers of foreign origin.[274] The reasoning is that: (i) most service suppliers of EC origin are classified as Category B operators, who benefit from the allocation of 30 per cent of the licenses at lower in-quota duty rates under category operator rules, hurricane licenses, as well as exemption from export certificates, while most service suppliers of third-country origin fall under Category A;[275] (ii) though import licenses are tradable and transferable, license transferees, who are usually Category A operators, do not benefit from tariff quota rents granted to initial license holders (the sellers), who are usually Category B operators;[276] (iii) on the one hand, service suppliers of foreign origin who sell third-country or non-traditional ACP bananas are subject to activity function rules, while like service suppliers of EC origin who sell EC bananas are not required to do so, and on the other hand, service suppliers of foreign origin do not enjoy equal competitive opportunities to make claims for performing ripening activities as service suppliers of EC origin do.[277]

De facto less favourable treatment was also found in the EC's revised license allocation system because foreign service suppliers "do not have opportunities to obtain access to import licenses" on equal terms and conditions.[278] In another case, *Canada – Autos*, the conditions of competition were modified where the Panel found that the Canadian value added (CVA) requirements extend an incentive to the beneficiaries of the import duty exemption to purchase services supplied within the Canadian territory over "like" services

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[272] Appellate Body Report, *EC – Bananas*, para. 233.
[273] Panel Report, *EC – Bananas*, paras. 7.326, 7.360, 7.379, and 7.392.
[274] *Id.* paras. 7.341, 7.368, 7.380, and 7.393.
[275] *Id.* paras. 7.335, 7.379, and 7.392.
[276] *Id.* paras. 7.336 and 7.363.
[277] *Id.* paras. 7.361 and 7.362.
[278] Panel Report, *European Communities – Regime for the Importation, Sale and Distribution of Bananas: Recourse to Article 21.5 by Ecuador*, WT/DS27/RW/ECU, adopted on 6 May 1999, para. 6.133.

supplied in or from the territory of other Members through Mode 1 (cross-border supply) and Mode 2 (consumption abroad).[279]

Secondly, in pursuant with GATT jurisprudence, the interpretation of modifying conditions of competition has followed objective assessment regardless of regulatory purposes. In the appeal, as mentioned earlier, the EC justified its licensing for bananas on the grounds of pursuing "entirely legitimate policies" and not being "discriminatory in design and effect", where (i) the aim of the operator category system was to set up a mechanism for allocating the tariff quota among operator categories; (ii) the aim of the activity function rules was to protect the banana ripeners against the concentration of economic bargaining power in the hands of the primary importers as a result of the tariff quota; and (iii) the purpose of the hurricane licenses is to compensate operators who suffer damage caused by tropical storms.[280] The Appellate Body, nevertheless, upheld the Panel's conclusions based on the reasoning that GATS had no words comparable to "should not be applied to imported or domestic products so as to afford protection to domestic production".[281] Therefore, this would imply that the attempt to introduce national regulatory purposes for justification of "less favourable" treatment is legally unacceptable in the context of Article XVII. In other words, it suggests that the standard of "no less favourable" treatment must be subject to an objective interpretation regardless of domestic policy aims.

Lastly, the standard of "no less favourable" treatment is further clarified by the footnote 10 to Article XVII:1, which reads:

> Specific commitments assumed under this Article shall not be construed to require any Member to compensate for any inherent competitive disadvantages which result from the foreign character of the relevant services or service suppliers.

In *Canada – Autos*, Canada argued that disadvantages in conditions of competition towards supply of foreign services, which were affected by the CVA requirements, inherently resulted from the foreign characteristics of those services because the maintenance and repair work exercised in Canada could not be supplied through Modes 1 and 2.[282] The Panel found that Canada's argument was true because it required the physical presence of service suppliers. Nevertheless, other services, including repair and maintenance-related services such as consulting and advisory services, which were affected by the CVA requirements, could be supplied through Modes 1 and 2.[283] The less favourable treatment accorded to foreign services could not be defended on the ground of "inherent competitive disadvantages which result from the foreign character" because footnote 10 only discharges Members' obligation of making compensation for any disadvantages due to foreign nature with respect to the application of national treatment.[284]

According to Zdouc, in examination of *de facto* discrimination, footnote 10 called for distinction between less favourable conditions of competition due to origin-neutral regulations, on the one hand and less competitive advantages due to foreign nature of services or service suppliers, on the other hand.[285] In order to appraise this distinction, Zdouc proposed a three-element test: (i) measuring the inherent competitive disadvantages resulted from foreign

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279 Panel Report, *Canada – Autos*, para. 10.307.
280 Appellate Body Report, *EC – Bananas*, paras. 242, 245, and 247.
281 *Id.* paras. 244, 246 and 248.
282 Panel Report, *Canada – Autos*, para. 10.298.
283 *Id.* para. 10.300.
284 *Id.* para. 10.300.
285 Zdouc (2004), pp. 412-413.

nature of services or service suppliers, (ii) assessing the restrictive impact of national regulation pursuing legitimate objectives on domestic services and service suppliers, and (iii) ascertaining the restrictive impact of national regulation pursuing legitimate objectives on foreign services and service suppliers; then the sum of elements (i) and (ii) must be compared with element (iii) to find out whether *de facto* discrimination exists.[286] However, the main problem is that it is impracticable to quantify these three elements in practice.[287] In addition, it seems to be very hard to introduce a separate test in appraising the legitimate objectives under Article XVII because the "no less favourable" treatment operates in an objective manner.

Therefore, footnote 10 is not a justification for *de facto* discrimination under the standard of "no less favourable" treatment.

Unfortunately, this analysis indicates that the standard of "no less favourable" treatment as a countermeasure to balance the broad scope of likeness is proved to have a broad coverage of both *de jure* and *de facto* discrimination. In the event a measure in question is found to modify conditions of competition in favour of domestic like services or service suppliers, there is a breach of this standard regardless of national regulatory purposes. Accordingly, the broad coverage of the "no less favourable" treatment would amount to another disincentive to WTO Members in negotiation of services liberalization.

The following example may be useful to illustrate the aforementioned problems.[288] Insurance agency services (CPC 8140) are allowed to supply in country B through either entity (legal person) or individual (natural person) under the full commitment on the national treatment obligation, i.e. no restrictions on the national treatment column in country B's Schedule of Specific Commitments. As noted earlier, supply of services by foreign entities in country B is exercised through Mode 3 (commercial presence) while that by foreign individuals is under Mode 4 (movement of natural persons). In order to obtain a license, entity or individual, either domestic or foreign, who wishes to supply insurance agency services, must satisfy certain requirements, including training courses in country B and licensing fees, which are different between agency entities and individual agents.

WTO Members, such as country A, may claim that those measures are inconsistent with Article XVII because both suppliers are supplying like services (under the same CPC 8140) and *de jure* discrimination exists between Mode 4 and Mode 3.

In contrast, country B may argue that all foreign and domestic agency entities are subject to the same licensing system, on the one hand, and all foreign and domestic individual agents are subject to the same licensing system, on the other hand. Accordingly, there is no discrimination between domestic and foreign service suppliers under either Mode 3 or Mode 4. While insurance agency services are codified as CPC 8140 for determination of likeness, there would be no competitive relationship between services supplied by agency entities and services supplied by individual agents because of different characteristics, including prices, quality, customers' services and network, and consequently different end-uses. Moreover, the cross-mode likeness of services was not established due to different service suppliers, i.e. entities vs. individuals, and different modes of supply, i.e. Mode 3 vs. Mode 4. Therefore, this *de jure* discrimination should be permitted by GATS because no likeness is confirmed.

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[286] *Id.*

[287] Krajewski (2003), p. 111.

[288] Further examples illustrated by Mattoo (1997), p. 128, concerning transport services; and Zdouc (2004), p. 402, concerning different regulations on different modes of supply.

However, from the point of view of country A, while there is no distinction among service suppliers under either Mode 3 or Mode 4 on the basis of national-origin, the requirement of an additional license by country B would put foreign service suppliers, who have been licensed by their home countries, including country A, at a disadvantage, and thus could constitute *de facto* discrimination against foreign service suppliers.

In response, country B may state the position that even though the likeness of services and service suppliers would possibly be established within either Mode 3 or Mode 4 under the meaning of Article XVII, all country B citizens, who have been trained abroad and licensed by other WTO Members, including country A, to supply insurance agency services, must also satisfy those licensing requirements. Those licensing requirements might be consistent with Article XVII because *de facto* discrimination against foreign service suppliers could not be established.

This example shows the strong possibility of violations of Article XVII because of the uncertainty in determining likeness as well as the broad coverage of "no less favourable" treatment.

As mentioned earlier, one of the distinct features of GATS is the negotiable national treatment, whereby Article XVII:1 specifically refers to "Schedule" and "conditions and qualifications". The text of Article XVII:1 would suggest that WTO Members may employ their schedules to limit such uncertainty of likeness and broad coverage of "no less favourable" treatment by introducing conditions and qualifications. As noted by Zdouc, WTO Members, nevertheless, do not deal with likeness of services and service suppliers in scheduling their commitments.[289] Concerning the standard of "no less favourable" treatment, a fundamental problem is that Members are only able to inscribe reasonably foreseeable discriminatory measures, but not all discriminations.[290] Moreover, the recourse to schedules would be impossible for those Members, who have undertaken the full national treatment obligation with regard to scheduled sectors and/or sub-sectors, e.g. insurance agency services as shown by the above-said example. Probably, those WTO Members would be safe to rely on the predictability and certainty of interpreting the national treatment principle.

To sum up, the WTO case law and literature review reflect the fact that in parallel with a broad approach to the interpretation of "measures" subject to GATS, the combination of uncertainty in interpretation of likeness and broad coverage of "no less favourable" treatment would lead to a high possibility for Members to violate the national treatment principle in the context of services. Although different proposals have been made to improve the certainty in determining likeness and limiting broad scope of discrimination, the problem has yet to be satisfactorily resolved. Consequently, uncertainty in interpretation of Article XVII would discourage Members from undertaking commitments on national treatment for further liberalization of trade in services.

5. Towards a two-stage approach: A balance between conditions of competition in Article XVII and policy objectives in Article XIV[291]

[289] Zdouc (2004), p. 403.
[290] Krajewski (2003), p. 113.
[291] This section draws from Vu Nhu Thang (2006a), pp. 173-194.

5.1 The recognition of national legitimate policy objectives

While expanding the production of and trade in goods and services, Members are recognized and ensured in pursuing their objective of sustainable development.[292] Specifically in the services sector, the establishment of a multilateral framework of principles and rules for trade in services has led to the acknowledgement of the right of Members to regulate, and to introduce new regulations for the supply of services within their territories in order to meet national policy objectives.[293] The negotiating history as discribed in section 1 of this chapter has showed the concern of negotiators, especially from developing countries, for national policy objectives, which resulted in the exclusion of the national treatment principle from general obligations. Furthermore, GATS specifies that the fundamental requirement of progressive liberalization of trade in services through multilateral negotiations is aimed at ensuring the overall balance between rights and obligations of Members, as well as paying due respect to national policy objectives.[294] Therefore, there is recognition for allowing national legislators the freedom to pursue domestic policy objectives, while preserving conditions of competition.

Although the national treatment principle in GATS has been interpreted, as discussed earlier, in an objective manner irrespective of national policy aims, an introduction of a second test, which respects national policy objectives, is necessary to secure balance between rights and obligations of WTO Members. In GATT dispute settlement, to justify the breach of Article III, Members have sought Article XX, which provides general exceptions.[295] At the

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[292] WTO Agreement, the preamble.

[293] GATS, the preamble.

[294] *Id.*

[295] GATT, Art. XX reads (Asterisk omitted):

> *General Exceptions*
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> Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:
>
> (*a*) necessary to protect public morals;
>
> (*b*) necessary to protect human, animal or plant life or health;
>
> (*c*) relating to the importations or exportations of gold or silver;
>
> (*d*) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement, including those relating to customs enforcement, the enforcement of monopolies operated under paragraph 4 of Article II and Article XVII, the protection of patents, trade marks and copyrights, and the prevention of deceptive practices;
>
> (*e*) relating to the products of prison labour;
>
> (*f*) imposed for the protection of national treasures of artistic, historic or archaeological value;
>
> (*g*) relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption;
>
> (*h*) undertaken in pursuance of obligations under any intergovernmental commodity agreement which conforms to criteria submitted to the CONTRACTING PARTIES and not disapproved by them or which is itself so submitted and not so disapproved;
>
> (*i*) involving restrictions on exports of domestic materials necessary to ensure essential quantities of such materials to a domestic processing industry during periods when the domestic price of such materials is held below the world price as part of a governmental stabilization plan; *Provided* that such restrictions shall not operate to

first layer, a discriminatory measure must be under any exceptional heading of "necessary" (Article XX (a), (b), and (d)); "relating to" (Article XX (c), (e), (g)); "for the protection of" (Article XX (f)); "in pursuance of" (Article XX (h)); "involving" (Article XX (i)); or "essential" (Article XX (j)). In a number of cases, panels and the Appellate Body have interpreted those exceptional headings with respect to "necessary" and "relating to".[296]

However, those national policy goals must be legitimate, or in other words, the application of those measures must reflect non-protectionist aims. Therefore, in order to prevent any abuse or misuse of the exceptions, in the second layer, the discriminatory measure also must satisfy the requirements imposed by the introductory clause (the chapeau) of Article XX. This chapeau indicates that the application of that inconsistent measure is not in a manner constituting a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction in international trade.[297] This approach is clearly confirmed in *US – Shrimp* where the Appellate Body reasoned that although Members are required to observe their obligations under the multilateral trade regime, their rights must be respected in balance with the obligations to prevent misuse or abuse.[298] While the first layer would suggest a balance between Article XX and other GATT provisions, including the national treatment obligation, the second layer would imply an internal balance within Article XX.[299]

The first case in GATS, which provoked Article XIV on general exceptions as justification for a violation of other GATS articles,[300] is *US – Gambling*, where the US sought

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increase the exports of or the protection afforded to such domestic industry, and shall not depart from the provisions of this Agreement relating to non-discrimination;

(*j*) essential to the acquisition or distribution of products in general or local short supply; *Provided* that any such measures shall be consistent with the principle that all contracting parties are entitled to an equitable share of the international supply of such products, and that any such measures, which are inconsistent with the other provisions of the Agreement shall be discontinued as soon as the conditions giving rise to them have ceased to exist. The CONTRACTING PARTIES shall review the need for this sub-paragraph not later than 30 June 1960.

[296] A discriminatory measure is proved as "necessary" only if there were no alternative measures consistent or less inconsistent with the GATT, which a Member country could reasonably be expected to employ to pursue its national policy objectives. This requires examination of existence of any least trade restrictive measure to fulfill the same policy goals. A discriminatory measure is proved as "relating to" only when it must be "primarily aimed at" the conservation of an exhaustible natural resource.

See Panel Report, *US – Section 337*, para. 5.26; Appellate Body Report, *EC – Asbestos*, para. 172; Appellate Body Report, *Korea – Beef*, paras. 163-166. *See also* Panel Report, *Canada – Measures Affecting Exports of Unprocessed Herring and Salmon*, L/6268 – 35S/98, adopted on 22 March 1988, para. 4.6; Appellate Body Report, *United States – Standards for Reformulated and Conventional Gasoline* [hereinafter *US – Gasoline*], WT/DS2/AB/R, adopted on 20 May 1996, pp. 19-20; Appellate Body Report, *United States – Import Prohibition of Certain Shrimp and Shrimp Products* [hereinafter *US – Shrimp*], WT/DS58/AB/R, adopted on 6 November 1998, paras. 141-145.

[297] Appellate Body Report, *US – Gasoline*, paras. 8-9.

[298] Appellate Body Report, *US – Shrimp*, para. 156.

[299] *See* Gaines, Sanford. 2001. The WTO's Reading of the GATT Article XX Chapeau: A Disguised Restriction on Environmental Measures. *University of Pennsylvania Journal of International Economic Law* 22, pp. 829-841.

In the words of Gaines, there is a dualism and integration in Article XX because Article XX balanced against the rest of the GATT, and the chapeau balanced against exceptional headings of Article XX, and accordingly, dual balances were integrated in the Article XX.

[300] GATS, Art. XIV reads (Footnotes omitted):

General Exceptions

to justify its discriminatory measures (the Wire Act, the Travel Act and the Illegal Gambling Business Act) in connection with general exceptions by relying on Article XIV (a), necessary to protect public morals or maintain public order, and Article XIV (c), necessary to secure compliance.[301] A similar two-layer test was adopted to examine (i) whether the discriminatory measures fall within any heading of exceptions under Article XIV, and (ii) whether those measures satisfy the requirements of the chapeau of Article XIV.[302]

5.2 Necessity test – A problematic approach

To limit the high possibility of violation of the national treatment principle, based on GATT jurisprudence on Article XX, it is advisable to read Article XVII in conjunction with GATS Article XIV, which deals with general exceptions, whereby legitimate regulatory objectives and purposes of the measures shall be considered as a justification for the less favourable treatment against foreign services and service suppliers.[303] In other words, the term "necessary" was integrated into Article XVII, which is called the necessity test.

GATT/WTO jurisprudence has developed this necessity test in the context of GATT Article XX (b) and (d), GATS Article XIV (a) and (c). In *US – Section 337*, if a measure consistent with other GATT provisions is not reasonably available, a requirement of "the least degree of inconsistency" was established in order to decide whether a measure was "necessary" under GATT Article XX (d).[304] This requirement indicates that the necessity test is met if there were no alternative measures that are consistent or less inconsistent with GATT provisions.[305] In following cases, a series of factors, which must be weighted and balanced in

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> Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:
>
> (a) necessary to protect public morals or to maintain public order;
> (b) necessary to protect human, animal or plant life or health;
> (c) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement including those relating to:
> (i) the prevention of deceptive and fraudulent practices or to deal with the effects of a default on services contracts;
> (ii) the protection of the privacy of individuals in relation to the processing and dissemination of personal data and the protection of confidentiality of individual records and accounts;
> (iii) safety;
> (d) inconsistent with Article XVII, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members;
> (e) inconsistent with Article II, provided that the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound.

[301] Panel Report, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services* [hereinafter *US – Gambling*], WT/DS285/R, adopted on 20 April 2005.

[302] *Id.* para. 6.449.

[303] Mattoo (1997), pp. 131-133. *See also* Verhoosel, Gaetan. 2002. National Treatment and WTO Dispute Settlement: Adjudicating the Boundaries of Regulatory Autonomy. Oxford: Hart Publishing.

[304] Panel Report, *US – Section 337*, para. 5.26.

[305] This requirement of the necessity test is also applicable to GATT Article XX (b).

examination of the necessity test under the context of GATT Article XX(d), include (i) contribution of the compliance measures to the enforcement; (ii) importance of the common interests or values; and (iii) impact of law or regulation on international trade.[306]

With respect to GATS Article XIV, the Appellate Body in *US – Gambling* underlined its reasoning in *EC – Asbestos* and *Korea – Beef* that in the context of Article XIV (a), an alternative measure that is reasonably available must be a measure that for the responding Member would preserve its right to achieve its pursued policy objectives.[307] Therefore, the underlying meaning of the word "necessary" by the invocation of GATS Article XIV would focus on finding the availability of other less trade restrictive measures in order to achieve specific objectives.[308]

Accordingly, the approach to including the necessity test into the interpretation of Article XVII suggests that the national treatment obligation should be understood and interpreted by reference to the necessity of domestic regulatory objectives. WTO Members are able to follow their domestic policy objectives as long as the applicable measures are not more burdensome than necessary to achieve the corresponding objectives.[309] This would call for a two-layer test within Article XVII to examine, firstly, whether a discriminatory measure accords less favourable treatment to foreign services and service suppliers than domestic like counterparts, and secondly, whether the application of such a measure is necessary to achieve national policy objectives. Although it would imply a balance between policy aims and conditions of competition within Article XVII, there are some concerns on this approach.

Firstly, as there is no GATT precedent in applying the necessity test in assessment of "no less favourable" treatment in Article III, it is very hard to expect that GATS jurisprudence will pursue a different direction. Furthermore, because the term "necessary" does not appear in either GATT Article III or GATS Article XVII, this indicates that there is no legal support for the necessity test in the language of Article XVII. Verhoosel suggested that footnote 10 of Article XVII would be relevant to imply a necessity test in this national treatment principle.[310] Based on the concept of "inherent" stated in footnote 10, a panel would be required to assess whether another measure aiming at the same objectives, if adopted, would result in the same adverse effects.[311] In other words, a measure "less inconsistent with GATS" must be analyzed in order to determine whether those adverse effects inherently originate from the foreign

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See Panel Report, *Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes,* DS10/R – 37S/200, adopted on 7 November 1990, para. 74.

[306] According to the Appellate Body, the greater contribution, the more easily a measure might be considered to be "necessary". In addition, the more vital or important those common interests or values are, the easier it would be to accept as "necessary" a measure designed as an enforcement instrument. A measure with a relatively slight impact upon imported products might more easily be considered as "necessary" than a measure with intense or broader restrictive effects.

See Appellate Body Report, *Korea – Beef*, paras. 162-163. The Appellate Body also adopted the same approach to examining the necessity test in the context of GATT Article XX(b). *See also* Appellate Body Report, *EC – Asbestos*, para. 172.

[307] Appellate Body Report, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/AB/R, adopted on 20 April 2005, para. 308.

[308] *Id.* para. 317.

[309] Mattoo, Aaditya and Pierre Sauve. 2003. Domestic Regulation and Trade in Services: Looking Ahead. In Aaditya Mattoo and Pierre Sauve, eds., *Domestic Regulation and Service Trade Liberalization*. Washington D.C.: World Bank, Oxford University Press, p. 225.

[310] Verhoosel (2002), pp. 90-91.

[311] *Id.*

character of services or service suppliers. If the answer were affirmative, the application of a discriminatory measure would not constitute a violation of Article XVII.

However, in the words of Krajewski this analysis would be a "circular conclusion" because the necessity test would be grounds for interpretation of both the national treatment principle as well as an "inherent competitive advantage".[312] In addition, as described earlier, footnote 10 only exempts Members' obligation to compensate for any disadvantages due to foreign nature with respect to the application of the national treatment principle, but not the grounds for justification of any less favourable treatment accorded to foreign services or service suppliers.

Secondly, if the necessity test was accepted, there would be no clear distinction between Article VI:4, which addresses non-discriminatory measures and calls for the introduction of future disciplines with respect to measures on qualification and licensing requirements, procedures, technical standards that are not more burdensome than necessary to ensure the quality of service, and Article XVII which deals with discriminatory measures.[313] In other words, as any measure that is more burdensome than necessary would constitute a violation of Article XVII, there would be no scope for introduction of such future disciplines.

Thirdly, as Article XIV deals with not only "necessary" ((a), (b), and (c)), but also "inconsistent" ((d) and (e)), it would be inappropriate if only the necessity test was read in Article XVII. In addition, as noted earlier, the chapeau of GATS Article XIV acts as a second layer to examine necessity, where a discriminatory measure must qualify three standards under the chapeau, namely arbitrary discrimination, unjustifiable discrimination and disguised restriction.[314] Therefore, the chapeau would constitute an integral part of the necessity test as an anti-abuse provision under the context of Article XIV. In other words, the introduction of the necessity test into Article XVII would be impartial as it ignores the importance of the chapeau under Article XIV.

Fourthly, if the necessity test were adopted in Article XVII, it would automatically invalidate Article XIV in relation to Article XVII. For instance, if a discriminatory measure were found necessary under Article XVII, there would be no need to examine the policy purposes in Article XIV. On the other hand, if a discriminatory measure were found unnecessary, it would be useless to re-examine policy purposes under both Articles XVII and XIV.

It might be said that general exceptions, nevertheless, are still applicable to violations of other provisions.[315] In response, this argument seems to be inappropriate, as the interpretation rules of *Vienna Convention* require "good faith" and "ordinary meaning".[316] It would be unreasonable for the reading of Article XVII to encompass Article XIV. In other words, other articles of GATS, including Article XVII must be interpreted with the recognition of the ordinary meaning of Article XIV. In addition, as Article XIV (d)

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[312] Krajewski (2003), p. 111.

[313] *Id.* p. 112.

[314] Panel Report, *US – Gambling*, para. 6.581.

[315] *See* Regan, Donald H. 2002. Regulatory Purpose and "Like Products" in Article III:4 of the GATT (With Additional Remarks on Article III:2), *Journal of World Trade* 36(3), pp. 454-455.

For example, in GATT context, Regan argued that while GATT Article XX is redundant in case of the inclusion of regulatory aims into GATT Article III, it still applies to other GATT obligations.

[316] *Vienna Convention*, Art. 31(1).

specifically refers to Article XVII, the general exceptions must be a separate test applicable to other provisions, including the national treatment principle.

Lastly, the reference to the necessity of domestic regulatory objectives in Article XVII would cause the survival of the "aims and effects" test, which was disregarded by both GATT and WTO jurisprudence.

5.3 Framing a two-stage approach

To limit the high possibility of violation of the national treatment principle while respecting the objective assessment of Article XVII, an alternative approach is to read Article XVII first, and then Article XIV. This means that the interpretation of Article XVII would follow a two-stage approach to determine, *firstly* whether a measure accords less favourable treatment to foreign services and service suppliers than the domestic like counterparts, and *secondly* whether that less favourable treatment, if found, could be justified under Article XIV. While the first stage is aimed at revealing any discrimination among like services and service suppliers, and is neutral to regulatory aims, the second stage will determine whether the proven discrimination is justifiable in pursuit of legitimate national policy goals.

Accordingly, Article XIV will balance against the broad coverage of both "like" services and the standard of "no less favourable" treatment under Article XVII. Specifically, the second stage will act as countermeasures against the broad coverage of discrimination as well as towards uncertainty in confirming likeness by balancing national legitimate policy objectives with allegedly protective measures against foreign services and service suppliers. However, in application of the second stage, WTO Members are required to qualify three standards set by the chapeau as an anti-abuse provision. In its turn, this anti-abuse provision would ensure the proposed balance between national policy objectives and conditions of competition.[317]

Figure 3 summarizes the analytical framework for interpretation of the national treatment principle by the two-stage approach. In short, this two-stage approach consists of four elements for analysis:

(1) Confirming a measure in question falling under the scope of Article XVII (Box 1);

(2) Confirming the likeness between foreign and domestic services and service suppliers (Box 2);

(3) Ascertaining that the discriminatory measure accords to foreign services and service suppliers irrespective of regulatory aims (Box 3); and

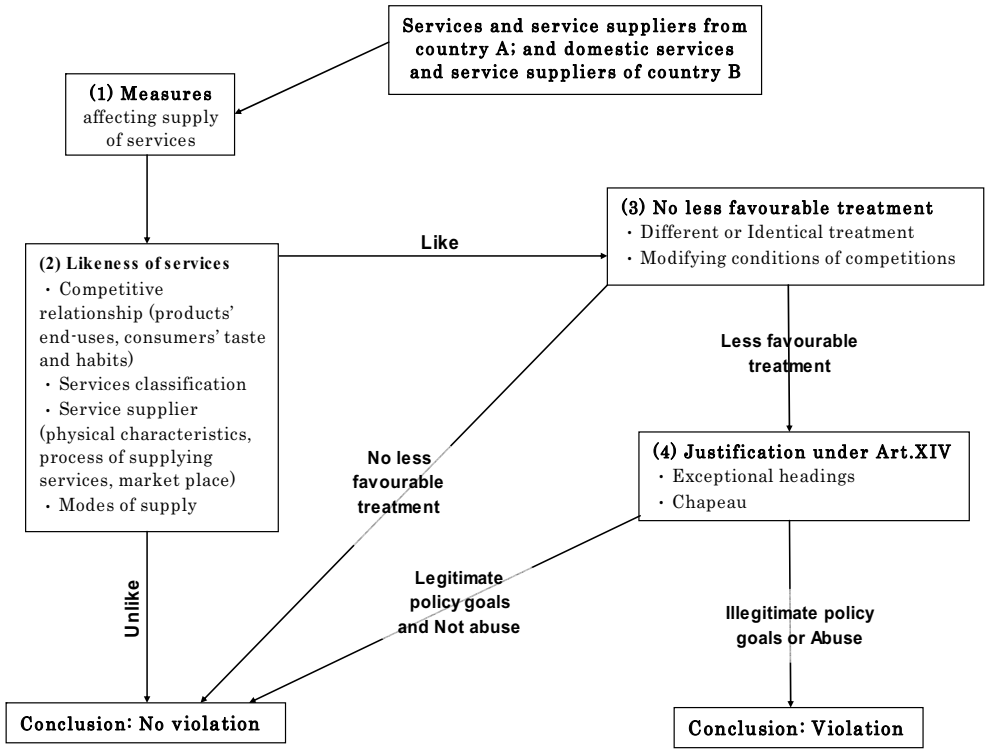
(4) Ascertaining that the discriminatory measure is used to pursue national policy objectives in a non-protectionist manner under any exceptional heading (Box 4).

Therefore, when a measure is found to be discriminatory against foreign services and service suppliers compared to domestic like counterparts in the context of Article XVII by the objective assessment, it would (i) not constitute a violation of Article XVII if it qualifies the

[317] Panel Report, *US – Gambling*, para. 6.581.

requirements for any exceptional heading and the anti-abuse provision under Article XIV; or (ii) constitute a violation of Article XVII if that measure does not fall into any exceptional heading or protective intent is proved based on the examination of three standards under the chapeau. Accordingly, a WTO Member does not violate its obligation under the national treatment principle as long as its measure does not constitute discrimination with protectionist aims.

Figure 3: Analytical framework for interpretation of the national treatment principle: Two-stage approach



To continue the above-said example on insurance agency services supplied in country B, as claimed by country A, the consequence of determining likeness by reference only to service classifications and the broad coverage of discrimination would make licensing requirements by country B inconsistent with Article XVII. However, country B could be safe by proving that, for example, those requirements are necessary to secure compliance with its company and labour laws without any protectionist aims under Article XIV.

There are a number of advantages in following this two-stage approach.

Firstly, it would ensure the transparency and predictability of the multilateral trading system, as well as protect WTO Members against the high possibility of violation of the

national treatment principle. On the one hand, it secures the duties of Members to carry out their obligations under GATS. On the other hand, it recognizes their rights in pursuing legitimate policy objectives. As discussed earlier, due to uncertainty in the determination of the national treatment principle in GATS, this approach would provide a reliable recourse for Members to reduce the high possibility of violation.

It has been argued that it is very hard to examine the relationship between means and end, and this difficulty produces restrictions on a Member's choice of policy objectives because of the exhaustive list of Article XIV.[318] In response to the first part of this argument, it must be recalled that one of the principles in the WTO dispute settlement system is to achieve "a satisfactory settlement of the matter in accordance with the rights and obligations" of Members under GATS.[319] In other words, it is inevitable to examine the discriminatory measure (the means) and national legitimate policy objectives (the end) and appraise their relationship. A determination of "the end" could be made by assessment of protective application of that measure, which is "often discerned from the design, the architecture and revealing structure". [320] Moreover, GATT and WTO jurisprudence indicates that the relationship between means and end is manifested by the terms "necessary" and "relating to", *inter alia*, under exceptional headings.

The second part of this argument seems to be reasonable as Article XIV provides for only five exceptions. However, on the one hand, the multilateral framework of principles would be less effective if there were too broad exceptions, which would harm the "transparency and progressive liberalization".[321] In other words, the existing five exceptions are enough. On the other hand, the existing provision of general exceptions should enjoy a broader interpretation so that they could be made truly "general".[322]

Secondly, this approach is supported by the interpretation rules under *Vienna Convention* Article 31(1), which require "good faith" and "ordinary meaning" of the terms.[323] Therefore, both GATS Article XVII and XIV would be examined without detriment to each other. In addition, the "object and purpose" of GATS are also taken into account in interpretation of the national treatment principle by examining both the obligation of Members in ensuring the expansion of trade in services through the observation of multilateral framework of principles as well as their rights to regulate the supply of services to satisfy national policy objectives.

Thirdly, this two-stage approach would be acceptable by panels and the Appellate Body as it would ensure a fair dispute settlement process by balancing rights against obligations of Members that is consistent with Article 3 (2) of DSU:

> The dispute settlement system of the WTO is a central element in providing security and predictability to the multilateral trading system. The Members recognize that it serves to preserve the rights and obligations of Members under the covered agreements, and to clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law. Recommendations and rulings of the [Dispute

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318 Verhoosel (2002), pp. 51-52.

319 WTO. The Understanding on Rules and Procedures Governing the Settlement of Disputes [hereinafter DSU], Art. 3(4).

320 Appellate Body Report, *Japan – Alcoholic Beverages*, p. 30.

321 GATS, the preamble.

322 Gaines (2001), p. 833.

323 *Vienna Convention*, Art. 31(1).

> Settlement Body] cannot add to or diminish the rights and obligations provided in the covered agreements.[324]

Moreover, this approach would be consistent with the objective assessment of the national treatment principle. The remaining duty is to examine two Articles together to determine whether measures in question constitute a violation of Article XVII.

Figure 4: Effective scope of the national treatment principle after employing the two-stage approach

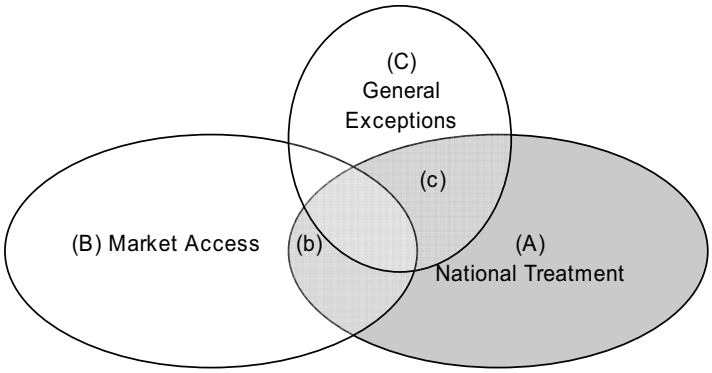

Figure 4 illustrates the effective scope of application of the national treatment principle after employing the two-stage approach for interpretation. As described earlier, in relation to Article XVI on Market Access, the scope of the national treatment principle has been equal to the area of [(A) – (b)]. The area of the general exceptions is named (C), which deals with not only the national treatment and market access obligations, but also other GATS articles. As far as Article XVII is concerned, the area (c) indicates those measures which violate Article XVII but are justifiable by the general exceptions. The effective scope of this principle is consequently narrowed down to the area of [(A) – (b) – (c)]. In other words, the general exceptions would probably determine the exact scope of the national treatment principle.[325] By defining the scope of the national treatment principle, Members would be more willing to inscribe their specific commitments for further liberalization of services.

6. Tentative conclusions on the national treatment principle in GATS

[324] DSU, Art. 3 (2).

[325] *See* McRae, Donald M. 2000. GATT Article XX and the WTO Appellate Body." In Marco Bronckers and Reinhard Quick, eds., *New Directions in International Economic Law: Essays in Honour of John H. Jackson*. The Hague/London/Boston: Kluwer Law International, p. 232.

According to McRae (2000), nothing in GATT requires that the interpretation of the exceptional provision is more stringent than substantive provisions. Exceptions to substantive obligations do not detract from those obligations, resulting in a suspension of treaty rights. They simply define the scope of those obligations. (Footnote omitted)

Three observations should be mentioned here as concluding remarks of this chapter.

First, there is no prevailing interpretation with respect to the scope of application of the national treatment principle as far as market access is concerned. This lack of clarity makes WTO Members unsure as to the extent to which they are obliged to extend this principle as well as less secure in scheduling their commitments. The hierarchical relationship between Article XVI and XVII is proved to be more persuasive, whereby the scope of the national treatment in GATS is limited to all discriminatory measures which are excluded from the domain of Article XVI against foreign services and service suppliers.

Second, the national treatment principle consists of three elements, namely "measures affecting the supply of services", "like" services and service suppliers, and "no less favourable" treatment. The first element is broadly interpreted to include both regulations governing the supply of services and other matters, which indirectly affect the supply of services. The uncertainty in criteria to compare foreign and domestic services and service suppliers would lead the second element to broaden the scope of likeness. As the interpretation by both panels and the Appellate Body is subject to an objective manner regardless of regulatory aims, the third element fails to balance the broad scope of likeness due to broad coverage of discrimination. This, in its turn, would result in a high possibility of violation of this principle by WTO Members.

Third, to avoid this problem, it is necessary for WTO Members to find an appropriate way to balance their broad obligations under GATS. By relying on legitimate national policy objectives provided by Article XIV, a two-stage approach is mapped for confirming the violation of Article XVII. Under this approach, although a measure may be found to be discriminatory against foreign services and service suppliers in the context of Article XVII by an objective assessment, it could not constitute a violation of Article XVII as far as the measure is not discrimination with protectionist aims.

CHAPTER THREE
Special Factors in Interpretation of the National Treatment Principle Applicable to Insurance Services

Chapter Two has demonstrated that the two-stage approach is appropriate for interpretation of the national treatment principle in the context of trade in services. As described in Chapter One, the applicability of the multilateral rules to the insurance services sector is governed by the Annex. The "prudential exception", which is only applicable to the financial services sector, is proposed to constitute the second stage in the two-stage approach towards interpretation of the national treatment principle in the insurance sector in order to counterbalance the broad coverage of both likeness and the standard of "no less favourable" treatment under Article XVII.

Therefore, the main objective of this chapter is to explore (i) the meaning of the "prudential reasons", (ii) the relationship between measures at issue and the prudential policy aims, and (iii) an appropriate test for anti-avoidance of this "prudential exception". Those special factors in trade in financial services, including insurance services, shall shed light on the application of the two-stage approach towards interpretation of the national treatment principle in the insurance sector.

1. Literature review[326]

1.1 Interpretation of the "prudential exception"

In the literature, there is a clear tendency to classify paragraph 2(a) of the Annex as an exception. This provision is informally called "prudential carve-out"[327], "prudential carve-out exemption"[328], "an exception for prudential measures"[329], or "prudential exceptions"[330]. The term "carve-out" means that prudential measures are not subject to schedules and not regarded as a departure from WTO Members' commitments on national treatment.[331] Although there are several discussions on the "prudential exception" in GATS (for example, Jarreau; Condon; and Skipper), most of them are restrained in the description of paragraph 2(a) as it appears in the Annex, rather than providing a detailed analysis on the application of this exception in the context of liberalization of financial services, including insurance services. Moreover, no

[326] This section draws in part from Vu Nhu Thang. 2007a. Applicability of GATS Prudential Exception to Insurance Services: Some Interpretative Issues. *Manchester Journal of International Economic Law* 4(2), pp. 88-123.

[327] *See* Dobson and Jacquet (1998), pp. 76-77; Nicolaidis and Tratchman (2000), pp. 255-256; Skipper, Harold D. Jr. 2001b. Insurance in the General Agreement on Trade in Services. Washington, D.C.: The AEI Press, pp. 32; Key, and Sydney J. 2003. The Doha Round and Financial Services Negotiations. Washington, D.C.: The AEI Press, p. 35.

[328] Panourgias (2006), p. 56.

[329] Leroux, Eric H. 2002. Trade in Financial Services under the World Trade Organization. *Journal of World Trade* 36(3), p. 430.

[330] Jarreau (1999), p. 110.

[331] Dobson and Jacquet (1998), pp. 76-77.

legal analysis has been developed yet with regard to how paragraph 2(a) of the Annex could constitute a "prudential exception". Few other discussions provide a very limited interpretation on special factors of this provision, namely the concept of "prudential reasons", the connection between the prudential objectives and measures, for which justification is sought, and anti-avoidance provision (Key; Nicolaidis and Trachtman; Trachtman; Leroux; Mattoo; Dobson and Jacquet; and Panourgias).

Concerning the concept of "prudential reasons", there seems to be no consensus on the scope of prudential measures. While Leroux noted that the two examples on prudential measures, namely protection of four types of persons and assurance of the financial system's integrity and stability, cover almost the entire scope of the prudential carve-out,[332] there is no further explanation for this interpretation nor discussion of the remaining measures which fall within the scope of this "prudential exception". Although the Annex provides an illustrative list for the term "prudential reasons", the word "including" in paragraph 2(a) would suggest that those two examples clarify some but not all prudential measures. Skipper has offered a few clues for the broadness of the "prudential exception", where the justification in insurance services is mainly the concern of consumer protection.[333] Particularly, Mattoo noted that those measures under the "prudential exception" are to safeguard the solvency and health of financial institutions.[334] It would imply that the concept of "prudential reasons" must relate to the solvency of insurers. In the words of Key, different countries may have different prudential regulations, which may lead to restrictions on trade in financial services.[335]

With regard to the relationship between prudential objectives and measures at issue, Mattoo suggests that prudential measures must be "not more burdensome than necessary".[336] This suggestion, however, does not address the rationale for application of the necessity test to this "prudential exception". In a more concrete analysis in the context of the banking sector, Panourgias noted that there must be a "rational link" between means and ends,[337] and if the term "prudential reasons" is broadly interpreted, a "least WTO inconsistent alternative" test should be incorporated.[338] In contrast, Key, while dealing with the "prudential exception" in banking and securities sectors, has mentioned that these prudential measures are not subject to such a necessity test.[339] However, Key does not offer further explanation on the connection between the measures in question and prudential reasons.

Alternatively, Nicolaidis and Trachtman have proposed a possible interpretation analogous to Article XX (g) of GATT (measures relating to the conservation of exhaustible natural resources), whereby in order for a measure to be considered under the "prudential exception", it would need to be "primarily aimed at" prudential regulation.[340] They nevertheless admit that this might be just one possibility and leave this issue for further research. As of yet, there is no further explanation on the rationale for such an interpretation. The literature, therefore, has offered no consensus on interpretation of the connection between prudential objectives and measures.

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[332] Leroux (2002), p. 430.
[333] Skipper (2001b), pp. 45-46
[334] Mattoo (1999), p. 7.
[335] Key (2003), p. 51.
[336] Mattoo (1999), p. 7.
[337] Panourgias (2006), pp. 61-62.
[338] *Id.* pp. 77-80.
[339] Key (2003), pp. 35-37.
[340] Nicolaidis and Trachtman (2000), pp. 255-256.

Concerning the anti-avoidance provision, although some interpretations have been proposed, they are unclear and insufficient. Key noted that a measure could be challenged under the anti-avoidance provision on the basis that it may be used as a means of avoiding the Member's commitments or obligations under the GATS.[341] Specifically, Key suggested that the application of a prudential measure inconsistent with GATS provisions and commitments might be challenged on whether its purpose is really trade restrictive or not.[342] This might imply a necessity criterion for determining the anti-avoidance provision. However, Key gives no explicit rationale for the adoption of this necessity criterion. Leroux suggests that this anti-abuse provision should be understood at minimum as 'good faith" in adoption and application of prudential measures as shown by GATT jurisprudence on Article XX.[343] The suggestion of Leroux is more relevant to good faith in application and performance of the treaty as provided in *Vienna Convention* Article 26 with respect to the anti-avoidance provision.[344] Alternatively, Trachtman noted that the words "they shall not be used" suggest intent to escape from GATS obligations. Therefore, while prudential regulatory needs are a basis for an exception as provided in the Annex, they may not be "intentionally used" to evade GATS obligations.[345] In other words, WTO Members shall be denied this "prudential exception" where there is an "intent" to avoid commitments on the national treatment principle. However, there is no suggestion on how to determine such intent.

In short, the literature contains only limited interpretations of this "prudential exception" in financial services in general and insurance services in particular, as well as in relation with the national treatment principle. Interpretative issues regarding the "prudential exception", more specifically on each of three factors above, remain open. A fundamental legal point here is whether a measure found inconsistent with GATS obligations, including the commitments on the national treatment principle, is justified on the grounds of this "prudential exception". A clear determination of the scope of prudential measures would be critically important for both scheduling commitments on the national treatment principle and examining whether a measure in question violates GATS obligations or not. The next two sections shall review the literature on the meaning of "prudential" as well as work of an international standard-setting organization in the insurance sector.

1.2 The concept of "prudential" in the insurance sector

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[341] Key (2003), pp. 35-37.

[342] Key, Sydney J. 2005. Financial Services. In Patrick F. J. Macrory, Arthur E. Appleton, and Michael G. Plummer, eds., *The World Trade Organization: Legal, Economic and Political Analysis*. New York: Springer (Volume 1), p. 965.

[343] Leroux (2002), p. 431.

[344] The Appellate Body in *US – Shrimp*, para. 158, has implicitly recognized the principle of *pacta sunt servanda*, as stipulated in the *Vienna Convention*, Article 26, in the context of exercising treaty's rights under GATT Article XX.

For detailed discussion on the distinction of good faith in treaty application and interpretation in the context of GATT/WTO, *see* Waincymer, Jeff. 2002. WTO Litigation: Procedural Aspects of Formal Dispute Settlement. London: Cameron May, pp. 498-500; *see also* Cottier, Thomas and Krista N. Schefer. 2000. Good Faith and the Protection of Legitimate Expectations in the WTO. In Marco Bronckers and Reinhard Quick, eds., *New Directions in International Economic Law: Essays in Honour of John H. Jackson*. The Hague/London/Boston: Kluwer Law International, pp. 47-68.

[345] Trachtman, Joel P. 1995. Trade in Financial Services under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis. *Columbia Journal of Transnational Law* 34, pp. 71-72.

As reviewed in Chapter One, section 1.2, literature agreed that although systemic risk might occur in the insurance sector, the underlying rationale for insurance regulation is consumer protection. Concerning the concept of "prudential", the literature review shows that prudential concerns are typically a characteristic of the financial sector in general, and the insurance sector in particular, which address the solvency of insurers *per se* in order to assure consumer protection. According to Revell, prudential regulation is concerned with balance sheet controls to ensure liquidity and solvency.[346]

More specifically, Spencer observed the prudential concerns in the insurance sector from the shareholder's point of view, where prudential regulation is aimed at preventing the management from excessive risk-taking in order to ensure that insurers have enough financial reserves to satisfy potential claims of policyholders and possible losses. In a circumstance where the insurer is financially troubled, insurance managers might engage in high-risk activities if there is no preventive regulation and supervision on excessive risk-taking conducts, since profits from those risky investments could bring the insurer, which is likely to fail, to a better financial position, while any more loss would not make shareholders worse off.[347] Accordingly, properly regulated capital requirements would limit management's high-risk activities, and ensure that shareholders suffer the cost of losses just as they benefit from gains.[348]

Harrington explained from the point of view of consumers that the underlying problem in information asymmetry, which brings about the case for solvency regulation on non-life insurers, is the insolvency risk of insurers. Consumers who are uninformed about an insurer's financial situation will tend to choose insurers with low prices, unaware that the insurer may face a high insolvency risk.[349] Because of imperfect consumer information, consumers are unable to judge the safety and soundness of financial institutions with which they are dealing.[350] This problem might be more exaggerated when all consumers are uninformed, safe and sound insurers would be kicked out from the insurance market by financially weak insurers who charge lower insurance premiums.[351] Solvency regulations are designed to protect safe and sound insurers against risk from insolvent insurers, and ultimately avoid losses incurred by policyholders due to the failure of insurers.[352] Regulations, including reserve regulations, investment restrictions, are designed to prevent insolvency of insurers and excessively risky investment and property management by insurers.[353]

Another problem which raises prudential concerns is the case of long-term contracts, especially in life insurance, since consumers would suffer a high cost in case of failure of insurers. According to Goodhart et al., even in the absence of any systemic risk, prudential regulation remains necessary to protect consumers against unsafe and unsound financial institutions "vis-à-vis consumer protection", where the consumer may face losses when an

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[346] Revell, Jack R. S. 1981. The Complementary Nature of Competition and Regulation in the Financial Sector. In Albert Verheirstraeten, ed., *Competition and Regulation in Financial Markets*. New York: St. Martin's Press, pp. 16-17.

[347] Spencer (2000), p. 69.

[348] *Id.*

[349] Harrington (1991), p. 240.

[350] Goodhart et al. (1998), pp. 13-14.

[351] Harrington (1991), p. 240.

[352] *Id.* p. 241.

[353] Brannon, Gerard M. 1991. Public Policy and Life Insurance. In Richard W. Kopcke and Richard E. Randall, eds., *The Financial Condition and Regulation of Insurance Companies*. Boston: Federal Reserve Bank, pp. 206-207.

institution fails.[354] As far as the insurance sector is concerned, the value of the contracts to the consumer is determined by the institution's behaviour and performance.[355] Those prudential concerns are distinct from systemic consideration, where the latter deals with the safety and soundness of the entire system. While both prudential and systemic regulations are necessary to protect consumers and the system, as well as those financing the safety net and compensation schemes, systemic regulation goes beyond concerns about each individual financial institution, and extends to the system as a whole. Systemic regulation is necessary due to the potentially high social costs incurred when a financial institution fails.[356]

In summary, the literature shows that prudential concerns in the insurance sector are to protect consumers against failure of insurers. They emphasize the financial situation of insurance companies, and include regulations on reserves and investment regime. In other words, a set of regulations and supervision is designed by government to ensure sound management of insurers with a view to reducing the likelihood of institutional insolvency, and consequential losses to policyholders. There is a significant difference between prudential concerns and systemic considerations, whereby the latter address the security and integrity of the whole financial market, which may be endangered by insolvent insurers.

1.3 The work of the international standard-setting organization

In the financial sector, financial standards are developed by several international organizations, such as the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors (hereinafter IAIS), and the International Organization of Securities Commission. International standards for insurance services are designed by the IAIS, which was established in 1994. The IAIS represents insurance regulators and supervisors of some 180 jurisdictions in more than 130 countries, as well as more than 80 observers representing industry associations, professional associations, insurers and re-insurers, consultants and international financial institutions.[357] The IAIS was formed to promote cooperation between insurance regulators and supervisors in improved supervision of the insurance industry on domestic and international levels.[358] To do so, the IAIS issues three layers of norms, namely global insurance principles, standards and guidance papers.

The first layer consists of principles that are fundamental to effective insurance supervision and identify areas where the insurance supervisors should have authority or control. Those principles form the basis for developing standards and guidelines. There are six groups of principles with respect to *Insurance Core Principles & Methodology, Supervision of International Insurers and their Cross-border Business Operations, Conduct of Insurance Business, Supervision of Insurance Activities on the Internet, Capital Adequacy and Solvency, and Minimum Requirements for Supervision of Re-insurers*.[359]

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[354] Goodhart et al. (1998), p. 5.
[355] *Id.* pp. 13-14.
[356] *Id.* p. 5.
[357] IAIS. Annual Report 2004-05, September 2005, p. iv.
[358] *See* IAIS website, available at http://www.iaisweb.org – Last visited 22 May 2006.
Other objectives are (i) to promote the development of well-regarded insurance markets, and (ii) to contribute to global financial stability.
[359] *Id.*

The second layer includes eleven detailed insurance standards on particular issues, which describe best or most prudent practices with regard to licensing, on-site inspections, derivatives, asset management, group coordination, exchange of information, evaluation of the reinsurance cover, supervision of re-insurers, disclosure concerning technical performance and risks for non-life insurers and re-insurers, fit and proper requirements and assessment for insurers, and disclosure concerning investment risks and performance for non-life insurers and re-insurers.[360]

The third layer under the principles and standards is ten guidance papers, which are designed to assist supervisors in effective supervision of insurance markets.[361]

The most important work of the IAIS that might be relevant to the discussion on the meaning of "prudential" is Principles No. 1, named *Insurance Core Principles and Methodology*, which set out grounds for developing other principles, standards, and guidelines.[362] There are twenty-eight insurance core principles (hereinafter ICP) covering seven broad topics serving as a basic benchmark for insurance supervisors in all jurisdictions:

1. Conditions for effective insurance supervision (ICP 1);
2. The supervisory system (ICP 2-5);
3. The supervised entity (ICP 6-10);
4. On-going supervision (ICP 11-17);
5. Prudential requirements (ICP 18-23);
6. Markets and consumers (ICP 24-27); and
7. Anti-money laundering, combating the financing of terrorism (ICP 28).

Six core principles, which are classified as "prudential requirements" are risk assessment and management, insurance activity, liabilities, investments, derivatives and similar commitments, and capital adequacy and solvency. Those prudential requirements are designed to assure the fulfillment of insurers' obligations under "all reasonably foreseeable circumstances".[363]

Firstly, insurers are required by the supervisory authority to be able to identify the range of risks that they face and to assess and manage them effectively.[364] In addition to reviewing the risk management process exercised by insurers, the supervisory authority is empowered to develop prudential regulations and requirements to contain risks absorbed by insurers, such as underwriting risks and risks related to evaluation of technical provision, market risk, operational risk, etc.[365]

Secondly, the supervisory authority requires insurers to have strategic underwriting and pricing policies, to establish and maintain an adequate level of premiums. A clear strategy

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[360] *Id.*
[361] *Id.*
[362] IAIS. Insurance Core Principles and Methodology, approved in Singapore in 30 October 2003 [hereinafter IAIS (2003)].
[363] IAIS (2003), para. 15, p. 32.
[364] IAIS (2003), ICP 18 on Risk Assessment and Management, p. 32.
[365] *Id.*

to mitigate and diversify risks that they underwrite, in particular through reinsurance arrangements is also required.[366]

Thirdly, insurers are required by the supervisory authority to observe standards for establishing adequate technical provisions and other liabilities in order to satisfy their obligations arising out of insurance contracts.[367] Moreover, the supervisory authority shall be empowered to assess the adequacy of the technical provisions and to require that these provisions be increased if necessary.[368]

Fourthly, the supervisory authority has the power to regulate standards on investment activities, which include requirements on investment policy, asset mix, valuation, diversification, asset-liability matching, and risk management.[369]

Fifthly, insurers are required to comply with standards on the use of derivatives and similar commitments, which address restrictions in their use and disclosure requirements, as well as internal controls and monitoring of the related positions.[370]

Lastly, insurers have to comply with the prescribed solvency regime that enables the insurer to absorb significant unforeseen losses.[371] This solvency regime shall deal with valuation of liabilities, including technical provisions; quality, liquidity and valuation of assets; matching of assets and liabilities; suitable forms of capital; and capital adequacy requirements.[372]

In addition, under the heading of "markets and consumers", another four core principles are developed in order to address issues of market conducts essential for supervision of the insurance sector, and that may have a "reputation risk" or "prudential" impact on insurers.[373] Thus, these four core principles might indirectly affect the financial health of insurers.

Firstly, as insurance intermediaries, such as agents and brokers, may serve as an important interface between consumers and insurers in distributing insurance services, the supervisory authority shall be empowered to set requirements for the conduct of insurance intermediaries, which may cover licensing requirements or registration, professional knowledge and ability, sufficient safeguards, and information disclosure.[374]

Secondly, insurers and intermediaries, including foreign insurers supplying products on a cross-border basis, are required to comply with minimum requirements in dealing with consumers in the consumers' jurisdiction.[375] This core principle is designed to protect the interests of consumers and to strengthen their confidence in the insurance market.[376]

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366 IAIS (2003), ICP 19 on Insurance Activity, p. 33.
367 IAIS (2003), ICP 20 on Liabilities, p. 34.
368 *Id.*
369 IAIS (2003), ICP 21 on Investments, p. 35.
370 IAIS (2003), ICP 22 on Derivatives and Similar Commitments, p. 37.
371 IAIS (2003), ICP 23 on Capital Adequacy and Solvency, p. 39.
372 *Id.*
373 IAIS (2003), para. 16, p. 40.
374 IAIS (2003), ICP 24 on Intermediaries, pp. 40-41.
375 IAIS (2003), ICP 25 on Consumer Protection, p. 41.
376 *Id.*

Thirdly, in order to facilitate transparency and protect the benefit of policyholders, insurers are obliged to disclose relevant information on their business activities and financial position, as well as the risks to which they are exposed.[377]

Lastly, to combat fraud in the domestic insurance market, insurers and intermediaries are required to take the necessary measures to prevent, detect and remedy insurance fraud.[378] This core principle is aimed at minimizing and avoiding reputation costs and financial losses.[379]

The work of the IAIS in the insurance sector shows two implications for the concept of "prudential".

Firstly, prudential concerns address three aspects of the financial health of insurers, namely liabilities, assets, and investment activities. All six core principles addressing prudential requirements are aimed at assuring the safety and soundness of insurers, and then ensuring normal operations of insurers, whereby they are able to absorb risks insured and other risks, and to fulfill claims of policyholders. In other words, the term "prudential" as it applies to the insurance sector represents the concerns regarding financial matters of insurers in order to assure their solvency.

Secondly, concerns regarding the integrity of the insurance market as well as promotion of public confidence are relevant to the financial health of insurers. Misconduct of insurance intermediation might undermine the solvency of insurers and consequently disrupt the stability of the insurance market as a whole. Any fraud or information asymmetry may also affect the public confidence in the insurance market, and then the operations of insurers.

2. Interpretative approach to the exception[380]

2.1 Annex on Financial Services: The prudential exception to national treatment

As described in Chapter One, section 2.2, the inclusion of the Annex reflects the need for more specific application of GATS to the complicated financial services sector. This Annex binds all WTO Members since the Annex is an integral part of GATS under Article XXIX. Paragraph 2(a) of the Annex provides that:

> Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including 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. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.[381]

A legal concern here is whether Annex paragraph 2(a) would constitute an exception to other obligations under GATS based on prudential reasons. The word "notwithstanding" appeared in the first sentence of paragraph 2(a) seems to permit Members to deviate from

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377 IAIS (2003), ICP 26 on Information, Disclosure & Transparency Towards the Market, p. 42.
378 IAIS (2003), ICP 27 on Fraud, p. 43.
379 *Id.*
380 This section draws from Vu Nhu Thang (2007a), pp. 88-123.
381 GATS, the Annex, para. 2 (a).

their GATS obligations and commitments in pursuit of prudential reasons. The Panel in *EC – Tariff Preferences* has interpreted the ordinary meaning of the word "notwithstanding" as "in spite of, without regard to or prevention by", which provides an authorization for deviation from certain rules establishing obligations.[382] In addition, in *US – Shirts and Blouses*, according to the Appellate Body, two criteria must be satisfied in order to determine whether a rule constitutes an exception, namely (i) it is not a positive rule establishing obligations in itself, and (ii) it authorizes a limited derogation from obligations under certain other GATT provisions.[383]

In terms of the first criterion, other GATS provisions require obligations to be implemented by WTO Members. For example, as discussed in Chapter Two, the national treatment principle obviously is a positive rule establishing obligation in GATS, which requires Members to grant foreign services and service suppliers no less favourable treatment than they accord to their domestic counterparts. Meanwhile, the first sentence of paragraph 2(a) under the Annex does not provide any obligation requiring Members to take prudential measures. In other words, it is the right of Members to introduce or refrain from introducing such prudential measures.

With respect to the second criterion, Annex paragraph 2(a) enables WTO Members to adopt legitimate domestic policy to regulate their financial markets. However, in exercising this prudential right, the second sentence of paragraph 2(a) under the Annex set out an anti-avoidance provision, whereby Members are not allowed to employ this right to "avoid" their obligations and commitments. In other words, prudential right must not be excercised in a manner of defecting GATS obligations and commitments. Accordingly, Annex paragraph 2(a) would apparently indicate a limited derogation from obligations under other provision of GATS, including the national treatment principle and national commitments on this principle.

Therefore, based on WTO jurisprudence, Annex paragraph 2(a) probably constitutes an exception to other GATS provisions, whereby WTO Members may pursue prudential objectives to regulate their financial systems, including insurance market. The interpretation of Annex paragraph 2(a) as the prudential exception is supported by the Explanatory Note for the scheduling of initial commitments in trade in services during the Uruguay Round, whereby prudential measures constitute an exception to GATS, and apply only to the financial services.[384] This is also confirmed by the following scheduling guidelines for negotiating future commitments on services, which adopted by the Council for Trade in Services in 2001.[385]

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[382] Panel Report, *European Communities – Conditions for the Granting of Tariff Preferences to Developing Countries* [hereinafter *EC – Tariff Preferences*], WT/DS246/R, adopted on 20 April 2004, para. 7.36.

[383] Appellate Body Report, *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India* [hereinafter *US – Shirts and Blouses*], WT/DS33/AB/R, adopted on 23 May 1997, p. 16.

[384] The Appellate Body explicitly regarded this Expanatory Note as "supplementary means" of interpretation under *Vienna Convention* Article 32. *See* Appellate Body Report, *US – Gambling*, para. 197.

Under Scheduling of Initial Commitments in Trade in Services, Explanatory Note, GATT Doc. No. MTN.GNS/W/164, 3 September 1993, para. 13 provides that:

> …[A]ny prudential measure justifiable under paragraph 2:1 of the Annex on Financial Services constitutes *an exception to the Agreement* and should not be scheduled. The *prudential measure exception* applies only to financial services as listed in the Annex, and not to other service sectors... (Emphasis added)

[385] Council for Trade in Services. Guidelines for the Scheduling of Specific Commitments under the General Agreement on Trade in Services (GATS), WTO Doc. No. S/L/92, 28 March 2001, para. 20:

The application of Annex paragraph 2(a), nevertheless, does not mean an erosion of the application of other positive rules establishing obligations, including the national treatment principle. As noted by the Panel in *EC – Tariff Preferences*, the relationship between exceptions and other provisions establishing obligations is not mutually exclusive.[386] This would indicate that Annex paragraph 2(a) and the national treatment principle apply concurrently to a measure in question, and Annex paragraph 2(a) prevails as far as the conflict between provisions is concerned.[387]

An important aspect of the prudential exception is that it is different from Safeguard for the Balance of Payment in Article XII.[388] Although both are exceptions to other provisions in GATS,[389] and the application of the two measures is not allowed to pursue protective purpose,[390] there are two major differences between the prudential exception and the safeguard for balance-of-payment. Firstly, the adoption of restrictions on trade in services for protecting the balance of payment is conditional on the event of or threat to serious balance of payment and external financial difficulties.[391] When such context lapses, safeguard measures are not relevant, and those restrictions must be progressively removed.[392] In contrast, as an exception, those prudential measures are adopted regardless of any context and time restriction. The second significant difference is that while measures falling under Article XII are subject to consultation,[393] prudential measures are applied without such an obligation. This means that WTO Members can flexibly adopt and introduce prudential regulations at their own discretion.

In addition, this prudential exception is also distinguished from Emergency Safeguard Measures as provided in Article X. Although under GATS Article X:1, multilateral negotiations on emergency safeguard measures were scheduled to be completed after three years from the date of entry into force of the WTO Agreement, there has been no agreement

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> …[A]ny prudential measure taken in accordance with paragraph 2(a) of the Annex on Financial Services constitutes *an exception to the Agreement* and should not be scheduled. Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons in accordance with paragraph 2(a) of the Annex on Financial Services... (Emphasis added)

386 Panel Report, *EC – Tariff Preferences*, para. 7.44.

387 *Id.* para. 7.45 reads as follows:

> … [T]aking the example of the relationship between [GATT] Article XX and Article…III…, the jurisprudence demonstrates that the two apply concurrently to a given measure…. [P]anels and the Appellate Body have consistently begun the examination of the consistency of the challenged measure with Article…III… After finding violations under [that] provision, the panels and the Appellate Body then went on to examine whether the measure could be justified under Article XX… Accordingly, the relationship between Article XX…, on the one hand, and …Article III…, on the other, is one where both categories of provisions apply concurrently to the same measure, but where, in the case of conflict between these two categories of provisions, Article XX… prevails…

388 During the Uruguay Round negotiations, the Malaysian delegation expressed that with regard to balance-of-payment considerations, measures might also include prudential concerns.

See Note on the Meeting of 13-15 September 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/3, 16 October 1990, para. 4.

389 Scheduling of Initial Commitments in Trade in Services, Explanatory Note, GATT Doc. No.MTN.GNS/W/164, 3 September 1993, para. 13.

390 GATS, Art. XII:3.

391 GATS, Art. XII:1.

392 GATS, Art. XII:2 (e).

393 GATS, Art. XII: 4 and 5.

of emergency safeguard measures so far.[394] However, looking at GATT Article XIX on Emergency Action on Imports of Particular Products, the application of safeguard measures must be conditional upon: (i) increased quantities in any imported products, (ii) serious injury to domestic producers, (iii) a "causing or threatening" linkage between (i) and (ii), and (iv) a limited period of time.[395] Accordingly, emergency safeguard measures are temporary exceptions, whereas the prudential exception is a permanent exception to generally applicable rules.[396] Moreover, safeguard measures are contingent upon a particular occurrence or circumstance.[397]

2.2 WTO jurisprudence on treaty interpretation

As noted in Chapter Two, section 5.1, panels and the Appellate Body have provided a general approach towards interpretation of general exceptions in GATT Article XX and GATS Article XIV. The first case in the WTO invoking GATT Article XX after a measure being found to be inconsistent with Article III:4 is *US – Gasoline*.[398] Because the Appellate Body found that the Panel was incorrect when overlooking "a fundamental rule of treaty interpretation", it quoted Article 31(1) of the *Vienna Convention* as a principal approach towards interpretation of GATT Article XX on General Exceptions.[399] Furthermore, according to the Appellate Body, this general rule of interpretation has attained the status of customary rules of interpretation of public international law in accordance with DSU Article 3 (2).[400] Article 31 of the *Vienna Convention*, which sets out the general rule for interpretation, reads that:

> 1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
> …
> 3. There shall be taken into account, together with the context:
> (*a*) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
> (*b*) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
> (*c*) any relevant rules of international law applicable in the relations between the parties.

Therefore, pursuant to Article 31(1) of the *Vienna Convention*, the general approach to interpretation of exceptions under GATT Article XX must be that the words of a treaty are to be given their ordinary meanings in their context and in the light of the treaty's object and

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[394] This deadline was rescheduled until the conclusion of the Doha round.
See Fifth Decision on Negotiations on Emergency Safeguard Measures adopted by the Council for Trade in Services on 15 March 2004, WTO Doc. No. S/L/159, 17 March 2004.

[395] GATT, Art. XIX.

[396] *See* WTO Secretariat. Note on Emergency Safeguard Measures under Article X of GATS, WTO Doc. No. S/WPGR/W/1, 6 July 1995; Note on Safeguard and Services. GATT Doc. No. MTN.GNS/W/70, 13 September 1989. *See also* GATS, Art. XII:2 (e).

[397] WTO Secretariat. Note on Emergency Safeguard Measures under Article X of GATS, WTO Doc. No. S/WPGR/W/1, 6 July 1995, para. 5.

[398] Appellate Body Report, *US – Gasoline*.

[399] *Id.* p. 15.

[400] *Id.* p. 16.

purpose.[401] A similar approach has been adopted by the Panel and Appellate Body in *US – Gambling* in the context of services when interpreting GATS Article XIV.[402] As a general rule of interpretation in the *Vienna Convention*, interpretation must give meaning and effect to all terms of a treaty.[403] The starting point for interpretation of the exception is the dictionary meaning of the terms concerned.[404] Moreover, footnote may add clarification to the dictionary meaning.[405]

The next issue is what would constitute "context" and "object and purpose" for interpretation under Article 31(1) of the *Vienna Convention*. With regard to the context of exceptions, the Appellate Body in *US – Gasoline* further determined the context of GATT Article XX to include, *inter alia*, Article III on National Treatment, and conversely the context of Article III includes Article XX.[406] In addition, the preamble of the WTO Agreement was also examined by the Appellate Body as a context for interpretation of the term "non-discriminatory" in the Enabling Clause (as an exception to GATT Article I:1).[407]

The scope of "in the light of its object and purpose" has been clarified by the Appellate Body to cover the object and purpose of Article XX *per se*.[408] While the Appellate Body in *US – Shrimp* underscored that the Panel was wrong in looking at the object and purpose of GATT 1994 and the WTO Agreement as a whole, not that of GATT Article XX,[409] the Panel in *EC – Tariff Preferences* noted that object and purpose of GATT 1994 and the WTO Agreement are relevant for interpreting the anti-abuse provision in the exception.[410]

In addition to the fundamental rule of interpretation set out in Article 31(1), other relevant rules of international law, as appropriate, could be employed for interpretation in pursuant with Article 31(3)(c) of the *Vienna Convention*, including the doctrine of *abus de droit*, in order to prohibit abusive exercise of a State's rights.[411]

Although the Appellate Body in *US – Gasoline* did not directly refer to Article 32 of the *Vienna Convention*, it asserted that the purpose and object of the chapeau is to prevent "abuse of the exception", and this finding is supported from the "drafting history of Article XX".[412] This interpretative approach would implicitly recall that in examination of the meanings of general exceptions, Article 32 on supplementary means of interpretation of the *Vienna Convention* may be relevant. In the following case, the Appellate Body expressly

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[401] *Id.* p. 16; Appellate Body Report, *US – Shrimp*, para. 114; Appellate Body Report, *Korea – Beef*, para. 159.

[402] Panel Report, *US – Gambling*, paras. 6.463-470; and AB Report, *US – Gambling*, para. 299.

[403] Appellate Body Report, *US – Gasoline*, p. 21. *See also* Panel Report, *US – Gambling*, para. 6.462.

[404] Appellate Body Report, *US – Gasoline*, p. 19; Appellate Body Report, *Korea – Beef*, para. 160; Panel Report, *US – Gambling*, paras. 6.463-468.

Dictionaries utilized by Panels and the Appellate Body have included *The New Shorter Oxford English Dictionary* (Clarendon Press, 1993), *Black's Law Dictionary* (West Publishing, 1995), *The Shorter Oxford Dictionary* (2002).

[405] Panel Report, *US – Gambling*, paras. 6.467-468.

[406] Appellate Body Report, *US – Gasoline*, p. 16.

[407] Appellate Body Report, *EC – Tariff Preferences*, para. 246.

[408] Appellate Body Report, *US – Gasoline*, pp. 16-17; Appellate Body Report, *Korea – Beef*, para. 159; Panel Report, *Canada – Measures Affecting Exports of Unprocessed Herring and Salmon*, L/6268 – 35S/98, adopted on 22 March 1988, para. 4.5.

[409] Appellate Body Report, *US – Shrimp*, para. 116

[410] Panel Report, *EC – Tariff Preferences*, paras. 7.156-158.

[411] Appellate Body Report, *US – Shrimp*, para. 158. Citing to and quoting B. Cheng, *General Principles of Law as applied by International Courts and Tribunal* (Stevens and Sons, Ltd., 153), Chapter 4, p. 125.

[412] Appellate Body Report, *US – Gasoline*, p. 20.

referred to Article 32 of the *Vienna Convention* to confirm the interpretation of the terms, which are reached by the application of Article 31(1).[413] Article 32 of the *Vienna Convention* reads:

> Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:
>
> (a) leaves the meaning ambiguous or obscure; or
>
> (b) leads to a result which is manifestly absurd or unreasonable.

Moreover, the Panel in *US – Gambling* also referred to examples of *Trade Policy Review* of some WTO Members in order to support its interpretation of the term.[414] Those examples are instructive to supplementary means of interpretation,[415] and consequently make the reasoning of panels and the Appellate Body more legitimate.

In summary, under DSU Article 3(2), interpretative rules of public law under Articles 31 and 32 of the *Vienna Convention* have been incorporated into WTO jurisprudence as customary rules for interpreting exceptions in WTO agreements, including GATS.

2.3 Applying the interpretative approach to the prudential exception

As described earlier, the general approach adopted in the WTO dispute settlement towards interpretation of exceptions is the interpretative rules set out by Articles 31 and 32 of the *Vienna Convention*. Those rules of interpretation of public law are applicable to the WTO agreements, including GATS, under DSU Article 3 (2).[416] Therefore, it is submitted that those interpretative rules are also applicable to the interpretation of the Annex as well as WTO Members' specific commitments regarding financial services, since both of them are an integral part of GATS, which is a part of covered agreements in DSU. In addition, paragraph 4 of the Annex reads:

> 4. *Dispute Settlement*
>
> Panels for disputes on prudential issues and other financial matters shall have the necessary expertise relevant to the specific financial service under dispute.[417]

Paragraph 4 implies that disputes on prudential matters, including justification for violation of any GATS articles based on the prudential exception, shall be subject to the WTO dispute settlement mechanism. In other words, the prudential exception is also governed by DSU Article 3 (2).

Accordingly, an interpretative approach of the prudential exception must be consistent with the general approach towards the interpretation of exceptions in GATT and GATS. As fundamental rules of interpretation, there must be an examination of the ordinary meaning of the terms "in their context and in the light of the treaty's object and purpose" under Article 31 of the *Vienna Convention*. The issue of interpretation of the prudential exception in financial services, including insurance services, however, seems to be vaguer as there are few cases in

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413 Appellate Body Report, *US – Shrimp*, para. 157.
414 Panel Report, *US – Gambling*, para. 6.471.
415 *Id.*
416 DSU, Appendix 1.
417 GATS, the Annex, para. 4.

GATS where decisions have been made, and none of them is related to financial services or to insurance services in particular. Ortino commented that too narrow an approach as well as overlooking all relevant elements for general rules of treaty interpretation, would be risky when assessing the meaning of a treaty provision for the first time.[418] Therefore, it may be safe and appropriate to see the object and purpose of GATS and the WTO Agreement for the interpretation of this prudential exception as complementary to the object and purpose of Annex paragraph 2(a). Supplementary means of interpretation as provided in Article 32 of the *Vienna Convention* shall be relevant to clarify and confirm the meaning resulting from the application of interpretative rules.

3. The prudential exception: Interpretative issues[419]

The following shall examine the interpretation of the prudential exception in three layers: (i) the scope of "prudential reasons", (ii) the relationship between the prudential objectives and measures, and (iii) the anti-avoidance provision.

3.1 Determining legitimate policy objectives pursued by measures: the scope of "prudential reasons"

If a discriminatory measure in the insurance services sector, which is found under the meaning of Article XVII, does not fall within the scope of "prudential reasons", that measure is not justifiable and will be in violation of the national treatment principle. Therefore, the first interpretative layer is required to examine the scope of "prudential reasons" in GATS.

(i) Ordinary meaning

The Annex does not state how measures are determined to be for "prudential reasons". Pursuant with Article 31(1) of the *Vienna Convention*, the general rule for interpretation is that a treaty shall be interpreted in good faith by starting with the ordinary meaning to be given to the terms of the treaty, in their context and in the light of its object and purpose. According to one dictionary, "prudential" (*adjective*) means:

> Of, involving, or characterized by prudence; exercising prudence, esp. in business affairs.[420]

According to the same dictionary, "prudence" and "prudent" mean:

> **Prudence** (*noun*): the quality of being prudent.
> **Prudent** (*adjective*): characterized by or proceeding from care in following the most politic and profitable course; having or showing sound judgment in practical affairs; circumspect, sensible.

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[418] Ortino, Federico. 2006. Treaty Interpretation and the WTO Appellate Body Report in *US – Gambling*: A Critique. *Journal of International Economic Law* 9(1), p. 145.

[419] This section draws from Vu Nhu Thang (2007a), pp. 88-123.

[420] The Shorter Oxford English Dictionary, Fifth Edition, 2002.

In another dictionary, the word "prudential" denotes something that "of the nature of prudence", "characterized by careful deliberation".[421] The dictionary meaning of "prudential" suggests that a degree of "care" must be an inherent characteristic in pursuing business affairs in a profitable way. Specifically, a measure that is sought to be justified under the prudential exception must involve prudence, which is characterized by a degree of care.

The dictionary definition of the word "reasons" that appears to be relevant in the context of Annex paragraph 2(a), reads as follow:

> A cause of a fact, situation, event, or thing, *esp*. one adduced as an explanation; cause, ground.[422]

Accordingly, "prudential reasons" would mean a degree of care must be paid to certain situations or facts in conducting business operations. The dictionary definitions, nevertheless, do not resolve two interpretative issues. *Firstly*, this dictionary definition does not indicate to which activities or business operations must take care in order to be considered "prudential reasons". The range of activities may include from only one type of business activity, such as investment or financial accounting, to the whole range of business activities, including marketing, acquisition of goods and services, undertaken by insurance service suppliers in pursuing profits. *Secondly*, this dictionary definition of "prudential" does not indicate from whose perspective the "prudential reasons" must be judged. Regulators and supervisors may have a view about the "prudential reasons" that differs from insurance service suppliers or the public.

Nevertheless, the term "prudential reasons" can not be read in isolation. Reading in conjunction with the words that follow this term, Annex paragraph 2(a) provides further clarification with an illustrative list of "prudential reasons", namely "the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier" and "to ensure the integrity and stability of the financial system". The first part of this illustrative list stated in the Annex is to encompass four categories of persons to be protected by domestic regulation, namely (i) investors, (ii) depositors, (iii) policyholders, and (iv) persons to whom a fiduciary duty is owed by a financial service supplier. As described in Chapter One, section 2.3, financial services addressed by the Annex cover insurance and insurance-related services, and banking and securities services. Therefore, this prudential exception deals not only with the insurance sector, but also the banking and securities sector. It is arguable that investors are protected by securities regulations and depositors by banking regulations, while policyholders are protected by insurance regulations. Moreover, Chapter One, section 1.2 also noted that the rationale for insurance regulations is consumer protection. In other words, as far as the insurance sector is concerned, the first example of the "prudential reasons" means that measures justifiable under the prudential exception must be designed to protect policyholders.

With regard to the scope of "person to whom a fiduciary duty is owed" by an insurance service suppliers, according to a dictionary, the word "fiduciary" (*adj.*) denotes "holding something in trust, acting as trustee".[423] This dictionary meaning indicates that insurers, in acting as trustee, are required to take care of money or property given to them by

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[421] The Compact Oxford English Dictionary, Second Edition, reprinted 1994.
[422] The Shorter Oxford English Dictionary, Fifth Edition, 2002.
[423] *Id.*

other persons, such as consumers, beneficiaries, shareholders.[424] In other words, the term "fiduciary" would identify the particular business operations important in assessing the "prudential reasons", i.e., those operations where insurers must take care in managing liability and capital as well as assets in order to fulfill their obligations towards relevant persons. Accordingly, those business operations would indicate the financial situation of insurers.

The second part of the illustrative list on "prudential reasons" provided by the Annex is meant "to ensure the stability and integrity of the financial system". Those words suggest a broader consideration for the whole system, rather than the protection of individual persons in the financial market. In abstract, this "prudential reason" addresses an unchanged and undivided condition in the financial system. The financial system would enjoy a broad meaning to cover not only insurance market, but also banking and securities market.

Based on the dictionary definitions and taking into account the clarification added by the drafters of GATS, the ordinary meaning of the term "prudential reasons" probably refers to financial situations of insurance service suppliers, to which a degree of care must be extended so that suppliers are able to fulfill their obligations towards policyholders and other relevant persons, as well as protecting the stability and integrity of the financial market.

(ii) Ordinary meaning "in the context" and "in the light of the object and purpose of the treaty"

The ordinary meaning of the word "prudential reasons" must be further explored in the light of its context as well as object and purpose of the Annex. As described in Chapter One, section 2.2, the negotiating history showed that the inclusion of the Annex into the multilateral framework of GATS reflected the needs of WTO Members in pursuing domestic policies in this sector while implementing obligations under GATS. In the financial sector, there is a need to introduce certain sustainable regulatory measures to protect the financial market and assure the success of its liberalization under GATS framework.[425] Consequently, WTO Members have the right to pursue prudential reasons in regulating the financial services sector. This result reflected the deep concerns of Members to include the financial services sector into the multilateral framework, whereby liberalization must aim at the stability of the financial system, and the prudential exception should be properly designed to empower regulatory authorities to protect depositors and the general public.[426]

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[424] The New Palgrave Dictionary of Economics and the Law, edited by Peter Newman, Macmillan Reference Limited, London/New York, 1998, pp 127-132, describes "fiduciary duties" as follow:

> **fiduciary duties**. Fiduciary duties fall into two broad categories: duty of loyalty and duty of care… The ultimate effect of the law is to provide entrustors with incentives to enter into fiduciary relationships, by reducing entrustors' risks and costs of preventing abuse of entrusted power, and ensuring quality of fiduciary services… The duty [of loyalty] requires fiduciaries to be honest: refrain from converting entrusted power to unauthorized uses. [Meanwhile], the duty of care requires fiduciaries to perform their services with care and skill that can be reasonably expected of them in the particular situation…

[425] Bagheri, Mahmood and Chizu Nakajama. 2002. Optimal Level of Financial Regulation under the GATS: A Regulatory Competition and Cooperation Framework for Capital Adequacy and Disclosure of Information. *Journal of International Economic Law 5(2)*, p. 517.

[426] Statement of the Indonesian delegation, Note on the Meeting of 13-15 September 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/3, 16 October 1990, para. 6. *See also* the argument of Canada, Note on the Meeting of 11-13 June 1990, Working Group on Financial Services

Moreover, this provision affords WTO Members certain autonomy to regulate the financial services sector.[427] It is said that the inclusion of financial services in the framework of GATS would be deniable if there was no specific exception for prudential regulation and supervision.[428] While the incorporation of financial services in the multilateral framework is considered as a major step, the prudential exception is to make this step more feasible and acceptable to domestic regulators.[429] Leroux has pointed out that the need for this prudential exception is based on the justification that trade liberalization in this financial sector would be unacceptable to any country if it were restrained from adopting and maintaining laws and regulations to protect investors and depositors in its territory.[430] Therefore, while GATS provides a framework for liberalization of financial services, the object and purpose of the Annex is to ensure that such liberalization does not adversely affect the interests of domestic consumers, as well as the security and integrity of the financial system.

Accordingly, "the context" and "the light of object and purpose" of the treaty have clarified another interpretative issue, that the term "prudential reasons" must be observed and assessed from the point of view of consumers of financial services. A degree of care must be paid to financial situations concerning management of insurance service suppliers' liability and capital, as well as assets during their business operations, to assure that consumers of financial services are properly protected, and consequently that the integrity and stability of the whole financial system is maintained.

(iii) Conclusion under Vienna Convention Article 31

The ordinary meaning of "prudential reasons" as it appears in the context and in the light of object and purpose of the Annex would suggest a certain degree of care must be given to the financial situations of insurance service suppliers in supplying insurance services with regard to consumer protection and the integrity of the financial system.

(iv) Supplementary means of interpretation

There are at least six sources instructive to interpretation of the term "prudential reasons". These sources - the preparatory note, note 1998 by the WTO Secretariat, Trade Policy Review, scheduling practices of WTO Members, the work of specialized international organizations, and scholarly works - are examined below.

(1) Preparatory note

Including Insurance, GATT Doc. No. MTN.GNS/FIN/1, 5 July 1990, para. 79; and Malaysian delegation on behalf of the SEACEN, Note on the Meeting of 13-15 September 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/3, 16 October 1990, para. 4.

[427] Jarreau (1999), p. 67.

[428] Key, Sydney J. 1999. Trade Liberalization and Prudential Regulation: The International Framework for Financial Services. *International Affairs (Royal Institute of International Affairs 1944-)* 75(1), p. 67.

[429] *Id.* p. 73.

[430] Leroux (2002), p. 430.

During the Uruguay Round, the Secretariat prepared several notes as background information for contracting parties to GATT negotiating the applicability of the general framework to different service sectors, including the financial services and insurance services sector. One concern here is the extent to which notes of the GATT Secretariat are relevant to interpreting the term "prudential reasons". In *US – Gambling*, the Panel found that the Explanatory Note prepared by the Secretariat for Scheduling of Initial Commitments in Trade in Services constituted a context [of the Members' specific commitments] within the meaning of Article 31 of the *Vienna Convention* because this note (i) related to GATS, (ii) formed an agreement among all parties, and (iii) was in connection with the conclusion of GATS.[431]

However, the Appellate Body held that the Panel erred in categorizing this note as "context" for interpretation, and reasoned that although the note was widely used and relied upon by Members, it was not obligatory.[432] Accordingly, notes of the GATT Secretariat are observed as "supplementary means of interpretation".[433] In the words of Waincymer, although the notes have no directly legal effect, they are highly influential in determining what WTO Members perceived to be the true nature of existing rules.[434]

In the insurance sector, a note was prepared by the Secretariat to provide information for negotiators' discussions on the implications and applicability of concepts, principles and rules of the multilateral framework in the insurance sector.[435] Concerning motivations for government regulations in the sector, this note described that, with a view to protection of consumers, licenses generally were granted only to insurers who complied with financial requirements intended to ensure their solvency on both pre and post licensing processes.[436] The rationale was to provide insurance companies with sufficient guarantee of their solvency and business integrity. This implies that the underlying concerns in the insurance sector are the financial viability of insurers, who supply insurance services to consumers. In addition to the solvency of insurers, regulations may also address other aspects, such as suitability of owners and managers, reinsurance arrangements, permitted investments, marketing practices, and the terms of insurance contracts.[437] This preparatory work for conclusion of the treaty would suggest that prudential measures, which are designed to protect consumers, address financial requirements on sound operations of insurers.

In addition to notes of the Secretariat, the negotiating history on the Annex demonstrates that there seems to be a consensus among negotiators on the necessity of prudential measures, which allow government certain flexibility in protecting consumers as well as the safety and soundness of the financial market.[438] Moreover, in the words of the EC delegation, "any agreement on services would need to respect national laws with respect to

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[431] Panel Report, *US – Gambling*, paras. 6.77-82.

[432] Appellate Body Report, *US – Gambling*, para. 204.

[433] *Id.* para. 196.

[434] Waincymer (2002), p. 381.

[435] Note by the Secretariat. "Trade in Financial Services". GATT Doc. No. MTN.GNS/W/68, 4 September 1989, para. 55.

[436] *Id. (*Emphasis added)

[437] *Id.*

[438] *See* Note on the Meeting of 11-13 June 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/1, 5 July 1990, paras. 86-95. *See also* Note on the Meeting of 18-22 September 1989, the Group of Negotiations on Services, GATT Doc. No. MTN.GNS/25, 23 October 1989, paras. 95-98.

financial services that aimed to ensure the *solvency* and *integrity* of the financial system and institutions".[439]

Accordingly, the preparatory note has clarified that a degree of care must be paid to the financial situation of service suppliers, and this financial situation is the solvency of insurers. The solvency of insurers would ultimately ensure the solvency of the whole financial system, and consequently its integrity and stability. In other words, the term "prudential reasons" would indicate careful judgment on the solvency of insurers with regard to certain types of persons and the integrity of the financial system.

(2) Note 1998 by the WTO Secretariat

A substantive discussion on prudential measures was engaged in a Note of the WTO Secretariat in 1998 with the view of facilitating further understanding among the WTO Members (hereinafter Note 1998).[440] Note 1998 was delivered after the conclusion of the Uruguay Round as well as the achievement of an agreement on liberalizing financial services in 1997.[441]

However, pursuant to Article IX:2 of the WTO Agreement, only the Ministerial Conference and the General Council have the exclusive authority to adopt interpretation of the WTO Agreement.[442] In addition, the Appellate Body in *US – Gambling* held that two requirements must be satisfied in order for "subsequent practice" under the meaning of Article 31(3) of the *Vienna Convention* to be established, namely common and consistent acts or pronouncements, and an implied agreement on the interpretation resulted from those acts and pronouncements.[443] Note 1998 also expressly states that "it is intended to provide background information for sectoral [financial services] discussion".[444] Accordingly, Note 1998 could not be considered "subsequent practice" under the meaning of Article 31 (3) of the *Vienna Convention*.

With regard to the meaning of the term "prudential reasons", unfortunately, Note 1998 focused most attention to the area of banking services, rather than financial services in general or insurance services in particular.[445] Although Note 1998 deals only with banking services

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[439] Note on the Meeting of 11-13 June 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/1, 5 July 1990, para. 82 (Emphasis added). *See also* Mexican delegation: "supervisors had to ensure the solvency and security of the financial system, and the safety of the depositors", Note on the Meeting of 10-25 July 1991, Group of Negotiations on Services, GATT Doc. No. MTN.GNS/44, 8 August 1991, para. 21.

[440] WTO Secretariat. Background Note on Financial Services, Council for Trade in Services, WTO Doc. No. S/C/W/72, 2 December 1998, para. 1.

[441] The agreement on liberalizing financial services, which was achieved by the end of 1997, shall be discussed in details in Chapter Four.

[442] WTO Agreement, Art. IX:2.

[443] Appellate Body Report, *US – Gambling*, para. 192.

[444] WTO Secretariat. Background Note on Financial Services, Council for Trade in Services, WTO Doc. No. S/C/W/72, 2 December 1998, para. 1.

[445] *See* UNCTAD Secretariat. 2005. Note on Trade and Development Aspects of Insurance Services and Regulatory Frameworks. New York and Geneva: UN, (Document No. UNCTAD/DITC/TNCD/2005/17), pp. 15-16 and 19-20.

In contrast to the Note of the WTO Secretariat, a Note by the UNCTAD Secretariat provides an intensive analysis on the term "prudential reasons". According to the Note of the UNCTAD Secretariat, prudential regulations are defined as "measures the compliance of which allows an insurer to continue its operation within a given market", which deal with a broad scope of operations of insurer, including consumer protection and

and does not constitute a "subsequent practice", several aspects might be useful in examining the term "prudential reasons", and thus be relevant for interpretation of this term in insurance services.

The scope of prudential measures in the banking sector may consist of capital adequacy ratios, limits on risk concentration and risk management system requirements, liquidity requirement, prohibitions on insider trading and transactions giving rise to conflicts of interest, rules on the classification of and provisioning for non-performing assets, as well as transparency and disclosure requirements.[446] In contrast, non-prudential regulatory measures may include lending requirements to certain sectors or geographic regions, restrictions on interest rates or fees and commissions, and requirements to provide certain services.[447] The Secretariat also admitted that there may be different views as to whether certain measures can be considered prudential, and the line between prudential and non-prudential regulations is blurred.[448] Note 1998, therefore, could suggest that prudential measures directly relate to the financial soundness of financial service suppliers.

(3) Trade Policy Review

Some examples of WTO Members who have relied on "prudential reasons" in order to explain their application of regulation of insurance services include Indonesia, Thailand, China, and Japan. The *Trade Policy Review – Indonesia* reported that all insurance companies must be licensed and satisfy certain prudential requirements, such as minimum capital levels.[449] Moreover, the Indonesian government also improved prudential supervision, including new regulations requiring insurers to phase in solvency requirements.[450] According to *Trade Policy Review – Thailand*, the government of Thailand underscores that, in order to facilitate insurance business operations in Thailand, the government streamlined the licensing

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establishment of reasonable solvency standards. The objective of prudential regulation is to ensure the security and solvency of the market and protect policy holders even if insurers fail. The note also provides a list of prudential regulations, including adequate entry requirements, capital adequacy and solvency margin; a system of monitoring operations; technical provisions; and regulations on investments of insurance companies. However, in the context of GATS prudential exception, the Note of UNCTAD Secretariat also recognizes the need for further clarification on what exactly the "measures for prudential reasons" are, and the exact nature of measures that are provided in the exemplary list of prudential reasons under paragraph 2 of the Annex.

[446] WTO Secretariat. Background Note on Financial Services, Council for Trade in Services, WTO Doc. No. S/C/W/72, 2 December 1998, para. 35.

[447] *Id*, para. 37.

[448] *Id,* footnote 44 reads as follows:

> Traditional line-of-business restrictions, such as the segregation of banking, securities and insurance businesses such as those existing in the US and Japan, have prudential objectives, but they can be perceived as having non-prudential elements from the point of view of European countries with a tradition of universal banking. Another example may be portfolio allocation rules for investments of financial institutions, where a shift appears to be occurring towards the adoption of prudent-person rules providing flexibility in investment decisions instead of numerical restrictions traditionally adopted in many European countries. This does not necessarily mean, however, that the traditional rules are trade restrictions limiting market access or national treatment.

[449] WTO. Trade Policy Review – Indonesia, Report by the Secretariat, WT/TPR/S/117, 28 May 2003, para. 82, p. 91.

[450] *Id.* (Emphasis added)

regime, and reviewed prudential measures, including, security deposit, capital fund, solvency margin.[451]

In case of China, the requirements for obtaining a license by foreign insurance companies include, *inter alia*, no less than US$ five billion gross assets at the end of the year prior to application, adequate solvency by the standards established in the home country, and other prudential conditions such as corporate governance and a good risk management system.[452] *Trade Policy Review – Japan* specifically noted that prudential requirements under Japan Insurance Business Law include capital requirements and portfolio restrictions.[453]

Those examples would suggest that the term "prudential" denotes a range of financial issues aiming at conditions of the solvency applicable to insurers for their business operations in a given market.

(4) Scheduling practices of WTO Members

Although it is not required that measures falling within the scope of the prudential exception be inscribed in WTO Members' schedules of specific commitments,[454] the EC and Korea have mentioned the term "prudential" in their schedules.

As noted by the Panel in *US – Gambling*, other Members' schedules represent the "context" for the interpretation of the US schedule under Article 31(2) of the *Vienna Convention* because all Members' schedules are an integral part of GATS under Article XX:3.[455] Moreover, in *EC – Customs Classification of Certain Computer Equipment*, the Appellate Body reasoned that even though commitments are undertaken by a Member in its schedule, they constitute a common agreement among all Members.[456]

However, the Panel in *US – Gambling* has set out a criterion for relying on a practice of other Members as a context for interpretation is that such practice must be coherent and consistent, and consequently, "few examples do not evidence any such practice by Members".[457] Accordingly, the scheduling practices of two WTO Members referring to the term "prudential" do not qualify as a "context" for interpretation of the term "prudential reasons" in GATS. Examples of these commitments, nevertheless, would be instructive in interpreting the term "prudential reasons".

In their revised schedule of specific commitments in financial services, the EC noted that, in case of insurance services, branches of a non-EC financial institution may be required to meet certain specific prudential requirements, such as specific guarantee and deposit

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[451] WTO. Trade Policy Review – Thailand, Report by the Government, WT/TPR/G/123, 15 October 2003, para. 79, p. 16. (Emphasis added)

[452] WTO Trade Policy Review – China, Report by the Secretariat, WT/TPR/S/161, 28 February 2006, para. 190, p. 202.

[453] WTO. Trade Policy Review – Japan, Report by the Secretariat, WT/TPR/S/32, 5 January 1998, para. 131, p. 137.

[454] Scheduling of Initial Commitments in Trade in Services, Explanatory Note, MTN.GNS/W/164, 3 September 1993, para. 13.

[455] Panel Report, *US – Gambling*, para. 6.97.

[456] Appellate Body Report, *European Communities – Customs Classification of Certain Computer Equipment*, WT/DS62/AB/R, WT/DS67/AB/R, WT/DS68/AB/R, adopted 22 June 1998, para. 109.

[457] Panel Report, *US – Gambling*, para. 6.98.

requirements, a separate capitalization, technical reserves and other solvency requirements.[458] In addition to the EC, another WTO Member who refers to the term "prudential" in its schedule is Korea. In its financial services sector-horizontal commitments, Korea understands that prudential measures include the minimum capital requirement or minimum operating funds requirement.[459] Thus, these examples support the claim that prudential requirements address the solvency situation of insurance service suppliers.

(5) Possibility of reference to the work of specialized international organizations

In several cases, panels and the Appellate Body have examined meanings of the terms by referring to the work of international organizations specializing in the matter of dispute. In *Dominican Republic – Cigarettes*, the Panel requested information from the International Monetary Fund on exchange control and found that the foreign exchange fee measure applied by the Dominican Republic does not constitute an "exchange restriction" under the meaning of GATT Article XV:9(a).[460] In another case, *EC – Poultry*, the Appellate Body found the meaning of the term "c.i.f. import price" in customary usage in international trade under Article 5.1(b) of the Agreement on Agriculture by reference to Incoterms 1990 of the International Chamber of Commerce.[461]

In case of services, panels for disputes regarding sectoral matters shall have the necessary expertise relevant to the specific services sectors in disputes.[462] Particularly, in financial services, including insurance services, according to Zdouc, the word "specific" in paragraph 4 of the Annex would mean that panelists should have appropriate expertise in prudential and other financial matters when a financial service is involved in a dispute.[463] In other words, this paragraph suggests that prudential issues must be interpreted in light of the specific financial service under dispute. To be more specific, if it is an insurance service, it must be interpreted in the light of the insurance sector, not banking sector, and as understood by an expert of the insurance services under dispute. This obligation expressly indicates that it was a strong intent of negotiators when liberalizing financial services including insurance services in the multilateral framework, that the interpretation of the term "prudential reasons" should be referred to the work of insurance experts. As mentioned earlier in section 1.3 of this chapter, at the international level, insurance standards are developed by the IAIS. Therefore, it is submitted that information from the IAIS should be taken into consideration in the panel procedure on insurance matters, and this might make panel reports more predictable and legitimate.

The reference to the work of the IAIS to clarify the meaning of the term "prudential reasons" could also be supported by the heading of Annex paragraph 2(a), which indicates "domestic regulation". A broader scope of domestic regulation is governed by Article VI, which provides that consideration shall be paid to international standards of relevant

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[458] EC – Schedule of Specific Commitments, GATS/SC/31/Suppl.4/Rev.1, 18 November 1999, footnote 1, p. 2.

[459] Republic of Korea – Revised Schedule of Specific Commitments in Financial Services, GATS/SC/48/Suppl.3/Rev.1, 18 November 1999, p. 2.

[460] Panel Report, *Dominican Republic – Cigarettes*, paras. 7.142-145.

[461] Appellate Body Report, *EC – Poultry*, para. 146.

[462] Decision on Certain Dispute Settlement Procedures for the General Agreement on Trade in Services, para. 4.

[463] Zdouc, Werner. 1999. WTO Dispute Settlement Practice Relating to the GATS. *Journal of International Economic Law* 2(2), p. 311.

international organizations.[464] Moreover, the WTO Agreement calls for making appropriate arrangements for consultation and cooperation with other organizations concerned with matters related to those of the WTO,[465] it is submitted that the works of the IAIS relating to prudential issues should be integrated into this consultation and cooperation.[466] The WTO Agreement also calls for cooperation between the WTO and the World Bank and International Monetary Fund.[467] For their part, the World Bank and International Monetary Fund clearly list standards, codes, and principles useful for both organizations in conducting operational works and producing reports on the observation of those standards and codes, including insurance supervisory principles developed by the IAIS.[468]

Accordingly, the work of the IAIS, as described earlier, has confirmed the meaning of the term "prudential reasons" as financial situations of insurers in order to ensure their solvency. In a nutshell, prudential concerns address three financial aspects, namely liabilities, assets and investment activities of insurers. The solvency of insurers, consequently, would ensure the integrity of the insurance market.

(6) Scholarly works

Other possible sources for clarifying this term might be scholarly works. Waincymer pointed out that, compared to GATT 1947, there is a greater degree of reference to scholarly writings in WTO panel reports, although the degree is still limited.[469] As described in section 1.2 of this chapter, literature review shows that prudential concerns in the insurance sector refer to the state of solvency of insurers. The rationale for those concerns is consumer protection.

In sum, it is unclear to what extent and how these six sources are treated as supplementary means of interpretation under Article 32 of the *Vienna Convention*. Nevertheless, they may be influential in clarifying the term "prudential reasons", and consequently, they could make reasoning of panels and the Appellate Body more legitimate. These instructive sources have clarified that the term "prudential reasons" would indicate a careful judgment on the solvency of insurance service suppliers. This solvency would ultimately ensure the integrity and stability of the whole financial system, and consequently consumer protection.

(v) Is a narrower or broader interpretation of the term "prudential reasons" acceptable?

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[464] GATS, Art. VI:5 (b).

[465] WTO Agreement, Art. V.

[466] The works of the IAIS relating to prudential issues have been proposed as information sharing mechanism for on-going discussion and consultation in order to provide clearer understanding on the term "prudential reasons" among WTO Members. The Committee on Trade in Financial Services has agreed to carry out informal future discussions, but not the official proceedings of the Committee, with three international standards-setting organizations, including the IAIS. Actually, a seminar was held in October 2001 to inform Members about activities conducted by those three organizations.

See Committee on Trade in Financial Services, Report to the Council for Trade in Services, WTO Doc. No. S/FIN/6, 3 October 2001, para. 4; *see also* Committee on Trade in Financial Services, Report of the Meeting held on 19 September 2005, WTO Doc. No. S/FIN/M/50, 23 September 2005, para. 70.

[467] WTO Agreement, Art. III:5.

[468] *See* www.imf.org/external/standards/scnew.htm – Last visited 22 May 2006.

[469] Waincymer (2002), p. 384.

The challenge of interpreting the term "prudential reasons" is that it must be broad enough for prudential objectives, but not too broad to undermine the purpose of GATS.[470] Specifically, in the words of Panourgias, if the term is broadly interpreted "to include any measure with a prudential function, this could cancel most of the trade commitments".[471] As pointed out earlier, the meaning of this term, based on WTO jurisprudence of treaty interpretation, would center on solvency requirements with regard to insurers, which address three aspects, namely liabilities, assets, and investment of insurance companies. This interpretation could ensure a balance between liberalization and the right of WTO Members to regulate their insurance sectors for prudential reasons, and be consistent with the light of the object and purpose of GATS.

In dispute settlement, however, panels and the Appellate Body may adopt broader or narrower meanings of the term "prudential reasons". The meaning could be broadly adopted to cover not only solvency requirements but also, among other things, the right of WTO Members to control rate regulations. For example, government could set up a minimum rate and premiums applied to each category of insurance services, based on the assumption that premium regulations could also reduce insolvency risk of the insurer, and then protect policyholders. In other words, government would control and monitor the prices that insurance companies charge for assuming risks covered under an insurance policy.

In response to this broader interpretation of the term "prudential reasons", in a competitive insurance market, insurance companies, based on their assessment of risks assumed, should determine rates and premiums.[472] Government interference into this pricing consideration would harm some policyholders due to high premiums charged on low risks. On the other hand, some other consumers would benefit from low premiums on their high risks. Accordingly, it is submitted that these regulations would not relate to consumer protection.

Moreover, these regulations would also distort a competitive financial system, rather than ensure its stability. This broader interpretation would suggest a protection of the financial industry. If "all" measures in the insurance sector were deemed prudential, the term "prudential reasons" would become abusive. Broader interpretation of the term "prudential reasons" would undermine commitments of WTO Members, and then would reduce the predictability of the multilateral trading system. Thus, it would impair the balance between liberalization under the multilateral trading system and the right of WTO Members to pursue prudential purpose; disrupting this balance probably contradicts the intent of GATS negotiators.

In an opposite scenario, a narrower meaning of the term could be adopted in dispute settlement to exclude, for example, investment regulations. It would be arguable that a prohibition on insurers investing abroad is a trade restrictive measure rather than a prudential regulation.[473] However, the main purpose of an investment program is to ensure security of

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[470] UNCTAD Secretariat (2005), p. 20.

[471] Panourgias (2006), p. 79.

[472] Outreville (1998), pp. 147-151; Harrington (1991), p. 251.

[473] *See* Committee on Trade in Financial Services, Report of the Meeting held on 23 November 2004, WTO Doc. No. S/FIN/M/47, 26 November 2004, para. 60.

For example, under Article 6 of China's Provisional Measures on the Administration of the Oversea Utilization of Insurance Foreign Exchange Funds, China Insurance Regulatory Commission provides a threshold of Yuan 5 billion for insurance companies to be able to invest oversea. According to the representative of China, this requirement is based on prudential consideration (9 August 2004) (China).

capital.[474] Too risky assets would cause financial losses to insurers, and then make them unable to pay claims and benefits to policyholders. Consequently, the fiduciary duty of the insurance company with regard to policyholders would not be fulfilled. The inability of the insurer to pay claims and benefits to policyholders could also lead to instability of the insurance market, and then financial system. Furthermore, too narrow interpretation of the term would reduce the flexibility of WTO Members, and impinge on the right of government to take prudential measures.

Examination of the term "prudential reasons" would be incomplete without some thoughts being given to the context of development of current negotiations. As commented by Leroux, the concept of prudential reasons is not "frozen", but rather it may evolve partly based on practice of WTO Members as well as international standards.[475] The balance between rights and obligations of WTO Members in engaging into trade in services in general has been asserted in the Ministerial Declaration of the Doha Round:

> We reaffirm the right of Members under the GATS to regulate, and to introduce new regulations on, the supply of services.[476]

Since then, a series of intensive discussions were centered on the relation between the Annex and international standards on financial services in general and insurance services in particular. While recognizing the importance of liberalization of financial services, including insurance services under GATS, WTO Members continue to underline their ability to take measures for prudential reasons as provided in the Annex, and this balance should be maintained.[477]

Therefore, either broader or narrower interpretation of the term "prudential reasons" would lead to an imbalance between two objectives, liberalization of insurance services under the multilateral trading system, on the one hand, and the right of WTO Members to pursue prudential measures in this sector, on the other hand.

(vi) Overall conclusion on the meaning of the term "prudential reasons"

In the context of the Annex, the term "prudential reasons" would refer to the financial situation of insurance service suppliers to preserve their solvency. In turn, this solvency would ensure the interests of policyholders and other relevant persons, and also contribute to the stability and integrity of the whole financial system. Accordingly, a measure justified under prudential reasons must show a degree of care for the solvency on the part of insurance service suppliers in particular, as well as the solvency of the financial system in general.

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[474] Outreville (1998), pp. 247-248.

[475] Leroux (2002), p. 430. *See also US – Shrimp*, paras. 129-130, whereby Appellate Body reasoned that the term "exhaustible natural resources" must be read in the light of "contemporary concerns of the community nations" and not "static" but "by definition, evolutionary".

[476] Ministerial Declaration, Doha 9-14 November 2001, WTO Doc. No. WT/MIN(01)/DEC/1, 20 November 2001, para. 7.

[477] Communication from Canada, WTO Doc. No. S/CSS/W/50, 14 March 2001, para. 5; Communication from Switzerland, WTO Doc. No. S/CSS/W/71, 4 May 2001, para. 18; statement of Japan in Committee on Trade in Financial Services, Report of the Meeting held on 23 March 2004, WTO Doc. No. S/FIN/M/44, 21 April 2004, para. 49.

3.2 Identifying the connection between the prudential reasons and measures: "for"

When the scope of "prudential reasons" is defined and a measure found discriminatory under GATS Article XVII falls within this scope, the second layer for interpretation of the prudential exception is whether a measure is taken "for" those prudential reasons. This layer shall determine the relationship between the general structure and design of the measure in question, and government policy that it purports to serve, namely the prudential reasons.

(i) Is the "necessity" test appropriate?

One interpretation proposed by Mattoo is that measures which are not more burdensome than necessary to ensure the solvency and the healthy operations of financial institutions shall be qualified for prudential reasons.[478] In other words, measures are permissible only if they are "necessary" to achieve prudential objectives.[479] Indeed, the proposal of Mattoo originates from GATS Article VI:4, which is partly read as follows:

> With a view to ensuring that measures relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services… Such disciplines shall aim to ensure that such requirements are, inter alia:
> …
> (b) *not more burden some than necessary to ensure the quality of the service*;…

GATS Article VI:4 is a call for removal of certain trade restrictive measures over licensing, technical standards and qualifications adopted by WTO Members. Specifically, in the field of accounting services, Members are required to "ensure that such measures are not more trade-restrictive than necessary to fulfill a legitimate objective."[480] Mattoo's suggestion, therefore, seems to contain a necessity test in the form of an obligation. In contrast, as discussed earlier, Annex paragraph 2(a) is an exception, not a positive rule establishing obligation.

Chapter Two, section 5.2 has described the requirement of the necessity test, in the form of exception, which is developed by GATT/WTO jurisprudence.[481] In a nutshell, a

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[478] Mattoo (1999), p. 7.

[479] *See* Mattoo, Aaditya. 2000. Financial Services and the WTO: Liberalization Commitments of the Developing and Transitional Economies. *The World Economy* 23(3), p. 254.

However, in a following article, Mattoo (2000) seems to withdraw his proposal when specifying that "This language [of paragraph 2(a)] differs from … that in Article XIV dealing with General Exceptions in that is does not require that the measures be *necessary* to achieve the stated objectives." (Original emphasis)

[480] Council for Trade in Services, "Disciplines on Domestic Regulation in the Accountancy Sector", WTO Doc. No. S/L/64, 17 December 1998, para. 2.

[481] *See* Neumann, Jan and Elisabeth Turk. 2003. Necessity Revisited: Proportionality in World Trade Organization Law After *Korea-Beef, EC-Asbestos* and *EC-Sardines*. *Journal of World Trade* 37(1), pp. 203-204 and 210-213. *See also* Desmedt, Axel. 2001. Proportionality in WTO Law. *Journal of International Economic Law* 4(3), pp. 463-470.

The necessity test under WTO jurisprudence is different to the proportionality test, for example, of the European Court of Justice. The proportionality test consists of three elements: (i) the measure must be effective or capable to foster the realization of the policy objectives; (ii) there is no other alternative measure available that would reach the legitimate objective just as effectively, but in a less trade-restrictive way; and (iii) whether the restriction on trade is out of proportion to the benefit arising from the protection of the legitimate value,

discriminatory measure is found "necessary" under the context of GATT Article XX and GATS Article XIV only if there were no alternative measures consistent or less inconsistent with GATT and GATS, which a WTO Member could reasonably be expected to employ to pursue its national policy objectives. This requires considering whether any less trade restrictive measure could fulfill the same policy goals.

In response to Mattoo's proposal of equating the word "for" with the necessity test, according to other scholars, prudential measures must be subject to a different test because all measures, not only those deemed necessary, would be permitted.[482] This would imply that any measure that pursues prudential reasons, regardless of necessity, is justifiable in the context of the Annex. In addition, the proposal on the necessity test to interpret the prudential exception seems not to be supported in negotiating history. During the negotiations of Annex paragraph 2(a), several negotiators employed the word "necessary" when discussing the prudential requirements in the field of financial services.[483] However, as the word "necessary" did not appear in the final text of paragraph 2(a), it probably suggests that negotiators did not intend a necessity test to be within the context of prudential exception.

(ii) An alternative interpretation by reference to "relating to"

The dictionary definition of the word "for", in accordance with the general approach to interpretation of exceptions, denotes a range of degree of "purpose", "result", or "destination".[484] This definition of the word "for" implies the existence of a connection between the measure at issue and prudential reasons. The context where this word appears in Annex paragraph 2(a) shows that the word "for" should be read in conjunction with "prudential reasons". According to the same dictionary, the word "for" is defined as follows:

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which the measure aims to pursue. However, the proportionality test has not yet been recognized under WTO jurisprudence.

[482] Key (2005), p. 965; Dobson and Jacquet (1998), pp. 76-77

[483] For example, Canada and the United States.

See Note on the Meeting of 11-13 June 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/1, 5 July 1990, para. 86. *See also* Note on the Meeting of 18-22 September 1989, GATT Doc. No. MTN.GNS/25, 23 October 1989, para. 241; Note on the Meeting of 10-25 July 1991, Group of Negotiations on Services, GATT Doc. No. MTN.GNS/44, 8 August 1991, para. 20.

The term "prudential" at first was used in the context of the National Treatment principle, whereby the US proposed that:

> Whenever market access has been achieved by as service provider of another Party with respect to provision of a service, each Party shall accord national treatment to that service provider with respect to provision of that service.
>
> [However,] the treatment of a Party accords to service providers of another Party may different from the treatment the Party accords its own persons provided that:
>
> - the difference in treatment is no greater than that *necessary* for prudential, fiduciary, or health and safety reasons; and
> - such different treatment is equivalent in effect to the treatment accorded by the Party to its own persons in like circumstances. (Emphasis added)

See Note by the Secretariat, Material to be Considered with a View to Fulfilling the Mandate Given to the GNS in paragraph 11 of the Montreal Declaration (MTN.TNC/11), GATT Doc. No. MTN.GNS/W/90, 18 December 1989, pp. 11-15.

[484] The Shorter Oxford English Dictionary, Fifth Edition, 2002.

> Following a verb, adjective, or noun of quality denoting suitability, appropriateness, appointment, purpose, or design; following a noun or as a predicate indicating the possession of such a quality.[485]

This definition suggests that there must be a degree of causal connection between the means and the ends, or a measure in question must be designed to pursue the policy purpose that the measure serves. It means that the measure is intended for or aimed at prudential reasons. Specifically, the inconsistent measure in question must result from the pursuit of prudential reasons in the insurance sector, and for their part, prudential concerns ultimately require the existence of such a measure. Moreover, this causal connection must show a degree of suitability or appropriateness between the measure and policy objectives. In other words, the degree of causal connection between the inconsistent measure at issue and prudential reasons must be direct and substantial. Accordingly, the dictionary meaning of the term "for" indicates that while all measures may be aimed at prudential reasons, only measures that are suitable and appropriate are qualified.

The word "for" must also be interpreted in its "context and object and purpose of the treaty" pursuant to Article 31(1) of the *Vienna Convention*. As noted earlier, the object and purpose of the Annex is to guarantee liberalization in financial services without prejudice to consumer protection and the integrity of financial markets. Furthermore, the preamble of GATS stipulates the right of Members to regulate and introduce new regulations for the supply of services to pursue their legitimate policy objectives. The exercise of the right to introduce prudential regulations by WTO Members, nevertheless, must not damage the object and purpose of the multilateral trading system. While an expansive reading of the words "for prudential reasons" may seriously undermine other obligations, including the national treatment principle, a too narrow interpretation may diminish the right of WTO Members to regulate their financial markets in general and the insurance sector in particular. Accordingly, the context and purpose of the treaty is meant to ensure that obligations under GATS do not jeopardize WTO Members' rights to design measures intended for prudential purposes.

Nicolaidis and Trachtman, as noted earlier, have proposed an interpretation analogous to GATT Article XX(g), whereby in order for a measure to be considered as a prudential exception, it would need to be "primarily aimed at" prudential regulation.[486] In WTO jurisprudence, a discriminatory measure is proved as "relating to" only when it must be "primarily aimed at" the conservation of an exhaustible natural resource.[487] To be qualified for the "primarily aimed at" test, there must be a "substantial" or "close and real" connection between measures at dispute and the prudential reasons, and this connection is revealed by examining the general structure and design of the measures, as well as their legislative policy objectives.[488] The proposal of Nicolaidis and Trachtman is consistent with the ordinary meaning of the word "for" in its "context and purpose of the treaty" as described above. Measures which are justifiable by Annex paragraph 2(a), therefore, must be "primarily aimed at" prudential reasons.

3.3 Applying the anti-avoidance provision

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[485] *Id.*

[486] Nicolaidis and Trachtman (2000), pp. 255-256.

[487] Appellate Body Report, *US – Gasoline*, pp. 17-18; Appellate Body Report, *US – Shrimp*, paras. 137-141.

[488] Appellate Body Report, *US – Gasoline*, p. 18; Appellate Body Report, *US – Shrimp*, para. 141.

When a measure is found to be "primarily aimed at" the solvency of insurance service suppliers and the financial system, a third layer must be examined. This third layer investigates whether the application of that measure satisfies requirements under the second sentence of paragraph 2(a) of the Annex.

The dictionary meaning of the word "avoid" (verb) is "to keep (away) from, refrain from, or escape".[489] The word "use" is defined as "make use (a thing), esp. for a particular end or purpose", and the word "means in pl. (usu. treated as single)" denotes "an instrument, agency, method, or course of actions, by which some object is or may be attained, or some result is or may be brought about".[490] In conjunction, these dictionary meanings suggest an intent of WTO Members to escape their obligations and commitments while applying prudential measures. This definition would indicate that the prudential exception must not be applied in a way to restrict trade in insurance services under the multilateral framework. In other words, there is no protectionist intent in the application of measures designed for prudential reasons. While WTO Members have the right to regulate and introduce new regulations in the insurance sector, they must not escape their obligations and commitments under GATS. More specifically, the core requirement of the anti-avoidance provision as stated in the second sentence of paragraph 2(a) of the Annex is to prevent regulatory abuse by WTO Members in exercise of the prudential measures. This interpretation is supported by the negotiating history, whereby negotiators have been expressly concerned about the possibility of abusing the prudential exception.[491]

On the other hand, as described earlier, the interpretation of the chapeau of GATT Article XX and GATS Article XIV has been developed by panels and the Appellate Body. According to the Appellate Body, the ultimate object and purpose of the chapeau of GATT Article XX is to prevent "abuse or illegitimate use of the exceptions".[492] The Appellate Body in *US – Shrimp* noted that an abusive exercise by a Member of its own treaty right will give rise to both a breach of the treaty rights of the other Members and a violation of the treaty obligation of that Member.[493] In case of services, WTO jurisprudence in interpretation of GATT Article XX has been incorporated into interpretation of the chapeau of GATS Article XIV due to the textual similarities between GATT Article XX and GATS Article XIV.[494] It means that the chapeau aims to ensure that the exceptions of GATS Article XIV are not abused, and the manner that measure in question is applied could be identified by three standards, namely arbitrary discrimination, unjustifiable discrimination and disguised restriction on trade.

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[489] The Shorter Oxford English Dictionary, Fifth Edition, 2002.

[490] *Id.*

[491] *See* Note on the Meeting of 17-27 September 1991, Group of Negotiations on Services, GATT Doc. No. MTN.GNS/45, 18 October 1991, para. 14 (for Malaysian delegation and SEACEN). *See also* Note on the Meeting of 11-13 June 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/1, 5 July 1990, paras. 79 and 88 (for Canada and South Africa, respectively); Note on the Meeting of 13-15 September 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/3, 16 October 1990, para. 12.

[492] Appellate Body Report, *US – Shrimp*, para. 116; and Appellate Body Report, *US – Gasoline*, pp. 20 and 23.

[493] Appellate Body Report, *US – Shrimp*, para. 158.

[494] Panel Report, *US – Gambling*, paras. 6.571 and 6.581.

Nevertheless, in the words of the Panel in *US – Gambling*, there is an overlapping area between "arbitrary or unjustifiable discrimination" and "disguised restriction on trade" because disguised restrictions may cover disguised discrimination and other restrictions which constitute arbitrary or unjustifiable discrimination in international trade.[495] With regard to disguised restrictions, the Panel in *EC – Asbestos* noted that this term indicates an intention to conceal the pursuit of trade-restrictive objectives.[496]

Because of a similarity between the purpose of the anti-avoidance in Annex paragraph 2(a) and that of the chapeau of GATS Article XIV, there is a possibility that case law on the anti-avoidance provision in Annex paragraph 2(a) would rely on WTO jurisprudence developed by case law on the chapeau of GATS Article XIV in order to appraise the intent of avoiding obligations and commitments under the prudential exception.[497] In addition, during the negotiations of GATS, several delegations suggested a phrase analogous to the chapeau of GATT Article XX to prevent the abuse of prudential exception, whereby a Member must be able to regulate any necessary prudential measure so long as those prudential measures were "not arbitrary, unjustifiable, or discriminatory".[498] Therefore, it is arguable that in order for a measure pursuing prudential reasons to satisfy the anti-avoidance provision, the application of that measure must not constitute a disguised restriction. In other words, the protectionist intent of a WTO Member could be found by examining whether or not the application of prudential measures constitutes a disguised restriction on trade in insurance services, and then qualifies for the prudential exception.

Under WTO jurisprudence, different indicators have been developed to examine disguised restrictions on trade, including "foreseen burden as a result of",[499] and "the rigidity and inflexibility",[500] "the consistency",[501] of application of the measure. Moreover, the interpretation of the chapeau of GATT Article XX by the Appellate Body in both *US – Gasoline* and *US – Shrimp* indicates that the necessity criterion could be another indicator for examining the application of measures at dispute.[502] It means that the application of these

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[495] *Id.* para. 6.580. The same reasoning is found in Appellate Body Report, *US – Gasoline*, p. 23 that "disguised restriction… may properly be read as embracing restrictions amounting to arbitrary or unjustifiable discrimination in international trade taken under the guise of a measure formally within the terms of an exception listed in Article XX."

[496] Panel Report, *EC – Asbestos*, para. 8.236.

[497] Leroux (2002), p. 431, proposed that the comments of the Appellate Body in *US – Shrimp* on the chapeau of GATT Article XX could be instructive to this anti-avoidance in prudential exception.

[498] For example the US and Canada.

See Note on the Meeting of 10-25 July 1991, Group of Negotiations on Services, GATT Doc. No. MTN.GNS/44, 8 August 1991, para. 20. *See also* Note on the Meeting of 18-22 September 1989, Group of Negotiations on Services, GATT Doc. No. MTN.GNS/25, 23 October 1989, para. 241.

[499] Appellate Body Report, *US – Gasoline*, p. 27.

[500] A criterion for determining the unjustifiable and arbitrary character of discrimination is the rigidity and inflexibility of application of the measure, i.e. Sec. 609, which led to the legal effect that the United States authority granted or refused other Members the right to export shrimp to the United States.

See Appellate Body Report, *US – Shrimp*, paras. 163-164 and 177. *See also* Appellate Body Report, *US – Shrimp: Recourse to Article 21.5 of the DSU by Malaysia*, para. 144.

[501] In considering whether the United States discriminatory measures qualify for three standards of the chapeau, the Panel concluded that the application of the measures in dispute on prohibiting the remote supply of gambling and betting services, is not in a consistent manner between those supplied domestically and those that are supplied from other Members through cross-border transactions, and the Appellate Body upheld this consistency assessment.

See Panel Report, *US – Gambling,* para. 6.607; and Appellate Body Report, *US – Gambling*, para. 351.

[502] Neumann and Turk (2003), pp. 228-230.

prudential measures should not be more trade-restrictive than necessary to pursue prudential reasons.[503]

Another context of Annex paragraph 2(a) guaranteeing this anti-avoidance provision is found in Article VI:1 because the title of both Annex paragraph 2(a) and Article VI is "*Domestic Regulation"*. Measures of general application affecting trade in services must be "administered in a reasonable, objective, and impartial manner".[504] This broad scope of measures also covers prudential measures affecting trade in insurance services. It is arguable that the application of measures for prudential reasons must not be contrary to the spirit and the letter of fundamental requirements under Article VI.[505] In other words, although prudential measures may not constitute a disguised restriction on trade in insurance services, those measures and the use of those measures must also satisfy the requirements of GATS Article VI:1. Moreover, it may be useful to recall the object and purpose of GATS requiring transparency under the multilateral system on trade in services, which would be guaranteed by an appropriate exercise of the right under the prudential exception. The requirement of transparency would be guaranteed by an appropriate exercise of the right of WTO Members under the prudential exception.[506] Accordingly, it is submitted that those requirements of transparency, reasonableness, objectiveness and impartial manner would constitute one of the criteria for determining the "avoiding" character for application of inconsistent measures.

3.4 Burden of proof

As observed by Pauwelyn, GATT/WTO practice has established the rule that the party which invokes an exception or defense must prove it.[507] The Appellate Body in *US – Shirts and Blouses* specified that "the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defense."[508] The Appellate Body also stated that:

> We acknowledge that several … panels have required such proof of a party invoking a defense, such as those found in Article XX …, to a claim of violation of a GATT obligation… Article XX … [is] limited exceptions from obligations under certain other provision of the GATT 1994, not positive rules establishing obligations in themselves. They are in nature of

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[503] This necessity criterion is different to the necessity test, which examines the connection between measures at issue and policy objectives as provided under GATT Article XX and GATS Article XIV. On the one hand, policy objectives of measures are examined in the first and second layers, i.e. whether such measures are necessary to pursue specific policy goals. On the other hand, as the anti-avoidance provision puts an obligation on WTO Members to not abuse such prudential rights, the necessity criterion in the third layer examines the degree and scope of the application of such measures.

[504] GATS, Art. VI:1.

[505] In the context of GATT Article XX, the Appellate Body in *US – Shrimp*, para. 183, held that GATT Article X:3 [Publication and Administration of Trade Regulations] establishes certain minimum standards for transparency and procedural fairness in the administration of trade regulations.

[506] During negotiations on applying the national treatment principle to the financial services sector and the prudential exceptions, for example, the delegation from Mexico noted that the national treatment should allow for prudential regulations, and for their part, those prudential regulations must be applied in a transparent manner.

See Note on the Meeting of 11-13 June 1990, Working Group on Financial Services Including Insurance, GATT Doc. No. MTN.GNS/FIN/1, 5 July 1990, para. 54.

[507] Pauwelyn (1998), pp. 238-42.

[508] Appellate Body Report, *US – Shirts and Blouses*, p. 14.

> affirmative defenses. It is only reasonable that the burden of establishing such a defense should rest on the party asserting it.[509]

This means that a party who relies on exceptions to justify its WTO-inconsistent measures must provide evidence of justification. More specifically, the Panel in *US – Gasoline* asserted that the US, which invoked GATT Article XX(b), as justification must prove three issues.[510] First, the inconsistent measure falls under an exceptional heading. Second, there exists a connection between legitimate policy objectives and the inconsistent measure. Third, the measure is in compliance with the three standards of the chapeau.

For trade in services, this approach was confirmed by the Appellate Body in *US – Gambling* when it found that the Panel was correct in assuming the "burden of constructing the defense under GATS Article XIV(a) for the US" because they sought to justify their measures based on general exceptions.[511]

Accordingly, by relying on the prudential exception to justify measures applied in the insurance services sector found to be inconsistent with other GATS provisions, a WTO Member that invokes prudential justification must provide evidence that: (i) its inconsistent measures fall within the scope of "prudential reasons", (ii) such inconsistent measures must be "primarily aimed at" prudential reasons, and (iii) the application of inconsistent measures must not constitute disguised restrictions on trade in insurance services.

4. Reframing the two-stage approach: A balance between conditions of competition in Article XVII and prudential reasons in the Annex on Financial Services

As discussed in Chapter Two, section 5.3, the two-stage approach is proposed for the interpretation of Article XVII in order to determine, *firstly* whether a measure accords less favourable treatment to foreign services and service suppliers than the domestic like counterparts, and *secondly* whether that less favourable treatment, if found, could be justified under Article XIV. The second stage constitutes a countermeasure against the uncertainty in interpretation of the national treatment principle by balancing legitimate national policy objectives with allegedly protective measures against foreign services and service suppliers.

In the insurance sector, when a measure is found discriminatory against foreign services and service suppliers in the context of Article XVII by an objective assessment, WTO Members would be safe to provoke the prudential exception to justify the discrimination. As an exception under GATS, which maintains a flexibility for governments to purpose legitimate policy objectives in liberalization of the financial system, prudential reasons provided under Annex paragraph 2(a) represent the second stage in the two-stage approach towards interpretation of the national treatment principle in the insurance sector. The two-stage approach towards interpretation of the national treatment principle as it applies to the insurance sector, therefore, may be summarized by the analytical framework in Figure 5.

This approach consists of four elements for analysis:

(1) Confirming a measure in question falling within the scope of Article XVII (Box 1);

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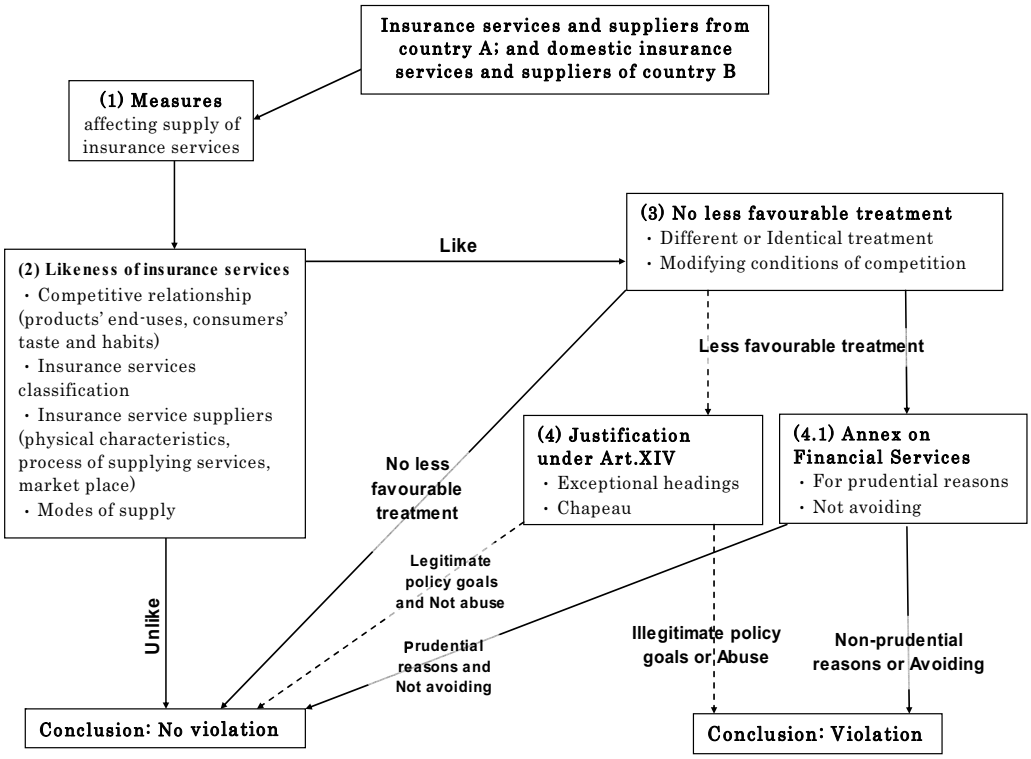
509 *Id.* pp. 15-16. (Footnotes omitted)
510 Panel Report, *US – Gasoline*, para. 6.20
511 Appellate Body Report, *US – Gambling*, para. 289.

(2) Confirming the likeness between foreign and domestic insurance services and service suppliers (Box 2);

(3) Ascertaining that the discriminatory measure accords to foreign insurance services and service suppliers irrespective of regulatory aims (Box 3); and

(4) Ascertaining that the discriminatory measure aims to pursue prudential reasons in a non-protectionist manner under Annex paragraph 2(a) (Box 4.1).

Figure 5: Analytical framework for interpretation of the national treatment principle in the insurance services sector: Two-stage approach



Fundamentally, the two-stage approach towards interpretation of the national treatment principle applied to the insurance sector is to determine whether the trade restrictive measure in question is acceptable based on balancing prudential concerns with trade restrictions on conditions of competition. Accordingly, when a measure is found discriminatory against foreign insurance services and service suppliers compared to domestic "like" counterparts in the context of Article XVII, by an objective assessment, it would (i) not constitute a violation of Article XVII if it falls within the scope of "prudential reasons" and qualifies the anti-avoidance provision; or (ii) constitute a violation of Article XVII if that measure does not fall within the scope of "prudential reasons" or the application of that

measure is proved to constitute a disguised restriction on trade in insurance services. In other words, while the first stage is aimed at revealing any discrimination, which is neutral to regulatory aims, among like insurance services and service suppliers, the second stage will distinguish the legitimate discrimination in pursuing prudential reasons. This means that a Member does not violate its obligation under the national treatment principle as it committed with regard to insurance services as far as its measure does not constitute discrimination with protectionist aims in the context of prudential exception.

Figure 6: Effective scope of the national treatment principle in the insurance services sector

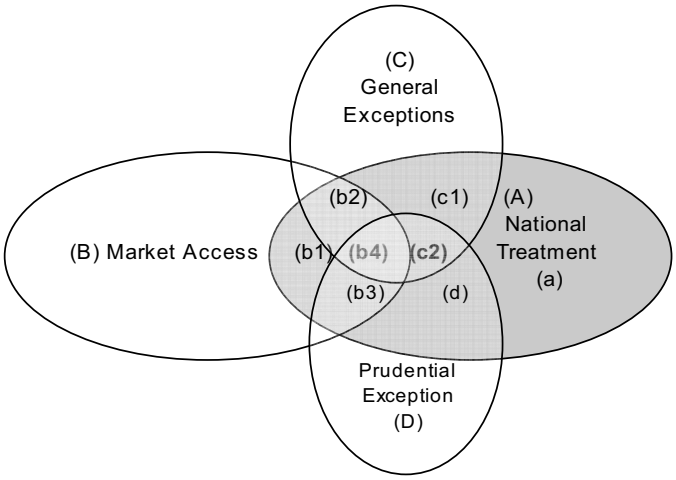


Figure 6 illustrates the effective scope of application of the national treatment principle in the insurance sector after employing the two-stage approach for interpretation. As described in Chapter Two, in relation with Article XVI on Market Access, the scope of the national treatment principle has been equal to the area of [(A) – (b)], where (b) = ∑ (b1), (b2), (b3), (b4). Moreover, by justifying discriminatory measures under the general exceptions, the effective scope of this principle is narrowed down to the area of [(A) – (b) – (c)], where (c) = ∑ (c1), (c2). The area governed by the prudential exception is named (D), which deals with not only the national treatment and market access obligations, but also other GATS articles. As far as Article XVII is concerned, the area [(d) + (c2)] indicates those measures, which violate Article XVII but are justifiable by the prudential exception.

There would be an overlapping scope between the prudential exception and general exceptions under GATS Article XIV. Certain measures could be found to fall exclusively within the scope of general exceptions, such as those measures necessary to protect public morals under Article XIV(a) or collection of direct taxes under Article XIV(d). Certain other measures could be found to fall exclusively within the scope of the prudential exception, such as regulations on technical provisions or investment rules as stipulated in insurance laws. However, a third category of measures could be found to fall within the scope of both GATS

Article XIV and the prudential exception. For example, some measures that fall within the scope of the prudential exception may also fall within the scope of a general exception for adoption and enforcement of measures "necessary to secure compliance with laws and regulations".[512] Specifically, those measures are designed to deal with "the effects of a default on services contracts" under GATS Article XIV(c)(i), or governmental measures on capital requirement of financial service supplier to enforce compliance with banking laws. This overlapping scope is illustrated by area [(b4) + (c2)]. It means that if a measure is found to accord less favourable treatment to foreign insurance services and service suppliers compared to domestic like counterparts under the meaning of GATS Article XVII in the first stage, a WTO Member may justify that measure by relying on Article XIV and/or the prudential exception in the second stage.

Therefore, in the insurance services sector, by employing the prudential exception as the second stage in examining whether a measure violates Article XVII, the effective scope of the national treatment principle is equal to the area of [(A) – (b) – (c) – (d)]. In other words, the prudential exception would probably re-determine the exact scope of application of the national treatment principle (the area (a)). By defining the scope of the national treatment principle, Members would be more willing to inscribe their specific commitments for further liberalization in insurance services.

5. Concluding remarks

The application of GATS national treatment principle to trade in insurance services would clearly define the proper space for WTO Members to pursue prudential regulations in this sector by examining the prudential exception based on three interpretative layers. WTO Members are entitled to introduce measures which are primarily aimed at the solvency of insurance service suppliers with a view to consumer protection as well as the stability and integrity of the financial system as a whole. However, in cases where these measures are inconsistent with the national treatment principle, WTO Members would be protected only if the application of these measures does not constitute disguised restrictions on trade in insurance services. Hence, the balance between trade and financial stability would be respected.

The interpretation of the prudential exception in insurance services might have a useful application in other financial services, such as the banking and securities services, to justify violations of GATS obligations and commitments, including the national treatment principle.

[512] Key (2005), p. 965.

According to the Panel in *US – Gambling*, para. 6.538, in order for a measure to secure compliance under GATS Article XIV (c), two requirements must be satisfied: (i) a measure must "enforce" the relevant laws and regulations, and (ii) that measure enforces "obligations" stipulated in those laws and regulations rather than merely ensure achieving their objectives.

CHAPTER FOUR
Post-Uruguay Round Negotiations on Insurance Services and National Treatment Commitments in Schedules of Selected Countries

As noted in Chapter One, the agreement on liberalization of the financial services sector, including insurance services, was achieved by the end of 1997, rather than at the time of conclusion of the Uruguay Round. This chapter provides a brief history of post-Uruguay round negotiation on this sector. The main part of this chapter reviews the specific commitments on insurance services with regard to the national treatment principle by the selected countries, namely the EC, US, Japan and China, in order to reexamine the interpretation of the national treatment principle in Chapter Two. The reasons for this selection are twofold. One is that the EC, EU, and Japan are the most developed insurance markets in the world. The other is that these countries have been involved both during and after the Uruguay Round negotiations on financial services, including insurance services. The case of China is included in order to examine subsequent practices of a newly acceded WTO Member after the conclusion of the financial service agreement in 1997.

In addition, an example of China's measure on the minimum capital requirement of branches of foreign non-life insurance companies shall be analyzed and tested through the application of the two-stage approach, framed in Chapter Three, towards interpretation of the national treatment principle in the insurance sector.

1. Post-Uruguay Round negotiations on insurance services: A brief history

1.1 The Second Protocol

Although in the Uruguay Round, by 15 April 1994, eighty countries (counting twelve EC member states individually) had made commitments on financial services,[513] there was no agreement among WTO Members on the liberalization of this service sector. As noted in Chapter One, section 2.2, the main reason was the dissatisfaction of developed countries, mainly the US, with the results achieved in financial services during the Uruguay Round, in exchange for extension of the MFN treatment. This was called the "free-riders" issue, where, from the US's point of view, other WTO Members, who undertook weak or no commitments on opening their financial services sector, would enjoy the US market-opening commitments

[513] Own calculation based on all commitments submitted by 15 April 1994. Two countries, which acceded to the WTO after 1995, namely Benin (22 February 1996) and Grenada (22 February 1996) are included in this calculation because they also submitted schedules of commitments by 15 April 1994.

Dobson and Jacquet (1998), p. 81, point out that there were seventy-six countries. In contrast, another figure shows that eighty-two countries made initial commitments on financial services at the end of the Uruguay Round in 1993. *See* Sapir, Andre. 1999. The General Agreement on Trade in Services: *From 1994 to the Year 2000*, *Journal of World Trade* 33(1), p. 59; and Das, Dilip K. 1998. Trade in Financial Services and the Role of the GATS: *Against the Backdrop of the Asian Financial Crisis*. *Journal of World Trade* 32(6), p. 81.

under the MFN treatment.[514] In the words of Dobson and Jacquet, one deadlock of the financial services negotiations was the unwillingness of many developing countries, and even Japan, to undertake "substantial and binding" commitments to liberalize their financial services sectors.[515]

Therefore, the Second Annex on Financial Services was incorporated into GATS in order to allow WTO Members a period of six months after the date of entry into force of the WTO Agreement, to review their commitments on financial services without offering compensation.[516] This Second Annex was made in contrary to GATS Article XXI on Modification of Schedules, which obliges a Member, while modifying or withdrawing any commitment in its Schedule, to provide compensatory adjustments.[517] It means that for financial services, WTO Members continued to carry out negotiations until the end of June 1995, and consequently, this deadline was extended to 28 July 1995.[518]

Before this deadline, the US announced that commitments on liberalization of financial services of some WTO Members, especially from emerging countries, were still unsatisfactory, and therefore, the US committed to bind only for existing operations of foreign financial companies.[519] In contrast, forty-three countries (counting fifteen EC member states separately) revised their commitments on financial services by the deadline of 28 July 1995.[520] Accordingly, in order to lock what was achieved in 1995, those improvements on financial services commitments were annexed to the Second Protocol to GATS, which entered into force on 1 September 1996 and lasted until 1 November 1997.[521]

As a result of the Second Protocol and new accessions to the WTO during 1995-1997, the total number of WTO Members who undertook commitments in financial services, had increased to ninety-six, in comparison with eighty countries at the end of the Uruguay Round.[522]

1.2 The Fifth Protocol

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[514] Jarreau (1999), p. 27.

[515] Dobson and Jacquet (1998), p. 81.

[516] GATS, Second Annex on Financial Services, para 2.

[517] GATS, Art. XXI.

[518] Dobson and Jacquet (1998), p. 81.

[519] Key (2005), p. 960.

[520] WTO. Financial Services Negotiations: The results of the financial services negotiations under the General Agreement on Trade in Services (GATS).

Available at http://192.91.247.23/english/tratop_e/serv_e/finance_e/finance_fiback_e.htm – Last visited 22 May 2006.

[521] *See* Second Protocol to the General Agreement on Trade in Services, 24 July 1995, WTO Doc. No. S/L/11; and Ministerial Decision on Adopting the Second Protocol, 24 July 1995, WTO Doc. No. S/L/13.

[522] Four WTO Members made commitments after the conclusion of the Uruguay Round: Kuwait (strictly speaking, Kuwait submitted its commitments on financial services for the first time in the Second Protocol, 28 July 1995), Lesotho (30 August 1995), Sierra Leone (30 August 1995, and Slovenia (30 August 1995). Twelve entrants to the WTO during 1996-1997 have included the financial services in their schedules of specific commitments: Angola (1 December 1996), Bulgaria (1 December 1996), Ecuador (21 January 1996), Gambia (23 October 1996), Haiti (30 January 1996), Mongolia (29 January 1997), Panama (6 September 1997), Papua New Guinea (9 June 1996), Qatar (13 January 1996), St. Kitts and Nevis (21 February 1996), Solomon Island (26 July 1996), and United Arab Emirates (10 April 1996).

The Second Decision on Financial Services adopted by the Council for Trade in Services on 21 July 1995 urged WTO Members to continue to modify or withdraw all or part of the specific commitments on financial services inscribed in their schedules by the end of 1997.[523] However, until the end of 1996, the Ministerial meeting at Singapore agreed to resume negotiations in the financial services sector from April 1997 in order to "significantly improve market access commitments with a broader level of participation."[524] Specific commitments on financial services sectors of seventy countries (counting fifteen EC member states separately) were submitted by 12 December 1997 and annexed to the Fifth Protocol to GATS.[525] The result of the Fifth Protocol has brought the total number of WTO Members who have specific commitments in financial services to 102 of the 132 WTO Members,[526] including five countries making commitments in financial services for the first time.[527]

According to Das, the most significant result of the Fifth Protocol is to make those commitments binding, whereby WTO Members agree to liberalize their financial services under the multilateral rules and disciplines.[528] In general, Dobson and Jacquet observed that the agreement on financial services guarantees a liberalization of insurance services better than the banking sector due to demands of insurance companies from developed countries as well as less developed insurance markets in developing countries.[529]

Fifty-two among seventy countries have opened market access through Mode 3 with respect to all four types of insurance services as provided in the Annex.[530] Among them, forty-five countries allow foreign insurers to establish wholly owned insurance subsidiaries or branches; seven countries allow only wholly owned insurance subsidiaries (Brazil, Chile, Indonesia, Jamaica, Nicaragua, South Africa, and Venezuela); and nine countries permit majority control of insurance subsidiaries (Egypt, Ghana, Kenya, Pakistan, the Philippines, Romania, Singapore, Slovenia, and Thailand).[531] With respect to Mode 1, twenty-seven countries undertook commitments on cross-border supply of marine, aviation and transport insurance, and thirty-five countries allow cross-border transactions on reinsurance and brokerage services.[532] By the deadline of 29 January 1999, fifty-three WTO Members

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[523] Second Decision on Financial Services, 24 July 1995, WTO Doc. No. S/L/9.

[524] Singapore Ministerial Declaration adopted on 13 December 1996, WTO Doc. No. WT/MIN(96)/DEC, 18 December 1996, para. 17.

[525] WTO News, 1997, Press releases, Press/86, 15 December 1997.
Available at www.wto.org/english/news_e/pres97_e/pr86_e.htm – Last visited 22 May 2006.

[526] This number goes up to 122 countries among 151 Members by 2007 because nineteen countries acceded to the WTO after the Fifth Protocol: Albania (8 September 2000), Armenia (5 February 2003), Cambodia (13 October 2004), China (11 December 2001), Croatia (30 November 2000), Estonia (13 November 1999), Former Yugoslav Republic of Macedonia (4 April 2003), Georgia (14 June 2000), Jordan (11 April 2000), Kyrgyz (20 December 1998), Latvia (10 February 1999), Lithuania (31 May 2001), Moldova (26 July 2001), Nepal (23 April 2004), Oman (9 November 2000), Saudi Arabia (11 December 2005), Chinese Taipei (1 January 2002); Tonga (27 July 2007); Vietnam (17 January 2007); and one WTO Member – Cote d'Ivoire – submitted its commitments in financial services in 18 November 1999.

[527] The five countries are: Bolivia, Costa Rica, Mauritius, Senegal, and Sri Lanka.

[528] Das (1998), p. 82.

[529] Dobson and Jacquet (1998), p. 90.

[530] Press Release, Office of the US Trade Representative, WTO Financial Services Negotiations, 13 December 1997. In Kennedy, Kevin C. 2003. A WTO Agreement on Investment: A Solution in Search of a Problem? *University of Pennsylvania Journal of International Economic Law* 24, p. 121.

[531] *Id.*

[532] *Id.*

(counting fifteen EC member states separately) accepted the Fifth Protocol, which entered into force on 1 March 1999.[533]

The reach of the agreement on financial services in December 1997 reflects a shift in attitude among developed and developing countries.[534] There was a significant change in the attitude of the US towards the offers of other WTO Members; although some offers remained "defective" or "inadequate" (in cases of Thailand and Malaysia), those offers should be "harvested" though a permanent agreement.[535] According to Key, another factor which would affect this attitude was the concessions by both Japan and Malaysia. While Japan accepted to extend the liberalizing measures agreed with the US to the multilateral framework, the Malaysian negotiators increased the ceiling limitations on foreign ownership in domestic insurers from 49 to 51 percent.[536] Moreover, the cooperative role between the US and EU has led to a situation where liberalization in the financial services sector was not a "transatlantic issue", and this joint effort in the negotiations would encourage other Members to adopt a cooperative attitude in liberalizing their financial services sectors.[537]

From the point of view of developing countries, the agreement on financial services is a response to pressure from the Asian crisis, information technology evolvement and increasing capital mobility.[538] The severity of the Asian financial crisis and "dramatic reversal in market sentiment towards Asia" forced governments to restore confidence from both domestic and foreign investors, and it was perceived that commitments under the multilateral framework could contribute to this attempt.[539] Specifically, in the words of Key, the Asian financial crisis put greater pressure on all WTO Members to finalize an "acceptable compromise" on liberalization of the financial services sector.[540]

2. Re-examining the scope of the national treatment principle

2.1 Scheduling methodology

Liberalization on trade in services is based on negotiations of specific commitments aimed at reducing or eliminating restrictions as well as securing overall balance of rights and obligations.[541] There are two ways of recording commitments: (i) horizontal commitments

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[533] *See* Fifth Protocol to the General Agreement on Trade in Services, 3 December 1997, WTO Doc. No. S/L/45; and Decision on Acceptance of the Fifth Protocol to the General Agreement on Trade in Services, adopted by the Council for Trade in Services, WTO Doc. No. S/L/68, 15 February 1999. *See also* Communication from Members which have accepted the Fifth Protocol to the General Agreement on Trade in Services, WTO Doc. No. S/L/67, 15 February 1999.

By February 2006, sixty-seven members (counting fifteen EC member states separately) have accepted the Fifth Protocol. Three remaining countries, which have not yet ratified the Fifth Protocol, are Brazil, Jamaica, and the Philippines. *See* Committee on Trade in Financial Services, Report of the Meeting held on 7 February 2006, WTO Doc. No. S/FIN/M/51, 24 February 2006, para. 3.

[534] Das (1998), pp. 81-82.

[535] Dobson and Jacquet (1998), p. 84.

[536] Key (2005), pp. 961-62.

[537] Dobson and Jacquet (1998), p. 84.

[538] *Id.* pp. 93-95.

[539] *Id.* p. 85.

[540] Key (2005), p. 961.

[541] GATS, Art. XIX:1.

that are applicable to trade in services in a number of sectors or sub-sectors, and (ii) sector-specific commitments, which govern the liberalization of sectors or sub-sectors concerned.[542] Members may select sectors or sub-sectors and modes of supply to be liberalized under the multilateral framework as well as inscribe any restrictions on market access and national treatment in their schedules.[543]

With regard to any sector or sub-sector and mode of supply, there are four levels of commitments.[544] First, no limitation or full commitment (None) refers to situations where a WTO Member accepts the full obligation with regard to market access and/or national treatment.

Second, no commitment (Unbound) is applicable when a Member is not obliged to undertake market access and/or national treatment obligations. In this case, Member is not required to refrain from introducing any restrictive measures, which is inconsistent with the market access or national treatment obligation.

Third, "Commitment with limitations" is applicable to a situation where Members reserve some measures inconsistent with obligations on market access and/or national treatment.

Last, there are some cases where a specific mode of supply may be not technically feasible, Members may make no commitments due to lack of technical feasibility (Unbound*).

2.2 Remarks about commitments on national treatment

The US made commitments on liberalization of insurance services with regard to direct insurance, both life and non-life, reinsurance and retrocession services, services auxiliary to insurance, including brokerage, agency, consultancy, actuarial, risk assessment, and claim settlement services.[545] Similarly, China undertook liberalization of its insurance services sector when it acceded to the WTO on 11 December 2001, namely life, health and pension/annuity insurance; non-life insurance; and services auxiliary to insurance.[546] Both EC and Japan, however, simply inscribe the heading of "insurance and insurance-related services" in their schedules of specific commitments.[547]

Table 2 summarizes specific commitments of the selected countries on national treatment by sub-sectors and modes of supply. The sub-sectors of insurance and insurance-related services are consistent with insurance service classification as provided by the Annex. As noted earlier, there are four levels for WTO Members to inscribe their commitments in the market access and national treatment columns. However, the fourth level of commitments

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[542] Scheduling of Initial Commitments in Trade in Services, Explanatory Note 1, MTN.GNS/W/164, 3 September 1993, paras. 20-21.

[543] *See* GATS, Art. XVIII.

Moreover, commitments, which may affect trade in services and not be subject to scheduling under either Article XVI or XVII, shall be inscribed in a column named "Additional Commitments".

[544] Scheduling of Initial Commitments in Trade in Services, Explanatory Note 1, MTN.GNS/W/164, 3 September 1993, paras. 24-28.

[545] US – Schedule of Specific Commitments, GATS/SC/90/Suppl.3, 26 February 1998, pp. 2-9.

[546] China – Schedule of Specific Commitments, GATS/SC/135, 14 February 2002, p. 28.

[547] EC – Schedule of Specific Commitments, GATS/SC/31/Suppl.4/Rev.1, 18 November 1999, p. 3; Japan – Schedule of Specific Commitments, GATS/SC/46/Suppl.3, 26 February 1998, p. 2.

(Unbound*) may be considered as a special case of "Unbound".[548] In addition, no schedule refers to the fourth level of commitments. Accordingly, each mode of supply consists of three levels of commitments, namely "None", "Unbound", and "Commitment with limitations".[549]

Table 2: Commitments on National Treatment: By sub-sectors and modes of supply

Modes of supply	Level of Commitments	Direct Insurance		Reinsurance/ Retrocession	Insurance Intermediation	Services auxiliary to insurance	Total entries
		(A) Life	(B) Non-life				
Mode 1	None	**2** (J, C)	**2** (J, C)	**2** (J, C)	**2** (J, C)	**3** (J, US, C)	**11**
	Unbound						**0**
	Commitment with limitations	**2** (EC, US)	**2** (EC, US)	**2** (EC, US)	**2** (EC, US)	**1** (EC)	**9**
Mode 2	None	**3** (J, US, C)	**3** (J, US, C)	**3** (J, US, C)	**3** (J, US, C)	**3** (J, US, C)	**15**
	Unbound						**0**
	Commitment with limitations	**1** (EC)	**1** (EC)	**1** (EC)	**1** (EC)	**1** (EC)	**5**
Mode 3	None	**2** (US, C)	**2** (US, C)	**2** (US, C)	**1** (C)	**2** (US, C)	**9**
	Unbound						**0**
	Commitment with limitations	**2** (EC, J)	**2** (EC, J)	**2** (EC, J)	**3** (EC, J, US)	**2** (EC, J)	**11**
Mode 4	None						**0**
	Unbound	**1** (US)	**1** (US)	**1** (US)	**1** (US)	**1** (US)	**5**
	Commitment with limitations	**3** (EC, J, C)	**3** (EC, J, C)	**3** (EC, J, C)	**3** (EC, J, C)	**3** (EC, J, C)	**15**
Total entries	None	**7**	**7**	**7**	**6**	**8**	
	Unbound	**1**	**1**	**1**	**1**	**1**	
	Commitment with limitations	**8**	**8**	**8**	**9**	**7**	

Notes: EC = European Communities; J = Japan; US = United States; C = China.

Source: EC – Schedule of Specific Commitments, GATS/SC/31/Suppl.4 dated 18 November 1999, pp. 3-9; Japan – Schedule of Specific Commitments, GATS/SC/46/Suppl.3 dated 28 February 1998, pp. 2-4; US – Schedule of Specific Commitments, GATS/SC/90 Suppl.3 dated 28 February 1998, pp. 2-14; China – Schedule of Specific Commitments, GATS/SC/135 dated 14 February 2002, pp. 28.

There are several observations noteworthy from the current commitments on national treatment by the selected countries.

First, commitment entries are different between Mode 1 and Mode 2, where the former is likely less liberal than the latter. The number of full commitments in Mode 2 is higher than that of Mode 1.[550] This may imply that Member governments may be more concerned with

[548] Scheduling of Initial Commitments in Trade in Services, Explanatory Note 1, MTN.GNS/W/164, 3 September 1993, para. 28.

Where the mode of supply thought to be inapplicable is in fact applicable, or become so in the future, the entry of "Unbound*" means "Unbound".

[549] *See* Scheduling of Initial Commitments in Trade in Services, Explanatory Note 1, MTN.GNS/W/164, 3 September 1993, para. 26.

Entry "Unbound except for" is counted as "Commitment with limitations".

[550] *See* Committee on Trade in Financial Services. "Technical Issues Concerning Financial Services Schedules", WTO Doc. No. S/FIN/W/9, 29 July 1996, paras. 10-11.

However, the difference between Modes 1 and 2 seems to be less significant in case of financial services in general and insurance services in particular. For example, in case of property insurance, a consumer of a

Mode 1 where consumers still locate within their own territories, while undertaking more liberal commitments in Mode 2. Another concern might be outward capital movement from the domestic market.

Second, in contrast to the other three modes of supply, the level of commitments in Mode 4 is substantially constrained in "Commitment with limitations", which usually appear in horizontal commitments rather than sector-specific commitments. The selected countries made a higher level of full commitments in Modes 1, 2 and 3 than that of Mode 4. In other words, the national treatment obligation would enjoy broader scope in the other three modes of supply.

Third, in Mode 4, the national treatment principle is extended only to certain categories of natural persons, particularly intra-corporate transferees, i.e. managers, executives and specialists, by the selected Members. This may suggest that Member governments prefer highly skilled personnel, who may transfer know-how, techniques and skill to local residents, and Mode 4 is considered as a supportive instrument to facilitate trade in insurance services through Mode 3.[551] Another implication might be to protect the domestic labour market, whereby job creation may result from promotion of commercial presence of foreign insurers, on the one hand, and prohibition of ordinary and less skilled foreigners, on the other hand.

Fourth, the schedules of specific commitments show that restrictive measures inscribed in the national treatment column by the selected countries cover, *inter alia*, tax measures and residency requirement.[552]

Last, as far as insurance and insurance-related services are concerned, a higher level of commitments were made in more international insurance services, such as reinsurance and retrocession, large commercial risks in non-life insurance, marine, aviation and transportation services, and insurance-related services, which may require professional skills. This may imply that the governments would be more willing to liberalize those services under Modes 1

Member purchases insurance policy from an insurer of another Member for his or her property in the latter Member. This transaction might be regarded as the consumption abroad under Mode 2 because his or her insured property is abroad, and the property insurance service is "delivered" outside the territory of the consumer in connection with the location of the property. On the other hand, the same transaction might be considered as cross-border supply of the property insurance service because the premiums are paid by the consumer in his or her home country, and the indemnity, if the risk occurs, shall be paid to the consumer in the home country. Accordingly, the service is "delivered" within the territory of the consumer under Mode 1.

[551] *See* OECD Working Party of the Trade Committee. 2003. Managing Request-Offer Negotiations under the GATS: the Case of Insurance Services. Paris: OECD (TD/TC/WP(2003)17), p. 9.

Although in insurance services sector, Mode 4 might be less significant than that in other services sectors, such as professional services, this mode may facilitate auxiliary services to insurance.

[552] *See* US – Schedule of Specific Commitments. GATS Doc. No. GATS/SC/90 Suppl.3, 28 February 1998, pp. 2-14; *see also* EU – Schedule of Specific Commitments. GATS Doc. No. GATS/SC/31/Suppl.4, 18 November 1999, pp. 3-9.

For example, under Mode 1, one per cent federal excise tax on all life insurance premiums covering US risks that are paid to companies not incorporated under US law in case of life insurance, and four per cent federal excise tax is imposed on all non-life insurance premiums covering US risks that are paid to companies not incorporated under US law. When more than 50 per cent of the value of a maritime vessel whose hull was built under federally guaranteed mortgage funds is insured by a non-US insurer, the insured must demonstrate that the risk was substantially first offered in the US market.

In case of the EU, concerning non-life insurance agency services under Mode 3, agent shall have his place of residence in Finland.

and 2. It would also indicate that these different insurance services sub-sectors are treated differently by the selected WTO Members.

2.3 Scope of the national treatment principle under the Understanding on Commitments in Financial Services

An alternative approach to undertaking the national treatment principle applicable to financial services in general and insurance services in particular is provided in the Understanding on Commitments in Financial Services (hereinafter the Understanding), which is a part of the Final Act of the Uruguay Round.[553] The intention of introducing the Understanding as an alternative approach is to provide a "formula that would facilitate undertaking commitments" in liberalization of financial services.[554] According to Jarreau (1999), the aim of this Understanding is to further clarify the national treatment principle in the field of financial services, which would improve predictability in trade in financial services.[555]

However, the main legal issue is to what extent the Understanding binds WTO Members for scheduling their commitments with respect to the national treatment principle in financial services in general and insurance services in particular. There is no provision that refers to the Understanding in either the framework of GATS or the Annex. Meanwhile, as described by Waincymer, the term "understanding" would suggest "something more" to clarify the ordinary meaning of the terms.[556] While in a strict legal sense, "understanding" has no validity, in a practical sense, if it is clearly acknowledged, the "understanding" is likely to have the legal effect of expressed rules.[557]

In the context of GATS, it is arguable that the process of "acknowledgment" is the practice of WTO Members to undertake specific commitments. Schedules of specific commitments, which apply to those service sectors and sub-sectors listed in a Member's schedule, constitute an integral part of GATS under Article XX:3.[558] Accordingly, it is submitted that although the Understanding is an alternative approach to Part III of GATS, and specifically the national treatment principle, it only binds Members who adhere to the Understanding in the event that they inscribe those obligations into their schedules of commitments with respect to the national treatment principle.[559]

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[553] The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Marrakesh, 15 April 1994.

[554] Committee on Trade in Financial Services, Report of the Meeting held on 26 February 2003, WTO Doc. No. S/FIN/M/39, 7 April 2003, para. 25.

[555] Jarreau (1999), pp. 39-40.

[556] Waincymer (2002), p. 380.

[557] *Id.*

[558] GATS, Art. XX:3.

[559] There are thirty-one Members (counting EC member states separately) expressly accepts the Understanding in scheduling their commitments in financial services: Australia (GATS/SC/6/Suppl.4 dated 26 February 1998), Bulgaria (GATS/SC/122/Suppl.2 dated 26 February 1998), Canada (GATS/SC/16/Suppl.4 dated 26 February 1998), Czech Republic (GATS/SC/26/Suppl.3 dated 26 February 1998), European Communities (15 Members) (GATS/SC/31/Suppl.4/Rev.1 dated 18 November 1999), Hungary (GATS/SC/40/Suppl.3 dated 26 February 1998), Iceland (GATS/SC/41/Suppl.2 dated 26 February 1998), Japan (GATS/SC/46/Suppl.3 dated 26 February 1998), Liechtenstein (GATS/SC/83-A dated 15 April 1994), New Zealand (GATS/SC/62/Suppl.2 dated 26 February 1998), Nigeria (GATS/SC/65/Suppl.1 dated 26 February 1998), Norway

Since the US, EU and Japan expressly adopted the alternative approach in scheduling their commitments on financial services, including insurance services,[560] several important aspects of the Understanding could clarify the scope of the national treatment principle.

Concerning insurance and insurance-related services supplied through Mode 1, certain insurance services in transportation, and reinsurance and retrocession services, as well as other services auxiliary to insurance are permitted to be supplied through cross-border transactions in accordance with the national treatment principle.[561] While according market access for those services under Mode 1, WTO Members are required to concurrently render the standard of "no less favourable" treatment. This would indicate that the national treatment principle shall be accorded to those foreign services upon their entry into the domestic market of a WTO Member.

With regard to established commercial presence of foreign service suppliers, firstly, the rights to establish and expand business activities, including acquisition of existing domestic companies, of foreign financial service suppliers are categorized under the heading of Market Access, rather than National Treatment.[562] This suggests that the right to establish a commercial presence falls into Article XVI on Market Access.

Second, the Understanding specifies obligation of each Member in granting to financial service suppliers of other Members established in its territory, under terms and conditions of the national treatment principle, access to payment and clearing systems operated by public entities and official funding and refinancing facilities available in the normal course of business.[563] The word "established" apparently indicates that the national treatment principle is applicable to those foreign service suppliers who have entered the domestic market of another Member.

Third, a WTO Member must ensure the national treatment principle be extended to financial service suppliers of other Members when "privileges or advantages" are granted to domestic service suppliers or the supply of services is conditional upon membership, participation, or access to any entity in that Member.[564] This obligation, nevertheless, is applicable to foreign service suppliers who are resident in that WTO Member.[565] Although there is no definition of the term "resident" in either GATS or the Understanding,[566] it is arguable that this treatment is only applicable to commercial presence of foreign insurers in supplying insurance services under Mode 3 to a WTO Member's domestic market. In other

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(GATS/SC/66/Suppl.4 dated 26 February 1998), Slovak Republic (GATS/SC/77/Suppl.3 dated 26 February 1998), Sri Lanka (for banking and other financial services excluding insurance, GATS/SC/79/Suppl.2 dated 26 February 1998), Switzerland (GATS/SC/83/Suppl.4 dated 26 February 1998), Turkey (GATS/SC/88/Suppl.3 dated 26 February 1998), United States of America (GATS/SC/90/Suppl.3 dated 26 February 1998).

[560] US – Schedule of Specific Commitments, GATS/SC/90/Suppl.3, 26 February 1998, p. 2; EC – Schedule of Specific Commitments, GATS/SC/31/Suppl.4/Rev.1, 18 November 1999, p. 2; Japan – Schedule of Specific Commitments, GATS/SC/46/Suppl.3, 26 February 1998, p. 2.

[561] The Understanding, para. B.3.

[562] *Id.* para. B.5.

[563] *Id.* para C.1.

[564] *Id.* para. C.2.

[565] *Id.* para. C.2. *See also* Leroux (2002), p. 440.

[566] *Id.* para. D.1 defines "non-resident" as follows:

> A non-resident supplier of financial services is a financial service supplier of a Member which supplies a financial service into the territory of another Member from an establishment located in the territory of another Member, regardless of whether such a financial service supplier has or has not a commercial presence in the territory of the Member in which the financial service is supplied.

words, a Member who agrees on this Understanding, shall accord the national treatment principle to those foreign financial service suppliers who have established commercial presence in its territory.

In summary, obligations in the Understanding will bind WTO Members as far as they schedule their specific commitments based on this alternative approach. This approach indicates that the scope of the national treatment principle could not broadly cover pre-establishment measures, which fall under the scope of the market access obligation.

2.4 Scope of the national treatment principle in the schedules

As discussed in section 4.1 of Chapter Two, the scope of the national treatment principle seems to be unclear when GATS Article XVI on Market Access is taken into account. The interpretation of the legal text of the national treatment principle implies a hierarchical relationship between Articles XVI and XVII. Specifically, the scope of the national treatment principle addresses all discriminatory measures, which do not fall within the ambit of Article XVI on Market Access.

Under their schedules of specific commitments, the selected WTO Members inscribe commitments on liberalization in insurance services in market access and national treatment columns. Therefore, in order to further clarify the scope of the national treatment principle as undertaken by the selected countries in their schedules of specific commitments, Table 3 represents the combinations of different levels of commitments inscribed in market access and national treatment columns. Accordingly, nine scenarios must be examined.

Table 3: Analytical scenarios on the scope of the national treatment principle

		National Treatment Column		
		None	Unbound	Commitment with limitations
Market Access Column	None	(1) Hierarchy	(4) No evidence but hierarchy	(7) No evidence but hierarchy
	Unbound	(2) Hierarchy	(5) No obligation	(8) No evidence but hierarchy
	Commitment with limitations	(3) Hierarchy	(6) Hierarchy	(9) Hierarchy

(i) Scenario (1)

In scenario (1), the entry "None" is inscribed in both market access and national treatment columns.[567] In other words, the full national treatment and full market access obligations are applied. As noted earlier, this scenario, nevertheless, has been dealt with by

[567] *See* US – Schedule of Specific Commitments. GATS Doc. No. GATS/SC/90 Suppl.3, 28 February 1998, pp. 2 and 11-14.

For example, with regard to supplying direct insurance services and services auxiliary to insurance, including insurance intermediation, the US inscribed "None" in both market access and national treatment columns under Mode 2.

Chapter Two, section 4.1, whereby the legal text would support a hierarchical relationship between Articles XVI and XVII.

(ii) Scenarios (2) and (4)

As far as scenario (2) is concerned, China inscribed "None" in the national treatment column and "Unbound" in the market access column with respect to supplying insurance brokerage services through Mode 2.[568] A legal point here is how entries "None" and "Unbound" are interpreted in case of those discriminatory measures falling within the overlapping area between Article XVI and XVII?

One interpretative option is that "None" prevails over "Unbound".[569] Consequently, a WTO Member must refrain not only from applying any measure that is inconsistent with the national treatment obligation, but also from introducing any discriminatory measure that falls within the scope of the market access obligation. In other words, while a Member is entitled to introduce only quantitative restrictions under Article XVI, that Member must ensure that those restrictions do not discriminate between domestic and foreign services and service suppliers. This interpretation, however, probably limit the scope of Article XVI because only non-discriminatory restrictions are allowed.[570] When a WTO Member inscribes a full commitment on the national treatment principle in a specific mode of supply, "no less favourable" treatment will be entirely bound for that mode.[571] This would mean that the inscription of "None" require Members to observe only the national treatment obligation, but not the obligations in Article XVI.

Moreover, as far as scenario (4) is taken into account,[572] i.e. the entry of "Unbound" inscribed in the national treatment column and "None" in the market access column, because the inscription of "None" in market access prevails over "Unbound" in national treatment, a WTO Member is required to remove all discriminatory measures that fall into Article XVI as well as Article XVII. This interpretation probably contradicts the intent of that WTO Member when inscribing "Unbound" in the national treatment column.

Another interpretation is that "Unbound" overrides "None". This reading may be supported by the progressive approach to service liberalization under GATS, whereby a negative listing would commence with "Unbound" and WTO Members liberalize their service

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[568] China – Schedule of Specific Commitments. WTO Doc. No. GATS/SC/135, 14 February 2002, p. 28.

[569] For example, the proposal of Switzerland.

See Council for Trade in Services, Report of the Meeting held on 14 May 2003, WTO Doc. S/C/M/66, 18 June 2003, paras. 26 and 29.

[570] For example, the argument of Hong Kong, China.

See Committee on Specific Commitments, Report of the Meeting held on 29 September 2003, WTO Doc. S/CSC/M/30, 1 December 2003, para. 42.

[571] *See* Guidelines for the Scheduling of Specific Commitments under the General Agreement on Trade in Services (GATS), adopted by the Council for Trade in Services on 23 March 2001, WTO Doc. No. S/L/92, 28 March 2001, para. 43.

If a member make a commitment under Art. XVI in a sector where commercial presence is limited to partnership, an entry "None" in the national treatment would refer to the whole mode of supply, and not only to partnership.

[572] *See* Bolivia – Schedule of Specific Commitments, GATS/SC/12/Suppl.2, 26 February 1998, p. 3.

Although this reverse scenario did not appear in the schedules of specific commitments of the selected countries, it exists in the schedule of, for example, Bolivia, where entries "None" and "Unbound" are inscribed in market access and national treatment column, respectively, under Mode 3 in supply of insurance intermediation.

markets by undertaking "None".[573] Under scenario (2), "Unbound" in market access could cover not only non-discriminatory measures, but also all discriminatory measures, which fall into Articles XVI and XVII. In other words, a WTO Member would be entitled to introduce discriminatory measures under the national treatment column. This situation is clearly contrary to the expectation of other WTO Members when that Member inscribes "None" in the national treatment column in its schedule.

Additionally, in scenario (4), while a Member could not introduce any non-discriminatory measures which fall into Article XVI, it could take any discriminatory measure in both Articles XVI and XVII. This situation, nevertheless, facilitates WTO Members to introduce discriminatory measures, which absolutely is not the intention of the drafters of GATS. In *US – Gambling* case, the Panel interpreted the inscription "None" in the market access column as "a full market access" commitment, whereby a Member is obliged to refrain from maintaining any of the six limitations and measures listed in Article XVI:2.[574]

Because neither interpretation proves to be persuasive, it is submitted that the entry of "None" would mean no limitation in the inscribed column, i.e. market access or national treatment only, and the entry of "Unbound" would mean no commitment in the inscribed column, i.e. market access or national treatment only. "Unbound" in the market access column deals with all discriminatory and non-discriminatory measures which fall within the scope of Article XVI only, while inscribing "None" in the national treatment column, WTO Members are only required to guarantee the no less favourable treatment when adopting those measures that fall exclusively into Article XVII.[575] Therefore, while China is required to accord to foreign insurance brokerage services supplied through Mode 2 treatment no less favourable than that of domestic "like" services under the meaning of Article XVII, China has the right to introduce other discriminatory measures, which fall within the scope of Article XVI:2, against foreign insurance brokerage services.

In the reverse scenario, "None" in the market access column addresses all six limitations and measures stipulated in Article XVI, and by inscribing "Unbound" in the national treatment column WTO Members are entitled to introduce all discriminatory measures that fall exclusively under Article XVII. This would mean that Members are not required to guarantee national treatment even when foreign services and service suppliers are allowed to enter a domestic insurance market.

Accordingly, the interpretation of scenarios (2) and (4) would indicate that the overlapping area between the national treatment and market access obligations shall be governed by commitments inscribed in the market access column.

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[573] For example, the arguments of Philippines and Brazil.

See Council for Trade in Services, Report of the Meeting held on 14 May 2003, WTO Doc. S/C/M/66, 18 June 2003, paras. 35-36; the Meeting held on 28 February 2003, WTO Doc. S/C/M/65, 21 March 2003, para. 21.

[574] Panel Report, *US – Gambling*, para. 6.279.

[575] *See* Mattoo (1997), p. 118.

According to Mattoo (1997), this interpretation is supported by Art. XX:2, whereby all measures, which are inconsistent with only Art. XVI as well as both Articles XVI and XVII, are governed by the entry "Unbound" in the market access column, and consequently, Art. XVII addresses those discriminatory measures not falling in the domain of Art. XVI. However, in response to his proposal, it is useful to revisit Art. XX:2. The wording of Art. XX:2 specifically refers that measures inconsistent with both Articles XVI and XVII "shall be inscribed" in the market access column. It would mean that Art. XX:2 does address the relationship between entries "None" nor "Unbound", but only situation where Members intend to inscribe any restrictions on market access and/or national treatment, i.e. the entry of "Commitment with limitations".

(iii) Scenarios (3) and (7)

Under scenario (3), while the US schedules no limitation on the national treatment column with regard to both life and non-life insurance services supplied through Mode 3, branches of foreign insurers are not permitted to supply surety bond for US federal government contracts under market access commitments.[576]

If "None" overrides "Commitment with limitations", the scope of the national treatment obligation would cover all discriminatory measures, and it would limit the scope of the market access obligation to only non-discriminatory measures. Accordingly, all discriminatory measures, which fall within Article XVI, would be eliminated. The US, therefore, was required to allow branches of foreign insurance service suppliers to supply surety bonds for US federal government contracts. This interpretation obviously contradicts the US intention when inscribing a limitation on the market access column.

The same conclusion is also found in scenario (7) where the scope of the market access obligation would cover all discriminatory and non-discriminatory measures.[577] WTO Members, therefore, had refrained from applying any discriminatory measure under the meaning of either Article XVI or XVII. This interpretation would render useless limitation intended by WTO Members when inscribing in the national treatment column.

In the opposite case, if "Commitment with limitations" overrides "None", in scenario (3), WTO Members could impose restrictions not only on market access but also on national treatment. It would mean that the US could apply discriminatory measures against branches of foreign insurance companies under the meaning of Article XVII. This interpretation apparently narrows down the scope of the national treatment obligation committed by the US to "Commitment with limitations" or even "Unbound", and consequently contradicts the inscription of "None" by the US in its schedule.

As far as scenario (7) is concerned, WTO Members would extend their limitations as inscribed in the national treatment column to prohibit market access. This interpretation would be contrary to the intent of WTO Members when inscribing "None" in the market access column. In addition, as noted earlier, the Panel in *US – Gambling* concluded that "None" in the market access column means "a full market access" commitment.

Accordingly, it is submitted that the entry of "None" would mean no limitation in the inscribed column, i.e. market access or national treatment only, and the entry of "Commitment with limitations" would permit WTO Members to reserve their rights to impose several restrictions as inscribed in the corresponding column, i.e. market access or national treatment only. The examination of commitments on scenarios (3) and (7) would indicate that the overlapping area between the national treatment and market access obligations is governed by commitments inscribed in the market access column.

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[576] US – Schedule of Specific Commitments, GATS/SC/90 Suppl.3, 28 February 1998, p. 3.

[577] *See* Thailand – Schedule of Specific Commitments, GATS/SC/85/Suppl.3, 26 February 1998, p. 2.

Although scenario (7) did not appear in the schedules of specific commitments of the selected countries, it exists in, for example, Thai schedule of specific commitments. While there is no limitations under market access column on supplying life insurance services through Mode 2, premiums on life insurance services supplied by foreign insurers under Mode 2 are not tax deductible similarly to that accords to holders of policies issued by local life insurers.

(iv) Scenario (5)

There is no evidence on this scenario in schedules of specific commitments of the selected countries. However, as the entry of "Unbound" is inscribed in both the market access and national treatment columns, there is no obligation on market access or national treatment. The problem of overlapping area, therefore, does not occur in this scenario.

(v) Scenarios (6) and (8)

Under scenario (6), while inscribing no commitments in the national treatment column with regard to insurance and insurance related services supplied through Mode 4 (Unbound), the US extends market access on temporary entry and stay of certain categories of natural persons.[578] If "Unbound" prevails over "Commitment with limitations", the US would only be allowed to apply market access restrictions on a non-discriminatory basis.

In contrast, if "Commitment with limitations" overrides "Unbound", as far as scenario (8) is concerned,[579] WTO Members would not be allowed to apply all discriminatory measures except for those inscribed in the national treatment column. It would mean that any discriminatory measures within the scope of Articles XVI and XVII must be eliminated. This interpretation, therefore, would lead to a situation such that the entry "Unbound" in the market access column is effective only for non-discriminatory measures, and consequently, excludes discriminatory measures from the scope of Article XVI.

Accordingly, the entry "Unbound" means no commitments with regard to the column concerned, i.e. either market access or national treatment. "Commitment with limitations" in either market access or national treatment column shall cover measures which fall within the scope of Article XVI or XVII, respectively. Scenarios (6) and (8) would suggest the hierarchy between the market access and the national treatment principle.

(vi) Scenario (9)

With regard to both life and non-life insurance services, concurrently with imposing restrictions on market access of government-owned or government-controlled insurance companies under Mode 1, the US also imposes excise tax on insurance premiums paid to foreign insurance companies under the national treatment principle.[580] Other examples of scenario (9) are China and Japan, where both countries undertake no horizontal commitments in the supply of services under Mode 4 with regard to the national treatment obligation,[581]

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[578] US – Schedule of Specific Commitments, GATS/SC/90, 15 April 1994, p. 1.

[579] *See* Israel – Schedule of Specific Commitments, GATS/SC/44/Suppl.2, 26 February 1998, p. 3.

An example of another WTO Member which undertakes "None" in the market access column and the entry of "Commitment with limitations" in the national treatment column is Israel with regard to consumption abroad of non-life insurance services. The limitation inscribed in the national treatment column is that compulsory car insurance must be purchased in Israel from an insurance company established in Israel and licensed by the Israeli commissioner of insurance.

[580] US – Schedule of Specific Commitments, GATS/SC/90 Suppl.3, 28 February 1998, p. 2.

[581] *See* Scheduling of Initial Commitments in Trade in Services, Explanatory Note 1, MTN.GNS/W/164, 3 September 1993, para. 26.

The entry of "Unbound except for…" belongs to the second level of commitment, i.e. "Commitment with limitations".

except for measures affecting the "categories of natural persons referred to under market access".[582]

However, for scheduling purposes as provided in Article XX:2 of GATS, measures inconsistent with both Article XVI and XVII shall be inscribed into the market access column.[583] This would indicate that, in this scenario, commitments on market access shall apply to the overlapping area between the market access and national treatment obligations.

In summary, the above-analyzed scenarios on the scope of the national treatment principle through the specific commitments by the selected countries demonstrate that Article XVII applies to all discriminatory measures which do not fall under the realm of Article XVI on Market Access.

3. Revisiting likeness

3.1 Reconfirming uncertainty of service classification

As mentioned in Chapter Two, section 4.3, the services sectoral classification list was developed by the GATT Secretariat for the purpose of negotiations during the Uruguay Round. This classification list covers twelve broad service sectors in the left column, which are corresponding to the UN CPC in the right column. The relevant section of the WTO Classification in the insurance sector is as follows[584]:

SECTORS AND SUB-SECTORS		CORRESPONDING CPC
7.	FINANCIAL SERVICES	
A.	All insurance and insurance-related services	812**
a.	Life, accident and health insurance services	8121
b.	Non-life insurance services	8129
c.	Reinsurance and retrocession	81299*
d.	Services auxiliary to insurance (including broking and agency services)	8140

Note:
* The (*) indicates that the service specified is a component of a more aggregated CPC item specified elsewhere in this classification list.
** The (**) indicates that the service specified constitutes only a part of the total range of activities covered by the CPC concordance.

UN CPC numbers 812 and 814, corresponding to sub-sector 7.A (All insurance and insurance-related services) of the WTO Classification are broken down as follows[585]:

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[582] *See* China – Schedule of Specific Commitments, GATS/SC/135, 14 February 2002, p. 3; Japan – Schedule of Specific Commitments, GATS/SC/46, 15 April 1994, p. 1.
[583] GATS, Art. XX:2.
[584] GATT. Services Sectoral Classification List, GATT Doc. No. MTN.GNS/W/120, 10 July 1991.
[585] *See* Provisional Central Product Classification of the United Nations (Provisional CPC), 1989.

812 Insurance (including reinsurance) and pension fund services, except compulsory social security services
- 8121 Life insurance and pension fund services
  - 81211 Life insurance services
  - 81212 Pension and annuity services
- 8129 Non life insurance services
  - 81291 Accident and health insurance services
  - 81292 Motor vehicle insurance services
  - 81293 Marine, aviation and other transport insurance services
  - 81294 Freight insurance services
  - 81295 Fire and other property damage insurance services
  - 81296 Pecuniary loss insurance services
  - 81297 General liability insurance services
  - 81299 Other insurance services n.e.c

814 Services auxiliary to insurance and pension funding
- 8140 Services auxiliary to insurance and pension funding
  - 81401 Insurance brokering and agency services
  - 81402 Insurance and pension consultancy services
  - 81403 Average and loss adjustment services
  - 81404 Actuarial services
  - 81405 Salvage administration services
  - 81299 Other services auxiliary to insurance and pension funding

As noted by the WTO Secretariat, there are four main differences between the WTO Classification and the UN CPC with regard to insurance and insurance-related services,[586] namely:

(i) accident and health insurance are included in "life" insurance instead of "non life" insurance as in the UN CPC;

(ii) reinsurance and retrocession services, which are not in a specific category in the UN CPC but included in "other insurance services", are separated as a sub-sector of insurance services in the WTO Classification;

(iii) pension fund management services are separated from life insurance services to be included in asset management services under "banking and other financial services" in the WTO classification; and

(iv) "insurance brokering and agency services" and other services auxiliary to insurance are combined as a sub-sector in insurance service in the WTO Classification.

The definition of insurance services in the Annex also differs to that of the WTO Classification.[587] In specific, the Annex distinguishes "insurance intermediation" from

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Available at http://unstats.un.org/unsd/cr/registry/regcs.asp?Cl=9&Lg=1&Co=81 – Last visited 5 October 2007.

[586] WTO Secretariat. Background Note on Financial Services, Council for Trade in Services, WTO Doc. No. S/C/W/72, 2 December 1998, para. 9.

[587] In addition to the WTO and CPC classifications, in the financial services sector, WTO Members may also employ the Annex on Financial Services for scheduling. Paragraph 16 of the Scheduling of Initial Commitments in Trade in Services, Explanatory Note 1, MTN.GNS/W/164, 3 September 1993, reads in part as follows:

> … In general the classification of sectors and sub-sectors should be based on the Secretariat's revised Services Sectoral Classification List. Each sector contained in the Secretariat list is identified by the corresponding Central Product Classification (CPC) number. Where it is

"insurance-related services" and explicitly specifies several services to include consultancy, actuarial, risk assessment and claim settlement services.[588] In addition, life and non-life insurance services are categorized under the same sub-sector of "Direct insurance".

The schedules of specific commitments of the selected countries may demonstrate these differences among those services classification lists.

First, as Japan specifically refers to the Annex in its schedule, it may indicate that Japan based its commitments on the Annex. Accordingly, it could be said that insurance intermediation (brokerage and agency) and services auxiliary to insurance (consultancy, actuarial, risk assessment and claim settlement services) are unlike because they are classified under different sub-sectors in Japan's Schedule of Specific Commitments. However, different to Japan, the US is strictly consistent with the numbering of insurance sub-sectors, namely life, non-life, reinsurance, and services auxiliary to insurance as provided in the WTO Classification. As noted earlier, in the WTO classification insurance intermediation is included into the sub-sector of "Services auxiliary to insurance". Therefore, it might be argued that insurance intermediation (brokerage and agency) and services auxiliary to insurance (consultancy, actuarial, risk assessment and claim settlement services) are alike because they are classified under the same sub-sector in the US's Schedule of Specific Commitments.

Second, the EC does not mention the relevant services classifications for their undertaking commitments on insurance and insurance related services. The EC simply inscribed sub-sector "A. Insurance and insurance-related services". If the EC's Schedule of Specific Commitments is interpreted based on the Annex, the likeness might be not established between insurance intermediation and services auxiliary to insurance. However, if the EC follows the UN CPC, reinsurance services and non-life insurance services might be alike because they are classified under the same sub-sector of "Non-life insurance services".

Third, China clearly inscribes health insurance services in the same category with life insurance services, which are under sub-sector 7.A (a) of its schedule.[589] In addition, China follows the same order as provided in the WTO Classification. It may suggest that China bases its commitments on the WTO Classification. Accordingly, likeness could not be established among life, non-life, reinsurance, and services auxiliary to insurance because they are classified under different sub-sectors in China's Schedule of Specific Commitments. However, the likeness might be found between insurance intermediation (brokerage and agency) and services auxiliary to insurance (consultancy, actuarial, risk assessment and claim settlement services) because the WTO Classification expressly incorporates brokerage and agency services into the sub-sector of "Services auxiliary to insurance".

In short, the examination reveals that the schedules of specific commitments have not been developed in a consistent and uniform manner. Some Members employed the Annex as a basis for scheduling, while others used the UN CPC or WTO Classification. Consequently, this scheduling practice confirms that the scope of likeness in Article XVII is broad and uncertain if panels rely only on the criterion of service classification.

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necessary to refine further a sectoral classification, this should be done on the basis of the CPC or other internationally recognized classification (e.g. Financial Services Annex)… (Footnote omitted)

[588] WTO Secretariat. Background Note on Financial Services, Council for Trade in Services, WTO Doc. No. S/C/W/72, 2 December 1998, para. 10.

[589] China – Schedule of Specific Commitments, GATS/SC/135, 14 February 2002, p. 28.

3.2 Likeness by reference to modes of supply and "like" service suppliers

As discussed in Chapter Two, section 4.3, the reference to modes of supply and likeness of service suppliers for interpretation of the national treatment principle would narrow down the scope of likeness as a whole. It is clearly significant for understanding this principle in each specific case as Article XVII:1 depends on "any conditions and qualifications" set out in the inscribed sectors or sub-sectors in WTO Members' schedules.

Table 2 reveals that no WTO Member undertakes the entry "None" in the national treatment column across all four modes of supply with respect to any sub-sector of insurance and insurance related services. It suggests that there are significant differences in commitments on national treatment among modes of supply. The US, while rendering full commitments on national treatment under Modes 2 and 3 in supplying direct insurance services, does not extend this treatment to cross-border transactions.[590] Similarly, in reinsurance services and services auxiliary to insurance, the US inscribes "None" in Modes 2 and 3, but "Commitment with limitations" in Modes 1 and 4.

Even new entrant, China, also inscribes "None" on the national treatment column with regard to only cross-border supply and consumption abroad, and reserves several limitations in Modes 3 and 4.[591] In Japan's Schedule of Specific Commitments, while undertaking full commitments on national treatment with regard to Modes 1 and 2, there are some limitations on national treatment in supplying all insurance and insurance-related services through Modes 3 and 4.[592]

These practical evidences on scheduling commitments of the selected countries would suggest clear intention of the WTO Members to treat insurance services differently under different modes of supply with regard to the national treatment obligation. However, the schedules of specific commitments by the selected countries do not provide any relevant evidence for examining likeness of service suppliers.[593]

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[590] US – Schedule of Specific Commitments, GATS/SC/90 Suppl.3, 28 February 1998, pp. 2-3.

[591] China – Schedule of Specific Commitments, GATS/SC/135, 14 February 2002, pp. 28-32.

[592] Japan – Schedule of Specific Commitments, GATS/SC/46/Suppl.3, 28 February 1998, pp. 2-4;

[593] *See* Thailand – Schedule of Specific Commitments, GATS/SC/85/Suppl.3, 26 February 1998, pp. 3-4; and Singapore – Schedule of Specific Commitments, GATS/SC/76/Suppl.3, 26 February 1998, pp. 3-4.

In schedules of specific commitments of other WTO Members, for example, Thailand has differentiated the level of foreign ownership in a commercial presence in order to extend the national treatment principle for "service auxiliary to insurance" supplied through Mode 3. Thailand undertook no commitments on the standard of "no less favourable" treatment with regard to commercial presence of foreign supplier, whose foreign equity participation exceeds forty-nine percent, in supplying insurance consultancy and average and loss adjustment services. This practice would indicate that while Thai companies and commercial presence of foreign companies in Thailand to supply the same "service auxiliary to insurance" through Mode 3, those commercial presences with foreign equity participation exceeding forty-nine percent are not subject to the "no less favourable treatment".

Another example is that, in the horizontal commitments, Singapore provides that commercial presence of foreign service suppliers must have a local manager and at least one director being locally resident. In addition, all branches of foreign companies that are registered in Singapore must have at least two locally resident agents. Although these two evidences, arguably relate to the physical characteristics of service suppliers in supplying insurance services through Mode 3, they do not clearly indicate the comparison of likeness between domestic and foreign insurers. Moreover, there is no evidence for comparing service suppliers in supplying insurance and insurance-related services through other modes of supply in the scheduling practice among these WTO Members.

4. Case study: China's measure on non-life insurance services[594]

China's Insurance Law was enacted in June 1995 and amended in October 2002.[595] Under China's Insurance Law, the requirement of having a minimum of Yuan 200 million (approximately US$ 24 million) in registered capital must be satisfied in order to set up an insurance company.[596] This requirement is applicable to both domestic and joint-venture insurance companies. However, in circumstances where foreign insurers wish to establish wholly owned branches in China to conduct non-life insurance business, they must also satisfy the minimum registered capital of no less than Yuan 200 million.[597]

During the transitional review under Section 18 of the Protocol on the Accession of the People's Republic of China,[598] several WTO Members raised concerns on China's excessively high minimum capital requirements for financial services, including insurance services.[599]

In response to those concerns, China based its arguments on three main reasons. Firstly, the measure on minimum capital requirements does not fall within the scope of Article XVII because it application is transparent and non-discriminatory.[600] Secondly, such a measure is in compliance with the prudential reasons, which are allowed by GATS.[601] Thirdly, the key element in assessing the prudential aspect of a measure is whether it is prudential to a particular Member.[602]

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[594] This section draws from Vu Nhu Thang (2007a), pp. 88-123.

[595] WTO. Trade Policy Review – China, Report by the Secretariat, WT/TPR/S/161, 28 February 2006, p. 221, para. 185.

[596] *Id.* p. 222, paras. 189-190. *See also* Art. 6.3 of Regulations on Administration of Insurance Companies of the China Insurance Regulatory Commission, effective as of 15 June 2004.

Available at http://www.circ.gov.cn – Last visited 2 April 2006.

[597] *Id.* p. 222, para. 190. *See also* Art. 7 of Regulations of the People's Republic of China on Administration of Foreign-funded Insurance Companies *(Adopted at the 49th Executive Meeting of the State Council on December 5, 2001, promulgated by Decree No. 336 of the State Council of the People's Republic of China on December 12, 2001, and effective as of February 1, 2002)*.

Available at http://english.gov.cn/laws/2005-08/24/content_25818.htm – Last visited 2 April 2006.

[598] *See* Accession of the People's Republic of China, Decision of 10 November 2001, WTO Doc. No. WT/L/432, 23 November 2001, p. 11.

Section 18 titled as "Transitional Review Mechanism" requires the subsidiary bodies of the WTO and the General Council to conduct the review on the implementation by China of the WTO Agreement and of the related provisions of the China's Accession Protocol in every year after the accession and for the period of eight years.

[599] For example, Communication from Japan, WTO Doc. No. S/FIN/W/36, 28 October 2004; Communication from the European Communities, WTO Doc. No. S/FIN/W/39, 8 November 2004; Communication from the United States, WTO Doc. No. S/FIN/W/40, 8 November 2004; and Communication from Chinese Taipei, WTO Doc. No. S/FIN/W/41, 15 November 2004.

[600] Committee on Trade in Financial Services, Report of the Meeting held on 23 November 2004, WTO Doc. No. S/FIN/M/47, 26 November 2004, paras. 54-55.

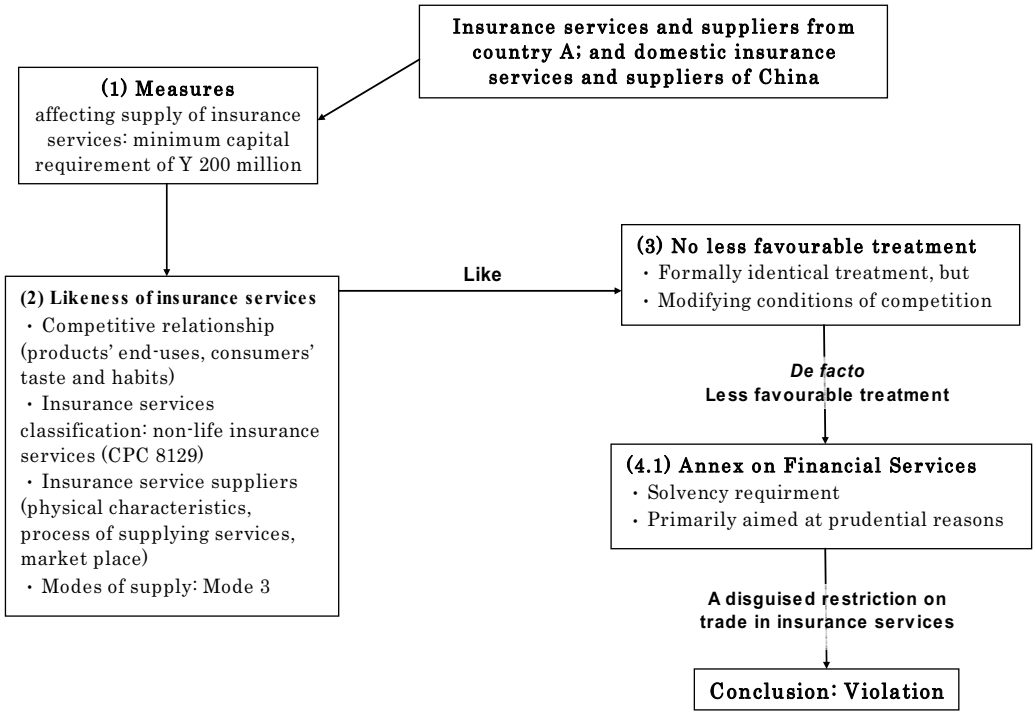
[601] Committee on Trade in Financial Services, Report of the Meeting held on 19 September 2005, WTO Doc. No. S/FIN/M/50, 23 September 2005, para. 17.

[602] Committee on Trade in Financial Services, Report of the Meeting held on 23 November 2004, WTO Doc. No. S/FIN/M/47, 26 November 2004, para. 75.

The legal issue for this examination is whether the China's measure on imposing the minimum capital requirement of Yuan 200 million on branch of foreign insurers violates Article XVII, and if yes, whether it is justifiable by the prudential exception.

As far as this measure affecting trade in insurance services is found under the scope of GATS Article XVII, the two-stage approach towards interpretation of the national treatment principle in insurance services sector, which is framed in Chapter Three, shall be employed. Figure 7 provides the analytical framework of the two-stage approach towards interpretation of Article XVII, which consists of four elements for examination.

Figure 7: Analytical framework of the two-stage approach towards interpretation of the national treatment principle: Example of China's non-life insurance services



(1) Whether a measure in question falls under the scope of Article XVII?

As described earlier, China has undertaken to allow foreign insurers to set up commercial presence, including branches, joint ventures, and wholly owned subsidiaries, in Chinese insurance market to supply non-life insurance services through Mode 3. In addition, China inscribes no limitation on the national treatment principle with regard to non-life insurance services supplied through Mode 3. Consequently, China is obliged to accord to non-life insurance services and service suppliers of other WTO Members treatment no less favorable than that China accords to its own like non-life insurance services and service suppliers under Article XVII.

Article XVII encompasses a broad coverage of measures, which affect the supply of services. The measure at analysis requires branches of insurers from other WTO Members to have capital of at least Yuan 200 million in order to supplying insurance services in China. This measure apparently affects the supply of insurance services by the branches. Moreover, because Article XVI only deals with maximum limitations, this measure of minimum requirement is excluded from the scope of the market access provision.[603] Therefore, it is submitted that this measure falls within the scope of Article XVII.

(2) Likeness under Article XVII

Assuming that the second element of this analytical framework is established, i.e. China's domestic companies and the branch of a foreign insurer from country A are supplying alike non-life insurance services because of competitive relationship between foreign and domestic insurance services, the same service classification entry, the same mode of supply (Mode 3), and the likeness among insurance service suppliers (the same market place, similar process of supplying services).

(3) Does this measure modify conditions of competition against foreign insurance services and service suppliers?

Because the minimum capital requirement of Yuan 200 million applies to both China's domestic insurers and branches of foreign insurers, it is submitted that this measure is not *de jure* discrimination, and thus arguably accords formally identical treatment to services and service suppliers regardless of their origin.

According to Article XVII, either formally identical or different treatment which modifies conditions of competition in favour of domestic services or service suppliers, or at the expense of foreign services or service suppliers, shall be prohibited. Therefore, in order for the measure to be qualified for this requirement of Article XVII, the application of the formally identical treatment must not modify conditions of competition for foreign insurance services or service suppliers.

This measure, in fact, imposes an excessively high level of minimum capital requirements compared to other WTO Members.[604] Moreover, the introduction of this measure may disregard the legal fact that branches constitute an integral part of foreign insurers, and they may be supported by their head offices in case of insolvency. In other words, branches operate on the ground of foreign insurers' consolidated worldwide capital,[605] and accordingly are not separately capitalized.

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[603] Scheduling of Initial Commitments in Trade in Services, Explanatory Note 1, MTN.GNS/W/164, 3 September 1993, para. 5. *See also* Guidelines for the Scheduling of Specific Commitments under the General Agreement on Trade in Services (GATS), adopted by the Council for Trade in Services on 23 March 2001. WTO Doc. No. S/L/92, 28 March 2001, para. 11.

[604] Committee on Trade in Financial Services, Report of the Meeting held on 23 November 2004, WTO Doc. No. S/FIN/M/47, 26 November 2004, paras. 70-72.

For example, Thailand and Turkey, impose the minimum capital requirements on branches of foreign insurers of approximately US$ 1 million and 4.7 million, respectively, while the level of China equals to US$ 24 million.

[605] *See* Key (2003), pp. 35-36.

Another important aspect is that branches are subject to two supervisory systems, one in China and the other one from the authority of foreign insurers. As noted by the IAIS, there may be differences in the supervision of subsidiary and branch because branches are assessed under provisions applied by both exporting and importing jurisdictions.[606] Arguably, this measure could result in higher operational costs for branches to supply non-life insurance services, and then would constitute the legal effect of prohibiting substantial number of foreign insurers from supplying non-life insurance services in China through branches. Consequently, although the measure of minimum capital requirement operates in a non-discriminatory basis, in practice, it creates an adverse impact on conditions of competition for insurance services and service suppliers from other WTO Members compared to China's like counterparts.

Thus, this measure could constitute *de facto* discrimination against foreign insurance services and service suppliers, and thus violate GATS Article XVII on National Treatment.

(4) Justification under Annex paragraph 2(a)

As China justifies its measure by relying on prudential reasons, the three-layer test as analyzed in section 3 of Chapter Three shall be examined. Specifically, in order for the Chinese measure on the minimum capital requirement of branches of foreign non-life insurance companies, which has been found in violation of the national treatment obligation, to be qualified for the prudential exception, (i) that measure must be concerned with "prudential reasons", (ii) that measure must be taken "for" the prudential reasons, and (iii) the application of that measure is not used as a means of "avoiding" obligations and commitments under GATS.

At the first layer, as discussed in section 3.1 of Chapter Three, the term "prudential reasons" refers to the solvency of an insurance company. This solvency could ensure the interests of policyholders and contribute to the stability as well as the integrity of the whole financial system.

As noted earlier, one argument from the Chinese government is that the minimum capital requirement is in conformity with prudential reasons. Article 1 of Regulations of the People's Republic of China on Administration of Foreign-funded Insurance Companies stipulates that the aim of those regulations is to "promote the healthy development of the insurance industry".[607] In addition, in the words of the IAIS, "*in order to protect policyholders from undue loss, it is necessary that a solvency regime establishes not only minimum capital adequacy requirement, but also a solvency control level, or series of control level…*"[608] Specifically, the IAIS also suggests that the regulatory framework must determine a threshold minimum capital requirement for insurance companies.[609] Therefore, it is submitted that the measure of minimum capital requirement of insurance service suppliers is concerned with solvency requirements, and falls under the scope of prudential reasons.

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[606] IAIS. Principles No. 2 on The Supervisions of International Insurers and Insurance Groups and Their Cross-border Business Operations, December 1999, p. 5.

[607] Art. 1 of Regulations of the People's Republic of China on Administration of Foreign-funded Insurance Companies.

[608] IAIS (2003), ICP 23 on Capital Adequacy and Solvency, p. 39.

[609] IAIS. Principles No. 5 on Capital Adequacy and Solvency, January 2002, p. 8.

The second layer under Annex paragraph 2(a) requires that a measure is taken "for" prudential reasons. As described in section 3.2 of Chapter Three, the WTO-inconsistent measure must be "primarily aimed at" prudential reasons. The Chinese measure on minimum capital requirement would allow a minimum guarantee on the financial health of insurance suppliers, by providing a financial buffering to absorb risks during their operations. Consequently, interests of policyholders are protected. In the words of the IAIS, "*this minimum level of capital is designed to provide a minimum assurance of the financial capacity and soundness of the insurer*."[610] The measure of minimum capital requirement and the legitimate policy objectives of prudential reasons are closely interrelated. This connection is a direct and substantial one. Furthermore, other WTO Members, like Japan, the EC and US, share a consensus that the measure on minimum capital requirement with respect to branches of foreign insurers would fall within the scope of the prudential reasons.[611] Therefore, it could be concluded that the Chinese measure of minimum capital requirement is taken "for" prudential reasons within the meaning of Annex paragraph 2(a).

The third layer needs to be evaluated before concluding that the measure is justifiable under the prudential exception. Under this layer, the application of the minimum capital requirement must not constitute a disguised restriction on trade in insurance services. As pointed out in section 3.3 of Chapter Three, different criteria might be applied under the anti-avoidance provision, such as rigidity and inflexibility, and necessity.

According to the IAIS, as mentioned earlier, the supervision of branches differs to that of subsidiaries. While subsidiaries are required to comply with the importing country's rules on capital adequacy and solvency, branch's solvency may be assessed under both exporting and importing jurisdictions. By adopting the excessively high capital requirement on branches of foreign non-life insurers, several special factors of branches are not taken into consideration by China. This would constitute an inflexibility of application of the prudential measure. The rigid application of the excessively high level of minimum capital would indicate protectionist intent of China's regulators and supervisors to limit foreign participation in the domestic insurance market, and consequently seeks to avoid its obligations and commitments towards branches in the Chinese insurance market. While this measure has guaranteed China's right to regulate its insurance market, rigid and inflexible application of this measure could constitute a disguised restriction on trade in insurance services.

Moreover, several WTO Members, for example Korea, also apply different levels of minimum capital requirement for branches of foreign insurers.[612] Other WTO Members apply minimum capital requirements equally between domestic insurers and branches of foreign

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[610] *Id.*

[611] *See* Committee on Trade in Financial Services, Report of the Meeting held on 23 November 2004, WTO Doc. No. S/FIN/M/47, 26 November 2004, paras. 70-72.

[612] *See* Republic of Korea – Schedule of Specific Commitments, GATS/SC/48/Suppl.3/Rev.1, 18 November 1999, pp. 9-10; Trade Policy Review – Republic of Korea, Report by the Secretariat, WT/TPR/S/137, 18 August 2004, p. 102, para. 82; and OECD. 2002. Insurance Solvency Supervision – OECD Country Profiles. Paris: OECD, pp. 160-161.

Although Korea undertakes that branches of foreign direct insurance (life and non-life) companies are permitted, there is a difference in minimum capital requirement between domestic companies and branches of foreign insurers. Foreign branches must maintain funds of at least Won 3 billion (USD 3 million) if wanting to do business with both Koreans and foreigners, or Won 100 million (USD 100,000) if only for foreigners. Meanwhile, domestic insurance companies must have Won 30 billion in paid-in capital or foundation funds.

insurers, but at a lower level than that of China.[613] It could be argued that China may apply a less strict requirement on minimum capital without undermining the objectives of policyholder protection and the stability of the whole financial system. Accordingly, the application of the Chinese WTO-inconsistent measure would also not satisfy the necessity criterion under the anti-avoidance provision.

The measure of minimum capital requirement, therefore, would not be entitled to justification under the prudential exception, and then constitute a violation of China's obligation under GATS Article XVII. The burden of proof lies with China for proving that the anti-avoidance provision is satisfied.

6. Concluding remarks

The examination of the schedules of specific commitments by the selected WTO Members reconfirms that the scope of application of the national treatment principle is limited to all discriminatory measures, which are excluded from the realm of GATS Article XVI on Market Access. In addition, the determination of likeness in Article XVII would be uncertain if only the criterion of services classification is taken into account. The practice of scheduling specific commitments also reveals that WTO Members indicate different treatment in different modes of supply with regard to the national treatment principle.

[613] *See* Thailand – Schedule of Specific Commitments, GATS/SC/85/Suppl.3, 26 February 1998, pp. 2-3; Trade Policy Review – Thailand, Report by the Secretariat, WT/TPR/S/123, 15 October 2003, p. 82, para. 49; and OECD. 2001. Insurance Regulation and Supervision in Asia and Latin America. Paris: OECD, Table 9, pp. 58-59.

For example, Thailand committed to allow foreign insurers to establish branches in their domestic insurance market for supplying insurance and insurance-related services. The minimum capital requirements are set at Baht 50 million (USD 1.5 million) for life insurers and Baht 30 million (USD 900,000) for non-life insurers. Moreover, in financial services commitments, Thailand allows foreign insurers to set up commercial presence in the form of branches. And branches of foreign insurers have to fulfill the same minimum capital requirements as domestic insurance companies.

CONCLUDING OBSERVATIONS OF PART ONE

Part One undertakes a study of general aspects of the applicability of the national treatment principle to trade in insurance services. Trade in insurance services under the GATS system is governed by three levels, namely the framework agreement, the Annex on Financial Services, and schedules of specific commitments by WTO Members. The first level is dealt with in Chapter Two, the second level in Chapter Three, and the third level in Chapter Four. Until the end of the Uruguay Round, trade in financial services in general and in insurance services in particular was subject to agreement only on the first and second levels. Agreement on the third level, which was subject to two subsequent negotiations in 1995 and 1997, was achieved by the end of 1997 and became effective from 1999. An additional level is the Understanding on Commitments in Financial Services, which affects trade in insurance services of those WTO Members who employ it for undertaking specific commitments.

Five tentative concluding observations of Part One are as follows:

Firstly, the national treatment principle in GATS is an object of both negotiations for liberalization and dispute settlement mechanism. WTO Members are obliged to respect the national treatment obligation for sectors and/or sub-sectors as well as level of commitments they inscribe in their schedules.

Secondly, there is a hierarchical relationship between Article XVI and XVII. Although the text of Article XVII in the framework agreement seems to support a broad domain of the national treatment principle to include pre and post entry stages of services and service suppliers, on the one hand, and all quantitative and non-quantitative discriminatory measures, on the other hand, the practice of scheduling specific commitments has indicated that the scope of this principle covers all discriminatory measures, which do not fall within the ambit of Article XVI on Market Access. This interpretation is also confirmed by an alternative approach of scheduling as provided in the Understanding on Commitments in Financial Services.

Thirdly, the national treatment principle consists of three interpretative elements, namely "measures" affecting trade in services, likeness, and the standard of "no less favourable" treatment. The first element covers all governmental measures, which directly or indirectly affect trade in services. Uncertainty in criteria to compare foreign and domestic services and service suppliers leads the second element to a broad coverage of likeness. The examination of schedules of specific commitments by the selected countries also reveals a lack of certainty with regard to the service classification criterion for comparing likeness.

As trade in services is defined through four modes of supply, it is submitted that the determination of likeness should also take into account modes of supply. Schedules of specific commitments reveal a clear intention of the WTO Members to treat insurance services and service suppliers differently under different modes of supply with regard to the national treatment obligation. In addition, the scope of likeness would be narrowed down by examining not only "like" services, but also "like" service suppliers. However, the schedules of the selected WTO Members seem not to be clear on criteria for comparing "like" service suppliers.

The third element in the national treatment principle addresses a broad scope of discrimination, both *de jure* and *de facto*. Accordingly, the uncertainty in interpretation of likeness as well as the broad coverage of discrimination would lead to a high possibility of violation of the national treatment principle, which apparently discourages WTO Members from undertaking commitments on national treatment for further liberalization of trade in services.

Fourthly, an appropriate way, where legitimate national policy objectives are taken into account, is needed for interpretation of the national treatment principle in order to balance this broad obligation. General exceptions as provided in GATS Article XIV constitute the second stage in interpretation of the national treatment principle. By employing a two-stage approach, even though in an objective assessment a measure is found discriminatory against foreign services and service suppliers in the context of Article XVII, it may not constitute a violation of the national treatment principle if the measure is a legitimate discrimination.

Lastly, as far as insurance services are concerned, the prudential exception under the Annex is proposed to constitute a second stage in the two-stage approach towards interpretation of the national treatment principle in the insurance sector in order to counterbalance the broad coverage of both likeness and the standard of "no less favourable" treatment under Article XVII. Through this approach, WTO Members would enjoy a proper space for regulating their insurance markets in order to protect policyholders as well as the stability of the financial system.

The interpretation of the prudential exception consists of three layers, namely the scope of "prudential reasons", the relationship between measures at issue and prudential policy aims, and tests for the anti-avoidance provision. The meaning of the term "prudential reasons" refers to preservation of financial conditions of insurers, through solvency requirements, vis-à-vis policyholders and other relevant persons in the financial market, and the stability of the financial system as a whole. A measure which is justified under the prudential exception must be primarily aimed at prudential reasons. In order to examine whether WTO Members abuse their right to invoke the prudential exception, the application of such discriminatory measures must not constitute a disguised restriction on trade in insurance services.

PART TWO

VIETNAM'S INSURANCE SERVICES MARKET

CHAPTER FIVE

Development of Vietnam's Insurance Services Market

This Chapter provides a general background on Vietnam's economic development from the start of doi moi in 1986. The role of the insurance sector as well as its legal framework is examined through three stages of development, namely pre-1993, 1994-2000, and post-2001.

1. Economic development

1.1 Overview

After the reunification in 1975, the national five-year plan 1976-80 was adopted in order to reconstruct the country from destruction and damage of the war, and to develop an economic base. The overall objective of this plan was to strategically emphasize agricultural development, which was considered a means of achieving national industrialization.[614] The state and collective sectors were perceived as the foundation of the economy, and heavily subsidized by the state budget.[615]

However, this plan proved a failure due to the poor performance of the agricultural sector as a result of forced collectivization undertaken in the Southern area, which discouraged farmers from production as well as distorted prices on agricultural products that were mostly below market levels.[616]In addition, some poor choices in the industrialization strategy, such as pursuing self-sufficiency in heavy industrial goods, strong market protection, and overvalued national currency, also limited this national plan's success.[617]

A new economic plan was introduced in the Sixth Plenum of the Central Committee of the Communist Party in 1979, which called for (i) developing production of domestic consumption goods; (ii) promoting exportation as a strategic priority; (iii) encouraging production by the non-state sector; and (iv) improving the distribution system of goods and production materials based on cohesion between production and market.[618] Although these economic policies brought about certain achievements in economic and social development, the country suffered severe problems, including hyperinflation, which reached 774.7 percent

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[614] Beresford, Melanie. 1989. National Unification and Economic Development in Vietnam. Basingstoke: Macmillan Press, p. 91.

[615] Vu Tuan Anh. 1995. Economic Policy Reforms: An Introductory Overview. In Irene Norlund, Carolyn L. Gates and Vu Cao Dam, eds., *Vietnam in a Changing World*. Richmond: Curzon Press, p. 19.

[616] Nguyen Xuan Oanh. 1990. Vietnam: Recent Economic Developments and the World Economy. In Seiji Naya and Akira Takayama, eds., *Economic Development in East and Southeast Asia: Essays in Honor of Professor Shinichi Ichimura*. Singapore: Institute of Southeast Asia Studies, p. 98.

[617] Ebashi, Masahiko. 1997. The Economic Take-off. In James W. Morley and Masashi Nishihara, eds., *Vietnam Joins the World*. Armonk, N.Y.: M.E. Sharpe, p. 38.

[618] The Resolution of the Sixth Plenum of the IV Central Committee of Vietnam Communist Party, No. 21-NQ/TW, 20 September 1979, on Directions and Responsibilities for Development of Consumption Goods Industry and Local Industries. In Van kien Dang Toan tap [Communist Party Documents]. 2005 (Volume 40), Hanoi: Nha xuat ban Chinh tri Quoc gia, pp. 391-396.

in 1986 as the consequence of extensive reform in "prices, wages, and currency" in late 1985, and shortage of essential foods and products.[619] State-owned enterprises (hereinafter SOE) were unable to increase their efficiency.[620]

In terms of foreign trade and aids, Vietnam continued to rely heavily on trade with and assistance from the Council for Mutual Economic Assistance (hereinafter COMECON) for its economic development, whereby centrally planning authorities intervened directly to control all exports and imports with COMECON countries according to five-year plans and annual protocols.[621] However, due to difficulties experienced in those countries, financial assistance to Vietnam gradually decreased and trade arrangements also witnessed great difficulties.[622]

Therefore, the economic development of Vietnam in the early 1980s was characterized by the overwhelming position and low efficiency of the state sector, macro financial difficulties, and over reliance on COMECON trading partners. The economic crisis in the mid 1980s was a desperate call for a comprehensive reform in Vietnam.[623] At the same time, other external factors, including the US embargo on trade and investment, the widening economic and technical gap between Vietnam and regional countries, as well as the rapid progress of China's economic reform and development, also contributed to the push for domestic reform.[624]

Thus, in 1986, Vietnam launched a fundamental economic reform program, called doi moi during its VI Congress of the Communist Party, which has been regarded as a turning point marking the country's transition from a centrally planned economy to a market-driven economy with a socialist orientation.

The key elements of doi moi were: (i) decentralization of state economic management and autonomy to SOEs in making decisions relating to production, distribution, and financing; (ii) replacement of administrative measures and controls by economic ones and in particular the use of market-oriented monetary policies to control inflation; (iii) adoption of an outward-oriented policy in external economic relations, where important measures of this policy were the introduction of real exchange rates and the liberal foreign investment law in 1988;[625] (iv) adoption of agricultural policies which allowed for long term land use rights and greater freedom in marketing products; and (v) reliance on or acceptance of the private sector as the engine of economic growth.[626]

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[619] *See* The Political Report at the VIII Congress of Vietnam's Communist Party, 1996, Part One: The country after a decade of reform, the preamble.
Available at http://www.cpv.org.vn/dcsvn/ – Last visited 5 October 2006.

[620] Vu (1995), p. 21.

[621] Than, Mya. 1993. Vietnam's External Trade, 1975-91: A Survey in the Southeast Asian Context. In Mya Than and Joseph L.H. Tan, eds., *Vietnam's Dilemmas and Options: The Challenge of Economic Transition in the 1990s*. Singapore: Institute of Southeast Asia Studies, p. 212.

[622] Cai, Wenguo and Michael Hart. 1996. Vietnam's Accession to the World Trade Organization. *Journal of World Trade* 30(6), p. 79.

[623] Ebashi (1997), p. 39.

[624] *Id.* p. 40.

[625] Law on Foreign Direct Investment (Dec. 29, 1987), amended in 1990 and 1992. This Law was replaced by the Law on Foreign Direct Investment Law (Nov. 12, 1996), amended in 2000 (Vietnam).

[626] Thant, Myo and Richard W.A. Vokes. 1993. Vietnam and ASEAN: Near-Term Prospects for Economic Co-operation. In Mya Than and Joseph L.H. Tan, eds., *Vietnam's Dilemmas and Options: The Challenge of Economic Transition in the 1990s*. Singapore: Institute of Southeast Asia Studies, p. 240.

The following shall review the development of three areas, namely SOE reform and private sector development, external trade and foreign investment, and liberalization of the financial market, which may affect development of the insurance sector.

1.2 State-owned enterprise reform and private sector development

Characteristics of the SOE reform program during doi moi included (i) commercialization of SOEs in order to place SOEs in a commercial position with increased autonomy and financial responsibility; (ii) re-organization, re-structuring and liquidation; (iii) pilot divestiture program; (iv) developing a legal framework, including Law on SOEs (1995); and (v) development of enterprise groupings (state corporations) in some key industrial sectors, including natural resources, foods, airlines, post and telecommunication.[627] The number of SOEs, thus, declined sharply from around 12,297 in 1987 to roughly 5,500 at the end of 1997.[628] While its share in GDP dropped from 22.7 percent in 1995 to 17 percent in 2005, the industrial output, at constant 1994 prices, of the SOE sector tripled in 2005 in comparison with that of 1995.[629]

However, problems persisted regarding the slow pace of SOE reform, especially in the fields of improving efficiency and accountability, and a lack of progress in the pilot divestiture program.[630] In more specific terms, only 40 percent of SOEs operated at a profit, while 60 percent suffered losses or no profit by the early years of 2000s.[631]

Priorities for furthering SOE reform are, therefore, given to: (i) continuing to restructure SOEs in order to delineate business operations and public utility purposes, as well as to put SOEs on equal footing and legal environment with private sector enterprises, including introduction of competition and bankruptcy laws; (ii) creating more autonomy for SOE's management in terms of investment decision making, labour and wages, and profit distribution; (iii) promulgating regulations to deal with pricing management and supervision of SOEs operating in monopoly sectors or industries; (iv) introducing regulations imposing compulsory information disclosure and auditing of annual reports; (v) and accelerating the divestiture program, as well as assignment, sale, lease and business contracts.[632]

The SOE reform has implications for private sector development in Vietnam. Because the SOE's share of employment fell from 9.3 percent of the total labour force in 1988 to 5.1 percent in 1995, the private sector was expected to absorb a great number of the redundant workers from the SOE sector.[633] In addition, legislation for private enterprise activities and

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[627] Arkadie, Brian Van and Raymond Mallon. 2003. Vietnam: A Transition Tiger? Canberra: Asia Pacific Press, pp. 123-135.

[628] *Id.* pp. 126-127.

[629] *Source*: General Statistics Office, Vietnam.
Available at http://www.gso.gov.vn – Last visited 22 May 2007.

[630] The Strategy for Socio-Economic Development by the year 2010, at the Ninth Congress of Vietnam' Communist Party, 2001, Part One: The country and international context, Sec. 1 (2).
Available at http://www.cpv.org.vn/dcsvn/ – Last visited 5 October 2006.

[631] Arkadie and Mallon (2003), p. 142.

[632] *See* the Resolution on State owned Enterprises of The Third Plenum of the IX Central Committee of Vietnam's Communist Party, 2003, Part III: Main solutions.
Available at http://www.cpv.org.vn/dcsvn/ – Last visited 5 October 2006.

[633] Arkadie and Mallon (2003), p. 154.

entrance into those business areas of production and trade which used to be restricted or under state monopoly further necessitated profound SOE reform.[634]

Another important reason for private sector promotion was to additionally satisfy the financial resources for economic development. The existence and development of the private sector has been recognized and protected by laws.[635] About 45,000 private sector enterprises were registered during the 1990s, and nearly two million household business were established in urban areas, contributing to enhanced performance of the economy as well as considerably improving the retail and service network.[636]

However, a need for further reduction of barriers to private sector development was pushed by concerns about potential impacts of the Asian financial crisis and decline in foreign investment during the late 1990s.[637] A notable change was that, instead of application for licenses, as provided in old legislations, domestic investors were only required to register their business operations with relevant competent authorities under Law on Enterprises (1999). Owing to this new registration procedure, about 56,000 new private sector enterprises were registered between January 2000 and December 2002 alone.[638] In comparison with 1999, the total investment capital made by the private sector in 2006 went up by 4.2 times, and the output, at constant 1994 prices, increased by 4 times, accounting for 35 percent of GDP.[639]

Despite these improvements, a number of problematic issues persisted, constraining the private sector from developing, including inconsistency in legal and regulatory system, biases against the private sector, and increased compliance costs imposed on businesses as a result of frequent changes in laws and regulations.[640] Nevertheless, since 2006, the difference in legal framework between SOEs and private sector enterprises has been completely abolished by the enactment of a new Law on Enterprises. This Law consolidates the Law on SOEs (2003), Law on Enterprises (1999), and a part of Law on Foreign Direct Investment (1996) and amendment thereof (2000). As a result, establishment and operations of enterprises, regardless of ownership, are categorized under limited liability, joint stock, partnership, and sole proprietorship.[641]

1.3 External trade and foreign investment

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[634] Leipziger, D. M. 1992. Awakening the Market – Vietnam's Economic Transition. Washington, D.C.: World Bank (Discussion Papers 157), p. 18.

[635] Company Law (Dec. 21, 1990) (Vietnam); Law on Private Enterprise Law (Dec. 21, 1990) (Vietnam).

The translation of Private Enterprises Law may be the Sole Proprietorship Law as Article 2 stated that this form of enterprise, as business entity, is owned by a sole person and liable for all business activities of the enterprise by his/her own assets.

[636] Vo Tri Thanh and Pham Hoang Ha. 2004. Vietnam's Recent Economic Reforms and Developments: Achievements, Paradoxes, and Challenges." In Philip Taylor, ed., *Social Inequality in Vietnam and the Challenges to Reform*. Singapore: Institute of Southeast Asia Studies, p. 66.

[637] Arkadie and Mallon (2003), p. 161.

[638] Tenev, Stoyan et al. 2003. Informality and the Playing Field in Vietnam's Business Sector. Washington, DC.: IFC, World Bank and MPDF, p. 2.

[639] *Source*: General Statistics Office, Vietnam.

Available at http://www.gso.gov.vn – Last visited 22 May 2007.

[640] Tenev et al. (2003), pp. 77-78.

[641] Law on Enterprises (Nov. 29, 2005) (Vietnam), Art. 1.

Another element in the economic reform was an increased integration into the world economy, which has been reflected by the rapid development in external trade and foreign direct investment.

Upon the commencement of doi moi, Vietnam's trade regime was still subject to a relatively comprehensive framework of regulations on trading rights and trade barriers, including both tariff and non-tariff barriers, aimed at export promotion and protection of import substituting production.[642] In addition, Vietnam lost its traditional trading partners due to the fall of COMECON in the late 1980s.[643] Accordingly, the important landmark was 1988 when major reforms in foreign trade policies were introduced, targeting the enhancement of incentives and providing more autonomy for enterprises in conducting foreign trade transactions.[644]

The structure of incentives that enabled Vietnam to trade at competitive world prices, consisted of: (i) a flexible exchange rate which maintained official price of the domestic currency close to the market price; (ii) a substantial reduction in the average tariff rate combined with some reduction in the range of tariff rates; (iii) a reduction in quantitative restrictions on imports; and (iv) a reduction in export controls.[645] As a result, foreign trade has expanded with remarkable speed on account of new trading partners, primarily from Southeast and East Asia.[646]

Moreover, the gradual reduction of the monopoly position of SOEs in foreign trading activities, and the abolishment of trade licenses in 1998 have resulted in an acceleration in the number of enterprises registered for trading activities from 2,400 in early 1998 to more than 16,000 in early 2002.[647] All those measures increasingly contributed to a growth of the total export volume, which jumped from US$ 0.733 billion in 1988 to US$ 16.7 billion and 39.3 billion in 2002 and 2006, respectively.[648]

Promotion of foreign trade and investment is vital for Vietnam's economic development since both foreign trade and investment (i) are directly linked with the process of economic growth and structural change; (ii) reflect Vietnam's policy priority in opening the economy and joining the world; and (iii) may be used to encourage an enabling environment for furthering economic reform and development.[649] Specifically, the significance of foreign direct investment is not only in financing economic development and job creation, but also in improving economic environment, corporate governance and technology transfer. This includes new ideas, processes, management skills, know-how, as well as models for domestic investors and facilitation of access to export markets.[650] The total invested capital in foreign

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642 Vo and Pham (2004), p. 71.

643 Than (1993), p. 221.

644 *Id.* pp. 219-220.

645 Griffin, Keith. 1998. Restructuring and Economic Reforms. In Keith Griffin, ed., *Economic Reform in Vietnam*. Basingstoke, Hampshire: Macmillan Press, p. 16.

646 Export market has increasingly expanded to the EU countries and the US since the late 1990s.

647 Vo and Pham (2004), p. 71.

648 *Source*: Ministry of Trade, and General Statistics Office, Vietnam.
Available at http://www.mot.gov.vn, and http://www.gso.gov.vn – Last visited 2 April 2007.

649 Gates, Carolyn L. and David H.D. Truong. 1995. "Development Strategy and Trade and Investment Policies for Structural Change." In Irene Norlund, Carolyn L. Gates and Vu Cao Dam, eds., *Vietnam in a Changing World*. Richmond: Curzon Press, pp. 86-87.

650 Arkadie and Mallon (2003), pp. 210-213.

direct investment has taken off from US$ 6.5 billion during 1991-1995 to US$ 12.3 billion in 1996-2000, and US$ 17.7 billion in 2001-2006.[651]

The difficult regional investment climate attributable to the Asian financial crisis has required further improvement in Vietnamese investment conditions in order to compete successfully for foreign investment resources.[652] Amendments of the Law on Foreign Direct Investment in 2000 have proved to be significant in attracting foreign inflows by streamlining licensing and administration procedures, especially automatic registration for export-oriented foreign invested enterprises,[653] and leveling the playing field with domestic enterprises by allowing them to buy foreign currencies from commercial banks in Vietnam to pay for their imports.[654]

Endeavour towards a better investment environment in Vietnam was marked by the promulgation of Investment Law since late 2005,[655] whereby legal equity between domestic and foreign investors was recognized in regard to the access to credit or other preferential financings,[656] public services;[657] and the government's maintenance of a single price system with respect to goods and services.[658] In addition, the government pledged to refrain not only from obliging investors to purchase domestic goods and services,[659] but also from applying geographical restrictions on supply of goods and services.[660] This would suggest a strong commitment towards promotion of the private sector and encouragement of foreign investment in Vietnam, which ultimately contribute to equal investment environment.

1.4 Financial market liberalization

Before 1990, Vietnam's financial system was a mono-banking system, whereby the main function of the central bank was to receive funds from SOEs and then extend loans to them through the state budget.[661] This system was largely responsible for SOEs' heavy dependence on the state budget, and blurring of monetary policy and commercial lending.[662] An effort to reform the banking sector was introduced in 1990 by enactment of two banking ordinances, where the mono-banking system was replaced by a two-tier system.[663] The first tier consists of four state-owned commercial banks, that exercise monetary transactions and provide banking services, and the second tier is the State Bank of Vietnam as the central bank.

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[651] *Source*: Ministry of Planning and Investment, and General Statistics Office, Vietnam. Available at http://www.mpi.gov.vn, and http://www.gso.gov.vn – Last visited 2 April 2007.

[652] Arkadie and Mallon (2003), p. 213.

[653] Decree 24/2000/ND-CP of the Government giving guidance on the implementation of the Law on Foreign Direct Investment (1996) and Law on amendments (2000) (Jul. 31, 2000) (Vietnam), Art. 71.

[654] Law on amendments of the Law on Foreign Direct Investment in Vietnam (Jun. 9, 2000) (Vietnam), Art. 1.6

[655] Investment Law (Nov. 29, 2005) repeals Law on Foreign Direct Investment (1996) (Vietnam).

[656] *Id.* Art. 14.1.

[657] *Id.* Art. 19.2.

[658] *Id.* Art. 10.

[659] *Id.* Art. 8.2.a.

[660] *Id.* Art. 8.2.b.

[661] Ariff, Mohamed and Ahmed M. Khalid. 2000. Liberalization, Growth and the Asian Financial Crisis: Lessons for Developing and Transitional Economies in Asia. UK: Edward Elgar, p. 269.

[662] *Id.*

[663] Ordinance on the State Bank (May 23, 1990) and Ordinance on Commercial Banks, Credit Cooperatives and Financial Companies (May 23, 1990) (Vietnam).

The central bank is in charge of both regulatory and supervisory functions over the banking sector. The monetary policy has become a typical economic instrument of the central bank with an overall objective of controlling inflation and promoting economic growth. During the 1990s, tightened monetary policy, supplemented and harmonized with tax reforms, ensured macroeconomic balance, especially by curbing the high inflation rate, and this, in turn, stabilized the exchange rate.[664] The inflation rate decreased substantially to 67.4 percent in 1990, 12.7 percent in 1995, and to a single digit from 1996 until 2006.[665] All of these were important factors for accelerating foreign trade liberalization, and ensuring a stable investment climate for business development.

In addition to monetary policy reform, the private sector and foreign investment were permitted in the banking sector under the forms of joint stock bank, branch of foreign bank, and joint venture bank.[666] While in 1991, there were only four state-owned commercial banks and one joint venture bank, by the end of 2006, six state-owned commercial banks, five joint venture banks, thirty-seven joint stock banks, and thirty-one branches of foreign banks were established and operating in Vietnam.[667] In 2003, capital mobilization through the banking sector increased by 5 times in comparison with 1996, and the outstanding loans amounted to VND 363,500 billion.[668] Domestic capital mobilization and lending market of domestic banks accounted for 90 percent while that of foreign banks was 10 percent during the period 2000-2004.[669]

Another encouraging development trend in the financial sector is the securities market. The establishment of a securities market in Vietnam was gradual and pursued in prudent steps.[670] Until 1998, most attempts of the government were to focus on formulating a necessary regulatory framework for securities and securities exchanges. Vietnam's State Securities Commission, which was established in late 1996, is empowered to grant securities business licenses to joint stock companies or limited liability companies, which are established to conduct securities business.[671] The first securities trading centre was set up in Hochiminh City in 2000 and the second one in Hanoi in 2004. The total trading value of listed

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[664] Griffin (1998), p. 18.

[665] *Source*: General Statistics Office, Vietnam. A
Available at http://www.gso.gov.vn – Last visited 22 May 2007.

[666] Ordinance on Commercial Banks, Credit Cooperatives and Financial Companies, Art. 1 defined that "state owned commercial banks" were commercial banks established by 100 percent capital form the State Budget; "joint stock commercial banks" were commercial banks established in the form of joint stock company, in which single organization or individual could not own shares exceeding the limitation set by the State Bank of Vietnam; "branches of foreign banks" were units of foreign banks in Vietnam which operated in conformity with Vietnamese laws; "joint venture banks" were banks, established from joint capital between Vietnamese bank(s) and foreign bank(s), which had headquarter in Vietnam and operated in conformity with Vietnamese laws.

[667] *Source*: State Bank of Vietnam.
Available at http://www.sbv.gov.vn – Last visited 22 May 2007.

[668] *Source*: State Bank of Vietnam.
In Thai Ba Can and Tran Nguyen Nam. 2004. Phat trien Thi truong Dich vu Tai chinh Vietnam trong Boi canh Hoi nhap [Developing Vietnam's Financial Services Market in the Context of International Integration]. Hanoi: Institute of Financial Science, pp. 81-82.

[669] *Source*: State Bank of Vietnam.
In Ministry of Planning and Investment and UNDP. 2006. Studies on the Competitiveness and Impact of Liberalization in Financial Services: The Case of Banking Services. Hanoi: UNDP, Tables 3 and 4, pp. 14 and 17, respectively.

[670] Ariff and Khalid (2000), p. 275.

[671] Decree 48/1998 of the Government on securities and securities exchange (Jul. 11, 1998 (Vietnam), Art. 29.

bonds and shares increased from VND 8,226 billion in 2003[672] to 26,600 billion in 2005.[673] By the end of the first half of 2007, there are 106 listed joint-stock companies in both securities trading centers in Hanoi and Hochiminh City.[674]

In summary, private sector and foreign participation are observed as fundamental engines for Vietnam's economic development. The financial sector has played a role in stabilizing investment environment and constituted a key channel for capital mobilization. Measures to create a level playing field for all enterprises, irrespective of ownership and origin, have been introduced sequentially over a period of time. All these factors have important implications for Vietnam's insurance services market.

2. Vietnam's insurance services market[675]

In the insurance sector, there are two important landmarks in the legal environment after doi moi. First, the governmental decree on insurance was introduced in late 1993, and second, the first law on insurance business was passed in 2000. Therefore, the trend of development of the insurance market in Vietnam can be divided into three stages: pre-1993, 1994-2000, and post-2001.

2.1 Before 1993

Three characteristics of Vietnam's insurance sector before 1993 were (i) the state monopoly in supplying insurance services, (ii) a modest role of the sector in the overall economy, and (iii) no separate regulator and supervisor.

The state-owned insurance company, the Vietnam Insurance Corporation, was established in the North under the Ministry of Finance (hereinafter MOF) in 1964 to provide cargo insurance, marine hull insurance, and personal accident insurance.[676] In terms of reinsurance activities, a part of insurance premiums was ceded to other insurance companies in the former Soviet Union and China.[677] After the reunification, fifty-two insurance and

[672] Symposium on Finding Solutions for Further Development of Vietnam's Securities Market. 2004. Hanoi: The State Securities Commission (on file with the author).

[673] Tran Dac Sinh. 2006. Thi truong chung khoan tap trung nam 2005 – Tao da tang truong cho cac nam tiep theo [The Official Securities Market in 2005 – A Locomotive for Further Development]. *Vietnam Securities Review* (1+2).

[674] *Source*: State Securities Commission of Vietnam.
Available at http://www.ssc.gov.vn – Last visited 5 October 2007.

[675] This section draws in part from Vu Nhu Thang. 2007b. Necessary reform of Insurance Business Law in Vietnam after its Accession to the World Trade Organization: Prudential Regulatory Aspects. *Fordham Journal of Corporate and Financial Law* 12(6), pp. 977-1009.

[676] Decision 179/CP of the Government Council on establishing Vietnam Insurance Corporation (Dec. 17, 1964) (Vietnam).

[677] BaoViet Insurance Corporation. 2005. Bao Viet 40 nam xay dung va phat trien 15/01/1965 – 15/01/2005 [BaoViet in Forty Years of Establishment and Development Jan 15, 1965 – Jan. 15, 2005]. Hanoi: Nha xuat ban van hoa thong tin, p. 18.

reinsurance companies operating in the South were merged with the Vietnam Insurance Corporation during 1976-1977.[678]

During the early 1980s, along with the economic development, several new insurance services were supplied, such as personal accident of passengers (1980), aviation insurance (1981), and agriculture insurance (1982).[679] Due to the participation of foreign investors in Vietnam, the Vietnam Insurance Corporation started to diversify insurance services to those foreign direct investment projects, including fire insurance (1989).[680] Reinsurance activities have been extended to Lloyd's market since 1992. In terms of foreign participation in the domestic insurance market, there was only one joint venture insurance brokerage company, which was set up in 1993.[681]

However, insurance services were confined to twenty-two products in non-life insurance.[682] There were no life insurance services in this period. According to Seibel, this was due to the high inflation rate and the scarcity of long-term investment opportunities.[683] In 1989, the total insurance premiums written achieved only 0.003 percent of GDP, with marine hull and personal accident insurance accounting for 65 and 25 percent, respectively.[684] The total insurance premiums written climbed to 0.37 percent of GDP in 1993.[685] In turn, investment activities from the insurance sector into the economy were very limited, and amounted to 0.021 percent of GDP in 1993.[686]

Concerning the regulatory and supervisory body, the Vietnam Insurance Corporation conducted both insurance business activities and state management function over the sector until 1992. The Insurance Division under the MOF was established in 1992, separated from the Vietnam Insurance Corporation in order to conduct regulatory and supervisory activities over the insurance market.

2.2 Period of 1994-2000

In parallel with the facilitation of foreign investment and promotion of the private sector, the second period, from 1994 until 2000, experienced fundamental changes in the domestic insurance market. Market players diversified significantly in this period. Vietnam permitted three domestic joint stock insurance companies to be established and operated in non-life insurance.

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[678] Truong Moc Lam. 2003. Nganh kinh doanh bao hiem o Vietnam – Mot chang duong. [Vietnam Insurance Sector – A History]. *Vietnam Insurance Review* 2, p. 1.

[679] BaoViet Insurance Corporation (2005), pp. 33-36.

[680] *Id.* p. 42.

[681] This joint venture was transformed to the wholly foreign owned insurance brokerage company in 2004.

[682] Nguyen Trong Nghia. 2004. Thuc trang va Giai phap Hoan thien He thong Phap luat Phat trien Thi truong Tai chinh va Dich vu Tai chinh [Current Situation and Solutions for Improving Legal System on the Development of Financial Markets and Financial Services] (academic research paper, Ministry of Finance, Vietnam) (on file with the *Financial Scientific Institute*), pp. 46-47.

[683] Seibel, Hans Dieter. 1992. The Making of a Market Economy: Monetary Reform, Economic Transformation and Rural Finance in Vietnam. Saarbrucken : Breitenbach, p. 67.

[684] *Source*: BaoViet Insurance Corporation.
Available at http://www.baoviet.com.vn – Last visited 5 October 2006.

[685] Ministry of Finance. 2005. Vietnam Insurance Market 2004. Hanoi: Nha xuat ban Tai chinh, p. 6.

[686] *Id.*

Foreign access to the domestic insurance market was allowed with four licenses in life insurance and four licenses in non-life insurance.[687] Among foreign counterparts, Japanese insurers were main players in 1996-1997, while European and American insurers were dominant in 1999-2000. In addition, two non-life insurers and one re-insurer with 100 percent state ownership were also established during 1994-1995. Life insurance services have been supplied since the mid point of this period by both domestic and foreign life insurers. However, there is no domestic private-sector insurer in the life insurance market.[688]

The total insurance premiums written in 2000 were recorded at VND 3,000 billion, an increase of seven times that of 1993; and of this figure, non-life insurance premiums have doubled.[689] Property insurance services have been increased as a result of demand for indemnifying investment projects of both domestic and foreign investors. In 2000 alone, 74 percent of the total foreign investment capital and 6.63 percent of the total domestic investment capital were insured, while these figures in 1995 were 0.77 and 0.81 percent, respectively.[690] In addition, the value of export-import cargo insured by insurance companies operating in Vietnam accounted for 17 percent of the total trade volume in 2000.[691] During the second period, in terms of the total premiums of both life and non-life insurance, the market share of foreign insurers in the domestic insurance market sharply increased from 3 percent in 1999 to 16.4 percent in 2000.

In comparison with 1993, the total investment capital from the insurance sector into the economy in 1999 increased by 58 times,[692] and achieved approximately VND 4,000 billion by the end of 2000.[693] The insurance sector, therefore, has played a clearer and more important role in economic growth.

Following the development of the domestic insurance market, the Association of Vietnamese Insurers started operations in May 2000 as a professional forum for: (i) contributing professional advices and opinions in policy-making process; (ii) propagating policies and regulations on the insurance industry, and providing information and data base for members; (iii) consulting members in insurance business development, and providing training services; (iv) building up a self regulatory system with a view to create a level playing field in the insurance industry; and (v) reconciling members in dispute resolution.[694]

However, several limitations were found in this period of development, namely newly-established insurance companies with limited range of insurance products, weak financial capacity and lack of management skills, and a simple set of investment portfolios.[695]

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[687] *Id.* p. 19.

[688] Reasons might be that life insurance business would require long-term investment of capital, highly professional skills that could not be satisfied by the private sector.

[689] Strategy on Development of Vietnam Insurance Market 2003 – 2010 [hereinafter Insurance Strategy] approved by Decision 175/2003/QD-TTg of the Prime Minister (Aug. 29, 2003) (Vietnam) [hereinafter Decision 175/2003/QD-TTg], Appendix 5. *See also* Ministry of Finance (2005), p. 6.

[690] Decision 175/2003/QD-TTg, Appendix 5.

[691] Insurance Strategy, Appendix 6.

[692] Ministry of Finance (2005), p. 6.

[693] Thai and Tran (2004), p. 86.

[694] Decision 51/1999/QD-BTCCBCP of the Ministry of Personnel and Organization on establishment of the Association of Vietnamese Insurers (Jul. 9, 1999) (Vietnam).

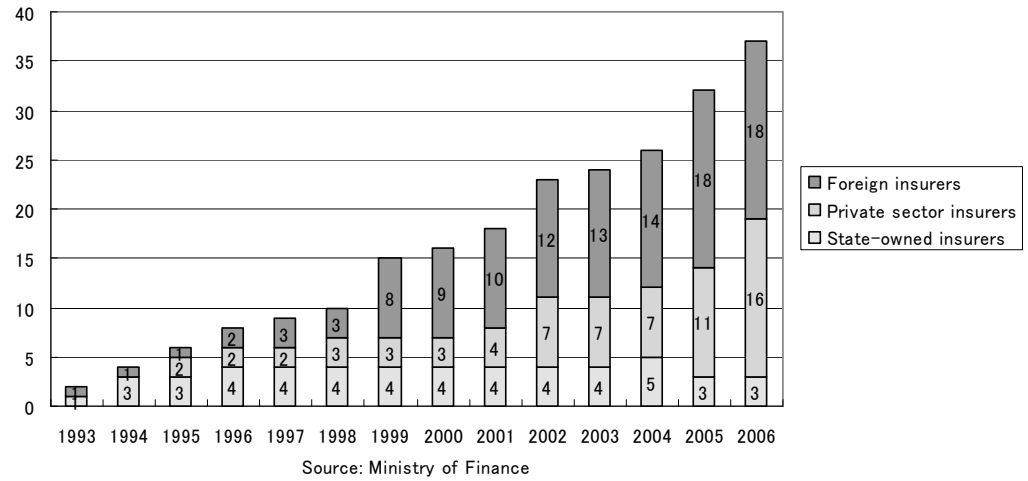
[695] Governmental Submission Letter on the Insurance Business Bill, Doc. No. 486/CP-PC dated 18 May 2000 (Vietnam), pp. 3-4.

2.3 After 2001

In the third period, from 2001 until now, Vietnam's insurance sector has recorded a significant growth rate and expansion with the total insurance premiums written amounting to nearly 1.6 percent of GDP in 2006.[696] This includes premiums in life insurance services equivalent to 0.9 percent of GDP, which helped increasing domestic savings, and channelling them to investment.

As of the end of 2006, thirty-seven insurance companies participated in the domestic insurance market, among them, twenty-one non-life insurers, seven life insurers, eight insurance brokerage companies, and one re-insurer (*see* Chart 1). In terms of ownership, there were thirteen companies with wholly foreign-owned capital, five joint venture companies, sixteen domestically joint stock companies, and three state-owned insurers.[697] The number of foreign owned insurers doubled in comparison with that of 2000. One of the main reasons is the implementation of trade agreements between Vietnam with the US and EU.

Chart 1: Structure of Vietnam's insurance market players



This period also marked an expansion of banks to the insurance sector by establishing BIDV-QBE Insurance Company Limited, a joint-venture between Bank for Investment and Development of Vietnam and Australian QBE Insurance Group in 1999, and Incombank-Asia Insurance Company Limited, a joint-venture between Industrial and Commercial Bank of Vietnam and Asia Insurance Company in 2002 to conduct non-life insurance.

Charts 2 and 3 describe the trend in premiums written in non-life and life insurance, respectively, during the period of 1994-2006.

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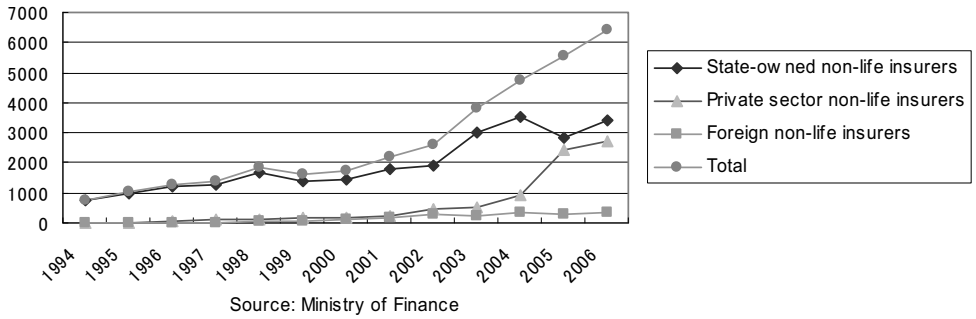
[696] Ministry of Finance. 2007. Vietnam Insurance Market 2006. Hanoi: Nha xuat ban Tai chinh, p. 6.
[697] *Id.* p. 7.

Chart 2: Growth of Vietnam's non-life insurance market

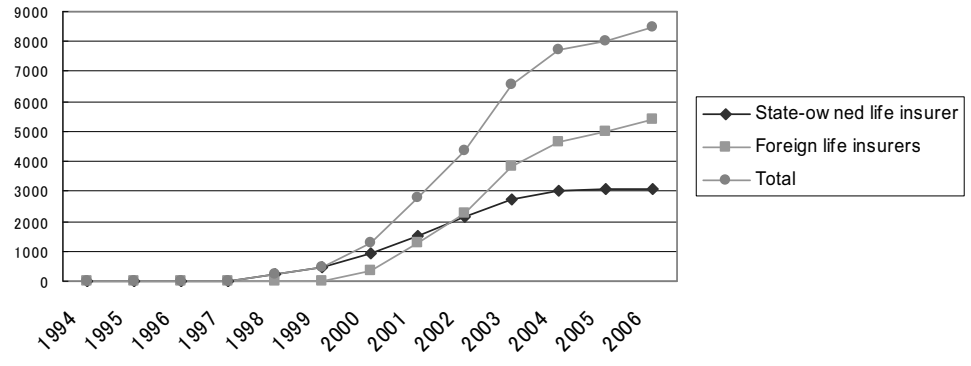
(Gross premium income in VND billions)



Source: Ministry of Finance

Chart 3: Growth of Vietnam's life insurance market

(Gross premium income in VND billions)



Source: Ministry of Finance

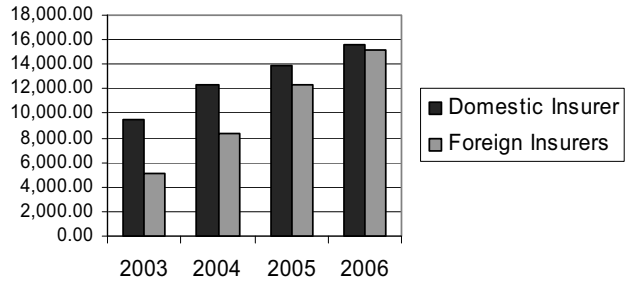
Foreign owned insurers represent less than 10 percent of the non-life insurance market, whereas their market share in the life insurance market accounts for approximately two thirds.[698] One reason might be that there is only one domestic life insurer who competes with the other six giant foreign life insurers, both wholly foreign-owned and joint venture, in supplying life insurance services. On the other hand, in the non-life insurance market, domestic insurers are dominant in terms of the number of market players as well as broad customer network. Moreover, as commented by Kovsted et al., the life insurance market in Vietnam enjoys more equal conditions of competition compared to the non-life insurance market, and foreign life insurers are perceived as more reliable as well as competitive than

[698] *Id.* Table 2.

domestic counterparts.[699] However, a sharp decrease in the non-life premiums of the state-owned insurers in Chart 2 from 2004 to 2005 occurred due to the equitization of one state-owned insurer in 2004.

In terms of indemnification, the availability of insurance services as well as insurers in the domestic market has enabled consumers to mitigate financial losses as a result of occurrence of uncertain events. Insurance claims paid in 2006 reached VND 5,758 billions, six times the figure for 2000; of that, claims paid by foreign insurers accounted for around 15 percent.[700] Accordingly, insurance not only assures the financial stability of individuals, families, and organizations, but also facilitates businesses by providing greater stability in business transactions.

Chart 4: Investment sources by ownership
(In VND billions)



Source: Ministry of Finance

Concerning capital investment in the economy, the amount increased by 11 times in 2006 compared to 1999.[701] This would likely be an important source for the securities market as well as other investment projects. Foreign insurers climbed gradually from 35 percent of the total capital investment from the insurance sector in 2003 to 40 percent and nearly 50 percent in 2004 and 2006, respectively (*see* Chart 4).

Chart 5 describes the structure of portfolios held by insurers. Looking at the investment portfolios of insurers as shown in Chart 5, it is observable that a large amount of the total available investment capital of insurers is concentrated in government bonds and deposits in credit institutions.[702] One explanation is that there is a lack of detailed regulations on investment, such as real estate and lending activities conducted by insurers, and consequently insurers may be reluctant to grant loans because there is no available mechanism for dealing with loss and risk management.[703] Another reason is due to a less-developed securities market in Vietnam, especially the small number of listed companies.[704]

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[699] Kovsted, Jens; John Rand; and Finn Tarp. 2005. From Monobank to Commercial Banking – Financial Sector Reforms in Vietnam. Singapore: NIAS Press, p. 40.

[700] Ministry of Finance (2007), Annex 4.

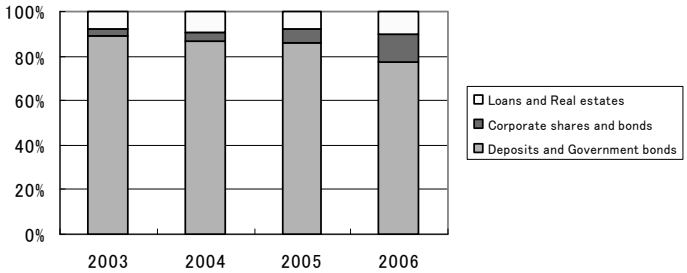
[701] *Id.* p. 6.

[702] *Id.* Figure 11.

[703] Phung Dac Loc. 2005. Dau tu an toan, sinh loi cao, dung phap luat dang la mong muon cua cac doanh nghiep bao hiem tai Viet Nam [Safe Investment and High Return in conformity with laws and regulations are a desire of Insurance Companies in Vietnam]; and Trinh Thanh Hoan. 2005. Can som ban hanh van ban huong dan chi tiet cho hoat dong dau tu cho vay cua cac DNBH Vietnam [A necessity for detailed regulations on lending

Chart 5: Investment portfolios

(In percentage)



Source: Ministry of Finance

The reinsurance market also experienced sound development during this period. The insurance premiums retained in the domestic reinsurance market increases from VND 8,980 billion in 2003 to VND 12,745 in 2006.[705] This trend would reflect the increasingly capitalized situation of insurance companies as well as the improved risk management skills.

Seven out of the current eight insurance brokerage companies were established in the third period. Of the eight insurance brokerage companies in existence at the end of 2006, there are five domestically joint stock companies and three companies with wholly foreign-owned capital. The amount of premiums was arranged through brokerage companies increasing from 5.14 percent in 2003 to 18 percent in 2006 of the total non-life insurance premiums.[706] Brokerage transactions concentrated in supplying property and casualty insurance services, health insurance and personal accident insurance services, and vehicle owner's liability.[707] However, foreign brokerage companies dominated the insurance market with the income exceeding 80 percent of the total brokerage fees in 2004-2005.[708]

With respect to the insurance supervisory authority, since 2003 the government has set up a new Insurance Department under the MOF, mostly based on the previous Insurance Division, to regulate the insurance market and promote its development.[709] Duties of the Insurance Department include: to formulate and submit to the Finance Minister for approval relevant regulations, strategies and market development plans, and to enforce those

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activities of Vietnamese insurance companies]. In *Symposium on Solutions for facilitating efficient investments by insurers into the economy* (on file with the Association of Vietnamese Insurers), pp. 11-13 and 35, respectively.

[704] Le Song Lai. 2005. Thuc trang va Giai phap nang cao hieu qua hoat dong dau tu cua cac doanh nghiep tren thi truong bao hiem Viet Nam [Current situation and Solutions on improving investment efficiency by companies in Vietnam's Insurance Market]. In *Symposium on Solutions for facilitating efficient investments by insurers into the economy* (on file with the Association of Vietnamese Insurers), pp. 22-23.

[705] Ministry of Finance (2007), Table 10.

[706] *Id.* Chart 12.

[707] *Id.* Chart 13.

[708] Moi gioi bao hiem trong nuoc lep ve (Domestic brokerage companies insignificant), 20 February 2006. Available at http://www.vneconomy.com.vn – Last visited 2 April 2007.

[709] Decree 77/2003/ND-CP of the Government on functions, rights, responsibilities, and structure of the Ministry of Finance (Jul. 1, 2003) (Vietnam).

regulations; to carry out licensing function and oversee insurance business operations; to protect the interests of policyholders; to promote the insurance market and maintain development thereof; and to set up a risk management and advance warning system to minimize insurance risk.[710]

Some observations

The insurance market in Vietnam has evidenced a robust development from 1994 through the abolishment of the state monopoly, which has led to the diversification of domestic insurers as well as promotion of foreign direct investment in the insurance sector. These statistical evidences show a strong link between the participation of foreign insurers and the development of the life insurance market in Vietnam.

However, there remain limitations on the role of the insurance sector in economic development, characterized by its small size and a limited variety of insurance products as well as lower competitiveness of domestic insurers. As noted earlier, the total insurance premiums in Vietnam accounted for less than two percent of GDP in 2006. In 2004, premiums per GDP of the US were 9.44 percent, while the EU (15) and Japan were 8.64 and 10.47 percent, respectively.[711]

Even though the number of insurance products has increased sharply to around six-hundred by the early years of this decade, there are still many areas which have not yet been adequately covered, such as natural disasters, agriculture,[712] credit insurance, and professional liability insurance.[713] Investment portfolios of insurers were not diversified. Investment in corporate bonds and shares as well as loans and real estate accounted for around 20 per cent of the total investment capital of insurers in Vietnam, compared to 80 percent in the EU.[714]

3. Legal framework[715]

3.1 Introduction of insurance regulations

As described earlier, before 1993, there was only one insurance company operating in Vietnam. The supply of insurance services was governed by rules of the MOF, which was designated exclusively to the Vietnam Insurance Corporation. Those rules included insurance

[710] Decision 134/2003/QD-BTC of the Finance Minister on functions, rights, responsibilities, and structure of the Insurance Department (Aug. 20, 2003), Art. 2 (Vietnam).

[711] SwissRe Sigma. World Insurance in 2004: Growing premiums and stronger balance sheets. Sigma No. 2/2005, November 2005.
Available at http://www.swissre.com/ – Last visited 5 October 2006.

[712] Insurance services in agricultural production accounted for one percent of domestic animals and plants in 2002. *See* Insurance Strategy, p. 12.

[713] Nguyen Trong Nghia (2004), p. 46.

[714] Le Song Lai (2005), pp. 22-23.

[715] This section draws in part from Vu Nhu Thang (2007b), pp. 977-1009.

products, insurance contracts, terms and conditions, premium rate, and dispute settlement.[716] However, there was no regulation on new entrant and exit of insurers.

In addition to rules of the MOF, certain insurance services were regulated by different laws, such as marine insurance contracts under Marine Code 1990 and civil liabilities of carriers under Law on Aviation 1992. The Marine Code consists of forty-one articles dealing with formation, performance and transfer of marine insurance contracts, subrogation, and payment of claims.[717] With regard to air transport, carriers are legally required to purchase insurance policies for their civil liabilities on passengers' body, health and injury.[718]

The government issued Decree 100/CP on December 18th, 1993 (hereinafter Decree 100/CP) on business insurance as the sole regulation guiding the industry. Decree 100/CP represented a landmark for diversifying insurance services in Vietnam, including direct insurance, both life and non-life;[719] reinsurance; brokerage; and agency.[720] Apart from those insurance services, an insurance company was also permitted to conduct assessment, inspection, calculation for loss distribution, and act as agent in assessment and settlement of compensation.[721]

In parallel with the policy on promotion of the private sector and encouragement of foreign direct investment in Vietnam, the monopoly in the insurance sector was replaced by diversifying players. The forms of insurance companies included (1) state-owned companies, (2) joint stock companies, (3) mutual insurance companies, (4) joint venture companies, (5) branches of foreign insurance companies, and (6) wholly foreign-owned subsidiaries.[722] The MOF was the regulatory and supervisory body in charge of delivering "Certificate of satisfaction of qualifications and conditions required for conducting insurance business" for new insurance companies in Vietnam. However, the opening of this sector was subject to various licensing criteria. These licensing requirements included: (1) clear objectives and areas of activity; (2) chartered capital not less than the legal capital; (3) fit and proper managers; and (4) the necessity of insurance services supplied to the national economy.[723]

Although foreign participation in the insurance market was legally recognized, there were several discriminatory measures against foreign insurance companies. First, foreign owned insurance companies were subject to higher legal capital requirements than those for

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[716] For example, Decision 254-TC/QD-BH of the Finance Minister permitting Vietnam Insurance Corporation to supply marine insurance services (May 25, 1990) (Vietnam).

[717] Marine Code (Jun. 30, 1990) was repealed by Marine Code (Jun. 14, 2005), Chapter XVI.

[718] Law on Aviation (Dec. 26, 1991), Art. 72.

[719] Decree 100/CP, Art. 7 defined the kinds of insurance which were permitted to be conducted: (1) life insurance; (2) voluntary health insurance and personal accident insurance; (3) property insurance and loss insurance; (4) cargo insurance covering land, marine, fluvial, railway, and air transportation; (5) hull insurance and civil liability for ship owners; (6) co-insurance; (7) aviation insurance; (8) automobile insurance; (9) fire insurance; (10) credit insurance and financial risk insurance; (11) business loss insurance; (12) agriculture insurance; and (13) other insurance activities stipulated by the Ministry of Finance. Insurance services stipulated in (2) to (13) were collectively referred to as non-life insurance.

[720] *Id.* Art. 3.

[721] *Id.* Art. 8.

[722] *Id.* Art. 2 defined "Mutual insurance company" as a company conducting insurance business for its members on the principles of mutual benefit and non profit, "insurance joint venture company" as a corporate form of capital contributions made by a Vietnamese party and a foreign party, "branch of a foreign insurance organization" as an unit of a foreign insurance organization operating in Vietnam, and "foreign insurance company with one hundred (100) per cent foreign-owned capital" as an insurance company established in Vietnam with one hundred (100) per cent capital owned by a foreign insurance company.

[723] *Id.* Art. 17.

domestic companies.[724] Second, conditions on entrance into the market were vague and open to administrative manipulation. It was hard for an insurance company as well as for the regulators and supervisors to interpret the licensing requirement on whether insurance services provided were "necessary for the national economy". Third, compulsory cession of 20 percent of domestic insurance premiums to the Vietnam National Reinsurance Company was applicable in case of ceding abroad.[725] This requirement made conditions for insurers abroad less favourable than insurers operating in Vietnam when supplying reinsurance services.

Concerning solvency requirements, insurers were required to set up a compulsory provision equivalent to 10 percent of the chartered capital.[726] There was no article on the establishment of technical provisions or requirements on the solvency margin to be held by insurers, except for rules of the MOF.[727] With regard to investment regime, insurers were allowed to invest in government bonds, corporate securities, real estate, banking deposits, lending activities, and contribution of capital to joint venture, in accordance with rules of the MOF.[728] However, investment rules simply set up the ceiling of each asset category not exceeding 25 percent of the technical provisions.[729] Moreover, there was no rule on financial recovery plans in case of an insurance company facing financial difficulties.

3.2 Vietnam Insurance Law

The Vietnam Insurance Law, which became effective from 1 April 2001, was drafted from 1991, based on experiences of different countries, such as the EU, China, Malaysia and Thailand.[730] This Law was also drafted on the basis of the experimental period of introducing Decree 100/CP. The Vietnam Insurance Law has expressed four fundamental objectives.[731] First is to protect the legitimate rights and interests of the organizations and individuals participating in insurance transactions. Second is to accelerate insurance business. Third is to promote and maintain a sustainable socio-economic development, and stabilize the people's living standards. The final objective is to strengthen the State's effective administration of insurance business. Accordingly, the Vietnam Insurance Law consists of nine chapters with 129 articles.

Chapter I, titled "General Provisions", covering eleven articles, sets forth the scope of application, and provides terms and definitions used throughout the Law. This chapter continues to reaffirm diversified insurance services in Vietnam, including direct insurance, both life and non-life;[732] reinsurance; brokerage; and agency. Moreover, statutory insurance is

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[724] *Id.* Art. 22 stated that legal capital requirement was VND 1.2 billion or US$ 2 million with respect to Vietnamese insurance enterprises or joint venture companies; and US$ 5 million with respect to branches of foreign insurance companies or insurance companies with 100 per cent foreign owned capital.

[725] Circular 78/1998/TT-BTC of the Ministry of Finance on reinsurance business (Jun. 9, 1998) (Vietnam).

[726] Decree 100/CP, Art. 11.

[727] *Id.* Art. 10.2.

[728] *Id.* Art. 12.2.

[729] Circular 45-TC/CDKT of the Ministry of Finance on Financial Regime of Insurance Companies (May 30, 1994) (Vietnam), Sec. V.2.f.

[730] Governmental Submission Letter on the Insurance Business Bill, Doc. No. 486/CP-PC dated 18 May 2000 (Vietnam), p. 1.

[731] Vietnam Insurance Law, the preamble.

[732] *Id.* Art. 7.

also introduced in some economic activities to ensure the public interest and social security.[733] The chapter also asserts that consumers may only purchase insurance services from insurers who are authorized to operate in Vietnam.[734] The principle of fair and lawful competition in providing insurance services has been recognized, whereby four types of conduct are prohibited, namely false and inaccurate information disclosure, illegal expansion of customer network, illegal sale promotion, and other illegal competitive activities.[735]

This chapter expresses the State's intent to protect the interests of policyholders and other relevant persons as well as promote a sound development of the domestic insurance market. However, there is a bias in favour of state-owned insurers, whereby the government is entitled to invest capital and other resources in order to secure the dominant role of these companies in the market as provided in Article 4.2.[736] This provision may discriminate not only against foreign insurance services and insurers, but also against domestic non-state-owned insurers. In addition, in case of cession abroad, all insurance companies in Vietnam are required to cede part of the direct risks insured to the Vietnam National Reinsurance Company in conformity with governmental regulations.[737] Again, this requirement constitutes less favourable treatment for insurers abroad than insurers operating in Vietnam with regard to supplying reinsurance services.

Chapter II covers forty-six articles governing insurance contracts, including categories of insurance contracts, their contents, rights and obligations of insurers and insured.

Chapter III codifies the forms of insurance enterprises. There are five categories of insurance companies, which are classified by ownership: (1) state-owned capital, (2) joint stock, (3) mutual-aid, (4) joint venture, and (5) wholly foreign-owned capital.[738] The MOF is the single supervisory authority, in charge of licensing newcomers into the insurance market.[739] To gain entrance, licensing requirements include: (1) chartered capital not less than the legal capital as provided by the government; (2) application documents; (3) appropriate corporate form; and (4) fit and proper managers.[740]

This chapter also provides some general principles for mutual insurance organizations, whereby members of such organizations must be both the owners and policyholders.[741] The chapter sets out conditions and procedures for transfer of insurance contracts in cases where an insurer is in danger of insolvency, or merged, consolidated, divided, separated and dissolved.

Although the language of this chapter requires insurers to report to the supervisory authority on their danger of insolvency, it fails to tell insurers what measures must be

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[733] *Id.* Art. 8.

Four statutory insurance services consist of civil liability of vehicle owners and air carriers; professional liability in legal services; professional liability of insurance broking companies; and fire, explosion.

[734] *Id.* Art. 6.

[735] *Id.* Art. 10.

[736] *Id.* Art. 4.2.

[737] *Id.* Art. 9.

The compulsory reinsurance was set at 20 percent of the liability under Decree 42/2001/ND-CP of the Government providing guidance on the implementation of a number of articles of the Law on Insurance Business (Aug. 1, 2001) (Vietnam), Art. 22.1.

[738] *Id.* Art. 59.

[739] *Id.* Art. 62.1.

[740] *Id.* Art. 63.

[741] *Id.* Chapter III, Sec. 2.

included in solvency recovery plans. Moreover, while the winding-up of insolvent insurers is stipulated, there is no mechanism to ensure that the interests of policyholders shall be protected and their claims shall be paid, either in full or partially.

Chapter IV, titled "Insurance Agents and Insurance Brokerage Enterprises", identifies the scope of operations, conditions for insurance agents and licensing requirements on insurance brokerage enterprises, rights and obligations of insurance agents, insurers, and insurance brokerage enterprises. An insurance agency may be conducted through either corporate or individual agents, whereas an insurance broker must be established in corporate form.

Chapter V lays down provisions with respect to finance, accounting and financial statements. In order to ensure the solvency, insurers are required to keep a minimum legal capital throughout their life, and to set out technical provisions and reserve funds. Insurers are obliged to prepare financial statements, which are certified by an independent auditing firm, and to make those financial statements public.

As financial institutions, insurance companies are legally entitled to use their idle capital to purchase government bonds, corporate shares and bonds; to invest in other enterprises, infrastructure and real estate; and to lend to other credit organizations.[742] The investment of insurance companies must ensure safety, efficiency and payment to parties to the insurance contracts.[743] This chapter, however, does not properly regulate investment activities, especially requirements on diversification and management of investment-related risks. This is of importance to ensure the solvency of insurers, hence to protecting the interests of policyholders.

Chapter VI designs a legal framework for foreign owned insurance and brokerage enterprises. Almost all of the requirements on licensing conditions, application documents for licenses, capital and reserve funds, and solvency regimes are analogous to Vietnam's domestic insurance and brokerage enterprises.[744] However, besides the Vietnam Insurance Law, the scope of operation of foreign owned insurance and brokerage enterprises is also subject to other relevant laws and governmental regulations.[745] This provision may suggest a possible discrimination against foreign companies in the insurance sector.[746]

Chapter VII contains provisions on "State Administration of Insurance Business". According to this chapter, the MOF is empowered to exercise administration of insurance business, including licensing, promulgation of regulations, supervisory duties, dealing with complaints and breaches of the Vietnam Insurance Law. In addition, other ministries and local people's committees are responsible for carrying out the state administration of the insurance

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[742] *Id.* Art. 98.2

[743] *Id.* Art. 98.1

[744] *Id.* Art. 109.

For example, to get a license of establishment and operation in Vietnam, apart from documents analogue to a Vietnamese insurance company, foreign insurance companies must submit their charter and operation license; and audited balance sheets and annual financial statements.

[745] *Id.* Art. 114 and 119.

[746] Decree 42/2001/ND-CP of the Government providing guidance on the implementation of a number of articles of the Law on Insurance Business (Aug. 1, 2001) (Vietnam), Art. 39.1 provided that foreign insurance companies and insurance brokerage companies were not permitted to supply insurance services to SOEs or certain compulsory insurance services.

industry within their authorities.[747] The chapter also sets out procedures for regular and *ad hoc* inspection on the insurance business of insurers.

Chapter VIII establishes a legal basis for "Rewards and Sanctions for violations". This chapter specifies ten categories of prohibited activities which might constitute either administrative violations or criminal offences, depending on the characteristics, seriousness, and consequences of those activities.[748] However, details of administration sanctions for such violations is governed by governmental regulations.

The final chapter, Chapter IX, gives implementation provisions. Such provisions allow continuation of operation of insurers licensed before the effective date of the Vietnam Insurance Law. In addition, this chapter also repeals all previously issued rules and regulations contrary to this Law.

4. Concluding remarks

The description of Vietnam's economic development reveals that foreign participation has made a contribution to the domestic economy. A clear tendency towards a level playing field for all enterprises, irrespective of ownership and origin, has been introduced in a sequence over a period of time, which has enabled the development of private sector and foreign direct investment, as well as external trade. This tendency also occurred in the insurance sector, whereby the legal framework shows a consistent approach towards an open insurance market with various players by gradually removing the state monopoly.

While foreign participation in the domestic insurance market has been allowed since 1994, there were a number of discriminatory measures against foreign insurance companies, such as capital requirements and limitations on the scope of business activities. Several discriminatory measures have been removed by the enactment of the Vietnam Insurance Law in order to create a level playing field for both foreign and domestic companies, including no difference in legal capital requirements for obtaining licenses,[749] and licensing fees.[750] In addition to according equal treatment to foreign owned insurers in Vietnam, the solvency regimes of insurers have been enhanced by more concrete provisions and regulations.

There are, however, several concerns over national treatment between domestic and foreign insurance companies as well as solvency regimes under the Vietnam Insurance Law, which shall be analyzed and discussed in Chapter Six and Chapter Seven, respectively.

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[747] Vietnam Insurance Law, Art. 121.

[748] *Id.* Art. 124 and 125.

The prohibited activities are: (1) Carrying out insurance business without a license, or in non-compliance with the contents stipulated therein; (2) Violating provisions concerning the issue of license of establishment and operation, inspection and supervision conducted by the competent State bodies; (3) Engaging in unfair competition; (4) Compelling others to enter into insurance contracts; (5) Breaching regulations on compulsory insurance; (6) Breaching the obligations of keeping confidential the information disclosed by customers in relation to the insurance contract; (7) Providing false information, data and report; (8) Carrying out business activities in failure to met financial requirements in accordance with laws; breaching regulations on legal capital, reserve funds, deposits, establishment, management and use of technical reserves; (9) Breaching regulations on investment; and (10) Committing other breaches of laws on insurance business.

[749] Decree 43/2001/ND-CP of the Government providing regulations on financial issues of insurance enterprises and insurance brokerage enterprises (Aug. 1, 2001) (Vietnam), Art. 4.

[750] Decree 42/2001/ND-CP, Art. 7.

CHAPTER SIX

Vietnam's Commitments on National Treatment and Implications for the Insurance Services Market

Along with the domestic economic reform, Vietnam has established and fostered economic relationships with other countries at bilateral and regional levels with a view to facilitating foreign trade relations and integration into the world economy. At the multilateral level, Vietnam became the 150th Member of the WTO on January 17, 2007.

The chapter starts with a brief description of Vietnam's commitments on liberalization of its insurance services. The main part of this chapter examines some implications for future development of Vietnam's insurance services market, and provides an overall assessment on the implementation of commitments on the national treatment obligation.

1. Vietnam's commitments in insurance services

At the bilateral level, the Bilateral Trade Agreement between the US and Vietnam (hereinafter US-VN BTA), which was concluded in 2001, has the most comprehensive coverage, and is formatted to be consistent with the GATS schedule of specific commitments. This is the first agreement to encompass trade in services, including insurance services, which significantly influences the development of Vietnam's insurance market. According to Kokko, the US-VN BTA served as an important step towards a membership in the WTO as well as continuance of the economic reform.[751] In addition, a significant implication of the US-VN BTA is that Vietnamese commitments have probably been regarded by other countries as grounds for both bilateral and multilateral negotiations during the process of WTO accession.

On the other hand, at the multilateral level, because Vietnam received observation status in GATT and the WTO in 1994, it did not participate in the negotiations for liberalization of insurance services during the Uruguay Round or during the Second and Fifth Protocols on financial services, including insurance services, in 1995 and 1997, respectively. As part of its accession negotiations, Vietnam submitted a schedule of specific commitments for liberalization of domestic services, including insurance services. This schedule constitutes an integral part of Vietnam's accession agreement and legally binds Vietnam from 2007. Accordingly, Table 4 summarizes the commitments in two schedules in insurance services, and shows the liberalization of Vietnam's insurance market from 2001 to 2012, the date by which all commitments on opening insurance services must be fully implemented.

(i) Scope of business

Similar to the bilateral commitments, in the 2007 commitments, market access on the cross-border supply of insurance services is applicable to four categories of insurance services, namely insurance services in international transportation; reinsurance services; insurance brokerage and reinsurance brokerage services; and consultancy, claim settlement and risk

[751] Kokko, Ari. 2004. "Growth and reform since the Eighth Party Congress". In Duncan McCargo, ed., *Rethinking Vietnam*. London and New York: Routledge Curzon, p. 77.

assessment services.[752] In addition, foreign insurers are permitted to engage in cross-border transactions with foreign owned companies or foreigners working in Vietnam.[753] Vietnam has agreed to ensure there are no limitations on market access with respect to consumption abroad (Mode 2) at both bilateral and multilateral levels.[754]

Statutory insurance services are permitted to be supplied by wholly foreign-owned companies from 2008.[755] There was no bilateral commitment in the US-VN BTA on supplying insurance agent services through Mode 3, whereas these services have been fully liberalized at the multilateral level.[756]

With regard to reinsurance, Vietnam committed in the US-VN BTA that the rate of 20 percent liability to be ceded to Vietnam National Reinsurance Company would be abolished from 2006.[757] However, under the multilateral commitments, the supply of reinsurance services under Mode 3 has been subject to no restrictions on market access.

(ii) Investment

In terms of equity participation into a subsidiary in Vietnam, in the 2001 commitments, US insurance companies are allowed to set up joint ventures with US equity participation of less than 50 percent from 2004, and up to 100 percent by 2006.[758] At the multilateral level, foreign insurers are permitted to establish either joint-venture or companies with 100 percent foreign invested capital from the date of accession, i.e., as of 2007.

As described in section 3.2 of Chapter Five, under the Vietnam Insurance Law, foreign insurers are not permitted to establish their branches in Vietnam to supply both life and non-life insurance services. Under the US-VN BTA, there was no commitment on market access for branches of foreign insurers. However, at the multilateral level, branches of foreign non-life insurers shall be allowed by 2012 in accordance with prudential regulations.[759]

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752 Vietnam – Schedule of Specific Commitments, GATS /SC/142, 19 March 2007, p. 42.
753 *Id.*
754 *Id.* p. 43.
755 *Id.* p. 43.
756 *Id.* p. 43.
757 The US-VN BTA, Chapter III, Annex G – Vietnam, p. 13.
758 *Id.*
759 Vietnam – Schedule of Specific Commitments, GATS /SC/142, 19 March 2007, p. 43.

Table 4: Vietnam's commitments in insurance services: past, present and future

Sub-sector	Mode of supply		US-VN BTA 2001	WTO commitments 2007	Phased in 2012
A. Insurance and insurance-related services: a. Direct insurance (a) Life insurance, excl. health insurance services (b) Non life insurance services b. Re-insurance and retrocession c. Insurance intermediation (such as brokerage and agency) d. Services auxiliary to insurance	Mode 1	MA	None for insurance services provided to foreign-invested enterprises, foreigners working in Vietnam; reinsurance services; insurance services in international transportation; insurance broking and reinsurance broking services; advisory, claim settlement and risk assessment services.	None for insurance services provided to foreign-invested enterprises, foreigners working in Vietnam; reinsurance services; insurance services in international transportation; insurance broking and reinsurance broking services; advisory, claim settlement and risk assessment services	
		NT	None	None	
	Mode 2	MA	None	None	
		NT	None	None	
	Mode 3	MA	None, except: Branches depending upon the Insurance Business Law; Joint ventures with US capital contributions less than 50 percent by 2004; and up to 100 percent by 2006; Unbound for insurance agent services; Statutory insurance business supplied by joint ventures with US capital contributions by 2004; and by companies with 100 percent US invested capital by 2006;* Abolishment of compulsory cession of 20 percent of the contracted liabilities to the Reinsurance Corporation of Vietnam by 2006.	None, except: Companies with 100 percent foreign invested capital not being permitted to engage in statutory insurance business.*	By 2012, branches of non-life insurers being permitted subject to prudential regulations. By 2008, companies with 100 percent foreign invested capital engaging in statutory insurance business.*
		NT	None except for statutory insurance business	None	
	Mode 4	MA	Unbound, except as indicated in the horizontal commitments	Unbound, except as indicated in horizontal commitments.	
		NT	Unbound, except as indicated in the horizontal commitments	Unbound, except as indicated in horizontal commitments	

Note:
MA = Market Access; NT = National Treatment.
* Statutory insurance business includes civil liability of vehicle owners, insurance in construction and installation, insurance for oil and gas projects, and insurance for projects and construction of high danger to public security and environment.

(iii) Movement of natural persons

The limitations on market access in supplying insurance services through the presence of foreign natural persons in Vietnam are consistent with the horizontal commitments, which apply to all service sectors and sub-sectors. In the US-VN BTA, the horizontal commitments under Mode 4 extend to three categories of persons, namely intra-corporate transferees, other corporate personnel, and service sale persons.[760] At the multilateral level, Vietnam inscribes no commitments on both market access and national treatment, except for measures relating to entry and temporary stay of five categories of natural persons, namely intra-corporate transferees, other personnel, service sales persons, persons responsible for setting up a commercial presence, and contractual service suppliers.[761]

(iv) National treatment

Full national treatment is granted to Modes 1, 2 and 3 at the multilateral level. These commitments are more liberal than those of the US-VN BTA, where the national treatment obligation is not guaranteed for the provision of statutory insurance services under Mode 3.[762]

With respect to Mode 4, Vietnam undertakes multilateral commitments with limitations, whereby only five categories of natural persons shall enjoy the full national treatment when supplying insurance services in Vietnam.

In general, Vietnam's commitments on liberalization of insurance services in 2007 are more liberal than those commitments in 2001 under the US-VN BTA, and make Vietnam's insurance market more open to competition by foreign insurance services and service suppliers under the WTO.

2. Implications for Vietnam's insurance services market[763]

2.1 More efficiency and stability

Trade liberalization in insurance services under the WTO framework could make Vietnam's insurance services sector more efficient and stable through: (i) better competitiveness, (ii) access to foreign markets, and (iii) positive spillover effect into the financial market.

First, competition fostered by existing as well as newly coming insurance service providers could offer both incentive and pressure for domestic insurance companies to reduce expenses and to increase corporate governance and management. According to a study conducted by the Institute of Financial Science, liberalization of insurance services in Vietnam has enabled domestic companies to gain experience and good practices in pricing

[760] The US-VN BTA, Chapter III, Annex G – Vietnam, p. 3.

[761] *See* Vietnam – Schedule of Specific Commitments, GATS /SC/142, 19 March 2007, pp. 4-9.

The entry of "contractual service suppliers" is allowed for computer and related services, and engineering services.

[762] The US-VN BTA, Chapter III, Annex G – Vietnam, p. 13.

[763] This section is based on Vu Nhu Thang. 2006b. Taking out a Policy on the Nation's Insurance Industry in the Post-WTO Era. *Vietnam Law and Legal Forum* 13(148), pp. 12-16.

and actuary techniques, insurance coverage design, customer network marketing, and risk management skills.[764] This trend is expected to continue during the post-WTO accession period. At the same time, domestic insurance companies may have an incentive to adopt international standards and prudential practices so that they can adjust to competition, as well as rationally expand operations by offering new financial services.

On the other hand, it has been argued that in order to continue and foster national economic reforms, a new motive and external "push" is necessary.[765] The WTO accession will be expected to provide such a motive and external "push" to strengthen Vietnam's economic reforms in compliance with the WTO rules and commitments.[766] This argument is also apparently applicable to the insurance services sector, whereby commitments towards more liberalization under the multilateral framework could push domestic insurers to improve their competitiveness.

Strengths of domestic insurers include broad customer networks and prestige in supplying insurance services in the domestic market.[767] In addition, domestic insurers also have competitive advantage in that they enjoy good understanding of customers' habits and culture, and have wide networks of local branches.[768] Diversity of high-quality insurance services supplied by foreign insurance companies operating in Vietnam will force domestic insurance companies to improve their service quality in order to foster competitiveness, and to avoid losing customer networks by raising financial strength and application of information technology. According to the same study by the Institute of Financial Science, despite concern about negative impacts on the domestic market, most existing insurance companies, including foreign insurance companies in Vietnam, see a positive impact on enlargement of insurance services as a result of foreign participation.[769]

By liberalization of the insurance sector, it is submitted that service quality and the variety of services will probably be improved to meet different needs of customers, hence ensure customers' interests. As described in section 2.3 of Chapter Five, areas for widening insurance products might include credit insurance for export and import activities, and liability insurance services, such as professional liability and general liability. It is observed that domestic insurance companies have been increasingly capitalized to improve competitiveness, and the total invested capital in 2004 grew by 16 times over that of 2000.[770] As a result, consumers, both businesses and individuals, will enjoy benefits of a fully-fledged domestic insurance market.

The second positive effect of the liberalization would be to help domestic insurance companies to extend their business to foreign markets. The WTO accession shall provide an opportunity for Vietnam to gain greater access to foreign markets with larger export potentials.

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[764] Institute of Financial Science. 2004. Assessment on the impacts of opening market for Vietnam insurance sector and some suggestions to develop insurance market in line with global integration process. Hanoi: Ministry of Finance (Vietnam), p. 103.

[765] Phan Thanh Pho. 2005. Vietnam Voi Tien Trinh Gia Nhap To Chuc Thuong Mai The Gioi [Vietnam's Accession to the World Trade Organization]. Hanoi: Nha xuat ban Chinh Tri Quoc Gia, pp. 14-15.

[766] Phan (2005), pp. 14-15.

[767] Ministry of Planning and Investment and UNDP (2006), pp. 48-49.

[768] *Id.* pp. 49-50.

[769] Institute of Financial Science (2004), pp. 140-141.

[770] Interview with Mr. Trinh Quang Tuyen, Chairman of the Association of Vietnamese Insurers. In "Thuong mai va Hoi Nhap – Van o dang … tiem nang" (Trade and Integration – Still in the form of … potential), *Vietnam Investment Review*, 18 June 2005.

Available at http://www.vir.com.vn – Last visited 5 October 2005.

By enjoying the MFN treatment as well as commitments of other WTO Members, it appears that insurance services exported from Vietnam shall be subject to less restrictive and discriminatory measures. Domestic insurance companies, after acquiring better competitiveness, are expected to expand their markets of business activities to other countries, and to cooperate with foreign insurance companies in order to establish subsidiaries to conduct insurance business abroad.

However, domestic insurers have limited experience in providing insurance services internationally, such as direct insurance services for certain oil projects invested abroad by domestic oil companies, or reinsurance services and agency for loss adjustment.[771] Moreover, even though there are reinsurance services supplied by local insurers to insurers abroad, this activity is very insignificant, accounting for less than US$ 10 million in 2006.[772] As long as most insurance companies focus on the domestic market, the expansion of their activities to other regional and international markets is very constrained. In addition, as mentioned earlier, it may take time for domestic insurers to improve their competitiveness. Therefore, it is arguable that greater market access to foreign territory would be a long-term rather than short or medium-term benefit.

Third, liberalization of insurance services may have a positive spillover effect on securities market development through mobilization of capital for economic growth. Insurers could play an important role in channeling savings to domestic investments as well as enhancing the efficiency of financial systems by (i) reduction of transaction costs, (ii) increase of liquidity, and (iii) facilitation of economies of scale in investment. Since the demand of capital for development investment from the government and enterprises is increasing, the total value of the securities market is forecasted at around 10-15 percent of GDP by the year 2010.[773]

On the supply side, insurance premiums will be expected to grow at annual average of 24 percent, equivalent to 4.2 percent of GDP by 2010.[774] Subsequently, by 2010 the total technical provisions of insurance companies will have accumulated to 12 times over the 2002 level, which should help raising the total investment by the insurance sector injected into the economy. For that reason, available funds in the insurance sector would apparently be an important source for securities market operations and development.

2.2 Facilitation of investment and external trade

As illustrated in section 1 of Chapter Five, the recent robust growth in the private sector and the expansion of international trade represent a strong demand for qualified and

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[771] Dinh Van Nha. 2002. Cac Giai phap Tong the Phat trien Thi truong Von va Thi truong Dich vu Tai chinh o Vietnam [Comprehensive Solutions for Developing Capital Market and Financial Services Market in Vietnam] (academic research paper, Ministry of Finance, Vietnam) (on file with the *Financial Scientific Institute*), p. 63.

[772] Ministry of Finance (2007), Table 10.

[773] Decision 163/2003/QD-TTg of the Prime Minister on approving the Strategy on Development of Vietnam Securities Market by the year 2010 with the objectives of further promoting securities market in terms of scope and quality in order to become an efficient and effective channel of capital mobilization; ensuring order and safety of the market as well as state regulation and supervision; and gradually improving competitiveness and active integration into international financial markets (Aug. 5, 2003) (Vietnam).

[774] Decision 175/2003/QD-TTg, Art. 1.2.a.

diversified insurance services. This demand has significantly intensified since entrepreneurs are more willing to create and expand their business ventures if they can secure adequate insurance protection. In addition, since the objective by the year 2010 is to better investment climate for both domestic and foreign investors,[775] more enterprises and business activities are expected to develop. According to the study of the Institute of Financial Science, most manufacturing enterprises observe foreign participation in the domestic insurance market as a positive factor for enlarging their choice of insurance services.[776] To some extent, insurance contracts could be considered as a guarantee for the quality of exported products to other countries.[777] While the government targets an annual export growth rate equivalent to two times of the economic growth rate,[778] the insurance premium written in export cargo was equal to only 6.55 percent of the total export volume in 2002.[779] This figure shows a potential need for insurance services in this domain.

On the supply side, Thai and Tran observed that the increasing development of Vietnam's insurance market has contributed to the expansion of foreign trade.[780] As noted earlier, further liberalization of trade in insurance services is expected to diversify insurance services in Vietnam as well as improve service quality. Therefore, it can be argued that further liberalization in the insurance sector under the WTO would be an appropriate response to such a desperate need in external trade.

With respect to foreign investment, increasing presence of foreign insurers in the domestic market would reassure foreign investors about satisfying their needs for insurance services, on the one hand, and make them more confident of Vietnam's investment environment, on the other hand.[781] Thai and Tran have also suggested that many foreign investors, who conduct investment business in Vietnam, wish to be insured by foreign insurers operating in Vietnam.[782] Furthermore, with liberalization, the choice will be extended to other foreign insurance services, including those supplied through Mode 1, which are probably suitable to the needs of entrepreneurs and investors. Consequently, commitments on foreign participation in Vietnam's insurance market could contribute to further facilitation of foreign investment.

2.3 Fierce competition

As observed in section 1 of this chapter, Vietnam's commitments in the WTO accession make the domestic insurance market relatively liberal. Vietnam, nevertheless, may impose several restrictions on market access with respect to unscheduled insurance service

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[775] The Strategy for Socio-Economic Development for the period of 2001-2010, at the Ninth Congress of Vietnam's Communist Party, 2001, Part II.1.

[776] Institute of Financial Science (2004), pp. 136-137.

[777] Pham Trung Cang, Chairman of Board of Directors, Tan Dai Hung Plastic Company. In "Lam an lon phai co bao hiem" [Big business deals need insurance]. *Thoi bao kinh te Vietnam*, 25 October 2006.

Available at http://www.vneconomy.com.vn – Last visited 22 May 2007.

[778] The Strategy for Socio-Economic Development for the period of 2001-2010, at the Ninth Congress of Vietnam's Communist Party, 2001, Part II.1.

[779] Insurance Strategy, p. 12.

[780] Thai and Tran (2004), p. 139.

[781] Institute of Financial Science (2004), p. 104.

[782] Thai and Tran (2004), p. 141.

sub-sectors or uncommitted modes of supply. Possible restricted measures may include, for example, cross-border supply of life and non-life insurance services supplied to Vietnamese citizens and domestic companies under Mode 1, establishment of branches of foreign life insurance companies under Mode 3, or movement of natural persons other than the five categories inscribed in the horizontal commitments under Mode 4.

Nevertheless, the implementation of commitments on liberalization requires Vietnam to open its insurance services sector to foreign participation and competition, and consequently domestic insurers might lose their markets. As noted by the government, weaknesses of domestic insurers include: (i) limited financial capacity compared to foreign companies; (ii) weak technological infrastructure and management system; (iii) lack of expertise and training; and (iv) lack of customer services and weak focus on service quality.[783] Other weaknesses affecting the development of domestic insurers could be a less-developed securities market and inexperienced individual customers.[784] As described in section 2.3 of Chapter Five, foreign insurers overwhelm the domestic life insurance market. As the majority of the domestic non-life insurance market is still held by domestic insurers, domestic insurers' share in Vietnam's insurance market as a whole was stable at 60 percent during 2003-2006.[785] This trend, however, may change in the future with increased foreign participation.

Another concern is that potentially fierce competition might cause failure of some insurance companies, especially domestic ones, thus affecting the efficiency and stability of the insurance sector.[786] However, as mentioned earlier, more competition could be a "push" for domestic insurers to improve their competitiveness. Competition also provides incentives for insurers to consolidate their financial capacity and adopt good standards and practices in business operations. Therefore, for the benefit of consumers and fair competition, any under-performing company should be closed. From the government standpoint, this competition should be properly addressed through better prudential regulation and supervision in order to assure the financial health of all insurers and thus improve credibility of Vietnam's insurance market.

Besides fierce competition, market access could give rise to the problem of cherry-picking, whereby foreign insurers selectively service the market, and only set up and expand their activities to profitable services and geographical areas.[787] The response to this concern is that those less profitable services, particularly those that were not profitable in the past, should not expect to gain from foreign participation in the domestic market. As pointed out by Skipper, there is no perfect national insurance market in the world.[788] Moreover, potential cherry-picking by foreign insurers is not a persuasive argument against opening the insurance sector because the government may follow a policy to promote insurance services on a non-discriminatory basis.

2.4 Increasing regulatory transparency, equity and complexity

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[783] Insurance Strategy, Sec. A.II.3.

[784] Ministry of Planning and Investment and UNDP (2006), p. 54.

[785] Ministry of Finance (2005), Table 2, p. 7; Ministry of Finance (2006), Table 2; and Ministry of Finance (2007), Table 2.

[786] Institute of Financial Science (2004), pp. 104-105.

[787] *Id.* pp. 105-106.

[788] Skipper (1997), p. 29.

As described in section 2.3 of Chapter One, one fundamental obligation under GATS is regulatory transparency. Transparency in policy-making procedures and application of laws are a pre-requisite condition for Vietnam to comply with the WTO agreements. In the insurance sector, for example, licenses for establishment and operation of insurance companies must be granted in conformity with master plan, roadmap, and orientation on development of Vietnam's insurance market as well as financial market.[789] This requirement apparently raises some concerns among investors in regard to how transparent and predictable the master plan and roadmap are in practice. Although the government has issued the Strategy on Development of Insurance Market, the full text of this strategy has not been published in the Official Gazette and is not accessible to both existing and potential investors.[790] Thus, to meet its transparency obligation, Vietnam is required to make public all laws, regulations and judgments relating to trade issues. In the long-term, regulatory transparency should result in a better investment environment by eliminating trade distortions, which are caused by ambiguity and information asymmetry, and therefore enable Vietnam to advance its economic development.[791]

In addition to regulatory transparency, GATS Article XVII on National Treatment indicates the assurance of equal treatment among enterprises, regardless of origin. This obligation may put domestic firms under pressure to restructure and innovate corporate governance to enhance their efficiency. It has been observed that an attempt towards a level playing field for all market players has proved to be a good condition for the promotion of trade in insurance services.[792] On the other hand, regulatory equity puts restraint on distortionary intervention by the government in the domestic insurance sector, as well as highlights incentives to eliminate discriminatory regulations. In other words, it would guarantee the removal of regulatory discretion and arbitrariness. Arguably, this endeavour would enhance the government's reputation in the eyes of both the international community and investors.

The national treatment obligation, however, probably makes it difficult for regulators to protect domestic insurance companies. As discussed in section 1.2 of Chapter One, the main rationale for insurance regulation is to address consumer protection. Liberalization will put pressure on domestic regulators and supervisors to ensure consumer protection with regard to services supplied not only by insurers headquartered in Vietnam, but also by other foreign insurers. Therefore, it is necessary that the supervisory authority should ensure that too strong competition from foreign insurance services and service suppliers does not seriously affect the solvency of domestic insurers nor undermine public confidence. It means that a more liberal insurance sector would require more complex, effective regulatory and supervisory framework to better ensure the interests of policyholders as well as the stability and integrity of the insurance market.

3. Compliance with the national treatment principle[793]

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[789] Vietnam Insurance Law, Art. 62.2.

[790] *See* the Official Gazette, No. 145 (6 September 2003), p. 9070 (in Vietnamese language).

[791] Cai and Hart (1996), p. 81.

[792] An interview with Finance Deputy Minister Le Thi Bang Tam. In "Bao hiem khong thuoc danh muc bao ho lon" (Insurance sector not subject to a high protection list). *Thoi bao kinh te Vietnam*, May 2005.

Available at http://www.vneconomy.com.vn – Last visited 5 October 2005.

[793] This section draws in part from Vu Nhu Thang (2007b), pp. 977-1009.

3.1 Implementation of commitments in insurance services: experience of Japan, the EU and China

Under the national treatment column, Japan made commitments on liberalizing its insurance market in the Second Protocol, which was binding to Japan until the end of 1997. In Mode 3, it undertook a limitation whereby foreign life insurance companies were required to retain in Yen currency an amount corresponding to their technical and claims provisions for Yen-dominated insurance policies until the end of June 1996.[794] In implementation of this commitment, in domestic law, the Yen currency requirement has been abolished since 1 April 1996.[795]

Moreover, foreign insurance companies must be licensed by the Financial Services Agency to supply insurance services in Japan, except for cross-border transactions on marine, aviation and transport insurance. It is reported that the criteria for granting licenses and the requirement of solvency margin are the same for Japanese and foreign insurance service suppliers.[796] In parallel with ensuring national treatment between domestic and foreign insurance companies, Japan also amended certain enforcement regulations of the Insurance Business Law with a view to introducing more stringent solvency margin standards and disclosure requirements.[797]

In case of the EU, in order to implement commitments in financial services, including insurance services, the European Council approved the Fifth Protocol to GATS by Decision 1999/61/EC dated 14 December 1998. While undertaking commitments on national treatment with regard to trade in insurance services, the EU introduced new legislation in order to increase solvency requirements for life and non-life insurers, especially in the areas of maritime, aviation and general liability business.[798]

With regard to China, as described in Chapter Four, section 2, China made commitments on liberalizing life and non-life insurance, reinsurance, and services auxiliary to insurance. There is no limitation on the national treatment column with regard to the supply of those insurance services in Modes 1 and 2. China also undertakes the full national treatment in Mode 3, except for the supply of statutory insurance services and the complete removal of 20 percent cession to Chinese Reinsurance Company by 2006.[799] China has revised its Insurance Business Law, and provided regulations and rules on implementation of these commitments, such as regulations on administration of foreign-funded insurance companies,[800] rules on administration of insurance brokerage, insurance agencies, and

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[794] Japan – Schedule of Specific Commitments. GATS Doc. No. GATS/SC/46/Suppl.1/Rev.1, 4 October 1995, p. 3;

[795] Japan – Notification pursuant to Article III.3 of the General Agreement on Trade in Services, Council for Trade in Services, WTO Doc. No. S/C/N/60, 28 May 1997.

[796] WTO. Trade Policy Review – Japan, Report by the Secretariat, WT/TPR/S/107, 9 October 2002, p. 62.

[797] *Id.* pp. 62-63.

[798] WTO. Trade Policy Review – European Communities, Report by the Secretariat, WT/TPR/S/136, 23 June 2004, p. 121.

[799] China – Schedule of Specific Commitments, GATS/SC/135, 14 February 2002, pp. 28-29.

[800] China – Notification pursuant to Article III.3 of the General Agreement on Trade in Services, Council for Trade in Services, WTO Doc. No. S/C/N/224, 24 December 2002.

reinsurance.[801] Foreign-funded insurance companies are allowed to supply property or life and health insurance in China.[802] A license is required to supply insurance services in China, and foreign-funded insurers must satisfy several requirements, including solvency standards and other prudential measures.[803]

Moreover, foreign-funded insurers are not required to cede to the China Reinsurance Corporation a portion of the primary risks for non-life, personal accident, and health insurance.[804] As observed by Chen and Shih, the level of competition in China's insurance market has become more intense due to the implementation of commitments in insurance services. This includes abolition of discriminatory measures which violate GATS Article XVII. [805] Accordingly, the supervision of insurance companies has been strengthened, including monitoring minimum solvency requirements, regulations on allocations of technical provisions, and raising capitalization.

Some remarks

In theory, international treaties might be applied directly or implemented by legislative and other measures.[806] From the experience of the above WTO Members, however, there are at least two observations with regard to the implementation of commitments on national treatment in supplying insurance services. First, for the application, commitments on liberalization of the domestic insurance services sector need to be incorporated into domestic legislation and other administrative regulations. In other words, specific domestic laws or regulations in the insurance sector should address the implementation of commitments. Second, there is evidence that enhancement of solvency requirements of insurers is considered a crucial measure when implementing commitments on national treatment in insurance services.

3.2 Implementation of commitments under Vietnamese legislation

[801] WTO. Trade Policy Review – China, Report by the Secretariat, WT/TPR/S/161/Rev.1, 26 June 2006, p. 222.

[802] Regulations of the People's Republic of China on Administration of Foreign-funded Insurance Companies, Art. 15.

[803] *Id.* Art. 8.

Other prudent measures, according to Article 11 of the Detailed Rules of 22 December 2005 for implementation of these Regulations include reasonable structure for corporate governance, stable and sound risk control system, sound internal control system, effective management information system, and good operating performance.

[804] Art. 101 of China Insurance Law 1995 on 20 percent compulsory cession to China Reinsurance Company was replaced by Art. 102 of China Insurance Law 2002. Accordingly, insurance companies, both domestic and foreign, are allowed to engage in reinsurance arrangement in accordance with relevant provisions of the China Insurance Regulatory Commission.

[805] Chen, Chien-Hsun and Hui-Tzu Shih. 2004. Banking and Insurance in the New China: Competition and the Challenge of Accession to the WTO. Edward Elgar: Massachusetts, pp. 146-148.

[806] Kong, Qingjiang. 2000. China's WTO Accession: Commitments and Implications. *Journal of International Economic Law*, p. 679.

As Vietnam acceded to the WTO, its commitments in the Protocol on the Accession[807] and other multilateral agreements, including GATS, became international treaties to which Vietnam is a party under Vietnamese legislation.[808] According to the Constitution, the National Assembly has the power to ratify international treaties, directly signed by or upon the proposal of the President of State.[809] The ratification of international treaties by the National Assembly shall be made in the following circumstances: (i) as provided in the international treaties, (ii) as signed on behalf of the State, and (iii) as signed on behalf of the government but containing provisions contrary to domestic laws.[810] Since several commitments are inconsistent with Vietnam's current legislation,[811] the Protocol on the Accession of Vietnam was ratified by the National Assembly in 29 November 2006.[812]

International treaties shall be bound by Vietnam in accordance with the provisions stated in these treaties.[813] In Vietnam, for the purpose of application of international treaties, an implementation plan is required, which consists of proposals on amendment of and addition to or repeal of current legislations, or enactment of new laws.[814] Therefore, the responsibility for implementation is allocated among legislative, administrative and judicial bodies.

In case of the US-VN BTA, for example, Vietnam commits to extend market access on banking services, whereby 100 percent equity participation by US banks in subsidiary shall be allowed by 2010.[815] Accordingly, revisions of the banking law were made in 2004 to include the form of wholly owned subsidiaries of foreign credit institutions under Mode 3. In addition, foreign credit institutions are allowed to contribute capital and purchase shares of credit institutions operating in Vietnam, in conformity with governmental regulations.[816]

The application and implementation of international treaties in Vietnam must be conducted by enacting legislative or other measures. In other words, the National Assembly has the power to incorporate international treaties into domestic laws and the government may provide administrative regulations and rules for such implementation. Specifically, any provisions in the Vietnam Insurance Law which are inconsistent with Vietnam's obligations and commitments under GATS, must be revised or removed. This approach is similar to that of Japan, EU and China as described earlier.

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[807] Protocol on the Accession of the Socialist Republic of Vietnam done at Geneva (Nov. 7, 2006). WTO Doc. No. WT/L/662, 15 November 2006.

[808] *See* Law on Signing, Acceding to, and Implementing International Treaty (Jun. 14, 2005) [hereinafter Law on Treaty] (Vietnam), Art. 2.1.

Under Vietnamese laws, "international treaty" signed or acceded by the Socialist Republic of Vietnam is defined as an agreement in written form, which is signed or acceded on behalf of the State or the Government of the Socialist Republic of Vietnam with one or several countries, or international organizations.

[809] Resolution of the National Assembly No. 51/2001/QH10, on amendment of and addition to the 1992 Constitution of the Socialist Republic of Vietnam (Dec. 25, 2001) (Vietnam), para. 17.

[810] Law on Treaty, Art. 31.

[811] For example, in insurance services, Vietnam commits to open market access for foreign non-life insurance companies to supply insurance services in Vietnam in the form of branches, while this form is prohibited in the Vietnam Insurance Law.

[812] Resolution of the National Assembly No. 71/2006/NQ-QH11 on ratifying the Protocol of Accession to the WTO Agreement (Nov. 29, 2006) [hereinafter Resolution 71] (Vietnam).

[813] Law on Treaty, Art 71.2(c).

[814] *Id.* Art. 31. *See also* Resolution 71, para. 3.

[815] The US-VN BTA, Chapter III, Annex G – Vietnam, p. 21.

[816] Law on Amendments of and Additions to some articles of the Law on Credit Institutions, (Jun. 15, 2004) (Vietnam), Art. 1.2.

On the other hand, direct application of commitments in insurance services is also permitted. Specifically, insurers are not required to cede a compulsory amount of 20 percent of non-life insurance liabilities to Vietnam Reinsurance Corporation in case of ceding to insurers abroad as provided in Article 9.2 of the Vietnam Insurance Law.[817] Moreover, in cases where there might be conflict between international treaties and domestic laws, the multilateral agreements and commitments shall prevail.[818] This indicates a clear legal basis of direct effect of the WTO obligations and commitments in Vietnam. One explanation for this direct application of commitments in reinsurance services is that these commitments are "sufficiently clear and detailed for implementation".[819] It would suggest that there is no need for any more specific provisions in the domestic legislation concerning compliance with these commitments. Another reason might be that Vietnam was required to abolish this compulsory cession by the end of 2006 under the US-VN BTA as described in Table 4.

3.3 Interpretative issues in the light of the national treatment principle

As Vietnam inscribed "None" in Modes 1, 2 and 3, the full national treatment applies to these three modes of supply. Under Mode 4, Vietnam accords the full national treatment only to five categories of natural persons. Accordingly, the general approach to interpretation of this principle governs Vietnam's Schedule of Specific Commitments in insurance services. The following section shall examine four elements of the national treatment obligation under the Vietnam Insurance Law, namely: (i) Vietnam's scheduled insurance service sub-sectors; (ii) measures affecting trade in insurance services; (iii) the issue of likeness between domestic and foreign insurance services and service suppliers; and (iv) the standard of "no less favourable" treatment.

(i) Scope of insurance sub-sectors

Vietnam undertakes to liberalize direct insurance, reinsurance and retrocession, insurance intermediation, and services auxiliary to insurance under the multilateral framework. Table 5 examines the consistency between Vietnam's current regulations on insurance services and Vietnam's commitments in the WTO accession.

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[817] Resolution 71, para. 2.

Under the Vietnam Insurance Law, Art. 9.2 stipulates that in case of reinsurance abroad, all insurers are obliged to reinsure a portion of the liability under reinsurance contracts to a domestic enterprise, which is engaging in reinsurance business in conformity with governmental regulations.

[818] *Id. See also* Vietnam Insurance Law, Art. 2.2.

[819] Law on Treaty, Art. 6.3. *See also* Governmental Submission Letter on the Results of the Negotiations and Ratification of the Protocol on the Accession to the WTO, Doc. No. 155/TTr-PC dated 22 November 2006 (Vietnam), pp. 41-42.

Table 5: Scheduled insurance services sub-sectors vs. Vietnam Insurance Law

	Vietnam's commitments	Consistent	Vietnam Insurance Law
a.	Direct insurance		
	(a) life, excl. health insurance services	↔	Art. 7.1 (life insurance)
	(b) non-life	↔	Art. 7.2 (non-life insurance)
b.	Reinsurance and retrocession	↔	Art. 61 (reinsurance)
c.	Insurance intermediation (brokerage, agency)	↔	Art. 90 (brokerage); Art. 85 (agency)
d.	Services auxiliary to insurance (consultancy, actuarial, risk assessment, claim settlement)	→	Art. 60.1 (business scope of insurers)

With regard to direct insurance services, both life and non-life insurance are permitted to be supplied under the Vietnam Insurance Law.[820] It is submitted that the scope of life and non-life insurance is consistent with Vietnam's commitments.

One legal concern over interpretation of Vietnam's commitments is whether Vietnam inscribes health insurance services for liberalization. Apparently, as Vietnam clearly inscribes sub-sector "life, excl. health insurance services", one possible interpretation is that Vietnam does not commit health insurance services under the multilateral liberalization. In other words, Vietnam implies the inscription of "Unbound" for these services under the national treatment obligation.

On the other hand, the general approach to inscribing Vietnam's commitments is that service sectors and sub-sectors are specifically encoded corresponding to the UN CPC. For all other scheduled service sectors, including business, distribution, education, environment, and tourism, Vietnam inscribes service sub-sectors corresponding to CPC numbers. It could be argued that Vietnam would follow either the WTO Classification or UN CPC for making commitments in insurance services.[821] In terms of the WTO Classification, it would appear that Vietnam excludes health insurance services from its schedule because the WTO Classification includes health insurance services into the category of life insurance. The opposite is true if Vietnam follows the UN CPC. As described in section 3.1 of Chapter Four, because health insurance services are classified under non-life insurance in the UN CPC, Vietnam would be obliged to liberalize health insurance services.

However, while other service sectors and sub-sectors specifically refer to CPC for undertaking commitments, this is not the case for financial services, including insurance services. This would suggest that the intent of negotiators is to undertake insurance services

[820] Vietnam Insurance Law, Art. 7.

Scope of life insurance services in Vietnam includes: (i) whole life insurance; (ii) pure endowment insurance; (iii) term insurance; (iv) endowment insurance; (v) annuity; and (vi) other classes of life insurance as may be prescribed by the Government from time to time.

Scope of non-life insurance service in Vietnam includes: (i) health insurance and personal accident insurance; (ii) property insurance and casualty insurance; (iii) transit insurance pertaining to land, sea, rivers, railways and air; (iv) aviation insurance; (v) motor insurance; (vi) fire and explosion insurance; (vii) hull insurance and ship-owner's civil liability insurance; (viii) public liability insurance; (ix) credit insurance and financial risk insurance; (x) business interruption insurance; (xi) agricultural insurance; and (xii) other classes of non-life insurance as may be prescribed by the Government from time to time.

[821] This reasoning was found in *EC – Bananas* case. *See* section 5.3 of Chapter Two.

based on different services classification, neither the WTO Classification nor UN CPC. The general structure of inscribing insurance service sub-sectors might imply that Vietnam bases its schedule on the Annex. However, the Annex does not expressly indicate how health insurance services are classified. Accordingly, this would cause an ambiguity in the implementation of Vietnam's commitments in this sub-sector. Moreover, under the Vietnam Insurance Law, health insurance services are not defined in life insurance, but non-life insurance.[822]

Therefore, although Vietnam clearly excludes health insurance services under the sub-sector of life insurance, panels would be likely to interpret Vietnam's commitments in non-life insurance services to include health insurance services. This issue is significant in cases where Vietnam allows foreign non-life insurers to supply insurance services through the form of branches starting from 2012. In other words, branches of foreign non-life insurers would claim that they are entitled to supply health insurance services under the Vietnam Insurance Law without being subject to any discrimination under the meaning of GATS Article XVII.

Under the Vietnam Insurance Law, the scope of reinsurance comprises: (1) ceding part of the risk assumed to one or more other insurance companies; and (2) assuming part or the entire risk insured by other insurance companies.[823] With regard to insurance intermediation, the Vietnam Insurance Law has permitted insurance companies to supply insurance brokerage services,[824] and agency services.[825] Accordingly, it is submitted that Vietnam's domestic law on reinsurance services and insurance intermediation is consistent with its commitments in the WTO.

The scope of services auxiliary to insurance in the Vietnam Insurance Law includes: (i) prevention and mitigation of risks and losses; (ii) loss surveys; (iii) acting as loss survey and claim settlement agents and/or third party claim agents; (iv) fund management and investment; and (v) other operations as provided by the laws.[826] However, there is no provision on insurance consultancy services and actuarial services. Although it may be argued that those two auxiliary services could be included in "other operations as provided by the laws", a clear provision on consultancy and actuarial services is necessary. This would ensure better compliance with Vietnam's commitments as well as fulfillment of the transparency obligation under GATS.

(ii) Measures affecting trade in insurance services

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[822] Vietnam Insurance Law, Art. 7.2.

[823] *Id.* Art. 61.

[824] *Id.* Art. 90.

Brokerage operations consist of: (i) providing information concerning the class of insurance, terms and conditions of insurance, premiums, and potential insurers to customers; (ii) advising customers on risk management, selection of suitable class of insurance, terms and conditions of insurance, tariffs, and appropriate insurers; (iii) negotiating and arranging the conclusion of insurance contracts between insurers and customers; and (iv) carrying out other activities relating to the performance of the insurance contracts as may be requested by customers.

[825] *Id.* Art. 85.

Agency activities include: (i) offering and selling insurance contracts; (ii) arranging for insurance contracts to be signed; (iii) collecting premiums; (iv) arranging for claim settlements or payment of indemnity or insurance benefits upon the occurrence of the insured events; and (v) carrying out other activities relating to the performance of insurance contracts.

[826] *Id.* Art. 60.1.

As described in Chapter Two, section 4.2, under the national treatment principle, the term "measures" would broadly cover any domestic measure of governmental nature and affecting trade in insurance services. This broad coverage of measures includes, but is not limited to, substantive and procedural regulations, compulsory and voluntary but legally enforceable measures, and taxes *per se* and tax administration measures causing financial burden on foreign services and service suppliers. It means that trade in insurance services is affected not only by insurance regulations, but also by other general rules and measures, such as foreign exchange control, tax policy, competition law, and subsidies.

Thus, Vietnam may be challenged by other WTO Members with regard not only to those measures which fall within the scope of the Vietnam Insurance Law, but also other measures, which directly or indirectly affect trade in insurance services. For example, any support by the government to domestic insurers or subsidies to consumers in order to purchase domestic insurance services may constitute a "measure affecting trade in services" under the meaning of GATS national treatment obligation. Moreover, any measures adopted by the competition authority under the Competition Law of Vietnam on approving merger and acquisition with a view to strengthening domestic insurers could also fall within the scope of GATS Article XVII.

Accordingly, the assurance of other laws and regulations, which may either directly or indirectly affect trade in insurance services, consistent with the national treatment obligation, could be an important factor for Vietnam's implementation of commitments under the WTO framework.

(iii) Likeness

As presented in section 4.3 of Chapter Two, the issue of likeness is of significance in interpreting GATS Article XVII. This is because WTO jurisprudence tends to rely only on service classification as an exclusive criterion for determining likeness between foreign and domestic services. Moreover, the likeness of service suppliers seems to be ignored in the assessment of likeness as a whole for the purpose of the national treatment obligation.

Concerning Vietnam's scheduled insurance service sub-sectors, four important legal issues need to be clarified here.

The first issue is whether likeness could be established among four different sub-sectors: direct insurance, reinsurance and retrocession, insurance intermediation, and services auxiliary to insurance. If all insurance and insurance-related services are like services under the meaning of GATS Article XVII, Vietnam is required to remove all different treatments among these four insurance service sub-sectors. For example, any differences in the minimum legal capital requirement between direct insurers and insurance brokerage companies must be removed.[827]

[827] *See* Decree 46/2007/ND-CP, Art. 4.
The current legal capital requirements are VND 300 billion (approximately US$ 18 million) for non-life insurance company; VND 600 billion (approximately US$ 36 million) for life insurance company; and VND 4 billion (approximately US$ 300,000) for insurance brokerage companies.

However, it is safe for Vietnam to argue that these four insurance service sub-sectors are unlike under the meaning of GATS Article XVII. There are at least two reasons. Although service classification could not be a decisive factor in determining likeness, this criterion is effective in excluding likeness when two services fall into different sectors or sub-sectors. As noted earlier, Vietnam's schedule seems to follow the Annex, which apparently categorizes direct insurance, reinsurance and retrocession, insurance intermediation, and services auxiliary to insurance in different sub-sectors. Especially, by putting these insurance services in different headings under its Schedule of Specific Commitments, Vietnam intentionally treats the four sub-sectors differently. In addition, as far as the criterion of products' end-uses is concerned, these four insurance services also serve different functions. As described in section 1.1 of Chapter One, direct insurance services are sold to the public, while reinsurance services are only sold to insurers. Insurance intermediation involves activities of introducing, proposing and arranging the conclusion of insurance contracts between insurer and insured.[828] Services auxiliary to insurance is to support insurers in supplying direct insurance services.[829]

The other reason is that scheduling practices of the selected WTO Members as examined in Chapter Four reveal that these four sub-sectors are treated differently in their inscriptions of commitments. This could suggest that these four insurance service sub-sectors are unlike under the meaning of the national treatment obligation.

The second issue is whether or not likeness could be established between life and non-life insurance services. Under Vietnam's Schedule of Specific Commitments, life and non-life insurance services are classified under the same sub-sector of "direct insurance". If life and non-life insurance services are alike, other WTO Members may challenge, for example, Vietnam's higher minimum legal capital requirement on life insurers.[830] As Vietnam's life insurance market is dominated by foreign insurers, this measure could accord less favourable treatment to foreign life insurers compared to domestic like non-life insurers.

However, Vietnam can argue that life and non-life insurance services are unlike under the meaning of GATS Article XVII. The above two reasons could effectively apply to this argument. More specifically, all three services classifications, i.e. the WTO Classification, UN CPC, and the Annex, expressly categorize life and non-life insurance services under different headings. As far as the criterion of products' end-uses is concerned, life and non-life insurance services serve different functions. As described in Chapter One, section 1.1, life insurance is insurance of the person, whereas non-life insurance is to protect property. Moreover, the scheduling practice of the selected WTO Members as analyzed in Chapter Four also shows that life and non-life insurance services are treated differently in their commitments on national treatment. Therefore, Vietnam may be safe to treat life and non-life

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[828] According to the explanatory note of the UN CPC to the sub-sector of 81401, insurance intermediation services are defined as "services of intermediaries between insurance companies and their clients". *See* Provisional CPC (1989).

In a new version of the UN CPC, insurance brokerage and agency services are categorized under the sub-sector 71610, which covers services of selling insurance and pension products. *See also* Central Product Classification of the United Nations, Version 1.1 (CPC Ver. 1.1), 2002.

Available at http://unstats.un.org/unsd/cr/registry/regcst.asp?Cl=16 – Last visited 22 May 2007.

[829] According to the explanatory note of the UN CPC to the sub-sector of 8140, services auxiliary to insurance are defined as "services closely related to management of insurance". *See* Provisional CPC (1989).

In a new version of the UN CPC, services auxiliary to insurance are categorized under the sub-sector 716. *See also* CPC Ver. 1.1 (2002).

[830] *See* Decree 46/2007/ND-CP, Art. 4.

insurance services differently because their likeness is not established under the GATS national treatment obligation.

The third issue is whether likeness could be established between insurance brokerage and insurance agency services. In all three services classifications, both services are categorized under the same sub-sector. More specifically, under the UN CPC, insurance brokering and agency services are in the same heading of CPC 81401. Accordingly, there is a possibility that these two services are alike under the meaning of GATS Article XVII. As far as service suppliers are concerned, they are alike if they supply these like services.

If likeness is broadly determined by relying on the same heading of "insurance intermediation", Vietnam might be found in violation of GATS Article XVII when according different treatment, which is at the cost of foreign services and service suppliers, between insurance brokerage and insurance agency services. Under the Vietnam Insurance Law, insurance brokerage services are supplied by insurance brokerage enterprises, and insurance agency services are supplied by either natural persons or business entities.[831] While insurance brokerage enterprises are subject to the minimum legal capital requirement of US$ 300,000, there is no such requirement on corporate agents.[832] Even though there is no discrimination between domestic and foreign owned insurance brokerage enterprises, Vietnam might be found in violation of GATS Article XVII as long as the likeness between insurance brokerage and agency services is established, because foreign owned insurance brokerage enterprises are treated less favourably than domestic corporate agents with regard to the measure on legal capital requirement. Moreover, in practice, as foreign owned insurance brokerage enterprises dominate Vietnam's insurance market in terms of the total brokerage fees, this measure of the minimum capital requirement may result in a financial burden on foreign owned brokerage enterprises.

As discussed in Chapter Two, section 4.3, the scope of likeness under the meaning of GATS Article XVII would be narrowed down if other criteria for determining likeness are taken into account, including product's end-uses and consumers' tastes and habits. On the one hand, the criterion of product's end-uses is to clarify the extent to which two services are able to carry out the same functions. Both insurance brokerage and agency services may share some similar functions, including introducing, proposing and arranging the conclusion of insurance contracts between insurer and insured. However, as far as the needs of consumers are concerned, consumers may see that agency services and brokerage do not share common end-uses. While brokers represent the insured, agents represent insurers in exercising insurance intermediation services. Therefore, insurance brokerage and agency services serve very different functions in terms of advising consumers in purchase of insurance contracts. On the other hand, the criterion of consumers' tastes and habits is to clarify the extent to which consumers are willing to purchase those services. Although both insurance brokers and agents receive commissions from insurance premiums paid by consumers, it could be argued that consumers are only willing to use and pay for brokerage services. Moreover, as far as likeness of insurance intermediation service suppliers is concerned, insurance brokers are independent from insurers, whereas insurance agents are dependent on insurers based on insurance agency contracts.[833] This means that because the likeness of service suppliers is not determined, the

[831] Vietnam Insurance Law, Art. 84 and 89.
[832] Decree 46/2007/ND-CP, Art. 4.
[833] *See* Vollbrecht, Jorg. 2001. Insurance Regulation and Supervision. In OECD. *Policy Issues in Insurance: Insurance Regulation and Supervision in the OECD Countries*. Paris: OECD, p. 59.

likeness of insurance brokerage and insurance agency services and suppliers as a whole under the meaning of GATS Article XVII could not be established.

The last issue is whether other services, including consultancy, actuarial, risk assessment, and claim settlement under the sub-sector "Services auxiliary to insurance" are alike or not under the meaning of GATS Article XVII. Under Vietnam's Schedule of Specific Commitments, all these services are under the same sub-sector. WTO Members may claim that, for example, because Vietnam would adopt the Annex for scheduling its commitments, actuary services and claim settlement services are alike because they are under the same sub-sector. In addition, if Vietnam wished to differentiate between these two services, Vietnam would expressly put them into different sub-headings, as it does regarding direct insurance services (between life and non-life). As far as service suppliers supply these like services, they are alike. Because likeness is established under the meaning of GATS Article XVII, Vietnam is liable for according foreign services and service suppliers no less favourable treatment than it accords to domestic like counterparts.

Consequently, Vietnam might be at risk and challenged by other WTO Members if it, for example, imposes indirect tax rate on actuarial services higher than that of risk assessment services. In practice, foreign insurers dominate Vietnam's life insurance market while Vietnamese insurers are the main players in the non-life insurance market. Moreover, as described below in section 1.2 of Chapter Seven, under Vietnam's current regulations, only life insurers are required to employ actuarial services. A higher indirect tax rate on actuarial services apparently could lead to a higher operational cost for foreign life insurers. By the same token, a low indirect tax rate on risk assessment services would result in a low operational cost for domestic non-life insurers. This measure, therefore, could modify the conditions of competition in favour of Vietnam's domestic insurers.

However, in the UN CPC, these services are categorized under different sub-headings, namely consultancy services (81402), actuarial services (81404), and average and loss adjustment services (81403). As far as the UN CPC is concerned, it could be argued that likeness has not been established among services auxiliary to insurance because they are categorized under different sub-headings. Moreover, if the criterion of product's end-uses is taken into account for the purpose of GATS Article XVII, these services do not share similarities in functions. Actuarial services involve professional expertise in determining insurance premiums as well as calculating technical provisions and other financial matters of insurance companies.[834] While risk assessment involves determining levels of risk exposed by insured or assets, claim settlement services are supplied once risk occurs under the insurance contract.[835] In general, it may be observed that consultancy services may be supplied at any

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According to Vollbrecht (2001), in most OECD countries, there is a distinction between supervision of agents and brokers because agents are directly employed by supervised insurers.

[834] According to the explanatory note of the UN CPC to the sub-sector of 81404, actuarial services are defined as "services consisting in calculation of insurance risks and premiums". *See* Provisional CPC (1989).

In a new version of the UN CPC, actuarial services are categorized under the sub-sector 71630, which covers services of calculating insurance risks and premiums. *See* CPC Ver. 1.1 (2002). *See also* IAIS. Guidance Paper No. 7 on The use of Actuaries as part of a supervisory model, October 2003, pp. 15-17.

Available at http://www.iaisweb.org – Last visited 22 May 2006.

[835] According to the explanatory note of the UN CPC to the sub-sector of 81403, average and loss adjustment services are defined as "evaluation and adjustment services of insurance claims". *See* Provisional CPC (1989).

In a new version of the UN CPC, insurance claims adjustment services are categorized under the sub-sector 71620, which covers (i) services of investigating insurance claims, determining the amount of loss or damages

time for the purpose of advising, producing, and implementing an insurance contract.[836] Even though consultancy, actuarial, risk assessment, and claim settlement services are categorized under the same heading of the Annex, these services could not be alike because they serve different functions. Accordingly, Vietnam would not be liable for the national treatment obligation when it accords different treatment to these unlike services auxiliary to insurance.

(iv) The standard of "no less favourable" treatment

As long as domestic and foreign insurance services and service suppliers are alike, Vietnam is required to ensure the standard of "no less favourable" treatment. This standard encompasses not only *de jure* but also *de facto* discrimination. An illustrative list of several possible discriminations against foreign insurance services and service suppliers includes:

- Any subsidies or favourable treatment by the government accorded to all non-life insurance companies in Vietnam might constitute *de facto* discrimination against foreign non-life insurers because Vietnam's non-life insurance market is dominated by domestic insurers. On the other hand, any subsidies or favourable treatment by the government accorded to domestic insurance brokerage companies might constitute *de jure* discrimination against foreign counterparts.

- Any tax incentives accorded by the government to foreigners and/or foreign owned capital companies in Vietnam to acquired non-life insurance services supplied by all insurers operating in Vietnam might constitute *de facto* discrimination against foreign insurers who supply insurance services through Mode 1 because domestic insurers account for more than 90 percent of the non-life insurance services market. Similarly, any tax incentives accorded by the government to all insurers in Vietnam to acquire reinsurance arrangements supplied by re-insurers in Vietnam might constitute *de facto* discrimination against foreign insurers who supply reinsurance services under Mode 1 because there is only one reinsurance company in Vietnam, which is domestically owned.

- Any incentives or favourable treatment, for example tax deduction, accorded by the Vietnamese government to its citizens who travel abroad, to acquire personal accident insurance supplied by domestic insurers, might constitute *de jure* discrimination against foreign insurers who supply insurance services through Mode 2.

- Any restrictions on foreign exchange applied by the government to all life insurance companies or all insurance brokerage companies in Vietnam might constitute *de facto* discrimination against foreign insurers and insurance brokerage companies because they dominate Vietnam's life insurance and insurance brokerage markets, respectively.

Concerning the implementation of commitments on national treatment under Vietnam's Schedule of Specific Commitments, there are at least three considerations.

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covered by insurance policies and negotiating settlements; (ii) services of examining claims which have been investigated and authorization of payments; and (iii) damage assessment services. *See also* CPC Ver. 1.1 (2002).

[836] According to the explanatory note of the UN CPC to the sub-sector of 81402, consultancy services are defined as "advisory services to businesses or persons on commercial or personal insurance coverage, with or without a profit element". *See* Provisional CPC (1989).

In a new version of the UN CPC, consultancy is categorized under the sub-sector 71690, which includes other services auxiliary to insurance and pensions. *See also* CPC Ver. 1.1 (2002).

First, to implement commitments on national treatment in insurance services, Vietnam has issued governmental regulations to address three discriminatory measures against foreign owned insurers.[837] The first measure on discrimination in business scope between domestic and foreign insurers has been eliminated.[838] This means that foreign insurance companies and insurance brokerage companies are permitted to supply insurance services to all enterprises in Vietnam as well as certain compulsory insurance services. The second measure on the phased-in establishment of internal branching of insurers in Vietnam has been removed.[839] Accordingly, clear and nondiscriminatory criteria are applicable to both domestic and foreign insurance companies.[840] The third measure on the compulsory cession of 20 percent of non-life insurance premiums to Vietnam Reinsurance Corporation in case of ceding to insurers abroad has been eliminated.[841]

By passing new governmental regulations, Vietnam has substantially addressed all issues concerning Vietnam's commitments on the WTO accession. However, as noted in section 3.2 of Chapter Five, Article 4.2 of the Vietnam Insurance Law maintains favourable conditions towards state-owned insurers, whereby the State shall invest capital and other resources in those enterprises to bolster their development and safeguard their dominant role in the insurance market. This provision indicates a discrimination against both foreign participation and the domestic private sector.

As far as foreign insurance service suppliers are concerned, other WTO Members may challenge Vietnam because this provision constitutes *de jure* discrimination in favour of domestic state-owned insurers. As discussed in section 3 of Chapter Three, in order for a measure inconsistent with Article GATS XVII on National Treatment to be justifiable by the prudential exception, that measure must be concerned with the solvency of insurers. It is submitted that this measure safeguarding the dominant role of state-owned insurers, is irrelevant to prudential reasons. Accordingly, this measure can not be justified by the prudential exception.

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[837] Decree 45/2007/ND-CP of the Government on providing guidance on implementation of a number of articles of the Law on Insurance Business (Mar. 27, 2007) (Vietnam) replaces Decree 42/2001/ND-CP of the Government on providing guidance on the implementation of a number of articles of the Law on Insurance Business (Aug. 1, 2001) (Vietnam).

[838] *See* Decree 42/2001/ND-CP, Art. 39.1.

Before accession to the WTO, foreign insurance companies and insurance brokerage companies were not permitted to supply insurance services to SOEs nor to offer certain compulsory insurance services. Moreover, the expansion of their operations was subject to the Ministry of Finance's discretion, a demand for market development, or provisions of international treaties.

[839] *Id.* Art. 39.3, 4 and 5.

Upon the entrance into Vietnam's insurance market under Mode 3, the commercial presence of foreign insurers was allowed to set up one domestic branch, in addition to its headquarters, within the first year in operation, and two additional domestic branches after three years in operation. Additional domestic branches of the commercial presence of foreign insurers could be permitted after five years in operation in accordance with the needs and development of Vietnam's insurance market.

[840] Decree 45/2007/ND-CP, Art. 11 sets out criteria for establishing branches of insurance companies, which are licensed under the Law on Insurance Business: (i) chartered capital in hand consistent with rules of the MOF; (ii) effective structure for management, operation and internal control and supervision; (iii) charter of branch; (iv) experienced management staff; and (v) application dossiers.

[841] *See* Decree 42/2001/ND-CP, Art. 22.1.

While insurance companies are allowed to reinsure for other insurance companies, including insurance organizations abroad, the former were required to cede at least 20 percent of the liability under reinsurance contracts to the Vietnam National Reinsurance Company.

In response, Vietnam may argue that the dominant role of state-owned insurers has not *de facto* existed in the insurance market. Until the end of 2006, all state-owned insurers have been subjected to privatization – so-called "equitization" in Vietnam.[842] This evidence indicates that there will be no more state-owned insurers in the domestic insurance market. Meanwhile, the government has decided to refrain from establishing new state-owned insurance brokerage enterprises, as well as new insurers wholly-owned by other SOEs.[843]

However, in a future revision of the Vietnam Insurance Law, it will be necessary to remove this *de jure* discrimination of Article 4.2 in order to ensure compliance with Vietnam's commitments under the WTO.

Second, Vietnam must refrain from introducing future discriminatory measures, both *de jure* and *de facto*, under the meaning of GATS Article XVII. As Vietnam undertakes the full market access and national treatment commitments with regard to branches of foreign non-life insurers, it is necessary to provide concrete regulations on licensing requirements and operation of such commercial presence. Experiences of several WTO Members show that Vietnam could apply prudential regulations on branches of foreign non-life insurers, including minimum capital requirements. The current legal capital requirements applicable to non-life insurance companies are approximately US$ 18 million.[844] Although branches may be subject to the same prudential requirements as applied to domestic non-life insurers in order for better protection of consumers, the introduction of requirements on the solvency of branches should take into account the financial back-up by parent companies as well as supervision in the exporting country.[845] An excessively high level of minimum capital requirement, as in the case of China, could make Vietnam more vulnerable to being challenged by other WTO Members for *de facto* discrimination against branches of foreign non-life insurers. Although this measure could be justified by the prudential exception, Vietnam is liable to prove that the application of any discrimination against branches of foreign insurers does not constitute a disguised restriction on trade in insurance services.

Last, with regard to Mode 4 (movement of natural persons), as mentioned in section 1 of this chapter, Vietnam undertakes the full national treatment towards the entry and temporary stay of only five categories of natural persons, namely intra-corporate transferees, other personnel, service sales persons, persons responsible for setting up a commercial presence, and contractual service suppliers. It means that any measure adopted by Vietnam that might limit the ability of those persons to supply insurance services, could constitute a violation of the national treatment obligation. For example, requirements of paying social security or obtaining approval on remittance of money abroad might constitute a less favourable treatment towards those five categories of natural persons under the meaning of GATS Article XVII. However, Vietnam may impose restrictions on national treatment with regard to the permanent stay of those five categories of natural persons. In addition, Vietnam

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[842] *See* Decision 175/2003/QD-TTg; Decision 310/2005/QD-TTg of the Prime Minister on the equitization plan and pilot establishment of Baoviet Financial-Insurance Conglomerate (Nov. 28, 2005) (Vietnam), Art. 1.1. *See also* Nha bao hiem phai tap trung manh vao dau tu [Insurers must concentrate in investment], 3 October 2006.

Available at http://www.vneconomy.com.vn – Last visited 5 October 2006.

[843] Decision 175/2003/QD-TTg, Art. 1. 3.a and b.

[844] Decree 46/2007/ND-CP, Art. 4.

[845] IAIS. Principles No. 2 on The Supervisions of International Insurers and Insurance Groups and Their Cross-border Business Operations, December 1999, p. 2.

may also apply limitations on movement of natural persons other than the five above-said categories of persons.

As noted in section 3.2 of Chapter Five, under the Vietnam Insurance Law, insurance agents may be either natural persons or business entities. Individual agents and employees of corporate agents who directly carry out insurance agent's activities must be Vietnamese citizens permanently residing in Vietnam.[846] Clearly, foreign individual agents are prohibited in supplying agency services. Because this measure involves a nationality requirement in supplying agency service in Vietnam, it falls within the scope of the national treatment principle. However, as Vietnam undertakes commitments only on the temporary stay of the five categories of natural persons, but not their permanent stay, the measure on nationality requirement of individual agents and employees of corporate agents directly carrying out insurance agents' activities does not fall within Vietnam's horizontal commitments under Mode 4. Moreover, as Vietnam also prohibits Vietnamese citizens who are not permanently residing in Vietnam, to be individual agents or employees of corporate agents directly carrying out insurance agents' activities, this measure does not constitute a discrimination against foreign individual agents. Accordingly, Vietnam is not required by GATS Article XVII to revise this measure in order to include individual permanently resident foreigners in supplying insurance agency services.

4. Concluding remarks

In general, Vietnam's commitments in insurance services are liberal to foreign participation and competition. Liberalization of insurance services under the WTO could offer some opportunities for further development of Vietnam's insurance market. The challenge of fierce competition, nevertheless, should not be ignored.

While several WTO-inconsistent measures have been eliminated by the Vietnamese government, some other measures must be taken through a revision of the Vietnam Insurance Law. The review of compliance with Vietnam's commitments on national treatment shows that uncertainty in interpretation of likeness under GATS Article XVII could put Vietnam at high possibility of violating this obligation.

[846] Vietnam Insurance Law, Art. 86.

CHAPTER SEVEN
Enhancement of Vietnam's Prudential Regulations

Chapter Six reveals that compliance with commitments on national treatment would require Vietnam to enhance regulations to protect consumers and ensure further development of the insurance market. Moreover, as concluded in Chapter Three, the meaning of the term "prudential reasons" as applied to the insurance sector is focused on the solvency of an insurance company. This chapter, therefore, examines and analyzes prudential regulations under the Vietnam Insurance Law, namely requirements on technical provisions, solvency margin, and investment rules.[847] The experiences of the EU, US and Japan are used to help analyze and identify problems with the Vietnam Insurance Law.

As discussed in Part One, interpretation of the GATS national treatment principle in the insurance sector should be read in connection with the prudential exception as stipulated under Annex paragraph 2(a) on. Based on this two-stage approach, the chapter proceeds to provide several policy suggestions for further enhancement of prudential regulations in the Vietnam Insurance Law.[848]

1. Technical provisions

1.1 Are the technical provisions properly regulated?

Under the Vietnam Insurance Law, technical provisions are defined as:

> [A]n amount of money which an insurer is required to establish in order to meet its predetermined liabilities arising from the concluded insurance contracts.[849]

Insurers are required to set up technical provisions, which must be calculated from insurance premiums separately for each class of insurance.[850] The minimum amount, equivalent to 25 percent of the total technical provisions in non-life insurance, and 5 percent in life insurance, must be deposited in a bank in order to ensure regular payment of claims and benefits.[851]

There are two types of technical provisions applicable to non-life insurers, namely (i) provisions for unearned premiums; and (ii) provisions for claims outstanding.[852] The purpose of the unearned premium provisions is to cover the liabilities arising from all contracts in

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[847] In general, technical provisions are designed to ensure that an insurance company is financially able to meet the liabilities arising out of accepted risks. In addition to the requirement of establishing technical provisions, the solvency margin guarantees that an insurance company has sufficient funds or assets to cover future insurance contracts. Although funds available from technical provisions may be invested in different categories of assets, investment rules are required to ensure good risk management with regard to investment portfolio of an insurance company.

[848] This chapter draws in part from Vu Nhu Thang (2007b), pp. 977-1009.

[849] Vietnam Insurance Law, Art. 96.1.

[850] *Id.* Art. 96.2.

[851] Decree 46/2007/ND-CP of the Government on regulating financial issues of insurance enterprises and insurance brokerage enterprises (Mar. 27, 2007) (Vietnam), Art. 13.

[852] *Id.* Art. 8.

force in the subsequent years, while the provisions for claims outstanding are used to cover unsettled claims at the end of the financial year, whether reported or not.[853]

With respect to life insurance, in addition to the above-said provisions, a life insurer is required to set up mathematical provisions, reserve for dividends to policyholders, and equalization provisions.[854] The mathematical provisions are to cover guaranteed obligations upon the occurrence of the insured event, and the reserve for dividend to policyholders is used to pay for dividend agreed with policyholders in the insurance contracts.[855] The equalization provisions are set up to pay benefits in case of material increase in mortality and other unexpected factors, such as interest rate.[856]

In case of the EU, the establishment of technical provisions is required by both life and non-life directives in order to ensure that insurers can meet any liabilities arising out of insurance contracts in respect of their entire business.[857] Technical provisions include provisions for unearned premiums, life insurance provisions, provisions for claims outstanding, provisions for bonuses and rebates, equalization provisions,[858] and other provisions such as provision for unexpired risks.[859] Non-life insurers may be required to set provision for unexpired risk if it is estimated that claims and administrative expenses, which might arise after the end of the financial year from contracts concluded before that date, shall exceed the provisions for unearned premiums and any premiums receivable under those contracts.

The establishment of technical provisions has also been addressed intensively by Japan and the US regulations. In Japan, insurance companies are required to establish different reserves for liabilities arising from accepted insurance. First, the underwriting reserve is set up to provide fulfillment of future obligations under insurance contracts.[860] Second, a reserve for outstanding claims is established equivalent to outstanding claims, premiums returnable, and policyholders' dividends payable.[861] Third, a price fluctuation reserve is to buffer losses incurred due to price changes with regard to shares and other assets.[862]

In the US, for example, New York Insurance Law requires insurers to establish loss or claim reserves,[863] valuation reserves in the case of life insurance companies,[864] and unearned premium reserve.[865]

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[853] *Id.* Art. 8.
[854] *Id.* Art. 9.
[855] *Id.* Art. 9.2(a) and (d).
[856] *Id.* Art. 9.2 (đ).
[857] Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance, Art. 20; Directive 92/49/EEC of the Council of 8 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life insurance and amending Directive 73/239/EEC and 88/357/EEC (third non-life insurance Directive), Art. 17; Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance, Art. 32.
[858] Directive 91/674/EEC of the Council of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertaking, Art. 6.
[859] *Id.* Art. 58.
[860] Japan Insurance Law (2001), Art. 116.1.
[861] *Id.* Art. 117.1.
[862] *Id.* Art. 115.
[863] New York Insurance Law, Sec. 1303.
[864] *Id.* Sec. 1304.
[865] *Id.* Sec. 1305.

Some remarks

Technical provisions are regulatory requirements which address the technical risks or liability risks arising from insurance business.[866] The fundamental purpose of setting up technical provisions is to ensure that insurers are capable of meeting commitments towards policyholders at all times.[867] The establishment of sufficient technical provisions is a "cornerstone of a sound capital adequacy and solvency regime".[868] Similar to other WTO Members, technical provisions of insurers, either life or non-life, have been addressed by the Vietnam Insurance Law based on both claims and premiums written in order to ensure financial soundness of insurers.

However, the regulations on establishing technical provisions are based on sound actuarial principles.[869] In particular, the actuary plays a critical role in maintaining financial soundness of insurers.[870] Accordingly, actuarial regime is closely connected to the sufficient establishment of technical provisions, and needs to be examined in the next section.

1.2 Could actuarial principles support compliance with regulation on technical provisions?

As noted in section 3.2 of Chapter Five, the Vietnam Insurance Law has no provision on actuary. However, under the government regulations, appointment of actuary in life insurers is obligatory in Vietnam.[871] This means that the use of actuary is irrelevant to non-life insurance companies. Duties of an actuary include setting up mathematical provision, appraising financial conditions of life insurer, and estimating future performance.[872]

However, there is no requirement that an appointed actuary reports financial conditions of insurers to the supervisory authority. In cases where a life insurer is in financial difficulty, the actuary is required to report to the general director, board of management on any unusual matters which might adversely affect the financial conditions of the insurer, and to propose remedies.[873] If there are no corrective measures by the life insurer in order to improve its financial conditions within a reasonable "period of time" as proposed by the above-mentioned reports, the actuary shall submit reports to the MOF.[874] There is no clarification on what "period of time" is deemed reasonable from the perspectives of an appointed actuary, the board of management, and the supervisory authority. Consequently, the

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[866] The effect of such technical risks, if occurred, would make the insurer unable to fully meet its guaranteed obligations because either claim frequency, claim amounts, or administration and settlement expenses are higher than expected.

See IAIS Sub-Committee on Solvency and Actuarial Issues. Issues Paper on Solvency, Solvency Assessments and Actuarial Issues, 15 March 2000, p. 10.

Available at http://www.iaisweb.org – Last visited 22 May 2006.

[867] Vollbrecht (2001), p. 41.

[868] IAIS (2003), ICP 20 on Liabilities, p. 34.

[869] *Id.*

[870] IAIS Sub-Committee on Solvency and Actuarial Issues (2000), p. 25.

[871] Decree 45/2007/ND-CP, Art. 14.

[872] Circular 98/2004/TT-BTC of the Ministry of Finance on guiding the implementation of Decree 42/2001/ND-CP, (Oct. 19, 2004) (Vietnam), Sec. III.1.

[873] *Id.*

[874] *Id.*

supervisory authority may not be promptly informed of financial conditions of life insurers, and this may affect their solvency.

Daykin has observed the role of actuaries as follows:

> … [t]he role of the actuary, both within the insurance companies and in the position of supervisor, is critical to the maintenance of financially sound insurance companies, both for life insurance and general insurance.[875]

This suggests that compliance with solvency requirements of insurers is well supported by the role of actuary. Appointed actuaries are common in both life and non-life insurance in several countries, such as the US, the United Kingdom, Canada, and Belgium.[876] Actuarial skills are important to assess risks exposed by insurers as well as to set up technical provisions for both life and non-life insurance.[877]

In Japan, the boards of management of all insurers are required by law to appoint an actuary. The appointed actuary is required to submit a statement of opinions to the board of management on: (i) underwriting reserves, (ii) fair and equitable distribution with regard to policyholder dividend or surplus, and (iii) other matters specified by a Cabinet Office ordinance.[878] Moreover, Article 121.2 of Japan Insurance Law stipulates that:

> … [T]he actuary shall, without delay, submit a copy [of his or her statement of opinions] to the Prime Minister.

This means that the actuary must submit reports to both the insurer's board of management and insurance supervisors. By this provision, the supervisory authority shall simultaneously be able to monitor the appropriateness of financial conditions of insurers, and then may rightly conduct intervention if the underwriting reserves prove to be insufficient in the light of prudential regulations.[879]

In case of the US, every life and non-life insurance company is required to submit an actuarial opinion on an annual basis.[880] The opinion given by the actuary must cover the adequacy of reserves, which are in conformity with requirements of insurance laws and regulations.[881] If an insurance company fails to provide actuarial opinions, the supervisory authority has power to assign another actuary to prepare reports at the expense of that insurance company.[882]

1.3 A need to strengthen the role of actuary in Vietnam

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[875] Daykin, Chris. 1999. The Role of the Actuary in the Supervision of Insurance. In OECD. *Insurance Regulation and Supervision in Asia*. Paris: OECD, p. 274.

[876] *Id.* p. 272.

[877] IAIS. Guidance Paper No. 7 on The use of Actuaries as part of a supervisory model, October 2003, p. 5. Available at http://www.iaisweb.org – Last visited 22 May 2006.

[878] Japan Insurance Law (2001), Art. 121.1.

[879] Kinoshita, Koji. 2002. Regulation of Insurance Services: The Japanese Perspective. In Basedow, Jurgen et al., eds., *Economic Regulation and Competition: Regulation of Services in the EU, Germany and Japan*. The Hague/London/New York: Kluwer Law International, pp. 200-201.

[880] NAIC, Actuarial Opinion and Memorandum Regulation, V-822-1 (2006), Sec. 5A; and NAIC Property and Casualty Actuarial Opinion, IV-745-1 (2006), Sec. 2.A.

[881] NAIC, Actuarial Opinion and Memorandum Regulation, V-822-1 (2006), Sec. 4A.

[882] NAIC, Property and Casualty Actuarial Opinion, IV-745-1 (2006), Sec. 2.C.

The use of actuary currently is limited to life insurance companies in Vietnam. Given the fact that the life insurance market in Vietnam is dominated by foreign owned insurers, this requirement may impose an additional burden on life insurers compared to non-life insurers. This measure, nevertheless, may not be challenged by other WTO Members because life insurance services and non-life insurance services would be unlike under the meaning of GATS Article XVII.

However, as recommended by the OECD, "actuarial techniques are a key component of insurance management; the role of the actuarial profession could be encouraged".[883] Appointment of actuary in both life and non-life insurers is necessary for Vietnam's insurance market in order to properly ensure financial soundness of all insurers. Future regulations on insurance business, therefore, should require actuaries also be appointed in non-life insurers. This requirement is more important when complicated new solvency regulations are introduced. As far as the compulsory appointment of non-life insurance actuaries applies equally to both domestic and foreign owned insurers, as well as branches of foreign non-life insurers, this requirement does not constitute a violation of the national treatment obligation.

The role of actuary must also be strengthened by requiring direct reporting to the insurance supervisory authority in case of issues which materially affect the solvency of insurers. The existing regulation makes the actuary's role less pro-active in dealing with financial difficulties of insurance companies. A more active role of the actuary in this process will not only foster policyholder protection, but also help the supervisory authority to intervene earlier when an insurance company faces financial difficulties. There should also be a more stringent requirement that the actuary simultaneously prepares reports to both the board of management and the supervisory authority.[884] An alternative is to require the actuary make reports to the supervisory authority after a clearly identified period of time lapses without corrective measures carried out by insurers. Again, Vietnam could differentiate reporting requirements on the basis of life and non-life insurers. These different treatments would not constitute a violation of the national treatment obligation because there is no likeness between life and non-life insurance services. These reporting requirements, nevertheless, should be applied equally to all life insurers or equally to all non-life insurers, regardless of their origin.

2. Solvency margin

2.1 Solvency margin under existing regulations

[883] OECD. Twenty Insurance Guidelines for Economies in Transition, Rule No. 12, April 1997. Available at http://www.oecd.org – Last visited 22 May 2007.

[884] In recently issued regulations by the MOF, the appointed actuary is required promply to the General Director, Board of Management and its members, and the Chairman, "on any irregular matter which may adversely affect the financial situation of insurers." In "serious circumstances", the appointed actuary is obliged to report to the MOF. Although this requirement put an obligation on the appointed actuary with respect to the solvency of life insurers, it fails to specify how the seriousness could be determined. *See* Circular 155/2007/TT-BTC of the Ministry of Finance on guiding the implementation of Decree 45/2007/ND-CP, (Dec. 20, 2007) (Vietnam), Sec. IV.3.

In Vietnam, in order to start business, an insurance company must have chartered capital higher than the legal capital as stipulated by the government.[885] In the on-going business, the most important requirement is that insurers maintain the state of solvency with respect to their entire business. This requirement is called "solvency margin", which is defined by the difference between the value of the insurer's assets and its outstanding liabilities.[886] The assets for the purpose of available solvency margin must be liquid, and the MOF shall regulate the exclusion of part or all of assets for the purpose of calculation of solvency margin.[887] In other words, Vietnam follows a negative approach towards identifying assets eligible for the solvency margin.

In principle, capital adequacy requirements must be correspondent to the size, complexity and risks of an insurer's operations.[888] As noted by Leflaive, different categories of assets must be weighed for the purpose of examining solvency margin according to the nature, degree of liquidity and class of credit risks.[889] More specifically, the solvency position of an insurance company must reflect the "ultimate collectability" of all income under assets.[890]

However, what appears to be missing here is a provision on categories of assets that can represent the solvency margin. The negative approach towards the solvency margin lacks transparency as there may be different interpretations of what assets would represent the solvency margin. Moreover, this approach would suggest that all assets are acceptable for the purpose of determining a solvency margin, and consequently simplifies credit risks of insurers' assets, such as loans, and securities. In other words, a lack of valuation rules may indicate that all investment portfolios shall represent the solvency margin of insurers without any deduction for changes in asset value.

In contrast, the approach of both the EU and US is to adopt a positive list of assets that are acceptable for the solvency margin. In addition, credit risks and liquidity of assets are also taken into account.

In the EU, the solvency margin shall consist of the following assets: (i) the paid-up share capital, (ii) statutory and free reserves, (iii) profit or loss brought forward after deduction of dividends to be paid, profit reserves, (iv) cumulative preferential share capital and subordinated loan capital up to 50 percent of the lesser of the available solvency margin

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[885] Vietnam Insurance Law, Art. 63.1.

[886] *Id.* Art. 77.3.

This term varies in different jurisdictions, for example, actual solvency margin, available surplus capital, eligible capital, free capital. *See* IAIS Sub-Committee on Solvency and Actuarial Issues (2000), p. 42.

In EU Directives, this term is called as *available solvency margin* that consists of the assets of the insurer/re-insurer free of any foreseeable liabilities, less any intangible items (*See* Directive 2002/83/EC, Art. 27.2; Directive 92/49/EEC, Art. 24; Directive 2005/68/EC, Art. 36.1).

In New York Insurance Law, this term is named as *admitted assets* that are allowed to determine the financial conditions of insurers (*See* New York Insurance Law, Sec. 1301).

[887] Decree 46/2007/ND-CP, Art. 17.

According to Circular 99/2004/TT-BTC of the Ministry of Finance on guiding the implementation of Decree 43/2001/ND-CP, (Oct. 19, 2004) (Vietnam), Sec. V.4, assets for the purpose of available solvency margin shall cover all kinds of assets of insurers, except for (i) capital contribution, which is originated from the owner's capital, to other enterprises, (ii) bad debts, and (iii) bonus fund, if any.

[888] IAIS (2003), ICP 23 on Capital Adequacy and Solvency, p. 39.

[889] Leflaive, Viviane. 2002. Comparative Analysis. In OECD. *Insurance Solvency Supervision: OECD Country Profiles*. Paris: OECD, p. 28.

[890] Dickinson Gerry. 1999. The Changing Focus in the Supervision of Insurance Company Investment. In OECD. *Insurance Regulation and Supervision in Asia*. Paris: OECD, p. 340.

and the required solvency margin, and (v) securities with no specified maturity date and other instruments up to 50 percent of the lesser of the available solvency margin and the required solvency margin.[891]

In the same approach, New York Insurance Law lists twenty-two admitted assets owned by insurers for the purpose of determining a solvency margin, including cash, investment and interests.[892] In addition, rules for valuation of those assets are also clearly stipulated. For example, investment in securities may be valued at market value, appraised value, or at a price set by the supervisory authority.[893]

Similarly, the case of Japan also specifies assets eligible for determining the solvency margin of insurers. In particular, the solvency margin consists of: (i) capital; (ii) price fluctuation reserve; (iii) risk reserve; (iv) general bad debt reserve; (iii) unrealized gains/losses on securities and real estate; (iv) any other amounts determined by the Financial Service Agency, such as subordinated debts, and margin contained in statutory provision.[894] For example, 90 percent of latent profit on stocks, 85 percent of latent profit on land, and 100 percent of unrealized losses are calculated for determination of the solvency margin.[895]

2.2 Insurance companies in financial difficulty

(i) Minimum solvency margin

Due to business fluctuations, insurance companies may sometimes have a low solvency margin and face financial difficulties. In order to assure that insurers hold sufficiently safe capital and assets, Article 78.1 of the Vietnam Insurance Law authorizes the

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[891] Directive 2002/83/EC, Art. 27.2 and 3; Directive 2002/13/EC of the European Parliament and the Council of 5 March 2002 amending Council Directive 73/239/EEC as regards the solvency margin requirements for non-life insurance undertaking, Art. 1.2; Directive 2005/68/EC, Art. 36.1 and 3. However, the available solvency margin shall be reduced by the amount of own shares directly held by the insurers/re-insurers.

[892] New York Insurance Law, Sec. 1301.

These admitted assets cover (i) cash, (ii) investment; (iii) declared and unpaid dividends on shares; (iv) – (vii) interest due or accrued upon a collateral loan, any evidence of indebtedness, deposits in solvent banks or trust companies, any real estate mortgage loan; (viii) rent due or accrued on real property; (ix) the unaccrued portion of taxes paid prior to due date on real property; (x) premium notes, policy loans and other policy assets and liens on policies, contracts or certificates of a life insurer; (xi) premium in course of collection; (xii) installment premium; (xiii) notes and like written obligations; (xiv) reinsurance recoverable by a ceding insurer; (xv) amounts receivable by an assuming insurer for funds withheld by a ceding insurer under a reinsurance treaty; (xvi) amounts receivable under a funding agreement; (xvii) deposits or equities recoverable from underwriting associations, syndicates and reinsurance funds, or from suspended banking institutions; (xviii) electronic data processing apparatus and related equipment constituting a data processing, record keeping or accounting system; (xix) aircraft if prior approval has been secured from the superintendent; (xx) amounts payable to the insurer from the property/casualty insurance security fund; (xxi) gross deferred tax assets; and (xxii) other assets.

[893] *Id.* Sec. 1414 b(1).

[894] Japan Insurance Business Law Enforcement Regulations, Art. 86.1 (Tentative translation by the General Insurance Association of Japan). *See also* Japan Financial Services Agency. Presentation material for a Meeting of Solvency and Actuarial Issues Subcommittee of International Association of Insurance Supervisors on 3-5 September 2003, p. 2.

Available at http://www.fsa.go.jp – Last visited 5 October 2006.

[895] General Insurance Association of Japan. 2006. Fact Book 2004-2005 General Insurance in Japan, p. 70.

government to set up a control level - the minimum solvency margin.[896] Accordingly, Article 16 of Decree 46/2007/ND-CP of the government provides that:

> 1. The minimum solvency margin of a non-life insurer shall be equal to the higher of the two results: (a) 25 percent of retained premiums at the time of determining the solvency margin; or (b) 12.5 percent of the total premiums and reinsurance premiums at the time of determining the solvency margin.
> 2. The minimum solvency margin of a life insurer shall be equal to: (a) 4 percent of technical provisions plus 0.1 percent of net amount at risk, in case of life insurance policies with term of 5 years or less; and (b) 4 percent of technical provisions plus 0.3 percent of net amount at risk, in case of life insurance policies with term over 5 years.

Insurers are deemed to be solvent if their solvency margin is not less than the minimum solvency margin. It indicates that there is only one control level, which might trigger the intervention of the MOF. In addition, Vietnam's approach to the minimum solvency margin is referred to as "fixed-ratio model". The main advantage of this fixed-ratio model is the involvement of simple functions with regard to several items on the balance sheet or profit and loss account, hence an easy application.[897] However, due to its simplicity, one main disadvantage of this model is that it does not reflect different risk profiles among different insurers.[898] In other words, these simple functions are irrelevant to different categories of risks incurred by an insurance company. As far as non-life insurance is concerned, only the premiums criterion is taken into account in determining the minimum solvency margin, while claims-based factors are not accounted for.

While the EU follows a fixed-ratio model in determining the required solvency margin of insurers, its model consists of two control levels. In addition, the EU determines the minimum solvency margin of non-life insurers is based not only on premium-based ratio but also on claim-based ratio, whichever is higher.[899] In the first control level, in order to determine the solvency margin of a non-life insurer, the said amount must be equal to a higher of 16 percent of the annual premiums written by the insurer or 23 percent of the average annual claims costs incurred by the insurer. By taking into account the claim basis for determining the minimum solvency margin, the EU approach could lessen the drawbacks of the fixed-ratio model.[900] Specifically, the EU also details the average annual claims during the previous three to seven years.[901]

With regard to life insurers, the minimum solvency margin shall be equal to the sum of two results: 4 percent of mathematical provisions of the life insurer plus 0.3 percent of the capital at risk, i.e. the amount payable on death (maximum payment under life policies) less the mathematical provision for main risks.[902] It is submitted that in determination of the

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[896] Vietnam Insurance Law, Art. 78.1 reads as follows:

> An insurer may be considered being in danger of insolvency when its solvency margin falls below the levels of minimum solvency margin provided by the Government.

This term varies in different jurisdictions, for example, required minimum margin, statutory minimum solvency margin, required surplus, regulatory capital requirement. *See* IAIS Sub-Committee on Solvency and Actuarial Issues (2000), p. 44.

[897] Leflaive (2002), p. 13.

[898] *Id.*

For example, because this ratio is based on technical provisions, an insurer having a prudent method of provisioning will have to produce a greater solvency margin than an insurer that tends to under-provision.

[899] Directive 2002/13/EC, Art. 1.3.

[900] Leflaive (2002), p. 13.

[901] Directive 2002/13/EC, Art. 1.3.

[902] Directive 2002/83/EC, Art. 28.2.

minimum solvency margin for a life insurance company, Vietnam follows the same formulas adopted by the EU.

The second control level is the guarantee fund, which is equivalent to one third of the required solvency margin or not less than EUR 3 million in case of life insurance, certain non-life insurance, reinsurance, or EUR 2 million in case of other non-life insurance.[903]

In contrast to this fixed-ratio approach to the minimum solvency margin, the US and Japan have adopted risk-based models, which take various risks into account with respect to determination of the solvency margin. In the US, the NAIC has approved risk-based capital since 1992 to supervise capital adequacy standards applicable to both life and non-life insurance. The objectives of the risk-based model are to equip adequate capital that is related to risks and improves the financial safety for insurers.[904] Categories of risks addressed by the risk-based model include: (i) asset risk; (ii) credit risk (non-life insurance); (iii) risk of adverse insurance experience with respect to the insurer's liabilities and obligations (life insurance); (iv) underwriting risks (non-life insurance); (v) interest rate (life insurance); and (vi) all other business risk.[905]

Insurers must submit an annual report of their risk-based capital levels.[906] There are four control levels applicable to an insurance company: (1) company action level of 200 percent;[907] (2) regulatory action level of 150 percent;[908] (3) authorized control level;[909] and (4) mandatory control level of 70 percent.[910] An insurer is considered to have appropriate risk-based capital if the ratio exceeds 200 percent.[911]

In Japan, to determine the adequacy of insurers' solvency to satisfy insurance claims, the solvency margin is calculated based on the total capital, including foundation funds, reserves and other amounts, one the one hand, and the amounts representing losses in excess of normal expectations, on the other hand.[912] Risks covered for the purpose of determining a solvency margin are: insurance risks, assumed interest rate risks, asset management risks (including price fluctuation risks, credit risk, and other risks for subsidiaries, derivative

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Of that, mortality risk is met by 0.3 percent of capital at risk; operating expense risk is met by 1 percent of the mathematical provision; and investment risk is met by 3 percent of the mathematical provision. The fraction of the second result shall be 0.1 percent in case of life insurance policies with a term of 3 years or less; and 0.15 percent in case of life insurance policies with a term of more than 3 years but not more than 5 years.

[903] Directive 2002/83/EC, Art. 29; Directive 2002/13/EC, Art. 1.4; Directive 2005/68/EC, Art. 40.

[904] *See* OECD. 2002. Insurance Solvency Supervision: OECD Country Profiles. Paris: OECD, p. 290.

[905] NAIC, Risk-based capital (RBC) for insurers Model Act, II-312-1 (1997), Sec. 2.B and C.

For example, New York Insurance Law, Sec. 1322, requires that risk-based capital of a life insurer must take into account the following risks:

(A) The risk with respect to the insurer's assets;
(B) The risk of adverse insurance experience with respect to the insurer's liabilities and obligations;
(C) The interest rate risk with respect to the insurer's business; and
(D) All other business risks and such other relevant risks.

[906] NAIC, Risk-based capital (RBC) for insurers Model Act, II-312-1 (1997), Sec. 2.A.

[907] *Id.* Sec. 3.

[908] *Id.* Sec. 4.

[909] *Id.* Sec. 5.

[910] *Id.* Sec. 6.

[911] New York Insurance Law, Sec. 1322 (a) (8).

[912] Japan Insurance Law (2001), Art. 130.

The solvency margin ratio = solvency margin/(total amount at risk x 0.5)

transaction, reinsurance and reinsurance recoverable), business management risks, and major catastrophe risks.[913]

There are three control levels of the solvency margin.[914] The first category is less than 200 percent; the second category is less than 100 percent; and the third category is less than 0 percent. The capital level of an insurer is considered acceptable when its solvency margin ratio is above 200 percent.

(ii) Available remedial measures in case of financial difficulties

Effective regulation and supervision could not ensure the prevention of insurers getting into financial difficulties. Crisis in a key insurance company may affect the integrity and stability of the insurance market as well as the whole financial system, and even financial difficulty of a small insurer may also affect a wide range of policyholders.[915]

In Vietnam, an insurance company is considered being in danger of insolvency when its solvency margin is less than the minimum solvency margin.[916] In such a circumstance, available remedial measures consist of three steps. First, an insurance company in financial difficulty is required to prepare and submit to the MOF a solvency recovery plan.[917] Second, the MOF is empowered to intervene and order the financially troubled insurance company to restore its solvency.[918] Remedial measures applied by the MOF include an increase of the owner's equity; reinsurance program, restriction of business operations; organizational restructure, and proposed replacement of the chairman of board of management, and the general director; transfer of the policy portfolio; and other measures.[919] If the insurer is unable to recover its solvency as provided, a solvency control committee shall be established by the MOF under the third step.[920]

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[913] Japan Insurance Business Law Enforcement Regulations, Art. 87 (Tentative translation by the General Insurance Association of Japan). *See also* Japan Financial Services Agency. Presentation material for a Meeting of Solvency and Actuarial Issues Subcommittee of International Association of Insurance Supervisors on 3-5 September 2003, p. 3.
Available at http://www.fsa.go.jp – Last visited 5 October 2006.

[914] *See* OECD. 2002. Insurance Solvency Supervision: OECD Country Profiles. Paris: OECD, p. 156.

[915] Vollbrecht (2001), p. 54.

[916] Vietnam Insurance Law, Art. 78.1.

[917] *Id.* Art. 79.1.

[918] *Id.* Art. 79.2.

[919] Decree 46/2007/ND-CP, Art. 19.2.

[920] Vietnam Insurance Law, Art. 80. Duties of the solvency control committee include:

a) Instructing and monitoring the implementation of the approved solvency recovery plan;
b) Notifying relevant State bodies on the introduction of the solvency recovery plan for joint implementation;
c) Restricting the business operations;
d) Suspending activities which may cause insolvency to the insurer;
e) Requesting the insurer to transfer all or part of its policy portfolio;
f) Temporarily suspending board members, the General Director and Deputy General Director(s) in exercising their power, or requesting the insurer to replace them if necessary;
g) Requesting the Board of Management, the General Director to dismiss any staff who are in breaches of the laws or fails to carry out the approved solvency recovery plan;
h) Making recommendations to the Ministry of Finance on continuation or termination of the solvency recovery plan;

However, there are several concerns over these remedial measures and procedures. First, there is no specific requirement on what should or must be included in the solvency recovery plan prepared by financially troubled insurance companies in the first step. It is arguable that more transparency on what measures should be taken by insurers would constitute a consensus between insurers and the supervisory authority, and thus facilitate the approval process by the MOF.

Second, as described earlier, Vietnam provides only one solvency control level. In addition, concerning the MOF intervention as well as establishment of the solvency control committee, there are no clear quantitative levels for application of those remedial measures. In other words, it is uncertain in which circumstances or at which level of solvency margin of insurers MOF intervention is required. It seems that in any case, all three steps must be applied in sequence. This situation may defer a prompt intervention by the insurance supervisory authority.

A solvency control level or series of levels, which may trigger supervisory intervention before an insurance company becomes insolvent, is important for consumer protection to mitigate undue losses.[921] According to the IAIS, the main purpose of this requirement is to: (i) reduce the probability of inability to pay claims, (ii) limit losses incurred by policyholders, (iii) provide early warning system for supervisory intervention and corrective actions, and promote public confidence in the insurance sector.[922] Solvency control levels, therefore, must be high enough to allow intervention at an early stage of financial difficulties in order to reduce the risk of failure and minimize losses to policyholders.[923] Timely action by the supervisory authority against a financially troubled insurer is crucial to protect policyholders as well as to mitigate adverse potential consequences of insolvency, including loss of public confidence. For example, Japanese Ministry of Finance has been criticized for failing to exercise prompt action against the insolvency of Nissan Mutual Life Insurance Company in 1997.[924]

Third, as far as financial difficulties of an insurer are concerned, even if an insurer is in conformity with the solvency recovery plan, it may still be unable to fulfill its obligations towards policyholders, and become insolvent. Financial difficulties of insurers may adversely affect policyholders and insured, and may cause instability of the entire insurance market.[925] The danger is that policyholders may not recover financial losses when insured risk occurs due to the insolvency of the insurer. In such a circumstance, the only solution available to the supervisory authority under the Vietnam Insurance Law is to appoint other insurers to take over those contracts. Specifically, the supervisory authority shall appoint an insurer responsible for taking over transferred insurance contracts in cases where the transferor, who is in the danger of insolvency, fails to reach agreement on transfer of insurance contracts with other insurers.[926] However, consumers could be at risk and the supervisory authority would be concerned if there were no insurance company willing to take over these insurance contracts.

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i) Making reports to the Ministry of Finance on the implementation of the solvency recovery plan and its results.

[921] IAIS (2003), ICP 23 on Capital Adequacy and Solvency, p. 39.

[922] IAIS Sub-Committee on Solvency and Actuarial Issues (2000), p. 17.

[923] Janotta-Simons, Frank. 1999. Solvency – Its Definition, Influencing Factors and perspectives of Co-Ordinated Solvency Rules. In OCED. *Insurance Regulation and Supervision in Asia*. Paris: OECD, p. 226.

[924] Kwon, Wook Jean and Harold D. Skipper Jr. 1997. Regulatory Changes in the Japanese Insurance Market. *Journal of Insurance Regulation* 16(2), pp. 160-161.

[925] Vollbrecht (2001), p. 54.

[926] Vietnam Insurance Law, Art. 74.

To be more specific, there might be a case where other insurers are unwilling or reluctant to take over those transferred contracts because those contracts, according to their calculation, would cause losses for their future business. In such a case, the supervisory authority has no alternative recourse to deal with such matter. Consequently, the objective of consumer protection of insurance regulation would not be achieved.

As commented by Mr. Le Song Lai, Deputy Director of Insurance Department under the MOF, after all corrective measures have been employed, if the solvency of an insurer is not recoverable and that insurer must be subject to Bankruptcy Law, there are no detailed regulations on the priority of policyholders in this case.[927] Moreover, even though policyholders may enjoy priority in bankruptcy proceedings, there is no guarantee of a full recovery of their claims and benefits.

The experience of the EU, US and Japan may clarify these concerns. According to EU directives on insurance business, if the solvency margin of an insurer has fallen below the required solvency margin, that insurer must submit to the supervisory authority a plan for the restoration of a sound financial position.[928] However, if the solvency margin of an insurer is less than the guarantee fund, that insurer must submit a short-term finance scheme.[929] A plan for recovering financial conditions of insurers must generally be projected for the next three financial years with references to: (i) estimates of management expenses; (ii) estimates of income and expenditures; (iii) a forecast balance sheet; (iv) estimates of the financial resources intended to cover underwriting liabilities and the required solvency margin; and (v) overall reinsurance/retrocession policy.[930] In any circumstance, the supervisory authority is empowered to restrict or prohibit free disposal of the insurer's assets in order to safeguard the interests of policyholders.[931]

As described earlier, Japan's approach to problematic insurers consists of three control levels, depending on solvency margin ratios. An insurer shall be ordered to submit and implement a management improvement plan if its solvency margin ratio is between 100 and 200 percent.[932] If the ratio is less than 100 percent but over 0 percent, an insurer shall be required by the supervisory authority to implement the following measures: (1) form and execute a solvency increase plan, (2) restrain or prohibit paying dividends or bonuses to members of a board of management, (3) restrain or prohibit paying dividends to policyholders, (4) change the assumed interest rate of new contracts, (5) restrain high–risked investment, (6) restrain operational expenses, (7) reduce business operations, (8) dispose of shares and subsidiaries, and (9) others.[933] The supervisory authority will order suspension of the whole or a part of an insurer's business operations for a specified period of time if its solvency margin ratio is less than 0 percent.[934] In addition, at this third control level, in some circumstances, the supervisory authority might include those measures of the second control level.

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[927] Doanh nghiep bao hiem ngung hoat dong: Quyen loi nguoi mua bao hiem duoc giai quyet ra sao? (Insurers at Cease: How to deal with rights and interest of policyholders?), 9 September 2005. Available at http://www.vneconomy.com.vn – Last visited 5 October 2006.

[928] Directive 2002/83/EC, Art. 37.2; Directive 92/49/EEC, Art. 13; Directive 2005/68/EC, Art. 42.2.

[929] Directive 2002/83/EC, Art. 37.3; Directive 92/49/EEC, Art. 13; Directive 2005/68/EC, Art. 42.3.

[930] Directive 2002/83/EC, Art. 38.1; Directive 2002/13/EC, Art. 1.7; Directive 2005/68/EC, Art. 43.1.

[931] Directive 2002/83/EC, Art. 37; Directive 92/49/EEC, Art. 13; Directive 2005/68/EC, Art. 42.

[932] *See* OECD. 2002. Insurance Solvency Supervision: OECD Country Profiles. Paris: OECD, p. 156.

[933] *Id.*

[934] *Id.*

In the US, the NAIC model law stipulates four risk-based capital levels, at which the supervisory authority may intervene in order to recover the solvency of insurers. At the company action level, an insurer must prepare and submit a risk-based capital plan to the supervisory authority which clarifies reasons and proposals of corrective actions, provides projections of financial conditions in the current year and at least four succeeding years, and identifies quality and problems of the insurer's business.[935] If an insurer's risk-based capital falls under the regulatory action level, the supervisory authority requires the insurer prepare and submit a risk-based capital plan; or the supervisory authority will examine the insurer's assets, liabilities and operations, and issue a corrective order.[936] In terms of the authorized control level, the supervisory authority will take corrective measures as provided in the regulatory action level, or may place the insurer under rehabilitation or liquidation.[937] If the insurer's risk-based capital is less than the mandatory control level, the supervisory authority will take necessary actions to put that insurer under rehabilitation or liquidation.[938]

Some observations

Experiences of other countries show that concrete quantitative solvency control levels are critically important for proper intervention by the supervisory authority in case of financial difficulty. Corresponding to each solvency control level, different remedial measures shall be applied to restore the solvency. Although Vietnam provides three steps for rescuing a financially troubled insurer, there are no concrete quantitative solvency control levels for intervention by the MOF. Moreover, if financially troubled insurers fail, there is no mechanism under the Vietnam Insurance Law to ensure minimum payments for policyholders against the failed insurers.

2.3 Policyholder protection fund

(i) A theoretical approach

The main idea of policyholder protection funds is to protect policyholders in certain situations, especially where insurers become insolvent, which may cause financial losses to their customers due to unpaid claims. This measure could ensure public confidence by providing a safety net for consumer protection, and consequently ensure the stability and integrity of the insurance market and the whole financial system. As noted by Sekiguchi, policyholders concern over the solvency of insurers, and consequently, the availability of such protection funds would protect them in case of an insurer's failure.[939]

(1) Advantages

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[935] NAIC, Risk-based capital (RBC) for insurers Model Act, II-312-1 (1997), Sec. 3.B.
[936] *Id.* Sec. 4.B.
[937] *Id.* Sec. 5.B.
[938] *Id.* Sec. 6.B.
[939] Sekiguchi, Alan. 1999. Policyholders Protection Funds in OECD Countries. In OECD. *Insurance Regulation and Supervision in Asia*. Paris: OECD, p. 367.

According to Yasui, there are four main arguments for the establishment of such a safety net in the insurance market, namely protection of non-professional policyholders, maintenance of public confidence, development of competitive markets, and a level playing field across the financial sector.[940] This safety net would provide a mechanism to protect the interests of policyholders, especially individuals and non-professionals, who may be at disadvantage in appraising financial soundness of an insurer, in the event of bankruptcy of such insurer. As described in section 1.2 of Chapter One, the most fundamental rationale for insurance regulation as well as prudential regulation is information asymmetry. Because individual and non-professional consumers might be unable to collect and analyze information on the financial soundness of an insurer, their interests would be protected by such a safety net scheme.

Moreover, by offering a safety net in insurance market, public confidence in this sector would be maintained, hence facilitating its sound development. Public confidence in the insurance market, especially in life insurance, which involves long term savings, is critically important.

Another reason for setting up a policyholder protection fund is that this safety net would enable supervisory authorities to handle bankruptcies of insurers without exposing policyholders to risks of severe losses. Establishing such a mechanism should facilitate a competitive insurance market. Protection through this safety net would be more flexible and faster than bankruptcy procedures, and policyholders would be ensured by at least minimum compensation.[941]

In addition, the safety net could ensure a level playing field between insurers and banks. While insurers and banks are competing more directly due to increasing level of convergence between the two sectors, deposit insurance systems in the banking area are more popular than policyholder protection funds. Moreover, as several life insurance products are very similar to some banking operations, an analogous system would be justifiable in the insurance market.[942] Without such a similar safety net in the insurance sector, insurers would have difficulty in competing with banks.

From the perspective of consumers, establishment of policyholder protection funds would ensure equal treatment among consumers of domestic and foreign insurers.[943] This concern might be true in the case where foreign insurers, who participate in safety net schemes in their home countries, are permitted to supply insurance services in a domestic market of another country. Accordingly, consumers of foreign insurers would be better protected than those of domestic insurers.

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[940] *See* Yasui, Takahiro. 2001. Policyholder Protection Fund: Rationale and Structure. In *Policy Issues in Insurance: Insurance Regulation and Supervision in the OECD Countries*. Paris: OECD, pp. 305-309.

[941] European Commission. Insurance Guarantee Schemes. Working Paper MARKT/2525/03-EN (June 2003), p. 2.

Available at http://ec.europa.eu/internal_market/insurance/docs/markt-2525-03/markt-2525-03_en.pdf – Last visited 2 April 2007.

[942] European Commission. Insurance Guarantee Schemes. Working Paper MARKT/2501/04-EN (Mar. 3, 2004), p. 7.

Available at http://ec.europa.eu/internal_market/insurance/docs/markt-2501-04/markt-2501-04_en.pdf – Last visited 2 April 2007.

[943] European Commission. Insurance Guarantee Schemes: State of Play and Orientation of the Future Work. Discussion Paper MARKT/2517/02-EN (Jul. 15, 2002), p. 4.

Available at http://ec.europa.eu/internal_market/insurance/docs/markt-2517/markt-2517-02_en.pdf – Last visited 2 April 2007.

(2) Disadvantages

One of the main drawbacks of policyholder protection funds is the moral hazard problem, which may provide consumers, insurers and supervisors with a disincentive for appraising financial conditions of insurers,[944] especially if it was believed that when a safety net exists, insurance supervisors would feel less pressure to ensure effective supervision.[945] Moreover, while insurers may have a tendency to adopt risky business practices,[946] consumers may be less careful in selecting insurers because they only consider prices rather than service quality and financial soundness of insurers.[947]

However, in response, the moral hazard problem might not be intensified due to the existence of a similar safety net in the financial services market, particularly deposit insurance systems in the banking sector.[948] In other words, although the problem of moral hazard might exist when introducing a safety net scheme, the experience of the banking sector would be persuasive for governments to set up a similar system in the insurance sector.

The second argument against policyholder protection fund is that it may impose extra financial burdens for insurers who participate into this safety net scheme.[949] Such a financial burden may weaken the financial soundness of insurers. Another aspect of this argument is that prudent insurers may be required to pay for their competitors' mismanagement.[950] In other words, bad performance of insolvent insurers would be supported at the expense of other participating insurers, who conduct business operations in a prudent manner.

Sekiguchi commented that, from the social point of view, as policyholder protection funds provide a safety net for a broad coverage of people, these extra financial costs incurred by insurers could be justifiable, and thus the impact of failure of insurers on policyholders or beneficiaries is minimized.[951] It suggests that the cost of bankruptcy of an insurer would be higher than such financial burdens. A domestic insurance market would experience financial losses of policyholders and insured, loss in public confidence, and even adverse affects on soundness of the financial system if there was no such a safety net scheme for consumer protection.

Another concern over establishment of a safety net scheme in the insurance sector is that the existence of other available preventive and remedial measures, such as technical provisions, would make policyholder protection funds redundant.[952] In other words, the existing preventive and remedial measures are enough to protect the interests of policyholders.

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[944] Yasui (2001), p. 309.

[945] Roberts, Paul G. 1989. Insurance Company Insolvencies and Insurance Guaranty Funds: A Look at the Nonduplication of Recovery Clause. *Iowa Law Review* 74, p. 932.

[946] Hawkins, Jeff. 2004. Comment: Which Faultless Party Will Be Forced To Pay For Another's Failure? A Proposal For Legislative Extending The Use of State Guaranty Funds to Absorb the Orphan Shares of Long-tail Claims. *Texas Technology Law Review* 37, p. 237.

[947] European Commission. Insurance Guarantee Schemes: State of Play and Orientation of the Future Work. Discussion Paper MARKT/2517/02-EN (Jul. 15, 2002), p. 5.

[948] *Id.* p. 4.

[949] Yasui (2001), p. 310.

[950] Roberts (1989), p. 932.

[951] Sekiguchi (1999), p. 367.

[952] European Commission. Insurance Guarantee Schemes. Working Paper MARKT/2525/03-EN (June 2003), p. 3.

In response, while the main concern of the current existing solvency measurers is to ensure sound financial conditions of insurers, the objective of policyholder protection funds is to, at least, assure a minimum of payment of claims by policyholders in case of the insolvency of an insurer. Accordingly, even if all preventive and remedial measures were employed, the insurer would still become insolvent, and there might not be sufficient assets to cover its obligations against the policyholders. Moreover, it has been observed that no solvency regulation could assure "complete policyholder satisfaction at all times under all circumstances".[953] As noted by Yasui, the recently introduced policyholder protection funds in several countries would suggest some limitations in the supervision of insurers' solvency through the current preventive and corrective measures.[954]

(ii) Employing an adequate safety net: Foreign experience and lessons for Vietnam

(1) United States

State guaranty associations are operated on state-by-state basis, and were established in the late 1970's with a view to protecting consumers from insurers' insolvency.[955] One significant reason for their establishment was an increasing tension in establishing a federal guaranty fund in 1969, prompting states to adopt guaranty funds in order to prevent federal intervention into the insurance business.[956] Policyholders are guaranteed to be paid up to a specified ceiling in case of failures of insurers. The funds are also responsible for preventing and detecting insolvencies.[957]

As of 1987, all fifty states had guaranty funds designed to protect policyholders, and most states had employed the NAIC model act of 1970.[958] In general, there are two systems of funds, namely property-casualty guaranty funds and life-health guaranty funds. Although the language of each state's insurance law is very similar because of the model act, funds differ in their details, such as the coverage, deductibles, policy limits.[959] All state guaranty funds, except for New York, operate on post-assessment basis, whereby no permanent fund exists, but participating insurers shall be assessed to cover payments to policyholders for the uncovered claims.[960]

The purpose of property and liability insurance guaranty funds is to provide payment of covered claims under insurance policies as well as to avoid excessive delay in payment to

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[953] Asian Development Bank. 2003. People's Republic of China: Strengthening the Insurance Industry Regulatory and Supervisory System. Manila: ADB, p. 99.

[954] Yasui (2001), p. 312.

[955] Goddard (2003), p. 163.

[956] Roberts (1989), pp. 933-34. *See also* Skeel (1998), p. 732.

[957] Giesel, Grace M. 1991. A Proposal for a Tort Remedy for Insureds of Insolvent Insurers Against Brokers, Excess Insurers, Re-insurers, and the States. *Ohio State Law Journal* 52, p. 1091.

[958] The full name is the National Association of Insurance Commissioners State Post-Assessment Insurance Guaranty Association Model Act. *See* Roberts (1989), pp. 933-34.

[959] Macey and Miller (1993), p. 72.

[960] *See* Macey and Miller (1993), p. 73. *See also* Hodkin, Adam. 1992. Insurer Insolvency: Problems & Solutions. *Hofstra Law Review* 20, p. 744.

New York Insurance Law adopted the pre-insolvency fund or pre-funded system, whereby the fund exists and the money is available prior to insolvency of insurers.

policyholders due to the insolvency of insurers.[961] The general characteristics of property-casualty guaranty funds are as follows: (1) the scope of application covers all direct property-casualty insurance, except for certain kinds: including life, annuity and health or disability insurance, credit insurance, and ocean insurance;[962] (2) each licensed insurer must be a member of the fund, and contribute in any year up to two percent of that member insurer's net direct written premiums of the preceding year;[963] (3) the fund is obliged to pay covered claims under the policies issued by an insolvent insurer;[964] and (4) coverage of compensation does not exceed US$ 10,000 per policy for a covered claim for the return of unearned premium and US$ 300,000 per claimant for all other covered claims.[965]

The purpose of life and health insurance guaranty funds is to protect policyholders, insured, and beneficiaries of life and health insurance policies issued by life insurers in case of insolvency.[966] Accordingly, (1) life-health guaranty funds are designed to cover direct life, health or annuity policies or contracts;[967] (2) compensation coverage with respect to one life is not exceeding US$ 300,000 in life insurance death benefits, US$ 300,000 for disability insurance, US$ 500,000 for basic hospital medical or surgical insurance, and US$ 100,000 for other coverage;[968] (3) the assessment to a member life and health insurer shall not in one calendar year exceed two percent of that member insurer's average annual premiums received from the policies and contracts during the three preceding calendar years;[969] and (4) if a member insurer is an impaired insurer or an insolvent insurer, the fund may guarantee, assume or reinsure policies or contracts of that insurer, or assure payment of the contractual obligations of that insurer.[970]

(2) Japan

The main objective of the policyholder protection fund in Japan is to protect policyholders and other persons, and then maintain public confidence in the insurance business in case of insurers in financial difficulties.[971] Historically, the policyholder

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[961] NAIC, Post-assessment Property and Liability Insurance Guaranty Association Model Act (1996), Sec. 2.

[962] *Id.* Sec. 3.

[963] *Id.* Sec. 8.A (3).

[964] *Id.* Sec. 8.A(1).

[965] *Id.* Sec. 8.A(1).

For example, the purpose of New York property/casualty insurance security fund is to pay allowed claims remaining unpaid due to the insolvency of an authorized insurer. Contributions by an insurer to the fund shall equal to 0.5 percent of net direct written premiums on policies. However, payment of any one claim shall not exceed one million dollars. *See* New York Insurance Law, Sec. 7603.

[966] NAIC, Life and Health Insurance Guaranty Association Model Act (2001), Sec. 2.

[967] *Id.* Sec. 3.B (1).

[968] *Id.* Sec. 3.C (2).

[969] *Id.* Sec. 9.E (1) (a).

For example, the purpose of New York life insurance company guaranty corporation is to provide financial protection for policyholders, insured, beneficiaries of life and health insurance policies issued by life insurers in case of insolvency. The maximum liability of the corporation shall not exceed 500,000 dollars with respect to any one life or any one covered policy. The corporation shall have the following duties to: (i) guarantee, assume or reinsure the covered policies of residents; (ii) assure payment of the contractual obligations of insolvent insurer to residents; and (iii) provide such moneys, pledges, notes, guarantees or other means as are reasonably necessary to discharge such duties. *See* New York Insurance Law, Sec. 7708.

[970] NAIC, Life and Health Insurance Guaranty Association Model Act (2001), Sec. 8.A and B.

[971] Japan Insurance Law (2001), Art. 259.

protection fund was firstly established in 1996 with the effectiveness of Japan Insurance Law (1996). Since it was not compulsory for all insurance companies to join the fund, this safety net could exist only when there was no rescue insurance company in the event of insolvency of an insurer.[972]

The compulsory system was introduced in December 1998 following the enforcement of the revised Japan Insurance Law 1998 with the establishment of the Policyholder Protection Corporation.[973] Similar to the US, there are two types of funds in Japan, one for life insurance and the other for non-life insurance.[974] Membership of those funds is compulsory for insurers,[975] and the amount of levy shall be calculated based on both insurance premiums and underwriting reserves for the payment of insurance claims.[976] This requirement would ensure a fair contribution among insurers.[977] In order to mitigate the problem of moral hazard arising from the existence of the safety net, the limitation on compensation is set at 90 percent of both life and non-life claims, and 100 percent for compulsory insurance.[978]

Duties of the policyholder protection organization include: (1) administration of levies contributed by insurers; (2) provision of financial assistance in an insurance portfolio transfer; (3) engagement in the management administration for a bridging insurer; (4) acceptance of an insurance portfolio of an insurer in difficulties; (5) provision of financial assistance in connection with payments of compensation of insurance claims; and (6) purchase of insurance claims rights.[979] The rescue insurance company, with an insurance company in financial difficulties may jointly apply for financial assistance by the policyholder protection organization relating to insurance portfolio transfer.[980] Such a case occurred with reorganization of Taisei Fire and Marine Insurance Company, when this company and the rescue insurance company, Sompo Japan Insurance Corporation, jointly applied for financial aid from the Policyholder Protection Corporation in 2002 to support their merger.[981]

If there is no prospective rescue insurance company, the insurance company in financial difficulty may apply for bridging or acceptance of insurance portfolio,[982] whereby the policyholder protection organization shall establish a new bridging insurance company as its subsidiary to carry out insurance contracts concluded by the insurance company in financial difficulty.[983] For example, Daiichi Mutual Fire and Marine Insurance Company transferred insurance contracts to the Policyholder Protection Corporation and dissolved in 2001, and consequently the Corporation took responsibility for paying claims to policyholders.[984]

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[972] Hara, Nobuo. 1999. Policyholders' Protection Measures in Japan. In OECD. *Insurance Regulation and Supervision in Asia*. Paris: OECD, p. 396.
[973] *Id.*
[974] Japan Insurance Law (2001), Art. 262.2.
[975] *Id.* Art. 265-3.1.
[976] *Id.* Art. 265-34.1.
[977] Hara (1999), p. 398.
[978] Yasui (2001), p. 315.
[979] Japan Insurance Law (2001), Art. 265-28.1.
[980] *Id.* Art. 266.
[981] General Insurance Association of Japan (2006), p. 75.
[982] Japan Insurance Law (2001), Art. 267.
[983] *Id.* Art. 270-3-3.
[984] General Insurance Association of Japan (2006), p. 74.

(3) EU

There is no common approach to the policyholder protection fund because the EU is in the process of harmonizing its insurance guarantee systems. While most EU Member States have no general insurance guarantee schemes,[985] the United Kingdom, France and Ireland have established insurance guarantee systems.[986] For example, the Policyholder Protection Board was established in the United Kingdom in 1975 by the Policyholder Protection Act, and funded by a levy of up to one percent on premiums.[987] Another feature of this safety scheme in the United Kingdom is that the fund managers are empowered to assist an insurance company in financial difficulties by financing or arranging transfer of insurance business.[988] Recently, the Policyholder Protection Board was replaced by the Financial Service Compensation Scheme, which compensates consumers of failed financial service suppliers under the Financial Services and Market Access 2002.[989]

At the EU level, the Working Group on Insurance Guarantee Scheme released an orientation in 2003, which advocated for harmonization of insurance guarantee schemes. The Working Group emphasized that the moral hazard argument is more theoretical than empirical because there is no concrete evidence that the existence of such a safety net in the banking sector has led to distortions in that sector.[990] In addition, it also observed that the cost of financing the policyholder protection fund would be of insignificance to premiums.[991]

A draft Directive on policyholder protection funds, delivered on the Meeting of 1st June 2005 of the Working Group on Insurance Guarantee Scheme, addresses five important points of the system.[992] First, the insurance guarantee scheme should cover both life and non-life insurance. Second, the coverage of compensation is up to 90 percent of both life and non-life claims above 100 EUR. Third, the insurance guarantee system will be triggered when an insurer is unable to meet its obligations, or to take measures specified in the restoration plan or financial scheme. Fourth, branches of non-Member State insurers may obtain a license to supply insurance services in the EU only when they belong to an insurance guarantee scheme of a Member State. Last, directors, managers, statutory auditors and other holding companies are excluded from the coverage of compensation by the insurance guarantee system.

Some observations

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[985] For example, Austria, Belgium, Germany, Denmark, Finland, Greece, Italy, Luxembourg, Netherlands, Portugal, and Sweden.

[986] *See* European Commission. Insurance Guarantee Scheme: State of Play and Orientation of the Future Work, Discussion Paper, MARKT/2517/02-EN (Jul. 15, 2002), Annex 1, p. 1.

[987] Goddard (2003), pp. 143-144.

[988] Birds and Hird (2001), p. 34.

[989] *Id.* pp. 22-23.

[990] European Commission. Insurance Guarantee Schemes – Orientation Debate. MARKT/2504/03-EN (Apr. 9, 2003), p. 4.

Available at http://ec.europa.eu/internal_market/insurance/docs/markt-2504-03/markt-2504-03_en.pdf – Last visited 2 April 2007.

[991] *Id.*

[992] *See* European Commission. Meeting on 1st June 2005, Working Group on Insurance Guarantee Scheme, MARKT/2512/05-EN (May 31, 2005).

Available at http://ec.europa.eu/internal_market/insurance/docs/2005-markt-docs/markt-2512-05_en.pdf – Last visited 2 April 2007.

The practices of the US, EU and Japan demonstrate that the problem of moral hazard could be mitigated by the design, powers and duties of policyholder protection funds. Specifically, claims are partially compensated, and certain corporate persons might be excluded from this safety net. Concerning financial burdens of insurers, the experience of New York Insurance Law shows that when the fund is well capitalized, the members need not be required to make a contribution.[993] The application of the policyholder protection system extends not only to an insolvent insurer but also to an insurer in financial difficulties. This would serve as a good lesson for Vietnam in designing insurance regulations on consumer protection as well as assuring the stability of the insurance market.

2.4 Future regulations on solvency margin

(i) A call for more concrete determination of permissible assets

As mentioned earlier, there is a lack of requirement on categories of assets that could represent the solvency margin of insurers. Therefore, a needed provision is to identify permissible assets for the purpose of determining a solvency margin. Mere exclusion of assets is not persuasive. A list of permissible assets for determining the solvency margin would provide clearer understanding and better compliance. In other words, it is required to regulate what categories of assets can be used in the capital base of an insurance company in order that those assets can be used to pay claims and benefits to consumers. This provision also indirectly supports investment rules, whereby an insurance company might refrain from creating excessively risky investment portfolios, as they would be partly ineligible for calculating the solvency margin.

In addition, as different assets shall be treated differently according to their exposure to risks, it is necessary to establish a requirement regarding the valuation of assets to be assumed for the purpose of solvency margin.[994] The experiences of the EU, US and Japan show that assets must be largely evaluated at market value in order to ensure proper

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[993] *See* New York Insurance Law, Sec. 7603 (c) (1).

No further contribution shall be made when the net value of the property/casualty insurance security fund is at least 150 million dollars.

[994] In recently issued regulations by the MOF, the valuation is stipulated as follows:

(i) assets permitted with 100 percent of book value: cash, deposits, government bonds, and assets corresponding to investment-linked insurance policies;

(ii) assets partly permitted:

- secured corporate bonds: 99 percent of book value;
- unsecured corporate bonds: 97 percent of book value;
- listed shares: 85 percent of book value;
- unlisted shares: 80 percent of book value;
- real estate used by insurers: 92 percent of book value;
- other real estate: 85 percent of book value;
- capital contribution to other companies, except for insurance companies: 80 percent of book value;
- overdue receivables: 50-70 percent of book value;
- fixed assets, computer software, and stocks: 75 percent of book value;
- other assets: 85 percent of book value.

See Circular 156/2007/TT-BTC of the Ministry of Finance on guiding the implementation of Decree 46/2007/ND-CP, (Dec. 20, 2007) (Vietnam), Sec. V.4.3.

determination of financial health of insurers. Furthermore, several categories of assets must expressly not be permitted, for example intangible assets, including good will, trade names.[995]

(ii) A need for the inclusion of claims criterion for calculating the minimum solvency margin of non-life insurers

Different fixed ratios of the minimum solvency margin are applied to life and non-life insurers under the Vietnam Insurance Law. Although Vietnam's life insurance market is dominated by foreign insurers, other WTO Members could not challenge Vietnam on any higher ratio of the minimum solvency margin imposed on all life insurers. In other words, Vietnam can continue to differentiate fixed ratios between life and non-life insurance companies without constituting a violation of the national treatment obligation because life insurance services and non-life insurance services are not alike under the meaning of GATS Article XVII. Moreover, different levels of minimum solvency margins applicable to life and non-life insurers are also found in the EU.

As described earlier, there are two main approaches towards the solvency margin, namely fixed-ratio model and risk-based capital. Vietnam has applied a fixed-ratio model towards the determination of the minimum solvency requirement of insurers under the EU model. This approach is simple and standardized. As China's case, the adoption of the EU approach would be a good decision because of the ease of administration.[996]

Under the US and Japan's risk-based capital model, assets are examined carefully by considering actual risks assumed by an insurance company. While the risk-based model could address disadvantages of the fixed-ratio model by incorporating all relevant risks faced by insurers, the main drawback is its complexity and difficulty in application.[997] Moreover, in Japan, there are some cases where life insurers, whose actual solvency margin standard was above 200 percent, still became insolvent.[998] As commented by O'Brien, the risk-based capital approach is not better at anticipating financial problems.[999] An empirical study by Cummins et al. found that a risk-based capital approach is less successful in predicting a large insurance company's insolvency than in predicting smaller insolvencies in case of the non-life insurance industry in the US.[1000] Recently, Pottier and Sommer, in comparing different approaches towards predicting insurer insolvencies, confirmed that the NAIC risk-based

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[995] In recently issued regulations by the MOF, several categories of assets are expressly excluded, for example intangible fixed assets, capital contribution in other insurance companies, bad debt, and unsecured loans. *See* Circular 156/2007/TT-BTC of the Ministry of Finance on guiding the implementation of Decree 46/2007/ND-CP, (Dec. 20, 2007) (Vietnam), Sec. V.4.2.

[996] Dickinson, Gerry. 2002. The Development of China's Insurance Industry. In OECD. *China in the World Economy: The Domestic Policy Challenges*. Paris: OECD, pp. 284-285.

[997] Leflaive (2002), p. 14.

[998] *See* Kinoshita (2002), p. 199.

Typical examples are Chiyoda Life and Kyoei Life with solvency ratio of 221 and 203 percent, respectively.

[999] O'Brien, Chris. 2003. The Regulation of Life Assurers in a Law Solvency Environment: The UK Experience. In Institute of Economic Affairs, *Economic Affairs: Financial Services Regulation*. Oxford: Blackwell Publishing, p. 18.

[1000] Cummins, J. David; Scott E. Harrington; and Robert Klein. 1995. Insolvency experience, risk-based capital, and prompt corrective action in property-liability insurance. *Journal of Banking and Finance* 19, p. 526.

capital is not a good predictor of insolvencies, and that a simple non-risk-adjusted capital ratio is much more effective.[1001]

Moreover, preconditions for good application of the risk-based approach are highly developed statistical data and a strong actuarial profession.[1002] However, both conditions are not found in Vietnam as the insurance market has developed for little more than a decade, and actuarial services are still inadequate. Supervision of and compliance with a risk-based capital model is probably not feasible at this stage. Therefore, Vietnam should continue with the fixed-ratio model.

As noted earlier, in case of life insurance, Vietnam's approach towards the minimum solvency margin is very similar to that of the EU. However, in case of non-life insurance business too, Vietnam should adopt the EU approach to overcome drawbacks of the fixed-ratio model. Therefore, a required provision will be the incorporation of a claims criterion in calculating the minimum solvency margin of non-life insurers. As far as this suggested requirement applies equally to both non-life domestic and foreign owned insurers, as well as branches of foreign insurers, there is no violation of the national treatment obligation.

(iii) A call for more detailed control levels

Adequate and proportionate enforcement measures for different solvency control levels are important to rectify undesirable situations relating to insurance companies.[1003] As noted by Skipper and Klein, appropriate rules and procedures for identifying and dealing with financially troubled insurers are required.[1004] Although the Vietnam Insurance Law provides measures to recover the solvency of a troubled insurance company, including establishment of a solvency control committee, they seem to be insufficient. Intervention by the supervisory authority in early stages of financial difficulties would limit adverse impacts of the failure on consumers and the whole financial system. A clearer procedure in the enforcement of remedial measures, therefore, would facilitate prompt action by the supervisory authority, and consequently avoid unnecessary delay in restoring the solvency of insurers. In addition, these transparency requirements could also help Vietnam to reduce the risk of violating the national treatment obligation due to any possible different and more burdensome application of remedial measures on foreign owned insurers.

Thus, Articles 79 and 80 of the Vietnam Insurance Law must be revised in order to include clear and different quantitative solvency control levels applicable to insurance companies, the MOF, and the solvency control committee. Different control levels corresponding with remedial actions by both insurers and the supervisory authority should be made in greater detail. Concrete remedial measures may include financial forecasts by financially troubled insurers for at least the medium term; composition of the solvency control

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[1001] Pottier, Steven W.and David W. Sommer. 2002. The Effectiveness of Public and Private Sector Summary Risk Measures in Predicting Insurer Insolvencies. *Journal of Financial Services Research* 21(1/2), p. 114.

[1002] Asian Development Bank (2003), p. 121.

[1003] IAIS. Towards a Common Structure and Common Standards for the Assessment of Insurer Solvency: Cornerstones for the Formulation of Regulatory Financial Requirements, Cornerstone VII, October 2005, p. 11. Available at http://www.iaisweb.org – Last visited 22 May 2006.

[1004] Skipper, Harold D. Jr. and Robert W. Klein. 2002. Insurance Regulation in the Public Interest: The Path Towards Solvent, Competitive Markets. *The Geneva Papers on Risk and Insurance* 25(4), p. 497.

committee; and prohibition of free disposal of assets by insurers during the period of applying corrective measures, in order to protect the interests of policyholders.

Nevertheless, the introduction of new prudential regulations on this matter could require foreign owned insurers to apply more stringent remedial measures than those of domestic insurers. For example, foreign owned insurers or branches of non-life foreign insurers who face financial difficulties might be temporarily prohibited from remitting money and assets abroad. This situation may constitute a discrimination against those foreign insurers under the meaning of GATS Article XVII. Vietnam could justify this measure by relying on the prudential exception under Annex paragraph 2(a). First, as the measure of prohibition on remittance abroad is concerned with the solvency of a foreign insurance company in financial difficulty, it is arguable that the first layer of the prudential exception is satisfied. Second, it can also be argued that this prohibition measure has a close and substantial connection with the solvency of the foreign owned insurer because without such a measure, that insurer could be insolvent, and put policyholders at danger. Under the third layer of the prudential exception, however, Vietnam is obliged to apply this prohibition measure consistently and transparently. If the application of this measure constitutes a disguised restriction on trade in insurance services, Vietnam could be found in violation of the GATS national treatment obligation.

Moreover, this measure might be justified by GATS Article XIV(c)(i), whereby Vietnam is required to prove that a measure is necessary to secure compliance with, for example, its foreign exchange law, in order to address "the effects of a default on services contracts". Nevertheless, similar to the prudential exception, Vietnam is responsible for applying this measure in a manner not violating the chapeau of GATS Article XIV.

(iv) Call for establishment of a policyholder protection fund

As commented by Skipper and Klein, some insolvency is inevitable in a competitive insurance market.[1005] Earlier discussion has shown advantages and disadvantages of a policyholder protection fund. The discussion also reveals that the experience of some jurisdictions in designing the fund could mitigate adverse impacts of such a safety net scheme in the insurance sector. Setting up a policyholder protection fund in Vietnam would protect policyholders against losses in the event that an insurer fails financially and is unable to pay claims and benefits. This system, therefore, would strengthen public confidence in the domestic insurance market by providing the funding to pay consumers who have claims and benefits against a failed company. Establishment of this fund in the insurance sector could also increase competitiveness of domestic insurers compared to foreign insurers, who enjoy safety net schemes in their home countries. Moreover, a similar scheme, the deposit insurance system, has been developed in Vietnam's banking sector since 1999.[1006]

The next question considers which model, pre-funded or post-funded, is appropriate for Vietnam.

One of the main advantages of the pre-funded approach is that the money is always available for compensation for policyholders.[1007] In other words, the safety net shall promptly respond to the insolvency of any insurer, and thus reduce the disruption to policyholders and

[1005] *Id.* p. 496.
[1006] Decree 89/1999/ND-CP of the Government on Deposit Insurance (Sep. 1, 1999) (Vietnam).
[1007] Macey and Miller (1993), pp. 74-75.

the danger of rush for money by policyholders. The second advantage is that the existence of visible safety net would promote public confidence in the insurance sector.[1008] As noted by Hodkin, the New York pre-funded system has been studied by many other states because the funds exist prior to insolvency of insurers.[1009]

However, as insurers are liable to make annual contributions to policyholder protection funds, the pre-funded system may discourage insurers from monitoring each other in order to prevent assessment.[1010] This would mean that in the post-funded system, in order to avoid assessment when insolvency of any insurer occurs, all insurers have an incentive to police their competitors in the market. In response to these issues, Han et al. examined different types of policyholder protection funds in the US and concluded that pre-funded approach can reduce agency problems while the post assessment approach tends to foster insurers' risk.[1011]

Another concern is that the availability of funds under the pre-assessment approach may cause administrative costs. In addition, it expropriates insurers from using such contributions in profitable investments.[1012] On the other hand, the administrative costs and forgone earnings may be justifiable, and reduced by the design and well-structured organization of policyholder protection funds.

Vietnam, therefore, should adopt a pre-funded policyholder protection system in order to protect the interests of consumers as well as the soundness of the insurance market. This would reinforce public confidence in Vietnam's insurance market after the WTO accession. It is necessary to design and structure a policyholder protection fund in order to mitigate disadvantages that may arise from the available safety net. Vietnam, however, can regulate different levels of contributions as well as claim compensations between life and non-life insurers. This different treatment would not constitute a violation of the national treatment obligation because there is no likeness between life and non-life insurance services under the meaning of GATS Article XVII. Moreover, other WTO Members also maintain different systems of safety nets applicable to life and non-life insurers.

Membership in the policyholder protection fund may be compulsory for all insurance service suppliers in Vietnam, regardless of domestic or foreign owned insurers, or branches of foreign insurers. Foreign insurers, especially branches of non-life insurers, however, may argue that this measure could constitute additional operating costs because they have paid contributions to their home country's policyholder protection funds. Consequently, this measure in practice could make them less favouble than domestic like insurance service suppliers. Vietnam, however, is safe by relying on the prudential exception. In other words, as this measure is primarily aimed at the solvency of insurers, the first and second layers of the prudential exception are satisfied. Under the third layer, this measure may be justified if Vietnam ensures that the application of this measure does not constitute a disguised restriction on trade in insurance services under the anti-avoidance provision.

Nevertheless, Vietnam is obliged to ensure that both substantive and procedural regulations on the policyholder protection fund must not constitute a discrimination against

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[1008] Yasui (2001), p. 318.
[1009] Hodkin (1992), p. 744.
[1010] Macey and Miller (1993), p. 75.
[1011] Han, Li-Ming; Gene C. Lai; and Robert C. Witt. 1997. A financial-economic evaluation of insurance guaranty fund system: An agency cost perspective. *Journal of Banking and Finance* 21, p. 1127.
[1012] Yasui (2001), p. 318.

foreign insurance services and insurers. For example, in some circumstances, during its application, the policyholder protection fund may have incentives to grant more favourable rescue packages, including capital injection, to domestic insurers facing financial difficulties. Such actions would affect trade in insurance services and constitute a violation of the national treatment obligation because they accord favourable treatment towards those domestic insurers. Although Vietnam might persuade a panel that this measure is primarily aimed at the solvency of those domestic insurers in financial difficulty under the meaning of the prudential exception, Vietnam could find it hard to prove how the application of this measure would satisfy the anti-avoidance provision. Similarly, while Vietnam may prove that such a measure would fall within the scope of "laws and regulations consistent with the WTO" and satisfy the necessity test under the meaning of GATS Article XIV(c), it may face a risk of qualifying the chapeau of this provision on general exceptions.

3. Regulation of reinsurance services

3.1 Current arrangement on reinsurance services

Re-insurers may contribute to the stability of the insurance market by diversifying risk profiles, and then enable insurers to improve their financial soundness.[1013] However, as noted by Wang, insurance supervisors as well as insurers are much concerned over financial conditions of re-insurers because the failure of a re-insurer may affect the solvency of insurers, and thus the interests of policyholders.[1014] Default by re-insurers accounted for three percent of insurance company failures in the US between 1969 and 1998.[1015] Accordingly, as suggested by the IAIS, re-insurers must be subject to regulation and supervision on technical provisions, solvency margin and investment rules.[1016]

Under the Vietnam Insurance Law, re-insurers are subject to the same solvency requirements as insurers.[1017] However, with regard to reinsurance services, these services may be supplied by either insurers or re-insurers.[1018] It means that an insurer can cede a part of its premiums to other insurers or re-insurers. Accordingly, one concern over Vietnam's regulation on the solvency margin is how reinsurance arrangements ceded by insurers could be treated. It is unclear whether a full or a part of these reinsurance arrangements can represent the solvency margin of a ceding insurer. As there is no specific regulation on this matter, it might suggest that Vietnam permits allowance for reinsurance up to 100 percent for the purpose of determining the solvency margin of ceding insurers. This situation could indicate that a risk of default by an insurer/re-insurer assuming reinsurance services does not receive due consideration.

[1013] IAIS. Principles No. 6 on Minimum Requirements for Supervision of Re-insurers, October 2002, p. 3.

[1014] Wang, Wallace. 2002. Developing Reinsurance Markets in emerging Economies: Regulatory Implication and Challenges. *Law and Business Review of the Americas* 8, p. 403.

[1015] Leflaive (2002), p. 22.

[1016] IAIS. Principles No. 6 on Minimum Requirements for Supervision of Re-insurers, October 2002, p. 5.

[1017] Vietnam Insurance Law, Art. 3.5 defines insurer as:

> [A]n enterprise, which is established, organized and operates in compliance with provisions of this Law and other applicable laws to conduct insurance business and reinsurance business.

[1018] *Id.* Art. 9.1.

According to Leflaive, reinsurance services, while limiting risks exposed by insurers, may cause credit risk to insurers because of the failure of other insurers who assume such reinsurance services.[1019] Therefore, credit risk arising from reinsurance is taken into account by many jurisdictions when dealing with the solvency requirements of insurers.[1020] As suggested by the IAIS, the supervisory authority must set rules on making allowance for reinsurance for the purposes of assessing technical provisions as well as the solvency margin of insurers.[1021]

The experiences of other countries may clarify this point. In EU directives, a Member State should fix the percentage of allowance for reinsurance recoverables if it allows any technical provisions to be covered by claims against re-insurers.[1022] In addition, only a certain amount of reinsurance arrangements are taken into account when calculating the solvency margin of both life and non-life insurance. This threshold is set at 50 percent for non-life insurance and capital at risk for life insurance,[1023] and 15 percent for mathematical provision in life insurance.[1024]

Under New York Insurance Law, reinsurance is recoverable in the full amount if the cession is with an insurer authorized to transact reinsurance business in New York or to the extent allowed by the supervisory authority if the cession is with other re-insurers.[1025] In Japan Insurance Law, reinsurance risk is included in asset management risk and taken into account for the calculation of risk-based capital.[1026]

3.2 A need to consider reinsurance risk

The inclusion of reinsurance risk in determining the solvency margin of insurers is another provision requiring further prudential regulations under the Vietnam Insurance Law. As suggested in section 2.4 of this chapter, because Vietnam follows the EU approach to calculating technical provisions and the minimum solvency margin, it should adopt the EU approach in dealing with reinsurance risks. In other words, Vietnam should set a threshold for reinsurance risks in both life and non-life insurance companies for determining their solvency margins. Different thresholds might be imposed for life and non-life insurers. Again, these differences would not constitute a violation of the national treatment obligation because likeness between life and non-life insurance services is not established under the meaning of GATS Article XVII.

[1019] Leflaive (2002), p. 22.

[1020] *Id.* pp. 23-24.

[1021] IAIS (2003), ICP 20 on Liabilities and ICP 23 on Capital Adequacy and Solvency, pp. 34 and 39, respectively.

[1022] *See* Directive 2002/83/EC, Art. 20.4; Directive 92/49/EEC, Art. 17.

[1023] Directive 2002/13/EC, Art. 1.3; Directive 2002/83/EC, Art. 28.2 (b).

[1024] Directive 2002/83/EC, Art. 28.2 (a).

[1025] New York Insurance Law, Sec. 1301 (14).

[1026] *See* Japan Insurance Business Law Enforcement Regulations, Art. 87 (1) e (Tentative translation by the General Insurance Association of Japan). *See also* Japan Financial Services Agency. Presentation material for a Meeting of Solvency and Actuarial Issues Subcommittee of International Association of Insurance Supervisors on 3-5 September 2003, p. 3.
Available at http://www.fsa.go.jp – Last visited 5 October 2006.

4. Investment rules

4.1 Vietnam's current regulations

Investment regime has been widely recognized as a main function of insurers which affects their financial soundness. As the nature of liabilities of an insurance company decides the nature of assets in investment portfolios, a primary consideration of the investment regime is to secure capital and liquidity in order to convert those assets to cash to pay out claims or satisfy unexpected claims.[1027] The fundamental aims of investment rules are to protect policyholders, minimize the probability of the insurer's failure, and prevent insurers from manipulating the financial market by prohibiting insurers from owning or controlling other financial institutions and industrial enterprises.[1028] According to Leflaive, investment risks, or asset risks, are the second major risks, followed by the technical risks, which must be addressed by the solvency regulation.[1029] In most OECD countries, including the EU,[1030] the US,[1031] and Japan,[1032] the investment regulations only relate to the funds that constitute the contractual liabilities to policyholders, i.e. technical provisions, rather than the capital base of insurers as a whole. The rationale is that, if regulations extend to and restrict investment of the capital base they may discourage insurers from holding a high level of capital, and thus weaken financial conditions of insurers.[1033]

Similarly, in case of Vietnam, in order to ensure good financial situations of insurers, Vietnam's investment regime also provides quantitative rules on the usage of funds from technical provisions. Insurers are permitted to make investment up to an amount equivalent to the balance between the total technical provisions and the fund required for regular payment of insurance claims or benefits during a period.[1034] In more specific terms, the permitted capital for the purpose of investment is equal to 75 percent for a non-life insurer, or 95 percent for a life insurer, of the total technical provisions. Investment portfolios of insurers may cover government bonds, corporate shares and bonds, real estate, equity in other companies, loans; deposits in banks.[1035] The overall qualitative requirement on managing investment portfolios by insurance companies is that "*investments by insurers shall be safe, effective and capable of meeting the demand for regular payments as undertaken under insurance contracts*".[1036]

The quantitative restrictions on investment have been set out by the government in order to limit permitted assets to be included in the investment portfolio of an insurance company, and they differ between life and non-life insurance.[1037] Maximum limitations are

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[1027] Outreville (1998), p. 248.
[1028] Vollbrecht (2001), p. 43. *See also* Dickinson (1999), pp. 307-308.
[1029] Leflaive (2002), p. 24.
[1030] Directive 2002/83/EC, Art. 24; Directive 92/49/EEC, Art. 22; Directive 2005/68/EC, Art. 34.
[1031] New York Insurance Law, Sec. 1404 (non-life insurers) and 1405 (life insurers).
[1032] Japan Insurance Law (2001), Art. 97.2.
[1033] *See* Vollbrecht (2001), p. 44. *See also* Dickinson (1999), p. 311.
[1034] *See* Decree 46/2007/ND-CP, Art. 13.2 and 3.
Regular payment of non-life insurance claims is equal to or more than 25 percent of the total technical provisions, and life insurance benefit is 5 percent.
[1035] Vietnam Insurance Law, Art. 98.2.
[1036] *Id.* Art. 98.1.
[1037] Decree 46/2007/ND-CP, Art. 14.

applied to three categories of assets. Firstly, there is no ceiling restriction for either life or non-life insurers with regard to government bonds, secured corporate bonds, and deposits in banks. Secondly, investments in unsecured corporate bonds and corporate shares, capital contributions to other companies shall not exceed 35 percent for non-life insurers, and 50 percent for life insurers, of the permitted capital. Thirdly, investments in real estate and provision of loans shall not exceed 20 percent for non-life insurers, and 40 percent for life insurers, of the permitted capital.

According to the IAIS, the standards on investment activities include "investment policy, asset mix, valuation, diversification, asset-liability matching, and risk management".[1038] Different investment-related risks are embedded in an investment portfolio, and might affect the coverage of technical provisions and the solvency margin.[1039] Moreover, as noted by Leflaive, the principle of diversification is aimed at spreading the investment portfolio over different asset categories or issuers in order to manage depreciation risk, liquidity risk and concentration risk.[1040]

There is strong correlation among credit risks of investments in the same issuer, and consequently an insurance company may be over indebted or insolvent.[1041] In examining the effect of life insurer insolvency in the US - First Executive Corporation on the value of other life insurers, Fields et al. concluded that the failure of an insurer may lead to losses in investment portfolios of other insurers, substantially for weak insurance companies, and those that engaged in more risky investment portfolios, junk bonds and real estate.[1042]

Although Vietnam's investment regime lays down some fundamental rules for holding portfolios, what appears to be missing here is a requirement on investment diversification. As commented by Mr. Tran Vinh Duc, the Chief Executive Officer of BaoMinh Insurance Corporation, Vietnam lacks regulations on investment ceilings for corporate shares, unsecured corporate bonds, and loans granted to enterprises under the same industry.[1043] While an insurance company is allowed to invest a maximum amount in each of three categories of assets, there is no restriction on a single investment. In other words, insurers may invest all permitted capital (20 percent and 40 percent regarding non-life and life insurers, respectively) from technical provisions into one piece of land or building, or provide a loan to one borrower. Similarly, insurers may also employ all permitted capital (35 percent and 50 percent with regard to non-life and life insurance, respectively) from technical provisions into unsecured bonds and shares of a single issuer with an expectation of high returns. The concern of risk concentration may be more intensified in life insurers due to high levels of the permitted capital for investment. This problem has been found in particular in cases of insurance companies facing financial difficulties.[1044] This is more concerning because insurers in

[1038] IAIS (2003), ICP 23 on Capital Adequacy and Solvency, p. 39.
[1039] IAIS (2003), ICP 21 on Investment, p. 35.
[1040] Leflaive (2002), p. 26.
[1041] *Id.*
[1042] Fields, Joseph A. et al. 1994. Junk Bonds, Life Insurer Insolvency, and Stock Market Reactions: The Case of First Executive Corporation. *Journal of Financial Services Research*, p. 108.
[1043] Tran Vinh Duc. 2005. Nang cao hieu qua dau tu von cua cac doanh nghiep bao hiem tai Vietnam [Improving Investment Efficiency of Insurers in Vietnam]. In *Symposium on Solutions for facilitating efficient investments by insurers into the economy* (on file with the Association of Vietnamese Insurers), pp. 63-64.
[1044] Petroni, Kathy Ruby. 1992. Optimistic reporting in the property-casualty insurance industry. *Journal of Accounting and Economics* 15, p. 504.

Vietnam have limited professional skill to expand their investment activities to complicated sectors such as corporate shares and bonds and real estate.[1045]

While there is a distinction between secured and unsecured corporate bonds, there is no such distinction between secured and unsecured loans. This regulation may be an incentive for insurers to grant unsecured loans with high risk and high returns, and adopt highly speculative investment portfolios. Furthermore, investment portfolios of insurers in these sectors would not be safe because of lacking assets secured for lending activities.[1046] In regard to corporate shares, even though the securities market is in place, the investment rules do not distinguish between listed shares and unlisted shares under the investment portfolio of insurers. Consequently, these problems could lead to a mismatched portfolio whereby the technical provisions for fulfilling obligations against policyholders are not fully covered by those investment assets, especially in the case of high exposure to declined share value.

In addition to the concern over investment diversification, no investment abroad is permitted.[1047] As noted by Vollbrecht, foreign investments are advisable because the domestic capital market might not absorb all investment funds.[1048] A too narrow scope of investment assets would probably adversely affect the insurer's profit-generating ability.[1049] Especially regarding marine and other international transport insurance, and reinsurance, regulation should allow some degree of currency mismatching to enable effective currency risk reduction.[1050] Mr. Trinh Quang Tuyen, the Chief Executive Officer of Vietnam Reinsurance Company, observed that since all foreign currencies collected from reinsurance premiums are required to invest in certain projects in Vietnam, which would generate foreign currencies in Vietnam, or make deposits in banks, this situation would limit the diversification of investment portfolios by insurers.[1051]

4.2 Foreign experience

It may be useful to examine the regulations of the EU, US and Japan on investments by insurers. All these countries make a distinction between the treatment of assets representing the technical provisions and assets covering other liabilities, and establish quantitative restrictions on the former. Accordingly, the concern on investment diversification has been substantially addressed. In the EU, investment rules applied to life and non-life insurers are as follow[1052]:

[1045] Le Song Lai (2005), pp. 27-28.

[1046] Thoi bao Tai chinh (Financial Times), No. 119, 5 October 2005.
Available at http://www.mof.gov.vn – Last visited 5 October 2006.

[1047] Vietnam Insurance Law, Art. 98.2.

[1048] Vollbrecht (2001), p. 47.

[1049] Chang, Kuan-Chun. 2004. Necessary Reform of Insurance Law in China After Its WTO Accession. *Syracuse Journal of International Law and Commerce* 31, p. 62.

[1050] Dickinson (1999), p. 313.

[1051] Trinh Quang Tuyen. 2005. Thuc trang trong hoat dong dau tu va giai phap khuyen khich dau tu cua cac doanh nghiep bao hiem [Current issues in investment activities and solutions for investment encouragement by insurance companies]. In *Symposium on Solutions for facilitating efficient investments by insurers into the economy* (on file with the Association of Vietnamese Insurers), p. 39.

[1052] Directive 2002/83/EC, Art. 24.1; Directive 92/49/EEC, Art. 22.1.

(a) 10 % of its total gross technical provisions in any one piece of land or building, or a number of pieces of land or buildings close enough to each other to be considered effectively as one investment;
(b) 5 % of its total gross technical provisions in shares and other negotiable securities treated as shares, bonds, debt securities and other money and capital market instruments from the same undertaking, or in loans granted to the same borrower;
(c) 5 % of its total gross technical provisions in unsecured loans, including 1 % for any single unsecured loan, other than loans granted to credit institutions, assurance undertaking…;
(d) 3 % of its total gross technical provisions in the form of cash in hand;
(e) 10 % of its total gross technical provisions in shares, other securities treated as shares and debt securities, which are not dealt in on a regulated market.

In order to increase the flexibility of those investment restrictions, the ceiling of 5 percent of the total gross technical provisions in securities and loans of the same issuer may be raised to 10 percent if the total value of securities and loans held by an insurance company does not exceed 40 percent of its gross technical provisions.[1053]

Moreover, the EU approach to qualitative principles on investment seems to be detailed and comprehensive. The most important requirement is that those investments from the technical provisions must be diversified and spread in order to ensure that there is no excessive reliance on any particular category of asset or investment market.[1054] In addition, investments in high risk assets or non-liquid assets must be ensured to be kept at prudent levels.[1055] This means that the requirement of investment diversification must be met by insurers and supervisors.

In the US, insurance laws fundamentally set out complicated rules on admitted assets and permitted investments. According to Lencsis, the rationale is that such assets held by insurers for the investment purposes "must be reasonably secure, both as to recovery of the amount invested and as to the rate of return, over a substantial period of time".[1056] While providing a list of authorized categories of investment,[1057] a maximum limitation is set for each category of assets.[1058] Moreover, individual ceilings of 3 percent and 5 percent of permitted assets in life and non-life insurance, respectively, are established for securities of a single issuer and its affiliates.[1059]

According to New York Insurance Law, there are nine categories of investments permitted for insurers: (1) government obligations; (2) obligations of American institutions; (3) preferred shares of American institutions; (4) loans secured by real property; (5) real property acquired as an investment; (6) foreign investments; (7) development bank obligations; (8) equity interests; and (9) investment companies.[1060] Similar to EU directives, while setting quantitative restrictions on each category of investments, investment regime under New York Insurance Law also lays down rules on avoidance of concentration risks, for example, investment in development bank obligations in each bank shall not exceed 5 percent,

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[1053] *Id.*
[1054] Directive 2002/83/EC, Art. 24.2; Directive 92/49/EEC, Art. 22.2.
[1055] *Id.*
[1056] Lencsis, Peter M. 1997. Insurance Regulation in the United States: An Overview for Business and Government. Connecticut: Quorum Books, p. 36.
[1057] NAIC, Investment of Insurers Model Act, II-238-1 (2004), Sec. 7.
[1058] *Id.* Sec. 8.A.
[1059] *Id.* Sec. 8.B.
[1060] New York Insurance Law, Sec. 1404 and 1405.

and in all banks not exceeding 15 percent of admitted assets; or aggregate amount of foreign investments not exceeding 10 percent of admitted assets, and investments in any foreign country not exceeding one percent (or three percent in case of having a highest sovereign debt rating) of admitted assets.[1061]

In addition, with a view to increasing flexibility in investment regimes, an insurer is permitted to invest up to 5 percent of the total admitted assets without being subject to any quantitative limitations, except for prohibited investments.[1062]

A similar approach dealing with the concentration risk has also been found in Japan. While allowing insurance companies to invest money received as insurance premiums in different categories of assets, Article 97-2.1 of Japan Insurance Law reads:

> No insurance company may use for investment the kinds of assets specified by a Cabinet Office ordinance in excess of an amount calculated in accordance with such ordinance.

A special account may be created in order to separate those assets corresponding to the underwriting reserve for insurance contracts.[1063] Accordingly, an insurance company is allowed to hold domestic stocks up to 30 percent, and assets in foreign currency up to 30 percent of the underwriting reserve.[1064]

In particular, the aggregate of the same asset categories shall not exceed 10 percent of the total of the special account assets with respect to: (1) corporate bonds and stocks used by one and the same person/group; (2) loans and lending securities to one and the same person/group; (3) deposits with one and the same person/group; (4) guarantee of obligation for one and the same person/group; and (5) assets related to trading in derivatives with one and the same person/group.[1065]

4.3 A need for more concrete investment rules

In general, the Vietnam Insurance Law has set limits on the maximum investment for each category of assets with regard to insurance funds, but not shareholders' funds. This approach is very similar to that of the EU, US and Japan. In addition, maximum amounts invested in three categories of assets differentiate between life and non-life insurers. These regulations are consistent with the national treatment obligation because there is no likeness between life and non-life insurance services under the meaning of GATS Article XVII.

However, a more diversified set of investment regulations should be adopted to take into account all risks relevant to insurers' investment schemes. Especially, a measure must be put in place to prevent insurers from credit and concentration risks. Accordingly, more detailed regulations on investment diversification are needed in order to ensure that insurers adopt sound risk management with regard to their investment portfolios, and policyholder protection. Moreover, the insurance sector is closely linked to the securities market, which offers investment opportunities to insurance companies. As Vietnam's securities market

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[1061] *Id.* Sec. 1404 (a).
[1062] *Id.* Sec. 1404 (b).
[1063] Japan Insurance Law (2001), Art. 118.1.
[1064] The Enforcement Regulation of the Japan Insurance Law, Art. 48. *See* General Insurance Association of Japan (2006), pp. 80-81.
[1065] *Id.*

develops, more concrete investment rules have become necessary. New investment regulations might include maximum limitations on corporate shares, unsecured bonds of each issuer and of all issuers; a piece of land, building; and unsecured loans of a single borrower and of all borrowers.

Although the main advantage of quantitative restrictions is its ease of application by insurers as well as supervision by the authority, they also have several limitations. The restrictions only address risk characteristics of the investments *per se*, but not other related risks arising from liabilities, including interest risk, and maturity risk of insurance policies.[1066] In addition, they do not flexibly and rapidly respond to economic developments and structural changes in the securities markets.[1067] Dickinson commented that qualitative restrictions could provide an overall guidance for managing investment portfolios and are supported by quantitative restrictions.[1068] As seen through the experience of the US and EU, some flexibility in investment regimes seems to be necessary because different insurers may have different liabilities and free assets. Accordingly, while introducing more concrete quantitative limitations, a new provision on diversification of investment portfolios under a revised Vietnam Insurance Law should ensure certain flexibility to enable insurers to adapt.

Furthermore, complete prohibition of investment abroad from technical provisions seems to be less persuasive. As noted in section 1.4 of Chapter Five, as Vietnam's securities market emerges, there might not be sufficiently diversified portfolios for investment schemes of insurers. In addition, as an insurer may assume foreign-currency cessions from foreign insurers, it is necessary to manage currency-mismatching risk. Particularly, re-insurers' investment strategies could be more complicated than those of insurers because they might be required to manage and match assets and liabilities in different currencies and markets.[1069] This concern is well-addressed by the EU, whereby a re-insurer can invest up to 30 percent of the gross technical provisions in currencies other than those in which technical provisions are set.[1070] On the other hand, total deregulation on investment abroad might undermine potential opportunities to further develop Vietnam's securities market in particular and the financial system in general. Therefore, one provision must allow certain amounts of technical provisions to be invested abroad by insurers. This measure should be applied equally to domestic and foreign owned insurers in order to fulfill the national treatment obligation. Nevertheless, Vietnam could regulate different amounts of permitted capital from the technical provisions eligible for investment abroad by life insurers and non-life insurers. These different treatments in investment abroad, again, would not constitute a violation of GATS Article XVII because there is no likeness between life and non-life insurance services.

An alternative approach is that Vietnam could permit re-insurers to invest abroad first, and then allow direct insurers later. The main argument for this approach is that re-insurers are strongly involved in foreign-currency reinsurance and retrocession services. However, as noted in section 3 of this chapter, under the Vietnam Insurance Law, reinsurance services may be supplied by either insurers or re-insurers. It means that both domestic and foreign insurers in Vietnam could offer reinsurance services to other insurers. As described in section 4.3 of Chapter Two, under WTO jurisprudence, likeness of services and service suppliers as a whole

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[1066] Dickinson (1999), p. 312.
[1067] Leflaive (2002), p. 25.
[1068] Dickinson (1999), p. 312.
[1069] IAIS. Principles No. 6 on Minimum Requirements for Supervision of Re-insurers, October 2002, p. 6. Available at http://www.iaisweb.org – Last visited 22 May 2006.
[1070] Directive 2005/68/EC, Art. 34.4.

is broadly determined only by the likeness of services. Because direct insurers and re-insurers supply like reinsurance services, they could be alike. Given the fact that there is only one re-insurer, which is domestically owned, in Vietnam's insurance market, Vietnam could be challenged by according less favourable treatment on *de facto* basis to foreign insurers in Vietnam as far as reinsurance services are concerned. Consequently, Vietnam could be found in violation of the national treatment obligation by adopting a measure on prohibiting investment abroad by direct insurers.

Vietnam would be safe if a panel accepts that likeness under the meaning of GATS Article XVII must include "like" service suppliers. Re-insurers appear to be distinct and different from insurers. For example, the customer base of the former is only insurers, whereas that of the latter is diversified, ranging from individuals to institutional customers. More specifically, even though reinsurance services supplied by direct insurers and those by re-insurers are alike, likeness in GATS Article XVII can not be established because service suppliers are unlike.

Vietnam, nevertheless, might not justify this measure by relying on the prudential exception. As this measure is concerned with the solvency of re-insurers, it could fall within the scope of "prudential reasons". Moreover, the measure on investment abroad directly affects the solvency of re-insurers. Accordingly, the relationship between this measure and "prudential reasons" could satisfy the "primarily aimed at" test. Under the anti-avoidance provision, Vietnam could establish that the application of this measure is in a transparent manner. Furthermore, the application of this measure is not rigid because the main business activities of re-insurers are to supply of reinsurance and retrocession services, whereas insurers mainly deal with supply of direct insurance services. The application of this measure also would not constitute additional financial burden on foreign insurers because if they accept reinsurance services in foreign currency, they could invest in some foreign-currency generating projects in Vietnam or deposit in any banks.

Given the fact that insurers and re-insurers in Vietnam are subject to the same solvency regime as mentioned in section 3 of this chapter, Vietnam might be found not satisfying the consistency criterion under the anti-avoidance provision. In other words, while the same regulations on technical provisions and minimum solvency requirements are applied to both insurers and re-insurers, any difference between them regarding investment rules might constitute an inconsistency in applying the measure on prohibition of investments abroad by insurers. Accordingly, the measure on permitting re-insurers to invest abroad first and then direct insurers later could not be justified by the prudential exception.

5. Regulation of insurance intermediation

5.1 How regulations on insurance intermediation could enhance the solvency of insurers

In the words of the IAIS, "good conduct of intermediaries is essential to protect consumers and promote confidence in insurance markets".[1071] Leflaive observed that:

[1071] IAIS (2003), ICP 24 on Intermediaries, p. 40.

> Failure of a brokerage business therefore entails a considerable loss for the insurer, since the premiums paid by policyholders commit the insurer once the broker has collected them.[1072]

Accordingly, financial health of insurance intermediaries also affects the solvency of insurers.

The EC directive on insurance intermediation applies to both brokers and agents, who are either natural or legal persons.[1073] Insurance intermediaries are required to ensure their financial soundness on a permanent basis. Specifically, insurance intermediaries must hold insurance policies for liabilities arising from professional negligence of at least EUR one million to each claim and in aggregate EUR 1.5 million per year for all claims.[1074] However, an insurance intermediary is discharged from this requirement if such insurance is covered by an insurer, on whose behalf the insurance intermediary is acting.[1075] The EC directive also requires that all necessary measures must be taken in order to protect consumers against the inability of insurance intermediaries to transfer premiums to insurers or remit amount of claims to insured.[1076] In addition, insurance intermediaries are required to have financial capacity equivalent to 4 percent of the sum of annual premiums received, subject to a minimum of EUR 15,000.[1077]

In the US, in order to limit the credit risk of an insurance agent, the agent is required to remit all funds due to insurer on a monthly basis, and may retain no more than three months' estimated claims payments and allocated loss adjustment expenses.[1078] Insurance agents are also required by insurers to maintain a surety bond for the protection of the insurer with the amount of at least US$ 100,000 or 10 percent of the agent's total annual written premiums, but not exceeding US$ 500,000.[1079] Moreover, the insurer must have an audited financial statement or report proving that its insurance agents have good financial conditions.[1080]

Under Japan Insurance Law, insurance companies are liable to damages for any losses caused by their agents to consumers.[1081] In return, insurance companies have the right to claim reimbursement from agents. Concerning brokerage services, Japan Insurance Law addresses financial conditions of insurance brokers in a detailed manner by requiring deposit money as security.[1082] This amount of security shall be determined by taking into consideration the state of activities of brokers and the need to protect policyholders.[1083] In addition, brokers are also required to hold an insurance brokers liability insurance contract in accordance with a cabinet ordinance.[1084]

In Vietnam, an insurance broker must be established in a corporate form.[1085] As noted in section 3.3 of Chapter Six, the operations of insurance brokerage enterprises include (i)

[1072] Leflaive (2002), p. 34.
[1073] Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on Insurance Mediation, Art. 2.
[1074] *Id.* Art. 4.3.
[1075] *Id.* Art. 4.3.
[1076] *Id.* Art. 4.4.
[1077] *Id.* Art. 4.4(b).
[1078] NAIC, Managing General Agents Act, 225-1 (2006), Sec. 4.B and C.
[1079] *Id.* Sec. 4.G.
[1080] *Id.* Sec. 5.A.
[1081] Japan Insurance Law (2001), Art. 283.
[1082] *Id.* Art. 291.1.
[1083] *Id.* Art. 291.2.
[1084] *Id.* Art. 292.
[1085] Vietnam Insurance Law, Art. 89.

providing information on terms, conditions and premiums of insurance contracts to consumers, (ii) consulting consumers on risk management, insurance services and insurance service suppliers, (iii) negotiating and arranging insurance contracts between suppliers and consumers, and (iv) other activities. There are two important provisions in the Vietnam Insurance Law which aim to ensure a sound financial situation of insurance brokerage enterprises. First, the legal capital requirement applicable to insurance brokerage enterprises is no less than VND four billion (approximately US$ 300,000).[1086] Second, insurance brokerage enterprises are required to hold professional indemnity insurance with regard to their activities.[1087]

Insurance agents may be either a business entity or an individual authorized under insurance agency contracts by an insurer.[1088] Similar to brokers, insurance agents may be delegated by insurers to collect premiums, settle claims or pay benefits to insured.[1089] In order to supply insurance agency services, agents may be required by an insurer to make deposit or mortgage assets.[1090] In addition, when an insurance agent violates agency contracts and thus causes loss or danger to insured, the insurer is responsible for fulfilling its obligations under the insurance contract with the insured, and consequently the insurance agent is obliged to compensate the sum which the insurer has paid as indemnity to the insured.[1091]

In general, it may be observed that, compared to other jurisdictions, the Vietnam Insurance Law has substantially dealt with the credit risk of insurance intermediaries with regard to professional indemnity insurance and capital requirement of brokers, and deposit money by agents. However, there is no clearer guidance on a minimum level of coverage with respect to the professional indemnity insurance. This issue becomes problematic when insurers delegate to insurance brokerage enterprises to collect premiums, settle claims or pay benefits to insured.[1092] In such circumstances, liability of the insurer against the insured is not discharged even if its claims have been paid by the insurer to a broker, but not the insured.[1093] Similarly, in the case of insurance agents, if the deposit or mortgaged assets of insurance agents are insufficient to pay back the insurer, there is no other available remedy as provided in the Vietnam Insurance Law. Especially, there is no specific requirement on financial matters of corporate agents.

5.2 A call for more concrete regulations on intermediation

The solvency of insurers partly depends on the fulfillment of obligations by insurance intermediation. The failure of insurance brokers and agents in effecting claim and benefit payments as well as transfer of premiums may affect financial health of insurers, and consequently public confidence.

An insurance brokerage company acts as an agent of consumers by advising and arranging insurance contracts with insurers, and dealing with claims settlement. In doing so,

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[1086] Decree 46/2007/ND-CP, Art. 4.
[1087] Vietnam Insurance Law, Art. 92.
[1088] *Id.* Art. 84.
[1089] *Id.* Art. 85.3 and 4.
[1090] Decree 45/2007/ND-CP, Art. 30.2(b).
[1091] Vietnam Insurance Law, Art. 88.
[1092] Decree 45/2007/ND-CP, Art. 29.1.
[1093] *Id.* Art. 29.2(e).

the broker provides independent, objective and professional advice for customers. Its professional indemnity is needed to meet possible claims for negligence. As noted earlier, although the existing regulations in the Vietnam Insurance Law have addressed this concern, they do not specify the level of professional indemnity insurance to be held by insurance brokerage enterprises. Therefore, future regulations on insurance intermediation should address in depth professional indemnity insurance, including clarifying levels, types of coverage, as well as other necessary arrangements. As far as this suggested requirement applies equally to both domestic and foreign owned insurance brokerage companies, there is no violation of the national treatment obligation.

Insurance agents act as agents of an insurer by advising and arranging insurance policies with insured, as well as dealing with claims settlement. In the existing regulation, legal responsibilities of insurer for its agents against consumers have been clearly stated, and this would ensure consumer protection. However, any misconduct by an insurance agent which leads to financial losses by an insurer that is not fully recoverable, might affect the solvency of that insurer. Hence, a provision setting a specific amount of money deposited by insurance agents is more persuasive. In addition, a clearer requirement on corporate agents could also limit the credit risk of insurance agents. Accordingly, these regulations might guarantee the fulfillment of insurance agents' obligations against insurers, and contribute to the stability of the whole insurance market.

As pointed out in section 3.3 of Chapter Six, if likeness is broadly determined by relying on the heading of "insurance intermediation" in the Annex, Vietnam might be found in violation of GATS Article XVII because foreign owned insurance brokerage enterprises are treated less favourably than domestic corporate agents with regard to the measure on legal capital requirements. Therefore, by setting a pre-determined amount of money to be deposited by insurance agents, including corporate agents, Vietnam might limit the possibility of violating the national treatment obligation. Thus, although likeness could be established under the meaning of GATS Article XVII based on only the criterion of service classification, there is no *de facto* discrimination between foreign owned insurance brokers and domestic insurance corporate agents.

6. Regulation of insurance holding companies

6.1 Is the supervisory authority adequately empowered to supervise the solvency of insurers?

As described earlier, the MOF is responsible for supervision of insurance business. Insurers must get approval from the MOF on application of as well as on any alterations in methods of calculating technical provisions.[1094] Appointment and alteration of actuaries by life insurers must also be approved by the MOF.[1095]

Insurers are required to periodically submit financial statements and technical reports to the MOF.[1096] Annual financial statements of an insurer must be certified by an independent

[1094] Decree 46/2007/ND-CP, Art. 10.
[1095] Decree 45/2007/ND-CP, Art. 14.2.
[1096] Vietnam Insurance Law, Art. 103.1.

auditor, who is authorized to conduct business in Vietnam.[1097] Moreover, the MOF is empowered to require insurers to submit *ad hoc* reports when (i) there are material changes during the course of their business; and (ii) financial conditions are not satisfied to meet their obligations towards the insured.[1098] Those reporting requirements would ensure that insurance supervisors have sufficient information to conduct off-site supervision in order to evaluate financial conditions of each insurer as well as the whole insurance market.[1099]

As commented by Randall, one reason for the weak supervision and insolvencies in the US in the 1980s was a time lag in getting information, whereby insurance supervisors had no means of detecting financial difficulties in a financial year until it received financial reports in the next financial year.[1100] Furthermore, several states did not carry out on-site supervision at all.[1101] According to the IAIS, the main objective of on-site supervision is to ensure compliance with supervisory requirements, including solvency regulations,[1102] and appraise insurers' current and prospective solvency, as well as identify risks and detect any problems that may affect the ability of insurers to meet their obligations towards policyholders.[1103] Referring back to the Vietnam Insurance Law, the MOF has the power to examine and inspect compliance with the financial regulations by insurers.[1104] The frequency of those on-site inspections shall not exceed one time per year, and the duration of each inspection shall not exceed 30 days.[1105] Arguably, this provision is to restrain the supervisor from abusing inspection power as well as intervening into daily business operations. The MOF is only permitted to conduct *ad hoc* inspection in cases where there is evidence of violation of laws and regulations by insurers.[1106]

In addition to on-site and off-site supervision, the MOF is also entitled to impose administrative sanctions. Any incompliance with prudential regulations shall be considered as constituting breaches of insurance law and regulations.[1107]

As described in section 2.3 of Chapter Five, there is a tendency for banks to expand their activities into the insurance sector by establishing insurance subsidiaries. On the other hand, insurance companies also seek involvement into banking and securities sectors. The first attempt was the foundation of BaoViet Financial-Insurance Conglomerate, which has a banking subsidiary and holds shares in three other commercial banks and two insurers.[1108] Accordingly, this trend would raise a concern over prudential regulation and supervision of those financial conglomerates.[1109] Although the current regulations have adequately

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[1097] *Id.* Art. 102.
[1098] *Id.* Art. 103.2.
[1099] IAIS (2003), ICP 12 on Reporting to Supervisors and Off-site Monitoring, p. 24.
[1100] Randall, Susan. 1999. Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners. *Florida State University Law Review* 26, p. 643.
[1101] *Id.*
[1102] IAIS (2003), ICP 13 on On-site Inspection, pp 25.
[1103] IAIS. Supervisory Standard No. 2 on On-site Inspections, October 1998, p. 5.
Available at http://www.iaisweb.org – Last visited 22 May 2006.
[1104] Vietnam Insurance Law, Art. 120.10.
[1105] *Id.* Art. 122.1.
[1106] *Id.* Art. 122.1.
[1107] *Id.* Art. 124.
[1108] Decision 310/2005/QD-TTg, Art. 1.2 (g) and (i).
[1109] The IAIS defines financial conglomerate as "any group of companies under common control, whose exclusive or dominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)". *See* IAIS, Supervisory Standard No. 5 on Group Coordination, p. 6.
Available at http://www.iaisweb.org – Last visited 22 May 2006.

empowered the MOF to ensure compliance of insurers with solvency requirements, the MOF lacks power in supervising insurance holding companies. Maybe like China, in Vietnam, as financial conglomerates are only at initial stages, supervisory issues and problems might be overlooked.[1110]

The rationale for financial services integration, according to Skipper is cost advantage and revenue effects.[1111] Challenges of a financial conglomerate remain, however, in understanding its risk profiles as a whole, and to develop an appropriate risk management system for the whole group.[1112] Leflaive observed that the fundamental concern is to formulate solvency requirements applicable to a group and conglomerate because of an "increased contagion risk".[1113] This contagion risk may occur when a financial conglomerate would "make good the financial losses of other company" and thus reduce the capacity available to cover its obligations towards customers.[1114] In more specific terms, the necessity to make an intervention into financial conglomerates has been underlined by Chang as:

> The problems of risk concentration and risk contagion can certainly materially affect the operation of the insurance holding company system in such a way that the holding company is duty bound to disclose it and thus trigger an examination by the regulator.[1115]

Therefore, the scope of supervision on financial conglomerates must address, *inter alia*, their capital adequacy, reinsurance and risk concentration, intra-group transactions and exposure, and risk management.[1116]

6.2 Lessons from other jurisdictions

The experiences of other countries may be useful references for Vietnam in its revision of insurance regulations in this area. In the case of insurance groups in the EU, additional supervision is extended to the insurance company, which is a parent company of or holds participation in at least one insurance company, or the parent company of which is an

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Under the EC law, financial conglomerate means "a group which meets five conditions, including at least on of the entities in the group is within the insurance sector and at least one is within the banking or investment services sector." *See* Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, Art. 2.14.

Under Japanese regulations, financial conglomerate means a corporate group falling under one or more than one of the following definitions: (1) financial holding company group, (2) de-facto holding company group, (3) financial institution parent company group, or (4) foreign holding company, etc. group. *See* Japan Financial Services Agency, Guideline for Financial Conglomerate Supervision, May 2006, Sec. I-1.

[1110] Chang (2003), p. 2.

[1111] Skipper, Harold D. Jr. 2001c. Financial Services Integration Worldwide: Promises and Pitfalls. In OECD. *Policy Issues in Insurance: Insurance Regulation and Supervision in the OECD Countries*. Paris: OECD, pp 105-108.

Cost advantage of financial conglomerate could materialize through economies of scale (increase of production leading to decrease of average cost), economies of scope (multiple products produced at less cost than the sum of costs producing each separately), and operational efficiencies. Revenue effect might materialize through economies of scope in consumption and market power.

[1112] *Id.* p. 115.

[1113] Leflaive (2002), p. 36.

[1114] *Id.*

[1115] Chang (2003), p. 17.

[1116] IAIS (2003), ICP 17 on Group-wide Supervision, p. 31.

insurance holding company or non-insurance holding company.[1117] Accordingly, the adjusted solvency margin of insurance groups shall be calculated based on one of three methods: (i) deduction and aggregation method, (ii) requirement deduction method, and (iii) accounting consolidation-based method.[1118]

In regard to insurance holding companies in Japan, there is a distinction between company and the supervisory levels. An insurance holding company is required by law to secure sound and proper operations of insurance companies that are its subsidiaries.[1119] Moreover, an insurance holding company must prepare and submit to the supervisory authority a business report, including activities and assets of the company as a whole and its subsidiaries.[1120] At the supervisory level, additional supervision is focused on capital adequacy;[1121] and risk management system, including risk contagion, credit risk, market risk and liquidity risk.[1122] The supervisory authority is empowered to require an insurance holding company to submit or alter reform plans in order to secure its sound and proper operations and to protect policyholders.[1123]

In the US, rules are provided for the solvency supervision of insurance holding companies relating to acquisition of control or merger, standards and management, examination, and receivership.[1124] More specifically, under New York Insurance Law, insurance holding companies are required to disclose information, which materially affects their financial conditions.[1125] In addition, the supervisory authority has the power to examine holding insurance companies if supervisors believe that their operations materially affect the financial conditions of such companies.[1126]

[1117] Directive 98/78/EC of the European Parliament and of the Council of 27 October 1998 on the supplementary supervision of insurance undertakings in an insurance group, Art. 2.

[1118] *Id.* Annex I, Sec. 3.

In the deduction and aggregation method, the adjusted solvency situation of the insurance conglomerate is equal to ∑ [(a) the elements eligible for the solvency margin of the insurance conglomerate, and (b) the proportional share of the insurance conglomerate in the elements eligible for the solvency margin of the related insurance company] - ∑ [(a) the book value in the insurance conglomerate of the related insurance company, (b) the solvency requirement of the insurance conglomerate, and (c) the proportional share of the solvency requirement of the related insurance company]. According to the requirement deduction method, the adjusted solvency of the insurance conglomerate is equivalent to ∑ [the elements eligible for the solvency margin of the insurance conglomerate] - ∑ [(a) the solvency requirement of the insurance conglomerate, and (b) the proportional share of the solvency requirement of the related insurance company].

In case of the accounting consolidation-based method, the adjusted solvency of the insurance conglomerate equals to ∑ [the elements eligible for the solvency margin calculated on the basis of consolidated data] – [(a) the sum of the solvency requirement of the insurance conglomerate and of the proportional shares of the solvency requirements of the related insurance companies, based on the percentages used for the establishment of the consolidated accounts] or [(b) the solvency requirement calculated on the basis of consolidated data].

[1119] Japan Insurance Law (2001), Art. 271-5.2.

[1120] *Id.* Art. 271-8.1.

[1121] *See* Japan Financial Services Agency, Guideline for Financial Conglomerate Supervision, May 2006, Sec. II-2.1.

Capital adequacy of financial conglomerate may be calculated based on either combined equity capital or requisite equity capital, with adjustment for treatment of companies who are not subject to prudential regulations.

[1122] *Id.* Sec. II-2.2.

[1123] Japan Insurance Law (2001), Art. 271-13.1.

[1124] NAIC, Insurance Holding Company System Regulatory Act (2006), 440-1.

[1125] New York Insurance Law, Art. 1504(a).

[1126] *Id.* Art. 1504(b).

6.3 A need for clearer power of the supervisory authority with regard to insurance holding companies

The tendency of banks to intrude on the insurance sector, and the expansion of an insurance company to other financial sectors in Vietnam would raise concern over financial supervision, especially intra-group risk contagion and risk concentration. The solvency of an insurance subsidiary in the insurance holding company may be affected by the financial conditions of the whole group, or *vice verse*, the insurance holding company may be in financial difficulty due to problems of another insurance subsidiary. Moreover, financial problems of an unregulated subsidiary (non-financial company) may also cause losses to an insurance holding company.

Accordingly, in a revised Vietnam Insurance Law, there should be a provision requiring insurance holding companies to cope with the above potential risks, including those risks arising from an unregulated subsidiary. Consideration should, therefore, be given to requiring an insurance holding company to disclose financial information relating to the whole group. Moreover, the calculation of adjusted solvency for insurance holding companies seems to be necessary to give a fuller picture on financial health of the whole group. The supervisory authority should be empowered to take necessary measures, including intervention when necessary, to ensure financial soundness of the insurance holding company.

7. Limits to the legal reform

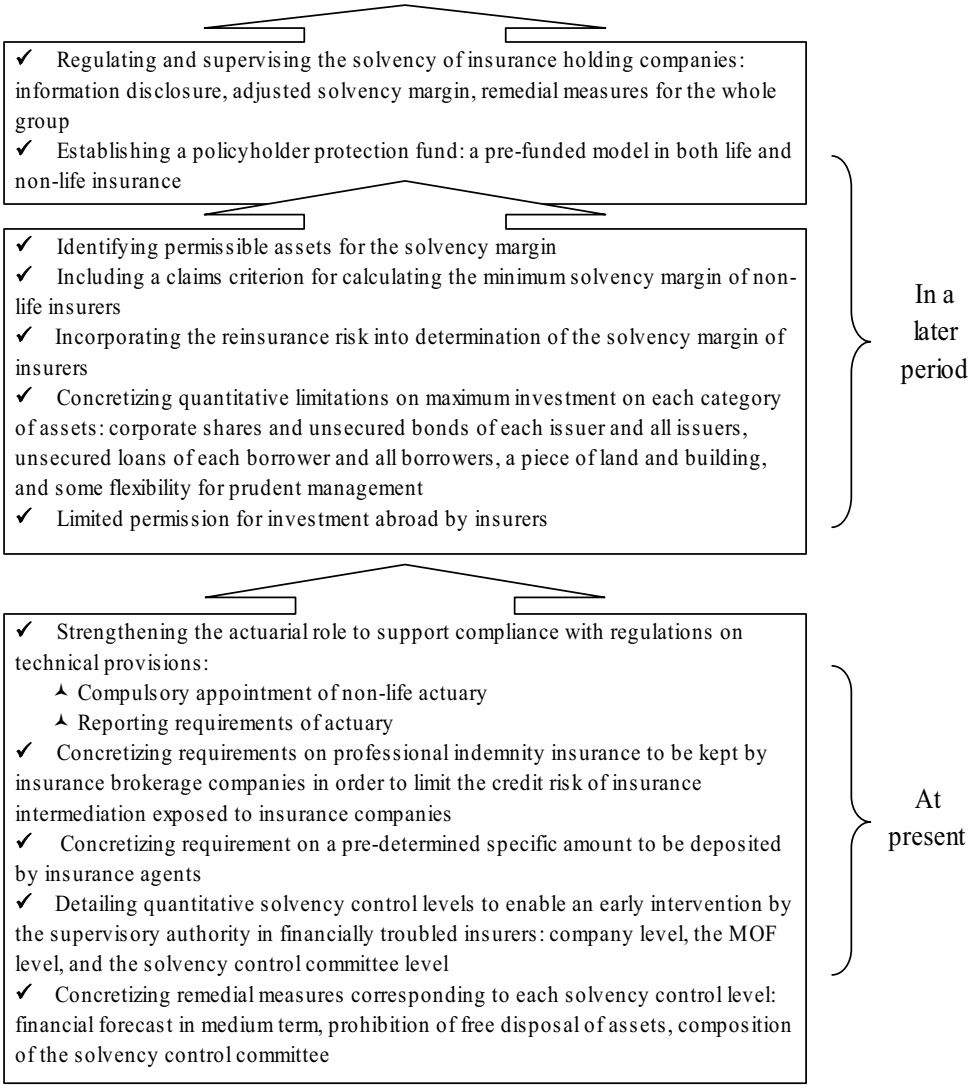
7.1 Factors influencing the enhancement of prudential regulations

Several deficiencies in the existing solvency regulations under the Vietnam Insurance Law might have negative impacts on consumer protection as well as soundness of the entire financial system. Therefore, prudential regulations must be enhanced. In introduction of new prudential regulations, Vietnam should refrain from any discriminatory measures, either *de jure* or *de facto*, against foreign insurance services and service suppliers. The tendency towards a level playing field for all insurance companies, irrespective of origin, could be a positive factor for Vietnam in adopting and implementing new prudential regulations in the insurance sector.

However, if there is any discrimination against foreign insurance services and service suppliers as a result of introducing prudential measures, Vietnam would still be safe if the measures satisfy the three-layer test under the prudential exception. In such circumstances, another factor, which also influences the enhancement of prudential regulations, is the relationship between measures at issue and prudential reasons. New regulations and measures in the insurance sector must have a close and substantial connection with the solvency of insurance companies in order to satisfy the "primarily aimed at" test. In addition, as discussed in section 3.3 of Chapter Three, the interpretation of the anti-avoidance provision suggests that Vietnam could exercise the right to regulate its insurance market in conformity with the Annex as long as the application of measures affecting trade in insurance services does not constitute a disguised restriction. In other words, the application of new prudential measures introduced by Vietnam must not be, *inter alia,* rigid, inconsistent, or opaque. Otherwise, any

measure found to be discriminatory against foreign insurance services and service suppliers under the meaning of the national treatment principle, could not be justified by the prudential exception because it would be deemed a means of avoiding Vietnam's commitments and obligations under GATS.

Figure 8: Roadmap for enhancing prudential regulations in Vietnam



Another factor which might influence the enhancement of prudential regulations is sequence of legal reform. Revision and introduction of new prudential regulations may be burdensome for law makers as well as the supervisory authority. Policy suggestions need not all be implemented at once. Accordingly, the enhancement of prudential regulations should

proceed in accordance with phased-in liberalization of the insurance sector and its development. Figure 8 summarizes the roadmap for further enhancement of prudential regulations in the Vietnam Insurance Law.

At present, because weaknesses of Vietnam's insurance market include a lack of management skills of insurance companies and inexperienced individual consumers, more supportive measures for compliance with the current solvency regime are a priority. The role of actuary must be strengthened, including requirements on appointed actuaries for non-life insurance companies, and reporting requirements. In addition, detailed quantitative control levels correspondent with remedial measures are necessary. The reason is that those measures could enable prompt intervention by the insurance supervisory authority in case of financially troubled insurers, and thus improve public confidence in the insurance market. Detailed regulations on insurance intermediation must also be improved at this stage in order to enhance the solvency of insurers. Success in implementing those measures could facilitate conditions for introducing more complicated prudential regulations.

In a later period, with further growth of the insurance market by diversifying market players, more stringent prudential measures will be required. Accordingly, there would be a fundamental improvement of solvency regime, including a clear identification of permissible assets and an incorporation of reinsurance risk for the purpose of determining a solvency margin, as well as inclusion of a claims criterion for calculating the minimum solvency margin of non-life insurers. In addition, diversification of investment portfolios and limited permission to invest abroad must be in place. These measures would allow the supervisory authority to cope with an increasingly competitive insurance market, including merger and acquisition as a result of competition. During this stage, more detailed regulations on supervision of insurance holding companies and establishment of a policyholder protection fund would provide an additional remedial mechanism to mitigate adverse impacts that might arise from liberalization.

7.2 Unsolved issues and future study

The previous analysis and discussion reveals several problems in the Vietnam Insurance Law with regard to the solvency regime of insurance companies. A number of policy suggestions on enhancing prudential regulations have been offered in the light of GATS national treatment principle. These suggestions could contribute to a more efficient and effective supervision of insurers in the context of fierce competition after Vietnam's accession to the WTO. Sound solvency of insurance companies in Vietnam would ultimately bring about better consumer protection as well as the stability and integrity of the financial system as a whole. Nevertheless, there are at least two unsolved matters for further research.

First, experience of other selected countries with regard to prudential regulations could offer a direction on future enhancement of Vietnam's solvency regime. The study reveals that despite emergence of financial conglomerates in Vietnam, there is a lack of regulations and proper supervision over the operations of insurance holding companies. Although the study emphasizes the need for enhancing prudential regulations in this area based on the experience of the US, EU and Japan, the next question is to what extent the solvency regime of those financial conglomerates should be regulated. Which adjusted level of the minimum solvency

margin and what corrective measures should be applied by the supervisory authority? These are critically important matters which need to be concretely researched in the future.

Second, the study also reveals that the lack of a policyholder protection fund would adversely affect the public interest as well as the stability and integrity of Vietnam's insurance market. While the study proposes that a pre-funded model of the policyholder protection fund should be adopted, the questions of how this fund should be established, operated and managed are clearly another important matter for future detailed research. Especially, level of contribution should not create a financial burden for insurance companies in the context of Vietnam's emerging insurance market. In addition, it is necessary to research appropriate levels of compensation coverage as well as possible measures offered by the policyholder protection fund in case of insurers facing financial difficulties.

CHAPTER EIGHT

Conclusions

The main purpose of this study is to examine the interpretation and application of GATS national treatment principle in insurance services, and the case of Vietnam's liberalization of its insurance services market under the WTO framework. While Part One provided general aspects of interpretation of this principle in the insurance sector, Part Two examined the specific application of this principle to Vietnam's insurance services sector.

Different findings were pointed out throughout each chapter. This concluding chapter presents an overall review of the previous chapters on this topic.

1. Contrary to GATT, where the national treatment obligation is automatically applied to foreign goods upon the custom clearance, the national treatment principle in GATS is the object of negotiations. The result of such negotiations is inscribed into WTO Members' schedules of specific commitments. Thus, a WTO Member is obliged to respect the national treatment obligation for service sectors and/or sub-sectors as well as level of commitments that a Member undertakes in its schedule.

2. The national treatment principle in GATS requires WTO Members to eliminate and refrain from adopting any discriminatory measures, either *de jure* or *de facto*, against foreign services and service suppliers in comparison with domestic "like" counterparts. However, the scope of the GATS national treatment principle addresses all discriminatory measures which do not fall within the scope of Article XVI on Market Access between foreign services and service suppliers, on the one hand and domestic counterparts, on the other hand.

3. Similar to the national treatment obligation in GATT, the national treatment principle in GATS consists of three core interpretative elements, namely measures affecting trade in services, likeness, and the standard of "no less favourable" treatment. WTO jurisprudence shows that the first element is broadly interpreted to cover all measures that directly or indirectly affect trade in services. The possibility of transplanting GATT jurisprudence on interpretation of likeness to GATS would bring about a broad scope of likeness under the second element due to the intangible and non-storable nature of services. In the event a measure in question is found to modify conditions of competition in favour of domestic like services and service suppliers, there is a breach of the third element of "no less favourable" treatment.

Several possible ways have been discussed to limit the broad scope of likeness and the standard of "no less favourable" treatment, and then reduce the high possibility of violation of the national treatment principle. They include considering other criteria in comparing likeness, such as consumers' tastes and habits, products' end-uses; a reference to likeness of service suppliers and modes of supply; and inscription of limitations and restrictions in schedules of specific commitments. Nevertheless, the problem of high possibility of violating the GATS national treatment principle has not yet been satisfactorily resolved due to uncertainty in criteria for determination of likeness and broad coverage of discrimination on the one hand, and the objective assessment of this principle on the other hand.

4. A two-stage approach has been proved to be an appropriate solution to balance against the broad scope of the national treatment principle. By relying on GATS Article XIV on General Exceptions, WTO Members could have a proper space to pursue legitimate domestic policy aims. In other words, although in an objective assessment a measure could be found discriminatory against foreign services and service suppliers, it does not constitute a violation of the national treatment principle as far as that measure is not discrimination with protectionist aims under the meaning of Article XIV.

5. In addition to the general framework of GATS, liberalization of the financial services sector, including insurance services, is governed by the Annex on Financial Services. This Annex represents a balance between concerns over the incorporation of financial services, including insurance services, into GATS and a need to pursue prudential objectives. The Annex, therefore, is submitted to constitute a second stage in the two-stage approach for the application of the national treatment principle in the insurance sector. This means that although in an objective assessment a measure may be found to be discriminatory against foreign insurance services and service suppliers, it would not constitute a violation of the national treatment principle as far as that measure is not discrimination with protectionist aims in the context of prudential exception as provided in Annex paragraph 2(a).

6. Pursuant to the Annex, in the financial market, including insurance services sector, a WTO Member may adopt a measure inconsistent with its commitments on the national treatment principle for prudential reasons. However, in order for a WTO Member to exercise the prudential exception, that Member is required to provide evidence that a measure which is inconsistent with rules and obligations under GATS, including the national treatment principle, satisfies a three-layer examination. First, that measure must be concerned with preservation of the solvency of insurance service suppliers to fulfill their obligations towards policyholders and other relevant persons, and towards the stability and integrity of the financial system as a whole. Second, a degree of connection between that measure and prudential objectives must be demonstrated through the "primarily aimed at" test. The third layer is to ensure that the application of that measure must not constitute disguised restrictions on trade in insurance services. This understanding of GATS prudential exception would maintain the balance between the rights of a WTO Member to regulate its insurance services sector, and the rights of other Members to rely on the performance of that Member's obligations and commitments with regard to liberalization of trade in insurance services.

7. A clear tendency towards a level playing field for all insurance companies, irrespective of ownership and origin, has been introduced in a sequence over time in Vietnam's insurance market. This tendency is a positive factor in Vietnam's implementation of its commitments under the Protocol of Accession to the WTO. In the insurance services sector, Vietnam inscribed the full national treatment in Modes 1, 2, and 3, and commitments with limitations in Mode 4. This means that, with respect to all measures affecting trade in insurance services under the meaning of GATS Article XVII, Vietnam is obliged to accord insurance services and service suppliers of any other WTO Member treatment no less favourable than it accords to its own like insurance services and service suppliers.

8. An overall evaluation of Vietnam's commitments in insurance services under the WTO accession shows that there are some opportunities, both medium term and long term, for further development of Vietnam's insurance market. However, threats of fierce competition and underdeveloped regulation should not be ignored, especially given

weaknesses in both insurance companies *per se* and the whole financial system. To mitigate negative impacts of such threats and maximize benefits of liberalization of the insurance services sector under GATS, more complex regulations should be enhanced in order to promote the solvency of insurance companies for consumer protection as well as for the stability and integrity of the whole financial system.

9. The review of insurance sub-sectors for liberalization in the WTO shows that regulations in the Vietnam Insurance Law are consistent with Vietnam's commitments, except for services auxiliary to insurance. Accordingly, a legal provision on the supply of actuary and consultancy services is required.

In addition to the Vietnam Insurance Law, assurance of other laws and regulations which may affect trade in insurance services, consistent with the national treatment principle, could be an important factor for Vietnam's implementation of commitments under the WTO framework.

Likeness under the meaning of GATS Article XVII could not be established among four insurance sub-sectors inscribed in Vietnam's schedule of specific commitments, namely direct insurance, reinsurance and retrocession, insurance intermediation, and services auxiliary to insurance. For the purpose of the national treatment obligation, life and non-life insurance services are also unlike. However, likeness between insurance brokerage and agency services could be established if only the criterion of services classification is taken into account. In addition, there is a high possibility that all services, including consultancy, actuarial, risk assessment, and claim settlement, under the sub-sector "Services auxiliary to insurance" could be alike because they are under the same sub-sector.

As far as likeness under the meaning of GATS Article XVII is determined, Vietnam is required to ensure the standard of "no less favourable" treatment. This standard encompasses not only *de jure* but also *de facto* discrimination. While Vietnam has amended its administrative regulations in order to remove certain discriminatory measures against foreign insurance services and service suppliers, Article 4.2 of the Vietnam Insurance Law safeguarding the dominant role of state-owned insurers in the domestic insurance market should be eliminated in a future revision of this law.

10. The solvency regime of insurance companies is regulated by the Vietnam Insurance Law with regard to technical provisions, solvency margin, and investment. This system is mainly based on the EU approach. However, compared to the EU as well as the US and Japan experience, there are several regulatory weaknesses in the current solvency system.

Different policy suggestions on enhancement of prudential regulations have been made in the light of GATS national treatment principle. They include: (i) enhancement of the actuarial role to support compliance with regulations on technical provisions; (ii) clear identification of permissible assets for calculating the solvency margin; (iii) incorporation of the reinsurance risk into the determination of solvency margin of insurers; (iv) inclusion of a claims criterion for calculating the minimum solvency margin of non-life insurers; (v) more detailed quantitative solvency control levels to enable an early intervention by the supervisory authority in financially difficult insurers; (vi) concrete remedial measures corresponding to each solvency control level; (vii) establishment of a policyholder protection fund; (viii) introduction of more concrete quantitative limitations on maximum investment on each category of assets; (ix) limited relaxation on investment abroad from the technical provisions of insurers; (x) a more detailed requirement on the professional indemnity insurance to be kept by insurance brokerage companies; (xi) a pre-determined specific amount to be deposited

by insurance agents; and (xii) concrete requirements on calculation of the adjusted solvency margin of an insurance holding company as well as group-wide information disclosure. These legal enhancements could protect the interests of consumers, and improve public confidence. Consequently, they would ensure the stability and integrity of the domestic insurance sector after Vietnam's accession to the WTO.

Nevertheless, in introducing new prudential regulations, some measures might be found in violation of GATS Article XVII due to uncertainty in interpretation of the national treatment obligation. In such a circumstance, it would be safe if Vietnam could satisfy Annex paragraph 2(a) that those new regulations and measures in the insurance sector are "primarily aimed at" the solvency of insurance companies. In addition, Vietnam must ensure that the introduction and application of these suggested solvency regulations is in a manner of, *inter alia*, flexibility, consistency, necessity and transparency, in order to avoid the possibility of violating the anti-avoidance provision under the prudential exception.

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