

A STUDY ON THE IMPLICATIONS OF THE RENEGOTIATION OF THE SERVICE AND INVESTMENT CHAPTERS OF THE KOREA-CHINA FTA THROUGH A CASE ANALYSIS OF THE FINANCIAL SERVICES CHAPTER OF THE KOREA-US FTA

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China's recent retaliation to the deployment of the Terminal High Altitude Area Defense system (THAAD) in the Korean peninsula has keenly targeted the Korean service sector. Problematically, however, the profundity of the service sector provisions of the Korea-China Free Trade Agreement (FTA) is neither deep nor intricate. The Korean government is aware of such vulnerability. However, China is yet considerably conservative in regards to the liberalization of its financial service market as demonstrated in their consistent implementation of a positive list approach mechanism to the Financial Service Chapter in all of its previous FTAs. On the other hand, the Korea-US FTA is comparatively liberal in terms of market access due to its negative list approach mechanism, which renders it a suitable framework for appropriation of certain provisions in its renegotiation of the Korea-China FTA Service Sector Chapter. In particular, there are five key provisions under the Financial Services Chapter of the Korea-US FTA that ought to be borrowed in the adoption of the Korea-China FTA. This paper analyzes the legitimacy and reasoning of why Korea and China should utilize the following provisions as a template for its renegotiations of Financial Services sector of the Korea-China FTA.

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Introduction

The Korea-China FTA was ratified in December 2015. During tariff negotiations, the sensitivity of the Korean domestic agricultural sector resulted in a conservative deal, which in turn caused discomfort and discontent in other domestic industries due to the long-term period of eliminating tariffs on flagship products. In reality, additional tariff reductions have proven to be extremely unprofitable in the Korean economy because its manufactured goods are rapidly losing its competitiveness compared to Chinese goods in recent years. At the inception of the Korea-China FTA, both countries had agreed that they would renegotiate the Service and Investment sectors two years after its establishment, and had pre-consented that during its renegotiation stage it would transition from positive list to negative list approach. From a mid- to long-term viewpoint, the challenge for the Korean economy is to increase the competitiveness of the

service industry in order to promote domestic companies' entry into the Chinese service market. A prominent issue of the renegotiation is the Financial Services Chapter, which is separately addressed as an independent Chapter due to its complex nature. In previous agreements, China had not agreed to such partition in chapters. Therefore, the existence of a separate Financial Service Chapter in the Korea-China FTA is an unprecedented action by China, which suggests its positive stance in this particular agreement. However, China continues to be conservative in regards to fully opening its financial service market, and has never implemented a negative list approach to the Financial Services Chapter in any of its previous FTAs. This study mainly analyzes the legitimacy and reasoning of why Korea and China should utilize the Financial Services [Chapter 13] of the Korea-US FTA (hereafter KORUS FTA), which was

constructed in a negative list approach and has been widely reputed as a sophisticated deal. The Financial Services sector of KORUS FTA raised the level of market access by adopting the North American Free Trade Agreement (hereafter NAFTA)'s scheme, which was the first negative list approach type of market opening, to Korea's financial services sector.¹

Coverage and Disciplines of the GATS (Positive List Approach) and the NAFTA Model (Negative List Approach)

There are two types of Services schemes: The General Agreement on Trade in Services (hereafter GATS) model and the NAFTA model.

Fundamentally, the GATS model is the positive list approach mechanism and the NAFTA model is the negative list approach mechanism. Each scheme has different aspects of which services are provided and liberalized. Depending on which scheme is adopted, the degree of the agreement's overall openness varies – rendering its selection a defining crossroad. The GATS scheme distinguishes four different modes of supplying services such as 'Cross-Border Supply' (Mode 1), 'Consumption Abroad' (Mode 2), 'Commercial Presence' (Mode 3), and 'Presence of Natural Persons' (Mode 4). The liberalization of market access of the GATS model enumerates areas to be opened as concessions, including regulations if there are any restrictions on market openings to related fields. On the other hand, the modes of supplying services of the NAFTA model are divided into 'Cross-Border Trade in Services' and 'Investment'. The premise of liberalization of market access of the NAFTA model is that all services are considered open, unless any restrictions are listed on either a non-conforming measure or Annex. Thus, higher levels of market access are possible under the negative list approach mechanism of the NAFTA model.²

China has maintained a positive list approach mechanism in all of its existing FTAs. However, both Korea and China agreed that they will modify

the existing positive list approach to a negative list approach when they renegotiate the Financial Services Chapter. This is a remarkable fact since China has not even modified the negative list approach method on the China-Hong Kong Comprehensive Economic Partnership Agreement (CEPA), which is regarded as the highest level of market access of existing negotiations completed by China.³ In contrast, Korea utilized both positive and negative list approaches on previous FTAs. In the case of Korea-Singapore FTA and Korea-Chile FTA, the agreements adopted the negative list approach, except for the Financial Services Chapters.

[Table 1] Positive and Negative List Approach of Previous FTAs by Korea and China

Korea	Positive / Negative List	China	Positive / Negative List
Korea-ASEAN FTA	Positive	China-ASEAN FTA	Positive
Korea-Peru FTA	Negative	China-Peru FTA	Positive
Korea-Singapore FTA	Negative	China-Singapore FTA	Positive
Korea-Chile FTA	Negative	China-Chile FTA	Positive
KORUS FTA	Negative	China-Pakistan FTA	Positive
Korea-EU FTA	Positive	China-Costa Rica FTA	Positive
Korea-EFTA FTA	Positive	China-Hong Kong CEPA	Positive
Korea-India CEPA	Positive	China-Thailand ECFA	Positive

Source: Yeo Jina, Park Min-Suk (2012), with revisions by the author.

¹ Trachtman, Joel P. "Trade in Financial Services under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis." Columbia Journal of Transnational Law, 1995.

² Ibid

³ Yeo Jina, Park Min-Suk. "A Study on the Strategy of Korea-China FTA Negotiation Strategy through the Analysis of the CEPA Services in China and Hong Kong." Korea Institute for International Economic Policy, 2012.

The Financial Services Chapter of the KORUS FTA

The KORUS FTA offers a high-level of the liberalization of market access compared to any existing FTA agreements done by Korea. However, it is important to note that the standard of an advanced agreement is not only its expansionary pursuits, but also its aptness. Therefore, the evaluation of the following provisions is a valuable starting point in the formulation of the Korea-China FTA renegotiation strategy.

(1) Cross-Border Trade

‘Cross-Border Trade’ is a type of service transaction in which foreign financial institutions could supply financial services to domestic financial consumers, even if they do not establish branches or subsidiaries in Korea. This is mainly applied to a NAFTA-type service trade.

The scope of ‘Cross-Border Trade’ of the Financial Services Chapter between Korea and the United States is permitted to be released only to ‘Insurance and Insurance-Related Services’ and “Banks and Other Financial Services” specified in Annex 13-A. In the case of the United States, ‘Insurance and Insurance-Related Services’ specified under both Article 1: (a) and (b) of Annex 13-A were fully opened without any conditions. Article 1: (a) and (b) of Annex 13-A specify the ‘Insurance and Insurance-Related Services’ as (a) insurance of risks relating to maritime shipping and commercial aviation and space launching and freight (including satellites); and (b) reinsurance and retrocession, services auxiliary to insurance.⁴

On the other hand, Korea permitted Article 1: (a) of Annex 13-A under the condition of non-face-to-face transaction method. Therefore, international trade-related insurance products such as maritime, aerospace, space insurance and import and export shipping insurance are permitted only through the Internet or telephone, but not through direct face-to-face transaction (i.e. presence of natural person).⁵

This is equivalent to Korean domestic regulations, known as the Supervision of Insurance Business Act. Respectively, Article 1-6:(1) and (2) of the following Act state that foreign insurance companies can sign insurance contracts with residents only via mail, telephone, facsimile transmission, or computer communication and that foreign insurers may not request or delegate to insurance companies, insurance agents, insurance agents and insurance brokers located in the Republic of Korea to mediate or represent an insurance contract. Therefore, the direct face-to-face transaction method is not permitted for the insurance services specified under the Article 1: (a) of the Annex 13-A of KORUS FTA. However, through the KORUS FTA, the direct face-to-face transaction method through the presence of natural persons is permitted for the reinsurance, retrocession and services auxiliary to insurance such as consultancy, risk assessment, actuarial and claim settlement services.

In terms of the ‘Banks and Other Financial Services’ sector, the United States fully opened without any conditions. However, Korea opened the market access of the corporate restructuring, strategic formulation consulting, financial information provision, investment advisory and portfolio management services of the following sector under certain conditions. Specifically, only a limited range was permitted regarding credit evaluation and credit inquiry services.⁶ For example, the Indirect Investment Asset Management Business Act of Korea maintains that if the collective investment scheme such as an investment trust or investment company registered with the Financial Supervisory Commission holds bonds issued in the United States, the evaluation of those bonds is only possible through domestic bond rating agencies.

(2) New Financial Services

The role of ‘New Financial Services’ sector is as crucial as ‘Cross-Border Trade’ sector of the Financial Services Chapter of the KORUS FTA.

⁴ Annex. 13.A KORUS FTA, 2012.

⁵ Ibid.

⁶ Shim Young. “Trends in US FTA Financial Services and Our Response.” International Transaction Law Society, 2006.

Article 13.6 [New Financial Services] states that each country shall permit a financial institution of the foreign country to supply any new forms of financial services and sales of financial products not sold in the domestic country. Regarding these new financial services, Korea could determine the institutional and legal form to be supplied, and could be refused only for prudential reasons.⁷ In addition, new financial services can be provided only when permitted under the current domestic law without additional legislation or existing law amendments, and only if the branch of the foreign financial institution is located in the domestic country as commercial presence. Therefore, the trade of new financial services through ‘Cross-Border Trade’ of overseas financial institutions that do not have the commercial presence in Korea is prohibited.

Unlike the existing domestic financial regulatory system based on the positive list approach, the ‘Capital Market Consolidation Act’ was implemented in 2009 to promote the enlargement and specialization of financial institutions based on the negative list approach. However, the ‘Capital Market Consolidation Act’ could pose loopholes with the introduction of new financial services in Korea.⁸

For example, if a foreign financial company that has entered the domestic market wishes to supply a new financial product that combines banking services and capital market services, permission cannot be denied by the Korean government in the case that the new financial product is in compliance with the Capital Market Consolidation Act. In contrast, the following new financial services could be inconsistent with the preexisted domestic financial regulatory system. However, this issue is not due to the introduction of the ‘New Financial Services’ of the KORUS FTA, but rather arises as a result of the amendment of domestic laws, namely the ‘Capital Market Consolidation Act’.

The co-existence in the financial legal system of the Capital Market Consolidation Act, based on the

negative list approach, and the preexisting domestic financial regulatory system, under the positive list approach, has created a loophole in the protection of the domestic market.⁹ On the contrary, the discipline of ‘New Financial Services’ of the KORUS FTA, such as denial due to prudential reasons, could be reinterpreted as a safeguard against the excessive supply of new financial services. In fact, there were no such disputes that arose in terms of the application of new financial services.

Among the provisions of the Financial Services Chapter of the KORUS FTA, there are other rules to be highlighted besides ‘Cross-Border Trade’ and ‘New Financial Services’ such as a ‘Short-term Financial Safeguard’, ‘Foreign Transfer of Financial Information and Consumer Protection’, and ‘Investment Dispute Settlement System’ in financial services.

(3) Short-term Financial Safeguard

In the aftermath of a financial crisis such as the subprime mortgage crisis in 2007, which led to the global financial crisis in 2008, short-term financial safeguard system could act as a buffer to control excessive foreign exchange flows by temporarily banning the inflow and outflow transmission of funds. The short-term safeguard system is valid for one year and may be extended with prior agreement with the partner country if necessary. This is a necessary system for Korea, which is significantly affected by the flow of the United States’ economy both internally and externally.

(4) Foreign Transfer of Financial Information and Consumer Protection

In addition to the movement of financial products and capital after the enactment of the KORUS FTA, another important factor was the transfer of financial information abroad. In accordance with the KORUS FTA, starting from March 2014, the US-based banks, securities and insurance companies operating in Korea could outsource financial

⁷ Art. 13.6 KORUS FTA, 2012.

⁸ Choi Nak-kyun, Lee Hong-Sik “Sectoral Evaluation and Policy Tasks of Korea-US FTA. Negotiations.” Korea Institute for International Economic Policy, 2007.

⁹ Ibid.

information on Korean customers to developing countries like India, where wages are cheaper than in the United States.¹⁰

Many US financial firms operate basic services such as call centers in third countries because of low wages. The ‘transfer of financial information’ provision of the KORUS FTA, however, prohibits the resale and reuse of consigned sensitive information, and it also stipulates that the storage of financial information such as data centers cannot be transferred abroad. This is to ensure the authority of Korean financial authorities to protect the private information of Korean consumers and to access the records of the consigned financial institutions. Government-level regulation on the trans-border data flow is a prerequisite for development rather than a barrier to free trade.¹¹ This is because the market could be smoother when consumers realize that their personal information is being protected under certain standards and disciplines that act as a buffer.

However, the corresponding governmental protection policy is not clear in the case of illicit personal financial data outflows from developing countries where the protection and technology of financial information are outdated. This issue may also lead to serious international conflict and friction.

(5) Investment Dispute Settlement System

Such disputes and conflicts arising from financial services could possibly arise in various contexts. In the case of any dispute arising out of financial services provided by Korea and the United States, the requested party, either Korea or the United States, shall submit a joint decision request to the Financial Services Committee within 120 days. The arbitral tribunal has indicated that it will proceed with arbitration ten days after the expiry of the 60-day period granted to the Committee.¹² Also, if the arbitral tribunal is created, the requested party shall promptly file a copy of the request to the arbitral tribunal as soon as possible. This is a clearer dispute

settlement procedure than the ‘Prior Consultation for Investment Disputes in Financial Services’ provision of the Korea-China FTA.

Issues and Implications of the Financial Services Chapter of the Korea-China FTA

Both Korea and China have agreed on multiple general obligations. The profundity of the agreement itself, however, is not deep enough since the following provisions were created while considering the renegotiations of the Service sector in mind. Fortunately, neither Korea nor China raised any dispute regarding financial services, but nonetheless the possibility of loopholes caused by the structural vulnerability of the agreement certainly exist.

Regarding the financial services investment dispute resolution system in financial services, ‘Prior Consultation for Investment Disputes in Financial Services’ sector of the Korea-China FTA has only a paragraph that states both parties shall consult ‘in good faith’ to make a binding decision to the arbitral tribunal within 180 days after a claim is filed.¹³ However, the statement itself is perceptibly vague and there are no further instructions. On the other hand, the counterpart statements and measures of the KORUS FTA are more concrete and practical.

If the financial market is widened in the renegotiating the Financial Services Chapter, investment in financial services and related disputes may also gradually increase, given the characteristics of the two countries being regionally proximate. Therefore, the investment dispute settlement system should be conducted more systematically in accordance with that of the KORUS FTA.

In addition, the ‘Treatment of Certain Information’ sector of the Korea-China FTA states that none of the Financial Services Chapters requires both countries to disclose any personal information of individual consumers.¹⁴ Thus, the Korea-China FTA do not consider the foreign transfer of financial

¹⁰ Kim, Eun-Mi “A Study on the Financial Service Sector of Korea-US FTA: Focusing on TBDF of Financial Information.” *Journal of the Korea Customs Service*, Vol. 14, No. 2, 2013.

¹¹ Ibid.

¹² Art. 13.19 KORUS FTA.

¹³ Art. 9.13 Korea-China FTA.

¹⁴ Art. 9.4 Korea-China FTA.

information as the financial services. However, illegal leakage of personal financial information and financial fraud have already caused serious problems between Korea and China.

On the other hand, the KORUS FTA treats foreign data flow of individual consumers' financial information as part of the financial services, but did not cause any issues. Therefore, considering the frequent illegal leakage of personal financial information from Korea to China, constructing regulations that ensure sufficiently secure institutional safety as the KORUS FTA is required. In particular, the storage of financial information such as data centers should not be transferred abroad. Also, the inspection authority of the domestic financial supervisory authorities is required on the possibility of leakage of illegal domestic consumers' personal and financial information in either China or third countries. Since the scope of information protection and information disclosure systems differ from one country to another, it is necessary to erect laws that ensure the evaluation of the level of information protection of other countries in advanced, such as the United Kingdom's 'Data Protection Act,' which assesses and evaluates the level of information protection of other countries.¹⁵

Moreover, there are no 'Cross-Border Trade' provisions since the current Financial Services Chapter of the Korea-China FTA was formed under the positive list approach method. The excessive introduction of the Cross-Border Trade transactions through the switch from positive to negative list approach may stimulate domestic financial firms to enter into the Chinese financial market. On the other hand, there is a concern that massive Chinese financial institutions may also be able to overtake the domestic financial market.¹⁶ Thus, the provisions of the Cross-Border Trade should be in accordance with that of the KORUS FTA as well as the degree of global competitiveness of China's

financial companies in each financial services sector should be analyzed in advance.

The Korea-China FTA also does not contain the 'New Financial Services' provisions. If the following provisions are to be implemented into the Korea-China FTA, the supply of new financial services should be limited to 'commercial presence' through domestic branches in accordance with the KORUS FTA. This is to prevent a case where the form of providing new financial services is expanded to the method of trade in financial services via the Internet.

Korea should not underestimate China's potential to erode the domestic financial market through a much more advanced field like financial technology (Fin-Tech), which utilizes internet banking and mobile payment systems. Therefore, it is crucial to vigilantly designate the tolerance of 'New Financial Services' and 'Cross-Border Transactions' provisions that can provide financial services to domestic financial consumers without establishing domestic branches.

The higher level of liberalization of market access through the renegotiation could strengthen competition between Korean and Chinese financial institutions and could increase the welfare of consumers in both countries.

However, it is also required to further develop the existing domestic legal system since it is inevitable that the conversion of the conventional positive list approach system to the negative list approach will take place. For example, short-term regulations on possible new financial services that combine banking services and capital market services are required since the current domestic financial legal system has both a positive and negative list approach system. In order to prevent such problems, it is necessary to gradually revise the domestic financial legal system in a comprehensive manner.¹⁷

¹⁵ Lee Jung-hoon, Park Seok-hoon, Lim Jong-In. "A Study on the Policy Direction for the Transfer of Financial Information through the FTA", *Journal of Information Security* Vol.21 (3), 117-130, 2011.

¹⁶ Lee Ki-Pyung, Im Mok-Sam, Lee Ju-Youn and 8 others. "Analysis and Research on Legal Issues in Korea-

China FTA Sector." Korea Legislation Research Institute, 2015.

¹⁷ Choi Nak-kyun, Lee Hong-Sik. "Sectoral Evaluation and Policy Tasks of Korea-US FTA Negotiations." Korea Institute for International Economic Policy, 2007.

Conclusion

China has progressively enhanced its competitiveness in the international financial market in recent years through its inclusion in the Special Drawing Rights of the International Monetary Fund (IMF), which has strengthened the yuan, and through its initiative in the establishment of the Asian Infrastructure Investment Bank (AIIB). Under the following circumstances, the renegotiation of the Financial Services Chapter of Korea-China FTA could be utilized by the Korean financial institutions as a stepping-stone into the Chinese financial market. On the other hand, the expected financial capital inflow into the Korean market from China during the post-transition from positive to negative list approach renders the need for additional deregulation and reorganization of domestic judicial systems probable.

Under the expectation and understanding of future renegotiations, the Financial Service Chapter of Korea-China FTA was initially contracted in a relatively light-hearted manner. Thereby, allowing the agreement to include ambiguities in terminology and shallowness in intent. Thus, the renegotiation of the Chapter to achieve a more detailed-oriented agreement as that of the KORUS FTA is imperative. Implementing and adopting key financial services provisions from the KORUS FTA template such as 'Cross-Border Trade', 'New Financial Services', 'Financial Safeguard', 'Foreign Transfer of Financial Information and Consumer Protection', and 'Investment Dispute Settlement System' to Korea-China Financial Services Chapter could revitalize the financial markets in both countries. However, since China is still conservative and reluctant to entirely open its financial service market, how much further China is willing to liberalize its financial market through the renegotiation is still unpredictable and uncertain. Nevertheless, China placed the financial service sector in a separate chapter for the first time with South Korea, and already agreed to convert the existing positive list approach to the negative list approach during the renegotiation of the service sector. These unprecedented decisions suggest that China optimistically considers the expansion of financial service exchanges with Korea. In

conclusion, Korea should refer to the Financial Services Chapter of the KORUS FTA while renegotiating with China to enhance its opportunity to stimulate the domestic financial market through favorable competition as well as to contribute to the amelioration of welfare for domestic consumers.

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