Methodology for Negotiations in the Area of Financial Services[?]

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May 2003

[?] Paper prepared for the V Meeting of the Trade Network of the Regional Policy Dialogue, to take place at the Inter-American Development Bank (IDB) on May 29 and 30, 2003, in Washington, D.C., United States.

I. Introduction

In the recent developments in the process of integration and internationalization in Latin America, Financial Services Negotiations (FSN) have become increasingly important, both at a multilateral level (WTO) as well as within Free Trade Agreements (FTAs).

However, as this is a relatively new issue –both in the framework of the WTO and FTAs, very few instances include a chapter on financial services- knowledge and experience accrued in the matter are very scarce.

This paper presents fundamental principles and a methodology that may contribute to improve the preparation and negotiation of financial services in countries in the region, with an empirical reference on FSNs and FTAs of Latin American countries that have incorporated financial aspects.

The following section presents a brief account and a summary of the main characteristics of multilateral agreements on trade in financial services within the framework of the WTO.

The third section presents some strategic considerations countries in the region should take into account in FSNs. They include certain general aspects we feel are relevant in light of the most recent FSN cases in FTAs and certain negotiation modalities (positive/negative lists; defensive/aggressive strategies).

The fourth section proposes a methodology to learn key areas of local financial systems, essential for an adequate preparation for FSNs, and ends with some methodological criteria linked to FSNs in recent FTAs.

II. Multilateral Trade in Financial Services Agreements

Currently there is only one multilateral, obligatory and legally applicable Agreement related to trade in financial services: the General Agreement on Trade in Services (GATS) of the WTO, which includes financial services as part of its sectorial coverage.

Inclusion of services in multilateral trade negotiations is considered as one of the main achievements of the Uruguay Round (1986-1994). The GATS is an integral part of the Uruguay Round agreements, and started to operate on January 1995.

Every WTO member is bound by this agreement. However, at the end of the Uruguay Round in 1993, the participants could not agree upon an appropriate level of specific agreements regarding market access and national treatment in a few services sectors, including financial services. Negotiations were difficult, among other reasons, due to the lack of experience in these matters, as this was the first attempt to discuss trade in financial services in multilateral terms. Financial services negotiations were delayed until July 1995. But again an adequate level of liberalization was not reached in terms of market access and

national treatment agreements that would be applicable to all countries based on the principle of Most Favored Nation (MFN), and an Agreement was put in place for two years, labeled "interim," its results being included in the Second Protocol to the GATS.

One of the main problems was the United States' refusal to accept the level of market access proposed by developed countries. In December 1997, WTO members finally adopted a series of specific agreements on market access and national treatment, which would be applicable to all participants on the basis of the MFN principle. In the sectorial field, financial services negotiations concluded that same month.

According to Article XIX, members agreed to hold successive rounds of negotiation, starting five years after the entry into force of the agreement (January 1995), and periodically thereon, in order to progressively attain a higher level of liberalization.

The first of these rounds began on January 2000. Initially it was centered on the incorporated program, with the objective of establishing a solid basis for negotiation of new specific commitments. In a balance meeting, held on March 2001, the members agreed (Appendix 1) upon the directives and procedures for negotiations in the new round, and examined a first series of sectorial proposals presented by certain countries.

Currently, negotiations in the area of financial services are in a stage of examining members' initial proposals. Moreover, many developing countries have committed to a unilateral liberalization process in services trade, including financial services, outside the WTO, often within programs supported by the IMF and the World Bank.

The GATS

The Agreement establishes a normative framework to ensure that services regulations are administered reasonably, objectively and impartially, and that they do not become obstacles for trade. It is applicable for all services, with two exceptions,[1] and all WTO members participate in it.

The objectives of the GATS are to create a credible and reliable system of international trade rules; to guarantee a fair and equitable treatment to all participants (principle of non-discrimination); to foster economic activity by means of warranted consolidations and to foment trade and development through progressive liberalization.

Part I of the Agreement defines its scope. Part II contains obligations and general rules. It establishes the principle of MFN as a basic obligation, as well as the possibility that parties may indicate specific exemptions to such treatment. There are provisions regarding transparency, and others directed at facilitating an increasing participation by developing countries in global trade in services. Part III contains provisions on market access and national treatment, which are not general obligations but rather they are commitments contracted in the national lists. Part IV establishes the basis for progressive liberalization of the services sector by means of successive negotiation rounds and the preparation of

[1] Services provided in the exercise of governmental functions, and those related to air traffic rights.

national lists. Part V contains institutional provisions and includes provisions on consultations and dispute resolution, as well as the establishment of a Services Council.

It was very complicated to arrive upon a document adopted by consensus in the area of trade in services, which is reflected in the Annex to the GATS regarding financial services, which contains only minimum criteria and basic standards where the key matter is lists of financial services offers, mainly related to national treatment and market access. This Annex on financial services establishes the right of the parties to adopt cautionary measures and to guarantee the integrity and stability of the financial system.

Obligations deriving from the GATS may be classified into two large categories: general obligations, which consider the immediate grant of the MFN treatment to any other member, as well as obligations of transparency; and specific obligations, in which both market access as well as national treatment may be subject to limitations, requirements and reservations.

Each WTO member must prepare a list of specific commitments, which indicates services for which the country guarantees market access and national treatment (these lists are available on the WTO website). These commitments entered into force on January 1, 1995, and may be broadened or improved at any time.

The GATS permits that in certain circumstances members adopt measures that imply a breach in their obligations with respect to financial services in the Agreement's framework, when it is necessary to guarantee the integrity and stability of the financial system, in cases of serious balance of payments difficulties and to prevent fraudulent practices.

Moreover, the Agreement offers a special flexibility so that developing countries may open their sectors less, liberalize fewer types of financial services and progressively increase access to their markets.

Directives and Procedures for Trade in Service Negotiations.[2]

According to the objectives of the GATS, negotiations must be conducted on the basis of progressive liberalization as a means to promote economic growth of all parties and the development of developing countries, recognizing the countries' right to regulate and introduce new regulations in the offer of services. Negotiations must allow progressively higher levels of liberalization of trade in services and increase the participation of developing countries. Special priority shall be given to less advanced countries, and the process of liberalization must respect national policy objectives, development levels and the size of the economies, providing special consideration to the needs of small and medium services enterprises.

[2] Contained in Annex 1 of the GATS.

Negotiations take place within the framework and principles of the GATS, including the right to specify sectors in which commitments will be made. There shall be no *a priori* exclusions of any service, and there will be special attention on those sectors of interest to developing country exports. Exclusions of MFN treatment will be subject to negotiation, proceeding flexibly with respect to developing country members.

Negotiations shall take place in extraordinary meetings of the Council for Trade in Services, which evaluates trade in services referenced on the GATS's objectives, and in particular on article IV. Evaluation shall be a continuous activity of the Council and negotiations shall conform to their results.

Liberalization will be attained through bilateral, plurilateral or multilateral negotiations, where the main method of negotiation is the request-offer approach. In the case of lists of offers, there must be explicit indication of what is negotiable in each sector or sub-sector.

Results

In the area of services, the Uruguay Round was but the first step of a long-term process of creation of multilateral regulations and trade liberalization. Even though negotiations achieved the Agreement's fundamental structure, the effects of liberalization have been relatively unimportant. Other than exceptions, in financial and telecommunications services, the majority of lists have been limited to confirm the *status quo* with respect to the situation of the market in a relatively small number of sectors. This may be in part due to the Agreement's novelty, and because members need to gain experience before assuming broader and deeper commitments. Moreover, many governments have required time to prepare the necessary regulations that guarantee that external liberalization will be compatible to their fundamental political objectives.

More than eight years have passed since the Agreement's beginning, and the economic importance of financial services has continued to rise. Therefore, there is room to improve on commitments and/or acquire new ones in ensuing negotiations.

All in all, in the area of financial services the WTO-fostered rounds of negotiation brought forth by developed countries, "natural" exporters of these services, who wish for less developed countries to open up their financial markets.

III. Strategic Considerations in FSNs

Among the benefits of Agreements on Trade in Financial Services are not only stimulation of these services, but also facilitation of trade in goods, contribution to creation of stable and transparent policies, and presentation of a "sign" of the country's "seriousness" to potential investors. Besides, these agreements may be considered positive to economic

growth and financial stability, as they reduce uncertainty. In particular, Kireyev[3] holds that the WTO provides safe and transparent rules to liberalize trade in services, which generates confidence and stimulates economic growth. However, Kireyev points out that FSNs must take place with progressive, careful and adequately sequenced liberalization, in which each stage's evaluation criteria must be the domestic financial system's degree of stability.

In the case of less developed countries, these Agreements may represent serious problems for local providers of financial services, as they often hold a weaker position than their international competitors. In the macroeconomic environment, the few empirical studies to this respect[4] suggest that those countries in which FSNs benefit commercial presence (right of establishment), more than cross-border trade in financial services, have a lower probability of suffering an exchange rate crisis. However, that study shows that in those cases there may be a higher probability of banking problems (if commercial presence of foreign financial institutions should negatively affect the local financial system). All things considered, in the long term commercial presence may be beneficial, introducing new services, expanding the market, allowing access to external saving, generating labor and transferring knowledge and technologies.

A first general question that must be considered in a FSN is the acceptance or consolidation (if it already exists), subject to pertinent regulations in both countries, that local issuers (businesses, banks and others) of financial instruments (stocks and bonds, mainly) may trade them in the foreign counterpart, typically a developed country (US), or a zone (European Union). In addition, that institutional investors of the counterpart receive authorization to invest on eligible financial instruments (for example, stocks and bonds) of local enterprises.

A second general question than must be expected from a FSN is that it imposes pressure on local regulators and supervisors, requiring modification of current regulation/supervision criteria, and making regulations more transparent, demanding and expeditious, which tends to make local financial markets dynamic and modern. In particular, FSNs in FTAs tend to produce agreements on transparency regulations for the form in which the Superintendences must develop and enact regulations, which will contribute to foster dialogue and interaction between regulated enterprises and the Superintendences. Moreover, financial sector standards will be more demanding, and such principles as notice and comment will be put into place, by which administrative rulings are published publicly ahead of time, and all interested parties have the right to comment them in public. In addition, rejections to requests received by regulators (for example, banking licenses) must be justified within a predetermined timeframe (ending with the very common legal practice of rejection "with no mention of cause"). In the area of consultation, FSNs in FTAs have created instances of periodic exchanges and analysis, which, even though they are not binding, they institutionalize a mode of operation that requires a high degree of

[3] Kireyev Alexei (2002) Liberalization of Trade in Financial Services and Financial Sector Stability. IMF Working Paper Nº 02/138, August.

[4] Valckx, Nico (2002) WTO Financial Services Commitments: Determinants and Impact on Financial Stability. IMF Working Paper Nº. 02/214, December.

professionalism, transparency and a sort of accountability from local regulators regarding commitments stemming from FSNs.

From another perspective, and complementarily, cross-border trade in financial services and the principle of financial innovation, which permits a faster transfer of products and technologies, generally meaning an increase in efficiency for the national financial industry, probably will generate some displacement of local producers by providers from the counterpart and, in terms of the financial system's stability, results will depend on the national regulators' capacity to adapt to these changes.

A third general consideration relates to taxes. Even though fiscal matters are not often included in FSNs, it is indispensable that national negotiators consider the eventual fiscal impact of the different transactions subject of negotiation, and that they look out for their implications, as fiscal arbitration, which typically may facilitate cross-border trade in financial services, would induce inefficiencies in the local industry, displacement of local producers and even more instability in the financial sector.

Fourthly, it is understood that as public faith is at stake, as there are important externalities (runs, contaminations), as governmental guarantees on bank deposits and public funds for financing minimum pensions become compromised –de jure or de facto-, aside from their macroeconomic implications, FSNs require special protection. For this, as pointed out, the WTO allows application of precautionary or prudential measures of exception, which predominate above specific regulations or agreements they have reached. There are two types of exceptions, prudential exceptions, in the regulatory area, typically associated with Superintendences, and those macroeconomic in nature (except those that affect transfers), typically associated with Ministries of Finance and/or Central Banks.

In fifth place, in practice, especially in a FTA, in FSNs the counterpart requests the highest openness possible of the local financial system. In the end, experience indicates there are certain intentions and requests from the counterpart that will have a higher priority and there must be preparation to this respect. For example, in the banking field, in the FTAs with the United States stands out the permanent request to authorize branches of its banks so the capital of the head office is considered as theirs, for regulatory and other effects. Even though they did not obtain this either with Mexico or Chile, its implications are so significant that negotiators must be very well prepared to face that request.

Sixth, it must be considered that in the foreseeable future the main benefit of the FTA for the country in the region will not come from its incursion in its counterpart's financial system, but from what is achieved in other areas of the FTA. And even though reciprocity regarding liberalization in the financial environment must be demanded, it is fundamental to deeply understand the domestic financial sector to know what is essential and what is not; that is, what is negotiable, with what period of time and with what safeguards. This knowledge must span, on one hand, the structure of property and the functioning (efficiency, competition, solvency and cash flow) of the domestic financial system sub-sectors; and on the other, there must be a profound understanding of the nature, scope, modality and capacity of the domestic regulation and supervision of the different sub-sectors in the domestic financial activity. Without this knowledge, it will be very difficult

for negotiators to agree on a gradual policy of financial liberalization and openness. And, in practice, the main challenge for negotiators in a FSN, beside defining the degree of openness they wish to carry out and assuming commitments made, is achieving an adequate graduation (as the application of reservations has a limit).

In summary, if there is no deep familiarity of the characteristics, limitations, needs and vulnerabilities to domestic financial system shocks, it is not possible to carry out a FSN with some probability of success.

In general, negotiation on the basis of positive lists, as is done in the WTO, in which what is committed is explicitly indicated, with the appropriate conditions and timeframes, leaving unlisted items out of the negotiation, is most convenient for the countries of the region.[5] In addition, in FSNs, especially in FTAs, the countries of the region (that in principle have no comparative advantages in this activity *vis a vis* their counterpart), are well off to negotiate on the basis of strategic defenses. These go from full commitment, to phase in, [6] in which after a certain period of time the obligation enters into force, to soft commitment (in which the commitment is limited to study a request and attempt to negotiate it), and to a declaration of principles, with no major commitments of any specific nature.

IV. Methodology for a FSN

IV.1 Information and Analysis

An essential requirement to carry out a FSN with a developed country counterpart is to obtain and analyze the relevant information relating to the financial services industry located in the country, with the objective of evaluating the effects of the FSN on the national financial sector. Naturally, it is expected that the national financial sector show more concern for the effects the FSN may have on the national industry, than interest for doing business with the counterpart.

Information and analysis must distinguish the main sub-sectors of the activity, typically highlighting banking, pension funds, insurance, mutual (or investment) funds and national stockbroker activities.

The methodology of preparation for FSNs consists on undertaking the following activities:

a) Deeply understand the financial services issues to be negotiated and, in particular, the counterpart's requests of openness.

[5] Some developed countries, including the United States, negotiate on the basis of negative lists, in which that which is not explicitly reserved is considered negotiated.

[6] This occurs, for example, when a request requires legislative modification of regulations dealing with the right of establishment; or when there are commitments regarding the portion of regulations and supervision that require time and resources to modify the current operative modality and/or the current capacity of the local supervising body.

b) Prepare a document that describes and explains these issues, lists the counterpart's requests for openness and contains a questionnaire with specific questions, to be presented to the various sub-sectors of the national financial system.

c) Select a representative group of institutions from each of the sub-sectors in the financial system, to perform a field study. This selection should contemplate certain criteria, such as:

i) Largest financial institution within the sub-sector.

ii) Largest national financial institution within the sub-sector.

iii) Financial institution with presence in the counterpart.

iv) Financial institution with presence in a specific segment of the market (niche institution), where FSN effects will very likely be different to those on large institutions.

v) Financial institution owned by the counterpart.

vi) Foreign financial institution (from a country different than the counterpart).

vii) Governmental Financial institution.

d) Meet with the highest executives (Chief Executive Officer, International Manager, Chief Financial Officer, General Counsel) of the selected enterprises in each financial system sub-sector. In each meeting, with each of the selected financial institutions, there must be:

- A delivery and presentation of the document referred to in point b).
- An explanation and commentary on the specific questions in the document to be answered, which must center on the following four topics:
  - Their opinion on the effect on their sub-sector and institution if his country accepts the counterpart's request of openness (i.e. requests for access to the domestic financial market made by the counterpart's private sector).
  - What business is carried out by the institutions in his sub-sector with the counterpart, and what requests of openness they would make to the counterpart (i.e. requests for access to the

counterpart's financial market made by national financial services providers).

?? What legal or administrative barriers does his business face or would it face if it wanted to invest (locate) or provide financial services in the counterpart. (i.e. barriers that national financial services exporters to the counterpart have faced, are facing or will face).

✍✍Financial institutions located in the country will be asked if they see discrimination in the national financial system regulation, relating to national treatment or the right of establishment.

?? Request a written answer to each question (so answers are more elaborate), assuring confidentiality of the responses.

e) Compile responses based on two orders. First, by type of activity: banks, pension funds, mutual funds, etc. Second within each activity, organize responses according to the main issues in negotiation, such as the right to installation, cross-border trade and fiscal treatment.[7]

f) Analyze the responses and develop conclusions regarding the main effects the sub-sectors consulted feel would be produced by the FSN in their respective industries.

g) Once the information from the financial system questionnaire is gathered, organized and evaluated, it follows to analyze the effect the FSN will have both upon users as well as upon the national financial industry services providers. It is convenient to perform the analysis based on certain principles, which usually frame the FSN, including the counterpart's requests regarding the financial sector. These principles are the right to installation, national treatment, most favored nation, right of establishment, cross-border trade, new financial services, regulatory framework and fiscal treatment.

[7] As indicated, even though FSNs and FTAs do not consider fiscal aspects, experience indicates financial institutions consider fiscal effects associated to FSNs as very relevant.

The analysis of the FSN effects on the national financial industry must be made separately for each sub-sector in the activity, starting with a comparative analysis between the country and the counterpart, in terms of relative size, degree of internationalization, costs and profitability, and depth of the sector. Then there is an analysis of the impact the main principles negotiated in the FSN and the requests made by the counterpart will have on each sub-sector.

Ideally there should be an analysis of the effect of the FSN on efficiency of the national financial industry (cost of services, quality and quantity), which directly affects the users' (consumers) well-being, the local financial services producers and the financial system stability.

In this manner, the analysis on each sub-sector of the financial industry is made with a matrix of eight principles (right to installation, national treatment, most favored nation, right of establishment, cross-border trade, new financial services, regulatory framework and fiscal treatment) by three effects (efficiency of the industry, local production, and stability of the financial system). The analysis should be made by "rows," evaluating the impact of the FSN associated to each principle on each one of the mentioned effects.

The matrix is as follows:

	Efficiency	**Production**	**Stability**
1. Right to Installation			
2. National Treatment			
3. Most Favored Nation			
4. Right of Establishment			
5. Cross-border Trade			
6. New Financial Services			
7. Regulatory Framework			
8. Fiscal Treatment			

Efficiency

International trade in financial services allows that, compared to a "closed" economic situation, they be provided at a lower cost, with better quality, and/or with more availability. These gains on efficiency come from higher competition, technology transfer, exploit of comparative advantages and taking advantage of economies of scale and the

breadth reached in larger markets. These benefits tend to be higher according to the more closed financial markets are in a country prior to the FSN. [8]

To evaluate the expected efficiency gains from the FSN on the national financial industry available indicators must be used. Typically they include the industry's degree of internationalization, in terms of what percentage of the local industry is foreign based; the relative cost of the financial service in the country and in the counterpart; and the relative coverage of the service in the country and in the counterpart.

Local Production

International trade in financial services may mean the displacement of the national industry, due to increased foreign competition. This would occur if the domestic industry is less efficient in the provision of financial services than the international industry, that is, if the domestic industry provides more costly financial services than the institutions of its counterpart.

There are few studies regarding the patterns of trade in financial services that allow a prediction of whether the country in question or the counterpart will be the exporter of a certain service. Moshirian's[9] paper demonstrates that the offer in international financial services depends on the country's expenditures on research and development, on the amount of financial assets it administers and on the level of physical and human capital. This allows us to establish a hypothesis with respect to whether the country or the counterpart will be the net exporter of financial services, and which of them. On the other hand, the study by Kono et al.[10] shows that the United States was the net exporter of the services analyzed in their Report, that they were banking, pension fund, mutual fund and stockbroker services. However, it was a net importer of insurance services.

To evaluate the effect on domestic providers of financial services the same indicators may be used as those for measuring efficiency gains, since they directly affect the competitiveness of domestic producers. Notice that a part of the difference in costs observed in some financial markets between countries of the region and the United States is not due to national sectors closed to foreign competition, but because regulations costs are different and that in certain cases local regulations impose certain barriers on entry, both for national and foreign potential competitors.

Financial System Stability

[8] The study by Harris and Piggot (1997) " Regulatory Reform in the Financial Service Industry: Where Have We Been? Where Are We Going?, DAFFE/CME (97)12, Paris, OECD, shows that financial liberalization in the European Union and the NAFTA produced efficiency gains associated to liberalization of financial services.

[9] Moshirian, Fariborz, 1994, "What determines the supply of international financial services?" Journal of Banking Finance, 18:495-504.

[10] Kono, M., and L. Schuknecht, 1999, "Financial Service Trade, Capital Flows, and Financial Stability", WTO, Staff Working Paper ERAD 98-12.

In the financial industry, such matters as integrity of the system, user confidence (public faith), security of deposits in the banking system and access to a minimum pension are of great importance. International trade in financial services may produce the effect of increasing these "public goods" or to reduce them.

Macroeconomic Effects

Financial markets that are more integrated with the rest of the world improve, in theory, the intertemporal assignment of resources and well-being of the population. In effect, competition among financial institutions and the rise of innovative forms of savings and financing tend to promote saving and investing, and therefore, the country's growth. Also, international trade in financial services increases the possibilities to administer risk more efficiently. This makes the economy less vulnerable to external economic shocks.

However, easy access to external financing, especially to consumer credit, may decrease the country's savings and turn its economy more vulnerable to foreign economic shocks.

In addition, financial and foreign exchange markets of a "small" size can and often do become seriously affected by relative significance, velocity and pro-cyclic behavior of international short-term financial movements. Experience indicates that even (and sometimes especially) emerging countries with adequate macroeconomic management and solid financial regulations, are often strongly affected by the aforementioned movements of short-term capital. In the FSN there must be protection of the national prerogative to safeguard the domestic economy from this type of shocks.

Following is a brief example of the methodology described, in the cases of the banking, pension funds and mutual and investment funds systems. The same procedure is applicable to insurance companies, stockbrokers and, in general, any other "important" intermediary or agent of the financial system in the country in question or with respect to the country where the counterpart has presented requests for openness.

The Banking System.

Even though it is most likely that the size of the banking sector of the counterpart will be significantly greater than that of the country, if the latter is sufficiently liberalized to international competition, and confronts this competition from the counterpart's banks, the size difference is not so relevant in analyzing the impact of the FSN on local industry. This may be analyzed by comparing, for example, the ROA and the ROE in the country's and counterpart's banks. Thus, for example, if these indicators are similar in the country and the counterpart, it is most likely that there will be no significant gains in efficiency in the local industry due to the arrival of the counterpart's banks, or with the possibility of increased cross-border trade in banking services.

Right of Installation.

If the FSN assures the banks and investors from the counterpart of the possibility of locating in the country, provided legal requirements are met, their effect on the sector's efficiency, production and stability will depend on initial conditions regarding this right and on the degree of initial openness of the national banking sector with respect to external competition.

It is worth mentioning that experience in the case of the US indicates its banks often request installation as branches, and that their head office capital be considered regarding regulatory credit limits and others. This measure's effect is generally quite negative for the local banking industry, therefore it must insist on the necessity of capital that is separated from the head office and wholly owned by the branch.

Regarding installation of local banks in the counterpart, if there are restrictions that obstruct operations in that country, these should be negotiated in relation to the most likely activity in the counterpart, as a complement of the services offered to their clients in their own country, more so that by way of direct competition in that country.

National Treatment

The effect of the FSN on the local banking system's efficiency, production or stability will depend on whether the local banking system regulations provide national treatment to foreign banks.

In the case of the US, its banking system has a complex regulatory structure, including federal and state supervision, different types of banking licenses, and insurance for depositors, therefore even though there may be *de jure* national treatment, it is not *de facto.* An advancement in this area in the FSN may be beneficial for local banks that wish to penetrate the American banking industry.

Most Favored Nation Principle

To evaluate if its application would affect the local banking system's efficiency, production or stability, it is necessary to analyze if the principle will entail a change in the conditions by which the counterpart's banks install in the country when the FSN is carried out.

It is important that this principle may limit the country's negotiation capacity to offer more openness in banking services to other countries.

Right of Establishment.

National regulation is often very precise and strict with respect to the legal form in which foreign bank branches may establish in the country, or respect the establishment of an office of representation. Generally, unless local regulations are modified due to the FSN, there will be no changes in incentives for installation of the counterpart's banks in the country, thus there will be no effect on the local banking system's efficiency, production or stability.

Cross-border Trade.

Generally it is not regarded as inconvenient that FSNs provide a possibility to trade certain banking services across borders. This should be reciprocal, as the country could possess comparative advantages in some of these services, and a local bank may be interested in providing this service in the counterpart.

New Financial Services.

FSNs tend to accelerate pressure on local regulators for approval of innovations on the offering of financial services in the country, and also likely for approval of trade in new banking services. This has a positive effect on the industry's efficiency. For national banks, this will probably generate some pressure to lower its margins and some displacement of certain banking products that will be provided by the counterpart's banks. In terms of the stability of the financial system, the Superintendence and the Banks must prepare for this new landscape and evaluate the need to require corresponding regulations.

Regulatory Framework.

Countries that fulfill most basic principles for an effective supervision on banks must maintain their independence to regulate and supervise banks that operate in the local market.

Fiscal Treatment.

Cross-border trade in banking services may generate tax evasion mechanisms that provide a comparative advantage to the counterpart's banks. Therefore, it is important that FSNs strive to prevent these fiscal discretions.

Pension Funds

The local pension funds sector is usually not directly comparable with that of the counterpart, as they generally function differently. Whether in the country there is a system of pensions based on individual capitalization and administered by private entities, a public system or a mixed one, it is usually very different than the ones in Europe and the United States. In the latter, there is on one hand the public pensions system, known as Social Security, which is a pay-as-you-go system, and on the other every public worker and close to half of workers in the private sector have different types of pension funds, such as defined benefit plans, defined contribution plans and individual retirement accounts, which are administered by private institutions.

Right of Installation.

The effect on efficiency, production or stability of the local system of pensions brought by the FSN will depend on whether there are initial restrictions for businesses to administer these funds, or if they may be owned by the counterpart or not. The more extensive these

restrictions are, the higher the incentive will be for the installation of new enterprises from the counterpart in the country, which will tend to affect local efficiency (costs and benefits for the users of the system) and production.

National Treatment.

The effect on efficiency, production or stability of the local system of pensions brought by the FSN will depend on whether at the time of the FSN pension system regulations give national treatment or not to the counterpart's pension funds.

Most Favored Nation Principle.

Similarly to the situation of the banking system, application of this principle may limit the country's capacity to offer more openness to pension fund services to other countries.

Right of Establishment.

National laws and regulations are often very precise and strict regarding the legal form in which pension fund administrating enterprises must be established; for example, as a special joint-stock company, in a public deed, and requiring explicit authorization of existence by the appropriate Superintendence. Therefore in cases where the right of establishment is very limited, its application will not significantly affect the national pension fund system efficiency, production or stability.

Cross-border Trade.

If the counterpart requests to provide the service of provisional funds administration from its country, this could have important effects on the system's stability. This is because, generally, the main public asset in the pensions system is the governmental guarantee of a minimum pension for everyone affiliated to the system. If consequently to authorizing a new modality of cross-border trade the local regulator/supervisor's capacity of control is lost, there would be a risk of excessive use of the governmental guarantee, which imposes a fiscal contingency that may become considerable. On the other hand, if the FSN entails installation in the country of new pension fund administrators property of the counterpart, and they will be governed by the same regulations as those already installed in the country, the public asset will no be altered.

New Financial Services.

The offer of new services would present a challenge to national producers of pension fund services, so as not to be left out of the market due to innovations. However, the industry as a whole would benefit due to increased efficiency gains derived from the offering of new services.

Regulatory Framework.

The main regulatory issue that will likely be put forth by the counterpart in the FSN in the complete liberalization of the maximum limit of foreign investment local pension funds

have or could have. Here it is fundamental that the national regulator keeps the prerogative of deciding what percentage of the funds accumulated in the system may be invested abroad, and on what type of instruments, currencies, etc., both due to prudent considerations as well as to the eventual macroeconomic destabilizing effect that may come from exit and entry of foreign exchange and capital associated to the investments and repatriations of capital and profits of the system of pension funds.

Fiscal Treatment.

Even though it would not provide efficiency gains, nor would it produce effects on producers or the stability of the local pensions system, it is to the country's benefit that the tax on returns is eliminated for pension funds invested in the counterpart. This would be a benefit for the pensioner, as it would increase the net return of local pension funds.

Mutual Funds and Investment Funds

Empirical evidence indicates that these types of funds in most countries of the region are significantly more expensive and less efficient that in the US, where there has been the highest development of this type of financial intermediaries. This indicates that if due to FSNs this type of funds may be provided to the country, there would be a gain in efficiency in the industry.

Right to Installation.

There needs to be an evaluation of whether there are barriers to install these foreign funds in the country. But even where there are no restrictions, FSNs could not significantly affect incentives for establishing these institutions in the country as in most cases the typically high costs of the local industry may be explained due to the complexity of developing a local distribution channel. The FSN does not eliminate this complexity, therefore it is not expected, at least in the short term, that there be installation of new mutual and/or investment funds from the counterpart that bring gains in efficiency, displace domestic producers or affect the industry's stability.

National Treatment.

There must be an evaluation of the eventual impact on the system's efficiency, production and stability of national treatment to mutual and investment funds in the counterpart in those cases where there was no such treatment prior to the FSN.

Most Favored Nation Principle

Application of this principle may limit the country's capacity to offer greater openness to this type of services to other countries, as it would also have to be given to the counterpart.

Right to Establishment.

National laws and regulations are often quite strict with respect to the legal form mutual and investment funds must use to establish, and they require explicit authorization by the appropriate Superintendence. Therefore in cases where the right of establishment is very limited, its application will not significantly affect the efficiency, production or stability of the mutual and investment funds sector.

Cross-Border Trade.

The FSN would significantly affect competition in the mutual and investment funds industry if it is allowed that counterpart funds be traded across borders in the country. This could displace an important part of the national activity, and would reflect on a reduction of commissions and quality, as well as on a larger variety of products.

New Financial Services.

The mutual and investment funds administration industry is one of the most innovative in countries such as the United States, and it is constantly offering new types of products and forms of commercialization. For the country going to the FSN it will be a challenge to maintain its regulations up to date and to allow these innovations to be passed onto the national industry without putting the industry's stability at risk.

Regulatory Framework.

The main public asset associated to the mutual and investment funds industry is the trust on the system on the part of the investors, which in part comes from governmental regulations and supervision over this activity. However, these investors are generally quite sophisticated and are able to manage their own risks, therefore they require less protection from the authority. This means that faced with the option of higher efficiency or higher safeguards, the FSN should favor the first alternative.

Fiscal Treatment.

Cross-border trade in mutual and investment funds may generate mechanisms of tax evasion that give an advantage to local agents to invest in the counterpart's mutual funds. Clearly this would be a loss for the country's resources. Therefore, to allow cross-border trade in this type of services fiscal systems of the country and the counterpart must be modified so that the same fiscal treatment is given to local and counterpart investments in local funds.

IV.2 Financial Services Negotiations in FTAs

In practice, FSNs in FTAs have been structured on the distinction between cross-border Trade in financial services and the Establishment of the financial institution in the country. The basic difference is that if the financial institution is not established in the country, it can only perform, under certain circumstances, cross-border trade of certain activities. However, if the financial institution is established or becomes established in the country, the FTAs consolidate the existing situation.

Cross-border trade is the offering (sale) of a financial services by institutions that are not established in the country. The main modalities are:

a) A national contracts a financial service in the counterpart (traveling to the counterpart or from the country).

b) The counterpart's providers offer financial services to country residents (for example, they promote, advertise and sell their services in the country by means of public offering and/or soliciting).

Even though the general principle is that there will be no restrictions on bilateral cross-border trade that is authorized upon entry into force of the FTA, as a rule (there are some exceptions) modality b) becomes forbidden.

The right to Establishment allows counterpart investors to chose the legal modality to install their financial institution in the country, from the possibilities offered in the country; thus they have a full right to access the domestic market. The main principles negotiated in relation to the right to establishment are:

a) National treatment. Provides the same treatment of investors and financial institutions from another country as its own investors and financial institutions, as long as they are in similar circumstances.

b) Most Favored Nation. Each country commits to grant investors, financial institutions and cross-border financial services providers from another country a treatment that is not less favorable than that granted to its equivalents from any other country. 11

c) New Financial Services. As indicated, FTAs contain a chapter on "Innovative Financial Services," which would provide greater dynamism to the financial market, as counterpart financial institutions established in the country could offer any new financial service, similar to those operating in the counterpart. It is fundamental to negotiate that the put into practice of these innovative financial services must be subject to prior authorization from the local regulator.

d) Safeguard of the Regulatory Framework in each Country. The FTA does not prevent each country to adopt or maintain reasonable measures due to prudent purposes (called prudence exception, referred only to regulators), in order to protect participants in the financial system, maintain the institutions' security and solvency and ensure the stability of the financial system.

In the macroeconomic area, the FTA should not limit the country's capacity to apply its exchange rate and monetary policy. Furthermore, it seems indispensable that each country may, under certain circumstances, in relation to significant instabilities of its financial

[11] Exception may be made only on the basis of their not being subject to the same regulations.

markets, impose restrictions to short-term capital flows for a certain period of time, with no penalty, as long as outflows of capital are not seriously encumbered.[12]

[12] Foreign direct investment flows, accumulated profits not yet remitted of these investments, normal foreign debt payments (not pre-payments) and normal payment of bonds issued by both the Government and by the private sector in international markets would not be subject to these restrictions.