



Financial Services in the Colombia - U.S. Free Trade Agreement

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Abstract

This study presents an analysis of the financial services chapter of the Free Trade Agreement (FTA) between Colombia and the United States. It evaluates the negotiation process, its results, and its expected impacts on Colombia's financial sector during the next few years. After Colombia's unilateral financial liberalization in the early 90's, the FTA is the more recent step towards greater openness of the domestic financial system. Even though the financial system is not expected to face any great changes, the agreement will have implications in specific areas such as insurance and changes in the current operation of collective investment schemes, as well as broader indirect effects on foreign investment. The study concludes that with the FTA, the country took advantage of the opportunity to start an internal reform process aimed at financial sector modernization and its greater efficiency, in order to deepen financial consolidation in favor of a productive sector more open to foreign competition.

Resumen

Este estudio analiza el capítulo de servicios financieros del TLC entre Colombia y Estados Unidos. Evalúa el proceso de negociación, sus resultados y sus potenciales efectos sobre el sector financiero colombiano durante los próximos años. Después de la liberalización financiera a principios de los 90, el TLC es el paso más reciente hacia una mayor apertura del mercado financiero doméstico. Aunque el sector financiero no enfrenta grandes cambios debidos al TLC, sí habrá algunas implicaciones en áreas específicas tales como los seguros y la operación de los esquemas de carteras colectivas, así como también efectos indirectos sobre la inversión extranjera en el sector. El estudio concluye que el gobierno colombiano aprovechó el acuerdo para iniciar la discusión sobre una reforma interna al sector financiero que apunte a la modernización y a una mayor eficiencia.

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INTRODUCTION

The negotiating process for the free trade agreement (henceforth known as the FTA) between the Colombian and U.S. governments was completed in February 2006. Among the many topics discussed and negotiated was a chapter on financial services. The agreement is currently being revised by groups of lawyers in both countries, and it has been announced that it will be presented to the Colombian National Congress during the next legislative period, in the second semester of 2006. In light of these events, this study has two main objectives: first, to evaluate the FTA's impact on financial services liberalization in Colombia country, and second, to closely analyze the negotiating process in order to highlight key lessons learned.

The paper places special emphasis on the achievements in the negotiation with the U.S. relative to the Colombian government's initial objectives, expectations and strategy. The study also evaluates the coherence of the results obtained in relation to the government's vision of the financial sector and in particular in furthering the development of a more open and globally integrated country with greater international competitiveness. With these objectives in mind, the study seeks to shed light on the Colombian financial sector's degree of openness before the FTA, and evaluate whether the FTA maintained the *status quo* or took liberalization one step further. In the latter case scenario, it bears asking whether this is the result of a deliberate policy choice on the part of Colombian authorities, or if it results from the negotiation.

The paper shows that in the Colombian case, the U.S. FTA has the direct impact of fostering the domestic reform in the financial sector, particularly in the area of collective investment schemes and insurance. But also the FTA triggered the debate on domestic financial reform, and as a matter of fact the latter is currently being setting by the government in the head of the Ministry of Finance.

The analysis covers the negotiation of the financial services chapter as a whole, with particular emphasis on banks and other deposit-taking institutions, and the insurance sector.

The document is organized as follows. The first chapter briefly describes the Colombian financial sector in the last few decades, highlighting two particular aspects: first, the situation before the 90's and the reforms that took place during this decade, taking into account the financial sector's internationalization not only unilaterally but also bilaterally and multilaterally; second, the financial sector's conditions at the time of entering the negotiation, measured by performance indicators and market structure. The second chapter evaluates the FTA negotiating process, highlighting Government's preparation and organization (also in relation to the private sector and civil society); the different sectors' approaches and actions during the process; and the Colombian government's negotiation strategy in financial services. The third chapter analyses the results of the negotiation on financial services, placing special emphasis on the differences between the Government's initial strategy that was negotiated with the other Andean countries, and that which was obtained in similar agreements with the U.S. Finally, the last chapter investigates the changes foreseen for the Colombian financial sector as a result of the FTA and the lessons for the country learned from the negotiating process.

RECENT EVOLUTION OF THE COLOMBIAN FINANCIAL SECTOR

The efforts to liberalize financial services in Colombia occurred unilaterally at the beginning of the 90s. Such efforts formed part of a large package of structural reforms that was intended to give the economy more openness and flexibility. In addition, this unilateral financial liberalization served as a framework for the negotiations for multilateral trade agreements that took place in the '90s, especially the commitments acquired through GATS, CAN and G3. In fact, instead of advancing towards a greater liberalization of financial services, these agreements merely consolidated what had been accomplished in the process of financial reform at the beginning of the '90s.

In this chapter the main characteristics of the gradual process of financial liberalization will be described up until the moment when the negotiations for the Free Trade Agreement with the United States were started.

A. Overview of the Colombian financial sector

Figure 1 presents the different phases of the evolution of the financial depth in Colombia in the last 20 years:

i) *Prior to the 90's.* In this period, the Colombian financial sector operated under a system of *specialized* banking and was subject to a high degree of financial repression, i.e. high levels of reserve requirements and forced investments, oriented credit policies and interest rate controls, high participation of Government in financial activity and strong limitations to the entrance of foreign capital into the sector. In the late 80's, the M3/GDP ratio was comparatively low for international standards -oscillating around 30%-- and the credit/GDP ratio was near 20%. Inefficiency and intermediation spreads remained high during this period (Barajas, et al. 1999a)².

ii) *1990 - 1998 period.* A wave of structural reforms carried out early in the decade introduced important changes regarding the organization and operation of the financial sector. Between 1990 and 1995, the Colombian economy grew at an average rate of 4.5%, enhanced by the favorable behavior of private consumption which grew at annual average rates of around 5%, as well as private investment which rose to 30% of GDP in 1995. The first years of the 90s was also a period of significant expansion of the banking sector. The positive economic behavior and the financial liberalization process contributed to an important improvement in financial deepening. The M3/GDP ratio went from 28% of GDP in 1990 to 43.2% in 1997. The number of financial institutions increased at the same time as advances in privatization reduced government participation in financial intermediation. Additionally, changes in regulations on foreign investment produced a significant increase of foreign capital in the banking sector.

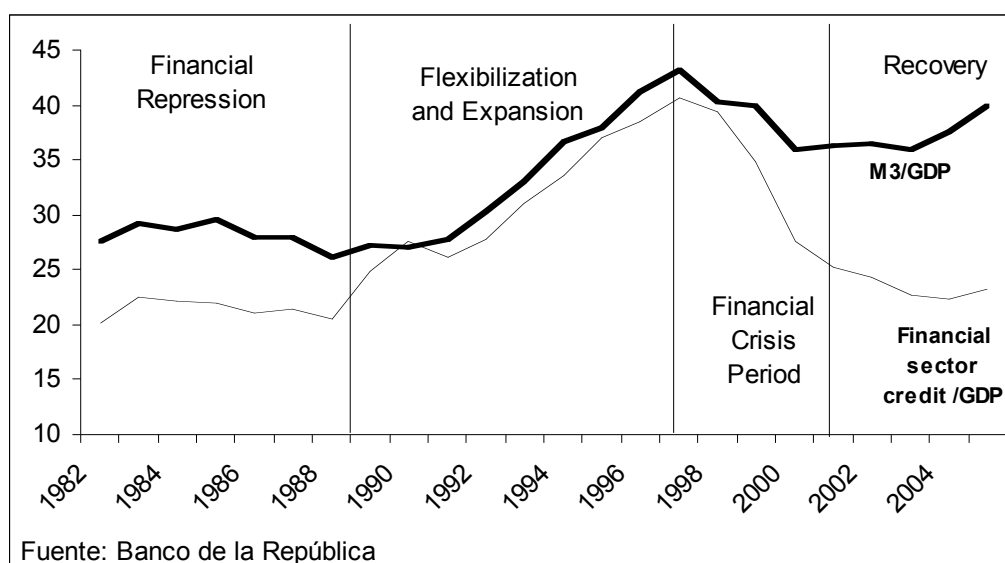
iii) *Period of crisis (1998-2001).* As a result of the poor economic performance and weaknesses in regulation and supervision, the financial sector entered a period of crisis. Most prudential indicators such as solvency and the asset quality deteriorated significantly. The economic recession of those years was accompanied by a credit stagnation phase without precedents in the recent economic

² The intermediation margin (defined as the net interest margin as a percentage of assets) averaged 6-7 percentage points, a level that was similar to the average for the region but that was practically double that of the level registered for industrialized economies.

history. The gains in financial deepening achieved between 1990 and 1997 were practically lost; the credit/GDP ratio returned to 20-25%.

iv) *Period of recovery (2002-2006)*. After the crisis, there was a period of financial adjustment in which a significant amount of public and private resources had to be allocated in order to recover the system. Since 2002, the system has improved considerably, although financial deepening is still below the levels registered before the crisis.

Figure 1. Main Phases of Colombian Financial Development
(M3/GDP and Financial Sector Credit/GDP)



In Colombia, the banking sector -which includes commercial and housing banks as well as other deposit-taking institutions- has been traditionally larger than the non-banking sector. The assets of the banking sector approach 47% of GDP and the credit granted to the economy reaches 22% of GDP (Table 1). The insurance sector (life and non life companies) has been small and its assets have oscillated between 4% and 5% of GDP. Finally, the private pension funds created in 1993 as a result of an important pension reform have shown a significant growth with a portfolio value approaching 12% of GDP. Despite the creation and growth of these large institutional investors, the equity market and private bond market are still small, illiquid and concentrated in a reduced number of issuers (around 100).

Table 1. Size and Depth of the Colombian Financial System: banking and non banking sectors

	2002	2003	2004	2005
Total Commercial Bank Assets (% of GDP) 1/	43.8	42.6	45.2	47.3
Domestic Credit to the Private Sector (% of GDP)	24.9	22.7	22.8	
Total Insurance Company Assets (% of GDP)	4.0	4.1	4.2	4.9
Total Pension Fund Assets (% of GDP)	7.7	8.9	10.3	12.3
Domestic Outstanding Government Debt (% of GDP)	23.5	28.2	30.3	
Domestic Outstanding Private Sector Debt (% of GDP)/2	8.3	8.6	8.2	
Stock Market Capitalization (% of GDP)	11.8	17.8	25.8	43.0
Stock Market Turnover (% of GDP)	0.3	0.5	1.5	

1/ Figures for banks include all credit institutions (and not just commercial banks) excluding financial cooperatives and second-tier development banks

2/ Includes financial sector bonds outstanding

Source: Project Database

The Colombian financial sector is small when compared to the existing ones in other developed countries. In Latin America Colombia's financial sector is of greater size than Mexico's and Peru's, but smaller than Chile's (Table 2).

**Table 2. Bank credit, stock market capitalization and outstanding domestic debt
(2004, % of GDP)**

	Bank credit	Stock market capitalization	Domestic debt		
			Government	Financial	Corporate
Mature Markets					
Japan	94.4	78.5	141.0	25.6	16.3
United States	45.8	129.0	47.1	94.4	22.0
Euro Area	103.9	54.6	53.6	29.8	10.0
Emerging markets					
Asia	103.6	74.1	22.3	13.4	6.9
Europe	24.3	34.1	26.9	0.5	1.0
Latin America	20.9	40.2	28.9	5.3	2.6
Argentina	10.4	30.7	5.8	3.4	6.4
Brazil	25.2	50.0	44.7	10.8	0.6
Chile	56.8	114.8	19.6	10.2	11.3
Peru	17.6	28.3	5.6	1.3	3.1
México	14.3	25.4	22.6	0.8	2.7
Colombia*	18.0	24.3	22.8	4.3	3.9

Source: Aguilar et al.(2006).

As it was mentioned previously, until the beginning of the 90's a scheme of *specialized banking* operated in Colombia. This system was characterized by: i) specialized legal vehicles created for different financial objectives and with specific permissible activities; ii) isolation between different financial system vehicles, and iii) severe investment restrictions for deposit-taking institutions in the real sector (De la Cruz and Stephanou, 2006). Law 45/1990 introduced changes to this scheme adopting a system similar to "multi-banking" (matrix-subsidiaries) and promoting the creation of financial conglomerates. In spite of the efforts that have aimed at greater flexibility, the structure of the system has not changed much. Within the group of credit institutions (deposit-taking institutions),

both commercial and housing banks have been the largest, followed by the financial corporations (investment banks) and companies of commercial financing (finance companies) (Table 3).

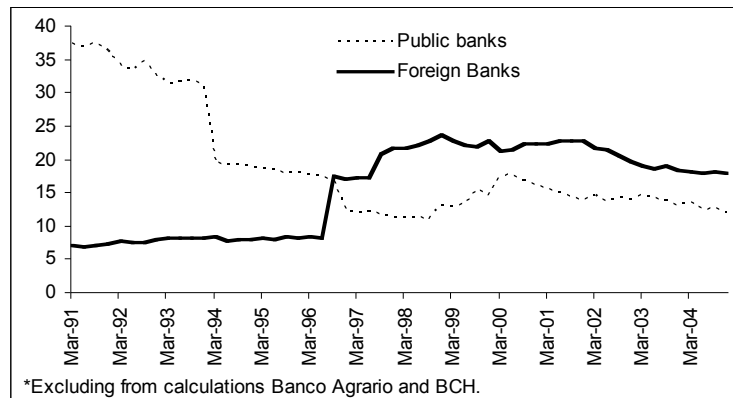
Table 3. Structure of banking (deposit-taking) institutions

	1995		2005	
	% of GDP	% of deposit-taking institutions assets	% of GDP	% of deposit-taking institutions assets
Total system	59,1	100,0	55,3	100,0
Total system excluding IOE and Cooperatives	52,7		47,2	
1. Banks	41,0	69,3	41,6	75,2
Comerciales (Commercial)	26,9	45,5	30,7	55,4
Hipotecarios (Housing)	12,6	21,3	10,9	19,8
Solidario	1,5	2,6	0,2	0,4
2. Corporaciones financieras, CF (investment banks)	6,8	11,4	1,9	3,4
3. Compañías de financiamiento comercial, CFC (consumer loan companies)	4,9	8,3	3,7	6,7
Tradicional	3,1	5,3	1,3	2,4
Leasing	1,8	3,0	2,4	4,3
4. Instituciones Oficiales Especiales, IOE (second floor institutions)	6,4	10,9	7,9	14,4
5. Cooperativas Financieras (Cooperatives)	0,0	0,0	0,2	0,3

Source: Superfinanciera and own calculations.

The liberalization carried out in the 90's allowed a greater participation of foreign capital in the operation of the banking and non-banking sector, as well as a smaller government intervention in the financial activity. In the banking sector, the public bank assets to total bank assets ratio dropped from 37% in 1991 to 11% in 2004, whereas the share of foreign banks assets increased from 7% to 18% in the same period (Figure 2). Nevertheless, despite greater flows of foreign investment into the banking sector, the latter are smaller compared to other Latin American countries. For instance, in Mexico, Argentina, Chile and Peru foreign banks assets represent nearly 60% of the total assets of the banking system and in Brazil, a less opened economy, this percentage is slightly higher than in Colombia. It is worth mentioning that the entrance of foreign capital into the financial sector occurred in three different ways (Barajas, et. al. 1999b): i) re-purchase of banks that had been nationalized in the 70's under the Law 75/75 by the old foreign owners (American, British, French, Italian, and Brazilian investors), ii) purchase of already existing local banks (by Spanish, Venezuelans and Peruvians investors), and iii) establishment of new foreign subsidiaries (by Ecuadorian, American and Dutch investors).

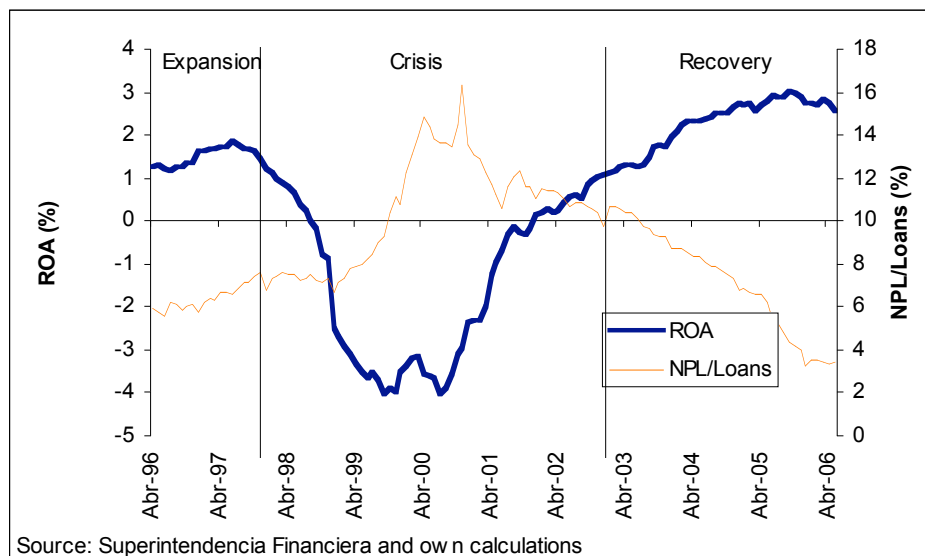
Figure 2. Public and foreign banks
(Share in total assets of the commercial and housing bank sector)



In the insurance sector, foreign ownership has also increased -in life and non-life activities. Currently, 31% of the sector assets in this sector belong to foreigners, whereas in 1991 foreigners owned approximately 15% (Vera, 2006). In the pension funds sub-sector the foreign assets share which oscillates around 50% has always been higher than in banks and insurance companies.

As previously mentioned, after a period of expansion in the early 90's the banking sector entered crisis between 1998 and 2001 in which the indicators of the sector deteriorated significantly. The non performing loans / total loans ratio went from 6% before the crisis to 16% for a few months in 1999 and the sector's losses represented almost 40% of the equity of the system between 1998 and 2000 (Salazar, 2005) (Figure 3). A consequence of the crisis was the stagnation of bank credit, which lasted from 1999 to the middle of 2001 (Figure 1). The financial crisis affected two segments in particular: the housing and the government-owned banks.

Figure 3. Profitability and NPL/total loans ratio in the banking sector

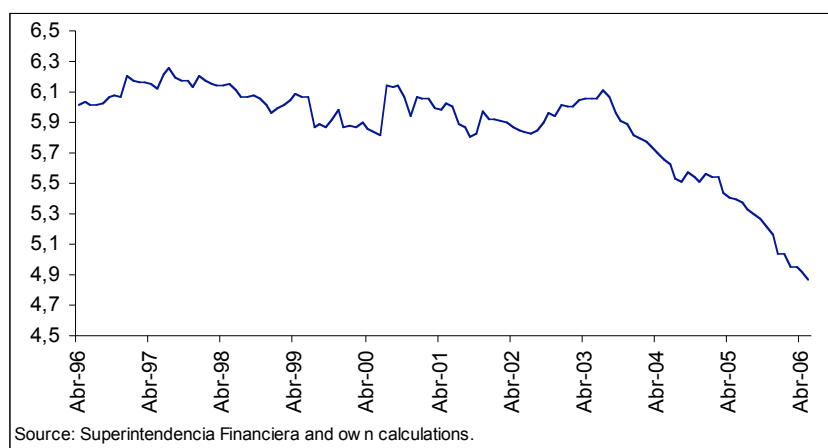


The Colombian economy recovered strongly in 2004 and 2005. It grew at a rate of 5.1% in 2005, the highest rate registered in the last ten years. Such performance was supported by internal factors like the recovery of household consumption and high investment rates. On the external front, exports grew rapidly but part of its positive effect on growth was offset by a large increase in imports. On the fiscal front, government spending also contributed to the domestic economic expansion and, because of high revenues, the fiscal accounts presented a balanced budget in 2005.

By the time the FTA negotiations had ended, the Colombian financial sector had recovered from the crisis experienced in 1998-99 as evidenced by bank profitability, solvency, and asset quality indicators. In fact, return on assets (ROA) reached 2.8% in 2005, which are levels comparable to those registered before the crisis. Similarly, non-performing loans (NPL) over total loans and provisions over NPL reached levels of 4% and 116.6%, respectively. This suggests not only a strong recovery, but also a much more positive behavior than during the mid 90's when the same indicators ranged between 4%- 5% and 30% respectively.

By contrast, efficiency indicators still look weak when compared to those registered in other developed countries. Several efficiency indicators like operating expenses over assets dropped from 6% in 1996 to 4.8% in 2005. Even though this decline was positive, countries such as Chile have reached slightly lower indicators (2.6% in 2005) (De la Cruz y Stephanou, 2006). There has been an upturn since the beginning of the 90's, however the existing literature on the subject indicates that there is further room for improvement. X-efficiency research also shows that, given the current product, the sector could still lower its operating spending (Anif, 2006).

Figure 4. Operating expenses / asset ratio in the banking sector (%)



During these last years, significant mergers within the banking sector have taken place and the number of financial institutions has declined (Table 4). The consolidation process has increased the concentration indicators. Yet, conventional indicators show that concentration levels are still low relative to other countries in the region. In Colombia, the share of total assets of the three biggest banks is 40%, while in Chile, Mexico and Peru the same share is over 50%. However, this measure

ignores the existence of financial conglomerates³. De la Cruz and Stephanou (2006) show that market concentration indicators that take into account financial conglomerates are considerably higher than conventional measures suggest.

Table 4. Number of Financial Institutions (1995-2005)

	1995	2000	2005
Number of Institutions	279	196	154
Commercial and Housing Banks	41	30	21
Private domestic	21	15	12
Public	5	4	3
Foreign	12	11	6
Solidarios	3	0	0
Other Credit (Deposit Taking) Institutions	98	54	32
Corporaciones Financieras (CF)	28	8	2
Compañías de Financiamiento Comercial (CFC)	73	32	24
Financial Cooperatives		13	5
Instituciones Oficiales Especiales (IOEs)	6	9	10
Organismos Cooperativos de Grado Superior (OCGS)	1	1	1
Almacenes Generales de Depósito	11	9	6
Insurance Companies	50	50	44
Life	35	27	24
Non-Life	25	23	20
Sociedades de Capitalización	8	5	5
Pension Funds	9	6	6
Fiduciarias	46	33	30

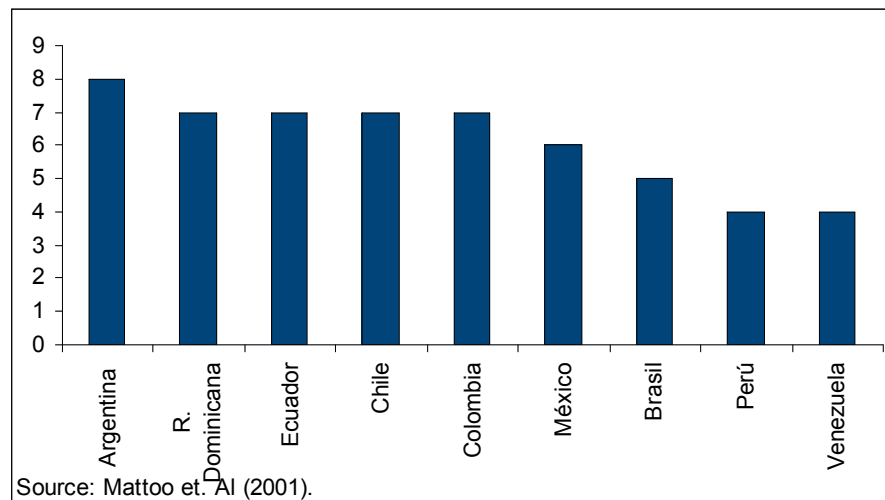
Source: De la Cruz and Stephanou, 2006.

Even though the level of liberalization of financial services has increased over the last 15-20 years and domestic and foreign banks have competed for some time, foreign presence has remained generally low (Figure 5). Under such circumstances, the US FTA is expected to increase foreign banks' presence and competition, forcing local banks to prepare accordingly.⁴

³ A financial conglomerate is a group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors -banking, securities, insurance and pensions-, (De la Cruz and Stephanou, 2006).

⁴ Since the last year, the FDI is returning back to the financial sector. In 2006 a Spanish bank acquired a local institution, which had been nationalized during the previous crisis, raising the foreign share to 21%. In the near future, another state-owned bank will be put on sale and the probability that it will end up in the hands of foreign investors is significant.

Figure 5. Financial Liberalization (FL) Index by country
(from 0 to 8, 0: low degree of FL, 8: high degree of FL)



B. Stages in the liberalization process for financial services in Colombia

1. Unilateral reforms

a) Until the end of the '80s, a period of strong restrictions on foreign competition

In 1967, in the midst of a severe balance of payments crisis, Colombia adopted strict exchange rate controls through Decree 444/1967 in order to prevent a massive devaluation. Through this measure the Central Bank (*Banco de la República*) established a total monopoly over the foreign exchange market, becoming the only entity authorized to buy and sell international reserves within the country. In addition, in order to promote non-traditional exports, an exchange rate regime of mini-devaluations (e.g. crawling peg) was adopted. Besides the dampening effect that exchange controls had on the movement of capital, Decree 444/1967 significantly restricted short-term foreign indebtedness. Decree 444 would remain in force until 1990 when the economic opening process started.

With regards to foreign investment, Decree 444/1967 as well as the measures adopted in the Treaty of Cartagena (Andean Pact, later Andean Community of Nations or CAN⁵) severely restricted foreign investment in the financial sector (Barajas, et. al. 1999b). As a matter of fact, in the Treaty of Cartagena it was agreed to establish strong barriers against the inflow of foreign investment, especially in the financial sector. As a general rule, Resolution 24 of 1969 in the Treaty required new foreign companies to become companies with mixed *national/foreign* ownership (foreign capital ownership could not exceed 49%) within a maximum period of 15 years. It imposed limits on the remittance of earnings and reinvestment and established controls on contracts for the transfer of technology. In addition, it reserved certain sectors for national capital, including the financial sector. The rule established in the Agreement was even stricter for foreign investment in the financial sector, because foreign entities had to become not *mixed* companies but *national* companies, in which no

⁵ Country members are Colombia, Bolivia, Ecuador, Peru and Venezuela.

more than 20% of the total capital could be owned by foreigners. Moreover, it prohibited further foreign investment in the financial sector from countries that were not part of the agreement.

By faculties contained in the norm, Colombia was able to exempt itself from this last obligation (Decision 24)⁶. Nevertheless, the vision on the foreign capital in the Colombian financial sector approached the rules of the Cartagena Agreement gradually. At first, the government tried to induce the transformation of foreign financial entities into *mixed* organizations, through individual “friendly” agreements, but only some banks acceded to make this transformation voluntarily. For this reason, the government decided to send a general regulation regarding the presence of foreign capital in banks and other financial institutions.

In 1975 Law 75, which was justly called “Law for the Colombianization of the Banking Sector” was issued. The norm established was a little more flexible than Decision 24, because it obliged foreign-owned companies to transform themselves into *mixed* companies within a maximum period of three years. This transformation had to be done through the creation of a new entity in which no less than 51% of the shares would belong to national citizens. In addition, Law 75 prohibited new foreign investment in banks and other credit establishments and in insurance companies.

From the beginning of 20th century several foreign banks were operating in Colombia, the origin of the capital being mainly American, English, Italian, French and Dutch. The obvious consequence of the “Colombianization of the Banking Sector” law was the stagnation of the entrance of foreign capital in the financial sector. Indeed foreign bank assets never reached more than 8-10% of the total bank assets. A similar behavior occurred in the insurance sector. However, the law did not have the desired effect because the total “colombianization” of the financial system did not actually occur. In the case of banks, for example, the forced sale of 51% of foreign shares to national citizens was not done as a single block but in fractions or small sales (Superintendencia Bancaria, 1989). This strategy allowed foreign owners to keep the greatest participation in each financial entity maintaining its control, and to reacquire the totality of the banks more easily at the time the sector opened for foreign investment in 1990.

At the beginning of the 80s, macroeconomic conditions deteriorated significantly, while the country was suffering from the effects of the debt crisis that the region was undergoing. Sizeable fiscal and external deficits had accumulated and the country entered a period of economic deceleration, which although serious, was not as pronounced as in other Latin American countries. Between 1982 and 1984, the Colombian financial sector went through a crisis and the causes of which were: first, the economic recession and second, the poor prudential framework and regulatory enforcement added to a bad management by the managers of some entities. The deterioration also made evident the existing inefficiencies in the banking sector’s operation. The crisis resulted in the nationalization of various intermediaries and a major increase in the government’s participation in financial activities. The crisis also highlighted the need for improvements in prudential norms (higher solvency requirements, creation of deposit insurance scheme managed by a new government institution, Fogafin, among others) and supervision (unification and improvement of information and transparency norms).

⁶ Article 44.

As it was previously mentioned, during this period the banking sector operated under a rather specialized structure. Commercial banks were the only entities authorized to offer checking accounts and they specialized in offering credit to businesses and consumers. Savings and Loan Associations (CAV or housing banks) were entrusted with the task of operating the housing financing system. Their deposits and allocations were indexed to the UPAC (*Unidad de Poder Adquisitivo Constante*) which was tied to the CPI inflation rate. The objective behind the implementation of the UPAC system was to create a housing financing scheme ensuring a constant real interest rate both on loans and deposits. However, in various occasions the Central Bank had to make adjustments to the formula, given that under specific macroeconomic conditions some intermediaries, without indexed deposits, perceived disadvantages in that (deposit) market. Thus, the formula of the UPAC was gradually linked to CD interest rates instead of CPI inflation. This scheme would be sustainable if the interest rates and the inflation moved in the same direction. Yet, in the late 90's the inflation rate and house prices diminished strongly, while interest rates augmented abruptly and the great problems of the UPAC system became evident.

b) The reforms in the 90s and the crisis of 1998-1999

The foreign debt crisis in Latin America, the closing of international markets and the effects that this had on growth highlighted the failure of a policy adopted in the Andean Pact which restricted the inflow of foreign investment. The countries found it necessary to relax their policy in this area and attract foreign investment as a mechanism for complementing the low level of domestic savings⁷. Even if the economic crisis turned out to be less severe in Colombia than in other countries in the region, making the policy more flexible towards foreign investment proved to be important in solving the crisis in the financial sector between 1982 and 1984. In fact, the possibility for foreign investors to own more than 49% of the shares of an entity allowed some foreign banks that had suffered serious losses to receive an influx of capital from their headquarters, thereby reducing the fiscal cost that the government would eventually have had to assume to maintain confidence in the system.

But it was not until the beginning of the 90s that the country embarked on a significant financial liberalization. This was not an isolated measure but rather a part of an important effort to make the economy more open and flexible. In fact, even though the financial sector reforms were a key part of overall reforming efforts, sensible changes to the labor market, the exchange rate and foreign investment, and to the institutional policies of the Central Bank were also introduced at the same time. Tariffs and barriers to foreign trade were also significantly reduced.

Later in the decade, the Colombian pension system was significantly modified with the introduction of a mandatory defined contributions pension pillar. Until 1993 a *pay-as-you-go* pension system operated in Colombia which was administrated by a public entity, the Instituto de los Seguros Sociales (ISS). Law 100 of 1993 introduced a dual pension scheme in which the old *pay-as-you-go* system (administrated by the ISS) competed with a fully funded regime (administrated by private pension fund managers). The accumulated funds in the individual accounts invested in the capital market have exhibited an important growth, being at the present time the most important player in this market. The value of pension funds portfolio increased from 1% of GDP in 1994 to near 12% of GDP in 2005.

⁷ Treaty of Cartagena, Decisions 220 and 244 of 1987.

Changes to the structure and operation of the financial sector were a response to growing recognition of inefficiencies in financial intermediation. This was, to a large measure, the result of having maintained a high degree of financial repression and of limiting competition between local entities, and between these and foreign providers (Ortega, 1990, and Hommes, 1990).

Among the most important measures that were introduced through Law 45/1990 and 35/1993 were the following: (i) simplifying the process of merger and acquisition; (ii) significant reduction in financial repression (elimination of the majority of forced investments and reduction of reserve requirements); (iii) establishment of stricter prudential norms; iv) adoption of a multi banking system and v) promotion and growth of financial conglomerates.

In 1991 the country adopted new regulations governing the exchange rate and foreign investment that allowed greater flexibility in the movement of capital (Law 9/1991 and Resolutions 55 and 57 of 1991 and 21 of 1993 by the Monetary Board). The Central Bank abandoned its monopoly over international reserves and allowed banks to buy and sell foreign currency. Likewise, the establishment of checking accounts abroad was made possible and the policy on short-term foreign debt was made substantially more flexible. The “crawling peg” exchange rate regime was maintained until 1994, when it was replaced by the “crawling band” regime.

Law 9/1991 also made the policy for short term foreign investment more flexible⁸ by (i) giving equal treatment to foreign and domestic investment and allowing an unrestrained inflow of capital for all economic activities⁹; and (ii) relaxing legal restrictions on foreign exchange and eliminating the maximum limits on the repatriation of earnings, capital reimbursements, and payments for technology transfer contracts (Garay, 2004 and Alonso et. al., 2003). In addition, foreign portfolio investments were permitted. The main implication of Law 9/1991 for the financial sector was that foreigners were permitted to take full ownership of local institutions (banks, other deposit taking institutions, financial services companies, insurance and reinsurance companies and securities firms). However, this law maintained certain market access restrictions, particularly the need to constitute financial institutions as legal entities under Colombian laws (i.e., take the form of subsidiaries) which meant that it was legally impossible to have commercial presence through direct branching.

Although the norms for private foreign indebtedness were made more flexible at the beginning of the 90s, in 1993, through the Resolution 21 issued by the Board of Directors of the Central Bank, a non-remunerated deposit in dollars based on short-term foreign debt was established. This deposit was similar to a tax and its purpose was to reduce the inflows of short-term capital, which had increased significantly at that time. Initially, the tariff of the deposit was set at 47% of the value of credits for periods under 18 months (Alonso et. al. 2003). As the capital inflows augmented, the conditions of the deposit became stricter, in terms of its tariff (increase) and indebtedness term (reduction). Then, in the late 90's, the authorities reduced the tariff on the deposit in response to a change in the direction of capital flows. In May 2000 it was reduced to zero percent.

⁸ This new regulation coincides with the elimination of the few restrictions on foreign investment that were still maintained in the framework of the Andean Pact (Resolutions 291 and 292).

⁹ Except for national defense and toxic waste.

The deposit for foreign debt was one of the most sensitive topics when the negotiations for the Free Trade Agreement with the United States started. As will be discussed in detail, in the FTA Colombia preserved a certain degree of discretionality in capital flows control, which can only be imposed temporarily, a similar result to the one obtained by Chile in the FTA with the US.

The tendency of public expenditure to grow was reinforced during the period 1995-1997 and was also supported by an expansive monetary and fiscal policy. As a result of the excess of private expenditure over savings, public and foreign deficits reached 4.5% of GDP in 1997. The unstable foreign environment during those years, the disequilibrium of Colombian economy, and the internal political instability caused frequent attacks on the exchange rate. The Central Bank's defense of the exchange rate band caused increases in domestic interest rates, which were aggravated by an increase in foreign interest rates when capital markets in the region shut down after the crisis in Asia and Russia. Towards the end of 1998, the country entered a period of economic crisis and in 1999 there was a strong contraction of the economy (-4.2% of GDP). During the same year, the crawling band regime was abandoned and a floating exchange rate was adopted. Also in 2000 the Central Bank formally adopted the strategy of inflation targeting.

The increase in interest rates, the economic recession and the devaluation had negative repercussions on the stability of the financial sector and resulted in a significant deterioration in its main indicators. Flaws in the regulation and supervision of the sector also became evident, especially when dealing with risk assessment and risk management. In particular, although the requirements in terms of solvency were seemingly strict and adequate, once the crisis began it was clear that the levels of provisions were very low. The housing financing scheme (UPAC) also revealed the regulatory flaws of the financial sector. Having tied the UPAC to interest rates, the existence capitalization of interests, the inadequate assessment of collaterals and the level of indebtedness of households which exceeded their ability to pay, made the UPAC system unsustainable. Finally, the poor management of public financial entities also revealed the deficiencies of the supervisory system and required substantial expenditures from the government in order to ensure their reorganization.

The crisis forced the adoption of changes in the financial system. In 1999, a new strategy to finance housing that sought to correct the weaknesses that prevailed between 1974 and 1998 was adopted and the old savings and loan associations were converted into banks (Law 546/1999). In addition, regulation and supervision were strengthened, primarily to ensure better evaluation and risk management by credit institutions. At the same time, minimum capital requirements were adjusted (Law 510/1999). Other measures changed permissible activities for some entities (Law 795/2003), created new financial institutions (Law 454/1998) and eliminated existing ones (Law 546/1999). However, the model of specialized financial service provision has not been significantly affected, with the possible exception of the specialized housing bank vehicle, which was eliminated (De la Cruz and Stephanou, 2006).

Until 2005 two institutions in charge of regulation and supervision existed: i) the Banking Superintendency (Superintendencia Bancaria), for the deposit-taking institutions, the pension funds, the insurance companies and the fiduciaries, and the Securities Superintendency (Superintendencia de Valores), for mutual funds, stock market traders and for all the activities related to the issuance of equity and bonds in the capital market. The different levels in regulation and supervision between both superintendencies had generated regulatory arbitrage problems. At the beginning of 2006 the two institutions merged into the Financial Superintendency (Superintendencia Financiera).

Some of the measures taken as a result of the crisis have been associated with financial repression. This is the case of the forced investment created to finance part of the mortgage crisis and the introduction of the financial transaction tax, named as 4xmil. But perhaps the main regulatory weakness of the financial system concerns several institutional aspects. In particular, Colombia has weak creditor rights protection (IADB, 2005), an obstacle that has been clearer since the mortgage sector crisis in 1999 when intermediaries found serious difficulties in recovering their loans. Besides, the great amount of accumulated unsolved processes revealed important inefficiencies in the judicial branch. In fact, regarding creditors' rights protection Colombia obtained a score of 0, which is low when compared to developing countries and even to Latin American region.

2. *Bilateral, regional and multilateral commitments*

It is important to highlight that since the financial reform of the early 90's, and notwithstanding the changes brought about by the financial crisis, Colombia stayed on a stable liberalization path lasting through to the US FTA negotiation. In fact, it did not undertake new (and liberalizing) external commitments on the financial sector during the time of commercial integration in the mid 90's.

Firstly, in The Group of Three (G3), an agreement signed in 1994 between Colombia, Mexico and Venezuela, the commitments undertaken by Colombia (and Venezuela) in financial services did not exceed what was already covered by existing legislation, although Mexico tried to negotiate with those two countries an agreement as broad and ambitious as NAFTA. The chapter on financial services makes evident that status quo was unchanged and, accordingly, in the list of commitments Colombia's reservations were all related to the existing legislation at the time.¹⁰

The Colombian government had no any particular interest in going further on financial services negotiations in the G3 due to the fact that (i) the government preferred to wait the results from the then ongoing multilateral negotiations on financial services under the GATS and (ii) the government considered that as a result of the unilateral reforms undertaken by Colombia few years ago the financial sector was open enough to foreign competition¹¹. In addition, given that the agreement involved many economic sectors and was expected to have far-reaching implications and coincided with a period of strong foreign exchange rate revaluation, both the private sector and Congress strongly opposed the signing of the agreement. Therefore the government considered it appropriate to limit the liberalizing commitments to topics related to the trade in goods.

Secondly, the commitments made under the GATS¹² in 1997 were also in line with domestic regulation in the sector. Regarding commercial presence the country committed to allow foreign investment in the financial sector establishing that the treatment of foreign investors should be equal to that given to domestic resident investors, in this way consolidating what was already included in the domestic legislation.

¹⁰ Article 12-15 G3 considers the creation of a reservation list in a protocol to Chapter XII. In this Protocol Colombia listed: article 16 (letter h) from the Law 31 de 1992, articles 3 (paragraph 1), 5 to 9, 11 and 27 from the Law 9 de 1991, articles 1 and 3 from the Law 66 de 1993, articles 59 to 63 from the Law 100 de 1993, article 60 of the Colombian Constitution, and finally articles 39, 41 (numeral 6, letter d), 188 (numeral 1) and 242 (numeral 4) from the Financial System's Statute *Estatuto Orgánico del Sistema Financiero* (EOSF.)

¹¹ In any case Venezuela was the G-3 country most strongly opposed to such a negotiation

¹² General Agreement on Trade Services.

The GATS/SC/20/Supl.3¹³ Document lists Colombia's specific commitments regarding financial services which by mode and sector are presented in detail in the annex 1. In terms of market access, the establishment of foreign financial services providers was allowed only through the legal form of subsidiaries. Commercial presence in the form of either representative offices or branches was not permitted. Colombia schedule also specifies that the supply of financial services in Colombia requires prior government authorization which is granted in accordance with the criteria and requirements contained in Colombian laws and regulation principles that are accepted on an international level that apply to a particular financial entity. Authorization for financial service providers to operate in Colombia is subject to the corresponding superintendency's verification of the character, responsibility, and competence of the people acting as owners, directors and managers. Additionally, the Superintendency must verify that the petitioning entities have the adequate controls to prevent asset laundering, appropriate risk management, and are subject to a consolidated supervision in accordance with the principles generally accepted internationally on this subject¹⁴.

In September 2003 Colombia presented an initial offer on financial services trade similar to the Doha Round commitments undertaken in 2001¹⁵. Regarding the offer some countries made petitions seeking that Colombia fully consolidate its financial internationalization process, raise limits on market access and eliminate national treatment limitations. Specifically, the US and Mexico's main request is for Colombia to allow financial entities' commercial presence in the form of direct branching and that minimum capital requirements not be required¹⁶.

Lastly, in relation to the Andean Community of Nations (CAN) there still aren't any commitments among the member countries regarding financial services liberalization, or that of any other service. In 1998, the countries expressed their willingness to liberalize sub-regional services trade including the financial sector by the end of 2005, a deadline that was then postponed to September 2007¹⁷. With this objective, they agreed on a "General Framework for Services' Trade" in which the four modes of supply were to be addressed¹⁸ together with a comprehensive coverage in terms of sectors (to be specified later on), as well as the commitment to grant all members the Most Favored Nation (MFN) treatment. In addition, each one of them would be required to list the restrictive measures to services trade¹⁹ under a negative list scheme, which have to be removed.

¹³ http://www.wto.org/english/tratop_e/serv_e/finance_e/finance_commitments_e.htm

¹⁴ The only limitation regarding the national treatment is that especial conditions on privatization of state-owned company will be exclusively offered to natural persons and national juridical persons, the latter being those that constitute a society following Colombian law.

¹⁵ This information is in the WTO's TS/S/O/COL document.
http://www.wto.org/english/tratop_e/serv_e/s_negs_e.htm.

¹⁶ There is still not much information available on the nature of market opening requests made by Colombia's main trading partners.

¹⁷ Decision 439, year 1998 stated that sub-regional service trade liberalization should be achieved no later than 2005. This deadline was first modified in January 2006 through Decision 629 and then in June 2006 through Decision 634. The former extended the deadline to June 30, 2006 for stating working tables and the latter to November 15, 2006 seeking to end revisions and agreements in September 2007.

http://www.comunidadandina.org/normativa/dec/dectema_servicios.htm

¹⁸ Commercial presence, cross-border trade, foreign consumption, and temporary movement of service suppliers.

¹⁹ Stated in the Decision 550 of 2001.

During the FTA negotiations, the commitments that Colombia, Ecuador and Peru had acquired with the CAN became a potential problem: if the U.S. was given unrestricted MFN treatment, it would fully enjoy the CAN benefits once trade within the Andean Community was liberalized. However, this was uncertain since the CAN negotiations had not made much progress and as a matter of fact they didn't meet the 2005 deadline. The inconvenience was resolved as follows: First, the Andean member countries agreed to postpone the services negotiation (including financial services) for November 2007, setting a work timeline²⁰. Second, they included in the FTA a clause by which these commitments do not extend to the services provided by North American companies

3. The launch of FTA negotiations with the United States

The initiative to sign a free trade agreement with the United States emerged in Colombia, aided by a variety of coincidental factors.

In the first place, after the economic crisis of 1998-1999, the economy recovered slowly. During the following three years, growth averaged between 2% and 3%, a rate that was considered low in comparison with the historical average and the needs of the country. The idea of encouraging foreign trade as a way of achieving higher growth rates began to be discussed in the government, the private sector and among the economic think tanks.

Secondly, the United States has been Colombia's most important trading partner, for instance, it is the destination of about 50% of Colombian exports, 30% of imports and 20% of annual FDI flows. Therefore, if better international trade and investment relationships are to be achieved, the United States would naturally be the candidate choice.

Thirdly, historically, the relationship with the United States has not been limited to the commercial area. The political relationship between the two countries has been important and dynamic, especially with regards to the fight against drug trafficking and terrorism. The Andean Tariff Preferences Act -ATPA-ATPDEA²¹- and "Plan Colombia" are examples of the importance of the diplomatic and political relationships between both countries. The idea of signing an agreement with the United States had a lot to do with the perceived need to give permanency to ATPA-ATPDEA tariff preferences. At the beginning, this program was to operate for 10 years. Therefore, in 2000, nearing the expiration date, Colombia asked the United States to renew it as well as to broaden its product coverage. This was approved by the U.S. Congress in 2002 thus leaving the program in force until the end of 2006. The uncertainty over the permanence of the program and the growing conviction among Colombian decision-makers over the positive direct and indirect effects for the country's trade

²⁰ Through Decisions 629 and 634, a high level working team was created in charge of revising the content of the restrictive measures listed in Decision 510, as well as the services that would be the object of liberalization. The team must present a proposal of those measures that will be subject to liberalization and sector harmonization to the Commission. The proposal will be approved and liberalization and harmonization will begin in September 2007 with the adoption of the corresponding decisions.

²¹ The ATPA-ATPDEA or Andean Tariff Preferences Act is the commercial component of the program for the War on Drugs that the United States initiated in 1991. It was put into force in 1992 for Colombia and Bolivia and in 1993 for Ecuador and Peru. Under ATPA-ATPDEA a significant list of Colombian products has benefited from the reduction and/or elimination of import tariffs in the United States.

and investment performance encouraged Colombian President Alvaro Uribe to propose the possibility of signing a free trade agreement, during a visit he made to the United States in 2003.

Fourth, the moment for exploring this possibility with the United States was appropriate. In August 2001 the U.S. Congress had approved the trade promotion authority (formerly known as *fast track*) granting the President the authority to complete negotiations on trade agreements with other countries without Congressional meddling until the end of 2005. As of 2003, the United States was negotiating CAFTA with the countries of Central America. This fact stoked fears in Colombia that if it did not succeed in making tariff preferences permanent through a free trade agreement with the United States, Colombia could end up at a competitive disadvantage in terms of its access to its main trading partner. In November 2003 at the Summit of the Americas in Miami, the launching of negotiations between the two countries was announced.

From the beginning it could be foreseen that the FTA with the United States would not imply significant reforms in the financial sector (at least) like the ones of the previous decade. First of all, it was thought that the sector was already sufficiently liberalized, at least in respect of commercial presence. If there should be changes, these might come in the area of cross-border supply and movement of natural persons. Secondly, as was previously documented the sector had already consolidated its recovery after the 1998-1999 crisis through significant adjustments and had made it stronger in the face of greater foreign competition. Although the need to make additional changes was discussed, it was clear that these would be minor in scope compared to those which were introduced through Laws 45/1990, 35/1993 and 9/1991. Thirdly, although the financial sector played an important role in the reform process in the 90s, in the context of a FTA with the United States it would be other economic sectors that would occupy a larger part of the discussions such as agriculture and intellectual property rights.

As we will see, given the conditions in which the financial sector found itself, it was possible to carry out the negotiations in such a way as to maintain the status quo, an option that was shared by the government and the financial industry itself.

THE FTA'S NEGOTIATING PROCESS

It is important to recall that neither the G3 nor the GATS had implied changes to Colombia's financial sector openness. However, both negotiations contributed significantly to the learning process of financial services reform and negotiations in three dimensions: i) both the government and the financial private sector became familiar with the technical issues of financial services agreements; ii) organization inside the government, and between it and the private sector; and iii) negotiating strategy. In particular, the experience of the G3 negotiation laid the foundations of the government's organization for the FTA with the U.S. since the text agreed between México, Colombia and Venezuela was based on NAFTA's format and contents. Also, Colombia adopted organization schemes for the negotiation that were similar to those used by México in the above-mentioned agreement. Examples of this were the technical preparation of the government and its interaction with the private sector as will be explained in more detail.

A. Government's organization for the FTA

Since the US FTA is a broader and more ambitious agreement than the ones previously signed by Colombia, the Government this time had a more strict organization and the procedure for each of the steps to take during the negotiation²² was very detailed.

The Colombian Government created a negotiating team coordinated by the Ministry of Trade, Industry & Tourism, and made up of public sector officers²³. A Negotiating Chief, in charge of overseeing the overall negotiation was assigned as well. The Chief Negotiator was in permanent contact with the various issue area coordinators and with the Vice Ministers or Directors of relevant governmental agencies.

Thematic Negotiating Committees²⁴ were created for the technical preparation, where Colombia's interests, aspirations, and sensitivities in each area were evaluated. Also, a diagnosis of each topic was made, which later helped in the negotiation with the private sector, the workers, the civil society, the media, the regions, and other estates and social agents throughout the negotiation process. The negotiating team constructed the country's negotiating position at the core of these Thematic Negotiating Committees.

The negotiating process for financial services specifically was led by the Ministry of Finance, as opposed to that observed in the other negotiating areas, which were overseen by the Ministry of Trade, Industry & Tourism. This decision, a tradition established in previous trade negotiations involving financial services, was made taking into account that the financial services negotiation is directly related to the Ministry of Finance's functions, the macroeconomic implications of the financial sector's performance, and because it is its responsibility to intervene in the financial, insurance and securities markets²⁵. The Central Bank also played an active role in the negotiation process, partly

²² Decree 2314 of 2004. See www.mincomercio.gov.co

²³ This was made up of public workers, the Central Bank, the Superintendencies, the Public Services Commissions, who would be coordinated by the Ministry of Trade, Industry and Tourism..

²⁴ Article 4, Decree 2314 of 2004.

²⁵ The Ministry of Finance was in charge of overseeing the Banking and the Securities Superintendencies (today merged into the Financial Superintendency).

due to its concern related to the capital controls and other aspects of monetary, credit, or foreign exchange policy. It is important to highlight that the Colombian government has traditionally been averse to dollarization, a stance that has underlined the country's financial strategy as well as the concerns around the financial sector's negotiations and the control of capital inflows and outflows.

The Superintendency of Banks and the Superintendency of Securities played an important role as part of the Financial Thematic Negotiating Committees. They helped the Ministry of Finance in assessing the different proposals presented in the negotiating table and writing the main documents used in the negotiation such as the specific commitments and the non-conforming-measures. They also supported the reviewing of the financial system legislation.

Other public financial institutions completed the Colombian Thematic Negotiating Committee. The Fondo de Garantías de Instituciones Financieras – Fogafin (the FDIC equivalent), the Banco de Comercio Exterior, Bancoldex -a second floor public bank specialized in export-import banking operations- also played an important role in advising on technical issues related to their own responsibilities.

The Financial Thematic Negotiating Committee met periodically. The meetings were extremely useful in preparing the government positions, analyzing the documentation, setting a strategy and organizing the coming negotiating rounds, and helped in constructing a unique position towards the private sector so that there were no flaws when discussing difficult issues. Aiming at keeping track of the discussions held inside the Committee the Ministry of Trade, Industry & Tourism assigned a person who served as Secretary and kept written records of the different meetings.

In order to coordinate with negotiators of other relevant chapters general and specific meetings were held. This was specially the case among Financial Services, with Cross Border Trade and Investment coordinators. The Thematic Negotiating Committee of each of these chapters met regularly aiming at discussing, among others, issues related to investment in financial institutions, social security, public debt and capital controls.

In this way, the government determined the country's negotiating position in financial services after a consultation process with members of the National Congress and representatives of various State entities such as the Central Bank, the Securities Superintendency and the Banking Superintendency, among others. Although there were concerns that setting a negotiating position would bring about problems in trying to arbitrate among so many and diverse interests the Ministry of Finance's strategy promoted the exchange of opinions amongst all interested State entities, allowing the consolidation of a unique (whole government) position in the financial services negotiation.

B. The decision-making procedures

The Government set strict decision-making procedures for the negotiating team which depended on the complexity of the issue. Such complexity was determined by the Thematic Negotiating Committee and the relevant Ministries through the use of a special tool acquired by the government known as the Tandem methodology (a complete explanation of this methodology is found below). The decision making process was subject to the following rules:

a) For the most important issues identified as such by the Thematic Negotiating Committee (commonly known by the negotiators as the “red lines”), the team had to follow the President’s direct instructions- adopted by the Foreign Trade Superior Council²⁶- and previously consulted and agreed with the private sector and the civil society.

Consultations with financial institutions and their different associations were conducted in meetings called upon by the Financial Thematic Negotiating Committee or the different financial associations. In addition, the government organized presentations open to the public which were carried out the week following each negotiating round. Anyone interested in the negotiations was allowed to attend, interact, ask or present opinions to the negotiators. The latter were obliged to give due consideration to all proposals or questions.

b) For less relevant topics identified by the Tandem methodology, the negotiators took decisions within a strict and limited framework (the “green lines”). An issue could be negotiated or decided directly by a negotiator as far as a consensus on the positions was reached at the Thematic Committee level and the chief negotiator agreed previously on it.

If a consensus on the interests and negotiating positions could not be reached in the Thematic Committees, these were put to the Negotiating Supervisor’s consideration²⁷. If a consensus could still not be attained, the Vice Minister of Foreign Trade would take it up with the Vice Ministers or officers at this level responsible for the subject. If disagreements persisted, the Minister of Foreign Trade, Industry & Tourism would call a ministerial-level meeting in order to unify the Government’s position. If the differences could still not be resolved, they would be taken up with the Foreign Trade Superior Council, the Ministers’ Council, and with Colombia’s President himself.

Throughout the negotiation of financial services, it was not necessary to go to higher instances regarding interests and negotiating positions to be adopted, since all agreements were reached at the Financial Services Thematic Committee’s level. Even though various topics that would imply changes were being discussed -such as the possibility of operating through branch offices and cross-border insurance trade- there was always a general consensus amongst the different government authorities and even between them and the private sector, except in a few specific topics as will be discussed.

Before the negotiations were initiated the Government hired Tandem Insourcing, a consulting firm, to complement the Government’s strategy in the decision-making process with the objective to facilitate the mechanics of the negotiation. At the outset, Tandem Insourcing began with a needs assessment which took the form of written questionnaires, in-person individual and group interviews.

Based on the needs assessment and in partnership with the negotiating team, a plan was developed. It included the following types of activities:

- running practice negotiation simulations for the negotiators
- facilitating the assessment of previous negotiating rounds
- training in negotiation skills
- cross-cultural briefings on issues relevant to negotiation styles

²⁶ Presided by the National President and a significant number of the Ministers.

²⁷ Decree 2314.

- developing strategy
- process consulting during the negotiating rounds
- individual or group coaching throughout the process

Tandem Insourcing provided the government a software (now and thereon the “Tandem Methodology”) which was used by the negotiators throughout the negotiation process. This software tracked issues, potential trade-offs, as well as variables that needed to be taken into account, providing the Chief Negotiator, the Thematic Committees, and the consultants with a clear overview to the state of the negotiation. The software was used to measure performance; to track progress during negotiation rounds; and to determine how well goals were reached during the post negotiation evaluation stage.

The Tandem Methodology was a systematic tool that provided negotiators with a complete catalogue of the offensive and defensive interests in each of the negotiation topics. These offensive and defensive interests were ranked taking into account its importance through a matrix that would evolve as the negotiations advanced. This matrix was completed by different possibilities of negotiation which were as well ranked according to its importance.

The Tandem Methodology helped to build the “negotiation map”, as it identified the negotiation’s various alternatives in each of the topics, assigning superior or inferior grades to each alternative of negotiation depending on their benevolence towards Colombia’s interests. This allowed the measurement of negotiators’ results objectively and the setting of boundaries that could not be trespassed by them as explained above.

In the specific case of financial services, the “negotiation map” served various purposes: control the negotiation exchange strategies and avoid imbalances; coordinate the financial services tables’ topics with those of other related negotiating tables (for example, coordinate cross-border services with the investments table and the dispute settlement table); facilitate a quick response to proposals from other Andean countries participating in the negotiation and from the U.S.; articulate the interaction between the private sector, the National Congress and the authorities; allow the transparent and objective evaluation of the negotiation’s progress and of the decisions taken in the financial services negotiation table; and set the type of decisions that can be taken directly by the negotiators without submission to higher authorities.

C. Coordination with Andean Countries

From the beginning, the U.S. government showed interest in negotiating the FTA with Andean countries as a group, namely, Colombia, Ecuador and Peru. After some discussions inside the Andean Community, these countries agreed to negotiate jointly with the United States.

With this in mind, Colombia, Peru and Ecuador had coordination meetings before the negotiating rounds with the United States. The idea behind these meetings²⁸ was to reach consensus on a single negotiating position with the U.S., starting from the assumption that negotiating as a block with the U.S. would improve the countries’ positions and allow them to obtain better results than if negotiations were carried out individually.

²⁸ These meeting took place a few days before the negotiating rounds with the U.S.

On several occasions, single negotiating positions were agreed and jointly presented to the U.S. by the three Andean Countries. This was the case of the commitments on social security and collective investment schemes explained below which were drafted and presented jointly by Peru, Ecuador and Colombia to the U.S. negotiators.

However, an agreement between the three countries could not be reached on all topics. Nonetheless, in those cases the meetings previous to the negotiation sessions were useful because the differences could be discussed and managed in such a way that the U.S. could not later take advantage of divergences within the Andean block. That was the case of the commitments regarding branches of banks and insurance companies which were only an interest of Colombia as Peru and Ecuador already allowed this type of commercial presence in their territories. Therefore, while Colombia hoped to receive some consideration or compensation for this commitment, Peru and Ecuador wanted Colombia to give without restrictions the same treatment than Colombian investors were already getting in the latter countries.

Regarding financial services, it is noteworthy that for Colombia a number of topics under negotiation in the FTA implied regulatory changes, while for Peru and Ecuador they only meant consolidation of the status quo, since their laws already allowed for issues that the U.S. wanted to include in the agreement. One example is the discussion about foreign financial institutions' access to markets through branches. While Colombia did not allow this kind of commercial presence, Peru and Ecuador did, so the impact, at least from a regulatory viewpoint, would be different for Colombia than for the other two countries. In this way, Peru and Ecuador tended to support more the U.S. position than the Colombian one, since eventual access to the Colombian markets would be in their favor as well.

It is important to note that some significant differences between the three Andean countries finally led to divergences on their particular negotiation perspectives. For example, Ecuador has a dollarized economy and Peru is highly dollarized, while Colombia has a clear posture against dollarization, a fact that clearly implied differences in a wide group of negotiation issues. Also, Peru and Ecuador didn't share the outset need for capital flow controls that Colombia defended.

A comparison of the commitments undertaken by Peru, Ecuador and Colombia shows that the three countries assumed very similar obligations in the Financial Services Chapter. The differences among the Andean countries were more on the strategy side: Colombia wanted to use its financial commitments with regards to the US to receive a more favorable treatment on the investment chapter, whereas Peru and Ecuador considered that each chapter should be negotiated individually. This explains why Colombia wanted to take all the time needed to assure that it would get favorable results in the Investment Chapter (the detail of those requests is presented below), while Peru and Ecuador wanted to close the negotiation of the Financial Chapter regardless of the outcome of the negotiation of the Investment chapter.

D. Interaction with the private sector, the National Congress and the Civil Society

Partly inspired by the experience of the G3 agreement -its methodology generally taking after the NAFTA- and aiming to obtain greater acceptance of the FTA with the U.S. and take advantage of the

private sector's knowledge and experience in obtaining the best possible agreement for the country, the Colombian Government since the beginning showed great interest in actively involving the private sector, the National Congress, and the civil society in defining the country's negotiating position. With this objective, the Government requested the private sector's organization and set a series of interaction procedures and permanent discussions with these actors.

In order to coordinate the private sector's participation in the negotiating process, the Government made an agreement with the Associations Council²⁹ (*Consejo Gremial*), a body that unites different private associations in the country. This agreement's purpose was to serve as a transmission channel of the private sector's interests to the Government, foreseeing that the interests of organizations, as well as of people not belonging to the Council, were equally important in the attainment of a good agreement. Diverse financial institutions' positions were also taken into consideration, as they made these known through the various financial associations.

Additionally, during the negotiations a permanent direct channel for consultation between the negotiating team and the private sector was created -a space parallel to the negotiating tables denominated "the side room". The "side room" was up and running during all the negotiating rounds, and in the case of financial services it helped negotiators consult and present information to the associations and financial institutions throughout the course of the negotiations.

As far as its "side room" is concerned, the financial sector witnessed firsthand the evolution of the negotiations and contributed with figures, information, and arguments to defend Colombia's negotiating standpoint. Research tasks were assigned to private sector representatives during these meetings, which gradually became clarifying documents that Colombia presented at the negotiating table. In this way, for example, Colombia presented documents to the agreement's signing countries explaining how the social security system works in Colombia, trust fund's types of operations and the size of the market in which they operate, the different types of mandatory insurance and their characteristics, and the investment regimes for pension funds and insurance companies.

The private sector's contributions turned out to be of crucial importance throughout the negotiation, allowing negotiators to identify problems and solutions during the rounds. Illustrative examples of these were the proposals related to the financial sector's taxes and supply of information regarding cross-border trade, which will be referred to later on.

As mentioned before, the negotiating team organized presentations open to the public which were conducted the week after each negotiating round³⁰. The Chief Negotiator supported by the negotiating team³¹ made a general presentation of the negotiation and highlighted the main progresses in each Chapter. These presentations were meant to give a good grasp of each of the topics discussed in the FTA.

²⁹ This entity unites fourteen associations in Colombia, and its mission is to consolidate the social function of the country's associations, by means of coordinating their activity in order to promote identification and unification criteria on topics of national interest as well as to stimulate the analysis and search for unified positions in the private sector regarding topics of social interest, among others.

³⁰ The meetings took around two days.

³¹ The Thematic Committee coordinators made a short presentation of around 15 to 30 minutes.

The general overview was followed by more specific and detailed presentations carried out by each Thematic Committee which were conceived as in depth reunions where the civil society could interact directly with negotiators of the different topics. They were scheduled to last for one complete morning or afternoon and the negotiators were obliged to give due consideration to all proposals or questions raised by the civil society.

Regarding financial topics, a good example of the civil society participation was the specific request made by the productive sector to accept the U.S. proposal under which Colombia should permit its residents to buy insurance products abroad. According to such representatives it was adequate to change Colombian legislation (which did not allowed consumption abroad of insurance products) as this would allow different industries to choose where to buy their insurance products (locally or in the U.S.). This flexibility, according to their say, would enhance industries' efficiency and competitiveness. The request was taken into account by the negotiators and, as it is explained below, the government undertook commitments under which Colombian residents are allowed to buy most insurance products from insurance companies established in the U.S., Ecuador or Peru, four years after the agreement comes into force.

E. Financial Private Sector's preparation and position regarding the FTA

In preparation of the negotiations in financial services, and in order to have a coordinated and frequent interaction with the Government's negotiating team at different levels, the associations representing the financial sector formed a group lead by the Banking Association (Asobancaria). The Colombian Insurance Federation (Fasecolda), the Trusts Association (Asofiduciarias), the Colombian Stock Exchange (BVC), the Exchange Institutions Association (Asocambiaria), the Colombian Federation of Leasing Companies (Fedeleasing) and the Association of Commercial Financing Companies (AFIC) were all part of this group. It is important to note that not all financial associations had equal importance and representation; in some cases, conflicting interests resulted in them taking different positions regarding the FTA negotiations. For instance, in capital markets, Colombia's stock exchange (BVC) asked for some degree of protection for market infrastructure or at least a gradual liberalization process, while the remaining bodies supported greater foreign competition. In the end, evidence showed that the most active associations during the negotiations were Asobancaria, Fasecolda and Asofiduciarias.

Additionally, in order to prepare technically for the negotiation and have an own position on defensive and offensive interests, the associations hired Fedesarrollo³² and Anif³³ to undertake a research project that would cover all financial services areas and that would present positions towards the FTA. The effort became relevant since it was, in the country, the first detailed technical approach to this type of agreement in financial services, making this an important tool not only for the financial sector and academia, but for the Government as well. In fact, the report's recommendations were subject to discussion between Fedesarrollo-Anif and each of the financial associations and presented to the Ministry of Finance's negotiating team. In general, everyone agreed with the conclusions and

³² The financial associations were seeking not only to count on a technical study that could help them setting a position but also to have recommendations coming from independent think tanks with credibility among the government and the country.

³³ Nacional Association of Financial Institutions, (Asociación Nacional de Instituciones Financieras).

these constituted the financial sector's positions. Throughout the process, however, the financial institutions identified other risk factors in the agreement as will be explained below.

- The report's main recommendations

The report³⁴ covered topics related to deposit-taking institutions, insurance, pension funds, capital markets and trust funds. In general terms and based on previous trade negotiations (NAFTA, US–Chile, CAFTA), the study did not identify any major downside risks for the Colombian financial sector, given that the latter presented adequate levels of openness to foreign investment and liberalization of the capital account, as compared to other countries that had negotiated with the U.S. Rather, it insisted on the need to preserve macroeconomic stability –balance of payments-, exchange regime, tax income- and to promote a competitive environment which, aside from not putting national entities at a disadvantage vis-à-vis foreign entities, would also respect the conditions under which foreign investors were already operating in Colombia. In addition, it was also recognized that the agreement had to protect consumers of financial services (including insurance). In very broad terms, the report was more inclined towards maintaining the *status quo* than advancing an aggressive liberalization agenda.

Regarding macroeconomic aspects, the report did point out that a deeper commercial liberalization of financial services could lead to greater dollarization and capital movements, particularly in the case of cross-border trade, which was not considered desirable for the country. It argued that dollarization – that could increase, for example, if management of dollar-denominated checking accounts was allowed- does not bring about better results in financial intermediation and economic growth. Instead, reversing dollarization is difficult and expensive in terms of macroeconomic stability, particularly because it reduces the government's control over monetary policy and may exacerbate exchange rate vulnerability. Regarding the increase in the degree of capital inflows/outflows, it stated that this process could bring about difficulties in short-term macroeconomic management, given the exchange rate's instability and contagion risks (massive capital outflows), and the fact that it makes it more difficult to avoid amplification of capital movements by the domestic financial sector. For these reasons, it was considered best for liberalization to take place via increased commercial local presence (FDI) than via cross-border trade, all under the regulatory framework applicable to local providers. The convenience of maintaining Colombia's ability to mitigate capital movements (i.e. preserve the capital inflow/outflow control instruments) was highlighted, particularly in the case of short-term capital flows.

The report was emphatic in reference to commercial presence, recommending that foreign financial and insurance companies looking for business opportunities in Colombia do so as subsidiaries (with contribution of their own capital) and not as branches (with no capital assigned to the country), as this would create unfair competition conditions³⁵, decrease foreign capital income, relax prudential norms (as required minimum capital could not be made mandatory), and hinder controls once different requirements per type of entity are established. In addition, it was suggested that the Government should preserve the possibility of regulating subsidiaries with local capital, defining their

³⁴ Junguito and Gamboa, (2004) “Los Servicios Financieros y el TLC con los Estados Unidos: Oportunidades y Retos para Colombia”, Cuadernos de Fedesarrollo, Fedesarrollo.

³⁵ The unfair competition arises from the fact that domestic institutions are exposed to minimum capital requirements and other prudential regulation whereas branches are not supposed to have local capital.

characteristics, their relation to headquarters, their capital requirements, their technical reserves, and their investment regime (particularly for insurance companies and funds). Competitive conditions for domestic companies and already operating foreign companies would be unequal in the absence of the ability to regulate the above mentioned factors; this would promote national savings' drainage and reduce income tax receipts in light of the fact that branches would not have the same tax burden as local companies.

In this direction, the report also recommended limiting and regulating cross-border trade and financial services consumption abroad. For the banking sector specifically, it was proposed that cross-border consumption services were provided by entities subject to prudential norms in their country of origin. Moreover, in order to achieve stability and efficiency of monetary policy, being able to limit individuals' indebtedness level abroad became necessary, whether such indebtedness resulted from cross-border trade or consumption abroad. All banking operations carried out by Colombian nationals in the U.S. market, in any of these supply modes, had to be registered by the Colombian authorities to prevent asset laundering, an aspect also applicable to Colombian investments in foreign funds. Finally, the report also suggested negotiating positive lists in both of these service supply modes, which would better assure those aspects which Colombia really intended to include in these obligations³⁶.

As regards Colombia's pension system, given that the social security scheme is supported by public guarantees, the report recommended that it would be crucial for the government to keep an autonomous management regarding mandatory pensions. Thus, maintaining commercial presence for this activity was suggested.

Finally, regarding the securities market and trust funds, even though no great threats were identified, the report did bring attention to the difficulties that could arise with the United States in reference to collective investment schemes, given that in Colombia these can only be managed by Trust Funds or Securities Broker-Dealers³⁷, a very different set-up to that operating in the United States. The securities sector expressed concern over the U.S.'s stock market infrastructure –securities

³⁶ Consumption abroad can be controlled by different means. Government can negotiate using a positive list which means that only the services contained in the list would be allowed to be consumed abroad. In order to enforce the list the Government can establish exchange rules under which any product consumed abroad not included in the list would be illegal and therefore subject to sanctions (the central bank might deter the entrance to the country of an indemnification and/or subject it to sanctions if not allowed to be consumed abroad). In addition, parties to a treaty can negotiate with respect to all modes of cross-border trade in financial services (including consumption abroad) that any party may require the authorization of cross-border financial service suppliers of the other party and of financial instruments before they are actually sold to its residents. This type of measure was actually negotiated in the Andean FTA at the request of Colombia. The requests of authorizations seem to be very difficult to exercise, as it calls in many cases for an extraterritorial application of the local law. In addition, consumption abroad can be controlled through the imposition of taxes to such consumptions. This is the case of the Andean FTA under which any party may adopt excise or other taxes levied on cross-border services, including the consumption abroad. This was included in the text at the request of Colombia in order to give relief to the Colombian insurance companies. In Colombia, as a general rule, the consumption of insurance products is levied by a VAT which can go up to 16% of the price premium paid for the insurance. As in the US there are not VATS or the tariffs are much below the Colombian tariff, Colombian insurance companies were worried that there would be an extra incentive for Colombian residents to consume abroad as they would end up paying a lower final cost.

³⁷ Firms Comisionistas de Bolsa.

transaction, deposit, compensation and settlement systems³⁸- but the report showed that contrary to this concern, such an infrastructure could benefit the country.

Few offensive interests on Colombia's part were identified, proving that the country's presence in the U.S. financial markets is very limited. Banking entities are present only through agencies, since the requirements to open subsidiaries in that country are extremely strict, and even the approval procedures to open agencies are complex and require a lot of work. On the other hand, even if the Colombian population legally settled in the U.S. could be a potential market for insurance companies, it is very difficult to exploit any market potential because the regulation varies in each state and in the Federal Government. For those reasons the report recommended not to sacrifice any defensive interests for offensive interests, notwithstanding that Colombia should try to improve the current conditions for Colombian providers to open agencies in the U.S.

The study concluded that Colombia's FTA negotiation with the United States offered significant great opportunities, such as enhanced access to foreign capital, reducing the cost of capital and offering a chance to improve know-how. Nonetheless, the FTA also implied important challenges, for which it was advised that the government makes modifications in the internal regulatory framework in order to put domestic financial entities in a better competitive position in the FTA context. For example, the report insisted on the need to revise the investment regime on insurance companies' technical reserves as well as regulation on pension funds (minimum profitability), which are considered to be restrictive and binding for their investment management in such a way that it hinders the industry competitiveness.

It bears mentioning that the Government was fully aware of the need to carry out domestic regulatory changes. Evidence of this can be found in the discussions which, simultaneously with the negotiation process, were carried out within the financial sector under the "Internal Agenda" framework, lead by the National Planning Department³⁹. In general terms, the objective of the Internal Agenda was for the economy's productive sectors to achieve a greater degree of competitiveness and efficiency. It was formed by all the projects and initiatives that seek the elimination of operational obstacles and barriers so that the economy may profit even more from any liberalization process.

The discussion of the Internal Agenda for the Financial Sector included the following subjects: i) The financial system's structure, specifically the need and convenience of the banking system to move towards a multibanking scheme and for a merger between the Banking Superintendency and the Securities Superintendency which was completed in February 28, 2006 with the creation of the Financial Superintendency⁴⁰; and ii) Other legal issues where the discussion was focused on the

³⁸ The main concern came from the Colombian stock exchange (Bolsa de Valores de Colombia) since it currently has the monopoly of the mentioned systems. The BVC was opposed to cross border trade regarding activities such as securities exchange, deposit, custody, compensation and settlement, and preferred instead commercial presence of foreign providers. However, other stock market participating agents considered useful to count on greater systems choices which allowed them depend less on the BVC's infrastructure.

³⁹ Within the process of negotiation of a trade agreement, the Colombian Government worked domestically along with regional entities, the private sector, political actors and the civil society on an agreement called the Internal Agenda. (www.dnp.gov.co/paginas_detalle.aspx?idp=489)

⁴⁰ One of the main implications of the merger is that the entire financial system comes under the same prudential framework and supervisory body. An evaluation of the advantages and disadvantages of this merger was contemplated in the Internal Agenda.

elimination of the financial transactions tax, mandatory investments⁴¹ and directed credit; lower commercial presence of publicly-owned banks; the legal rights of creditors, the efficiency of judicial administration and the elimination of interest rate ceilings⁴².

However, the Ministry of Finance was even more ambitious and since the beginning of the negotiations pointed out the need for a comprehensive financial sector reform, which materialized into an on-going process since year-end 2005 with the support of the World Bank and USAID. The project aims to develop solid technical fundamentals to design a financial reform aiming at modernizing the financial sector and fixing any failures that today keep it from being bigger, deeper, and more competitive⁴³. The reform will likely be presented in Congress during the second semester of 2006.

- The financial sector's biggest fears

Financial institutions had two big concerns regarding the US FTA: (i) that the agreement would put the Colombian financial sector at disadvantage vis-à-vis financial institutions of other signing countries; (2) the possibility that, as a result of the changes brought about by the agreement, there would be a financial reform that could be negative for the sector's interests.

Regarding the first concern, the financial industry feared that the FTA would favor foreign financial entities -in tax matters, for instance. Insurance companies, for example, were worried that Colombia would allow its residents to acquire insurance with U.S., Peruvian or Ecuadorian companies. This is explained by the fact that, in Colombian legislation, buying insurance generates a Value Added Tax (VAT), while in other legislations, like the U.S.'s, the VAT on insurance does not exist or is inferior to that in Colombia (16%). As a result, Colombian insurance companies feared that domestic consumers would end up seeking insurance with foreign companies. In general, Colombian financial institutions thought that greater foreign competition with the FTA would be positive and would support it, as long as equal conditions for competition were guaranteed to all -that is, in the absence of regulatory advantages for foreign companies.

Regarding the second concern, financial institutions looked apprehensively at the fact that the FTA would allow presentation of a legislative project in the National Congress, either because the agreement needed it for its future implementation or because the Government considered a parallel financial reform to be necessary. That the National Congress undertakes a legal project for financial reform based on the FTA was considered dangerous by Colombian financial institutions since the sector is not particularly popular amongst congressmen⁴⁴. Under this light, the financial sector feared that Congress might change any proposed measures in a way that could adversely affect them.

⁴¹ Article 32 of the Ley 545 of 1999.

⁴² Such as those interest rates specifically for mortgage loans and those for all loans (tasa de usura).

⁴³ The Colombian government, supported by the Word Bank, commissioned studies in different areas in order to identify the main problems faced by the sector. Some topics covered by research studies are the financial sector structure, organization and multi-banking, pension funds, insurance companies, collective investment schemes, and electronic payments. The Ministry of Finance recently organized seminars where the main results, conclusions and proposals were discussed with the industry.

⁴⁴ Amongst some congressmen and other groups of the society the Colombian financial sector is perceived as a sector that pursues its own interest and profitability at the expense of their clients. To give an idea, according to some views interest margins are high -financial services in general are costly-, credit is restricted not reaching the poorest groups of the society. Banks do not help population income distribution and are

In spite of this concern, as was previously mentioned the Ministry of Finance is working on a structural financial reform for which it has involved the sector representatives and academia through research papers and seminars. The government's main objective is to open the debate and hold discussions that are helpful to identify the sector's problems and the ways to solve them, in order for the country to count with a more efficient and competitive financial sector with a broader impact in the economy. During this process the financial sector has accepted that some changes are needed and beneficial and has actively participated in the discussions.

F. Government's strategy for the FTA on financial services

The country's strategy took shape into a "negotiation map" for financial services⁴⁵. Based on the Tandem methodology, the following Colombian defensive interests at the financial services table were defined, which Colombia fought for during the negotiation:

- Protect domestic financial services consumers from financial services providers based outside the country, in case problems came up in the services or products provided.
- Guarantee the constitutional right to a minimum pension for Social Security Pensions' contributors.
- Non-extension to FTA signing countries of deeper benefits in other multilateral agreements, such as those reached or to be reached with members of the Andean Community of Nations.
- Facilitate access for the establishment and operation of Colombian financial entities in Peru, Ecuador, and the U.S., by eliminating restrictions and speeding up processes⁴⁶.
- Maintain an acceptable level of Central Bank of supervision of cross-border indebtedness with foreign financial entities in order to avoid asset laundering⁴⁷.
- Protect national savings. The government was worried that the results of the negotiations would entail the possibility that the scarce national savings would go out of the country. This was specially the case in pension funds. The government did not want that the resources

binding for development purposes. The recovery of financial sector earnings in the last years has deepened those kinds of perceptions.

⁴⁵ During the process it was complemented with Colombia's specific interests, based on an assessment of each sector's (securities, banking, insurance) strengths and weaknesses, which were in turn validated in their respective associations and by the higher authorities in the negotiation's decision making process.

⁴⁶ Colombian banks were very interested on speeding up the administrative processes to establish branches or agencies in the U.S. According to their say many of them took long periods of time to get approval or were rejected without any objective explanation. This information was very valuable for the negotiators when negotiating the rules regarding the right of establishment. Colombian negotiators focused on two aspects: On one hand, in the establishment of a fixed period of time for the supervisors to accept or deny licenses; and on the hand in the elimination of any subjectivity in the decision of an application filed. As a result of the negotiations the parties agreed that (i) A Party's regulatory authority shall make an administrative decision on a completed application of an investor in a financial institution, a financial institution, or a cross-border financial service supplier of another Party relating to the supply of a financial service within 120 days, and shall promptly notify the applicant of the decision; (ii) each Party's regulatory authorities shall make publicly available the requirements, including any documentation required, for completing applications relating to the supply of financial services; (iii) on the request of an applicant, a Party's regulatory authority shall inform the applicant of the status of its application. If the authority requires additional information from the applicant, it shall notify the applicant without undue delay.

⁴⁷ This would normally be covered by the prudential carve-out and applied on a non-discriminatory basis, but was a major concern of the Central Bank.

administered by private pension funds established in Colombia, which invest its resources mainly in Colombia, could end up outside the country. This could be the case if, for example, consumption abroad of the mandatory pension services was permitted.

- Preserve the ability to determine whether certain insurance products cannot be acquired outside the country, such as mandatory insurances or those relating to social security or to events in which there is a national guarantee (such as pension for life insurance). With regards to mandatory insurances Government did not want to allow certain mandatory insurances (such as the mandatory cars insurance) to be consumed abroad. The reason for this is that part of the premium paid for this insurance goes to a public fund (named “Fosyga”) which covers the payment of accidents caused by cars that unlawfully flee the scene of the accident (commonly known as “ghost cars”) . If this type of insurances could be consumed abroad it would be more difficult to fund Fosyga. With regards to pension funds the government worried that any additional liberalization might entail new risks which would have to be burden by the State. In Colombia pension funds are guaranteed by Fogafin (FDIC equivalent). According to the Fogafin guarantee, if a pension fund goes into bankruptcy the pensioners have the right to claim to Fogafin their payments. For the Government any negotiation had to take into account that any exacerbation of such risk might affect Fogafin’s finances. This could happen, for instance, if the cross border portfolio management commitments allowed a Colombian pension funds to give the money to a foreign collective investment scheme which might not adequately manage the funds. This might create a higher burden on the Fogafin guarantee which would be directly affected as it would end up paying the guarantee for the mistakes made by someone not subject to local supervision.
- Guarantee transparency in regulatory changes, minimizing the administrative load and costs of regulation and supervision.
- Maintain discretionary powers to control capital inflows/outflows in order to preserve macroeconomic stability.
- Preserve the right to accord advantages for State financial entities (such as Banco Agrario or the National Savings Fund) in order to address market failures. Banco Agrario is a commercial bank meant to extend credit to farmers and agricultural industries. For this purposes it has the most extended branch network in Colombia and operates in towns where no private banks are established. As this bank has the most extender branch network (more than 700 offices) the Government has given it the monopoly to receive certain official deposits such as bails presented to public authorities. These deposits help the bank to operate in rural areas as they mitigate –through a cheap funding- the costs of operating in market failure towns. If such a monopoly was lost it would be too costly for the government to continue operating the extended branch network mentioned.
- Protect local financial services consumers from foreign financial institutions’ mistakes, if they have been subcontracted by a financial institution with commercial presence in Colombia to supply a given financial service (no delegation of responsibility in, for example, the case of collective investment schemes subcontracting portfolio management). In this regard it was important for the Government that in case a Collective Investment Scheme would be allowed to contract a U.S. portfolio manager, any mistakes committed by the latter could not serve as an excuse for the former in case a suit by an investor. For the Colombian government mistakes made by subcontractors had to be burden by the collective investment scheme who subcontracted them and not by the individual investor who did not play a role on it.

Another important aspect of Colombian negotiation strategy once negotiations began was the conditioning of concessions on direct branching and the cross-border provision of insurance concessions on, first, the ability for the Central Bank to maintain controls on capital flows – specifying that this control would not be permanent and control measures could only be applied for a maximum of one year without compensation⁴⁸; and, second, ensuring that the Investment Chapter will treat investments in public debt securities taking into account its special particularities⁴⁹.

⁴⁸ This petition was similar to what Chile obtained in the FTA with the United States.

⁴⁹ According to the initial US proposal, an investment in public debt securities should receive the same treatment as any other type of investment. This meant that any investor in public debt securities would be granted the same rights and protections than any other type of investor (e.g. protection from expropriation). The Colombian negotiators considered that such proposal was not acceptable as the Investment Chapter covers only political risks and not commercial risks. When an investor acquires public debt securities he is assuming commercial risks (such as a default on its payment) which is reflected in the price paid and on the Embi (emerging markets bond index). Therefore, such public debt acquisition should not be covered by the Investment Chapter. As a result of the negotiation the parties agreed on a special Annex (Annex 10-F) which provides, among others, (i) that the parties recognize that the acquisition of public debt securities issued by one party supposes a commercial risk. Therefore, any default should not be considered an expropriation unless the investor proves it; (ii) No public debt restructuring can be subject to an FTA arbitration under Section B of the Investment Chapter, as this cannot be considered by itself as an expropriation.

THE US FTA'S FINANCIAL SERVICES CHAPTER

A. Main negotiating results

In the FTA's financial services chapter, the participating countries negotiated the rules on regulation and supervision such as the procedures to issue measures of general application and to respond to applications relating to the supply of financial services, applicable to different financial institutions, stock exchange and insurance companies; the way and type of services that these entities will supply after the agreement in the case of commercial presence; and the way in which these entities may supply cross-border financial services in each one of the different modes (consumption abroad, cross-border supply, and presence of natural persons).

The Andean Financial Services chapter is self contained which means that all issues related to financial services are dealt in this chapter. When some aspects in other chapter apply to financial services a concrete reference to it is made in the Financial Services one. This is the case of the provisions in the Dispute Settlement Chapter and the Investment Chapter that apply to financial services which are modified by the Financial Chapter relevant articles.

The Andean Financial Services chapter is composed of general provisions, annexes and understandings, as follows:

- General provisions: They regulate the scope and coverage of the chapter; provide for the disciplines of national treatment, most-favored-nation treatment, market access for financial institutions and cross border trade; regulate the supply of new financial services, treatment of certain information and of senior management and board of directors on financial institutions; regulate the application of non-conforming measures and exceptions to the application of the chapter; provide for the transparency and administration of certain regulation, supervision and self regulatory measures; regulate the dispute settlement procedure and the investment disputes settlement in financial services; and finally contain definitions applicable to the chapter.
- Understanding concerning social security financial services: this annex sets up the understanding among the parties of the application of the scope and coverage of the chapter with regard to the provision of services related to social security. This is the first FTA negotiated so far containing an annex of this type.
- Cross Border Trade Annex: It contains the positive list on insurance and insurance-related services as well as in banking and other financial services that can be offered cross border.
- Transparency Annex: It specifies the coming into force of the regulation and supervision transparency measures contained in the chapter that may require legislative and regulatory changes.
- Expedited Availability of Insurance Services Annex: It provides that the parties should endeavor to maintain existing opportunities or may wish to consider policies or procedures such as not requiring product approval for insurances; allowing introduction of products unless those products are disapproved within a reasonable period of time; and not imposing limitations on the number or frequency of product introductions.

- Specific Commitments Annex: It provides for specific commitments regarding portfolio management, banks and insurance companies branching and, for the case of Colombia, consumption abroad of insurance products.
- Financial Services Committee Annex: It provides for the composition of the Financial Services Committee. This Committee is in charge of supervising the implementation of the Financial Services Chapter and its further elaboration, considering issues regarding financial services that are referred to it by a party, and participating in the dispute settlement procedures in accordance with the chapter.
- Understanding regarding financial services: This understanding clarifies, among others, that nothing in the chapter prohibits a party from requiring the issuance of a decree, resolution, or regulation by the executive branch, regulatory agencies, or central bank, in order to authorize new financial services not specifically authorized in its law. It also clarifies that a party may adopt excise or other taxes levied on cross-border services as far as such taxes are consistent with national treatment and most-favored-nation treatment. Finally, with respect to cross-border trade in financial services it specifies that a party may require the authorization of cross-border financial service suppliers of the other party and of financial instruments.

The following are important topics negotiated in the FTA related to commitments on right of establishment, cross-border insurance trade, cross-border trade in financial services other than insurance, collective investment schemes and social security.

1. Right of establishment⁵⁰

As was mentioned in the first chapter, prior to the FTA negotiations, Colombia had norms that established a good degree of freedom for setting up foreign financial institutions in its territory. Since the enactment of Law 9 of 1991, in fact, deposit-taking institutions, financial service companies, insurance and reinsurance companies, securities firms, and in general all financial institutions established in Colombia could be of foreign ownership without limitations regarding the amount or percentage of equity owned by foreign investors. Proof of the regime's openness comes from the fact that several insurance companies, pension funds and banks are foreign-owned without restrictions or discrimination between these and Colombian financial institutions.

Colombia has however maintained certain market access restrictions, particularly the need to constitute financial institutions as legal entities under Colombian laws, as well as specifying the legal forms in which such entities could be constituted. This meant that in the country it was legally impossible to have commercial presence through direct branching and it was unacceptable for foreign institutions to simply open up a branch dependent on the head office and its capital and offer financial services domestically. Colombia therefore allowed the presence of foreign financial institutions, but access for them implied the creation, under Colombian law, of subsidiaries which had to operate autonomously in Colombian territory and comply with the domestic ownership regime⁵¹ -

⁵⁰ Right of establishment refers to the rules of establishing financial institutions in a given country. Such rules include freedoms and restrictions for financial institutions established in the country to be fully or partially owned by a foreign company; the legal forms for purposes of establishment (i.e. the need or not to create a legal entity under local law as well as its legal form, such as an Anonymous Corporation –Sociedad Anónima-, or a Limited Company -Sociedad Limitada- etc.).

⁵¹ Regimen Societario

they had to have a board of directors, a physical address, have a commercial registration number, publicly swear in their management officers, etc. As will be discussed later on, this aspect changed with the FTA negotiation⁵².

During the FTA negotiations, the U.S. asked the three Andean countries to agree in the treaty that there would be complete freedom for establishment in their territories, including the possibility for market access through branches, and to eliminate the imposition of specific legal forms for the establishment of financial entities.

As regards the entry of Andean financial institutions into the U.S. market the U.S. proposed a non-conforming measure -in the end accepted by the Andean countries- under which access to the U.S. market of financial service providers from Ecuador, Peru or Colombia would be subject to non-discriminatory legal measures at the state and federal level, which can entail prudential measures and other type of customary limitations applicable to financial institutions. In a footnote to Appendix III of the financial services chapter, however, the U.S. makes it clear that this means, for example, that partnerships and sole-proprietorships are not generally legal forms under which diverse financial institutions can be constituted. Through its non-conforming measures, also, the U.S. made it clear that access to its markets in the form of branches was subject to limitations related to its federal and state legislation⁵³ which constitutes some limitations for Colombian, Peruvian and Ecuadorian banks and insurance companies wanting to access the U.S. market. This means that there will not be reciprocity as the U.S. would have complete access to the territories of Peru, Ecuador and Colombia whereas these countries banks and insurance companies will not be able to open branch offices into several U.S. states (see footnote).

In the FTA, the three Andean countries agreed to allow the establishment of U.S. banks and insurance companies in their territories as branches. This commitment does not imply big changes for Peru or Ecuador, since prior to the FTA they already allowed such an establishment. For them, this commitment brings about consolidation at an international-treaty level of their internal

⁵² Colombian regulation made it mandatory for financial institutions in Colombia to establish themselves as anonymous corporations or as cooperatives in such a way that there were limitations to the type of legal forms for establishment in Colombian territory.

⁵³ 1) Federal legislation as much as state legislation prohibit credit unions, savings banks, and savings associations- the last two known as 'thrift institutions'- to establish in the U.S. as branch offices of institutions established under a foreign law; 2) Foreign financial institutions wanting to accept or keep deposits under US\$100,000 in the U.S. must constitute a subsidiary under Federal law. This means that it is not possible for a foreign bank to establish a branch office dedicated to accepting deposits under the above mentioned limit, which constitutes a huge limitation to develop Andean citizens' retail markets, which is what Colombian, Peruvian or Ecuadorian banks would naturally be seeking in the U.S.; 3) Establishing foreign banks as branch offices is not allowed in the states of: Alabama, Kansas, Maryland, North Dakota, Wyoming, Delaware, Florida, Georgia, Idaho, Louisiana, Mississippi, Missouri, Oklahoma, Texas and West Virginia; 4) Foreign insurance companies' branch offices are not authorized to sell surety bonds for agreements with the Government of the United States. 5) Finally, the U.S. included in its non-conforming measures "all the existing non conforming measure for all states, the District of Columbia, and Puerto Rico". Some US states prohibit the establishment of insurance companies through branch offices, which constitutes an additional limitation for Colombian, Peruvian and Ecuadorian insurance companies wanting to access this market. The states that do not allow initial entry of a non-US insurance company as a branch to supply life, accident, health (excluding worker's compensation) insurance, non-life insurance, or reinsurance and retrocession are Arkansas, Arizona, Connecticut, Georgia, Hawaii (branching allowed for reinsurance), Kansas, Maryland, Minnesota, Nebraska, New Jersey, North Carolina, Pennsylvania, Tennessee, Vermont, and Wyoming.

legislation's *status quo*. Such a commitment, however, requires a legislative change for Colombia, for it implies accepting a new way to access its market that was not permitted until now. Colombia's commitment to allow access through branches will be limited to banks and insurance companies -that is, it will not apply to other types of financial institutions-, and will become effective four years after the treaty comes into effect.

The domestic industry accepted these commitments as it perceived that branches with capital assigned and brought into the country would not threaten them as there is not much advantage in establishing a subsidiary in the country. Banks and insurance companies, however, wanted to have time to prepare, in case competition increased. This was achieved with the four years period negotiated, which would give enough room to prepare for this new type of commercial presence.

In the FTA Colombia retained the right to determine under which circumstances and with which characteristics branches can establish in the country⁵⁴. According to the corresponding specific commitment this would permit Colombia to regulate branches including their characteristics, structure, relationship to their parent company, capital requirements, technical reserves, and obligations regarding risk patrimony and their investments. This regulation, however, cannot nullify or impair the commitment (see footnote 39) or unduly restraint market access.

⁵⁴ According to the Specific Commitment Annex, Colombia may choose how to regulate branches of banks of another party, including their characteristics, structure, relationship to their parent company, capital requirements, technical reserves, and obligations regarding risk patrimony and their investments. For this purpose Colombia may establish the following requirements, among others: 1) Demand from the branch offices the same obligations currently required or which could come to be required from banks and insurance companies constituted under Colombian laws; 2) Require previous existence of exchange mechanisms between the respective supervisors (the foreign financial institution's supervisor and the branch office's supervisor) in order to guarantee the information exchange; 3) Require that the bank or insurance company comply with the regulation and prudential supervision requirements in its country of origin, in agreement with international practices; 4) Require that the acts and agreements by the banks' or insurance companies' branch offices in Colombia, which are to have effect in Colombia, comply with Colombian law and authorities; 5) Issue the applicable regulation to the branch office, which may contemplate, among other aspects, its structure and characteristics; the licence regime (*regimen de licenciamiento*); the equity regime (*regimen patrimonial*), including minimum capital requirements, technical equity (*patrimonio técnico*), and solvency margin; its relation to headquarters; its investments; its accounting; its management's liability; its authorized operations, including operations with the central bank; its liability with local creditors. For insurance companies' branch offices, their technical reserve regime (*regimen de reservas técnicas*) will also be regulated; 6) Require that the minimum capital requirements (in the case of banks) and the minimum capital and technical reserves (in the case of insurance companies) assigned to their branch offices in Colombia be effectively incorporated into the country and converted to local currency, in agreement with local laws' dictum on the subject; 7) Require that every subsequent capitalization (in the case of banks) and any capitalization or increase in reserves (in the case of insurance companies), are given equal treatment to that of initial capital and reserves; 8) Require that, for transactions between a branch office in Colombia and its headquarters or other related companies, each one of these entities be considered an independent institution. Notwithstanding this consideration, the foreign company's headquarters will back-up the obligations contracted by its branch office in Colombia; 9) Require that branch office owners and representatives meet the solvency and moral integrity requirements legally established in Colombia for financial entities' shareholders in Colombia; 10) Establish that branch offices constituted in Colombia may send remittances of their liquid profits, so long as they meet the minimum required solvency margin and other minimum capital requirements contemplated by local regulation. And, in the case of insurance companies' branch offices, they may send remittances of their liquid profits so long as there isn't a deficit in investments of their technical reserves that may imply incompliance of their contractual obligations, nor a deficit in their solvency margin or technical equity (*patrimonio técnico*) which implies insufficient coverage of the calamity deviation and other risks that may be present in their operations.

Finally, it must be pointed out that the three Andean countries made their respective non-conforming measures clear: even though they accepted banks' and insurance companies' access to their markets as branches, in every case a minimum capital must be assigned to banks, and a minimum capital and technical reserves must be assigned to insurance companies, which must be effectively incorporated in the country where the branch operates and converted to local currency⁵⁵.

With these non-conforming measures and through the creation of legal entities under local laws, Colombia looked to guarantee equal conditions for banks established in Colombia and foreign financial institutions' branches settled in the country. Colombia also looked to protect local consumers in case of the foreign financial entities' bankruptcy, for there will always be assets in Colombia that, according to local laws, may be used to pay for the companies' liabilities, and avoid having to submit to an insolvency process⁵⁶ under foreign law.

Under the agreement the Government can provide that the capital required for setting up a branch be equivalent to that required to set up a bank or insurance company under Colombian law, so as to eliminate any advantages of a branch office over a subsidiary, at least from a capital viewpoint.

The local industry believes there will not be an unequal treatment among foreign bank branches and banks established in the Colombian territory. Under this perspective, they were not concerned with the result of the negotiation. It is important to mention that the Government has publicly declared that its intention is, in fact, to provide that the capital to establish branches and subsidiaries will be equivalent. This guarantees that there will not be unequal treatment regarding access costs among the two possibilities.

According to the local industry Colombian negotiators did well at reserving the possibility to regulate branches including their characteristics, structure, relationship to their parent company, capital requirements, technical reserves, and obligations regarding risk patrimony and their investments. This will permit the Government to regulate adequately branches from a prudential point of view.

The U.S. would have preferred a negotiation under which Colombia accepted the establishment of branches with no capital assigned. Nonetheless what was negotiated provides new opportunities for its industry. According to the U.S. negotiators the agreement has advantages for their industry. Firstly, a subsidiary has to organize a board of directors. Under Colombian law, the board has to be presented to the supervisor, has to comply with very strict regulation and can be subject to significant fines. As this board of directors is different from the parents' board of directors there might be some administrative difficulties (the directors in Colombia might not want to proceed as directed by the parent). These difficulties are solved as there is not need of a second board of directors in Colombia: the parent's board of directors, by definition, would take directly the decisions of all its branches.

Secondly, according to Colombian corporate law, a subsidiary can only pay dividends when, among others, it has closed its financial statements, they have been audited, the supervisor has approved them and the shareholders have met and approved such payment. This procedure is long and expensive. According to what has been negotiated, branches constituted in Colombia may send

⁵⁵ In agreement with local laws' dictum on the subject.

⁵⁶ Proceso Concursal.

remittances of their liquid profits, so long as they meet the minimum required solvency margin and other minimum capital requirements contemplated by local regulation. This seems to speed up the process of paying the profits and make it less costly as, by definition, there will not be need of a shareholders meeting.

2. Cross-border trade in insurance

Before the FTA, Colombia had a highly restrictive cross-border trade regime for insurance. In fact, Colombian legislation prohibited domestic residents to acquire insurance policies internationally⁵⁷: it prohibited foreign insurance companies to offer cross-border insurance policies to domestic residents as well as the movement of persons (such as visits from foreign insurance companies' representatives) to offer insurance policies. The only exception was foreign insurance companies offering or Colombian companies acquiring reinsurance policies. In these cases, the country's legislation allowed all service supply modes as long as the insurance companies have the obligation to reinsure, which usually involves a cross-border transaction.

The mentioned regulations were meant to be enforced by two different means: On one hand, the Estatuto Organico del Sistema Financiero (a compilation of the main financial laws) provides that any person who unlawfully buys an insurance abroad will be subject to fines. On the other hand, according to Colombian exchange rate regulations it is illegal to introduce into the country indemnifications paid on an insurance illegally bought outside the country. The violation of these regulations is also sanctioned with fines⁵⁸. In practice, however, we could not find cases where sanctions were imposed or someone prosecuted for violating the mentioned regulations.

The FTA signatory countries made several commitments in the agreement in terms of cross-border insurance trade. In the case of Colombia, this will generate fundamental changes in the market, since it will give way to greater competition for insurance companies established in the country.

Insurance Consumption Abroad. Until now, Colombian residents had to acquire their insurance policies with locally established companies, mandated by law. The FTA will bring the possibility of acquiring most insurance policies, as it was explained below, from Peruvian, Ecuadorian or U.S. insurance companies as well as the possibility for those companies to offer such policies four years after the FTA comes into effect⁵⁹. This commitment does not, however, force Colombia to allow suppliers to "do business" or "solicit business" in its territory. For this, the country will define "doing business" and "soliciting/advertizing" such that definitions are not inconsistent with the commitment itself.

The commitment to allow consumption abroad is made on the basis of a "negative list", meaning that by general rule, consumption of all insurance policies internationally will be allowed except those that

⁵⁷ See articles 39, 108.3, and 188.1 of Estatuto Organico del Sistema Financiero.

⁵⁸ See Decree 2080 of 2000.

⁵⁹ According to Article 5 and its respective annex, Colombia will allow individuals living in its territory and Colombian citizens, regardless of their place of residency, to purchase insurance policies from cross-border insurance financial service suppliers of US, Ecuador or Peru, located in their territories, including third country insurance companies established in these three countries.

are explicitly excluded⁶⁰. The “negative list” includes the following insurance products: 1) Those which are or may become mandatory under Colombian law. These insurance products were excluded from the commitment keeping in mind that some of them are based on principles of solidarity which assume that part of the premium will go to social programs⁶¹; 2) Annuities, in any form related to social security. These were excluded because they are strategic for Colombia, given that a big part of future national savings will come from them⁶²; 3) Insurance for disablement and survival related to social security⁶³; 4) Professional risk insurance related to social security⁶⁴; 5) Other insurance products related to social security that Colombian law may establish in the future⁶⁵; 6) All branches when the taker, insured or beneficiary is a State entity⁶⁶.

Cross-border Insurance Supply. Under the FTA, Colombia’s commitments on cross-border insurance supply turned out to be quite limited. Only Peruvian, Ecuadorian and U.S. insurance companies will be able to offer a limited number of insurance policies –a “positive list”⁶⁷-, which are fundamentally related to international trade⁶⁸. To impose the acquisition of insurance policies from Colombian companies only does not make much economic sense, since the route involves several countries.

Finally, it must be pointed out that the commitments of the U.S., Peru and Ecuador are similar to those of Colombia described above.

⁶⁰ The “negative list” indicates what insurance policies Colombian residents will not be allowed to purchase in foreign markets. Therefore, such insurance policies must be purchased from companies established in Colombia.

⁶¹ This is the case of the mandatory insurance for car accidents (SOAT), where the premium is assigned to the Fondo de Solidaridad y Garantía (FOSYGA). This fund covers, for example, accidents caused by unidentified vehicles.

⁶² The reason for this rests in the fact that once a person retires, one of the ways to access his/her pension is by purchasing an annuity insurance contract.

⁶³ These are acquired by pension funds for insurance against the risk of contributors’ disability and survival, to which pension funds are subject in the case that a contributor becomes disabled or passes away. These were excluded for the same reasons discussed in the case of annuities.

⁶⁴ These insurance products protect people who have a working relationship in case they suffer an accident at work or contract a work-related illness. These products were excluded for the same reasons discussed in the case of annuities.

⁶⁵ This is a general exclusion aiming to ensure that Colombia is able to prohibit the consumption abroad of any insurance relating to social security that may exist in the future. The reason for this exclusion is to guarantee the Colombian State’s greatest possible degree of autonomy in social security matters after signing the FTA, which would have been affected if insurance services relating to it could be consumed abroad.

⁶⁶ These insurance services were excluded so that the State remains insured or beneficiary of policies issued only by Colombian insurance companies, taking into account the State’s current prerogatives. Example of these prerogatives is the State’s possibility, in the case of State agreements, to declare the event of a calamity and affect the policy covering it, by means of an administrative act declaring its expiry. This prerogative, which allows the State to make effective an insurance policy in an expedite manner, would be lost in the event that the policy was acquired with a foreign insurance company.

⁶⁷ Colombia committed to allow cross-border financial services providers from Peru, Ecuador and the U.S. to supply the following insurance products across border, under terms and conditions that give National Treatment: 1) Insurance covering the following risks: International sea transport, international commercial aviation and space launching and transporting (including satellites) that completely or partially includes the following elements: merchandise to be transported, the vehicle transporting the merchandise, and any civil liability that may derive from these; 2) Merchandise in international transit; 3) Insurance brokerage to which the two previous paragraphs make reference.

⁶⁸ Such as cars on international routes and merchandise in transit.

Temporary presence of persons offering insurance services in the Colombian territory. The four countries agreed to allow the temporary presence of persons of other party⁶⁹ offering insurance policies to their residents. For this, Colombia used the same positive list containing the commitments related to cross-border insurance supply (see previous paragraphs).

This means that the commitments for supply through physical presence of persons are also limited since they are basically connected to insurance policies related to international trade. The positive list negotiated by Colombia includes the following: 1) Insurance covering the risks of international sea transport, international commercial aviation and space launching, and transporting (including satellites) that completely or partially includes merchandise to be transported, the vehicle transporting the merchandise, and any civil liability that may derive from these; 2) Merchandise in international transit; 3) Insurance brokerage to which the two previous paragraphs make reference. According to this list cross-border supply through physical presence of persons of life insurance or insurance covering personal risks will not be allowed, so the big bulk of consumers will be protected.

Other important issues related to insurance. As for the case of banking services, Colombia will still have the ability to impose taxes, to require “authorization” both for “suppliers” and “instruments”, and to authorize “new financial services”⁷⁰.

3. Cross-border trade in other financial services

Cross-border trade of financial services other than insurance is the topic that caused less controversy during the FTA negotiations, except for certain exceptions mentioned below. On the one hand, the commitments made were very limited⁷¹ and, on the other hand, many of the commitments had little impact on Andean countries to the extent that financial authorities in these countries do not consider some of the services subject to regulation or supervision, such as the transfer of financial information, the financial data processing and related software.

The U.S. proposed that the four countries should commit to allow cross-border trade under the three modes of supply⁷² under the FTA. The financial services provided under such commitments were: i) financial information transfer and supply; ii) financial data processing and related software; and iii) advising and other auxiliary financial services, excluding intermediation related to banking services and including reports and credit analysis, investment portfolio analysis and advisory, and advisory services related to acquisitions and corporate restructuring.

⁶⁹ We refer here to the supply of a financial service by a national of one Party in the territory of another Party

⁷⁰ According to the Andean Financial Services Chapter each Party shall permit a financial institution of another Party established in its territory to supply any new financial service that the Party would permit its own financial institutions, in like circumstances, to supply without additional legislative action by the first Party. This means that a “new financial service” is a service that (i) is not supplied in the territory by any financial institution and (ii) that would be supplied, for first time in the country, by a financial institution of another party without need of additional legislative action.

⁷¹ The negotiation was based on a “positive” list. This positive list contained the following services: provision and transfer of financial information; financial data processing and related software; and advisory and other auxiliary financial services, excluding intermediation and credit reference and analysis, relating to banking and other financial services.

⁷² Cross-border, consumption abroad and presence of natural persons.

Commitments related to the supply and transfer of financial information did not generate problems⁷³. In Colombia, for example, information vendors (Bloomberg and Reuters) have cross-border operations, they do not require commercial presence or the government's authorization to operate and they do not need to comply with any regulation in particular⁷⁴. Moreover, it is considered necessary for the well functioning of the market and the adequate price setting to have this type of information vendors. Thus, this commitment meant the consolidation of the *status quo*.

The commitments related to financial data processing and software did not cause any controversy either, although capital market operators were concerned that such a commitment could be understood as an authorization for stock exchange platforms (infrastructure) to have cross-border operations. For local capital market operators, these institutions should operate in Colombia under commercial presence and not under cross-border supply. To prevent misunderstandings, it was made clear that the supply of either electronic or physical exchange platforms was not contemplated within the supply of cross-border services.⁷⁵

On the other hand, the Constitutional Court gave⁷⁶ Colombian residents the right to request the review and elimination of negative or mistaken information resting in any database (normally in credit bureaus⁷⁷) as well as the right, especially for financial debtors, for the elimination of information on default payments after a given time⁷⁸. Therefore, it was made clear that the use of consumer credit information had to be done according to Colombian legislation, protecting the right to privacy and the integrity of a natural or juridical person's "good name".

Finally, the commitments regarding "advising" and "other auxiliary financial services related to banking services" did not present any major problem except on the matter of "credit reports and analysis." The concern lied in the fact that it includes bond issuers' credit ratings. Colombian legislation requires that companies wishing to issue certain securities, particularly those of fixed income, should have a rating given by a ratings agency established in Colombia and supervised by the Financial Superintendency. This need implies that in order to issue such securities a financial service (the rating of the company) has to be contracted with an entity with commercial presence in Colombia so a cross-border supply of this service is not legally accepted for the purpose of issuing securities in Colombia⁷⁹. Consequently it was agreed to exclude from the Colombian positive list the commitment related to "credit reports and analysis"⁸⁰.

⁷³ The general rule is that this service may be supplied in any of the territories without the requirement of a state license or of compliance with strict regulation. This means that such a service does not represent a major interest to the government to the extent that it is not subject to state intervention.

⁷⁴ This financial information is supplied to capital market operators through passive screens (*pantallas pasivas*).

⁷⁵ Supply of these services in any of the signatory countries can only be done through commercial presence.

⁷⁶ Based on the Colombian Political Constitution.

⁷⁷ Centrales de Riesgo.

⁷⁸ According to the Court this follows the "right to oblivion" (*derecho al olvido*).

⁷⁹ For an adequate rating of securities issuers, it is necessary to understand the country's conditions especially those of its economic sectors. The major concern with this commitment is that the knowledge and understanding of such conditions is almost impossible or very difficult to achieve without a local presence. It is for this reason that the cross-border supply of this service is not allowed.

⁸⁰ However, if Colombia in the future allows any other country to supply these services, financial institutions of the signatory countries of this treaty will automatically gain the right to supply the same services under the same mode on a MFN basis.

4. Collective Investment Schemes⁸¹

Collective Investments Schemes (CIS) in Colombia are structured and managed by trust companies through “Common Ordinary Funds” and “Special Funds”⁸², by securities broker-dealers through “Equity Funds”⁸³, and by investment management companies offering investment funds. Prior to signing the FTA, Colombian legislation did not allow investment fund administrators (CIS’s) to outsource management of any part of those funds to third parties⁸⁴.

The U.S., Colombia, Peru and Ecuador agreed that after the FTA came into effect, they would allow CIS administrators established in their territories to hire other financial institutions for diverse services. In accordance to the specific commitments, the U.S., Colombia, Ecuador and Peru shall allow financial institutions organized outside their territories (but in one of the parties) to provide investment advice and portfolio management services to collective investment schemes located in their territories⁸⁵.

Colombia, Ecuador and Peru committed to issue regulation in virtue of which they would allow the previously mentioned subcontracting in favor of U.S. companies. In return, the U.S. agreed that its mutual investment funds⁸⁶ subcontract Colombian, Ecuadorian or Peruvian CIS administrators for the same two services: investment advice and portfolio management.

In addition, the Andean countries have committed to allow local CIS administrators to hire other local CIS administrators to manage all or part of their portfolio (local portfolio management), i.e. local subcontracting between financial institutions constituted and located in Colombian, Ecuadorian or Peruvian territories.

For Colombia the above implied a significant change, which may even lead to a full reconsideration of collective investment schemes. Currently, a Trust Company (for example) cannot subcontract a third party to provide portfolio management services. This is because a CIS administrator must carry out in-house all tasks in relation to that CIS: once the public’s resources are collected, the administrator must take all investment decisions, monitor and value securities positions, and give back the resources at investors’ request, according to each scheme’s rules. That any of these tasks may be carried out by a third party, such as investment decisions, is currently considered to be a “delegation or professionalism” subject to sanctions from the Financial Superintendency.

This contrasts with what happens in many other countries, where the tasks related to administration of a CIS are commonly carried out by diverse institutions. In the case of CIS that invests in stocks, for

⁸¹ Management of Collective Investment Schemes (*carteras colectivas*) means public’s savings’ collection through the constitution of collective portfolios with several contributors, who own such portfolios in proportional parts.

⁸² Fondos Comunes Ordinarios y Fondos Especiales.

⁸³ Fondos de Valores.

⁸⁴ For more details regarding Collective Investment Schemes in Colombia see De La Cruz and Stephanou (2006).

⁸⁵ Notwithstanding paragraph 1.

⁸⁶ The investment companies registered in the Securities and Exchange Commission – SEC, under the Investment Company Act from 1940.

example, a financial institution may be the one to design the product (i.e. types of investments, investment limits, etc.); another to market it (offer it to third parties and collect the resources from the public); another to carry out the investments (buy or sell the stock according to the CIS administrator guidelines); and a different one to watch over the investments, guaranteeing compliance with the offered product's guidelines.

The FTA changes the actual scheme for the better⁸⁷. Four years after the treaty comes into effect, a CIS may contract tasks with several expert institutions located in that country or in other signatory countries. To illustrate, a Colombian securities broker-dealer would be able to hire a trust company to carry out all its CIS investments. In the meantime, the entity that collected the resources from the public will be able to manage another part of such resources (for example, carry out those investments in which they have more expertise), or simply concentrate on the CIS's marketing and leave to third parties the investment task.

In the case of cross-border subcontracting, a Colombian CIS created to wholly or partially invest in U.S. securities, for example, will be able to subcontract a U.S. financial institution to carry out such investments. This is much more logical than carrying out such investments from Colombia, where presence and experience in U.S. securities are absent. Moreover, this will allow the creation in Colombia of CISs that would otherwise be impossible to offer given the difficulties in having to carry out all related tasks from the country.

5. Social Security

The issues that probably commanded more attention from Colombian negotiators during the negotiating rounds were those related to social security. One of the reasons is that anything that refers to changes in social security is sensible in all four countries, calling attention from the media and Congress. In addition, the Colombian Constitutional Court is very demanding with every change made to the system, the functioning of it and the rights of the people. Proof of the latter is that almost every statute making modifications to the Colombian social security system has been contested in court. In almost all cases the Court has found some parts of the modifications unconstitutional or constitutional pendant on its interpretation (normally the most favorable to the users of the system).

According to the above it was important that anything negotiated in the FTA could be well explained to the Constitutional Court, the Congress and the media. This would be easier if the result of the negotiation would be that Colombia did not make changes to the system and that retained complete autonomy to make future changes to the system.

One of the main problems with the text proposed by the US is that it provided that the financial services chapter will not apply to measures adopted or maintained by a Party relating to activities or services forming part of a public retirement plan or statutory system of social security unless a Party

⁸⁷ The current scheme in Colombia is restrictive and inadequate. It is restrictive because it does not allow different business models under which a financial institution can, for example, concentrate only on marketing the CIS and collecting the resources from the public, leaving other tasks to other institutions. It is inadequate because it inhibits the achievement of economies of scale based on specialization: since a single CIS administrator must do everything (marketing, resource collection and investment, monitor the investments, value them etc.), the CIS cannot concentrate on what is best or more effective.

allows any of such activities or services to be conducted by its financial institutions in competition with a public entity or a financial institution.

In the case of Colombia there are in fact some services that are part of the social security system which are conducted by financial institutions in competition with a public entity. That is the case of the pension system (which is part of the Colombian Social Security System) where there are two subsystems in competition: a fully funded system (Ahorro Individual con Solidaridad) administered by private pension funds (AFPs) and a pay-as-you-go system (Prima Media con Prestación Definida) administered by the state owned Instituto de los Seguros Sociales (ISS).

According to the text proposed to the Andeans, as there was some competition in the Colombian social security system the chapter would apply. What was completely unclear is what would be the effect of such application.

Taking into account what has been said, Colombia proposed the U.S. an understanding annex under which all parties would agree on how the chapter would apply. In this annex, Colombia took into account all judicial precedents so its Constitutional Court will not find the negotiation violated the Constitution. The annex, accepted by all parties, establishes the following: a) The parties clarified that the Financial Services Chapter does not apply to measures to the extent that a party reserves such activities and services to the government, a public entity or a financial institution and they are not supplied in competition with another financial institution, or relating to those contributions with respect to which the supply of such activities or services is so reserved. b) The Parties recognized that taking any of the following actions with regards to social security is not inconsistent with this Chapter.

- A Party may designate, formally or in effect, a monopoly, including a financial institution, to supply some or all activities or services related to social security. This will allow Colombia to keep unmodified its severance system (which is considered part of the Colombian Social Security System). Currently the Fondo Nacional del Ahorro, a state owned entity, has the monopoly to administer the severance payment funds for public servants. This entity can also administer severance payment funds from private employees. Meanwhile private severance payment funds (Administradores de Cesantías) can only administer severance payment funds from private employees.
- A party may permit or require participants to place all or part of their relevant contributions under the management of an entity other than the government, a public entity, or a designated monopoly. This will permit Colombia to modify its system, if it so chose, so part of the contributions are administered by a state owned entity and the rest by a private owned entity. In this case, there cannot be claims arguing that market access has been diminished.
- A party may preclude, whether permanently or temporarily, some or all participants from choosing to have certain activities or services supplied by an entity other than the government, a public entity, or a designated monopoly. This will permit Colombia, as has happened in the past, to order new public employees to have their pension administered by the ISS, so they will not have the chance to have services performed by the AFPs. Once again, in this case there cannot be claims arguing that market access has been diminished.
- A party may require that some or all activities or services be supplied by financial institutions located within the Party's territory. Such activities or services may include the management of some or all contributions or the provision of annuities or other withdrawal (distribution)

options using certain contributions. This will permit Colombia to preclude any social security cross border services.

THE COLOMBIAN FINANCIAL SECTOR AFTER THE FTA: IMPACTS AND LESSONS

The evaluation of the scope and impact of what Colombia negotiated in the FTA's financial sector must start by considering what the conditions of the financial sector were at the time of launching the FTA negotiations. This can be helpful for understanding the Colombian government's strategy before and after the negotiating process. From the analysis the following elements appear most relevant:

At the time of the initiation of the Colombia – U.S. FTA negotiations, the financial system had been operating for more than ten years in an open and competitive environment. The most important changes in terms of liberalization were made in the early 1990s, when the financial system opened to foreign investment and controls on short term external indebtedness were relaxed, in addition to other economic and financial reforms that were adopted then. Furthermore, following the financial crisis of 1999, the country enjoyed a healthy and recovered financial system at the moment the FTA engagement, conditions that will prevail when the agreement comes into effect. In addition, Colombia has made important improvements in financial system regulation and supervision during the past decade, especially after the financial crisis that took place at the end of the nineties.

Despite the higher levels of liberalization since the beginning of the 1990s foreign investment in the financial sector has not been dynamic. There has been -and remains- insufficient competition between domestic and foreign entities. In addition, the financial system still faces obstacles such as tributary burdens on financial activity, deficiencies with respect to creditor rights, imposition of forced investments, and regulation weaknesses –for example the rules that govern investments of insurance companies and pension funds. All of them weigh on the sector's competitiveness, reflects in higher intermediation costs and lower levels of efficiency. As a matter of fact, although financial sector efficiency has improved, studies reveal that much remains to be done.

Aware of this situation the Colombian government's strategy has been mixed: on the one hand, as it is explained below the government adopted some liberalizing steps for certain activities in the FTA, and on the other hand, simultaneously, the government tackled internal weaknesses in regulation and supervision that negatively affect financial operation, efficiency and competitiveness. These topics are being thoroughly analyzed by the financial authorities in the context of the ongoing financial sector reform which is expected to be presented to the Congress in the coming months.

- The U.S. FTA fostered a domestic financial reform

One of the most interesting aspects that gathers up from the analysis is that the Colombian government took advantage of the FTA in framing a domestic structural financial reform, which undoubtedly will have relevant effects on the future sector's operation and structure. Since the launch of the FTA the government has advocated the need for continued change in the financial sector in order to enhance market access conditions, promote greater competition, and increase overall efficiency in financial intermediation. The authorities are conscious of the adjustments that need to take place such as promoting economies of scale and scope and overcoming regulatory obstacles, among others. There are other aspects related to financial repression -such as financial transaction taxing, forced investment and directed lending practices, weak right protection for creditors and regulation on insurance companies and pension funds- that require continued attention.

Taking into account the adjustment pressures and legislative changes flowing from the FTA, authorities hopped on the discussion of financial reform. Due to President Alvaro Uribe's reelection, the continuity of this process is highly probable, with a package of further reforms expected by the end of 2006.

- The expected impact of the FTA on financial services

With regards to the FTA with the United States, the analysis on the subject suggests that, after the reforms adopted in the 90s, this is the first step towards greater liberalization of financial services in Colombia, although the changes deriving directly from the treaty's negotiation seem, at a first glance, to be relatively modest. From the Financial Services chapter in the FTA some elements can be highlighted.

With respect to commercial presence the main change for the country was the allowance of branches as a new legal form for foreigners to supply financial services in Colombia, although foreign branches are required to operate with capital assigned to the country and under Colombia's prudential norms. This places Colombia in the same situation than that of most Latin American nations in this regard, and negotiations' results are similar to the case of Chile and most CAFTA member countries.

In practice, this does not differ much from the current situation. However, the agreement has advantages for the U.S. industry as branches are not required to constitute a local board of directors and it speeds up the process of sending remittances of branches' liquid profits. Thus, it is likely that this policy change might imply for Colombia to become more attractive for financial foreign investment. The last few months bear witness to this, with *BBVA's* purchase of *Granahorrar*. Besides, forecasting an even greater competition of foreign investment in the local market the financial sector and the government have developed various strategies, such as encouraging mergers within the financial sector aiming at reaching a larger size of the sector and improve efficiency and competitiveness.

Concerning the insurance sector the FTA was much more ambitious in the sense that Colombian individuals and companies will be able to purchase insurance policies from foreign insurance companies when the treaty enters into effect. Additionally, foreign insurance companies will be able to offer in Colombia insurance services on a cross-border basis and through the presence of natural persons. The liberalization of these two modes of supply may generate significant changes in the insurance market, because a wider degree of competition will arise for insurance companies already established in the country. Also, from a consumers' viewpoint, the FTA liberalization measures are positive. Although these changes will be implemented gradually and, at first sight, it may be foreseen that the effects within the insurance sector will not be abrupt or traumatic, efficiency efforts in the insurance sector will be important and constitute a challenge for those activities in Colombia.

Finally, the FTA brought important changes regarding collective investment schemes. The agreement foresees the right for CIS administrators to subcontract other country's portfolio administrators, and as a consequence, also local administrators (a feature prohibited in Colombia before the FTA). This will take place over a four year transition period. It is worth noting that several years ago the financial industry itself and related authorities had made significant efforts to modify the model under which collective investment schemes work. As such, the FTA's impacts are completely in line with previous domestic strategy. This too should have positive effects on the Colombian financial system. The legal

improvements required by the FTA and the changes noted above have been important discussion topics within the agenda of financial reform that the country is working on.

Beyond the direct changes introduced by the financial chapter negotiations, one cannot underestimate other types of indirect effects that the FTA may exert in regard to foreign direct investment. The FTA almost certainly places Colombia in a better position for attracting foreign investment, including in its financial sector. This is so because of the stabilizing effect that promotes better legal enforcement, more effective information flows, clearer dispute resolution and also a sounder macroeconomic environment. All these factors contribute to enhancing the country's investment climate and to reassure foreign and domestic investors. Simultaneously, changes introduced through the forthcoming financial reform should back up and complement those brought about by the FTA.

- Lessons learned from the U.S. FTA financial services experience

A first element worth mentioning is that the government's preparation and previous organization for negotiations was adequate. This, having in mind not only the final results that are positive for the financial sector's operation, but also the acceptance of the financial services agreement throughout the process by key financial representatives.

First of all, the coordination between monetary and fiscal authorities –i.e. the Central Bank and the Ministry of Finance and its Superintendencies- as well as with financial associations constituted a positive and important factor, facilitating a consensus on proper negotiation strategies. This contrasted with the experience of other key sectors, such as agriculture and pharmaceuticals, where important disagreements emerged inside the government and, in several cases, within the private sector.

Secondly, the Ministry of Finance's deliberate decision of isolating financial sector negotiations –the only issue not negotiated directly by the Ministry of Trade, Industry & Tourism- from other sectors resolved the problem of sacrificing crucial aspects of the industry in exchange for gains in other sectors. In practice this allowed the Ministry of Finance to focus on its issues regardless of the rest of the Chapters negotiated. In addition, this strategy guaranteed that the negotiators were specialists on the subjects under negotiation.

Thirdly, other crucial factor in the negotiation was the joint discussion of public debt, capital flows and financial services issues, which made sense not only because these topics are in many ways related, but also because this brought quite satisfactory results for Colombia on these fronts.

As it was previously mentioned, the US initial proposal was that an investment in public debt securities should receive the same treatment as any other type of investment. This meant that any investor in public debt securities would be granted the same rights and protections than any other type of investor (e.g. protection from expropriation). The Colombian negotiators considered that such proposal was not acceptable as the Investment Chapter covers only political risks and not commercial risks. When an investor acquires public debt securities he is assuming commercial risks (such as a default on its payment) which is reflected in the price paid and on the Embi (emerging markets bond index). Therefore, such public debt acquisition should not be covered by the Investment Chapter.

As a result of the negotiation the parties agreed on an special Annex (Annex 10-F) which provides, among others that the parties recognize that the acquisition of public debt securities issued by one party supposes a commercial risk. Therefore, any default should not be considered an expropriation unless the investor proves it. In addition, the parties agreed that public debt restructurings cannot be subject to an FTA arbitration under Section B of the Investment Chapter, as this cannot be considered by itself as an expropriation.

Finally, on the private sector front, communication and information flows between financial associations and the negotiating team were clear and constant, although –and not surprisingly- some particular differences arose, mainly from the insurance sector regarding cross-border trade and foreign consumption. Acceptance of the treaty by the Colombian financial industry offers proof of this, especially when one considers that no public debate -that could slow negotiations- ever opened on this subject. Indeed, the financial services chapter was one of the first ones to be concluded during the FTA discussions.

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ANNEX 1

COLOMBIA SCHEDULE OF SPECIFIC COMMITMENTS UNDERTAKEN IN THE GATS AGREEMENT

Sector or subsector	Limitations on market access	Limitations on national treatment
ALL FINANCIAL SERVICES	<p>3) The National Government may require national and foreign financial entities to meet an economic needs test so as to be able to operate in Colombia. Factors such as public interest, economic and financial local and general conditions will be considered.</p> <p>The establishment of a company in the form of an affiliated company or subsidiary is permitted. Other forms of supply, in particular branch offices, are excluded. The commercial presence shall be carried out in accordance with the purpose specifically authorized for the affiliated company or subsidiary, and the latter shall adopt the legal status required by the Colombian regulations. Representative offices of foreign financial entities may not supply financial services in Colombia.</p> <p>The Supply of financial services in Colombia requires prior government authorization. Such authorization is granted in accordance with the criteria and requirements contained in Colombian laws and regulation principles that are accepted on an international level that apply to a particular financial entity.</p> <p>Authorization for financial service providers to operate in Colombia is subject to the corresponding superintendency's verification of the character, responsibility, and competence of the people acting as owners, directors and managers.</p> <p>Additionally, the specific superintendency must verify that the petitioning entities have the adequate controls to prevent asset laundering, and manage risks. These entities must count with a consolidated supervision, in accordance with the principles generally accepted internationally on this subject.</p>	<p>3) The especial conditions on privatization of state-owned company will be exclusively offered to natural persons and national juridical persons.</p>
<p>1. Insurance and insurance-related services</p> <p>a) Direct insurance (including co-insurance) different from life insurance.</p>	<p>1) Unbound, except for insurance concerning foreign-trade operations, exclusively for external journeys, i.e. those which begin or end in a Colombian port.</p> <p>2) Unbound</p> <p>3) None</p> <p>4) Unbound, except as indicated in the horizontal commitments applicable to all the sectors included in this list.</p>	<p>1) Unbound</p> <p>2) Unbound</p> <p>3) None</p> <p>4) Unbound, except as indicated in the horizontal commitments applicable to all the sectors included in this list.</p>
b) Reinsurance and retrocesión	<p>1) None</p> <p>2) None</p> <p>3) None</p> <p>4) Unbound, except as indicated in the horizontal commitments applicable to all the sectors</p>	<p>1) None</p> <p>2) None</p> <p>3) None</p> <p>4) Unbound, except as indicated in the horizontal commitments</p>

Sector or subsector	Limitations on market access	Limitations on national treatment
	included in this list.	applicable to all the sectors included in this list.
c)Insurance intermediation, such as brokerage and agency ⁸⁸ d)Services auxiliary to insurance, such as consultancy, actuarial, risk, assessment and claim settlement services	1)Unbound 2)Unbound 3)None 4) Unbound, except as indicated in the horizontal commitments applicable to all the sectors included in this list.	1)Unbound 2)Unbound 3)None 4) Unbound, except as indicated in the horizontal commitments applicable to all the sectors included in this list.
2. <u>Banking and other financial services</u> (excluding insurance) Includes all the activities in the definitions in paragraphs (5)(a)(v) to (5)(a)(xvi) of the Annex on financial services.	1)Unbound 2)Unbound 3)None 4)Unbound, except as indicated in the horizontal commitments applicable to all the sectors included in this list.	1)Unbound 2)Unbound 3)None 4)Unbound, except as indicated in the horizontal commitments applicable to all the sectors included in this list.

⁸⁸ The information from this table is taken from **GATS/SC/20/Suppl.3**. This document is authentic in Spanish only. http://www.wto.org/english/tratop_e/serv_e/finance_e/finance_commitments_e.htm