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AN INTERIM FILLING THE GAP IN MULTILATERAL, REGIONAL, AND DOMESTIC HARD LAW DEFICIENCIES. RESPECTING FINANCIAL SERVICES INTEGRATION WITHIN THE AMERICAS

*Professor Joseph J. Norton**

I. INTRODUCTION

THE January 2005 deadline for the implementation of the Free Trade Agreement of the Americas (FTAA) among thirty-four nations (excluding Cuba) of the Western Hemisphere has passed virtually unnoticed by the world press.¹ The Heads of State Declaration of the Fourth Summit of the Americas, held in November 2005 at Mar de Plata Argentina, did recommit to the FTAA process in passing, but without any specificity.² Numerous reasons can be given for the current stalling of the FTAA process: the Brazilian position not to cut a final deal until the World Trade Organization (WTO) Doha Round negotiations have been concluded to the satisfaction of the Developing World, the shift to the left of certain Latin American governments in recent years giving rise to a new scepticism toward the virtues of free trade and the Washington Consensus, the hemispheric divisions caused by the Iraq Invasion and resultant U.S. neglect of its Latin American foreign policy and trade agenda, and the impending expiration of the U.S. presidential fast-

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1. See generally FTAA, <http://www.ftaa-alca.org> (last visited Apr. 4, 2006). The latest draft (3rd) of the proposed treaty, dated November 21, 2003, is contained on this site.
2. See Fourth Summit of the Americas: Declaration of Mar Del Plata, Creating Jobs to Fight Poverty and Strengthen Democratic Governance (Nov. 5, 2005), available at <http://www.summit-america.org/Eng-2004/previous-summits.htm>. This site also contains declarations from the prior three summits (Miami 1994, Santiago 1998, and Quebec 2001), along with those from the 1996 Bolivia and 2004 Monterrey Special Summits.

track authority authorized by the U.S. Congress.³

From the perspective of financial services integration in the Americas, it was hoped by many that the FTAA, through its proposed comprehensive provisions on services generally and on financial services particularly, would have set the stage for the substantial liberalization of the hemispheric legal environment for the cross-border provisions of financial services and for a significant increase in cross-border financial services investments.⁴ All this obviously is not going to occur according to the original timetable set out in the Declaration of Principles, emanating from the First Summit of the Americas held in Miami in December 1994.⁵ But, the point being presented in this chapter is that there are various layers of economic integration going on within the Americas, both *de jure* and *de facto*; and that, notwithstanding the current uncertainties of both the WTO and FTAA processes respecting financial services, the *de facto* dimensions, rooted largely in soft law underpinnings, will continue to bring about a broadening and deepening of financial services integration within and throughout the Western Hemisphere.

In general, there are three forms of economic integration in place in the Western Hemisphere at some level. The first is a *de jure* multilateral approach under the WTO umbrella. Nearly all countries of the Western Hemisphere are currently WTO and General Agreement on Trade in Services (GATS) members. Therefore, the framework for the liberalization of trade in financial and banking services applies to them, yet the individual country policy positions may vary considerably. As alluded to above, the advancement of WTO-GATS negotiations on financial services has been bogged down pending a satisfactory resolution of the Doha Round negotiations.⁶

A second economic integration mode is also a *de jure* approach, but it comprises regional, sub-regional, and bilateral agreements such as the proposed FTAA (currently under standstill negotiations), or South-South regional and sub-regional schemes such as the Central American Common Market (CACM),⁷ the Caribbean Community and Common Market

3. See Jeffrey J. Schott, *Does the FTAA Have a Future?*, INST. FOR INT'L ECON., Nov. 2005, available at <http://www.iie.com/publications/papers/schott1105.pdf>; see also Sherry M. Stephenson, *The State of the FTAA Negotiations at the Turn of the Millennium*, SICE, (Mar. 25, 2000) available at http://www.sice.oas.org/tunit/STAFF_ARTICLE/steph00_negmil_e.doc (discusses the complexity of the FTAA negotiations at the turn of the millennium).

4. See, e.g., Joseph J. Norton, *Doing Business Under the FTAA: Reflections of a U.S. Business Lawyer*, 6 LAW & BUS. REV. OF THE AM. 421 (2000).

5. See First Summit of the Americas: Declaration of Principles (Dec. 9-11, 1994), available at <http://www.summit-americas.org/miamidec.htm>.

6. See World Trade Organization, Ministerial Declaration of 18 December 2005, WT/MIN(05)/DEC (2005), available at http://www.wto.org/english/thewto_e/minist_e/min05_e/final_text_e.htm.

7. General Treaty on Central American Economic Integration, Dec. 13, 1960, 455 U.N.T.S. 3. According to its article 1, the contracting states agreed to establish among themselves a common market and also to create a customs union in respect of their territories. The treaty entered into force on June 4, 1961 (Guatemala, El

(CARICOM),⁸ the Andean Community,⁹ the Common Market of the South (MERCOSUR),¹⁰ the South American Community of Nations (launched this past year),¹¹ and the Latin American Integration Association (LAIA).¹² This type also embraces North-South regional agreements such as the North American Free Trade Area (NAFTA).¹³ Equally, it takes into consideration a U.S.-Central America agreement (CAFTA, which narrowly passed the U.S. Congress in late 2005),¹⁴ bilateral preferential trade agreements (PTAs) such as the U.S.-Chile PTA,¹⁵ and the U.S.-some Andean Countries PTA (currently under negotia-

Salvador, and Nicaragua); on April 27, 1962 (Honduras), and on September 23, 1963 (Costa Rica).

8. Treaty Establishing the Caribbean Community, July 4, 1973, 946 U.N.T.S. 17, 12 I.L.M. 1033. CARICOM was signed on July 4, 1973 and entered into force on August 3, 1973. The protocol amending the treaty signed at Chaguaramas in 2001 established the Caribbean Community, including the CARICOM single market and economy.
9. Andean Subregional Integration Agreement (Cartagena Agreement), May 26, 1969, 8 I.L.M. 910. The Cartagena Agreement was signed in 1969 setting up the Andean Pact or Pacto Andino. Its original members were Bolivia, Colombia, Ecuador, Peru, Chile (withdrawn in 1976), and Venezuela (joined in 1973). The Protocol of Trujillo (1996) created the Andean Community and the Andean Integration System.
10. Southern Common Market (MERCOSUR) Agreement, Mar. 26, 1991, 301 I.L.M. 1041. Argentina and Brazil agreed on setting up an Integration and Economic Co-Operation Program in 1986 under LAIA's framework, which was enhanced by establishing the goal of a common market in 1988. It led to the creation of MERCOSUR, when Paraguay and Uruguay joined in 1991.
11. South American Community of Nations, Dec. 8, 2004, *available at* <http://www.comunidadandina.org/ingles/sudamerican.htm>. On December 8, 2004, Argentina, Brazil, Paraguay, Uruguay, member countries of MERCOSUR, Colombia, Ecuador, Venezuela, Peru, Bolivia, member countries of the Andean Community, Chile, Guyana, Suriname, and Panama, in the Third South American Summit held in Cuzco Peru, launched the South American Community of Nations as a political endeavour. This community will gradually be established through the convergence created by the Economic Complementation Agreement No. 59, signed by Argentina, Brazil, Paraguay, Uruguay, member countries of the MERCOSUR, Colombia, Ecuador, Venezuela, member countries of the Andean Community, (Bolivia and Peru had already adhered to MERCOSUR) and the commitments of Chile, Guyana, Suriname, and Panama.
12. Treaty of Montevideo Establishing the Latin American Integration Association, Aug. 12, 1980, 20 I.L.M. 672. The Montevideo Treaty 1980 established LAIA. It is actually made up of twelve countries as follows: Bolivia, Ecuador, Paraguay, Uruguay, Cuba, Chile, Colombia, Peru, Uruguay, Venezuela, Argentina, Brazil, and Mexico.
13. There are bilateral or multilateral treaties signed in the regions that follow the model of NAFTA, signed by Canada, Mexico, and the United States, that took effect on January 1, 1994. The G-3 Accord and the bilateral PTAs signed between the United States and Chile and the United States and Central American countries are examples of these NAFTA-like agreements. The proposed FTA is also influenced by NAFTA but goes beyond NAFTA in certain respects.
14. Stephen Norton, USTR Spokesman, Statement Regarding CAFTA-DR Implementation, (Dec. 30, 2005) (signed CAFTA-DR on Aug. 5, 2004 but has not been entered into force at the time of writing), *available at* <http://www.ustr.gov>.
15. United States-Chile Free Trade Agreement, U.S.-Chile, June 6, 2003, State Dep. No. 04-35, 2003 WL 23856180, *available at* http://www.ustr.gov/assets/Trade_Agreements/Bilateral/Chile_FTA/Final_Texts/Section_Index.html (signed on June 6, 2003 and entered into force January 1, 2004).

tions),¹⁶ and numerous other bilateral agreements signed under LAIA's framework.¹⁷ This approach also takes into consideration three lateral PTAs such as the G-3 Accord.¹⁸ But all these schemes differ in their methodologies and the scope of their commitments. Further, while these varying treaty approaches most likely will continue within parts of the hemisphere to varying degrees, not all of them comprehensively embrace banking and financial services and not all of them have been implemented consistently. More significantly, there is no coordination among this spaghetti bowl of Western Hemispheric trade treaties.¹⁹

A third integration form promotes economic and financial integration through the unilateral openness of the capital account, by liberalization of rules of entry to foreign banks, and by adoption of soft law international standards in the banking and financial services area. As a consequence of the economic crises of the 1980s and 1990s, Central and South American countries carried out individual domestic structural reforms to that end. They often were implemented under the guidance and monitoring of multilateral international institutions (e.g., the International Monetary Fund (IMF), World Bank, and Inter-American Development Bank (IADB)), whose mandates were evolving towards these kinds of roles within the international financial arena. The adoption, implementation, and compliance of certain economic policies prescribed as the solution to the underlying structural failures of the developing countries of the region was under way. In turn, this environment has promoted a *de facto* financial integration through the allowed activities of banks, mainly from the United States but also Spanish banks, acting internationally and multinationally in the region.

This chapter addresses this third form of economic integration as the prevailing form that is presently maintaining some positive level of momentum as to economic and financial services during the period of political divisiveness that currently appears to be impeding the furtherance of both multilateral (WTO) and Western Hemispheric free-trade initiatives (FTAA). Section II of this chapter considers two external catalysts to this

16. For an analysis of the process towards this PTA in the Andean sub-region, see Mauricio Baquero-Herrera, *The Andean Community: Finding Her Feet Within Changing and Challenging Multidimensional Conditions*, 10 *LAW. & BUS. REV. AM.* 577 (2004).

17. For an analysis of the consequences of the regional or partial scope agreements under LAIA's framework, see Mauricio Baquero-Herrera, *A Decade of Open Regionalism in Latin America: The Need for Effective and Efficient Articulation, Coordination, Cooperation and Convergence*, in *MULTILATERALISM v UNILATERALISM: POLICY CHOICES IN A GLOBAL SOCIETY* 257 (J.B. Attanasio & J.J. Norton eds., 2004).

18. Treaty on Free Trade Between the Republic of Columbia, the Republic of Venezuela, and the United Mexican States, June 13, 1994, available at <http://www.sice.oas.org/TRADE/GO3/g3c14s1.asp>. The group of three is the member states of a Treaty on Free Trade between the Republic of Colombia, the Republic of Venezuela, and the United Mexican States. It was signed in September 1990 and entered into force in January 1, 1995.

19. This phrase was dubbed over a decade ago by Bhagwati and has since been translated into a graphically complex, but highly depictive chart by the IADB.

third trade mode: the internationalization of U.S. and Canadian banks and the pervasiveness of evolving international banking and financial standards. Section III then analyzes this de facto integration process within the various Latin American and Caribbean nations. In the concluding section IV, an attempt is made to draw some relevant concluding observations.

II. TWO EXTERNAL CATALYSTS FOR THE DE FACTO LATIN AMERICAN FINANCIAL SERVICES INTEGRATION: THE INTERNATIONALIZATION OF THE U.S. AND CANADIAN BANKING INDUSTRIES AND THE PERVASIVENESS OF INTERNATIONAL STANDARDS

The de facto banking and financial services integration occurring in Latin America results, in part, from several major external catalysts: the internationalization of U.S. and Canadian banking institutions, the global pervasiveness of international standards in the financial services area, and the aggressive Latin American business strategy of the major Spanish banks. This section addresses only the first two external factors.

A. THE U.S. AND CANADIAN BANKING INDUSTRIES

Financial integration among the two developed countries in the FTAA area, the United States and Canada, has been primarily carried out through the international and multi-national activities of domestic and, nowadays, truly global banking institutions based in these countries. This has not only led to an internationalization of financial services within these countries themselves but has provided a launching pad for the cross-border financial services penetration of many Latin American countries.

The Canadian Bankers Association reports that the Canadian banking industry now encompasses nineteen domestic banks, twenty-nine foreign bank subsidiaries, and twenty-one foreign bank branches.²⁰ But none of these international banks acting through a subsidiary or a branch in Canada comes from a Latin American or Caribbean country. According to Christian Calmès of the Bank of Canada, corporate bonds and equity have been the means that a great proportion of financing has been carried out in Canada.²¹ Canadian firms issue a substantial share of their bonds in the U.S. bond market, and an increasing share of their stocks in the U.S. stock market.²²

Based on information released by the U.S. Federal Reserve Board as of December 31, 2004, six Canadian banks are present in the U.S. financial

20. See Canadian Bankers Association, *Banks in Canada*, <http://www.cba.ca/en/section.asp?fl=2&sl=204&tl=&docid=> (last visited Dec. 19, 2005).

21. Christian Calmès, *Regulatory Changes and Financial Structure: The Case of Canada* (Bank of Can., Working Paper 2004-26, 2004), available at <http://www.bankofcanada.ca/en/res/wp/2004/wp04-26.pdf>.

22. *Id.*

markets by way of fifty-eight offices, mainly through thirty-five U.S. commercial banks majority owned by Canadian banks, twelve branches, six representative offices, and five agencies.²³ The country total of U.S. domestic assets is about \$168,291,000.²⁴ In contrast, the Latin American and Caribbean participation in the U.S. market shows that only fourteen out of the thirty-five independent countries that comprise the FTAA area have a presence in the U.S. banking market, mainly by means of branches of twenty-seven different banks.²⁵ Those banks have only thirty-seven offices: nineteen are branches, eight are representative offices, eight are agencies, one is a U.S. commercial bank majority owned by an Ecuadorian bank, and one is a U.S. office of banking edge or agreement corporation majority owned by a Colombian Bank.²⁶ Their total assets in the U.S. amount to \$9,507,000 (about seventeen times less than the Canadian banks).²⁷ At the same time, as a result of the severe Latin American banking crises and the policies implemented during the 1990s, foreign banks, mainly from Spain and the United States, control majority shares in nearly all of the Latin American financial systems, with the important exceptions of Brazil and Colombia.²⁸

In 2001, a report by Salomon Smith Barney on the foreign financial institutions in Latin America found that foreign institutions controlled 47 percent of loans and 43 percent of deposits in the seven major economies of Latin America (Argentina, Brazil, Chile, Colombia, Mexico Peru, and Venezuela).²⁹ At the time, Mexico scored as the country with the largest portion of foreign control and Citibank was the largest foreign institution by economic participation in the total of the region.

The participation of banks acting internationally (without having a commercial presence in any other jurisdiction through a subsidiary, branch, or representation office) or acting multi-nationally (maintaining a commercial presence) in other financial systems has created a web of complex economic and legal relationships that have increased the risk of contagion among the participant institutions and economies. Different episodes of international financial crises spreading from one country to another brought about the need for establishing and implementing international standards of banking supervision. At the beginning, these efforts were aimed at determining the responsibilities among regulators, supervisors, and central banks related to banks of developed financial

23. Federal Reserve Board, *Structured Data For U.S. Offices of Foreign Banks By Country of Foreign Bank*, (Sept. 2005).

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. Jennifer S. Crystal et al., *Has Foreign Bank Entry Led to Sounder Banks in Latin America?*, 8 *CURRENT ISSUES IN ECON. & FIN.* 1, (2002) (Federal Reserve Bank of New York), available at http://www.newyorkfed.org/research/current_issues/ci8-1.pdf.

29. See *Foreign Financial Institutions in Latin America: 2001 Update*, SALOMON-SMITHBARNEY (2001), available at <http://www.superbancaria.gov.co/English/Bancosfondospension esenla.pdf>.

systems acting international and multi-nationally. But these standards have evolved, focusing more on the activities of such banks and the determination and adequate management of all risks involved in the provision of banking and financial services as well as on the new complexities created by the domestic and global activities of the financial conglomerates.

In addition, due to the activities of global banks acting in developing countries with higher levels of macroeconomic and financial instability and the heavy losses some of them have had to bear as a consequence of having such a presence, a strategy for the formulation, adoption, and implementation of sound principles and practices to strengthen financial systems was launched in 1997.³⁰ It has been implemented throughout developing financial systems under the guise of fostering international financial stability. In fact, the core goal of preserving international financial stability has changed the functions of multilateral institutions such as the IMF and the World Bank and has produced a set of standard-setters composing the so-called international financial architecture. The more sophisticated the financial activities have become the more complexity that is required in the international standards. The recent Basel II Capital Accord is an example of this. This proliferation of international standards in the financial services area has not only permeated the developed countries but also most of the Latin American and Caribbean developing countries.

B. THE INTERNATIONAL STANDARDS FACTOR

This permeation of international standards within the Latin countries has occurred though domestic financial infrastructure reforms generated unilaterally through International Financial Institutions (IFI) conditionality and through the influence of the international banks themselves.

The above chart sets out the main standard-setters at the international level. Step-by-step core areas of banking and financial activities have been covered by the work of informal international arrangements or international financial/economic institutions. The consistent and coherent work of the Basel Committee and its method of using soft law as a means for stating its principles and codes of conduct and good practices has served as a starting model for other institutions and arrangements. But other standard-setters may not achieve the consistency gained by a group of experienced central bankers, regulators, and supervisors of a reduced but powerful group of developed countries that comprise and finally influence the decisions of the Basel Committee.³¹

30. See FINANCIAL STABILITY IN EMERGING MARKET ECONOMIES: A STRATEGY FOR THE FORMULATION, ADOPTION AND IMPLEMENTATION OF SOUND PRINCIPLES AND PRACTICES TO STRENGTHEN FINANCIAL SYSTEMS, REPORT OF THE WORKING PARTY ON FINANCIAL STABILITY IN EMERGING MARKET ECONOMIES (Apr. 1997), available at <http://www.bis.org/publ/gten02.pdf>.

31. See JOSEPH JUDE NORTON, DEVISING INTERNATIONAL BANK SUPERVISORY STANDARDS (Graham & Trotman/Martines Nijhoff 1995); see also *About the Basel Com-*

Chart: The main standards and standard-setters at the international level.

The Basel Committee on Banking Supervision (BASEL)	<i>Banking Supervision</i>
International Organisation of Securities Commissions (IOSCO)	<i>Securities</i>
The Committee on Payment and Settlement Systems	<i>Payment Systems</i>
The International Association of Insurance Supervisors (IAIS)	<i>Insurance Supervision</i>
Financial Stability Forum (FSF)	<i>Financial Conglomerates</i>
World Bank	<i>Insolvency</i>
IMF	<i>Macroeconomic Policies</i>
International Accounting Standards Board (IASC)	<i>Accounting Standards</i>
International Auditing and Assurance Standards Board	<i>Auditing</i>
Organization for Economic Co-operation and Development (OECD)	<i>Principles of Corporate Governance</i>
Financial Action Task Force	<i>Market Integrity</i>

The organizational structures and cultures present in each one of these arrangements and institutions acting as standard-setters may determine their final product. For instance, in some cases the IMF and the World Bank have had contrasting views as to issues related to economic policies and their implementation. IOSCO has a different structure and membership (108 ordinary members), as well as IAIS (insurance supervisory authorities of some 180 jurisdictions), as compared to the Basel Committee (thirteen country members), which may require higher levels of consensus in these broader based arrangements and, therefore, may deliver decisions with a greater degree of generality.³²

The Financial Stability Forum (FSF) was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance.

mittee, BANK FOR INTERNATIONAL SETTLEMENTS, <http://www.bis.org/bcbs/index.htm>.

32. See IOSCO, <http://www.iosco.org> & Internacional Association of Insurance Supervisors, <http://www.iais.web.org>. See generally IMF, <http://www.imf.org> & World Bank, <http://www.worldbank.org>.

The Forum brings together on a regular basis national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSF seeks to co-ordinate the efforts of these various bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk.³³

Representatives mainly from developed countries and international bodies and institutions with diverse mandates that regulate, supervise, or oversee the domestic and international activities of conglomerates dealing with contracts of different nature and dissimilar levels of risks require a significant amount of coordination, cooperation, understanding, and ability to negotiate. Furthermore, reaching consensus on the minimum standards does not mean that financial stability will be reached instantly or ever, especially in developing countries. All these general standards have to face the mediation of their local implementation and enforcement and the continuing test of financial stress and crisis at domestic and international levels.

All these considerations led to crucial questions raised during recent years. Who sets the international financial standards? Who implements and interprets these rules? Who enforces the rules? Who adjudicates disputes? All these questions are related to the legal nature of the standards, to the missing link between those standard-setters and democratic institutions and representation, to the ability of domestic regulators and supervisors to understand the purpose of each one of the standard-setters and the scope of all the standards available, to their capability of implementing them thoroughly, to their capacity of adequate monitoring and enforcing such regulation, and to the aptitude of the local law-makers and judiciary to properly understand the context of this global effort.³⁴ Are they prepared to deliver proper regulation and decisions coherent with the purpose of financial stability?³⁵

The so-called New International Financial Architecture (NIFA) is a set of different international bodies whose mandates, jurisdictions, and powers are unclear. It is composed of: multilateral agencies (IMF, the World Bank, the Bank for International Settlements (BIS), OECD), policy formulation groups (G7/8, G10, G22, but primarily the G7/8), and international regulatory and standard setting authorities (BASEL, IAIS, IOSCO, IASC, IFI, FSF)³⁶ that are composed of senior representatives of

33. See generally Financial Stability Forum, <http://www.fsforum.org/home/home.html> (last updated Mar. 30, 2006).

34. See Stijn Claessens, Regulatory Reform and Trade Liberalization in Financial Services, Paper Presented at the Joint OECD-World Bank Conference on Regulatory Reform and Trade Liberalization in Services in Paris (Mar. 4-5, 2002), available at <http://www1.fee.uva.nl/fm/PAPERS/Claessens/reform.pdf>.

35. Andrew Sheng, *The New International Architecture: Is There a Workable Solution?*, in *A NEW INTERNATIONAL FINANCIAL ARCHITECTURE: A VIABLE APPROACH* 35 (J.B. Atanasio & J.J. Norton eds., 2001).

36. *Id.*

national financial authorities (central banks, supervisory authorities, and treasury departments), international financial institutions, international regulatory and supervisory groupings, and committees of central bank experts. This side of the NIFA has the purpose of imposing minimum internationally accepted supervisory standards and practices for emerging and transitioning economies.

Furthermore, NIFA has another side that is indeed marching towards a new evolving governance structure, reflecting a public-private partnership among governments, banking authorities, international financial institutions, and international commercial banking institutions, in the search for grounding a stable but viable financial environment. But this side is not available to all. A small class of elite global banking institutions, which possess far greater expertise and resources to manage risk exposures using sophisticated risk measurement and aggregation methodologies that greatly exceed the sophistication of other banks and banking authorities, are separating regulation and supervision towards a more functional self-regulatory framework.³⁷

"This 'risk-based supervision' framework essentially redirects responsibility and accountability for the design, development and implementation of risk management and internal control processes to the elite banks themselves, subject to purported oversight of and imposition of general parameters and standards set forth by the authorities."³⁸ This is the case of the new Basel II Capital Accord finally released last year.

C. THE SOFT LAW FACTOR: A SUBSTITUTE FOR A FORMAL TREATY FRAMEWORK?

Soft laws have been defined as "statements prepared by individuals in a nongovernmental capacity, but which purport to lay down international principles"³⁹ These statements are legally non-binding instruments, recommendations, and codes of good practices issued by experts that are not democratically elected. "The use of the non-legal form is dictated by lack of formal law-making capacity and the impact of a non-binding text depends upon the political and economic interests of the relevant players."⁴⁰

The setting up of international standards in the form of soft law has raised controversial issues. Following Philip Turner of BIS, the first issue is the number of standards that are a result of a decentralized process

37. Joseph J. Norton, *A 'New International Financial Architecture?': Reflections on the Possible Law-based Dimension*, in *A NEW INTERNATIONAL FINANCIAL ARCHITECTURE: A VIABLE APPROACH* 135, 175-178 (J.B. Attanasio & J.J. Norton eds., 2001) [hereinafter Norton].

38. *Id.* at 176.

39. C. M. Chinkin, *The Challenge of Soft Law: Development and Change in International Law*, 38 *INTL. & COMP. L.Q.* 850, 851 (1989).

40. Christine Chinkin, *Normative Development in the International Legal System*, in *COMMITMENT AND COMPLIANCE: THE ROLE OF NON-BINDING NORMS IN THE INTERNATIONAL LEGAL SYSTEM* 21, 29 (Dinah Shelton ed., 2000).

with no mechanism for setting priorities.⁴¹ Because each standard-setter believes its standards are of prime importance, there is a risk that the most important or urgent standards could be ignored.⁴² The second issue is the membership of standard-setting bodies.⁴³ Even though the Basel Committee has proven that one small group may be effective enough, the resulting exclusion of others in the membership is indeed a polemic matter.⁴⁴ It has lead to the establishment of consultative mechanisms, bringing together countries left out and the private sector.⁴⁵ The third issue is whether standards should be differentiated or standardized.⁴⁶ Countries with different levels of development may need different standards. But the standards should be general so they can be applicable to all. At the same time, the standard-setters issue detailed guidelines that can be applied in different ways to adapt to individual circumstances.⁴⁷

A further question is related to the implementation of these set of instruments, recommendations, and codes. To those participants in their establishment, there is no other mechanism to enforce their implementation but a kind of gentlemen agreement among their setters. To the rest, especially developing countries, the IMF conditionality has proven to be an effective method.

Following Dr. Y. V. Reddy's, Deputy Governor of the Reserve Bank of India, classification, there are some standards that are purely technical (i.e., accounting, auditing, and supervision).⁴⁸ In this sense, the lack of democratic grounds may not be a fundamental issue as no one considers leaving decisions of prudential regulation or specific accounting or auditing matters in the hands of politicized members of a country's legislature.⁴⁹

There are other standards related to monetary and financial policies, fiscal transparency, and securities regulation that have certain policy implications. In this sense, as Reddy points out, they would form an integral part of the economic reform process in many developing countries.⁵⁰ The implementation of such policies may "depend on timing, sequencing and complementarity in related areas and availability of institutional, techno-

41. Philip Turner, Bank for International Settlements, Development and the International Financial Architecture, Presented at the Overseas Development Institute Meeting Series on Financing for Development (Apr. 11, 2001), *available at* <http://www.odi.org.uk/speeches/schneider7a.html>.

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. Y.V. Reddy, Deputy Governor of the Reserve Bank of India, Legal Aspects of International Financial Standards - National Law Perspective, Presented at the International Seminar on Legal and Regulatory Aspects of Financial Stability Sponsored by the World Bank, IMF, the Bank for International Settlements and the Financial Stability Forum at BIS, Switzerland (Jan, 23, 2002), *available at* <http://www.bis.org/review/r020215d.pdf>.

49. *Id.*

50. *Id.*

logical and legal infrastructure.”⁵¹ When the reforms do not take into account these factors, they may not deliver the expected results leading to an extremely severe social cost. These reforms, shaped through standards implemented by way of IMF conditionality, have proven to be controversial if they do not deliver their economic promises, resulting in international standard-setters being involved in problems of accountability, social unrest, and political unrest.

Finally, Reddy suggests that standards “in the areas of corporate governance, insurance and to a certain extent, insolvency and bankruptcy practices take a socio-cultural dimension and pose challenges of design, adoption and implementation.”⁵²

The increasing establishment of PTAs that contain chapters or clauses related to the provision of banking and financial services is intersecting NIFA’s world. Even though PTAs do not include clauses related to prudential regulation, as in the cases of NAFTA-like agreements, some provisions require for the countries involved to fulfil certain minimum standards or conditions that become hard law as a result of being contained in the treaty.

For instance, articles 1410 of NAFTA and 12.10 of the U.S.-Chile PTA regulate the exceptions to the rules concerning trade in financial services. Both articles, with some differences, allow the parties to adopt or maintain reasonable measures for prudential reasons, such as: (a) the protection of investors, depositors, financial market participants, policyholders, policy claimants, or persons to whom a fiduciary duty is owed by a financial institution or cross-border financial service provider; (b) the maintenance of the safety, soundness, integrity, or financial responsibility of financial institutions or cross-border financial service providers; and (c) ensuring the integrity and stability of a party’s financial system. Equally, the provisions allow the parties to prevent or limit transfers by a financial institution or cross-border financial services provider to, or for the benefit of, an affiliate of or person related to such institution or provider, through the equitable, non-discriminatory, and good faith application of measures relating to maintenance of the safety, soundness, integrity, or financial responsibility of financial institutions or cross-border financial service providers.

The U.S.-Chile PTA defines the term prudential reasons as the maintenance of the safety, soundness, integrity, or financial responsibility of individual financial institutions or cross-border financial service suppliers. It also establishes that such measures must not be used as a means of avoiding the party’s commitments or obligations under the general provisions of the treaty.⁵³

51. *Id.*

52. *Id.*

53. See United States-Chile Free Trade Agreement, *supra* note 15, art. 12.09, art. 12.10 & related Annexes.

Certainly, the existence of international standards of banking supervision is an important step to clarify the broad meaning of the concept prudential reasons. But in cases of disputes between members, the mechanism to resolve such controversy involves not the standard-setter and its group of senior central bankers, nor the regulators and supervisors that implement them domestically, but a group of arbitrators from different countries and cultures. As the group of standard-setters usually comes from public entities, doubts concerning their capability to become international arbitrators still remain.

III. THE LATIN AMERICAN AND CARIBBEAN COUNTRIES AND THE DE FACTO INTEGRATION PROCESS

This Section considers the de facto financial integration consequences of the unilateral openness of Latin American economies as well as the financial reforms carried out during the 1990s. Structural reforms were implemented with the aim of gaining macroeconomic stability in the region. The opening of the capital account by the Latin American countries was another policy adopted with the purpose of attracting foreign direct investment. At the same time, financial regulation and supervision have been strengthened through the local implementation of international standards of banking supervision. Such decisions have fostered a significant commercial presence of foreign banking institutions of non-member countries in Latin America and the Caribbean.

A. FINANCIAL SECTOR INFRASTRUCTURAL REFORMS: DOMESTIC MACRO-ECONOMIC INSTABILITY, IFI REFORMS, AND DOMESTIC INITIATIVES

In Latin America and the Caribbean region, the provision of banking and financial services at a domestic level has been affected by turbulent macroeconomic environments involving volatile terms of trade and real exchange rates. The whole region has had a long history of macroeconomic instability that has been the result, in part, of unstable fiscal and monetary policies and the adoption of unsustainable exchange rate regimes.⁵⁴ In most Latin American countries, these circumstances have been a critical factor restraining financial system development.⁵⁵

As a consequence of the external debt crisis of the 1980s and the strategies adopted to bring economic stability to the region, there was political will to implement structural reforms through out Latin America. International financial institutions, such as the IMF and the World Bank, began

54. See SHAHID JAVED BURKI & GUILLEMO E. PERRY, *THE LONG MARCH: A REFORM AGENDA FOR LATIN AMERICA AND THE CARIBBEAN IN THE NEXT DECADE* (The World Bank 1997).

55. Anoop Singh et al., *Stabilization and Reform in Latin America: A Macroeconomic Perspective on the Experience Since the Early 1990s*, IMF OCCASIONAL PAPER 238, ch. VII (Feb. 2005), available at <http://www.imf.org/external/pubs/ft/op/238/index.htm> [hereinafter IMF 2005].

to play a supervisory role by conditioning their loans upon economic policy reform of the debtors.

The IMF reform programs put into practice in Latin America focused on policies aimed at gaining macroeconomic stability in the region. Among others, the following should be underlined: reduction in the budget deficit to limit inflation, local interest rates, and the need for foreign borrowing; limits on domestic credit expansion to control inflation; exchange rate devaluations to discourage imports and encourage exports; and limits on borrowing consistent with the debtor's capacity to pay.⁵⁶ Apart from reducing the size and role of local governments, IMF structural adjustments were also focused on curtailing protectionism as opposed to the Washington Consensus,⁵⁷ by which "economic growth is promoted through unilateral tariff cuts and reductions in import restrictions."⁵⁸ These neo-liberal policies, introduced at the domestic level led to the opening of the Latin American markets, which at some point shared the same market-oriented economic policies.

During the 1990s, countries in the region recorded significant advances in the area of macroeconomic stability by implementing structural reforms focused on achieving better allocation of resources.⁵⁹ Certainly, the disastrous macroeconomic phenomenon of hyperinflation evidenced in the 1980s as well as the practice of using monetary expansion to finance public expenditure and fiscal deficit have almost disappeared or have been heavily reduced in the region. In addition, budget balances, fiscal savings, and the quantum and diversification of exports have improved considerably. Privatizations have also been massively conducted throughout Latin America.⁶⁰

In the financial sector, emphasis was made on improving legal frameworks, capital account opening, and on the implementation of the international standards of banking supervision developed during the last decade by the BASEL. Financial reforms in the 1990s generated significant transformations and developments in the banking sector in the region.⁶¹ Considerable reduction in public owned banks, decline in the numbers and increasing consolidation of the banking operators,⁶² by

56. Other structural adjustments included: 1) higher income and sales taxes, 2) higher charges for state-produced goods and services such as electricity and water, 3) privatization of state-owned companies, and 4) deregulation of the labour market. See ROSS P. BUCKLEY, *EMERGING MARKETS DEBT: AN ANALYSIS OF THE SECONDARY MARKET* 32 (Kluwer Law 1999).

57. John Williamson, *What Should the World Bank Think About the Washington Consensus?*, 15 *WORLD BANK RES. OBSERVER* 251 (2000).

58. See BUCKLEY, *supra* note 56, at 32.

59. See IMF 2005, *supra* note 55.

60. See RICARDO FRENCH-DAVIS, *REFORMING THE REFORMS IN LATIN AMERICA: MACROECONOMICS, TRADE, FINANCE* (2000).

61. See *REFORM OF LATIN AMERICAN BANKING SYSTEMS*, (Ernesto Aguirre & Joseph Norton eds., 2000); see also Ernesto Livacic & Sebastián Sáez, *La Agenda de la Supervisión Bancaria en América Latina*, 74 *REVISTA DE LA CEPAL* 125 (2001).

62. See Ignacio S. Palacios, Presidente, *La Consolidación de la Banca Latinoamericana*, Presentation at FELABAN: Federación Latinoamericana de Bancos (2003),

means of mergers and acquisitions, as well as, an important share in the participation of the foreign banks in the domestic banking sectors were significant consequences of such reforms. Additionally, the structure and market mechanisms were improved by enhancing the scope of authorized operations to be performed domestically by the banks, including financial operations such as factoring and leasing. Equally, banks were allowed to participate in securities related operations and insurance commercialization. Such transformations were conducted through deregulation or the reduction of state intervention in the markets by basically procuring the elimination of interest rates controls, mandatory reserves, limits to international transactions, and rules on providing credits to specific sectors.⁶³

In this sense, these processes of financial liberalization, privatization, and implementation of market-based reforms were some of the causes of the surge of financial sector foreign direct investment not only to Latin America but to all emerging economies in the 1990s.⁶⁴ But the mid and late 1990s witnessed the Tequila crisis of 1994 ("the first time that Latin America experienced an important impact generated by financial globalization"),⁶⁵ the trans-nationalization of finance, the tele-information revolution, the Asian (1997) and Russian (1998) crises, and the Brazil and Argentinean crises (starting in 1999).⁶⁶

The evidence found by the IADB in 1997 suggested that countries in the region that implemented deeper structural reforms experienced greater reductions in macroeconomic volatility.⁶⁷ But such "volatility during the 1990s was very high by international standards and their own historical standards in several major countries, including Argentina, Mexico, and Peru, all major reformers."⁶⁸ The World Bank, concerning Latin America and the Caribbean region, concludes that macroeconomic instability is the third most-reported constraint to private investment, preceded by policy uncertainty and corruption.⁶⁹

In February 2005, the managing director of the IMF, pointing to the challenges and opportunities of Latin America in the macroeconomic front, considered that policymakers in the region still need to keep their

available at <http://www.asobanca.com.ve/data/archivos/200201/Consolidaci%F3nBancaLatinoamericanaFINAL.ppt>.

63. See Livacic & Sáez, *supra* note 61, at 126-130.

64. COMMITTEE ON THE GLOBAL FINANCIAL SYSTEM, FOREIGN DIRECT INVESTMENT IN THE FINANCIAL SECTOR OF EMERGING MARKET ECONOMIES, (Bank for International Settlements 2004), available at <http://www.bis.org/publ/cgts22.pdf>.

65. Juan F. Rojas Penso, General Secretary of the Latin American Integration Association, Address Delivered at the Panel Latin American and Caribbean Options in Light of the International Financial Crisis: The Effects of the Crisis on Integration, (Oct. 2, 1999).

66. *Id.*

67. Michael Gavin, *A Decade of Reform in Latin America: Has It Delivered Lower Volatility?* 1 & 15 (IADB, Working Paper Green Series No. 349, 2003), available at <http://www.iadb.org/res/publications/pubfiles/pobWP-349.pdf>.

68. *Id.*

69. See generally WORLD BANK, WORLD DEVELOPMENT REPORT 2005: A BETTER INVESTMENT CLIMATE FOR EVERYONE (Oxford University Press 2004).

eyes on the following: 1) maintaining appropriate public debt levels, as a reduction in debt levels would ease existing vulnerabilities and increase the scope for flexible fiscal responses to macroeconomic shocks; 2) balancing spending and capital investment, cutting on spending in nonessential areas, and increasing investments in infrastructure, health, and education; and 3) keeping inflation in check.⁷⁰ The prime objective of monetary policy should be to lock in and strengthen the substantial progress made in the last ten years in the region.⁷¹

Overall, as a result of the implementation of structural reforms and economic stabilization policies, Latin America is a less volatile region.⁷² Such achievement would have not been reached without political will. Certainly, as the President of the IADB evidenced in 2002, there is "genuine political will in the region to deepen interdependence and reduce volatility."⁷³ Such certainty led him to propose and conduct the bank towards introducing programs of macroeconomic cooperation in the region.⁷⁴

B. THE LATIN AMERICAN FINANCIAL SYSTEMS IN CONTEXT

Although the Latin American Financial Systems are not homogeneous, there are certain common features present in the overall activities of the banks in the region.⁷⁵ Traditional commercial banking operations have been their main focus, whereas the securities market is still poorly developed, mostly small and illiquid. The private sector use of bond and equity markets to raise finance remains limited in relation to its recourse to banks. Financing from securities markets is usually available to only a limited range of top quality corporate borrowers.⁷⁶

The banks' lending activities are also not that significant. When referring to the size of the region's credit markets, the IADB concludes that it is shockingly small when compared with developed countries.⁷⁷ The state has traditionally played a major role in the financial sector by specializing public-sector financing institutions in long-term funding. Despite the im-

70. Rodrigo De Rato, Managing Director of IMF, Remarks at Canning House: Latin America in the Global Economy—Challenges and Opportunities (Feb. 4, 2005), available at <http://www.imf.org/external/np/speeches/2005/020405.htm>.

71. *Id.*

72. See Gavin, *supra* note 67. See also Ben S. Bernanke, Member of the Board of Governors of the U.S. Federal Reserve System, Inflation in Latin America - A New Era?, Speech at the Stanford Institute for Economic Policy Research Economic Summit, Stanford, California (Feb. 11, 2005), available at <http://www.bis.org/review/r050216g.pdf>.

73. Enrique V. Iglesias, Former IDB President, Speech in Washington, D.C.: Is Macroeconomic Coordination Desirable and Possible in Latin America? (Sep. 26, 2002).

74. *Id.*

75. See Graciela Mognillansky et al., *Foreign Banks in Latin America: A Paradoxical Result*, CEPAL REVIEW No. 82 (2004).

76. See IMF 2005, *supra* note 55.

77. UNLOCKING CREDIT: THE QUEST FOR DEEP AND STABLE BANK LENDING (IADB 2005), available at <http://www.iadb.org/res/ipres/2005/index.cfm> (last visited July 18, 2005) [hereinafter UNLOCKING].

portant presence of foreign banks, the largest institutions remain in government hands, as was the case in Brazil and Argentina in 2000.⁷⁸

The region's banking systems are shallow and the scope of their activities is very narrow. It can be explained, on the one hand, by the fact that Latin American banks operate within an environment of structural factors that increase a bank's aversion to lending.⁷⁹ The repeated financial crises during the 1990s led to a lack of adequate information on potential borrowers: the long time bank customers disappeared and the new ones did not have long credit histories, did not present sound business plans, or did not have good collateral. In addition, inadequate auditing and accounting standards and practices affect banks' ability to monitor both financial and non-financial companies.

On the other hand, there is an inefficient judiciary that undermines the legal certainties needed to foster financial intermediation. The Latin American domestic legal frameworks do not consistently support enforceability of creditor's rights, and the insolvency laws in the region do not protect financial creditors efficiently. All Latin American countries, and some in the Caribbean, are civil law based. In this sense, La Porta, Lopez-de-Silanes, Shleifer, and Vishny, in different papers, have professed that common law countries generally display the strongest protection to creditors, whereas French civil law countries have the weakest legal protections of investors.⁸⁰ German and Scandinavian civil law countries are located in the middle. As López-de-Silanes suggests, there is a growing consensus that reforming the legal infrastructure supporting business should be an important component of reforms in many developing countries.⁸¹ But there are still many forces reluctant to changes, and there is little agreement about what constitutes feasible legal reforms.

As for Latin American banks' profitability, returns on assets and equity remain below those in industrial countries, despite having high interest margins on private lending. The weak profitability performance of Latin American banks "reflects a continued reliance on interest earnings, both from lending and from large holdings of government bonds as the main source of revenue."⁸² These banks have not found other sources of income, such as commissions from asset management and fees from securities trading, as in most of Latin America these lines of business remain limited.

Cost inefficiencies are another source of reduced profitability. Banks' operating costs remain high, amounting to more than 90 percent of oper-

78. See IMF 2005, *supra* note 55.

79. *Id.*

80. See La Porta et al., *Law and Finance* (Harv. Inst. Econ. Res., Working Papers 1768, 1996), available at <http://post.economics.harvard.edu/faculty/shleifer/papers/lawandfinance.pdf>.

81. Florencio Lopez-de-Silanes, *NAFTA and Mexico's Reforms on Investor Protection*, YALE U. AND NBER, (June, 2002), available at <http://www.sice.oas.org/geograph/north/silanes.pdf>.

82. See IMF 2005, *supra* note 55, at 68.

ating income, which is about a third higher than banks in advanced countries. Part of the explanation for higher costs is that banking is labor intensive and labor productivity has been low. The cost of provisioning, nonperforming loans is another burden on banks' costs.⁸³

According to the IADB⁸⁴, in the 1990s the average level of credit to the private sector in the region was only 28 percent of Gross Domestic Product.⁸⁵ This was significantly lower than in other developing regions, such as East Asia and the Pacific (72 percent) and the Middle East and North Africa (43 percent). An explanation of it may be cherry-picking behavior, as many banks can achieve higher profits through commission income and investment in government securities. The consequence of such behavior is the limited access to bank credit; there is low access to credit by micro-enterprises, small rural producers, and the poor, who cannot save and nobody is willing to lend money to them.⁸⁶ In fact, it represents only a fraction of bank assets in the region.

Another feature of the Latin American banking systems is market concentration. Due to the financial crises of the mid and late 1990s, the decrease in the number of banks led to an important increase in bank concentration in Nicaragua, El Salvador, Chile, Guatemala, and Colombia. But Latin America as a whole did not experience an increase in bank concentration as large as that observed in other developing countries.⁸⁷ In this area, there are some findings that are important to take into account. For instance, it appears that in developing countries, consolidation does not improve efficiency. Further, the optimal size of banks operating in developing countries may be smaller than that of banks operating in developed countries.⁸⁸ Also, Levy-Yeyati and Micco, studying Latin American bank performance, found that concentration appears to produce no impact on the level of risk taken by banks.⁸⁹ There is also evidence that a more concentrated banking system may improve access to credit for small firms.⁹⁰ Moreover, it seems that banking system concentration does not necessarily lead to less competition in countries with easier entry and fewer restrictions on bank activity.⁹¹ In addition, it appears that concentrated access to financial markets also contributes to the

83. *Id.*

84. See UNLOCKING, *supra* note 77.

85. *Id.*

86. *Id.*

87. *Id.* at ch. 9.

88. *Id.*

89. See Eduardo Levy-Yeyati & Alejandro Micco, *Concentration and Foreign Penetration in Latin American Banking Sectors: Impact on Competition and Risk* (Universidad Torcuato Di Tella Bus. Sch., Working Papers 5, 2003), available at <http://www.utdt.edu/departamentos/empresarial/cif/pdfs-wp/wpcif-122003>.

90. See UNLOCKING, *supra* note 77.

91. See Stijn Claessens & Luc Laeven, *Competition in the Financial Sector and Growth: A Cross-Country Perspective*, in FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH: EXPLAINING THE LINKS (Charles Goodhart ed., 2003) (forthcoming Nov. 2003), available at <http://www1.fee.uva.nl/fm/PAPERS/Claessens/Competition%20and%20Growth4.pdf>.

highly concentrated pattern of growth that characterizes most of Latin American and Caribbean countries.

In relation to the state ownership of financial institutions, public banks still control a large fraction of banking assets in Latin America. La Porta, Lopez-de-Silanes, and Shleifer found that government ownership of banks is large and pervasive around the world.⁹² Such ownership is particularly significant in countries with low levels of per capita income, underdeveloped financial systems, interventionist and inefficient governments, and poor protection of property rights. Also, government ownership of banks is associated with slower subsequent financial development. Furthermore, government ownership of banks is associated with lower subsequent growth of per capita income, and in particular with lower growth of productivity rather than slower factor accumulation.

According to a recent work by Micco and Panizza,⁹³ cross sectional evidence shows that public banks in Latin America have lower profitability, high levels of overhead costs, and higher levels of nonperforming loans relative to their private banks. In consequence, one of the main aims of the privatization process in developing countries of the region has been to improve the economic efficiency of banking activities. But a dynamic analysis of banks' performance before and after the privatization process conducted by the referred scholars, shows mixed results in terms of privatizations increasing economic efficiency. They conclude that in Latin America, in the last nine years, privatized banks do not appear to have increased systematically their profitability and efficiency.⁹⁴ In the same vein, the IADB has found some new evidence indicating that, at least in the case of Latin America, public banks may play a useful role in reducing credit pro-cyclicality.⁹⁵

A final feature of the market structure that Latin American banks conduct are activities in the dollarization process: Ecuador and El Salvador embraced full dollarization as a political decision; Bolivia and Peru have experienced a market-driven process of currency substitution while some countries such as Brazil, Mexico, Chile, and Colombia have avoided such phenomenon.⁹⁶

It was expected that the presence of foreign banks in the region would help to improve some of the structural deficiencies of the Latin American financial systems briefly described above. The following sub-section analyzes the behavior of foreign banks inquiring on the consequences of their presence and their fulfillment of such expectations.

92. Rafael La Porta et al., *Government Ownership of Banks*, J. FIN (2000), available at http://post.economics.harvard.edu/faculty/shleifer/papers/banks_paper_jof.pdf.

93. Alejandro Micco & Ugo Panizza, *Bank Ownership and Lending Behavior* (IADB Banco Interamericano de Desarrollo Research Department Departamento de Investigación, Working Paper No. 520, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=629382.

94. *Id.*

95. See UNLOCKING, *supra* note 77.

96. But bans on foreign currency deposits or discouraging their use seem to encourage the shifting of financial assets offshore. See IMF 2005, *supra* note 55.

C. THE UNILATERAL OPENNESS AND THE FOREIGN
BANKS' PRESENCE

The unilateral openness of the Latin American banking systems to foreign competitors was based on the conception that their local presence would be essential to improve their efficiency through increased competition as well as to meet the capital needs of domestic banks. Following Sukanya Bose, it is assumed that foreign banks are more efficient than domestic banks in emerging economies due to their ability to introduce best practices and new technologies into the host countries.⁹⁷ In addition, the domestic operations of foreign banks would raise market discipline and increase the efficiency of domestic banks, as well as, financial intermediation, and the supply of credit. Furthermore, foreign banks have a positive effect on the macroeconomic stability of a country in times of domestic economic shocks.⁹⁸

Since the second half of the 1990s, there has been an increasingly strong presence of foreign banks in the region.⁹⁹ The bank restructuring processes of the last decade have led to increased concentration, as more than two-thirds of bank assets are concentrated in the ten largest institutions, which hold about 70 percent of deposits and provide 75 percent of credit.¹⁰⁰ In 2004, Spanish and U.S. banks accounted for about 80 percent of cumulative investments.¹⁰¹ In 2001, the twelve largest foreign institutions accounted for 32 percent of the banking business and controlled around 47 percent of loans and 43 percent of deposits in the seven major economies of Latin America.¹⁰²

In general, there is a consensus on the fact that foreign ownership of foreign banks has strengthened the Latin American financial systems at a microeconomic level, as foreign banks tend to maintain greater asset liquidity and rely less on deposit financing, to show stronger loan growth than private domestic banks, to provision more aggressively against bad loans, and to have higher loan recovery rates.¹⁰³ They also display more efficient overall financial intermediation, maintain higher risk-based capital ratios, and are more willing to tolerate lower returns in the near term

97. See Sukanya Bose, *Banking FDI in Latin America: An Economic Coup*, IDEAS (2005), available at http://www.networkideas.org/focus/mar2005/Banking_FDI.pdf.

98. See Joe Peek & Eric Rosengren, *Collateral Damage: Effects of the Japanese Bank Crisis on Real Activity in the United States*, 90 AMER. ECON. REV. 30 (2000).

99. See Crystal et al., *supra* note 28, at 1-2.

100. See IMF 2005, *supra* note 55. See also Moguillansky et al., *supra* note 75, at 23.

101. For an account of the strategies and activities of the Spanish banks in Latin America, see Mauro F. Guillen & Adrian E. Tschoegl, *At Least the Internationalization of Retail Banking? The Case of the Spanish Banks in Latin America* (Wharton School, Center for Financial Institutions, Working Paper No. 99-41, 1999).

102. See *Foreign Financial Institutions in Latin America: 2001 Update*, *supra* note 29.

103. See Crystal et al., *supra* note 28. See also Ramon Moreno & Agustin Villar, *The Increasing Role of Foreign Bank Entry in Emerging Markets*, BIS Papers No 23 (May 9, 2005), available at <http://www.bis.org/publ/bppdf/bispp23a.pdf>.

aiming at building up longer-term institutional strength.¹⁰⁴

The aggressive expansion of the foreign banks in the region elevated the efficiency of the local banking system. It certainly is a positive outcome. But as some scholars have pointed out, this has not translated into greater macroeconomic effectiveness.¹⁰⁵ It was expected that foreign banks would help improve or mitigate bad credit conditions by enhancing the existing supply, cost, and maturity conditions of financing. Even though lending by domestic affiliates has increasingly displaced direct dollar-denominated lending by the head of offices of international banks,¹⁰⁶ the supply of credit is still very low, as foreign banks are more cautious than domestic banks when extending credit in the region, and their response to crisis is pro-cyclical, intensifying with it the effects of monetary tightening. In addition, the entry of foreign banks has not had a meaningful effect on the cost of capital. Foreign banks seem to be adopting a pragmatic approach, adapting to the features of the Latin American banking markets that register large spreads in the process of banking intermediation, rather than imposing their own dynamic on the determination of capital costs.

The performance of foreign banks in Latin America has also been criticized because their expertise and extra resources might allow them to display cherry picking behavior as well as concentrate their lending on large enterprises, instead of small and medium sized ones.¹⁰⁷ The evidence found by the IADB is still inconclusive regarding the effect of foreign bank presence on lending to small enterprises.¹⁰⁸ Furthermore, Levy-Yeyati and Micco studied the evidence for eight Latin American countries and found that foreign bank penetration appears to have led to less competitive banking sectors.¹⁰⁹

Cardenas, Graf, and O'Dogherty also found evidence that in cases where foreign bank ownership is highly concentrated, decisions taken by foreign banks can inflict economic damage to host economies.¹¹⁰ They refer to the effects of the decisions made by the head office of the Spanish bank Santander as a consequence, among other factors, of the regulation applied by the home country authorities.¹¹¹ Its subsidiary Banco Santa Cruz started restructuring its balance sheet with a really dramatic reduction of credit. This policy was followed by other foreign subsidiar-

104. These observations are based on a study of the behavior of foreign banks in Latin America during the period 1995-2000. See Crystal et al., *supra* note 28.

105. See Moguillansky et al., *supra* note 75.

106. See Moreno & Villar, *supra* note 103.

107. *Id.* at 13. Moreno and Villar justify this behaviour of foreign banks in Latin America by arguing that it reflects the performance of "small foreign banks, which may lack the resources to evaluate small borrowers."

108. See UNLOCKING, *supra* note 77.

109. See Levy-Yeyati & Micco, *supra* note 89.

110. See Juan Cárdenas et al., *Foreign Banks Entry in Emerging Market Economies: A Host Country Perspective* (2004), available at <http://www.bis.org/publ/cgfs22mexico.pdf>.

111. *Id.*

ies, and the overall effect was to worsen the conditions of the already troubled Bolivian economy.

As Crystal, Dages, and Goldberg argue, "[t]he ownership changes in Latin America remain relatively recent, and have taken place during a period when local economic conditions have been difficult while home-country conditions for foreign parent banks have been strong."¹¹² In this sense, although the evidence supports the contribution of foreign banks to sounder and more stable banking systems in the region, these results are not enough to draw concluding statements on the behavior and consequences of foreign banks acting in developing countries.¹¹³

Furthermore, as stated by Moreno and Villar, "[t]he supervisory response to the rapid rise of foreign banks is still being refined - and, in some countries, remains an important task."¹¹⁴ This is a core area, as there is evidence that foreign banks transmit shocks from their home countries. Changes in their claims on other countries where they also operate extend to the individual financial system that hosts their activities.¹¹⁵ In this sense, the risk of systemic crises and contagion in the region is still very high. Following Mogueillansky, Studart, and Vergara, the behavior of banks acting multi-nationally

towards their subsidiaries and branches depends on a number of factors: the institutional framework in the corporation's country of origin; the institutional framework in the host country; and steps taken by the local authorities during the crises. In practice, the parent companies of international banks cannot be considered lenders of last resort; their behaviour at times of crisis has depended on the nature of the problems the banks were facing in the host country and the type of establishment in question.¹¹⁶

Their findings suggest that foreign banks tend to adapt to the local systems more than local banks adopt international norms and standards that suppose an unconditional support of the headquarters company as an insurance against systemic risk.

Finally, it is important to consider that local banks in the region do not become multi-national banks as they usually do not have branches or subsidiaries in other countries of the region or sub-region. According to the IADB, financial integration in Latin America has occurred mostly in a de facto fashion with developed countries, rather than with other countries of the region.¹¹⁷ More than 98 percent of the foreign banks' share of assets comes from developed country banks, and only 2 percent come

112. See Crystal et al., *supra* notes 28.

113. See James R. Barth et al., *The Foreign Conquest of Latin American Banking: What's Happening and Why?* (Center for Research on Economic Development and Policy Reform, Working Paper No. 171, 33 2003).

114. See Moreno & Villar, *supra* note 103, at 9.

115. See Maria Soledad Martinez Peria et al., *Banking on Foreigners: The Behavior of International Bank Lending to Latin America 1985-2000*, 82 CEPAL REV. 19 (2004).

116. See Mogueillansky et al., *supra* note 75, at 33.

117. See UNLOCKING, *supra* note 77.

from banks within the region.¹¹⁸ The same is true for cross-listings and other forms of financial integration. These cross-border operations are not sophisticated or representative (except from the remittances from citizens living abroad). The main reason is that capital is scarce and financial development is limited in the Latin American countries.

IV. CONCLUDING OBSERVATIONS

Due to the external debt crisis of the 1980s, economic policies based on the so-called Washington Consensus¹¹⁹ started to be implemented unilaterally and/or in conjunction with IFI conditionality¹²⁰ by various Latin American countries during the mid to late 1980s and 1990s. Fiscal adjustment, trade liberalization, financial deregulation, welcoming of foreign investment, and the privatization of a substantial number of public enterprises were the focus of structural reforms. But such policies and their implementation seemed to be insufficient in terms of economic growth, development, and prevention of financial crises. As a result, many Latin American citizens have come to view themselves to be poorer today than in the 1980s. One of the main criticisms argues that the neo-liberal policies ignored the potential role that changes in institutions and the legal system could play in accelerating the economic and social development of the region.¹²¹ Moreover, the region, in the past several years, has witnessed the reappearance of left-wing populist politicians emphasizing the explicit aim of counteracting economic neo-liberalism.¹²²

Eduardo Lora of the IADB developed a structural policies index aimed at describing and measuring the advance of the structural reforms in Latin America.¹²³ This index summarizes the progress of policies in the trade, financial, tax, privatization, and labor areas.¹²⁴ Using the indicator, he concluded that the reforms have made it possible to appreciably raise the quality of policies, especially in the trade and finance areas, and to a lesser extent, in privatization and in the tax and labor areas.¹²⁵ In a recent paper, Lora and Panizza found that the overall index for structural reforms, which combines the referred five areas of policies in seventeen Latin American countries, had risen from 0.34 in 1984 to 0.58 (out of a

118. *Id.*

119. See Williamson, *supra* note 57.

120. Cf. Ariel Buira, An Analysis of IMF Conditionality, Paper Presented for the XVI Technical Group Meeting of the Intergovernmental Group of 24 Port of Spain, Trinidad and Tobago (Feb.13-14, 2003).

121. See BURKI & PERRY, *supra* note 54.

122. Brazil, Argentina, Uruguay, Venezuela, and Bolivia, with even Mexico possibly to follow suit in 2006.

123. Eduardo Lora, *A Decade of Structural Reforms in Latin America: What Has Been Reformed and How to Measure It* (IABD Office of the Chief Economist, Working Paper Green Series No. 348 1997).

124. *Id.*

125. *Id.*

maximum value of one by the late 1990s).¹²⁶ To them, these results suggest that many countries have a very broad margin of unexploited potential for the introduction of additional reforms.

The increasing partial opening of national boundaries through the *de jure* multilateral agreements and various PTAs, and even more so by the increasing presence of banks acting internationally or multi-nationally consequent to the *de facto* financial integration originated by the unilateral decisions of the involved nations and underpinned by soft law international standards, is integrating financial systems not only in the Western Hemisphere but also globally. There already are or will be global, hemispheric, regional, or sub-regional banking and financial markets but, still national laws, regulations, and institutions prevail. In this sense, it will be of essential importance to focus on the need for strong domestic, sub-regional, regional, and hemispheric institutions and to make clear rules of the road to be able to viably support these markets and to begin reconciling the differences among these integrationist cultures and those of the countries involved. These institutions should adapt to the significant unfolding changes and challenges, firmly stand up against crude political interference, and give confidence to the providers of financial services as well as to the investors and customers at domestic and international levels.

A gradual and eventual convergence will need to join the following divergent processes: the shallow integration originated by formal, hard law, multilateral, and PTAs based on the removal of barriers to trade of financial services and limited coordination of national policies, and the deeper integration promoted by banks and financial institutions actually acting internationally and multi-nationally, ruled by international standards and codes embodied in soft law and requiring coordination of domestic policies. Such a convergence process also will need to bring together different legal systems that protect differently the rights of creditors and investors and that promote the development of financial systems more or less efficiently. As a consequence, governments in the Latin American region will need to work together towards harmonizing rules applicable to domestic and foreign financial and banking services providers, with the aim of avoiding regulatory arbitrage. These governments also will have to cope with linking efficient and inefficient judiciary systems, which may produce forum shopping and significantly impact the flow of Foreign Direct Investment to the countries in the Hemisphere. All these circumstances call for domestic and supranational strong institutions.

To the end of achieving a constructive convergence process, a bottom-up-building block strategy should still be considered the best option for the Latin American countries. Under this approach, the first stage would

126. Eduardo Lora & Ugo Panizza, *Structural Reforms in Latin America Under Scrutiny*, Prepared for the Seminar Reforming Reforms, IADB, Research Department (Mar. 11, 2002).

focus on laying an appropriate foundation in the form of an effective institutional framework for the regulation and supervision of the financial system in each country. This would require truly independent central banks, regulators, and supervisors as well as adequately structured private institutions and markets. Following this initial program, by no means an insignificant accomplishment, the goal would then be to address more substantively the issues of market access and potential sub-regional, regional, and hemispheric harmonization and integration.¹²⁷

At the same time, our thinking of legal educational is a core issue that should be carefully addressed, moving beyond a century-old, traditional, domestic approach and making legal education more global and integrated and more of a life-long experience. Regulators, supervisors, administrative judges, and potential arbitrators will need to be trained and periodically updated in the knowledge of the different cultures addressed in this article. But the specific reform priorities still will differ from country to country based on their own needs and capabilities.

127. See Norton, *supra* note 37, at 175-78.

