Free Trade Agreement EU – Colombia & Peru: Deregulation, illicit financial flows and money laundering

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SUMMARY

This report assesses how the EU-Colombia-Peru free trade agreement deals with the liberalization of financial services and capital movements in the context of problems of illegal financial flows existing between the signatory countries due to money laundering, drug trafficking and tax avoidance or evasion. The report reveals that the FTA exposes the EU to increasing risks of money laundering and tax evasion, and undermines the EU's full future policy space to regulate the financial sector and capital flows, as follows:

- The power by authorities to apply controls on capital flows are being restricted by the FTA. However, there are no particular articles in the agreement that ensure that instruments and regulations are in place that effectively prevent and halt illicit flows. This contrasts with other trade agreements the EU has signed, which have stronger commitments of cooperation and implementation of actions against money laundering, crime and tax evasion or avoidance.

- Although the EU has different countries with jurisdictions that have a high level of tax dodging companies and individuals, the FTA does not have any strong commitment to reduce tax evasion or tax avoidance. On the contrary, the FTA provides for more free capital movements without supervision, liberalization of trusts services and tax advisory services, and does not fully exclude that foreign investors establish themselves with the purpose of tax dodging practices. The use of EU secrecy jurisdictions and tax havens result in important income being lost for signatory governments, which could be used for debt reduction and sustainable development.

- Although a wide range of sometimes risky and speculative financial services are being liberalized by the FTA, there are no particular mechanisms established by the FTA to ensure strong regulation or joint supervision of these financial services. This could weaken the financial sector and financial stability.

- The FTA rules discipline how financial regulation can be undertaken and insufficiently protect the full right of the EU and its two counterparts to regulate the financial sector and control capital. Several EU financial reforms are already in contrast with the FTA rules on market access and domestic regulation. FTA rules do not allow to fully apply the lessons from the financial crisis and reforms that could not have been foreseen in the past.

This report was commissioned after warnings were made in a publication by the organization Global Financial Integrity that shed light on the fact that illicit financial flows between the US and Mexico were importantly increased after NAFTA (the North America Free Trade Agreement) had become operational.[1]

Brussels, December 2012

[1] Global Financial Integrity, Mexico: Illicit financial flows, macro-economic imbalances and the underground economy, 2011

FOREWORD

Dear readers,

While Europe is being shaken to its core by the crisis that was sparked by the nearly general failing of the whole banking system; when it is starting to understand that perhaps some kind of regulation of the financial markets is, in fact, vital, another set of principles is being proposed to Colombia and Peru.

As part of the Free Trade Agreements that were negotiated between the EU and Colombia and Peru, the documents comprise elements dealing with financial activities such as lifting capital controls, and at the same time do not deal with effectively tackling money laundering or illicit capital flows in general. As deregulating financial flows appears contradictory with what is nowadays professed in Europe, it is also worth noting that according to United Nations Office on Drugs and Crime, 9.9 billion U.S dollars in gross transit profits are generated by the flow of Andean cultivated drugs.

According to Global Financial Integrity (GFI), since the implementation of NAFTA and similar financial clauses, illicit money flow in Mexico has soared up to 50 billion dollars a year.

I therefore ordered this report in order to analyze the potential impact of the FTA on illicit inflows and existing regulations (and the risks for the financial system as a whole) both in Colombia/Peru and the EU.

In the hope that the report will provide you with food for thought,

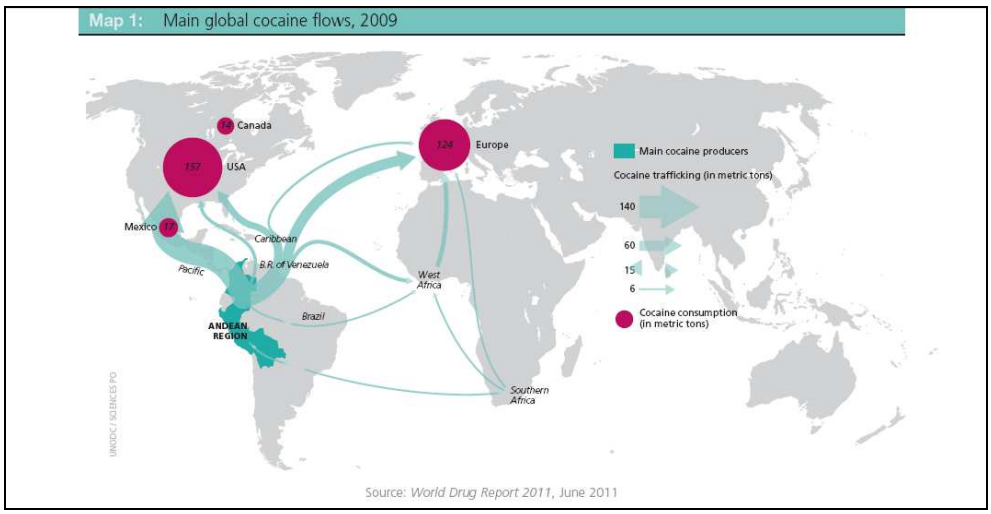
Jurgen Klute.
German MEP, GUE/NGL

1. A SHORT OVERVIEW ABOUT DRUG TRAFFICKING AND MONEY LAUNDERING BETWEEN COLOMBIA/PERU AND THE EU

1.1. Drug trafficking

The United Nations and the US estimate that Peru has become the world's biggest producer of coca leaf, and now rivals Colombia for cocaine production. Some attribute this trend as a consequence of fighting production in one country - such as Colombia – which results in traffickers transferring their operations elsewhere, such as Peru.

Calculations by United Nations Office on Drugs and Crime (UNODC)[2] suggest that 217 tons leave the Andean countries for final consumption of 123 tons in West and Central Europe. In total, US$9.9 bn in gross transit profits are generated by this flow. Of this, some US$0.4 bn are generated by traffickers in West Africa. Out of the remaining US$9.5 bn, the bulk of the money seems to be reaped by organized criminal groups from South America, notably groups from Colombia.



Source : UNODC [United Nations Office on Drugs and Crime] , Estimating illicit financial flows resulting from drug trafficking and other transnational organized crimes - Research report, October 2011, p. 65

[2] United Nations Office on Drugs and Crime, Estimating illicit financial flows resulting from drug trafficking and other transnational organized crimes - Research report, October 2011, p. 67-68; (see also Table 45: Gross profits generated from trafficking cocaine to main consumer markets.)

1.2. Money laundering and transfer of drug money

UNODC estimates that the profits up to the main European transit countries (such as Spain and the Netherlands) would amount to US$7.1 bn, which are to a large extent reaped by South American groups. The remaining US$2.4 bn are mostly made by criminal groups within Europe.[3] It assumes that a third of the profits generated by importing cocaine from South America via Spain to the UK is generated by UK residents (who often purchase the cocaine from traffickers in Spain or the Netherlands to ship it to the UK, as well as smaller amounts directly in South America); the rest is generated by residents from the respective production and transit countries.

While available data allow for a reasonably good understanding of the overall transit profits, only rough estimates are possible for the allocation of such profits to individual countries, which remains a major challenge. With regard to trafficking of cocaine to West and Central Europe, cocaine is trafficked by Colombian groups to West and Central Europe, notably to Spain, Europe's main entry point for cocaine. Here, it has been assumed that some 40% of the total flow to the European entry points (generating profits of US$7.1 bn) are generated by Colombian groups, a further 30% by groups from other countries in the Americas, including South America, Central America and the Caribbean, and most of the rest by various European and African groups.

A similar proportion for the involvement of Colombian groups (40%) was also assumed for trafficking cocaine to countries in East and South-East Europe (US$1 bn), while the importance of Colombian groups for cocaine trafficking to Asia (US$1.2 bn), Oceania (US$0.5 bn) and Africa (US$1.2 bn) seems to be slightly lower (assumed to be around 30%).[4]

1.3. Conclusion

While there are officially recognized problems of drugs trafficking and money laundering between the Colombia, Peru and the EU, none of the projects or cooperation agreements or political initiatives have been able to fully prevent or stop the drugs trafficking and money laundering. In the context of these remaining problems and risks, the EU-Colombia-EU free trade agreement has been signed and is being asked to parliaments in the EU to be ratified.

[3] UNODC [United Nations Office on Drugs and Crime], Estimating illicit financial flows resulting from drug trafficking and other transnational organized crimes - Research report, October 2011, p. 67-68; (see also Table 45: Gross profits generated from trafficking cocaine to main consumer markets.)

[4] Ibidem.

2. FIGHT AGAINST ILLICIT MONEY UNDERMINED BY LIBERALIZATION OF FINANCIAL FLOWS AND FINANCIAL SERVICES

Notwithstanding the well-known many risks for the EU from illicit capital flows coming from Colombia and Peru, the free trade agreement (FTA) that the EU has negotiated with these two countries obliges the signatory parties to lift controls on capital flows. Apart from the general risks of money laundering and financial transfers related to drug trafficking, there are some particular risks that money can be laundered to the EU or by the EU financial sector. For instance, the EU has some secrecy jurisdictions that attract a lot of money and tax evaders from abroad, and has a large shadow banking sector worth $ 17 trillion[5]. Also, an EU based bank, HSBC – headquartered in the UK -, has recently been caught twice in money laundering, and is to pay at least $ 700 million in a settlement with US authorities who also accused HSBC of tax evasion. HSBC is present in Colombia and Peru[6] but announced[7] that it sold its presence in those countries by the end of 2012. However, the HSBC Colombia and HSBC websites were still fully operational by end of November 2012 (with no announcement that its presence or operations would end).[8] In general, trillions of dollars in illicit drug money is estimated by the United Nations Office on Drugs and Crime to enter the system each year as a result of so-called normal business relations between global drug cartels and the international financial system.[9]

Removing capital controls

Article 168 of the FTA ensures that the signatory countries allow “any payments and transfers” on the current account of the balance of payments “in freely convertible currency”. These payments include transfer of money by citizens, workers’ remittances, payments for trade in goods and services, royalty payments from patents and copyrights, and dividend payments. In other FTAs that the EU has negotiated, e.g. with South Korea, there is not such full liberalization of current account transfers, but only for those financial transfers related to trade, loans and investments (Art. 8.2 on capital movements of the EU–South Korea FTA[10]).

In addition, Art. 169 of the agreement ensures free movement of capital relating to foreign direct investments (which excludes for instance portfolio investment and loans for trading) and its profits, and repatriation from foreign direct investments, i.e. partial liberalisation of the capital account.

[5] N. Nielsen, Art. “EU shadow banking assets worth €17 trillion”, EU Observer, 19 November 2012.
[6] Art. “HSBC Caught in New Drug Money Laundering Scandal”, Global Research, 2 November 2012, http://www.globalresearch.ca/hsbc-caught-in-new-drug-money-laundering-scandal/5310397.
[7] Art. “HSBC sells units in Peru, Colombia, Paraguay and Uruguay for $400 million, 12 May 2012, Andean Air Mail & Peruvian Times, http://www.peruviantimes.com/12/hsbc-sells-units-in-peru-colombia-paraguay-and-uruguayfor-400-million/15707/
[8] Websites of HSBC Peru (http://www.hsbc.com.pe/1/2/es/home) and HSBC Colombia (http://www.hsbc.com.co/1/2/es/home) viewed end November 2012 and 4 December 2012.
[9] Art. “HSBC Caught in New Drug Money Laundering Scandal”, Global Research, 2 November 2012.
[10] Official document to be downloaded at: http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2011:127:SOM:EN:HTML

2.1. No effective obligation to tackle money laundering

The FTA between the EU, Colombia and Peru has no particular articles or annexes that oblige the signatory countries to have measures in place to tackle money laundering and financing of criminal activities (regarding tax evasion and avoidance, see below). Also, the EU itself still has not yet revised its Anti-money laundering directive.[11] However, the FTA will be implemented in a context in which even international bodies such as the UN and the IMF indicate that serious money laundering and other financial flows related to drug crime between the signatory countries exists (see above).

According to Art. 155, signatory countries only have to undertake "best endeavours" to implement international standards for the fight against money laundering and the financing of terrorism. To that extent, Art. 155 refers to the Forty Recommendations on Money Laundering and Nine Special Recommendations on Terrorist Financing of the Financial Action Task Force.

These weak commitments contrast with other FTAs which the EU has signed. For instance, the EU-Central America FTA has stronger and more specific references to combatting money laundering and illicit financial flows, and has hard commitments and even particular measures to encourage the prevention and the halting of illicit flows.
In the EU-Central America FTA, there is a cooperation chapter with particular articles to deal with:

- Money laundering, including the financing of terrorism (Art. 36);
- Organised crime and citizen security (Art. 37);
- The Fight Against Corruption (Art. 38)

The activities of cooperation in these articles include information exchange, cooperation between authorities, training programmes, administrative and technical assistance with purpose of adoption of appropriate standards (with reference to Financial Action Task Force (FATF), the United Nations Convention on Transnational Organized Crime and its supplementing Protocols, and the United Nations Convention against corruption).

The FTA allows the signatory countries to take some 'safeguard' measures that in principle could be useful for the prevention or halting of illicit financial flows. However, these measures can only be taken when fulfilling different conditions and are in practice weak instruments in the battle against money laundering. The following measures can be used:

- Art. 170 allows safeguard measures relating to capital flows but only in "exceptional circumstances" that cause "serious" difficulties for monetary and exchange rate policies. These measures can be taken for one year, and only in exceptional circumstances for Colombia, and "extremely exceptional circumstances" for the EU and Peru, can these measures be extended.

- Art. 167 allows the signatory countries to adopt measures that are contrary to the FTA rules on current payments and movement of capital (Title V), and the rules on trade in services, establishment and electronic commerce (Title IV) if they are not discriminatory in favour of domestic companies. Although Art. 167 has not been formulated in a way specifically for fighting criminal activities and money laundering (rather the general language of other FTAs that the EU has been signing was used), some of these so-called "general exceptions" could be used in the context of such policies. Signatory countries can adopt measures in order to:

[11] The revision of the Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, was announced in April 2012 (http://europa.eu/rapid/press-release_IP-12-357_en.htm) but still not published be 2 December 2012

- Protect safety and public order (“ only” when a “ genuine and sufficiently serious threat is posed to one of the fundamental interest of the society”);
- Protect human health;
- Prevent deceptive and fraudulent practices[12].

However, one has to be aware that Art. 167 does not necessarily mean that these measures are in place, but only mean that they can be taken. Also these measures should be “not inconsistent” with the articles related to current payments and capital movements. Only Peru has introduced more clarity of what exactly is allowed and what not (in footnote 55 of Art. 167).

- Art. 297 allows imposing restrictions of trade in goods and services, investment, and related payments, in case of balance-of-payments problems or threat thereof. However, the use of these restrictive measures are disciplined by many conditions such as avoiding unnecessary damage, using an assessment by the IMF, being of limited duration, submitting a time-schedule for removing the measures, endeavouring to avoid imposing these restrictions and being subject to scrutiny by the Trade Committee established under the FTA.

- The FTA does not cover investments (Art. 111) and cross-border supply of services (Art. 118) in the areas of, for instance, nuclear or war materials, toxic waste, or audiovisual services. No exception of the applicability of the FTA rules is made for investment or services trade related to drugs or other criminal activities including money laundering.

- General exceptions that apply to the whole agreement (Art. 295) allow countries to take measures to protect essential security interests when in relation to defence, nuclear materials, materials for a country’s military, in time of war or to restore international peace and security. In other words, there is no general exception to the applicability of the FTA in order to combat international drugs trafficking or money laundering, nor are these activities described as threats to essential security interests.

Given that the above described measures can only be taken mostly in exceptional circumstances, they can hardly be effective to combat money laundering as described by the FATF (see box).

BOX: The Financial Action Task Force defines the three stages of money laundering

1) In the initial - or **placement - stage** of money laundering, the launderer introduces his illegal profits into the financial system. This might be done by breaking up large amounts of cash into less conspicuous smaller sums that are then deposited directly into a bank account, or by purchasing a series of monetary instruments (cheques, money orders, etc.) that are then collected and deposited into accounts at another location.

2) After the funds have entered the financial system, the second – or **layering – stage** takes place. In this phase, the launderer engages in a series of conversions or movements of the funds to distance them from their source. The funds might be channelled through the purchase and sales of investment instruments, or the launderer might simply wire the funds through a series of accounts at various banks across the globe. This use of widely scattered accounts for laundering is especially prevalent in those jurisdictions that do not co-operate in anti-money laundering investigations. In some instances, the launderer might disguise the transfers as payments for goods or services, thus giving them a legitimate appearance.

[12] For Peru the FTA specifies that it can for instance implement in good faith laws relating to criminal and penal offences, or enforcement by financial authorities: footnote 55 of Art. 167.

3) Having successfully processed his criminal profits through the first two phases the launderer then moves them to the third stage **– integration** – in which the funds re-enter the legitimate economy. The launderer might choose to invest the funds into real estate, luxury assets, or business ventures.

Source: United Nations Office on Drugs and Crime, Estimating illicit financial flows resulting from drug trafficking and other transnational organized crimes - Research report, October 2011, p. 52, http://www.unodc.org/documents/data-and-analysis/Studies/Illicit_financial_flows_2011_web.pdf.

2.2. Risks of tax evasion and lost public spending

Tax avoidance and tax evasion are not only a typical aspect of money laundering and financial transfers by criminals. Tax avoidance is now a central part of 'tax planning' strategies by most multinationals and financial firms (e.g. hedge funds, banks). This tax avoidance is mostly legal, as opposed to tax evasion, through very complex structuring of company parts with artificial residence (often with no staff presence) in tax havens and secrecy jurisdictions. It is also done through artificially allocating activities and profits ('transfer pricing') and other financial flows within the company (loans and interests, fees from royalties and licensing), as well as particular financing instruments (dividend payments, bond issuing) in those jurisdictions where the tax rate is the most profitable. Research and media coverage expose[13] more and more huge tax avoidance is happening in the EU through:

- jurisdictions with bank secrecy and low tax rates (such as the UK channel Islands of Jersey and Guernsey, Luxembourg, Ireland[14]) , and
- jurisdictions with special low tax rates for foreign investors/companies and particular activities of these foreign investors, such as the Netherlands and Belgium.

The Netherlands is the largest 'conduit' country in the world through which money is transferred to tax havens (including the Netherlands Antilles which are situated near Colombia) and secrecy jurisdictions. The Netherlands hardly taxes incoming and outgoing capital generated by income from interests (e.g. from a company's subsidiaries), royalties, dividends, licencing fees, and (under certain circumstances) profits from subsidiaries. As a result, the Netherlands has around 20.000 mailbox companies (with no or very little staff) including from almost all the largest companies in the world (which could include some operating in Colombia and Peru, e.g. Endesa[15]). An estimated € 5500 bn per year is flowing into the Netherlands (around 10 times its GDP) and around the same amount is flowing out of the country each year.[16]

Tax avoidance and evasion can have very important consequences. In Europe, this means that not enough tax income is generated in the many countries that have serious debt problems or budget deficits, which leads to austerity measures and changes in democratic decision making about budgets in the EU. Also for developing countries like Colombia and Peru, tax evasion and avoidance can be a drain on government income that can be used for necessary public spending (e.g. education, health services, sanitation) and sustainable development (as outlined in the EU-Colombia-Peru trade

[13] See for instance research reports and articles on the following websites: http://www.taxjustice.net ; http://somo.nl/dossiers-en/economic-reform/tax-justice; http://eurodad.org.

[14] See for instance: TASC, Tax Justice :following the tax trail, Christian Aid Ireland, September 2012, http://www.tascnet.ie/upload/file/2055%20Tasc%20Booklet%20A4%2044pg_LR%20WEB.pdf

[15] See for instance: http://company.info/org/332487620000/International_Endesa__Amsterdam_Zuidoost/nieuws_jaarverslag_cijfers_management_uittreksel_markt .

[16] Tax Justice NL, Verdragsparadijs Nederland – Briefing paper, 2012, http://www.taxjustice.nl/?nid=30000&oid=b5d8de6b-f41d-4496-85e6-39af3aa8b8c2 .

agreement). Global figures about illegitimate capital flows from developing countries are estimated to have been $ 903 billion in 2009, half of which is attributed to tax avoidance.[17]

One needs to be reminded that tax havens and secrecy jurisdictions were used to base special purpose vehicles for issuing Collateralised Debt Obligations that caused the financial crisis to erupt (the subprime crisis) in 2008. The lack of transparency also resulted in the ensuing credit crunch in 2008-2009 because banks did not have enough information to safely lend to each other.

The FTA has no instruments to tackle tax dodging

Many legislative proposals at EU level, which can tackle tax evasion and avoidance, have been long delayed. For instance, the revision of the Savings Tax Directive[18] is still in a process of decision making. Also the revision has been delayed of the Directive[19] on transparency requirements for listed companies in order include proposals on country by country reporting (including for banks). It remains to be seen how efficient these new legislations will be once finalised, since critics[20] already point at weaknesses such as the lack of proposals in the draft new transparency directive for compulsory reporting of profit/losses and turnover in order to assess the level tax payments. Also, it remains uncertain whether tax crimes will be considered an offence under the still to be revised anti-money laundering directive.

In this context in which the EU does not have efficient instruments to tackle tax evasion and avoidance, the EU has not negotiated strong anti-tax dodging instruments in the trade agreement with Colombia and Peru although multinational companies get more access and improved treatment as foreign direct investors or service suppliers under the FTA.
The EU-Colombia-Peru trade agreement (Art. 296) has some general provisions that each of the signatory countries can implement and enforce measures that “aim” at collecting direct taxes and at “preventing” tax avoidance or evasion, and which can distinguish between residents and those whose residence or capital is abroad. However, as part of the provisions which are specific for the financial sector (covering banks, hedge funds, trusts, etc.), Art. 154 stipulates that no signatory country is required to disclose information relating to the affairs and accounts of individual customers nor and any confidential proprietary information in the possession of public authorities. Such a clause does not provide support for official actions to tackle tax evasion and avoidance, for which (automatic) information exchange across borders is essential.

There are no other particular articles or annexes in the FTA which oblige the signatory countries to have measures in place to tackle tax evasion and avoidance. The signatory countries only “take note”, in Art. 155.5, of the Ten Principles for Information Sharing issued by the G-7 Ministers of Finance, and the Agreement on Exchange of Information on Tax Matters of Organisation for Economic Co-operation and Development (OECD), and the Statement on Transparency and Exchange of Information for Tax Purposes of the G20.

[17] Global Finance Integrity, Illicit Financial Flows from developing countries over the decade ending 2009, 2011, http://iffdec2011.gfintegrity.org .

[18] The revision of the Directive on Taxation of savings income in the form of interest payments was proposed (COM (2008) 272 final) in November 2008, and WAS still not been agreed upon by beginning December 2012 http://www.tascnet.ie/upload/file/2055%20Tasc%20Booklet%20A4%2044pg_LR%20WEB.pdf (viewed 2 December 2012) .

[19] Officially, the Directive 2004/109 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, published 30 December 2004 in http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:390:0038:0038:EN:PDF.

[20] See for instance: See for instance, A. Garda Art. “Legal Affairs Committee vote: Country-by-country reporting for banking, construction and telecommunications would help to address corruption, tax evasion and other malpractice”, Eurodad news, 18 October 2012, http://eurodad.org/1543845/ .

This weak formulation contrasts, for instance, with the EU- South Korea FTA that has a provision, in Art. 7. 24 (on governance), whereby the signatory parties at least included a best endeavour clause to adopt international standards for the battle against tax evasion, with specific reference to the Agreement on Exchange of Information on Tax Matters of OECD, and the Statement on Transparency and Exchange of Information for Tax Purposes of the G20.

The FTA texts specifies that double tax treaties, that prevent double taxation of a company but can also have other cooperation arrangements, will have precedence over the FTA text. However, both Colombia and Peru have only very few double tax treaties and only with one EU country, namely Spain.

EU allows trust companies from Colombia and Peru

An important strategy by companies and individual tax evaders and avoiders is to be able to be officially recognized or defined as an 'investor, while having no obligation to have personnel or activities ('substance') in that particular company (often by being a 'mailbox company' or 'shell company'), nor to declare the name of the (ultimate) owner. This can be avoided by a strict definition of who can be an 'investor' or 'establishment' and benefit from tax regimes, or from the provisions that give access and protection as is the case in the EU-Colombia-Peru trade agreement (see below).
The definition of 'establishment" to indicate foreign investors in the EU-Colombia-Peru trade agreement (Art. 110, footnote 19 and 20) prescribes that a foreign investor "includes" the establishment in any activity to produce goods or supply services. However, a "service supplier" is loosely defined as any natural or juridical person that "seeks to supply and supplies a service", but a "juridical person" needs to have a real and continuous link with the host country (as defined in Art. 108).
These definitions provides for some, but not full, guarantees that companies that establish themselves in any of the signatory countries undertake real economic activities and not only transfer money or evade or avoid taxes. However it is not sure if the (ultimate) owners of foreign companies are known and can be easily traced.

Most tax avoidance and evasion happens through the use of trusts and trusts services. The EU member states have liberalized their trust services sectors in the FTA, which means that Colombian and Peruvian trust service suppliers (trusts) can establish themselves in the EU (with some legal conditions). At the same time, the EU trust services companies can establish themselves in Peru (subject to domestic legal requirements) but not in Colombia (except for collective investment schemes).

Given the lack of cooperation on tax dodging and information exchange, liberalizing trust services by the EU does not support a policy that attempts to deal with tax dodging.

Complicit tax advisory services

The constructing of a complex net of company parts in different profitable jurisdictions in order to evade and avoid taxes, is designed and supported by a specialized tax advisory industry. EU countries have opened up the EU market (with small conditions attached in Austria and Cyprus) for the establishment of Colombian and Peruvian suppliers of tax advisory services, but the EU did not allow cross-border supply of tax advisory services.[21] Colombia allows for the establishment and cross-

[21] See the list of EU commitments under business services and legal services (Annex VII and VIII of the FTA).

border supply of tax advisory services from EU countries and Peru, and also Peru allows the establishment and cross-border taxation services coming from the signatory countries of the agreement.

Given the essential role of some tax advisory companies in designing and providing tax evasion and avoidance mechanisms, liberalization those services with some legal requirements but without instruments to stop them from advising on tax dodging, might increase tax evasion. For instance, it does not reduce the risks of tax advisers or clients in the EU to link up with tax advisers from Colombia and Peru, which could stimulate (new ways of) tax avoidance and evasion.

2.3. Risks to monetary policy, crisis prevention and investment regulation

Liberalization of capital flows with too little possibilities to control the capital and financial account (as partly happens under Art. 169 of the FTA), and other financial flows (such as current account payments in Art. 168) has recently been more and more criticized. The need for at least some capital controls has been recognized in a recent staff paper by the IMF[22] - which constitutes a revision of its previous policy to promote full liberalisation of the capital account - and has been called for by an open letter from more than 100 economists in the context of free trade agreements.[23] Indeed, uncontrolled financial inflows and outflows can destabilize a country's economy and can be very risky especially in times before and during a financial crisis.

Even the IMF concludes that the experiences of European countries like Spain and Ireland show the dangers of allowing free flow of large and volatile capital movements and an insufficiently regulated financial system.[24] Indeed, the EU is still having pre-crisis neo-liberal rules that severely restrict capital controls. The Lisbon Treaty (Art. 63-66) only allows the EU states to restrict freedom of capital movements with third countries in very exceptional circumstances. In fact, the EU is imposing on its own trading partners these restrictions on capital controls.

Capital controls have been reintroduced by quite a few countries such as Brazil, South Korea, Taiwan and Indonesia. These countries want to avoid and prevent financial crises due to capital inflows that are unstable and can very rapidly leave a country. Also, Brazil introduced capital controls to avoid currency wars. Large foreign capital inflows not related to the domestic economic performance, but resulting from outflows from weak economies, like in the EU, or lax monetary policies of other countries (e.g. money printing or 'quantitative easing' by US), caused the Brazilian currency to raise so that its exports became less competitive. Thailand has actually experienced that just the threat of using capital controls was already a strong deterrent for speculators.[25]

[22] IMF, The liberalization and managementof capital flows: an institutional view, 14 November 2012, http://www.imf.org/external/np/pp/eng/2012/111412.pdf; see also: Bretton Woods Project, Art. "IMF divided over capital flows management?", News - update 82, 2 October 2012, http://www.brettonwoodsproject.org/art.shtml?x=571191, (viewed 2 December 2012).

[23] The letter can be downloaded at: http://ase.tufts.edu/gdae/Pubs/rp/TPPAEconomistsLetter.pdf .

[24] A. Beattie, Art. "IMF drops opposition to capital controls", Financial Times, 3 December 2012.

[25] M. Vander Stichele, R. van Os, Business as usual? – How free trade agreements jeopardize financial sector reform, SOMO paper, December 2012, p. 9.

Controlling capital movements can also be done to encourage longer term investment. For instance, Chile has an investment measure which has been praised world-wide as efficient against capital flight during financial crises, and which imposes a tax on investment capital flows if it leaves a country before one year after the investment is made. The EU tried to eliminate this rule during the FTA negotiations with Chile, and during the GATS negotiations, but has not succeeded.

According to the IMF staff, liberalization of capital flows needs to be well panned, timed, and sequenced in order to ensure that the benefits outweigh the costs.[26] These conditions are far from fulfilled in the EU-Colombia-Peru FTA.

2.4. Conclusion

Given that Colombia and Peru are susceptible to illicit financial flows and money laundering and since the EU has many countries with special jurisdictions that result in a serious amount of tax evasion and avoidance amongst others by multinational companies that will benefit from the EU-Colombia-Peru FTA, there are many risks that the mentioned malpractices will increase because of:

- Controls on capital flows which are being restricted by the FTA without cooperation to monitor the impact and set up exchange information mechanisms;
- Weak provisions in the agreement to fight against money laundering and the financing of terrorism while the EU has negotiated other FTAs with much stronger commitments and implementation instruments to that extent;
- The provisions to deal with tax evasion or avoidance that do not engage any of the signatory parties to take action or to cooperate. The fact that tax evasion and avoidance can be increased by the liberalization of trust services and tax advisory services.

The removal of capital controls is contrary to the experiences of financial crises in general, and particularly of European countries like Spain and Ireland that show the dangers of allowing the free flow of large and volatile capital movements. The EU-Colombia-Peru FTA does not implement the recent advice by the IMF that liberalization of capital flows needs to be well planned, timed, and sequenced.

The use of EU secrecy jurisdictions and tax havens result in important incomes being lost for governments, which could be spent to avoid austerity measures, like in the EU, or to provide public services and sustainable development – an objective of the FTA -, like in Colombia and Peru.

[26] IMF, The liberalization and management of capital flows: an institutional view, 14 November 2012, executive summary.

3. FTA RULES CONTRAST WITH FINANCIAL REFORMS

The financial crisis that erupted in the EU in 2008 has revealed, as have crises before, the riskiness of the liberalization of financial markets and financial services with free capital flows, and with insufficient financial regulation and supervision at equivalent levels. Before 2008, the liberalization of financial services through the General Agreement on Trade in Services (GATS) under the World Trade organization (WTO) and free trade agreements have been negotiated without guaranteeing sufficient financial regulation and supervision. Worse, the agreements were based on the pre-crisis overriding model that the financial sector should only be lightly regulated and be allowed to fully expand globally. Therefore, restrictions on governmental interventions were included in the GATS and other free trade agreements covering the liberalisation of financial services. Moreover, there was an underestimation how the resulting increased international competition was resulting in more risky strategies and innovative products by financial conglomerates, which contributed to the financial crisis.

The EU has negotiated about financial services in the FTA with Colombia and Peru, as is the case with many other EU FTAs, using the same approach (i.e. without guaranteeing sufficient financial regulation and supervision), the same rules (and lack of them) and the same strategy (aiming at as much market opening for EU financial conglomerates as possible), as in the pre-crisis agreements – as if the financial crisis never happened (see below). However, many of these pre-crisis rules that cover liberalization of financial services are contrary to various financial reforms undertaken by the EU, which are necessary, and by some even considered as just a bare minimum, to avoid new financial crises.

The FTA with Colombia and Peru has been negotiated, and is presented to parliaments for ratification, at a time the EU is far from having finalized the reforms of regulation and supervision of the EU financial sector. After having ratified the FTA, the EU and its member states can thus find themselves to be bound to restrictions and commitments that might curtail to room of manoeuvre, or 'policy space', for on-going and future reforms.

3.1. Wide range of commitments to open up markets in financial services

In the FTA with Colombia and Peru, the EU has allowed a far reaching market opening for investments and cross-border services in the financial sector. The financial services and services suppliers that are cover by the FTA are defined in Art. 152. They include all insurance and insurance-related services, and all banking and other financial services, and cover the following activities:

a) insurance and insurance-related services:
    i. direct insurance (including co-insurance):
        (A) life;
        (B) non-life;
    ii. reinsurance and retrocession;
    iii. insurance inter-mediation, such as brokerage and agency; and
    iv. services auxiliary to insurance, such as consultancy, actuarial, risk assessment and claim settlement services;
b) banking and other financial services (excluding insurance):

i. acceptance of deposits and other repayable funds from the public;
ii. lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions;
iii. financial leasing;
iv. all payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts;
v. guarantees and commitments;
vi. trading, for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following:
(A) money market instruments (including cheques, bills, certificates of deposits);
(B) foreign exchange;
(C) derivative products including, but not limited to, futures and options;
(D) exchange rate and interest rate instruments, including products such as swaps, forward rate agreements;
(E) transferable securities; and
(F) other negotiable instruments and financial assets, including bullion;
vii. participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues;
viii. money broking;
ix. asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services;
x. settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments;
xi. provision and transfer of financial information, and financial data processing and related software; and
xii. advisory, intermediation and other auxiliary financial services on all the activities listed in subparagraphs (i) through (xi) above, including credit reference and analysis, investment and portfolio research and advice, and advice on acquisitions and on corporate restructuring and strategy;

The EU, Colombia and Peru have each annexed to the trade agreement lists in which they specify the services sectors (including financial service suppliers, financial services and financial products), for which they open up their markets for cross-border trade (Annex VIII) and investors that supply financial services (Annex VII) by companies of the other signatory country. In these lists of liberalization commitments, called “schedules”, the signatory countries can make exceptions to the application of the rules of the agreement as regards national treatment and market access rules (see below).

Once a country has made these commitments to open up the listed specific services markets, that country is not allowed to reverse these commitments even if circumstances, such as a severe financial crisis, would expose that a country is vulnerable to external shocks or is unable to implement effective regulation and supervision. If it withdraws its commitments, the country can be subject to the dispute settlement system as agreed by the FTA.

FTA widely opens the door for financial services

The EU, Colombia and Peru have made substantial liberalization commitments in most of the above mentioned financial services. The EU and some particular EU member states have nevertheless listed some very specific limitations to the broad liberalization commitments that allow all Colombian and Peruvian financial sector investors to establish themselves in the EU. These specific limitations can be summarized in very broad terms[27] as limitations to the establishment of branches or the provision of pension funds, the obligation to form a joint venture, requirements regarding nationality or residence for particular financial services (often related to asset management).

This broad ranging market opening includes for instance the liberalization of over-the-counter (OTC) derivatives trade while the EU is in the process of restricting OTC derivatives trade during the revision of the Market in Financial Instruments Directive (MiFID), and the legislation of a new Market in Financial Instruments Regulation (MiFIR) that will compel particular standardized OTC commodity derivatives to be traded on exchanges. In general, OTC derivatives trades have proven to be very risky and contributing if not causing a financial crisis. So why should Colombian and Peruvian suppliers of OTC derivatives be allowed to establish themselves in the EU that still has not finalized its regulatory and supervisory reforms and wants to legislate how third country providers can operate in the EU?

3.2. FTA rules that restrict financial regulation

The FTA does not only provide for lists by which the signatory countries commit to liberalise particular (sub)sectors (see above), but also stipulates a series of rules that have to be abided and whose breach can be challenged by a dispute settlement process. These rules include stipulations that restrict what governments, parliaments, supervisors and other competent authorities can do. Several of these provisions only apply to the sectors to which the parties of the FTA have made liberalisation commitments in their schedules (as described above). The analysis of what these FTA provisions mean for financial sector regulation, is as follows.

3.2.1. Market access rules

The FTA restricts what governments and parliaments can do in relation to investments and cross-border services trade in those sectors for which they have made liberalization commitments without exemptions (see above). In relation to financial services and investment in the financial services sector, FTA 'market access' rules (Art. 112, 119) prohibit the signatory countries to maintain or adopt particular measures and regulations that limit the number of investments or financial services suppliers, and/or limit the total value and number of their transactions or operations. Also, countries are forbidden to apply tests whether a particular investment or service or investment in the financial sector is needed ('economic need test'). In addition, countries cannot have laws that restrict foreign ownership or that require particular legal entities through which an activity can be performed.

[27] For details, see annex VII "Lists of Commitments on Establishment", Section B - List of Commitments on Establishment of the European Union.

These rules are contrary on, for instance:

- The revision of the Markets in Financial Instruments Directive (MiFID) on which the European Parliament's plenary has made its position clear on 26 October 2012, and about which the Council of Ministers of Finance working groups have been discussing, will almost certainly limit the number of contracts, or the size of open contracts, that financial players can have in commodity derivatives ('position limits'). This would be contrary to the market access rule that prohibits the total number or value of financial operations (in the form of quotas).
- Proposals to prevent banks to become too big to fail and/or to separate the retail banking activities from risky investment banking activities (see the 'Liikanen report' in the EU, and the 'Vickers report' in the UK)

3.2.2. Disciplines on domestic regulation

When applying licensing or qualification requirements, technical standards or procedures for financial service suppliers and their products that have been liberalised in the FTA (see above, list of commitments), the authorities have to adhere to specific disciplines (Art. 131) that are identical to GATS rules, such as:

- Not be more burdensome than necessary to ensure the quality of the service;
- Not result in impairing the liberalisation commitments or, in relation to licensing, be a restriction on the supply of the service;
- Being objective;

In addition, no licensing or qualification requirements, technical standards or procedures for financial service suppliers and their products can be applied that could not have been "reasonably" expected at the time that commitments were made and that are impairing the liberalization commitments.

In case of dispute or doubt how to apply these disciplines, international standards can nevertheless be take account into account.

Contradictions with new EU financial regulation

Several new EU financial reforms that have been taken after the crisis year of 2008 are in contrast with FTA rules. For instance[28], the legislation on credit rating agencies (CRAs) adopted on 19 September 2009 (Regulation nr 1060/2009), among others, prohibits CRAs from continuing to provide particular consultancy or advisory services to those entities they rate, a practice considered to be a cause of the financial crisis. This new CRA legislation could be considered to be too burdensome "than necessary to ensure the quality of the service", as it can be argued that 'Chinese walls' within a CRA would be sufficient, and thus in principle contrary to the FTA rule.

The FTA rule that restricts new requirements, standards or procedures to be introduced if they "could not have been 'reasonably' expected at the time that commitments were made" is damaging to policy space. In principle, the EU has already breached such identical commitments under GATS. For instance, the European Parliament adopted in November 2010 a Directive to regulate managers of hedge funds and private equity funds (the Alternative Investment Fund Managers Directive (AIFMD). Such a Directive had been resisted for many years at all EU levels, and many did not expect in 1997

[28] See for more details: M. Vander Stichele, R. van Os, Business as usual - How Free Trade Agreements Jeopardise Financial Sector Reform, SOMO, December 2010, p. 6, http://somo.nl/publications-en/Publication_3611.

(when GATS financial services commitments were made by the EU) that hedge funds would be regulated, until the financial crisis of 2008 happened and it was recognised that hedge funds played a role in it. Moreover, the AIFMD prohibits private equity managers to strip particular capital of a non-listed company within the two years after it was taken over by a private equity investor. This rule aims to prevent short-term profit-taking by a sharp reduction of a company's assets and employees, etc. However, such short-term strategies are key to the high returns sought by investors in PE. The prohibition in the directive could be seen under GATS Art. VI.5 as an impairment of the EU's GATS commitment to 'asset management' as it affects the quality of PE services.

Another example is the fact that the EU introduced regulations to be applied to CRAs. It was not expected that CRAs would be strictly regulated because CRAs had remained unregulated in the past and central bankers officially accepted (under the Basel II accord) that their unregulated ratings were used by banks to make risks assessments.

The FTA disciplines on domestic regulation can become even more restrictive in the future because the FTA stipulates that the signatory parties can agree to integrate amendments on the domestic regulation rule after changes made during new GATS or other multilateral negotiations. Indeed, GATS negotiations in the WTO Working Party on Domestic Regulation are attempting to further narrow down the disciplines. They could result in signatory countries being legally challenged if licensing or qualification requirements and technical standards or procedures fail to be 'relevant' or being 'as simple as possible'. There is a possibility that new GATS domestic regulation rules will require signatory countries to apply some tests whether the requirements, standards and procedures are necessary.[29]

Such continuing disciplining of how financial services can be authorized and regulated reduces the policy space of regulators and supervisors in a financial sector. The recent financial crises have shown that it is difficult to predict what is relevant or necessary to avoid a financial crisis. It certainly indicated that too simple and 'light touch' regulation was insufficient to avoid and handle a financial and economic crisis and that unforeseen reforms might be needed in the future.

3.2.3. National treatment in the financial sector and related to all investments: risky for the financial sector

Each of the signatory parties has to treat the investments and cross-border traded products, in those financial sub-sectors that were committed without exceptions, "not less favourable" than the domestic investments and financial services (Art. 113, Art. 120). This means that even if the financial sector of the counter party is less regulated and supervised as desirable, a more restrictive approach that targets those foreign financial sector investments or services, are not allowed. Also, Peru and Colombia will need to give national treatment to those financial sector providers for which they have given market access, even if EU financial reforms and strong financial supervision measures are far from finalized. Financial sector problems in one signatory party can thus impact on the other signatory party.

Note that this formulation of the 'national treatment' rule means that foreign financial sector investor and cross-border services can be treated more favourably!

[29] M. Vander Stichele, R. van Os, Business as usual, SOMO, December 2010, p. 6.

This 'national treatment' rule also makes it more difficult to take preventive action against investments and financial services or products that are likely to be used for criminal purposes, especially in relation with countries where money laundering from drug trafficking is a risk.

The national treatment rules also apply for investments in all agricultural, industrial and services sectors that have been liberalised under the agreement according to the lists of commitments.

3.2.4. Public financial services

There are specific exceptions from application of the FTA rules for public entities that provide financial services, for instance pension services or social security services or for authorities carrying out governmental functions (Art. 151, Art. 159). However, these exceptions do not apply for public financial services that are supplied in competition with commercial suppliers or when the services are principally supplied on commercial terms. This restriction of how public entities can operate limits their room of manoeuver, for instance of what a privatized bank can do.

3.2.5. Limits on regulating new financial services

A country has to permit any new financial service that is similar to those supplied by domestic financial service suppliers and according to domestic law. Authorisation for such a new financial service can only be refused for prudential reasons.

3.2.6. Uncertain protection of the freedom to implement financial regulation

In Art. 107.5, the FTA stipulates that each party retains the right to regulate and introduce new regulation in order to meet legitimate public policy objectives. This right to exercise a state's power is restricted by the formulation that it is subject to the provisions in the chapter that are related to liberalization of establishment and trade in services. These provisions include the following specifications that limit the right to regulate:

- Countries can only avoid implementation of the FTA rules in the financial services sectors they liberalized, if they have made exemptions of the market access and national treatment rules in the lists of their liberalization commitments in the financial sector.
  According to Art. 154, countries may adopt measures and laws regarding financial services and capital flows for prudential reasons, such as for ensuring the integrity and stability of the financial system and protecting investors and clients of financial service suppliers. This could mean that measures regarding money laundering could be allowed as a protection of the integrity of the financial sector. However, these 'prudential carve-out' measures are not allowed to be "more burdensome than necessary to achieve their aim" which contradicts with the lessons from the financial crisis that has exposed how difficult it is to know what will be risky in the future and undermine financial stability. Also, there are still many disagreements whether a measure is prudential or trade restrictive. This is visible for instance during discussions about financial reforms at international level (e.g. G-20, Basel Committee on Banking Supervision) where there is not always agreement of what is necessary to avoid another financial crisis or what might be too restrictive for the financial industry's competitiveness for trading and investing at international level.
  In addition, the prudential carve-out rule (art. 154) does not allow discriminating between domestic financial services and their suppliers, and those from the other signatory countries.

In case of countries who are known to have financial flows that are money laundering, this rule might restrict preventive measures that are discriminatory.
It needs to be noted that prudential and financial regulations that are allowed under the 'prudential carve-out' clause, are not allowed when they are to provide non-financial objectives such as preventing speculation on food and commodity prices (e.g. by restricting commodity derivatives trading) or to alleviate poverty or to stimulate particular parts of the economy (e.g. to compensate producers of coca that switch to other production or economic activities).

- While Art. 155 aims at "effective and transparent regulation" it also provides that the countries shall endeavour that all interested persons have an opportunity to comment before a measure of general application is being adopted. In practice, the interested persons who have the capacity to monitor and give comments on measures that are proposed for adoption, are mostly the lobbyists of the financial industry, not in the least those from the foreign financial industry. This article in practice provides a legal basis by which lobbyists can require to be able to comment before a financial regulation is adopted, and thus influence the final outcome of that regulation. It is to be reminded that lobbying by the financial sector, called 'regulatory capture', has often resulted in weakening financial regulation and is seen as one of the causes of the financial crisis.

If countries do not apply the rules of the FTA, including the implementation of the liberalization commitments, and when a country accuses another country of not applying the rules and the specifications by which exceptions can be made, this dispute can be brought before the FTA's dispute settlement system (Title XII of the FTA). In other words, any financial regulation of one country, which is being accused by another country to be in breach of the FTA rules and commitments, can be subject to an assessment of an arbitration panel set up according to the FTA's rules (no financial sector qualification required).

The European Commission (EC) always officially states that the prudential carve-out article is sufficiently flexible to allow all financial regulation and that there is no immediate threat to the EU's financial regulation. However, when discussed more informally some EC officials would admit that both the EC as well as European supervisors need to be careful as to how prescriptive their rules can be[30]: This is typically a 'chilling effect' which the FTA and GATS rules can have.

It has to be noted that if no country makes a complaint about a financial regulation, a country can continue to breach the rules. This will indeed probably be necessary to design and apply all financial reforms that are needed, to not only prevent or stop a financial crises and a resulting economic crisis, but also to ensure that the financial sector is at the service of the real economy and sustainable societies.

3.3. Conclusion

The FTA rules that apply to the financial sector are not at all adapted to the lessons from the financial crisis. They are disciplining what regulators, including parliaments, and supervisors can do to regulate and control the financial sector. Several EU financial reforms are already in contrast with the FTA rules

[30] J. Mulder, Briefing on the state of play of EU-US dialogue, email note sent 2 December 2012.

on market access and domestic regulation. Indeed, the FTA rules do not allow to fully apply reforms that could not have been foreseen in the past.

Exceptions to the FTA rules can be made under the so-called prudential carve-out clause. This provision allows prudential regulation, but does not provide a full protection against a legal challenge to financial regulation.

The FTA widely liberalizes a wide range of sometimes risky and speculative financial services, even if current legislative proposals aim at restricting them, and the EU or global financial reforms are far from finalised.