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**Financial Regulatory Reform and US Investment Treaties**

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The US Department of State is about to conclude its revision of US model investment rules. The model forms the initial bargaining position for the US in negotiations over Bilateral Investment Treaties (BITs) and Free Trade Agreements (FTAs). When completed, the Obama Administration hopes to proceed with official negotiations with China, India, Vietnam, and possibly Brazil.

The current “Model BIT” could make it difficult for the US and its trading partners to deploy effective policies to prevent and mitigate financial crises. The US should ensure that no measures designed to maintain financial stability are actionable under US treaties.

On the campaign trail, Barack Obama said he was against investment rules that elevated foreign firms over their host governments. Once he took office, Obama established a sub-committee of business groups, labor and environmental organizations, and academic experts tasked with making recommendations for reforming the Model BIT.

Despite high ambitions of forging a consensus, the sub-committee’s [final report](#) reflected longstanding divisions over these issues. Indeed, on issues related to financial crises, the full sub-committee came to consensus on only one thing.

The one consensus recommendation was for the administration to undertake a legal review of the [prudential measures exception](#). Currently, the exception states that parties to the treaty should “not be prevented from adopting or maintaining measures … to ensure the integrity and stability of the financial system.” However, the following sentence: “Where such measures do not conform with the provisions of this Treaty, they shall not be used as a means of avoiding the Party’s commitments or obligations under this Treaty” is seen as vague at minimum while some [legal scholars](#) argue that the sentence is “self-canceling” and in need of deletion.

Given the high degree of contention, the report includes an annex where members provided additional arguments. A group of sub-committee members made three other recommendations that should be implemented by the US in its model review:
1. Make sure that any measure taken in response to the financial crisis is deemed consistent with investment rules.

Regulatory measures that create “too big too fail” safeguards could be challenged on grounds that they deny a foreign investor’s right to “fair and equitable treatment.” Such an argument was made against the Czech Republic, when a foreign firm said the Czech Republic had violated its rights by excluding a small bank in which it had invested from a bailout program made available to larger “too big to fail” Czech banks.

2. Include a safeguard provision for balance of payments crises that is not subject to investor-state dispute settlement.

US investment rules essentially force nations to liberalize their capital accounts, regardless of their institutional capacity — or be prepared to literally pay the consequences. This stands in stark contrast with economic science. Ayhan Kose of the IMF, Eswar Prasad of Cornell University and Ashley Taylor of the World Bank confirm that capital account liberalization is not correlated with economic growth in developing countries. These authors expand such findings to show that capital account liberalization only works for those nations above a certain threshold of economic and institutional development. In contrast to WTO and IMF rules, the capital controls used by nations until they meet their thresholds would be barred under the current Model BIT.

3. Exclude “sovereign debt” from “definitions” of an investment.

The U.S. Model BIT does not explicitly exclude sovereign debt from the definition of covered investments, as NAFTA does. It should. The U.S. government is the largest issuer of sovereign debt, and countries across the world have taken on much debt to get out of the financial crises and could risk default. The IMF and others have raised concerns that efforts to restructure sovereign debt may give rise to investor-state claims. New model investment provisions should not obstruct global efforts to set up adequate facilities for sovereign debt restructuring that could be undermined if bondholders are able to circumvent such mechanisms by filing claims under BITs.

Ensuring that the US model is in tune with global efforts to prevent and mitigate financial crises benefits both the US and its trading partners. Making sure that ample prudential exceptions exist can buffer the US from liabilities for prudential regulations. What’s more, stability among our trading partners helps US exporters and investors have more certainty for markets. Crises could lead to defaults and large losses to US assets and export markets. And, crises can cause contagion that spreads to other US investment and export destinations. Trade and investment treaties should not prevail over regulations for financial stability in the US and abroad.