INTERNATIONAL LAW ASSOCIATION

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INTERNATIONAL MONETARY LAW

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1 June 2004

Introduction

Since the New Delhi Conference of the ILA in 2002, the Committee (generally known under its acronym MOCOMILA) has held three meetings: in Athens, Greece (27-28 September 2002), Linz, Austria (26-27 September 2003) and Tokyo, Japan (1-2 April 2004). Approximately twenty members and observers attended each of the European meetings. The topics discussed by the Committee are reflected in the following sections of this report.

I. International Financial Architecture

- A. International Financial Standards and Basel II (by Dr K P Follak, Prof C Lichtenstein and Mr J H Freis, Jr)
- B. Sovereign Debt Restructuring (by Professor F Gianviti)
- C. Prevention of International Terrorist Financing (by Messrs T C Baxter, Jr and W Blair)

II. Regional Monetary Areas

- A. European Economic and Monetary Union (by Messrs A Sáinz de Vicuña, R Smits, and J-V Louis)
- B. Dollarization and Cross-Border Uses of Currency (by Mr J H Freis, Jr)

III. Payment Systems

A. Japanese Deposit Insurance — Protecting the Payment and Settlement Deposits (by Professors H Kanda and K Sono)

B. Preventing Creditor Disruption of International Payments (by Prof M Giovanoli)

C. CLS Bank (by Mr J H Freis, Jr)

IV. Future of the Committee

This report reflects the views of the individual rapporteurs and not necessarily those of any institutions with which they are associated. The members wish to acknowledge the additional contributions of the Committee Secretary in editing and finalising the report.

Tokyo International Monetary Law Seminar

On 1 February 2004, the Committee organised in conjunction with the Institute for Monetary and Economic Studies of the Bank of Japan the Tokyo International Monetary Law Seminar: Redefining the Concept of *Lex Monetae* for the 21st Century—International Monetary Obligations and Payment Systems. Six presentations were made:

- Mr Sáinz de Vicuña addressed *The Concept of Money in the XXIst Century*, recalling developments from F A Mann's "state theory of money" to A Nussbaum's "society theory of money" and espousing a new "institutional theory of money".
- Mr Gruson prepared a paper (presented by Mr Freis) on *The US Jurisdiction over Transfers of US Dollars Between Foreigners and over Ownership of US Dollar Accounts in Foreign Banks*.
- Mr Baxter described the *Impact of Dollarization on Payment Systems and Lex Monetae*.
- Mr Blair discussed *Monetary Obligations, Governing Law and Jurisdiction*, defining key terms and reviewing developments in monetary law in areas such as financial sector supervision, as well as efforts to stop money laundering and prohibit the spread of terrorism.
- Mr Gianviti prepared a note entitled *Reflections on Current Legal Aspects of Monetary Sovereignty*, detailing that monetary sovereignty includes the rights to issue currency, regulate its use and determine its value.
- Mr Giovanoli summarised and concluded with a presentation on *National and International Evolution of Money and Implications for Monetary Law*.

Thanks to the initiative of Professors Sono and Kanda, the seminar proved to be a great success with participation by eleven Committee members (in addition to two who provided written papers) as well as approximately two dozen leading Japanese experts from academia and private practice, as well as the Bank of Japan. For the Bank of Japan, this was also deemed a great success, as its first event bringing together such groups of international as well as Japanese legal experts.

Prof Kanda noted that the issue of *lex monetae* had not been referred to in any Japanese academic literature within the last 20 years, which was part of the background in bringing this discussion to Japan to examine the extent to which traditional monetary law doctrine remains valid and identify legal as well as systemic issues which call for reconsideration. In order to extend the debate to a wider Japanese audience, Professors Sono and Kanda plan to draw upon the seminar for a presentation at the October 2004 meeting of the Academic Society of the Japanese Financial Law Association. Additionally, the Committee will pursue publication of the papers presented.

I. International Financial Architecture

A. International Financial Standards and Basel II

In recent years, the Committee has devoted significant discussion to the development process as well as the substance of international financial standards. As discussed in MOCOMILA's report to the 2000 ILA Conference in London, international financial standards developed by experts' groups such as the Basel Committee on Banking Supervision ("BCBS") form a body of "soft law". Arguably the single most successful standard, at least in terms of application — having been implemented into national laws and regulations in over 100 countries — is the 1988 Basel Accord on Capital Standards for internationally active banks ("Basel Accord"). This Committee first mentioned the Basel Accord in its 1990 report to the Queensland Conference. Further developments with respect to the Basel Accord have been a recurring subject of the Committee's reports.

Currently, the most important development in the field of international financial standards is the revision of the Basel Accord, to create "Basel II". The final text of Basel II will be released at the end of June 2004. As such, this report will not focus unduly on details from the earlier draft texts, but rather will attempt to introduce Basel II at its Working Session at the Berlin Conference. The majority of this section of the Report is devoted to providing background and an understanding of prominent issues that have arisen in the revision process.[1]

1. Background on the Basel Accord

The BCBS was established in 1974 by the central bank Governors of the G10 countries. Its members currently come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. The BCBS does not have any direct regulatory or supervisory competence, but rather formulates guidelines and recommendations that must be implemented by national supervisors. The BCBS Secretariat is provided by the Bank for International Settlements in Basel, Switzerland, and its publications, including with respect to the capital requirements, may be found on the BIS website at www.bis.org.

Harmonized capital adequacy standards were expected to promote both a "level playing field" for internationally active banks and contribute to international financial stability. In addition to protecting individual institutions from failure, capital requirements are necessary for three principal reasons:

- to restrain a banking system from becoming overly exposed to particular risks;
- to prevent banks from weak jurisdictions expanding internationally and undermining banks from sound jurisdictions;
- to provide a basis for early intervention in failing institutions.

In basic terms, the Basel Accord established for internationally active banks a minimum level of capital of 8% of risk-weighted assets and off-balance sheet exposure. By risk weights, it is meant that only a certain percentage of a bank's individual assets will be taken into account for the purpose of calculating the capital requirements, based on broad categories of riskiness for such assets. For example, sovereign debt securities of OECD countries were assigned a risk weighting of 0%, meaning no capital need be held with respect to such assets. At the opposite end of the spectrum, corporate securities or loans were assigned a 100% risk weighting, meaning that they were fully counted towards the minimal capital requirement. The primary focus of the original Basel Accord was on credit risk (ie, that an individual debtor will not repay; the above example reflects the fact that an investment in any individual corporation is as a general rule more risky than high grade sovereign debt). Over the ensuing decade the Basel Accord was amended a total of five times, in particular to address market risk.

2. Towards a New Framework

In June 1999, the BCBS announced its intention to introduce a new capital adequacy framework, known as Basel II, to replace the 1988 Basel Accord. The reason for the change was that, despite the widespread acceptance of the Basel Accord, growing sophistication in the global financial markets had made the relatively simplistic approach outdated. New product areas, such as derivatives and asset securitisation, and ways to measure and control different risk types, such as operational risk, were not covered by the Basel Accord. Moreover, some banks were seen as engaging in regulatory arbitrage, taking advantage of the overly simplistic risk weightings.

From the perspective of the Committee's assessment of the process of developing international financial standards, perhaps the most important aspect of Basel II is that it was developed in a uniquely public and unprecedentedly transparent way. This consisted of a series of documents being published for public consultation. Moreover, the BCBS conducted a series of Quantitative Impact Studies – essentially surveys of internationally active banks to whom the standards would eventually apply, to determine how the recommendations would work in practice. Hence, there has been extensive feedback from the private sector. (For example, the Third Quantitative Impact Study, launched in late 2002, involved participation of 188 banks from countries represented on the Basel Committee and 177

[1] For further details, *see* K P Follak, Basel II: The New Capital Accord, ÖBA March 2004.

institutions from 30 other countries.) One of the main reasons for this interaction was that the goal of the Committee was not to increase the overall level of capital held by financial institutions, but rather to have their capital better reflect actual risks.

The foregoing notwithstanding, even if the broad amount of capital would remain relatively constant and would aim to provide a level playing field for banks from different jurisdictions, as could be expected, any regulatory change in capital adequacy could have a drastically different impact at the level of individual institutions or even from country to country, based upon different economic structures. The latter caused a number of public and even politically-charged statements about how the rules should be rewritten. Such developments could hardly have been imagined in the drafting phases of the original Basel Accord, which was left largely to technical experts.

3. Basel II Details and Challenges

The basic structure of Basel II consists of three pillars comprising quantitative capital requirements (Pillar 1), a supervisory review process (Pillar 2) and market discipline (disclosure requirements, Pillar 3). As far as Pillar 1 is concerned, unlike under the old Basel Accord, there will not be a single series of risk weightings to be applied by all financial institutions. On the contrary, Basel II has three separate approaches to risk weightings. The first, the Standard Approach, is based on external credit ratings supplied by ratings agencies (ie, BBB-rated debt will be subject to a higher risk-weighting than AAA); it will nonetheless differentiate risk categories to a greater extent than the old Basel Accord. The other two approaches are based on bank-internal models which take into account each bank's own risk assessments based upon past experience (Basic and Advanced Internal Risk Based ("IRB") Approaches). While it is certainly more complicated for an individual institution to adopt an IRB approach, this is expected to be quite useful to the largest global institutions to tailor their capital requirements to their specific risk exposures. The Pillar 2 supervisory review will help ensure that banks' own IRB approaches are sound. The Pillar 3 market discipline will encourage high disclosure standards and enhance the role of market participants in encouraging banks to hold adequate capital.

To summarize the numerous comments on Basel II, the positive ones generally stress the incentives for institutions to improve their systems of data collection and analysis, moving the system of regulatory capital requirements closer to economic capital. The criticism focused on the complexity of the proposals as well as lack of means of verification, excessive prescription, and inappropriate interference in bank governance. Subsidiary concerns have arisen, for example, in the context of parallel accounting reform efforts, in that banking regulations and accounting treatment are not fully consistent.

As far as complexity is concerned, this is clear on the face of the documents. The second proposal package of Basel II extended to over 700 pages. Among others, the United States Office of the Comptroller of the Currency, the primary regulator of national banks in the US, has publicly stated its opposition on the grounds that proper implementation would be difficult. Basically, one has to admit that complexity is the price of certainty. But there is also a need for regulatory flexibility and adaptation to local financial structure, with supervisors disclosing implementation policies in a transparent way.

The issue of verification is also of a technical nature that will not be solved by transparency. This stems from the nature of modern risk analysis under which assumptions of potential losses are calculated on the basis of past experience. The problem is that the data just does not exist for many institutions or the past experience is too limited to draw conclusions solid enough upon which to make capital decisions. In some cases, data pooling and data sharing between banks could be a good solution, and has been encouraged by the July 2002 BCBS paper. Related efforts have been undertaken, for example, by the Association of German Mortgage Banks and the German savings and cooperative banks and building societies. But data pooling alone will not solve this technical problem.

4. Scope of Implementation

Although the original Basel Accord framework was intended to be mandatory only for internationally active banks, it was applied to the whole banking industry by most national supervisors. Nevertheless, the BCBS recommendations are still formally aimed only at internationally active banks, leaving extended application to national discretion. Moreover, the Committee acknowledges that emerging financial systems may need more time for implementation beyond 2006. But divergent views on the scope of implementation have also arisen among the G10 countries.

It seems already clear that under the US supervisory regime Basel II will be applied to only approximately 10 national banks, whereas the implementation by the EU will cover the whole banking industry. The US supervisors have stated that they plan only to implement the IRB Advanced Approach. US banks that do not meet the mandatory criteria are not required to adopt Basel II, and only approximately 10 further banks are expected voluntarily to do so. These 20 banks nonetheless account for 99% of the foreign assets held by the top fifty domestic US banking organizations, and also for approximately two-thirds of the domestic assets of all US banking organizations. The US decision, although in accordance with the stated scope of both Basel Accords, has been broadly criticised.

The EU will implement Basel II by a Directive which will be applied to the whole banking industry and not just to internationally active banks. Although the draft Directive mirrors the BCBS decisions, some amendments are proposed, such as slightly more room for partial uses of the approaches of capital requirement calculation, and a new risk weight class of 10% for banks specializing in interbank and public debt business.

For internationally active banks, recall that distinct legal entities including subsidiaries are subject to the jurisdiction of their respective state of incorporation, whereas branches are additionally regulated by the authorities of the host country. The BCBS states that under the New Accord, cross-border issues are likely to receive even greater attention than they do today. A BCBS paper, "High-Level Principles for the Cross-Border Implementation of the New Accord" was published in August 2003. Further focus upon implementation, included through the BCBS own Accord Implementation Group, will surely be a continuing focus beyond the publication of the final Basel II provisions, though the timeline for implementation in the G10 countries by end-2006, and beyond.

The issue of implementation in various jurisdictions had been flagged by this Committee when it first mentioned the Basel Accord in its 1990 report to the Queensland Conference. The main focus at that time, however, was with respect to the global debt crisis of the 1980s. A major theme was how the Basel Accord would affect lending to developing countries. While problems of unsustainable sovereign debt burdens have resurfaced in recent years, this has happened in the context of different market structures, which hence require different solutions. The following Section of this report explains the Committee's recent studies in this area.

B. Sovereign Debt Restructuring

There is increasing recognition in both the official sector and private markets that allowing countries with clearly unsustainable debts to restructure in a fashion that preserves economic activity and asset values is to the benefit of all concerned. Both official and private sector representatives and institutions have been actively engaged in exploring ways to improve the crisis resolution framework, and in particular the means by which unsustainable debt can be restructured in a rapid and orderly manner.

Problems arise from the fact that for countries with unsustainable debt burdens, collective action difficulties create incentives for individual creditors to "hold out" from the restructuring in the hope of obtaining more favourable terms after the restructuring is completed. This in turn complicates the task of achieving broad participation in the restructuring that may serve the interests of both the debtor and creditors as a group. These difficulties seem to be most acute in cases where the restructuring is conducted prior to a default, in which cases creditors have an incentive to gamble on continued repayment of claims.

Recent developments in capital markets have amplified collective action difficulties. The last twenty years have witnessed a change in the sovereign debt market from syndicated commercial bank lending toward bonds and a variety of tradable financial instruments issued in a number of jurisdictions that are held by a diffuse and broad base of creditors, including retail investors and vulture funds. Broadly speaking, vulture funds and some retail investors may have a greater propensity to litigate than commercial banks.

Moreover, recent changes in the legal environment have also provided greater opportunity for creditor litigation against sovereigns. The restrictive theory of sovereign immunity now prevails in almost all jurisdictions, so a foreign sovereign can be subject to civil proceedings in a foreign court with respect to its commercial activities, and the assets of that sovereign used for commercial purposes within the court's jurisdiction can be attached in satisfaction of a claim. Furthermore, sovereign debt documentation typically provides – through a waiver of sovereign immunity – for the sovereign's consent to a foreign jurisdiction and judgment enforcement proceedings. The erosion in the United States of the law against champerty (the purchase of a claim with the intent and for the purpose of bringing a legal action) is another procedural development that has favoured sovereign debt litigation. The development of novel and creative arguments by a number of creditors as to the meaning of certain

clauses contained in sovereign bonds, such as the arguments made by Elliot Associates on the meaning of the *pari passu* clause in its litigation against Peru in Belgium (*see* Part III.B.2 of this Report), has emboldened other creditors to bring litigation along similar lines.

The key challenge for markets and policymakers is to develop effective tools that resolve collective action problems, while strengthening the incentives for a sovereign and its creditors to reach early agreement on a restructuring that preserves asset values and provides a credible exit from crisis. The proposals by the official and private sector fall into three broad categories: the first focuses on a statutory framework, the second relies on a contractual approach and the third favours a voluntary code of conduct.

1. Statutory Approach — Sovereign Debt Restructuring Mechanism and Other Proposals

An innovative, public sector proposal for improving the existing sovereign debt restructuring process was presented by the International Monetary Fund ("IMF") in early 2003 — the Sovereign Debt Restructuring Mechanism ("SDRM") (see "Proposed Features of a Sovereign Debt Restructuring Mechanism", at http://www.imf.org/external/np/pdr/sdrm/2003/021203.htm). The SDRM proposal envisaged the establishment of a new statutory framework by amendment of the IMF's Articles of Agreement.

The principal feature of the SDRM was that it would allow a sovereign and a qualified majority of creditors to reach an agreement that would then be made binding on all creditors that are subject to the restructuring, paying due regard to seniority among claims and the diversity of creditor interest. Giving creditors the ability to make this decision on an aggregated basis would not shift the legal leverage from the creditors to the debtor; rather it would increase the leverage of the majority of creditors over potential holdouts and free riders, enabling an agreement to be secured more rapidly.

The SDRM was intended only to be used to restructure debt that is judged to be unsustainable. It would apply only to sovereign debt governed by foreign law or subject to the jurisdiction of foreign courts; sovereign debt subject to domestic law and jurisdiction would be excluded. The SDRM framework gave great emphasis to transparency requirements. One important requirement was that creditors would be provided with information on how other creditors were being treated during the restructuring process.

Finally, the SDRM proposal contemplated the establishment of an independent dispute resolution forum to verify claims, to ensure the integrity of the voting process, to adjudicate disputes that might arise following activation of the SDRM, and to certify the debt restructuring agreement. The terms establishing the forum were designed to ensure its independence, competence, diversity and impartiality.

While the SDRM would provide an effective tool to overcome collective action problems, there is currently insufficient support for its establishment. One concern raised in the markets is that this could create a type of moral hazard, in that the very existence of a mechanism for restructuring sovereign debt could lower incentives of sovereigns to fulfill their debt obligations. Nonetheless, the debate triggered by the proposal over the past two years has been helpful in creating better awareness of these problems and the need to pay more attention to preventing the building up of unsustainable debt.

Apart from the SDRM, another statutory approach, involving the use of the existing United States federal rules of civil procedure, has been suggested in the context of overcoming collective action problems. The proposal involves a group or committee of representative creditors commencing a class action in a US court and putting forward a proposed restructuring – in the form of a class action settlement – that, if approved by the court, would be made binding on all affected creditors through the court judgment. A number of legal uncertainties, including questions surrounding international jurisdiction of US courts, and how the class is defined, would need to be resolved in order to provide the necessary predictability to make this proposed approach workable.

2. Contractual Approach — Collective Action Clauses

While the SDRM would have established by international treaty a comprehensive framework to deal ex post with sovereign debt problems, progress has already been made on an ex ante, albeit piecemeal, basis through a contractual approach. Collective Action Clauses ("CACs") refer to provisions in bond contracts that enable the sovereign, and a qualified majority of its bondholders, to take decisions that become binding on all bondholders within the same issuance.

Perhaps the most important provision of CACs is the majority restructuring provision, which enables a qualified majority of bondholders to bind all bondholders within the same issue to the terms of a restructuring agreement, either before or after default. In addition, majority enforcement provisions are designed to limit the ability of a minority of bondholders to disrupt the restructuring process by enforcing their claims after a default but prior to a restructuring agreement. While majority restructuring provisions currently exist in sovereign bonds that are governed by English, Japanese and Luxembourg law, bonds governed by New York law have not, until recently, included these provisions.

Notwithstanding encouragement by the official community since 1996 to use CACs, progress towards their widespread inclusion in sovereign debt contracts had been limited. More recently, however, there have been a number of important developments with respect to both the design of CACs and their inclusion in sovereign bonds governed by New York law. In September 2002, a G10 Working Group issued a report that contained recommendations on the design of clauses in sovereign bonds that aim to foster early dialogue, coordination and communication among creditors and the debtor, to ensure that there are effective means for creditors and debtors to agree to restructuring, without a minority of bondholders obstructing the process; and to ensure that disruptive legal action by individual creditors does not hamper a workout that is under way. In addition, the Institute of International Finance and six other financial industry trade associations put forward in March 2003 a draft set of model CACs developed for bonds governed by New York and English laws.

Since Mexico first issued bonds under New York law with CACs in March 2003, there has been a clear shift in the use of CACs in international sovereign bonds issued under New York law, where they had previously not been market standard. Belize, Brazil, Chile, Colombia, Costa Rica, Guatemala, Indonesia, Israel, Korea, Mexico, Panama, Peru, the Philippines, Poland, South Africa, Turkey, Uruguay and Venezuela are among emerging market countries that have successfully issued bonds with CACs since that time, and this rapid progress is nurtured by a greater acceptance of these contractual provisions by the markets and the absence of any apparent premium in pricing.

Moreover, a number of mature market countries have also taken steps to introduce CACs in their international sovereign bonds. In particular, EU members have committed to include CACs in bonds issued under a foreign jurisdiction that reflect the recommendations of the G10 Working Group. Italy has already launched such bonds under New York law. Also the UK issued a US dollar denominated bond governed by English law that contains CACs consistent with the G10 recommendations. Now that the first-mover hurdle has been removed, the challenge is to consolidate the progress made and to ensure that the use of CACs becomes market standard.

While CACs provide a technique for mitigating collective action problems, they are subject to important limitations.

- Even if CACs were widely accepted in new instruments, they would not apply to the outstanding stock of bonds and other debt instruments. (Presumably, however, maturing debt will be replaced with new debt issues subject to CACs, thereby diminishing this concern over time.)
- At least in the US and UK, CACs (and exit consents) appear to have no effect on bondholders that have already obtained court judgments on accelerated claims prior to a restructuring agreement, leaving these judgment creditors outside of the contractual restructuring framework.
- While CACs provide for collective action among bondholders within the same issuance, they do not provide for the aggregation of voting across instruments.

In addition to CACs, another approach to sovereign debt restructuring under the contractual framework also worth mentioning is to establish ad hoc creditor associations in the context of crisis to facilitate organization of small bondholders for future debt restructuring negotiations. An example of such approach is the Argentine Bond Restructuring Agency ("ABRA"), a special purpose company established under the laws of Ireland (see www.hypovereinsbank.de/pub/io/prku/97283.jsp). Bondholders who wish to participate in the ABRA on a voluntary basis may surrender their bonds to ABRA in exchange for certificates to be issued by ABRA. As the legal owner of the bonds, ABRA will represent the participating bondholders in the restructuring negotiations. The negotiations will be conducted on behalf of ABRA by a special negotiation team retained by ABRA on a contractual basis. The chief benefit of this approach is creditor coordination, which is more likely to be attractive to smaller retail investors who, on their own, have little or no leverage. ABRA operates to unite them

within a single legal framework which delegates negotiations to a single party on behalf of all ABRA participants.

Finally, a contractual approach to facilitate the restructuring of the existing stock of bonds that do not contain CACs has been suggested by JP Morgan and is based on a variation of the use of CACs. This approach involves a two-stage process designed to provide predictability on the resolution of intercreditor equity issues. In the first stage, investors holding international sovereign bonds would exchange their existing instruments for new instruments. New instruments would provide for a legal framework that would facilitate a final restructuring agreement in the second stage. In addition to the cost of these exchanges, the key challenge in implementing the two-stage restructuring framework is to persuade investors to participate in the first stage of the exchange because investors may be unwilling to surrender their individual contractual rights and enter into a collective process in a post-default scenario.

3. Voluntary Approach

There has been considerable discussion within both the official and private sectors regarding the potential benefits of a voluntary code of conduct that could guide the behaviour of sovereign debtors and their creditors during periods of relative tranquillity as well as periods of acute stress. These discussions have taken place in different fora. One of these is an informal working group led by the Banque de France and the Institute of International Finance which consists of participants from several emerging market countries, a number of the major economies and private sector representatives. Although this group includes only selective representatives, it is attempting to develop a voluntary code of conduct ("Code") that could gain wider acceptance in the official and private sectors. This Code would lay down general principles to be complied with by all stakeholders, provide sovereign debtors and their creditors a roadmap of the debt negotiation process, and set forth procedures regarded by the international community as best practices. The Code is intended to be voluntary, and none of its provisions would be given any legal effect as a matter of contract, comity or otherwise. The main challenge for the working group has been to reach consensus on the right balance between a framework that is flexible enough to be applied to a diverse set of country circumstances, and one that is still normative enough to offer a useful guide to how the process should work in practice.

More recently, the G20, in the context of its work on crises resolution, has held several high-level meetings with representatives of the private sector to develop a voluntary code on debt restructuring. A technical group including Brazil, Korea and Mexico has been established to prepare a draft code for broader consideration. At the same time, the Institute of International Finance is continuing is efforts to contribute to a code, based on key principles predicated upon enhanced creditor-debtor cooperation.

In summary, the official and private sectors have been actively engaged in exploring ways to resolve collective action problems that hinder the restructuring of sovereign debt in an orderly and rapid manner. The different approaches of a statutory regime, contractual framework and voluntary code of conduct are not mutually exclusive. The rapidly evolving nature of the sovereign debt market is likely to bring all three approaches into play in some form or other.

C. Prevention of International Terrorist Financing

The Committee's report to the New Delhi Conference in 2002 noted the growing international cooperation in efforts to combat terrorist financing; since then, this process has only accelerated. The horrible events of September 11, 2001, and other terrorist attacks including March 11, 2004, have had a tremendous impact causing all of us to question whether there will be any security in future. In November of 2001, the Security Council of the United Nations reiterated the view that the Council expressed immediately after September 11th that "acts of international terrorism constitute one of the most serious threats to international peace and security in the twenty-first century."[2]

In December of 2001, the Chairman of the Basle Committee on Banking Supervision, William J. McDonough, expanded on this statement by the Council, and identified terrorism as a threat to financial stability.[3] He observed that terrorism adversely impacted the ability of central banks and

[2] United Nations Security Council Resolution 1377, U.N. SCOR, 56th Sess., 4413th mtg. at 2, U.N. Doc. S/Res/1377 (2001). *See also* United National Security Council Resolution 1368, U.N. SCOR 56th Sess., 4370th mtg, U.N. Doc. S/Res/1368 (2001); United Nations Security Council Resolution 1373, U.N. SCOR, 56th Sess., 4385th mtg., U.N. Doc. S/Res/1373 (2001).

[3] Speech before Representatives of Supervisory Authorities and G10 Central Banks (Basel, Switzerland, Dec. 14, 2001).

banking supervisors to perform their essential functions. He urged central banks and bank supervisors to add their voices to the international outcry against terrorism, to take affirmative action to cut off terrorist access to financing, and to close payment systems so terrorists cannot move money in support of their nefarious activities.

More recently, Claes Norgren, the Chairman of the Competition Authority of Sweden and the president of the Financial Action Task Force, and Jaime Caruana, the Governor of the Bank of Spain and current Chairman of the Basle Committee on Banking Supervision, following the terrorist strike in Madrid, reaffirmed the earlier views of Mr McDonough.[4] They sounded an "urgent need for the private sector to become more closely involved in efforts to isolate terrorist networks." They concluded with the admonition that, "[i]f we can choke off the terrorists' money supply, they will be severely handicapped. The clear objective of both of our organizations is to make sure this scourge of civilized society will never find a haven in the global banking system."

A significant role in facilitating international cooperation has been played by the Financial Action Task Force ("FATF"). Originally established in 1989 by the G7 countries, FATF now counts 33 members. In May 2004, its mandate was renewed for eight years, ie through December 2012. Its Forty Recommendations on Money Laundering (revised in June 2003) together with the Eight Special Recommendations on Terrorist Financing (issued in October 2001) have become international standards. They detail measures to be taken at the criminal justice and regulatory levels, by financial institutions and other businesses, and with respect to international cooperation. The FATF's newly extended mandate calls for it to continue its role in standard setting and in promoting implementation in national jurisdictions. It will also expand its focus on informal and non-traditional methods of financing terrorism and money laundering.

Accordingly, the position of those who set policy for the international monetary system is clear. Terrorism is seen to be a threat to international monetary stability, and the international monetary system must do what it can to thwart terrorists and terrorist financing.

1. International Instruments Prohibiting the Financing of Terrorism

The UN International Convention for the Suppression of the Financing of Terrorism of 9 December 1999 was the product of General Assembly concern about the need for measures to counteract the movement of funds suspected of terrorist purposes without impeding free capital movements. The Convention obliges states to create various offences relating to the funding of terrorism, and to take measures for the identification, detection, freezing and seizure of such funds, and the proceeds of terrorism. For example, Article 8 provides that:

> Each State Party shall take appropriate measures, in accordance with its domestic legal principles, for the identification, detection and freezing or seizure of any funds used or allocated for the purpose of committing [terrorist offences] as well as the proceeds derived from such offences, for purposes of possible forfeiture.

The Convention is restricted to terrorist acts with an international element. It is a useful and in many ways impressive piece of work, though it took until April 2002 for it to come into force.

There were also measures taken against the Taliban and Osama bin Laden, namely Security Council Resolutions 1267 of 1999 and 1333 of 2000 respectively. They were imposed after the embassy bombings in East Africa in 1998. In both cases, the measures included a financial freeze.[5]

Following the September 11 atrocity, on 28 September, acting under Chapter VII of the UN Charter, the Security Council decided that all states should criminalise the funding of terrorism, and should "freeze without delay funds and other financial assets or economic resources" of terrorists, entities owned by terrorists and those acting for them (SC Resolution 1373 of 28 September 2001). This resolution is now one of the most important international instruments as regards terrorism and finance. The obligation to freeze terrorist assets is unqualified, and of universal application. The Security Council also established a Counter-Terrorism Committee to monitor compliance with Resolution 1373. Over a hundred states have reported to it on the implementation of the resolution. However the Committee's role is limited, and it has made it clear that will not get into scrutinising legislation, let

[4] C. Norgren and J. Carvana, "Wipe Out the Treasuries of Terror," Financial Times at 15 (April 7, 2004).

[5] See also Council Regulation (EC) No 467/2001 [2001] OJ L67/1, Art.2, imposing a freeze across the European Union.

alone the effectiveness of implementation.[6] Resolution 1373 was widely put into effect by implementing measures in domestic law.[7] It was also the spur to new legislation dealing with terrorism generally.[8] In some countries the process has been controversial. In India, the Prevention of Terrorism Ordinance passed onto the statute book only after an extraordinary joint sitting of both Houses of Parliament on 26 March 2002.

2. US Efforts to Fight Terrorist Financing

To better understand how the international policy consensus can be put into practice, it is useful to review the ways in which measures to combat the financing of terrorism have been implemented in the United States. In general, the policy can be seen as being executed in three basic ways. First, the international monetary system is devoting resources to tracing funds used by alleged terrorists for the intelligence value that this information may have. Second, new legal techniques are being developed to interdict terrorist funds in transit. Third, the last part of this section addresses efforts to improve the resilience of the financial system, if the actions to combat terrorist financing prove unsuccessful.

Immediately after the attacks of September 11th, the Federal Reserve Bank of New York began circulating among the international financial community a list of the 19 hijackers, and other people who may have provided financial assistance to them. The list came to be known as the "control list". The concept was to disseminate a list to the global financial community and to try to obtain intelligence information about their financial affairs that could be delivered to law enforcement at the earliest possible time. However, the object of the exercise was not to obtain evidentiary material that could be used in a courtroom. The hijackers were dead. The object was to obtain intelligence information that might be used to prevent another catastrophic attack.

On October 26, 2001, the USA Patriot Act was enacted in the United States. A comprehensive description of this legislation is beyond the scope of this report, but the legislation contains provisions designed to extract information from the international monetary system. The regulations issued under Section 314 of the Patriot Act permit a law enforcement agency, through the US Treasury Department's Financial Crimes Enforcement Network ("FinCEN"), to request a financial institution to search its records in an effort to determine whether it maintains or has accounts for, or has engaged in transactions with, specified individuals, entities, or organizations. In addition, Section 314 provides for voluntary information sharing among financial institutions and associations. These legal methods are designed to capitalize on the information treasure that may be discovered in the international financial system. Pursuant to Section 362 of the Patriot Act, FinCEN has developed an electronic network that allows financial institutions to communicate certain kinds of information, such as suspicious activity reports and currency transaction reports.

Another illustration of the effort at intelligence and deterrence can be seen in Section 328 of the Patriot Act, and FATF Special Recommendation VII. Both serve to promote the inclusion in wire transfer information of the originator of a funds transfer. The idea is to force insertion into a financial message of information that might have critical intelligence value.

Other provisions of US domestic law seek to meet the challenge of terrorism by capturing money and not merely information. Section 319 of the Patriot Act permits funds deposited in an account at a foreign bank to be "deemed" to be deposited inside the United States in an interbank account of that foreign bank, under certain conditions and for certain purposes. The new provision significantly increases the power of the Department of Justice to forfeit the funds of terrorists, in the event that such funds are deposited outside the United States in a bank that has an interbank account inside the United States. Some consider this provision to be an attempt to apply US law extra-territorially, and it has been criticized on those grounds. While Committee discussions have shown differing initial views on that issue, this provision is referenced here as an illustration of the new tools being used to respond to the threat of terrorism (note that it can be used in other criminal matters too). The purpose of the provision is different than intelligence gathering. It is intended to create a device that might be used to

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[6] Press briefing by the Counter-Terrorism Committee Chairman, 19 October 2001.

[7] In the UK, see The Terrorism (United Nations Measures) Order 2001, 2001 SI No. 3365, made by order in council under the United Nations Act 1946. See now 2002 S1 No. 111. On 27 December 2001, the European Community passed Council Regulation (EC) No. 2580/2001 [2001] OJ L334/70 to the same effect.

[8] In the UK, the Anti-Terrorism, Crime and Security Act 2001. *See generally* Cranston, *Principles of Banking Law*, 2nd ed., 2002.

"choke off" the terrorists' supply of money consistent with the above-quoted statements by Messrs. Norgren and Caruana that in so doing you will help stop terrorism.

Another example can be seen in Section 311 of the Patriot Act, which enables the US Treasury Department to designate certain countries and certain institutions, classes of transactions, or types of accounts as being "primary money laundering concerns", and to take measures against such concerns. The "special measures" can range from recordkeeping or reporting requirements to compulsory legal process ordering the termination of correspondent banking relationships with the designated countries or institutions. The idea behind the provision allowing prohibition of opening or maintaining correspondent accounts is a denial of access to the US payments system to those who are not cooperative or those who are in non-cooperative jurisdictions. Section 311 is, in general, consistent with the pronouncements of the FATF of certain countries considered to be non-cooperative with international anti-money laundering principles. Again, the object is not to gather information but to coerce cooperation.

3. Resilience and Recovery

In the aftermath of the September 11 terrorist attacks in New York, the financial supervisory and regulatory agencies of the United States and United Kingdom undertook to explore whether the resiliency of the financial system could be strengthened. After a careful study of the financial markets' reactions and responses to the events of September 11, the US agencies proposed a set of sound practices for core clearing and settlement systems and financial institutions that play significant roles in critical financial markets. The UK efforts focused more on the potential need for an expansion of the emergency powers available to the supervisory/regulatory authorities, although recommendations for improved preparations by both market authorities and participants were made.

In May 2003, three financial services regulatory and supervisory agencies – the Federal Reserve Board, the Securities and Exchange Commission, and the Office of the Comptroller of the Currency – published the Interagency Paper on Sound Practices to Strengthen the Resilience of the US Financial System ("Interagency Paper"). While the paper directed its sound practices at those institutions and entities that pose the greatest risk to the financial system of systemic disruption if they fail to complete their outstanding transactions, it suggested that all banking organizations and financial market participants review their own practices and consider implementation of the sound practices.

The sound practices described in the Interagency Paper seek to ensure that the critical financial markets, including the markets for federal funds, foreign exchange, commercial paper, corporate equities and bonds, and government, agency and mortgage-backed securities, return to a reasonable level of clearance and settlement within a short time after the disruptive event. The Interagency Paper defines business continuity objectives, including: rapid recovery and timely resumption of critical operations following either a wide-scale disruption or the loss or inaccessibility of staff in at least one major operating location; and a high level of confidence, through ongoing use or robust testing, that critical internal and external continuity arrangements are effective and compatible. Sound practices should include geographical dispersion of back-up sites dependent upon different infrastructure components. As to time frames, core clearing and settlement organizations should substantially achieve the sound practices by the end of 2004. Firms that play significant roles in critical financial markets are expected to achieve substantially the sound practices by May 2006.

The Bank of England published a report of its Task Force on Major Operational Disruption in the Financial System ("Task Force") in December 2003, which provided recommendations to help further improve the resilience of the UK financial markets. The Task Force reviewed the current structure of market preparedness for disruptive events and noted the importance of contractual provisions, market infrastructure rules, and coordinated contingency planning by market participants. Specifically, its report investigated the current legal regime in the UK in both private and public law with respect to emergency situations, and it reviewed the regulatory and supervisory powers currently existing under current statutes to determine if further legislation is required to fill any gaps that might hinder the recovery of the financial system.[9]

[9] The Financial Markets Law Committee ("FMLC") also published its own report on the need for further emergency powers legislation in December 2003. The FMLC report provides a summary of the current state of statutory law and private law applicable to emergency situations as embodied in many of the wholesale financial market master agreements. The conclusions of the FMLC are in line with those of the Task Force.

The Task Force concluded that, on balance, no new statutory powers are needed. This notwithstanding, the Task Force made eight recommendations to help further improve the resilience of the UK financial markets, directed to private market participants as well as supervisory and regulatory authorities. The eight recommendations are as follows:

1. Market participants and financial authorities should continue to place a high priority on business continuity planning.
2. Market participants and their trade associations should work to ensure that private contracts are reviewed to take account of major operational disruption.
3. Market infrastructures should ensure that they have both flexible and specific (rather than general) powers to deal with major operational disruption.
4. The UK financial authorities should continue to contribute to international efforts to develop recognized good business continuity practice for systemically important market infrastructures.
5. Participants in significant markets should consider whether there would be benefits from further defining the principles on which to base claims arising from the delayed performance of contracts following major operational disruption.
6. The financial authorities should aim to clarify further, and publicize, their respective roles in the event of major operational disruption.
7. The financial authorities should consider with market participants the need for a high-level committee to help ensure coordination across financial markets in the event of major operational disruption.
8. The UK financial authorities should continue to promote international cooperation and coordination in developing responses to major operational disruption.

In conclusion, as can be seen from the foregoing summary, international monetary law has responded to the threat that terrorism poses to financial stability. These new tools, and other changes to law and in law enforcement, may be what is necessary to assure security to future generations. International law has played its part. There is now a positive obligation on states to inderdict the financing of terrorism. We conclude with that hopeful thought.

II. Regional Monetary Areas

A. European Economic and Monetary Union

Since the last ILA conference, major developments have taken place in the area of European Economic and Monetary Union ("EMU"). This section of the report seeks to give an overview of those major developments focusing, of course, on the legal aspects. First, developments in the external value of the euro are noted, in that they are relevant to the question of central bank independence. Following this are discussions of progress in the development of the internal market (freedom of capital movements and payments, organisation of a single financial market); a summary of the debate over budget discipline in the economic union and the non-observance of the Stability and Growth Pact; and a description of the portions of the Accession Treaty for the ten new Members States, to the extent relevant to EMU. Finally, this section concludes with a review of the process of establishing an European Constitution, focussing upon the draft provisions relevant to EMU. One recurring theme over the past few years — from a judgement of the European Court of Justice through the drafting of the European Constitution — is the issue of how to describe the European Central Bank ("ECB") in the context of other Community institutions.

1. External Value of the Euro

Five years after the introduction of the euro (on 1 January 1999) and the abolition of national currencies (whose physical existence in bank notes and coins was also abolished after a short transitional period beginning on 1 January 2002), the euro's value on the exchange markets still seems to attract most of the attention. Whereas the ECB is entrusted with the primary objective of maintaining price stability, the stability of the euro vis-à-vis third currencies has been a major focus of attention. The steady rise of the euro in 2003 and 2004 once again revealed the weak institutional structure of EMU when it comes to exchange-rate policy and the dangers for the ECB's independence. The former weakness is clear when one considers that the Council (of Ministers of Economic Affairs and Finance) is competent to act in the external sphere but can only issue general orientations for exchange-rate

policy in the absence of formal fixed exchange rates (article 111(2) EC Treaty). The reticence shown by European policy makers has resulted in a low-key approach of exchange-rate policy. Nevertheless, statements in the context of G7/G8 conferences have sought to influence the value of the euro vis-à-vis the dollar and dollar-related Asian currencies.

On the issue of the independence of the ECB, fears both by business and politicians of the negative impact of the euro's rise on the upswing of the European economy have led to calls for interest rate reductions. Repeated and becoming louder over time, these calls have been resisted by the ECB Governing Council. The newly appointed president, Jean-Claude Trichet, has publicly stated (during the March 2004 press conference following the Governing Council meeting) that the ECB "should not be influenced in either direction", meaning "that we should not do something because we are told to do something. And that we should not do something because we are told to do the contrary".[10] The ECB's independence was also at issue in the context of the appointment of its first president, Wim Duisenberg, who stepped down within his statutory eight-year mandate in October 2003 to make place for Jean-Claude Trichet.

2. Progress on the Internal Market

As the first, ground-laying element of EMU, the establishment of an internal market with freedom of payments and capital movements has essentially been a feature of the European Union since 1 January 1994. On that date, starting date of Stage 2 of EMU, the Treaty provisions on capital movements and payments became operative (currently, Articles 56-60; these essentially took over the provisions of the earlier Council Directive 88/361/EEC of 24 June 1988 on the free movement of capital). They enshrine full freedom to effect financial transactions within the European Union and vis-à-vis the outside world (the latter extension being subject to several restrictions defined in the Treaty itself). One year before, the completion of the internal market was supposed to have been achieved under the so-called 1992 programme establishing a system of comparable standards for the production for goods and services, mutual recognition of these standards and their enforcement by the States. Nevertheless, by the time the euro was introduced, it was recognised that the internal market programme had not resulted in the materialisation of a fully integrated capital market.

For that reason, a Financial Services Action Plan was adopted,[11] which should lead to the adoption and implementation of a host of legislative measures supposedly ensuring a free, well-regulated financial services market. This legislative programme is now coming to an end and its results have not met expectations. Especially in the retail banking area, but also in other areas of the financial services industry, markets remain largely national and the introduction of the euro has not (yet) led to a single payments area. The latter element has been taken up directly by the banking industry, which aims at a single European payments area by the year 2010, as well as by the ECB (which issued two progress reports on retail payments within the eurozone) and by the European Commission. The latter published a green book with possible legislative measures to ensure that payments are effected as smoothly within the EU as within a single Member State.[12]

The European Court of Justice has contributed to the removal of barriers by several judgements which relate to the ability of investors to acquire assets throughout the common market, unimpeded by restrictions of a regulatory nature. Notably, in ground breaking rulings on golden shares in formerly publicly held companies, the Court has found that the maintenance of such prerogatives by their former state owners may deter investors from other Member States from investing in such privatised companies. This very broad reading of the term "restriction" (outlawed in Article 56 of the EC Treaty) is coupled with the acknowledgement that, under a rule-of-reason reading of the relevant provisions, a State cannot be denied the right to regulate formerly publicly held companies. Such regulation,

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[10] Transcript of the questions asked and the answers given by Jean-Claude Trichet, president of the ECB, and Lucas Papademos, vice-president of the ECB, at: http://www.ecb.int/key/04/sp040304.htm

[11] See Communication from the Commission - Implementing the framework for financial markets: action plan (COM/99/0232 final), *available at*t http://www.europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=COMfinal&an_doc=1999&nu_doc=232.

[12] See the Communication from the Commission to the Council and the European Parliament concerning a New Legal framework for Payments in the Internal Market (Consultative Document), COM (2003) 718(01), released on 2 December 2003, *available at* http://www.europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/03/1641|0|RAPID&lg=EN.

however, must uphold legal certainty and make it possible for the potential investor to assess in advance, in what circumstances the State might make use of its interventionist powers.[13]

3. Budgetary Discipline and the Stability and Growth Pact

Whereas monetary union is characterised by a transfer of sovereignty from the State to the Community level of government and the assumption of monetary policy powers by the ESCB, as well as exchange-rate powers by the ESCB and the Council, economic policy for the remainder is still a prerogative of the individual Member States. Economic policies have to be coordinated, however, within a Community framework. Besides annual rounds of coordination within broad economic policy guidelines (Article 99 EC treaty), economic union is mainly characterised by certain rules of behaviour, notably in regard to budgetary restraints (Articles 100 – 103).

Article 104 of the EC Treaty requires Member States to avoid excessive deficits. It is for the European Commission to monitor budgetary developments in the Member States and to establish whether it finds a budget to be excessive. Two reference values are given in this respect: the budgetary deficit in relation to Gross Domestic Product ("GDP"), which is not to exceed 3%, and the relationship between accumulated public debt of a Member State, which is not to exceed the level of 60% of GDP. It is for the European Council to establish whether excessive deficits exist. Under annual review procedures which have been established by the so-called Stability and Growth Pact, an assessment is made of a State's compliance with the budgetary rules. (MOCOMILA's 1998 report to the Taipei Conference reported on the development of this pact in the context of the EMU provisions of the Maastricht Treaty. In general, the pact consists of a set of measures adopted in 1997 and operative since the introduction of the euro, which fill in the discretion which the Treaty itself permits when applying the rules on fiscal prudence).

The Stability and Growth Pact, moreover, requires budgetary balance over time rather than the less strict Treaty requirements of a 3% maximum of actual budget deficits. This Treaty-given standard has been flouted by several Member States, calling into question the fiscal underpinnings of the single currency project. This came to a climax in November 2003 when, after earlier findings of excessive deficits for France and Germany, the European Council acknowledged the European Commission's assessment of the severe budgetary situation in both Member States, but failed to follow up under the rules of the Stability and Growth Pact. The Council adopted its conclusions in the non-legal text of a communiqué, thereby effectively suspending the application of budgetary rules of the Treaty and the Stability and Growth Pact with respect to France and Germany.[14]

Since these rules have been applied to other Member States (most notably Portugal which has since fully restored fiscal discipline), there was uproar among Member States and in the financial press. Although the euro exchange rate was not affected (it continued to rise on the foreign exchange markets), the legal position needed clarification in the eyes of the European Commission. The Commission brought the Council before the European Court of Justice, requesting the latter to declare the Council in breach of its obligation to apply the Treaty rules.

4. EU Enlargement

On 1 May 2004 the Treaty of Accession entered into force, enlarging the European Union to 25 Member States. In addition to the Accession Treaty, the then 15 Member States have also separately ratified the new version of Article 10.2 of the Statute of the ESCB/ECB, which adapts the voting modalities in the Governing Council of the ECB to a potentially enlarged eurozone. The Accession Treaty was published in the Official Journal L 236 of 23 September 2003, and the total *acquis communautaire* (i.e. the whole of the EU legislation in force as of 30 April 2004, applying as from 1 May 2004 to the new Member States) has been published on 1 May 2004 by the Official Journal in all the new official languages of the European Union.

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[13] See Judgments of the European Court of Justice of 4 June 2002 in Case C-367/98 (Commission vs. Portugal), Case C-483/99 (Commission vs. France) and Case C-503/99 (Commission vs. Belgium), (2002) ECR I-4731, I-4781 and I-4809, respectively, and Judgments of the European Court of Justice of 13 May 2003 in Case C-463/00 (Commission vs. Spain) and Case C-98/01 (Commission vs. UK).

[14] See document 14492/1/03 (Presse 320), at http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=PRES/03/320|0|AGED&lg=EN&display=.

The main text of the Accession Treaty contains five parts:

- Part One: Principles. Among other issues it provides that the *acquis communautaire*, including the legal acts of the ECB, and international agreements concluded by the Community, will be binding on the new Member States subject to the temporary derogations set out in Part Four. This part of the Accession Treaty (Article 4) provides that "each of the new Member States shall participate in Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of Article 122 of the EC Treaty." This means that so long as the economic and legal convergence criteria are not met, the new Member States cannot adopt the euro as their currency.
- Part Two: Adjustment to the Treaties. Adjustments are made to the main rules relating to the institutions of the European Union, including the ECB, to allow for the participation of the new members. The most important one affecting the ECB is Article 17 of the Accession Treaty, which adds a new paragraph 3 to Article 49 of the Statute of the European System of Central Banks and of the European Central Bank to provide for the automatic increase upon any EU enlargement of the subscribed capital of the ECB and of the amount of foreign reserves to be transferred to the ECB. Such increase is henceforth based on the amended ECB capital key, determined by the percentage share of the new Member States in the population and GDP of the Community.
- Part Three: Permanent provisions. This part of the Accession Treaty provides for the adaptation of various European law acts made necessary by accession.
- Part Four: Temporary Provisions. These are transitional measures for the new Member States regarding different parts of the *acquis communautaire*. In the financial domain, only a few temporary exceptions to the application of the EU *acquis* are foreseen (basically, limited delays in the application of banking, accounting and deposit insurance provisions).
- Part Five: Provisions relating to the implementation of the Accession Treaty. This part provides for the amendment of the rules and procedures of the different EU institutions. It also provides that upon accession, the pre-existing acts of the EU institutions will be applicable in the new Member States, which will be considered as being addressees of directives and decisions of the EU institutions, under the same conditions as the earlier 15 Member States.

The new version of Article 10.2 of the Statute of the ESCB and of the ECB provides for a change in the current voting system in the Governing Council of the ECB when a number of Member States adopt the euro. Basically, a rotation of voting rights will be introduced among the governors of the NCBs of Member States having adopted the euro. During a first phase, the governors are classified into two groups with separate rotation periods; and after a certain threshold of Member States having adopted the euro is attained, the rotation of voting rights is organised under a three-group system. Classification of governors into one of these groups is made under three criteria: GDP, population and size of the financial sector. The system aims at ensuring that, in spite of rotation, the monetary decisions are taken always by a Governing Council which is, collectively, sufficiently representative of a great part of the economy of the eurozone.

5. EMU in an European Constitution

EMU was not at the centre of the preoccupations of the Convention on the Future of Europe, charged by the European Council meeting in Laeken (Belgium) in December 2001, to prepare an intergovernmental conference ("IGC") for the revision of the treaties on the European Communities and the European Union, as provided by Declaration N° 23 annexed to the Treaty of Nice signed on 21 February 2001. This revision was more concerned with the simplification of the treaties, the clarification of the allocation of competences, the insertion of the Charter on Fundamental Rights and the efficiency of governance in an enlarged Union.

A draft Constitution for Europe (hereafter, "the Constitution") was adopted by the Convention on 13 June and 10 July 2003, and submitted to the IGC that has met from 4 October 2003. After being unable to achieve a consensus by the end of December 2003, the IGC committed itself in March 2004 to reach

an agreement in June 2004 at the latest. Once adopted by the IGC, the Constitution must be submitted to the 25 Member States for ratification.

In the text agreed by the Convention, EMU is no longer listed in Part One of the Constitution as an objective of the Union, as it is today. This absence has no legal significance, considering the content of Part Three of the same text. The objective of "non inflationary growth" disappeared from the first articles. The Irish Presidency, however, in 2004 re-introduced "price stability" as an objective of the Union. Nothing had been changed, however, in the provisions on EMU in Part Three which contain the references to "price stability" and "stable prices". "Balanced growth" was included in article 3, paragraph 3. At the time this report was prepared, the main new elements concerning EMU in the draft Constitution were related to the classification of monetary policy as an "exclusive competence", the "institutionalisation" of the ECB, and some developments in the field of economic coordination and closer cooperation within the euro area, in particular for its external representation.

For the first time, the Constitution proposes a classification of competences attributed to the Union. It distinguishes between exclusive competences, shared competences and areas of supporting, coordinating or complementary actions (article 11). The coordination of economic and employment policies are listed in a separate article (article 14) as is the Common Foreign and Security Policy (article 15). Monetary policy of the Member States whose currency is the euro is mentioned among the few cases of exclusive competence of the Union in article 12. The term can be held to refer to both internal and external (including exchange rate) monetary policies.[15] The rather obscure drafting of article 14 on the coordination of economic policies reflects the compromise and mainly political features of this provision. The substance of the matter lies in chapter II of Title III of Part Three of the Constitution. This observation could have a more general bearing. The provision of article 11, paragraph 6, of Part One, referring to the specific provisions of Part Three on every field, for the extent and modalities of exercise of the competences of the Union, demonstrates the importance of the articles defining the legal basis, the limits and the procedure to be respected in an Union based on the principle of conferred powers.

The Constitution distinguishes, in Title IV of the first part, between the traditional institutions plus the European Council, which form the "institutional framework", and "other institutions", like the ECB and the Court of Auditors. Article 29 is related to the ECB. This provision defines the European System of Central Banks ("ESCB") and introduces, in its first paragraph the concept of "Eurosystem", which includes the ECB and National Central Banks ("NCB") of those Member States having adopted the euro. Article 29 mostly summarises existing provisions in a new presentation and includes various references to the third part of the Constitution and to the Statutes of the ESCB and the ECB. Worth mentioning are the affirmation that "the ECB, together with the NCB of the Member States, whose currency is the euro, which constitute the Eurosystem, shall conduct the monetary policy of the Union"[16] and the explicit reference to the independence of the ECB "in the management of its finances", which confirms the right of the ECB for a budget separate from the EU's general budget.

The qualification of the ECB as an "other" institution does not imply the complete assimilation of it to the political institutions as far as access to the European Court of Justice is concerned. Unlike these institutions, the ECB will only be able to bring a case for annulment before the Court for the purpose of protecting its prerogatives (article III-270, paragraph 3), as it can under the present treaty.

The Constitution has introduced majority voting in the European Council and legislative procedure characterised by the *codecision* procedure between the European Parliament and the Council, for many provisions, including EMU matters. It is especially the case in article III-79, paragraph 5, for the simplified revision procedure that allows for a modification of mostly financial provisions of the Protocol on the Statute of the ESCB and ECB, without the necessity of making use of the complex and cumbersome revision procedure of the treaties. The legislative procedure will also be applicable for the adoption of so-called complementary legislation under article III-79, paragraph 6, bearing on a lot of

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[15] For a criticism of this provision which should have mentioned exchange rate policy as well as management of exchange reserves, issue of bank notes and oversight of payment systems (the latter being a shared competence), *see* René Smits, *The European Central Bank in the European Constitutional Order*, Utrecht, Eleven International publishing, 2003, p. 39 et seq.

[16] Quotations of the draft are from IGC Doc. 50/03, Nov. 25, 2003. At the time of writing, divergences remained between the various linguistic versions, available at http://european-convention.eu.int. Only the French version was meant to be completely accurate. In the French text, one reads: "La BCE *et* les BCN des Etats membres dont la monnaie est l'euro…conduisent la politique monétaire de l'Union. »

subjects important for the functioning of the EMU, like statistics, compulsory reserves, and sanctioning financial institutions. Majority vote has been provided for the appointment of the members of the Executive Board of the ECB by the European Council (article III-289 bis). Up to now the appointments required a unanimous vote of the Governments. If a suggestion of the Italian Presidency (IGC Doc 52/03, ADD 1, annex 8, 25 Nov. 2003) is finally accepted, the unanimity in the Council will be preserved for the assignment to the ECB of special tasks concerning the prudential supervision of financial institutions, insurance companies excepted (as in the present text of article 105.6 of the EC Treaty, a limitation which should have been now removed, considering the present trend towards the conglomeration of financial institutions), and the European Parliament will only have a consultative voice for that matter (article III-77, paragraph 6). This is unfortunate, since unanimity in a Community of 25 is tantamount to submission to the wish of one, and since that unanimity does not distinguish between Member States under monetary union (for which the ECB has a real role) and those keeping their individual monetary policy.

As far as coordination of economic policy and budget discipline are concerned, the Constitution includes some very modest improvements for the role of the European Commission, anyway less than that institution has proposed. One could have expected a more central role for the Commission, considering the obvious shortcomings of economic policy coordination and budget discipline. The relatively more substantial changes are limited to the euro area. A new section (articles III-88 to 90) contains some provisions that could allow for strengthening the coordination of budgetary discipline and multilateral surveillance and for elaborating broad economic policy guidelines ("BEPG") specific to the States of the euro area, providing they are compatible with the BEPG adopted for the whole of the European Union. These provisions, allowing the adoption of measures by the Council with the majority vote of the States whose currency is the euro, do not open the way for a revision of the Treaty limited to the euro area. The Constitution has to be respected. In parallel with these new possibilities offered by the Constitution, the Eurogroup, a club of euro area Ecofin ministers meeting with the Commission and the ECB Governor, created in 1997, finds an official recognition in a Protocol that underlines its informal nature and provides for the election of a chairman with a prolonged mandate.

Perhaps regrettably, the constituents did not address the need to facilitate the further integration of financial markets following monetary union. Unanimity of all Member States is retained for any supervisory function of the ECB. No enabling clause was foreseen for any future European regulatory/supervisory agency. No treaty changes were foreseen that would support, clarify or facilitate the complex 4-level structure of the "Lamfalussy" methodology,[17] still subject to institutional and legislative difficulties. Finally, there is no recognition of financial services as an area in need of special Treaty provisions, namely after monetary union.

In the field of external relations, a new article III-90 provides for the definition of common positions and a unified representation in international organisations and conferences, a matter that was evoked in preceding MOCOMILA reports. The first paragraph refers to the place of the euro in the international monetary system. These provisions are substituted for former article 111, paragraph 4 of the EC-Treaty, which has not been enforced up to now. It is remarkable that no reservations are made anymore for the possibility of international agreements signed by Member States with third countries, as provided by present article 111, paragraph 5. Decisions will have to be taken by the Council with the majority vote of members of the euro area. The ECB will have to be consulted. It is to be hoped that the new provisions will help somewhat to realise the aim expressed by some Governments, especially the French and German ones, during the work of the Convention, in favour of "a single chair" in the IMF.

Overall, one can say that the basic features of EMU have been maintained: the objectives of the ESCB and its independence; and the asymmetry between (i) competences for economic policy shared across the Member State and Union levels versus (ii) exclusive competence of the Union over monetary policy (for Member States participating in monetary union). The Statute of the ESCB and the ECB has

[17] *See* the Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (15 February 2001) (the Committee was chaired by Alexandre Lamfalussy), *available at* http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf. In short, the four-level approach recommended in the report foresaw financial directives or regulations being developed: (1) on the proposal of the European Commission adopted under the codecision procedure with the European Council and European Parliament; (2) with advice from the European Securities Regulators Committee in consultation with market participants; (3) the latter Committee working on joint interpretation recommendations and consistent implementation and application; and (4) the European Commission checking Member State compliance with EU legislation.

not been modified in substance, but merely adapted to new terminology and to general changes of the Treaty. The status of the ECB has been clarified as unequivocally that of an institution of the Union, and the implications of this move will have to be analysed. While it would have been preferable to strengthen economic coordination more substantially, as the European Council mandate from Laeken requested, clearly, there was no consensus on that point.

B. Dollarization and Cross-Border Uses of Currency

While the Committee has focussed much attention on the subject of European Economic and Monetary Union, in recent years a portion of the discussion has been devoted increasingly to drawing lessons from the European experience that might have significance in other regions in the world. Debate has often contrasted EMU with the phenomenon of dollarization, currency boards, and other cross-border uses of currency. The report to the London Conference outlined the Committee's plans for a seminar in Mexico City, which was since successfully completed on 14-15 February 2002, on the topic Legal Aspects of Currency Boards, "Dollarization" and Similar Arrangements. The Committee intends to publish a series of papers on the basis of the seminar presentations. This section sketches out some of the main issues under review.

First, however, it is useful to recall that the debate raised by EMU over the scope of *lex monetae*, in particular in contrast to contractual law or *lex causae*, was a subject of the Committee's report to the London Conference in 2000.[18] Already at the Taipei Conference in 1998, the following resolution was adopted by the ILA on the proposal of the Committee, recognising the exclusive competence of the *lex monetae*:

> ACKNOWLEDGES that the State of issue of a currency, or a group of States adopting a common currency, has the exclusive competence to define its currency, to change the definition of such currency and to define the rate of exchange between any new monetary unit and the former monetary unit or units it is intended to replace (the so-called recurrent link).

1. Can One Country Use Another's Currency?

Having one's own currency is an ancient symbol of sovereignty — enshrined in the portrait of the sovereign or a national seal minted on coins or printed on banknotes. According to the classical work of the late Francis A Mann (a long-standing member of the Committee), *The Legal Aspect of Money*, each sovereign state possesses the exclusive sovereign power to determine its *lex monetae*. Therefore, by its very nature, the decision to forego one's own currency necessarily implies a compromise of state sovereignty. In the establishment of a regional currency area where neighboring countries mutually adopt a single currency such as the case of EMU, the transfer of powers from the national to a supranational level is quite clear through the multinational treaties. The unilateral situation of one country using the currency of another (the "issuing currency") raises quite different questions, however, starting with the preliminary issue of whether absent a multilateral agreement, one country can use another's currency.

The International Monetary Fund concludes that under international law there is no basis for an issuing country to prohibit the use of its currency by a foreign country.[19] This conclusion notwithstanding, the issue appears only relevant to freely available currencies. The IMF recognises the right of a country to impose exchange controls that could limit or even prohibit an outflow of currency from the issuing country. Under the IMF Articles of Agreement (art. VIII(2)(b)), any contracts contrary to such exchange control regulations are unenforceable.

The views of the issuing authorities of the world's two major reserve currencies are interesting in this respect. The longstanding policy of the US Government and Board of Governors of the Federal Reserve System has been neither to encourage nor discourage dollarization or other uses of the US dollar. In effect, such country must purchase its dollars in the open markets, and the US authorities will not take into consideration such country's actions nor extend any specific protections to such country when carrying out US policies with respect to monetary policy, banking supervision, etc.

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[18] *See also*, James H. Freis, Jr., Continuity of Contracts After the Introduction of the Euro: The United States Response to European Economic and Monetary Union, 53 The Business Lawyer 701-766 (1998).

[19] *See* François Gianviti, Use of Foreign Currency Under the Fund's Articles of Agreement, *available at* http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/gianvi.pdf.

The European Central Bank recently reiterated its position on unilateral euroisation with respect to accession countries:

> The ECB considers that the euro area represents a *multilateral* currency union formed by Member States of the European Union with common and shared responsibilities among its members. When forming Monetary Union, the EU Treaty specified certain economic and institutional criteria that have to be fulfilled by future Member States of the common currency area in order to safeguard its sustainability. Moreover, the Treaty provides that there has to be a Community assessment of the fulfilment of these criteria and mutual agreement on the appropriate exchange rates.
>
> That is why with regard to current and future EU accession countries, the ECB does not welcome unilateral euroisation, as such an adoption of the euro outside the Treaty process would run counter to the underlying economic reasoning of European Monetary Union. In particular, it would undermine the process of convergence prior to the adoption of the euro. Unilateral euroisation would also imply circumventing the process of multilateral assessment of new members by current EU Member States and as such would be difficult to reconcile with the cooperative spirit of a community of fellow members . . . .[20]

With respect to the limited circle of the accession countries, the European Union retains the bargaining power to withhold the benefits of membership from those countries not in compliance with EU recommendations. With respect to non-accession countries, the ECB's position has not been stated so generally, but rather is developing with respect to individual countries. The ECB released an opinion dated 1 April 2004 concerning monetary relations with the Principality of Andorra (2004 OJ C 88/18 – 19, CON/2004/12), which country had unilaterally adopted the euro by an Andorran law dated 11 October 2000. The ECB advocated "that a third country should only introduce the euro following agreement with the Community" and proposed a draft European Council decision defining the position and issues to be addressed in such agreement, including the use of euro banknotes and coins, anti-counterfeting rules, financial legislation and supervision and access to payment systems. In other cases, no formal objections were raised when in 1999 both Montenegro and Kosovo adopted the Deutsche Mark as their currencies; they have since fully euroised. Yet these post-conflict situations might be deemed special cases.

Similarly with respect to the United States, dollarization of small countries such as Panama and Ecuador would not have a significant impact upon the ability of the United States to implement monetary and economic policies in the issuing country's own interest. One could imagine that the issuing currency might need to reconsider its policy if more and larger countries were to unilaterally dollarize, whether that be Canada adopting the US dollar or Russia adopting the euro. There has been consideration in the US Congress about sharing seigniorage revenues with dollarized economies, the International Monetary Stability Act of 2001 (H.R. 2617), although this bill was not adopted.

From the perspective of the country unilaterally adopting a foreign currency, one could argue that the using country has an obligation not to interfere with or undermine the policies of the issuing country. There does not appear to be any avenue other than cooperation, however, for the issuing currency to receive support for its policies (for example, to exchange information used in determining monetary policy or in supervising financial institutions).

2. Legal Structures

The appropriate legal framework will differ across the type of currency regime (a regional currency area, currency board or use of a foreign currency), across different legal systems, and in accordance with the goals of the regime/reasons for adopting it. In all cases, the level of detail contained in the law itself will be related to the national legal framework. Strictly speaking, a currency area established on a cooperative basis has the greatest requirement for some law, in effect an international treaty through which the contracting states cede some of their sovereign rights in accepting common obligations.

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[20] *See* European Central Bank, Occasional Paper No. 11, *Official Dollarisation / Euroisation: Motives, Features and Policy Implications of Current Cases* at 5 (February 2004), *available at* http://www.ecb.int/pub/ocp/ecbocp11.pdf. *See also* European Council of Economics and Finance Ministers (ECOFIN), 2301st Council meeting on 7 November 2000, 12925/00 (Press Release 417), *available at* http://ue.eu.int/newsroom/newmain.asp?lang=1.

While the experience of EMU is the prime example of this, other countries might choose to pursue monetary cooperation without all of the broader context of European political integration.

One example of a currency area based upon bilateral treaty is that whereby Liechtenstein, a country too small to support its own independent currency, has adopted the currency of neighboring Switzerland. Although both countries are small on a global scale, they have in common strong financial sectors of broader importance. The countries first established a customs union in 1923, and a year later Liechtenstein unilaterally passed a law declaring the Swiss franc to be its sole legal tender (essentially an act of unilateral "dollarization"). The arrangement was formalised in 1980 in a bilateral treaty[21] providing that Swiss laws and regulations concerning monetary policy shall automatically also apply in Liechtenstein. These include commercial bank financial and statistical reporting obligations to the Swiss National Bank (the central bank) and penal norms against counterfeiting and the powers to enforce them. Liechtenstein entities are entitled to equal treatment under the Swiss monetary laws and have the right to appeal before Swiss courts. The treaty provides for consultation and a dispute resolution mechanism between the two countries.

Another example of a formal treaty structure governing the use of a foreign currency is with respect to the Multilateral Monetary Agreement among South Africa, Lesotho, Namibia and Swaziland. An official agreement for the South African rand to be used by its neighbors dates back to 1974 and assumed its current form in 1992. While the South African Reserve Bank essentially makes monetary policy for all four countries and the South African rand also has legal tender status in Lesotho and Namibia, the other three countries still maintain their own central banks and currencies for local circulation which have a fixed 1:1 exchange rate with the rand. One notable issue is that South Africa is obliged to share seigniorage revenue with the other countries. The countries allow for free movement of capital as part of a customs union.

The foregoing along with the agreements for Monaco, San Marino and Vatican City to use the euro, are examples of treaties between smaller sovereign states and their larger neighbors. Many more cases exist where former dependent states or autonomous territories use the currency of another (eg, Panama, Micronesia and the Marshall Islands using the US dollar or the Faroes Islands using the Danish krone).

In recent times, rather than entering into a formal treaty agreement to adopt another country's currency, there have been examples of the dollarizing country acting unilaterally in legally adopting the foreign currency, such as was done by El Salvador in 1999 and Ecuador in 2000. This has involved amending the legal tender law to establish that payment in the adopted currency shall be a valid form of extinguishing debts, and in particular debts due to the government, such as in the payment of taxes.

3. Payment Systems and Jurisdictional Issues

One relevant issue in considering a unilateral adoption of a foreign country is the types of connections that are necessary between an "offshore" payment system and the "onshore" system in the country of issue. How would a participant in the adopting country invest funds – only locally, or would it not be expected that some investments would be made in the issuing country or in securities traded there? Where the different jurisdictions maintain distinct payment systems, one practical solution would be for financial institutions to participate directly or establish correspondent relationships in the payment systems of the respective jurisdictions.

Noteworthy developments have occurred in Hong Kong with respect to clearing of currencies in jurisdictions outside the country of issue of the respective currency. In 2000, a real-time gross settlement ("RTGS") US dollar payment system began operating in Hong Kong. That system is owned by HSBC, with which all participants (foreign as well as Hong Kong-based financial institutions) establish direct account relationships. A similar euro clearing system, organised by Standard Chartered Bank, began operating in 2003. Links with the RTGS system for Hong Kong dollars also allows for payment-versus-payment settlement, thereby avoiding settlement risk in foreign exchange transactions involving these currencies (see the discussion of CLS Bank in Part III.C *infra*). One obvious advantage of these clearing systems is the ability to settle transactions during Asian business hours. As compared with the US and euro area RTGS systems, it must be noted however, that notwithstanding the high quality of the commercial banks operating the systems, settlement on their books involves a greater degree of credit risk than payment of US dollars through the Federal Reserve Banks' Fedwire system or

[21] Monetary Accord between the Swiss Confederation and the Principality of Liechtenstein (19 June 1980), RO 1981 1715.

of euros through the TARGET system. And once again, the early success of such settlement systems has been partly due to the links of many of the participants to the markets in the respective issuing jurisdictions.

While correspondent relationships certainly provide benefits in terms of access to various markets and payment and settlement systems, it must be noted that for the same reasons they have been the subject of increased attention in recent years. This is driven by concern that they could be abused to violate laws and best practices regarding "know your customer" policies, anti-money laundering measures, financial sanctions or more recent concerns with respect to the financing of terrorism. Any country that adopts the currency of another must understand its interactions with or dependence upon a foreign payment system in an issuing country, and, therefore, should consider the extent to which various laws and regulations of the issuing country will have effect — especially to the extent that a payment originating and ending in the adopting country settles by way of an intermediary or payment system in the issuing country. While Committee members were of different views with respect to the implementation of national policies with respect to payments and the use of a country's currency — particularly in the context of efforts to prevent the financing of terrorism — the broader implications for the use of international reserve currencies is likely to be a topic of continued interest in future discussions.

III. Payment Systems

This Section of the report returns to a traditional area of focus of the Committee — payment systems. First, at the national level, there is a summary of recent changes to the Japanese law on deposit insurance that distinguish a special class of deposits in recognition of their important role in the Japanese payment system. Second, there is a discussion of unsettling developments in national courts, where debtors have attempted to disrupt payment and settlement operations of custodians in order to recover debts due from their creditors. The final part explains the first link among national payment systems of major economies through the development of CLS Bank to minimise foreign exchange settlement risk.

A. Japanese Deposit Insurance — Protecting the Payment and Settlement Deposits

Japan established its bank deposit insurance scheme in 1971. In general, the insurance scheme is similar to that of other countries and protects deposits up to a ceiling of 10 million yen (roughly $100,000) per depositor. The system has undergone changes in the context of broad reforms over the past decade to strengthen the Japanese financial system. As an interim measure to promote confidence in the banking system but which is now being phased out by 2005, the deposit insurance cap on various classes of bank accounts was temporarily removed, so that insurance would apply to all credit balances without limit as to amount. For a special class of accounts of crucial importance to the payment system, however, deposit insurance will continue to apply to unlimited balances.

The 2002 amendments to the Deposit Insurance Act in Japan introduced this new approach for bank deposit protection, effective as from April 1, 2005. The amendments establish a new class of accounts that will benefit from unlimited protection for funds in a special category which is called "payment and settlement deposits."

Before exploring the details, it is useful to recall the rationale behind the limitation in most countries on the amount of deposits per customer that benefits from deposit insurance protection. There are three reasons for the limitation. First, unlimited protection might put the insurance system itself at risk, because, if the amount to be paid out of the insurance fund is too high, the insurance fund may collapse. Second, unlimited protection might trigger serious moral hazard problems both to banks and depositors. Any bank has incentives to continue to take deposits and lend until it fails unless the risk of poor management is not transferred to its depositors. Similarly, depositors have no incentive to choose sound banks if their deposits are fully protected in any event. Third, limited-amount protection is thought sufficient because the purpose of deposit insurance is to protect at least the "last money" of small depositors.

This traditional rationale for deposit insurance, however, does not take into account the important fact that certain deposits are often used as a means of payment through debits and credits to an account. Recall that money serves both as a means of saving and as a means of payment. Not only cash (typically bank notes and coins) but also bank deposits serve these two purposes. In Japan, as well as most developed countries, it is common that both individuals and firms utilize bank accounts for payment transactions. For example, at the individual level, suppliers of electricity, water or gas ask their customers for advance authorization to debit the monthly fee from the customer's ordinary deposit account specified by the customer on a certain date of each month as agreed on in their contract for

utility services. Firms put a correspondingly larger amount of money in their accounts used for payment and settlement purposes. If a bank fails before such fund transfers are initiated, and if the customer's deposits are protected only up to a certain amount under the deposit insurance system, then the payment process might be jeopardized. The resulting impact on the economy is far-reaching since this defined class of bank deposits form an integral part of the payment system.

Therefore, the new scheme has been introduced with a specific view to protecting the stability of the payment system itself. To do so, the scheme has created a special category of bank deposits and offers full protection to such deposits without any ceiling in the case of bank failure. Such "payment and settlement deposits" (*kessai-yo yokin*), are defined to include "traditional demand deposits" (which typically can only be withdrawn by writing checks), but also include such deposits that meet the following three specific conditions: (i) withdrawable at any time, (ii) no interest paid by the bank on such deposits, and (iii) freely disposable by the depositor for payment by means of fund transfers.

Of course, if a huge amount of money is put into payment and settlement deposits (which are not necessarily required to be used solely for payment), the insurance coverage could become enormous and might put the deposit insurance system at risk (the risk ultimately to be borne both by tax payers and by banks which are the parties to the insurance fund). However, given the fact that bank deposits are the most popular means of payment throughout Japan, the full protection offered by the new scheme serves to protect the stability of the payment system. The new scheme is based on a policy decision that at least one "safe" means for payment in addition to cash should be provided and that such means should be offered only when the depositors use the form of a strictly defined bank deposit.

Until now, the deposit insurance has primarily been discussed in the context of the protection of an individual's "last money." However, for the payment and settlement deposits under the new scheme, it may even be said that the protection of individuals is rather secondary. Furthermore, if the money in the deposit is for use in the payment system, it might even be possible to regard the bank's function as an entrusted custodian of the deposited funds for beneficiaries within the payment system. Moreover, even if taxpayers' money had to be drawn upon in order to ensure full protection, the result may functionally be similar to an exercise of the lender of last resort function to ensure monetary stability.

In reality, direct insurance payments would be made only in very exceptional situations, because most bank failures will likely continue to be resolved through the so-called "purchase and assumption" procedure. (In this process, a failed bank is typically divided into a good bank and a bad bank. The "good bank" refers to a group of assets and deposit liabilities that are absorbed by another sound bank which also receives financial assistance from the insurance fund; no direct insurance payment is made to the depositors. The "bad bank" refers to the remaining assets that are liquidated.) This notwithstanding, the idea behind the new deposit insurance scheme can be viewed as a novel and challenging experiment for the protection of a payment system. It could also have an impact on the evolving concept of money, in that categories of assets at a bank such as these, to the extent they effectively have a guarantee, could be considered as safe as cash or central bank deposits.

B. Preventing Creditor Disruption of International Payments

The globalised financial markets involve a huge volume of daily movements of funds and therefore heavily rely on efficient payment and settlement procedures. This not only raises technical issues, but also involves a number of legal aspects, which have been highlighted by a number of recent incidents. Indeed, payment procedures are complex and typically involve, besides the originator's and the beneficiary's banks, the intervention of several intermediary banks (with correspondent accounts) and of at least one payment or settlement system. Each phase of the payment or settlement process may be subject to a different applicable law and jurisdiction (unless the whole process is occuring within one single jurisdiction without any element of extraneity).

1. Protecting intermediaries

It is not new that unsatisfied creditors seek to attach their debtor's assets worldwide, with a view to obtaining execution of judicial decisions in their favour, or that they try to effect prejudgement attachments in an attempt at "forum shopping" in various countries. As long as such attempts are directed against accounts of the defaulting debtor, they do not interfere with the payment or settlement process as such. The situation is different if such attempts aim at blocking payments once they have been initiated in a payment system or, more generally, if they aim at interfering with the payment process at the level of intermediary banks or correspondent accounts. In this regard, it may be recalled that, according to prevailing views, the assets in the hands of correspondent banks and payment

systems do not normally belong to the originator or to the ultimate beneficiary of the payment process, but rather to the relevant intermediary.

The protection of the orderly implementation of payment processes is precisely the concern which prompted legislators to introduce specific legal provisions such as the European Directive 98/26 EC of 19 May 1998 on settlement finality in payment and securities settlement systems and related national legislation as well as certain sections of the Uniform Commercial Code ("UCC") in the USA. For instance, Art. 5 of the EC Directive 98/26 provides as follows: "A transfer order may not be revoked by a participant in a system, nor by a third party, from the moment defined by the rules of that system". The Belgian law of 28 April 1999 (introducing the EU settlement finality directive into Belgian legislation) provides as follows:

> Tout compte de règlement sur espèces d'un organisme gestionnaire ou d'un agent de règlement d'un système, ne peut être saisi, mis sous séquestre ou bloqué d'une manière quelconque par un participant (autre que l'organisme gestionnaire ou l'agent de règlement), une contrepartie ou un tiers.

The relevant provision in the American UCC, Section 4A-503, is even more precise:

> Injunction or Restraining Order With Respect to Funds Transfer: For proper cause and in compliance with applicable law, a court may restrain (i) a person from issuing a payment order to initiate a funds transfer, (ii) an originator, or (iii) the beneficiary's bank from releasing funds to the beneficiary or the beneficiary from withdrawing the funds. A court may not otherwise restrain a person from issuing a payment order, paying or receiving payment of a payment order, or otherwise acting with respect to a funds transfer.

As explained in the official comment, the main purpose of this provision is to exclude any injunctions against intermediary banks in the payment process, after the initiation of the payment process and until its completion.

In recent times, creditors who have pursued sovereign debt litigation tried to obtain court orders enjoining payment and settlement systems from making interest payments, which in their view are contrary to contractual provisions applying between the debtor and the creditor. Two recent cases illustrate how these attempts can significantly disturb the effectiveness of payment and settlement systems, and create difficulties for the clearing agency.

2. Recent Cases in Belgium

In 2000, Elliott Associates, a New York hedge fund, obtained a Federal Court Judgement against Banco de la Nacìon (a Peruvian public sector bank) and subsequently, in an effort to intercept Brady bond payments made by Peru, sought to enjoin Morgan Guarantee Trust Company, as the operator of the Euroclear system, from processing any payments received from Peru. The Brussels Commercial Court denied the motion. On appeal, the Court of Appeals of Brussels reversed the lower Court and granted Elliott's motion (Elliott Associates, LP, General Docket No 2000/QR/92, Cour d'Appel de Bruxelles, 8ème chambre, 26 septembre 2000). The case was based on a very controversial and extensive interpretation of a pari passu clause as imposing ratable payments by the debtor.[22] A similar situation occurred in September 2003, when LNC Investments LLC, in seeking to enforce a court judgement against the Republic of Nicaragua, obtained an order preventing Euroclear from paying interest on Nicaragua's bonds unless proportional payments were made to LNC (Audience publique des référés du jeudi 11 septembre 2003, en la cause R.K. 240/03 République du Nicaragua c. LNC Investments LLC et Euroclear Bank S.A.). However, the Court of Appeals of Brussels (9ème chambre, en la cause No 2003/KR/344 République du Nicaragua contre LNC Investments LLC et Euroclear Bank) on 19 March 2004 reversed the prior decision and invalidated the order against Euroclear Bank. The Court of Appeals declared in particular that the principle of privity of contracts prevented any measure which would turn third parties into guarantors of the performance of contracts. It should be noted that following the uncertainties arising from the Elliot/Peru decision and the first LNC/Nicaragua decision (before its reversal before the Court of Appeals), legislators in Belgium and Luxembourg are likely to be asked to consider new more comprehensive provisions that would bar the Elliott/LNC type injunctions and attachments.

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[22] *See* Lee C. Buchheit and Jeremia S. Pam, The hunt for pari passu, International Financial Law Review, at 20-26 (February 2004) and 47-56 (March 2004); Phillip R. Wood, Pari passu clauses – what do they mean?, Butterworths Journal of International Banking and Financial Law, at 371-374 (November 2003).

The situation in Belgium and Luxembourg is particularly relevant for international payments and settlements, as these countries are home to two major settlement systems, namely Euroclear and Clearstream. However, this issue arises with regard to all internationally relevant payment and settlement systems, as well as more generally in connection with all payment processes linked to international financial transactions. It is highly desirable to avoid interferences in the payment process which might disrupt their normal execution, at least until the payment reaches the beneficiary's bank. The kind of interferences from which the payment process as such (and the intermediaries involved) need to be protected are primarily rooted in private law (attachments, procedural injunctions arising from claims). There also are public law interferences which might disturb the payment process. In this latter respect, it is desirable that jurisdiction for any freezing or blocking measure (for instance in connection with the fight against money laundering) is clearly allocated and essentially based on the place where assets of the suspected party are actually held (ie where the account in its name or for its benefit is held). Unnecessary duplication of jurisdictional competence to order freezing measures, mainly through unilateral extraterritorial extension of jurisdiction should be avoided whenever possible, unless in emergency situations or in relations with the authorities of uncooperative countries or territories. (See Section I.C.2 of this Report on US efforts to fight terrorist financing). International cooperation in determining jurisdiction over payment and settlement systems, although of a more technical nature, remains important and would be consistent with broader cooperative approaches in reforming the international financial architecture as detailed throughout this report.

C. CLS Bank

Of all the world's financial markets, one of the largest, at least in terms of trading value, is the global market for foreign exchange, with average daily turnover well in excess of one trillion US dollars ($1,000,000,000,000, with some estimates of almost double that amount). A very significant development in foreign exchange trading came to fruition in 2002 with the commencement of operations by Continuous Linked Settlement ("CLS") Bank. CLS Bank was established through a joint effort of commercial banks to reduce settlement risk and reduce liquidity needs by clearing transactions on a payment-versus-payment basis. This Part provides background information and explains the operations and benefits of CLS Bank.

Traditionally, notwithstanding the value transacted, trading in foreign exchange has been largely unregulated, particularly in comparison to trading of securities or commodities through an organised exchange. By definition, a transaction in foreign exchange entails the sale of the currency of one jurisdiction in order to purchase the currency of another jurisdiction: eg, selling US $1 million to purchase 112 million Japanese yen. The wholesale foreign exchange markets do not involve the barter of banknotes (such as at an airport exchange counter), but rather a transfer of bank balances, which are claims for value on a financial institution. Hence, the transaction fundamentally involves the monetary and financial law of multiple jurisdictions.

As a factual matter, settlement of a foreign exchange transaction involves two distinct transfers usually through distinct payment systems for the respective currencies in their jurisdiction of issue, often across different time zones. The parties to the transaction run the risk that one will pay, but the other does not. Note that this contrasts with the delivery-versus-payment ("DVP") principle so fundamental to transactions in securities that ensures payment being made only if the corresponding securities are transferred, and vice-versa.

This risk is not merely academic. In 1974, a German bank with an active foreign exchange business, Bankhaus Herstatt, was closed by its banking supervisor. Due to time zone differences, only the European side of many foreign exchange transactions had been completed, which in turn had a ripple effect in many financial markets as banks that had not received expected payments from Herstatt, in turn faced difficulties in meeting their own obligations. This failure greatly increased awareness and concerns of financial institutions and supervisors with respect to foreign exchange settlement risk, also known as "Herstatt risk". (The Herstatt crisis also led to the establishment of the Basel Committee on Banking Supervision to increase international cooperation among banking supervisors, and within Germany to the establishment of the deposit insurance system.) Subsequent banking failures, such as Drexel, BCCI and Barings, have caused similar problems. Global supervisors have urged individual banks to better control their foreign exchange settlement exposure and called upon the industry to develop multi-currency netting and settlement arrangements (*see* G10 Committee on Payment and Settlement Systems report on Settlement Risk in Foreign Exchange Transactions, March 1996, *available at* www.bis.org). CLS Bank is a result of such an industry effort.

Financial institutions continue to trade foreign exchange as in the past – a trader in a dealing room makes an agreement with a counterparty over the phone or through an electronic trading system,

subject to the terms of a master agreement, which contract governs all such transactions. CLS Bank functions by operating for each of its settlement members a multicurrency account; details of trades between members are entered into the CLS computer system for matching and settlement. On the value date, CLS Bank informs each participant of the net amount that it will owe in each currency, for all of its transactions to be settled. Through a complex computer algorithm developed by IBM, each individual transaction is settled on a gross, payment-versus-payment basis. Each participant will then receive the net amounts due to it in each individual currency. Under the contractual terms of CLS (with respect to which legal opinions on enforceability have been obtained in all relevant jurisdictions), settlement is final and irrevocable. The system eliminates foreign exchange settlement risk, because, as is the case in a DVP mechanism, a trade is only settled if funds are available from both parties to a transaction.

CLS Bank began operations in seven currencies – Australian dollar, Canadian dollar, euro, pound sterling, Japanese yen, Swiss franc and US dollar, and has since expanded also to settle the Danish krone, Norwegian krone, Swedish krona and Singapore dollar. Further expansion is planned to include the Hong Kong dollar, New Zealand dollar, Korean won, and South African rand. With respect to each of these currencies, CLS Bank maintains an account at the respective central bank or monetary authority, further reducing any credit risk with respect to the payments settling through it. The operating hours for settlement are in the European morning, when the settlement systems with respect to all of the above currencies are operating.

The legal structure of CLS Bank is as follows. CLS Bank International is chartered under US law as an Edge Act corporation, a type of limited purpose financial institution to facilitate international banking transactions. It is based in New York and regulated by the US Federal Reserve System. The actual settlement functions are performed by CLS Services Ltd, based in London. Both CLS Bank and CLS Services are wholly owned by an intermediate holding company, CLS UK Intermediate Holdings Ltd., which in turn is owned (primarily for tax reasons) by a Swiss company, CLS Group Holdings AG. The ultimate shareholders of the Swiss holding company are approximately seventy financial institutions, including most of the world's leading banks involved in foreign exchange trading. The majority of these shareholders directly settle their foreign exchange transactions through CLS Bank, and some provide services on behalf of customers and other third-party institutions.

One indicator of the early success of CLS Bank is that in terms of value, by early 2004 (less than a year-and-a-half after becoming operational), it was settling on average close to half of all global foreign exchange transactions and over 100,000 payment instructions (equivalent to 50,000 trades) per day. But the significance of CLS Bank extends beyond mere numbers (however large), and the welcome reduction in foreign exchange settlement risk.

For the first time, there is a link between the Real-Time Gross Settlement ("RTGS") payment systems of the world's major currencies. Along with the obvious benefits, it must be understood that the system is also premised upon increased vigilance and cooperation both in the private sector and among financial supervisors, due to the potential systemic impact of any disruption. From a legal perspective, it should not be underestimated that such a development would never have been possible without years of preceding reform and harmonisation of relevant laws. Particularly noteworthy is legislation to recognise netting of offsetting payment obligations, which often involved changes to national commercial and bankruptcy laws.

The development of CLS Bank also poses interesting questions with respect to liquidity and timing of payments. In traditional financial operations, a debt is deemed due and payable on a payment date, without regard to a specific time during the day (other than perhaps with respect to operating hours); payments are processed throughout the working day and (subject to exposure limits) ledgers settled at the close of business. The large values involved and specific funding timelines for CLS Bank have raised the possibility of developing intraday lending markets, where interest would be charged by the minute or second. In the longer term, such a development would have to be viewed in terms of the evolution of other financial markets, such as the settlement period for securities trades. Legal and contractual frameworks would have to be revised to allow such market evolution, taking due consideration to balance increased settlement speed with needs to ensure finality and account for inevitable human and technological failures and the overall stability of the financial system.

IV. Future of the Committee

As is shown in this report, the Committee remains actively engaged in a range of important issues of monetary and financial law. This extends a continuum that reaches back to its establishment in 1950 as the oldest of the ILA's Committees by far. Many of the issues addressed in this report have been

studied by MOCOMILA from different viewpoints over the course of time. Recent debate over the international financial architecture echoes some of the challenges in reforming the international monetary system in the 1970s; debates over the eurocurrency markets in the early 1980s hardly portended modern uses of currency related to dollarization, much less the intricacies of European Economic and Monetary Union that have occupied the Committee from the early 1990s. Moreover, the successful experience of the Tokyo International Monetary Law Seminar underlined the challenge and value of returning to basic legal concepts and attempting to redefine them for a global audience in the modern world.

Nevertheless, consistent with the ILA's revised procedures for establishing international committees, as a formal matter, the mandate of the Committee on International Monetary Law would be scheduled to expire after the Berlin Conference. At this junction, the Committee would like to take special note of the excellent stewardship of its Chairman since 1995, Professor Mario Giovanoli, who regrettably will be relinquishing his position after the Berlin Conference. During his tenure, the work of the Committee was revitalised and witnessed an impressive expansion in terms of active participation and geographical reach, as well as increased visibility of the Committee through seminars and publications.

The Committee has recently endorsed its longstanding membership policy, which has been a clear factor in the group's ongoing success. In addition to the ILA's general policy for renewing Committee mandates and membership every four years, there are essentially three elements to the practice of MOCOMILA. First, the Committee should consist of a group of experts in monetary law with a balance of representation from institutions (central banks and international financial institutions), academia and private practice of law. Second, members must be in a position to actively participate in the work of the Committee (rather than merely appear on membership lists), including through participation in the Committee's semi-annual meetings (not necessarily every time, but regularly) and in contributions to its seminars and publications. Third, consistent with its established practice, the Committee will invite prospective new members first to attend Committee meetings as Observers in order to determine whether each such person is in a position to contribute to the work of the Committee; only afterwards would nomination to membership by the ILA Executive Committee be sought.

The current Committee members wish to continue their cooperative efforts to contribute to the study and development of monetary and financial law. For this reason, the Committee members unanimously request that the ILA Executive Council renew the mandate of the Committee for an additional four years to continue its work in the area of international monetary law.