INTERNATIONAL LAW ASSOCIATION

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INTERNATIONAL MONETARY LAW

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Introduction

Since the last Conference of the ILA, held in Sofia, Bulgaria, in 2012, the Committee (generally known by its acronym, MOCOMILA) has held three meetings: in Lima, Peru (5-6 April 2013), Madrid, Spain (19-20 September 2013), and Frankfurt, Germany (15 November 2013). The Lima meeting was held at the Central Reserve Bank of Peru and focused on two themes: issues of monetary law affecting Latin America and mobile payments. It included presentations by Mr Julio Velarde and Mr Renzo Rossini, the Governor and General Manager of the Central Reserve Bank of Peru. The Madrid conference, hosted by Banco de España, focused on three issues: the financial crisis, banking union in Europe, and ethics and the financial crisis. It featured talks by Mr Fernando Restoy, the Vice-Governor of Banco de España, and Mr Javier Priego, Secretary General and General Counsel of Banco de España. Our Frankfurt conference was a very special meeting for the committee. It was jointly organized by the Legal Committee of the European System of Central Banks and MOCOMILA, and was held at the European Central Bank. The discussion concerned the future of banking regulation and supervision in the European Union, and included remarks from Vitor Constâncio, the Vice-President of the ECB, as well as other dignitaries, academics, and private practitioners. At the Frankfurt meeting, the group

honoured the Vice-Chair of MOCOMILA, Mr Antonio Sáinz de Vicuña y Barroso, on the occasion of his retirement as General Counsel of the ECB. We wish him all the best.

The subjects of the foregoing meetings and other topics discussed by the Committee are reflected in the following sections of this report.

I. Transformation of International Economic Law and Financial Reform in Latin America (by Dr M Monteagudo)

II. Approaches to Sovereign Debt Resolution: Recent Developments (by Mr M Jewett)

III. European Banking Union (by Professor R Lastra, Mr B Krauskopf, Professor C Gortsos, and Professor R Smits)

IV. The risk of fragmentation of the global financial markets (by Professor Mario Giovanoli and Professor C. Lichtenstein)

V. The FSB and the G20 (by Dr E Hüpkes)

VI. Bitcoin (by Professor B Geva)

VII. The Balkanization of Global Banking (by Mr E Patrikis)

VIII. The Role of Culture and Ethics in Financial Regulation (by Sir William Blair)

This report reflects the views of the individual members and not necessarily those of any institutions with which they are affiliated.

I. Transformation of International Economic Law and Financial Reform in Latin America

A. Introduction

In recent years Latin America has experienced an unprecedented economic transformation. Several countries in the region implemented sound macroeconomic reforms (OECD Report 2011), as a result of which Latin America became one of the world's less vulnerable regions to the international financial crisis (Eyzaguirre, IMF, March 2011). Even though today it is possible to identify some remarkable differences in the economic processes of Mexico, Colombia, Peru, and Chile vis-à-vis countries like Venezuela and Bolivia, a preeminence of economic liberalization has clearly developed in most of the countries.

This transformation has not been built through a centralized regional convergence. Economic liberalization in Latin America is based on a diversified and *fragmented* system, formed by policies promoted by international organizations (IMF, World Bank, BIS), Free Trade Agreements (FTAs), Bilateral Investment Treaties (BITs), partial integration efforts (CAN, MERCOSUR, SICA, UNASUR), and domestic legislation and policies. However, a close inspection of the legal framework of this fragmented transformation reveals some *common principles* like non-discrimination, fair and equitable treatment, fiscal responsibility and transparency, monetary stability, and central bank independence. Moreover, economic liberalization in Latin America has coincided with a strengthening of the Inter-American Court of Human Rights.

In fact, those common principles are already present in international instruments that are reshaping international economic law as a whole. They could facilitate a deeper economic and financial integration in Latin America, placing the region in a better position to demand reforms at the multilateral level (IMF, World Bank, WTO). The objective of this report is to highlight the major aspects of financial reform in Latin America, in the context of the general evolution of international law.

B. The Transformation of International Law

One of the major changes in international law is the fact that national states are no longer alone in the international arena, if one considers the growing influence of international organizations and private persons (individuals and corporations). For example, IMF conditionality promoted a unification and harmonization of

economic and legal reforms during the debt crisis of the Third World (80s), the transition of socialist economies into market economies (90s and 2000s), and the Asian crisis (90s) (R. Lastra). After a short period of relegation marked by prepayments by some major country members (Brazil and Argentina), the IMF has restored and reinforced its rule-making influence in all regions. Besides the special financial assistance to European countries, the IMF is gaining more influence in domestic affairs in industrialized countries through *multilateral surveillance* (MS) and the Financial Sector Assessment Program (FSAP).

In fact, international organizations *compete* with national states in the design and discussion of domestic policies that used to be reserved to national authorities. However, *national sovereignty* can also be upheld with the assistance of international organizations when sound policies are attacked by interest groups and rent seekers (Raustiala).

International investment law and human rights are clear examples of the reinforcement of private individuals' power to challenge domestic public power at the international level. This capacity is based on the idea that the protecting role of international law (in the benefit of producers, investors, traders, consumers, or simple citizens) should fully operate against arbitrary interferences by governments and other forms of abuse of public power (Petersmann). Globalization, as the backdrop for the evolution of international law, is not a purely economic phenomenon because it has coincided with the growing strengthening of International Human Rights Law.

C. Financial Reforms in Latin America

When financial reforms in Latin America are assessed through the prism of the general evolution of international economic law, it is possible to identify a general pattern characterized by some predominance of soft law mechanisms. In fact, major reforms in finance, monetary and fiscal law were pressed forward by international economic organizations (IMF, World Bank or the BIS), including the rapid emergence of international investment law (almost 40% of ICSID cases involved Latin American countries). And this economic process has also coincided with the reinforcement of the Inter-American Court of Human Rights (25 countries are members).

Between 1989 and 2004 the IMF accorded facilities to 17 Latin American countries under Stand-By Arrangements, Extended Fund Facilities, Poverty Reduction and Growth Facilities, and Supplemental Reserve Facilities. Latin American countries follow IMF and World Bank standards and codes and are subject to *Report on the Observation of Standards and Codes* (ROSC) programs. This trend has created some convergence in policies and domestic legislation, although it is not part of a formal integration process. The figures are quite impressive: average inflation in the region was 198.5% during the 1980s and 5.8% in 2012. The ratio debt/GDP of long-standing debtor countries like Brazil and Mexico were 17.7% and 28.7 in 2012 (quite better than current U.S. and European standards). The increase in international reserves in most Latin American countries provides them with considerable protection against classical balance of payments crises (Peru US$ 66 billion, Chile US$ 39.3 billion, and Brazil US$ 376 billion).

1. Monetary Stability and Central Bank Independence

As part of the worldwide trend towards ensuring central bank independence, many Latin American countries amended their central banks' legislation in order to consecrate monetary stability as their main goal, as well as governance independence, independence in the conduct of monetary policy, prohibition or limitations to finance the government, and accountability.

The following countries were part of this general trend: Chile (1989), El Salvador (1991), Argentina (1992 and 2002), Colombia (1992), Jamaica (1992), Nicaragua (1992 and 1999), Venezuela (1992 and 1999), Ecuador (1992 and 1998), Peru (1993), Mexico (1993), Bolivia (1995), Costa Rica (1995), Uruguay (1995), Paraguay (1995), Honduras (1996 and 2004), Guatemala (2001), and the Dominican Republic (2002).

According to the *Cukierman* index, Peru, Chile and Mexico are among the most independent central banks in the world, having been the least independent during the pre-reform period.

2. Fiscal Transparency

By 2007 almost all Latin American countries (except the Dominican Republic, Venezuela, and Bolivia) had performed assessments under the IMF code of Fiscal Transparency. Today some countries have already

approved specific legislation on fiscal transparency and responsibility, including limits for the fiscal deficit and public debt, under the principle of setting rules rather than discretion based on transparency rules.

Brazil: The *Fiscal Responsibility Law* (inspired by the IMF code, the 1994 Fiscal Responsibility Law of New Zealand, and the 1998 IMF stabilization program) was approved in 2000 (amended in 2009). It provided a numerical fiscal target (*golden rule)*; auditing and accountability; a medium-term budget; and a macroeconomic framework. The law also established that credit and rescheduling operations between different levels of government are prohibited.

Mexico: The *Federal Budget and Fiscal Responsibility Law* was approved in 2006 (amended in 2010) with a zero fiscal target for the public sector balance and the principle that the annual budget law must provide macroeconomic forecasts and fiscal objectives.

Chile: The *Transparency and Responsibility Fiscal Law* was approved in 2006 (amended in 2011), following the recommendations of international organizations (IMF, IADB, WB and the OECD). It provides a medium-term macroeconomic framework and forbids municipalities to issue debt.

Peru: The *Law on Fiscal Prudence and Transparency* was approved in 1999 (amended in 2003 and 2007) with a numerical target (deficit below 1% of GDP) and real growth for consumption expenditure below 4% per year. The law establishes a medium-term macroeconomic framework, as well as limits on the deficit, borrowing of sub-national governments, and spending during election years.

Colombia: Having already a *Semaphore* Law since 1997, Law 819 (*Organic Budget Rules for Fiscal Transparency and Macroeconomic Stability*), approved in 2003, establishes a numerical target, borrowing limits, and a medium-term macroeconomic framework. The constitutional reform of 2011 established the principle of fiscal sustainability and a fiscal rule.

3. Payments System

The following countries have implemented legislation and regulations on the payments system according to international standards (finality and irrevocability):

- Argentina: Central Bank regulation (1997) under statutory powers
- Bolivia: Central Bank regulation (2009) under statutory powers
- Brazil: Law 10.214 on the payments and settlement system (2001)
- Colombia: Law 964 on the settlement system (2005) and subsequent regulations
- Chile: Law 20.345 on the compensation and settlement system for financial payment instruments (2009) and previous regulations under statutory powers
- Ecuador : Central bank regulation (2011) under statutory powers
- Mexico: Payments System Law (2002)
- Paraguay: Law 4595 on the Payments System and Securities Settlement (2012)
- Peru: Law 29440 on the Payments System and Securities Settlement (2009)
- Venezuela: Central Bank Resolution (2010) under statutory powers
- Treaty for the Payments System and Securities Settlement: Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua (2006)

4. Basel II Implementation, Deposit Insurance, and Electronic Money

Almost all Latin American countries have launched legislative reforms aimed at implementing the recommendations of the Basel Committee on Banking Supervision. Countries like Argentina, Brazil, Peru, Colombia, and Chile are in the process of concluding full implementation of Basel II (see *Report on status of Basel II adoption for each member jurisdiction*). In the same direction, since the mid-1980s most Latin American countries began to create deposit insurance systems funded by public and private sources. For example, Mexico, which created its system in 1999, has the highest insurance (US$ 153 thousand), Brazil covers US$ 35 thousand, and Peru US$ 35 thousand. Electronic *money* has also attracted interest in the region with an aim to integrate rural businesses and population with modern areas. In 2012 Peru became the first country to approve the Electronic Money Law (Law 29985), defining electronic money *as a monetary value represented by a credit against the issuer*, with the following characteristics: a) stored in an electronic device; b) accepted as payment instrument; c) issued for the *exact* received amount of legal money; and d) convertible into legal money.

5. Responses to the Financial Crisis and the Future

Monetary authorities in Latin America have responded to the international financial crisis using conventional and non-conventional mechanisms (interest cuts, special liquidity lines based on repo transactions with a larger list of securities, including private securities or banking loans) and emphasizing the approval of institutional arrangements for macro-prudential supervision. Brazil created the Central Bank's Financial Stability Committee (COMEF) in 2011 and the Committee for the Regulation and Oversight of Financial, Capital, Insurance and Pension Markets (COREMEC) in 2006. In 2010 Mexico established the Financial Stability Council (Ministry of Finance, Security Exchange Commission, National Commission of Insurance and Finance, Pension Savings Commission, Insurance Deposits Commission, and the Central Bank). Finally, in 2011 Chile created the Financial Stability Council, formed by the Ministry of Finance, financial regulators, and the central bank (as a "permanent guest" advisor).

It is interesting to note that this process of financial and institutional domestic reforms has also been accompanied by the strengthening of some initiatives at the regional level, such as the *Fondo Latinoamericano de Reservas* (FLAR), originally created in 1978 by the Andean community countries (plus Costa Rica and Uruguay), which has expanded its operations throughout the entire Latin American region as an agent for greater regional integration and financial stability. Another promising initiative is the Latin American Integrated Market (MILA), which includes Chile, Colombia, and Peru, as a market capitalization area of over US $ 700 billion.

D. Conclusion

International economic law *is experiencing times of deep transformation* and Latin America is part of this momentum. New actors, soft law, and international jurisdictions are reshaping and multiplying a general convergence in economic and human rights principles. A significant group of Latin American countries, with the support of international economic organizations (soft law), has developed an important degree of convergence in areas such as monetary stability, fiscal transparency, the payments system, banking supervision, and policy responses to the financial crisis.

This new situation places the region in a better negotiation position at a global scale. At the same time, given its enhanced interconnectedness, Latin America should reinforce its security mechanisms against the perverse consequences of a new financial crisis generated in the industrialized world.

II. Approaches to Sovereign Debt Resolution: Recent Developments

In the period since the ILA's meetings in Sofia in 2012, there has been important work on sovereign debt resolution. This note will provide an update on the work of the ILA's Sovereign Bankruptcy Study Group.

A. Background

Sovereign debt crises, which have been with us for a very long time, are very much back on centre stage. Past crises have mainly involved developing countries; that is no longer the case, a situation in large measure attributable to the global financial crisis and its spill-over into the sovereign sector of some euro area member states, which has posed a severe threat to global economic stability, due to both the interconnectedness of the global economy and the accompanying risk of contagion.

Further, the uncertainty generated by ongoing litigation between NML Capital *et al.* and Argentina,[1] and the decisions taken to date by United States federal courts, have alarmed a number of market participants (including trustees, paying agents, clearing systems and infrastructure providers) as well as debtors and many in the official sector, together with various creditors who participated in Argentina's restructuring.

Most restructurings of sovereign debt involve debt owed to commercial creditors, or bilateral (government to government) debt; many involve both. In some cases the process has taken years to complete, at great cost to all.

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[1] For a collection of the relevant documents, *see* http://www.emta.org/litigation-cases.aspx.

Unlike corporations, municipalities and individuals, sovereign borrowers cannot seek a rearrangement of their debts pursuant to a formal bankruptcy code. Neither the sovereign debtor nor its creditors can therefore know with confidence in advance how a debt workout might proceed if one became necessary.

While there have been several proposals over the years for reforming the sovereign debt workout process, as far back as the nineteenth century, in recent times, two distinct approaches have emerged. One (the "treaty approach") argues for some form of statutory or treaty-based bankruptcy regime that will be applicable to sovereign debtors, ranging from a "Chapter 11 for sovereigns" to more modest efforts to replicate certain key features of corporate bankruptcy codes, in particular supermajority creditor control of the workout process. The IMF's proposal in 2002 for a Sovereign Debt Restructuring Mechanism,[2] which foundered for being too ambitious, was subsequently modified and slimmed down,[3] but the main implementation mechanism proposed remains: an amendment of the IMF's Articles of Agreement.

The other principal proposal (the "contractual approach") advocates and builds on the widespread use of collective action clauses (CACs) and other contractual devices in sovereign bonds. CACs are contractual provisions that permit a specified supermajority of the holders of an instrument to agree to changes in the terms of the instrument. If approved by that specified supermajority, those changes will then bind all holders, even a dissenting minority of debt holders. "Aggregated" collective action clauses, which have to date been used by a limited number of sovereign issuers, permit the holders of multiple series of bonds issued under a single instrument like a trust indenture or a trust deed to vote on a restructuring proposal as a single class, very much like the creditor class voting procedure in a Chapter 11 corporate reorganization.

B. The Prior Contributions of ILA Study Groups

The present economic climate makes the work of the ILA's Sovereign Insolvency Study Group and its successor, the Sovereign Bankruptcy Study Group, very relevant to the international agenda.

The Sovereign Insolvency Study Group was formed in 2008 to study the existing legal framework and to propose the broadest range of policy options, without regard to their political feasibility. The Study Group's mandate was not to favour any of the options, as this task was to be left to a successor group after receiving feedback and thoughts from interested parties on the merits of the policy options.

In August 2010, the Sovereign Insolvency Study Group submitted its report entitled "State insolvency: options for the way forward" at the ILA's 2010 Conference in The Hague.[4] This report described the existing regime for restructuring sovereign debt and compared the legal regimes for states and the private sector. The Sovereign Insolvency Study Group proposed four policy options without making recommendations. They were: first, leave it to the market (e.g., collective action clauses); second, introduce a limited provision for creditor voting with a stay on creditors as voted on by creditors; third, a full bankruptcy regime by treaty so far as feasible; and fourth, reduce protections available to sovereign states.

C. The Sovereign Bankruptcy Study Group

In 2012, a successor Study Group was formed, the Sovereign Bankruptcy Study Group. Its mandate is to explore treaty-based and contractually-based options to resolve enduring sovereign debt issues.

The Study Group selected an innovative and unusual format to enliven the debate: a moot court setting. One team (the "Treaty Approach") will argue that the efficient resolution of future sovereign insolvencies requires the intervention of transnational law in some form. The other team (the "Contractual Approach") will make the case that future sovereign debt restructurings can and should be addressed primarily through the use of

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[2] *See* Ann Krueger, *International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring* (Nov. 26, 2001), at http://www.imf.org/external/np/speeches/2001/112601.htm.

[3] For a full description of this process, *see* Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36 Geo. J. Int'l L. 299 (2005).

[4] Sovereign Insolvency Study Group, *State insolvency: options for the way forward* (Paper delivered at the International Law Association Conference at The Hague 2010), available at http://www.ila-hq.org/download.cfm/docid/0A7ACEAC-94A3-4B47-B9E642CF4BEA5D81.

contractual mechanisms. A tribunal composed of three distinguished judges has been asked – based solely on the arguments presented at the moot court – whether a stronger case has been made in favor of the contractual approach or the treaty approach to this problem. This format is intended to expose the two streams to challenge and get these ideas circulating and available to a broader audience. The moot court will take place in Washington on April 9, 2014, in conjunction with the ILA's 2014 Washington Conference.

1. The Treaty Approach

The essence of the treaty approach is that contractual mechanisms (essentially conventional collective action clauses) are by their nature inadequate, even with enhancements such as aggregated CACs. Generally, CACs operate only bond by bond. It is relatively easy for a determined holdout to secure a blocking position and, if the sovereign cannot use the CAC to sweep in the entire bond issue, it must either (i) default on the holdouts; or (ii) pay the holdouts in full. Alternative (i) can lead to years or decades of litigation. Alternative (ii) virtually ensures that the restructuring will fail, since there is little incentive to consent to and join a restructuring when the alternative is full and prompt payment. Aggregated CACs are an improvement, to be sure, but very few countries have adopted them to date and they encounter considerable market resistance and skepticism. Both existing and proposed aggregated CACs require a "per series" vote (with a somewhat lower voting threshold for each series) so they represent only a marginal improvement over conventional CACs. Aggregated CACs cannot easily be made to work across different types of debt (e.g., bonds, loans, trade finance instruments, treasury bills, etc.). Even if a form of model aggregated CAC were to be widely endorsed today, it would take a decade or more before it permeated sovereign debt stocks. The empirical evidence thus far suggests that collective action clauses are, at best, only a partial solution.

Finally, even where the contractual approach is desirable, the contractual tools would work better with a baseline statutory regime for the purposes of enforcement, process uniformity, and predictability.

Therefore the treaty approach is seen as providing a better solution. The objectives are not essentially different from the contractual approach: to encourage timely remedial action; promote inter-creditor equity; minimize holdouts/free riders; and improve predictability of the process.

Possible implementation vehicles are an Amendment of the IMF Articles of Agreement (as proposed by the IMF in its original proposals and in subsequent iterations). This would replicate as many of the key features of a Chapter 11 bankruptcy regime as may be considered feasible (e.g., supermajority creditor control of the process,[5] automatic stay,[6] priority for new lending, etc.).[7] A new treaty is also a possibility, but the practical difficulties make success unlikely. Other possible measures could include something very minimalist, such as immunizing debtor assets against attachment by holdout creditors (as was done in 2003 re Iraq via Security Council resolution).

2. The Contractual Approach

The contractual approach is characterized by negotiations and contract, where insolvencies are resolved through existing voluntary methods. As such, the thrust of the contractual team's argument is that the current system has

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[5] There will be many issues here: which creditors are included, and how should other creditors, especially bilateral creditors (Paris Club), be treated?

[6] The use of a statutory approach could obviate or mitigate the need for a stay because creditors will not commence a disruptive suit with little chance of profiting as a result of the new regime.

[7] Other possible features are:

- Independent assessment of debtor's financial condition. Who makes the decisions about who enters the restructuring: the creditors or a subset of them, the debtor country, or the IMF?
- Dispute resolution mechanism – Should the dispute resolution mechanism be judicial or quasi-judicial? If the body is judicial, on what aspects should it be asked to rule?
- Due process considerations – The Treaty Team may address which body should rule on the legitimacy of the underlying debts. A prominent belief is that a quasi-judicial body should not be asked to determine the validity of claims.
- Supervisory function –which organization should oversee the regime: the IMF or a new body? A new body carries the threat of a new transnational bureaucracy.
- Claim submission/verification process – *cf.* the claim verification process in Iraq's debt restructuring.
- A "Master of Ceremonies" role – A neutral, procedural arbiter could usefully oversee the process.

worked well and that sovereign debt crisis resolution should evolve through "refinement" and "improvement". Therefore, a main focus of the contractual approach is on mechanisms for a super-majority of bondholders to bind holdouts to new payment terms through collective action clauses.

There have been a number of recent innovative approaches. The Euro Area Model CAC is an aggregated CAC that has been adopted in relation to both foreign and domestic law issues by euro area sovereigns.[8] Within the euro area it has been compulsory since the beginning of 2013. Preceded by extensive consultation and legal analysis, it has to a large extent been a market neutral event (and some non-euro area sovereigns and euro area non-sovereigns have opted in).

In December 2013 the International Capital Market Association (ICMA) published a Sovereign Bond Consultation Paper[9] which consults on standard aggregated CACs for inclusion in the ICMA Primary Market Handbook (for non Euro Area sovereigns) and introduces standard *pari passu* provisions in the ICMA Primary Market Handbook.

Other enhancements in the ICMA proposals include:

(a) Standstills (as a standalone contractual provision in the terms and conditions of the sovereign notes, or as a reserved matter in a CAC).

(b) An enhanced sovereign immunity provision, which may diffuse some litigation.

(c) Increased use of trustee sovereign bond issuance structures (as opposed to fiscal agency structures).[10]

(d) Diversification of instruments issued by sovereigns. Contractual features akin to those seen in bank and insurance regulatory capital instruments could be explored further, e.g., coupon and principal deferrals/maturity extensions.[11]

(e) GDP linked bonds and warrants.

Criticisms of the treaty or statutory approach include technical implementing difficulties and the considerable resistance to it in the past.

The benefits purported to flow from a treaty approach could be provided for adequately in an equivalent or superior manner by the current or future market approaches. An international treaty would be unlikely to replicate many elements of bankruptcy regimes applicable to corporations and could be seen to be discriminatory. Irrespective of the fact that a treaty was entered into, under public international law, sovereigns would continue to enjoy sovereignty. Therefore, if a statutory solution was implemented to address a rogue debtor, a treaty based solution would not make a difference.

D. Conclusion

The arguments of the Contractual Team and Treaty Team in Washington should produce a lively, thoughtful, and insightful debate on necessary reforms for sovereign bankruptcy restructuring. On one side, the contractual approach will advocate a voluntary regime that is forward looking and independent of statutory development; on the other side, the Treaty Team will seek to demonstrate the inadequacies of the purely contractual approach and the need for a minimal treaty or statutory framework to avoid those pitfalls.

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[8] "Euro area Model CAC 2012" (22 March 2013), online: Europa Economic and Financial Committee, available at http://europa.eu/efc/sub_committee/cac/cac_2012/.

[9] "ICMA Sovereign Bond Consultation Paper" (December 2013), online: International Capital Market Association, available at http://www.icmagroup.org/resources/Sovereign-Debt-Information/.

[10] Additional contractual protections for trustees / paying agent and service providers may be necessary if the judgment in the NML Capital *et al.* and Argentina litigation is not reversed, in respect of those elements which affect market infrastructure providers, in any event.

[11] The challenge would be to determine the right trigger points for such features and to lessen broader implications (e.g., for collateral purposes/capital treatment/CDS triggers).

III. European Banking Union

A. Introduction

The launch of European Monetary Union (EMU) on 1 January 1999 was not accompanied by a fiscal union and a transfer of supervisory responsibilities from the national to the supranational arena. The asymmetry between a centralized monetary area (for those Member States who adopted the euro - the euro area) and decentralised financial supervision (albeit subject to a substantial amount of common rules) became evident in the aftermath of the great financial crisis; reforms first to federalise and then to centralize supervision found political agreement amongst eurozone Member States.

The concept of a European Banking Union is based upon three pillars: The first pillar is a central and common European Banking Supervision, the Single Supervisory Mechanism (SSM), with the ECB as the institution in charge. The second pillar deals with the restructuring and resolution of financial institutions and contains a unified European Restructuring and Resolution mechanism: the Single Resolution Mechanism (SRM), which should be aligned with the proposed EU Bank Recovery and Resolution Directive (BRRD). The third pillar is common deposit protection.

Underpinning these three pillars is the concept of a common supervisory rule book, laying down uniform terms for the authorisation and withdrawal of credit institutions, for the conduct of micro-prudential supervision over credit institutions, for the resolution of non-viable credit institutions and for the operation of deposit guarantee schemes.[12]

The banking union will co-exist with the single market in financial services. From an institutional perspective this means that the expanded mandate of the ECB – the entity at the centre of the SSM – will impact upon the work of the European Banking Authority, whose jurisdiction is the EU at large.[13]

B. The Rationale for the Banking Union

The crises in Europe (the twin financial and sovereign debt crises) have shown a relationship of interdependence between sovereign nations emitting sovereign debt and financial institutions (banks) purchasing sovereign debt, while relying on restructuring and resolution frameworks, in particular a full bail-out, backed by national budgets. Refinancing failing banks can threaten the solidity of national budgets and rapidly increase national indebtedness; the sustainability of sovereign debt can threaten the stability of banks that hold the sovereign debt. A vicious circle or doomed loop was created in this way during the sovereign debt crisis.

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[12] *See*, notably:

- Directive 2013/36/EU of the European Parliament and of the Council "*on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC*" (known as CRD IV), which consists of 165 articles, and

- Regulation (EU) No 575/2013 of the European Parliament and of the Council "*on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012*" (known as CRR), which consists of 521 articles.

See Official Journal of the EU, No. L 176/1 and L 176/338, 27 June 2013. A corrigendum of the originally published text was published in Official Journal No. L 321/6 of 30 November 2013. For corrigenda of the CRD IV, see Official Journal No. L 208/73 of 2 August 2013.

[13] *See generally* Rosa Lastra,"Banking Union and Single Market: Conflict or Companionship?" *Fordham International Law Journal*, Vol. 36, No. 5, 2013, pp. 1189-1223.

See also Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013.

To break this vicious circle between financial institutions and sovereign nations a common European back-stop with the ability to recapitalize banks directly was requested to relieve (some) Member States from the substantial rise of their national indebtedness due to the need to finance the restructuring of their banks. In June 2012 the Euro Area Summit decided that the European Stability Mechanism should get an instrument to recapitalize banks directly (under its current set of instruments, the ESM can only give credit to its Member States which can transfer the credit to their banks).[14]

To address the risk of moral hazard and the possibility of regulatory forbearance, the Euro area summit also decided to transfer banking supervision to the European level and to build a Banking Union consisting of a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and common deposit protection. A key aim of this Banking Union is to prevent the financial consequences of improper national supervisory measures from being transferred to the European level and, thereby, to the taxpayers of other Member States. The creation of the Banking Union is the logical consequence of the political intention to create a possibility for the ESM to recapitalize banks in the Euro area directly. In this context, the Euro Area Summit of 29 June 2012 stated: "When an effective single supervisory mechanism is established, involving the ECB, for banks in the Euro area the ESM could, following a regular decision, have the possibility to recapitalise banks directly."[15]

C. The Single Supervisory Mechanism and the Single Rulebook on Banking Regulation

1. The Single Supervisory Mechanism

Legal Basis

The SSM was based on Article 127 (6) TFEU which states that the Council, acting by means of regulations, may unanimously confer specific tasks upon the ECB concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings. On the basis of this provision, the SSM Regulation, namely Regulation (EU) No 1024/2013 'conferring specific tasks on the European Central Bank concerning policies relating to the (micro-) prudential supervision of credit institutions' was adopted on 15 October 2013. On 3 November 2013 the SSM-Regulation entered into force. According to Article 33 (2) the ECB shall assume the tasks conferred on it by this SSM regulation on 4 November 2014.

Asset quality review and stress tests

Before the actual start of the first stage of the Banking Union (i.e., before November 2014), it is necessary to determine and assess existing legacy assets in the balance sheets of the financial institutions subject to the SSM to avoid having hidden legacy assets undermine the credibility and reputation of the ECB's supervisory work. The Member States are responsible and liable for the risks in the balance sheets of their financial institutions that have arisen under the supervision of their national authorities. Therefore, these risks must be borne and financed (if necessary) by the respective Member States and their national restructuring and resolution institutions, e.g. their national resolution funds.

The ECB – in collaboration with the national competent authorities – will perform a Comprehensive Assessment of the credit institutions that will be directly supervised by the ECB, consisting of three components:

(i) a 'Supervisory Risk Assessment' to review, quantitatively and qualitatively, key risks, including liquidity, leverage and funding;

(ii) an 'Asset Quality Review' to enhance the transparency of bank exposures by reviewing the quality of banks' assets, including the adequacy of asset and collateral valuation and related provisions; and

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[14] The statement at the end of the Euro Area Summit of 29 June 2012 was clear: "We affirm that it is imperative to break the vicious circle between banks and sovereigns". However, banking union is not enough to break this vicious link. We also need to address – as Jens Weidman writing in FT on 1st Oct 2013 suggested – the regulatory treatment of sovereign exposures and end the 'fiction of risk-free assets' which receive favourable ratings by credit rating agencies. *See also* the Joint Statement of the Ministers of Finance of Germany, the Netherlands and Finland, 25 September 2012: "the ESM can take direct responsibility of problems that occur under the new supervision, but legacy assets should be under the responsibility of national authorities", available at:
http://www.vm.fi/vm/en/03_press_releases_and_speeches/01_press_releases/20120925JointS/name.jsp

[15] Euro Area Summit Statement from 29 June 2012, available under
http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

(iii) a stress test to examine the resilience of banks' balance sheet to stress scenarios. This exercise will be performed in collaboration with the European Banking Authority.

Content of the SSM Regulation

The SSM-Regulation confers specific tasks related to the prudent supervision of financial institutions on the ECB.[16]

The ECB will directly supervise "significant" institutions and indirectly the other "less significant" institutions. In principle, a financial institution is considered "significant" if it belongs to the three major credit institutions in its Member State or if its balance sheet total exceeds either 20% of the GDP of its Member State, or 30 billion Euros.[17] The day-to-day supervision of other institutions will remain in the competence of the national supervisors. However, the ECB has the power to take over the surveillance of any bank in individual cases. The ECB is responsible for the entry into the market of any credit institution[18] and for the authorisation of holdings in authorised credit institutions.[19] The ECB is mandated to organise coherent supervision of the entire banking system by these NSAs and itself.[20]

While all Euro area Member States are legally required to take part in the SSM, non-Euro area Member States may participate voluntarily by agreeing a "close cooperation" with the ECB.[21]

The supervisory tasks conferred on the ECB shall primarily be planned and executed by a new internal body called the Supervisory Board. The Supervisory Board is composed of its Chair and Vice Chair, four representatives of the ECB who may not be charged with any tasks directly linked to the monetary policy tasks of the ECB, and one representative of the national authority competent for the supervision of credit institutions in each participating Member State.[22] Decisions of the Supervisory Board shall be taken by a simple majority of its members and each member shall have one vote.[23]

The Supervisory Board shall carry out preparatory works regarding supervisory tasks conferred on the ECB and propose complete draft decisions to the Governing Council of the ECB.[24] These decisions are adopted by the Governing Council as the decision-making body of the ECB. A draft decision of the Supervisory Board shall be deemed adopted unless the Governing Council objects within a certain period.[25] According to this "non-objection procedure" the Governing Council can adopt or object to a draft decision of the Supervisory Board ("take it or leave it"). In case of an objection by the Governing Council, the matter can be referred to a Mediation Panel. However, the non-objection procedure has to be interpreted narrowly. It should only be applied for decisions (with addressees) in the supervisory process and sanction procedure, thus respecting the Governing Council's ultimate decision making competence which cannot be restricted by secondary EU law.

Assessment of the SSM Regulation

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[16] On 7 February 2014, the ECB has launched a public consultation on an implementing regulation on SSM (ECB Framework Regulation); *see* http://www.ecb.europa.eu/press/pr/date/2014/html/pr140207.en.html.

[17] Article 6 (4) SSM-Regulation.

[18] Article 14 SSM-Regulation in conjunction with Articles 4 (1) (c) and 6 (4).

[19] Article 15 SSM-Regulation in conjunction with Articles 4 (1) (c) and 6 (4).

[20] Articles 6 (1), (2), (3), (5), (7) SSM-Regulation.

[21] Article 7 SSM-Regulation.

[22] Where the competent authority is not a central bank, the member of the Supervisory Board may decide to bring a representative from the Member State's central bank.

[23] Article 26 (6) SSM-Regulation.

[24] Article 26 (8) SSM-Regulation.

[25] Article 26 (8) SSM-Regulation.

The decision-making structures of the ECB were designed primarily for monetary policy. This poses challenges with regard to the actual conduct of supervision by the ECB. Supervision, lest we forget, is by definition resource and personnel intensive, very litigious, prone to reputational damage and, generally, a 'thankless task' in which failures are magnified and successes are often hidden. The conferral of supervisory responsibilities onto the ECB also poses challenges for its cherished independence. After all, the central bank's independence is of a different kind than the regular 'supervisory independence' that characterizes the exercise of prudential supervision. The need to resist what is referred to as 'regulatory capture', a phenomenon that should be labeled 'supervisory capture', i.e., the measure of influence over supervisory decisions by the supervised, is one element that distinguishes the two.

The creation of 'Chinese walls' within the ECB, in order to ensure the effective separation of its monetary responsibilities from its supervisory tasks, is a key challenge for the ECB. The possibility of conflict is recognised in Article 25 of the SSM Regulation which foresees the establishment of a 'mediation panel'.

Furthermore, every transfer of a new task to the ECB raises concerns about democratic legitimacy. These issues have been addressed in arrangements between the ECB and the Council,[26] on the one hand, and the European Parliament,[27] on the other. These arrangements provide for extensive reporting and accountability mechanisms.

The coexistence between the SSM and the Single Market is a further challenge for the effectiveness of both realities (banking union and single market). Though it is stated in the SSM Regulation that the inclusion of the 'single supervisory mechanism' in the European System of Financial Supervision (ESFS) will not affect the current tasks of the European Banking Authority, this remains to be tested.

2. The Single Rulebook on Banking Regulation

On 26 June 2013, the following acts were published in the Official Journal of the European Union:

- Regulation (EU) No 575/2013 of the European Parliament and of the Council "*on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012*" (known as CRR), which consists of 521 articles;[28] and

- Directive 2013/36/EU of the European Parliament and of the Council "*on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC*" (known as CRD IV), which consists of 165 articles.[29]

Both texts have transposed into EU law the regulatory framework of the Basel Committee on Banking Supervision (known as 'Basel III'). Regulation 575/2013 and Directive 2013/36/EU collectively set the framework which governs access to activity, the supervisory framework and the rules on prudential regulatory intervention in the operation of credit institutions and investment firms.

D. The Single Resolution Mechanism and the Single Rulebook on the Resolution of Credit Institutions

1. The Single Resolution Mechanism

General aspects

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[26] Memorandum of Understanding between the Council of the European Union and the European Central Bank on the cooperation on procedures related to the Single Supervisory Mechanism (SSM), available at: http://www.ecb.europa.eu/ssm/pdf/memorandum-ssm-eucouncil-ecb.pdf?d922daf6c03ae2503cd5dff03061ecb5.

[27] Interinstitutional Agreement between the European Parliament and the European Central Bank on the practical modalities of the exercise of democratic accountability and oversight over the exercise of the tasks conferred on the ECB within the framework of the Single Supervisory Mechanism, Official Journal of the EU, No. L 320/1, 30 November 2013.

[28] EE L 176, 27.6.2013, pp. 1-337.

[29] EE L 176, 27.6.2013, pp. 338-436.

The establishment of a Single Resolution Mechanism is a logical complement to the creation of the SSM. The SRM shall ensure that financial institutions (banks) can be resolved in times of crisis according to common rules and pre-established procedures. A resolution fund is foreseen as a common financial back-stop; the need to revert to taxpayers' money in a financial crisis should be reduced to a minimum in order to break the vicious circle between financial institutions and sovereigns.

On 10 July 2013, the Commission presented a proposal for a Regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund. Taking into account the disputes among the Member States concerning this draft regulation, the Council reached a compromise (political agreement with the European Parliament) on 18 December 2013 which includes arrangements for the transfer of national contributions to the Single Resolution Fund and their progressive mutualisation over a 10-year transitional phase.[30] The proposed SRM regulation is expected to enter into force on 1 January 2015 and the bail-in and resolution functions shall apply from 1 January 2016.

Legal Basis of the Proposed SRM Regulation

Article 114 of the Treaty on the Functioning of the European Union (TFEU) is the legal basis for the proposed SRM Regulation. Article 114 allows the EU to adopt measures for the approximation of national provisions laid down by law, regulation or administrative action aiming at the establishment and functioning of the Internal Market of the European Union. This legal basis is controversial and has been criticised as insufficient (given that it deals with the needs of the internal market), with some arguing that a treaty revision is needed.

In its *Meroni* judgment of 1958,[31] the European Court of Justice declared inadmissible under EU law the delegation of discretionary powers to bodies that are not established in the European Treaties. New bodies with discretionary powers can only be established by the Member States by a transfer of competences in the way of a Treaty amendment but not by normal secondary legislation. Therefore, the *Meroni* doctrine requires a basis in primary law for authorities with discretionary powers. It has been argued that Article 114 TFEU in principle does not provide for such a basis.[32] Although the establishment of the three European Supervisory Authorities[33] was also based on Article 114 TFEU, it has to be noted that the establishment of an SRM including a Single Resolution Fund is substantially different from the ESAs. While the core decision-making competences remain at the national level in the case of the ESAs,[34] with regard to the Single Resolution Mechanism, the core decision-making competences are transferred to the European level, to European "authorities".[35]

Bearing in mind the aforementioned legal limitations, the proposed SRM regulation creates a Mechanism instead of a new authority (with a Single Resolution Board), but results in a complex decision-making mechanism [which has already been criticized by some as inefficient].

The content of the proposed SRM Regulation

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[30] For a short summary of this compromise, *see* press release from 18 December 2013, available under http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140190.pdf.

[31] *Compare* ECJ, case 9/56, *Meroni*.

[32] *See, e.g.,* the Opinion of Advocate General Jääskinen in Case C-270/12, mentioned below.

[33] The three agencies within the European Systems of Financial Supervision are the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). The ESRB forms also part of the ESFS.

[34] A situation that will be altered by the beginning of operation of the SSM by 1 November 2014, as explained before.

[35] In this context, the recent judgment of the European Court of Justice in a case on the implementing powers of the European Securities Market Authority (ESMA) may be relevant. It seems to broaden the possibilities for endowing agencies established by the EU in the context of harmonized rules applying in the internal market with powers. These powers should be circumscribed by conditions and criteria concerning substance and procedure that limit this discretion. Also, the EU institutions must remain ultimately in charge of economic policy decision-making. This 'update' of the *Meroni* doctrine takes into consideration that decisions by agencies established by the EU under secondary law are subject to judicial review.

The SRM shall supplement the Bank Recovery and Resolution Directive (BRRD). The BRRD is expected to be adopted shortly, and as with all EU legislative instruments, it has to be implemented in all EU Member States. The BRRD aims to give the national competent authorities common resolution tools for financial institutions in the EU. The jurisdictional domain of such BRRD is the EU/single market.

On the basis of the harmonization of the national legal frameworks on the restructuring and resolution of financial institutions to be effected on a cross-EU basis by the BRRD, the SRM establishes a Single Resolution Board and a Single Resolution Fund for all credit institutions subject to the supervision of the SSM, i.e., in the Euro Area and, possibly, in Member States that do not have the euro as their currency but wish to adhere to 'banking union'. Therefore, the SRM shall replicate the instruments and competences provided for by the BRRD at the European level.

Although the SRM-Regulation shall apply in principle to all EU Member States, its scope covers only institutions from the Member States participating in the SSM. However, the SRM shall not be limited to the "significant" institutions which are directly supervised by the ECB. Also "less significant" institutions shall fall under the scope of the SRM.

Resolution decisions will be taken on the European level. According to the political agreement reached on 18 December 2013, a Single Resolution Board with broad powers concerning bank resolution shall be established. The Single Resolution Board shall adopt resolution schemes and determine the application of resolution tools and the use of the single resolution fund on its own initiative or if it is notified by the ECB that a bank is failing or likely to fail. The Single Resolution Board shall refer its decisions to the European Commission. If the European Commission does not object to such a decision within 24 hours of its adoption the decision will enter into force. In the case of an objection by the European Commission the Council has the final decision right.

The national resolution authorities shall be responsible for executing the decisions of the SRM. However, the Single Resolution Board has the power to address decisions to the national resolution authorities for the execution at the national level in accordance with the proposed SRM Regulation. The Board shall also monitor the execution by the national resolution authorities of its decisions at the national level and can directly address decisions to banks, if a national resolution authority does not comply with its decision.

The financing of resolution measures shall be carried out through the Single Resolution Fund. This Fund shall be financed through contributions by the financial institutions which are subject to the SRM. The target size of the Fund should be at least 1% of covered deposits in the banking system of the participating Member States. During the ten-year initial build up period of the Fund, the contributions of the financial institutions shall be raised at the national level and flow into 'national compartments' of the Single Resolution Fund, which shall be used only for the resolution of banks in the respective Member State. This means that during the buildup period, the Single Resolution Fund consists of national compartments. These national compartments shall be gradually merged. While the cost of resolving banks would mainly come from the 'national compartments', during the first years this national share would gradually decrease as the contribution from other countries' compartments increases.

To guarantee the budgetary sovereignty of the Member States, neither the Commission, nor the Council nor the Single Resolution Board shall have the power to require Member States to provide extraordinary public financial support to the Single Resolution Fund. However, as the Fund may not have enough financial means at the beginning of its functioning, it has to be ensured that the national budgets of the Member States are not used to finance resolution measures. Thus, the Council also agreed on the design of a backstop to the Single Resolution Fund. During the build-up period of the Fund, bridge financing will be available from national sources, backed by bank levies, or from the European Stability Mechanism, in accordance with agreed procedures. Lending between the national compartments of the Fund shall also be possible. In addition, a common backstop shall be developed during the buildup period. This backstop shall become fully operational at the latest after ten years. Political agreement has been reached to establish this fund on the basis of a separate, intergovernmental treaty instead of on secondary legislation based on the TFEU.[36] Concerns about the legality

[36] *See* the Ecofin Council press release of 18 December 2013, which refers to "a decision by euro-area member states committing them to negotiate, by 1 March 2014, an intergovernmental agreement on the functioning of the single resolution fund", at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140190.pdf.

of this latter method led the Member States to opt for this alternative route, which finds opposition in the European Parliament.[37]

2. The Single Rulebook on the Resolution of Credit Institutions

Concurrently, on 18 December 2013, the European Parliament and the EcoFin Council reached political agreement on the adoption of a Directive that had been on the table for a long time, the provisions of which will harmonise rules governing, *inter alia*, the resolution of non-viable credit institutions (and certain investment firms). It is worth pointing out that it is the first time that harmonisation rules will be implemented at the EU level in this field, as opposed to the fields of prudential supervision and prudential regulatory intervention in the operation of credit institutions and bank deposit guarantees, for which a regulatory framework has been in place (for a long time).

E. Deposit Protection

Although a common European deposit protection fund shall not be established for the time being, there are discussions concerning the harmonization of the national deposit protection regimes and a commitment of the national deposit protection funds to grant credits among each other if one fund has not enough financial means in a crisis. The prospect of establishing a European deposit guarantee scheme, as the third main component of a 'European Banking Union', is discussed in terms of principles and "high-level politics", i.e., no specific regulatory proposals have been tabled by the European Commission. In this sense, this field is currently characterised by inaction.

Nonetheless, it should be pointed out that a Directive of the European Parliament and of the Council, repealing Directive 94/19/EC of the same EU institutions (as applicable, already amended to raise the level of deposit protection)[38] regarding deposit guarantee schemes, is expected to be adopted in 2014. This Directive will further harmonise rules governing national deposit guarantee schemes, with a view to strengthening the single banking market (particularly as regards swift payout if a scheme's intervention is triggered). The European Parliament and the Council reached political agreement on this proposal on 17 December 2013.

F. Conclusion

The establishment of the Banking Union is intended to break the vicious circle between the sovereign debt crisis and the banking crisis. In this context, the establishment of the SSM and the creation of the SRM can be seen as a first positive step to break this link between sovereigns and banks. It remains to be seen which effects the SSM and the SRM will have in practice. The jury is out.

TABLE

Legal sources re: key components of a European Banking Union

	Prudential supervision and regulatory intervention in the operation of credit institutions	Resolution of non-viable credit institutions	Bank deposit guarantees
Banking Union	Single Supervisory Mechanism: *Regulation 1024/2013*	Single Resolution Mechanism *Proposal Regulation of July 2013*	*No initiatives as yet*

[37] *See* the EP's statement on the work on the single resolution mechanism for banks of 9 January 2014, at: http://www.europarl.europa.eu/news/en/news-room/content/20140109IPR32201/html/MEPs'-statement-on-the-work-on-the-single-resolution-mechanism-for-banks.

[38] By Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay, Official Journal L 68/3, 13 March 2009.

Single Market-Harmonisation of substantive rules (single rulebook)	• *Regulation 575/2013 of the European Parliament and of the EcoFin Council (CRR)* • *Directive 2013/36/EU of the European Parliament and of the Council (CRD IV)*	*State aid rules and proposed Bank Recovery and Resolution Directive*	*Directive 94/19/EC of the European Parliament and of the EcoFin Council (expected to be replaced by a new Directive in 2014)*

IV. The risk of fragmentation of the global financial markets

Over the last decades international financial standards (IFS) as well as national regulations have developed at an unprecedented pace that even accelerated since the global financial crisis of 2008. This evolution to a degree reversed the earlier trend of the 1970s, which experienced an extensive de-regulation and globalization of international financial markets, with great benefits in terms of competition and profitability, but also highly increased systemic risks.

IFS and their implementation at the national level precisely aim at mitigating systemic risks and ensuring properly functioning markets, while providing a level playing field on international financial markets. However, the most recent developments entail a certain risk of fragmentation of the global financial markets, which has also been termed as "balkanization" of the international financial markets.[39]

* * *

Some of the factors contributing to this situation are summarized below:

1. There are too many regulatory and supervisory authorities, not to speak of those involved in the restructuring, resolution or liquidation of failing financial institutions. This plethora of authorities and other bodies may be observed at national level, at the regional (viz. European) level as well as among international bodies and institutions. This obviously makes it problematic to coordinate their action rapidly, especially in case of crises. Furthermore, there are cases of overlapping laws, jurisdictions or responsibilities.

2. Similarly, there is a huge volume of IFS and of implementing rules at national or regional (viz. European) level. These rules are often very complex. The current trend for regulation is to address even the smallest details and each and every aspect of a given financial crisis (although the next crisis will probably be very different and unexpected, with new products and services falling outside the regulatory box). This approach makes the rules very complex and doesn't help their implementation, which becomes increasingly difficult and costly. Some of the rules that appeared to be fully appropriate at the time of their introduction may develop undesirable side effects (e.g. volatility and pro-cyclical effect induced by mark-to-market principle; capital requirements based on risk-weighted assets as an incentive for off-balance sheet transactions). Finally, there is a significant risk of overshooting regulation.

3. Cross-border transactions are made more difficult and complex by the multiplicity of connecting factors (such as the nationality of counterparty or customer; the residence, domicile or place of incorporation of the parties involved; the place of issuance of a product or the place of negotiation; etc.). This may lead to overlapping IFS and various national regulations, involving inconsistencies and conflicts of laws and jurisdictions. As a result there appears to be a non-negligible legal risk owing to uncertainties with regard to jurisdiction and applicable rules.

4. This situation is further exacerbated by the increasing extraterritorial outreach of national rules. The extraterritorial character may be explicit (by law) or implicit (when the activity of international banks or financial firms is de facto dependent on the access to certain markets or currencies). While the purpose of such rules mostly appears to be perfectly legitimate (e.g. fighting money laundering and tax evasion), their extraterritorial outreach is a source of complexity and potential conflicts, not to speak of the additional administrative burden involved for foreign banks or financial institutions.

[39] *See* Section VII, *infra*.

In short, while the aim of these rules and regulations may be absolutely legitimate in itself, their effect is increasingly to hamper offshore banking and international transactions. The resulting complexity induces many banks or other financial institutions to decline accepting foreigners or even non-resident nationals as customers, or to enter into certain categories of international transactions. This evolution, if confirmed, may make international financial markets less efficient, may reduce competition and eventually have a protectionist effect.

Are we on the brink of the end of global banking? Such a view is perhaps exaggerated, but some of the recent developments are undoubtedly a matter of concern and would need to be properly addressed.

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Among the various actions that could help avoiding a counterproductive evolution in this respect, the following would deserve to be further considered:

First and most importantly, a major streamlining of current regulatory agencies, standard-setting bodies and applicable rules would have a positive effect. Concentration on essentials in international harmonization would not only enhance its impact, but also avoid overshooting or overly detailed standards. Thus the limits of international harmonization and the weight of reality would be duly taken into account.

Second, restraint should be exercised with regard to national regulations with extraterritorial effect, which are a potential source of inconsistencies, legal uncertainty and conflicts. Similarly, the multiplication of connecting factors and the increase of administrative burden imposed upon foreign financial institutions should be limited or, even better, avoided. In general, mutually agreed international harmonization is preferable to unilateral national legislation with extraterritorial effect.

Third, the focus should be put on essential issues, such as ensuring international cooperation in case of financial crises, bank restructuring and resolution. In particular, international efforts with regard to resolution of international banks in case of insolvency need to be pursued. There is an obvious need for clear ex-ante burden-sharing arrangements as to how the cost of a bank resolution will be allocated between the relevant stakeholders and countries. In particular national ring fencing with regard to assets of failed institutions should be avoided.

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Hopefully, these and other appropriate measures will address in the near future the concerns expressed above, in order to avoid resurgence of protectionism in financial markets.

From a more general viewpoint, in the context of the evolution of financial standards and regulations, some reflection should also be devoted to the links both between bank resolution and sovereign debt, on the one hand, and between sovereign debt and monetary issues (flooding markets with liquidity, little or no return on capital, inflation and/or deflation), on the other hand.

V. The FSB and the G20

The global financial crisis of 2007/2008 revealed serious shortcomings in financial and economic policies and existing regulatory and supervisory practices and led to a fundamental re-thinking of the broader framework for the international coordination of financial and economic policies and for the future of financial regulation and supervision.

The first "Leaders Summit" held in Washington in November 2008 constituted a sea change in how and by whom international financial policies would be developed. The G-20 replaced the G7 in their central policy-making role and committed to "implement reforms to avoid future crises and in particular to "*ensure* that all financial markets, products and participants are regulated or subject to oversight." Regulatory reform was at the core of the first Leaders Summit in Washington, DC, in November 2008 and has retained a very prominent place in the communiqués of the G20 leaders, finance ministers and central bank governors at all their subsequent meetings.

Prior to the crisis, regulatory policy was left to 'networks of regulatory authorities and was an unlikely topic for a leaders' summit, let alone for Summit declarations. At the Pittsburgh Summit, the Leaders designated the G20 as the premier forum for economic cooperation.

A. The Establishment of the FSB

The international regulatory reform process began before the November 2008 G20 leaders meeting in Washington, DC. At their meeting in October 2007, G7 finance ministers requested the Financial Stability Forum (FSF) to prepare a road map for reform. The FSF released a comprehensive set of recommendations in April 2008, which formed the basis of the G20's detailed work plan to strengthen financial regulations. At the London Summit in 2009, the G20 transformed the FSF into the Financial Stability Board (FSB) with "*expanded membership, broader mandate and enhanced operating structure*".[40] The memberships of the FSB, as well as of key regulatory groupings such as the Basel Committee, were enlarged to correspond roughly with that of the G-20.

At the Pittsburgh Summit of September 2009, the G20 Leaders endorsed the FSB's Charter, which set out the FSB's mandate and tasks.[41] The FSB was established to coordinate at the international level the work of national financial authorities and international standard-setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. Its membership consists of authorities responsible for maintaining financial stability, namely ministries of finance, central banks, supervisory and regulatory authorities, international standard-setting bodies (SSBs), regulatory, supervisory and central bank bodies,[42] and international financial institutions (IFIs).[43] The jurisdictions represented on the FSB comprise the G-20 countries, Hong Kong, the Netherlands, Singapore, Spain and Switzerland. The Charter requires the FSB to review periodically the eligibility of Members in the light of the FSB's objectives.[44] The FSB announced that it would undertake the first review of the structure of representation in the FSB by the Brisbane Summit.[45] To promote the interaction with authorities in a wider group of countries, the Plenary has established six regional consultative groups (for the Americas, Asia, the Commonwealth of Independent States, Europe, the Middle East and North Africa, and Sub-Saharan Africa) that bring together FSB members and authorities from about 65 non-member jurisdictions to discuss vulnerabilities affecting regional and global financial systems and the current and potential financial stability initiatives of the FSB and member jurisdiction.

The FSB Plenary, which comprises representatives of all members of the FSB, is the FSB's decision-making body. The number of representatives of individual countries on the FSB Plenary varies from one to three, reflecting the size of the national economy, financial market activity and national financial stability arrangements.[46] The Plenary makes all decisions relating to the FSB's work programme, membership, the adoption of FSB reports, principles, standards, recommendations and guidance, the appointment of the Chair, amendments to the Charter, and any other matter relating to the business and affairs of the FSB. The FSB does not have any formal voting procedures. All decisions are made by consensus.[47] While this term has not been formally defined, the FSB has developed practices for reaching consensus under which "the Chair makes clear on what issue a decision is being sought, and then asks for the views of members. If there is no immediate convergence of views, the different points of view are discussed and attempts are made to reconcile competing

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[40] G20 Declaration on strengthening the financial system - London, 2 April 2009.

[41] Leaders' Statement, 24-25 September 2009, Pittsburgh Summit ("We endorse the institutional strengthening of the FSB through its Charter, following its establishment in London, and welcome its reports to Leaders and Ministers….").

[42] International standard-setting bodies include the Basel Committee on Banking Supervision (BCBS), the Committee on Payment and Settlement Systems (CPSS), the Committee on the Global Financial System (CGFS), the International Accounting Standards Board (IASB), the International Association of Insurance Supervisors (IAIS), and the International Organization of Securities Commissions (IOSCO).

[43] The IFIs include the International Monetary Fund (IMF), the World Bank, the Bank for International Settlements (BIS), and the Organisation for Economic Cooperation and Development (OECD).

[44] FSB Charter Article 4 (1).

[45] See Press release of the meeting of the Financial Stability Board in Moscow on 8 November 2013.

[46] FSB Charter Article 10 (1).

[47] FSB Charter Article 7.

or conflicting views. In practice, a consensus, in the sense of general agreement, is reached when there is no sustained opposition to the Chair's proposal for decision."[48]

The FSB Steering Committee provides operational guidance between Plenary meetings to carry forward the work of the FSB.[49] The FSB recently reviewed the composition of the Steering Committee, to achieve "better-balanced geographical and institutional representation".[50] It now has representation from the executive branch of governments of "G20 Troika" countries, of the five countries with the largest overall systemic-importance ranking of their financial sectors, as assessed by the IMF, as well as geographic regions and financial centres that were not previously represented in the Committee.

The FSB Chair[51] is appointed by the Plenary from among the representatives of its members for a term of three years. The Chair presides over the meetings of both the Plenary and the Steering Committee.[52] The FSB has also established Standing Committees and a number of working groups. Reflecting the FSB's three-pronged approach to promoting financial stability, the FSB established Standing Committees on (i) the assessment of systemic risks and vulnerabilities; (ii) the identification of suitable regulatory and supervisory policy actions to address these risks and vulnerabilities; and (iii) the coordinated implementation of these agreed actions, as a Standing Committee on Budget and Resources.[53]

B. FSB Governance and Legal Status

The G20 Seoul Communiqué of 2010 reaffirmed the FSB's role in coordinating the work of national financial authorities and international standard setting bodies in developing and promoting the implementation of effective regulatory, supervisory and other financial sector policies in the interest of global financial stability.[54] Despite its growing importance, the sense prevailed that FSB remained a temporary construction – a crisis management task force that would either be dissolved post crisis or a provisional body whose functions could be assigned to another institution. The FSB lacked resources and its standing, governance and accountability arrangements were not commensurate with its mandate and tasks. At the Cannes Summit in November 2011, the G20 acknowledged the FSB's growing role in this area and agreed to strengthen the FSB's capacity, resources and governance. More specifically, they called for the "establishment of the FSB on an enduring organizational footing with legal personality and greater financial autonomy […]".[55] The FSB subsequently established a high-level FSB working group that made several recommendations directed towards these objectives which were endorsed by G-20 Leaders at the Los Cabos Summit in June 2012.[56] In particular, the working group recommended that the FSB be established as a legal entity with its own legal personality. In June 2012 at the Los Cabos Summit, the G20 endorsed a revised Charter for the FSB that reinforced its role in standard setting and in promoting Members' implementation of international standards. While consideration was given to the establishment of the FSB as an inter-governmental organisation based on a multilateral treaty, this option did not appear appropriate at the time.[57] The process of negotiating a treaty would have taken considerable time and diverted attention and resources from the more pressing policy agenda. Also, the setting up of such a formalized structure could have compromised the flexibility in the FSB's operations that have

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[48] *See* International Monetary Fund, « IMF Membership in the Financial Stability Board », February 22, 2013.

[49] FSB Charter Article 13.

[50] http://www.financialstabilityboard.org/press/pr_100112.pdf.

[51] Currently Mark Carney, Governor of the Bank of England.

[52] FSB Charter Article 14.

[53] *See* FSB Charter, Articles 14 to 17.

[54] G20 Seoul Summit Declaration, 11-12 November 2010, paragraph 40.

[55] G-20 Cannes Summit Final Declaration, November 4, 2011, paragraph 38.

[56] FSB Report to the G20 Los Cabos Summit on Strengthening FSB Capacity, Resources and Governance, June 12, 2012, www.financialstabilityboard.org/publications/r_120619c.pdf; Los Cabos G-20 Leaders Declaration, June 19, 2012, paragraph 46.

[57] *See* Report to the G20 Los Cabos Summit on Strengthening FSB Capacity, Resources and Governance, 12 June 2012.

proved so effective in times of crisis. Instead, the FSB concluded that the establishment of a corporate body in the form of an association under Swiss law offered the FSB a sufficiently firm institutional basis and the greatest degree of functional flexibility to meet its needs. The Articles of Association establishing the FSB as association under Swiss law were adopted on 28 January 2013.[58] The BIS hosts the FSB and provides resources to its Secretariat on the basis of a five-year renewable service agreement with the FSB.

US Treasury Secretary Timothy Geithner described the FSB as the "fourth pillar" of the architecture of global economic governance, alongside the International Monetary Fund (IMF), the World Bank (WB) and World Trade Organisation (WTO).[59] The FSB is different in nature from the other pillars of global economic governance. It does not have any formal rule making or enforcement powers. The FSB Charter is a statement of terms of reference for international cooperation. The "commitments of Members" set out in the Charter to "implement international standards"[60] do not imply formal legal obligations.[61] The academic literature therefore categorises the FSB as a "soft law institution",[62] a "transnational or transgovernmental regulatory network"[63] or a "manifestation of global administrative law".[64] The FSB's effectiveness in promoting regulatory reform in the wake of the crisis hinges on the nexus between the political level, regulatory policy making and technical expertise, and accountability to its stakeholders, including the G20.

C. The FSB Reform Agenda

Since the Washington Summit, the G20 have pursued an ambitious policy agenda. One of its main objectives has been to reduce the moral hazard risk posed by the existence of the largest and most complex financial institutions. At the Seoul Summit the G-20 Leaders endorsed an FSB policy framework for "Reducing the moral hazard of systemically important financial institutions (SIFIs)" (SIFI Framework).[65] The objective of the SIFI Framework is to address the moral hazard risks associated with SIFIs by significantly reducing the probability and impact of SIFIs failing. Authorities should no longer be faced with the binary choice between a disorderly Lehman-style failure and a bail-out with taxpayers' funds.

At the St Petersburg Summit, the FSB presented a report on the progress towards ending "too big to fail".[66] The report sets out what has been achieved so far and what remains to be done to complete the policy agenda that was set out in Seoul. International agreement has been reached on higher capital requirements for banks. The FSB has also designated those banks and insurers that are systemic at the global level and that therefore should be subject to additional policy measures, such as higher loss absorbency requirements, more intensive supervision, recovery and resolution planning, resolvability assessments, the establishment of institution-specific cross-border crisis management groups and cooperation agreements amongst home and key host authorities. The FSB also adopted an international standard ("The Key Attributes of Effective Resolution Regimes for Financial Institutions") that sets out twelve core elements that should be part of the resolution regimes of all jurisdictions. As noted in the FSB TBTF report, firms and markets are beginning to adjust to

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[58] *See* FSB Articles of Association of 28 January 2013.

[59] Press Briefing by Treasury Secretary Timothy Geithner on the G20 Meeting, 24 September 2009, Pittsburgh.

[60] FSB Article 6 of the Charter.

[61] FSB Article 16 of the Charter states that the Charter "is not intended to create any legal rights or obligations."

[62] Eilis Ferran and Kern Alexander, *Can Soft Law Institutions Be Effective? The Case of the European Systemic Risk Board* (European Central Bank Legal Working Paper Series).

[63] For policy networks, *see generally* Anne Marie Slaughter, *A New Global Order* (2004), Joseph Norton, 'Comment on the Developing Transnational Network(s) in the Area of International Financial Regulation: The Underpinnings of a New Bretton Woods II Global Financial System Framework' (2009) 43 International Lawyer 175.

[64] Benedict Kingsbury, Nico Krisch and Richard B Stewart, 'The Emergence of Global Administrative Law' (2005) 68(34) Law and Contemporary Problems 15.

[65] Available at http://www.financialstabilityboard.org/publications/r_101111a.htm.

[66] "Progress and Next Steps Towards Ending 'Too Big To Fail'", Report of the Financial Stability Board to the G-20 ("FSB TBTF report"), 2 September.

authorities' determination to end TBTF.[67] However, much remains to be done, in particular in terms of implementation. Key priorities are achieving agreement on the adequacy of gone-concern loss absorbing capacity (GLAC) and addressing the remaining obstacles to cross-border resolution. An important initiative will be the Resolvability Assessment Process (RAP), which should enable senior policy makers to gauge progress in making globally systemically important financial institutions (G-SIFIs) resolvable by developing effective resolution strategies and plans and institution-specific cross-border cooperation agreements. The FSB TBTF report also notes that structural reform measures (including separation of activities, intra-group exposure limits, local capital and liquidity requirements, etc.) can contribute to improving the resolvability of SIFIs at a jurisdictional level and help reduce the moral hazard of TBTF. Yet, it also acknowledges that there is a risk that diverging structural measures imposed by different jurisdictions may have an impact on integration across national or regional markets. The FSB, in collaboration with the IMF and OECD, therefore committed to assess the cross-border consistency and global financial stability implications of these measures by end-2014.

VI. Bitcoin[68]

Bitcoin is a peer-to-peer payment network and digital currency based on an open source protocol, which makes use of a public transaction log. It was introduced in 2009 by pseudonymous developer Satoshi Nakamoto. A bitcoin does not represent a claim to a physical object or to a physical currency – it aims to be in itself a currency. It substitutes a physical object as well as a credit to a bank account with a *computer file* – containing a list of all past transactions with a unit as of its creation. Bitcoin is a fiduciary currency. As it has no intrinsic value it is not a commodity-based currency.

In making a payment, the payer requests an update to a public transaction log, the block chain. This master list of all transactions shows who owns what bitcoins – currently and in the past. It is maintained by a decentralized network that verifies and timestamps payments using a proof-of-work system. Bitcoin is a cryptocurrency because it uses public-key cryptography to control the creation and transfer of the computer file which purports to be 'money'. Users send payments by broadcasting digitally-signed messages to the network. Participants known as miners verify and timestamp transactions into a shared public database called the block chain, for which they are rewarded with transaction fees and newly minted bitcoins.

Upon payment with bitcoins, Bitcoin protocol ascertains the payer's ownership in the file – and validates its transfer to the payee. The protocol also regulates issue of bitcoins; it defeats counterfeiting and double spending; and ensures the safe transfer of the computer file. It does all that without relying on a single authority.

The block chain is a public ledger of every bitcoin transaction that provides a certain level of anonymity. Thus, it identifies transactions by Bitcoin address and not by individual names. However, tracking the flow of bitcoins through transactions can give clues as to who the owner is. As well, while Bitcoin uses cryptography, it does not do so to protect the identities of its users. In addition, Bitcoin intermediaries such as exchanges are required by law in many jurisdictions to collect personal customer data.

The development process relies heavily on community 'rough' consensus. The gatekeeping function by 'core developers' includes control over the infrastructure and the conduct of discussions on patches to the protocol. As of 2012, Bitcoin Foundation, a US self-regulatory body called the Data Asset Transfer Authority (DATA), was formed. Its mission: standardizing, protecting and promoting the Bitcoin project.

The acceptance of bitcoins in payment of goods and services raises significant issues as to the protection of the public. Also, as a privately issued currency, Bitcoin raises a challenge to conventions on the meaning of money that have crystalized for thousands years. The acceptance of its ideas by libertarian thinkers and politicians certainly raises its profile. Specific legal issues include:

- The legal nature of 'computer file'? Is it a claim? Against whom?

[67] See FSB TBTF report and Letter of the FSB Chair available at http://www.financialstabilityboard.org/publications/r_130905.pdf.

[68] Conventionally "Bitcoin" capitalized refers to the technology and network whereas "bitcoins" lowercase refers to the currency itself.

- Who is liable for the [nominal?] value?

- Is it in fact 'money', currency, commodity or intangible? Even if it is not 'legal tender' or 'official currency', is it 'money' as a matter of statutory interpretation [e.g. BEA, SGA], particularly when it is agreed to be a means of payment? Is it 'money' by its mere acceptance as a means of payment?

- Is it subject to securities regulation?

- Does its use impact Monetary Policy?

- How is it governed by anti-money laundering?

- How is it as a subject for taxation?

So far no uniformity has been achieved in the treatment of all such issues.

VII. The Balkanization of Banking

Banking is one of the few businesses conducted globally on a cross-border branch basis. This permits an efficient use of bank capital allowing the capital of a single legal entity to back all of the bank's business worldwide. It also means that a transaction with a bank's branch in a host country is a transaction with the bank itself, not just the branch. On September 26, 1975, the international forum of banking supervisors known as the Basel Committee on Banking Supervision ("Basel Committee") established basic responsibilities for cross-border supervision of internationally active banks' foreign branches.[69] This is referred to as the Basel Concordat. The host country bank supervisory authority was to be primarily responsible for liquidity of activities in the host country. The home country authority was to retain responsibility for overseeing the liquidity of the bank as a whole. The home country was to be responsible for the capital adequacy of the bank. The Basel Committee at the time noted that some host countries would impose a "dotation de capital" or capital deposit requirement to ensure a foreign bank's minimum investment in the host country and to equalize competitive conditions. Those principles were reaffirmed in a May 1983 report of the Basel Committee.[70]

Those principles have been in place all those years – and remain so. Have the global financial and sovereign debt crises of recent years put those principles under question? Will the answer be the Balkanization of global banking? By this, we mean that host country supervisory authorities may curtail cross-border branching and force some or all of the host country business of a foreign bank into a subsidiary bank in each host country. The purpose of the change in permissible forms of entry would be to permit the host country banking supervisory authority to have full supervisory authority over the subsidiary bank as they do today. A subsidiary bank has its own capital requirement. Its activities are limited by its own capital and surplus, not that of its parent bank. It may be that requiring a foreign bank to close a branch and operate instead through a subsidiary would serve to bolster the ability of banks and other financial organizations in the host country to compete more effectively. A small foreign-owned subsidiary would pose far less of a competitive threat than a branch backed by a global bank's capital and assets. The host country could further limit the ties of a host country subsidiary to its home country parent bank by requiring that the subsidiary be owned directly by an intermediate holding company that resides in the host country or jointly owned by financial organizations in the host country. During the global financial crisis, some host country authorities expressed concern with the capital adequacy of foreign banks operating branches in the host country and with the adequacy of the liquidity of those branches. Another concern was that some of those host country branches were providing funding to the home country bank or its branches in other countries, creating the potential for the host country branch to suffer a liquidity shortfall that would have an adverse impact on the financial stability of the host country. A host country subsidiary bank would not require a cross-border resolution proceeding. The host country could better address each of these concerns if the foreign bank had to establish a subsidiary bank and close its branches in the host country.

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[69] Report to the Governors on the supervision of banks' foreign establishments (Sept. 26, 1975), available at http://www.bis.org/publ/bcbs00a.pdf.

[70] Principles for the Supervision of Banks' Foreign Establishments (May 1983), available at http://www.bis.org/publ/bcbsc312.pdf.

That type of thinking was rumored to have motivated UK bank supervisory authorities not to permit Chinese banks to establish branches in the United Kingdom and to require them instead to establish UK subsidiary banks instead. This may have been related to the experience of the UK authorities with the London branch of Iceland's Landbanki upon the failure of that bank.[71] The UK authorities resolved their trepidation by stating that Chinese banks could establish wholesale branches in the United Kingdom.[72] Permissible wholesale branching would address questions regarding the responsibility of the UK authorities for guaranteeing to repay retail deposits at such branches. In the case of the Chinese banks in the UK, some already had subsidiary banks in the United Kingdom. It is not clear if they will nonetheless find it worthwhile to transfer their wholesale activities to a UK branch.

The UK authorities' solution is quite similar to that found in the United States. Banking legislation enacted quite some time ago limits a foreign bank to establishing and maintaining a wholesale U.S. branch whose deposits are not insured by the Federal Deposit Insurance Corporation and a U.S. subsidiary bank whose deposits are insured.[73] While the deposits of a foreign bank's U.S. branch are not guaranteed by the U.S. government, a U.S. branch does have access to U.S. government funding at favorable rates through the Federal Reserve Bank discount windows or other Federal Reserve funding programs made available to U.S. banks. Many foreign banks with U.S. branches took advantage of these sources of funding during the 2008 global financial crisis.

The question still before us is whether and to what extent host country bank supervisory authorities will view the events of the recent crises as requiring added limits on the permissibility of foreign bank branches or if permitted, the range of the activities that branches would be permitted to conduct or the requirements that the host country might impose. It may be that where host countries continue to permit branches, prudential limits will be imposed to ensure that the foreign bank retains sufficient capital and liquidity at the branch level and not be allowed to fund the home country bank. The Federal Reserve Board has taken this approach in implementing the requirements of the U.S. financial reform legislation known as the Dodd-Frank Act. The Federal Reserve Board has issued for comment a program for enhanced supervision of foreign banks operating in the United States. While not precluding foreign banks from continuing to operate in the United States through branches, the proposal would require the ringfencing of the U.S. bank and other subsidiaries of a foreign bank into a U.S. intermediate holding company. The U.S. offices would be subject to liquidity and lending limits, and required to show that the foreign bank parent complies with capital adequacy, stress testing and risk management limits akin to those required for U.S. banks.[74]

The Committee plans to continue to monitor developments on this over the coming year.

VIII. The Role of Culture and Ethics in Financial Regulation

This subject has currently been the subject of much debate, and MOCOMILA discussed it at its meeting in Madrid in September 2013. A range of views was expressed.

The committee noted that in the UK, a Parliamentary Commission on Banking Standards was established in July 2012 in the wake of the problems with LIBOR to conduct an enquiry into professional standards and culture in the UK banking sector. Following its report in July 2013, a board is being set up with a view to improving banking standards.

Whilst the response to the global financial crisis has centred on enhanced financial regulation, there are limits as to what can be achieved by that route. It is not possible formally to regulate all aspects of the behaviour of

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[71] *See* Icesave dispute, http://en.wikipedia.org/wiki/Icesave_dispute.

[72] UK opens door to Chinese banks with special terms for lenders, Financial Times (Oct. 14, 2014), available at http://www.ft.com/intl/cms/s/0/d2de8356-34f6-11e3-a13a-00144feab7de.html?siteedition=intl#axzz2pMGZcev8.

[73] *See* Board of Governors of the Federal Reserve Board, Order approving acquisition of shares of The Bank of East Asia (U.S.A.) National Association by Industrial and Commercial Bank of China Limited (May 9, 2012), available at http://www.federalreserve.gov/newsevents/press/orders/order20120509a.pdf.

[74] 77 Fed. Reg. 76628 (Dec. 28, 2012), http://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-30734.pdf.

financial institutions, nor is it necessarily desirable to try to do so, in the interests of competition and innovation. Further, regulation will always be subject to arbitrage, and there are current issues as to the complexity of regulation.

The financial services industry has acknowledged the importance of encouraging an ethical culture to support the legal framework. The principles set out by the Basel Committee on Banking Supervision in 2010 make it clear that a bank is expected to have in place a code of conduct or comparable policy document articulating "acceptable and unacceptable behaviours". Many banks internationally have formal codes of ethics, or similar documents, and in some countries (like the United States) there are requirements to this effect. MOCOMILA discussed how these codes operate internationally, and what their status might be.

One view is that high level ethical standards are private matters for financial institutions. Another view is that the law may have a part to play. There is a case for financial regulators to engage with banks' processes, not necessarily to prescribe the content of codes of ethics, but to monitor how ethical considerations are carried forward within organisations. In any case, the key issue is how higher standards can be implemented. There is the potential to improve standards that have widely been regarded as suboptimal, and it is in the interests of financial institutions as well as their customers that these issues are addressed in a way that is compatible with a highly competitive business environment.

MOCOMILA discussed the view that public support for higher standards, along with the stated commitment of financial leaders, has created an opportunity to promote an ethical culture. In principle, the same criteria should apply internationally, even if formulated in different ways. It is possible to recognise ethical values as underlying the formal framework of financial regulation and soft law, and to try to give a more formal recognition to the role that an ethical culture in finance may play.