COMMITTEE ON INTERNATIONAL MONETARY LAW

WORKING SESSION

Wednesday, 07 April 2014, 1:15 PM

Chair: Mr Bruce Mauleverer (UK)

The Chair welcomed the audience, made some introductory remarks and commended the excellent report of the Committee and each of its eight parts. He then introduced Sir William Blair, the Chair of the Committee.

Sir William Blair (UK) thanked everyone for attending the session. He introduced Mr Thomas Baxter Jr., vice chair of the Committee and informed the audience that the other vice chair, Mr Antonio Sáinz de Vicuña y Barroso could not be present for the session. He also introduced Mr David Gross, secretary of the Committee.

He then introduced the structure of the report, which consisted of eight sections:

1. The Transformation of International Economic Law and Financial Reform in Latin America
2. Approaches to Sovereign Debt Resolution: Recent Developments
3. European Banking Union
4. The Risk of Fragmentation of the Global Financial Markets
5. The FSB and the G20
6. Bitcoin
7. The Balkanization of Global Banking
8. The Role of Culture and Ethics in Financial Regulation

Sir William Blair noted that the head author(s) of each section would speak on their respective sections. He also mentioned that the session would address the financial systems in Ukraine and Thailand because of the recent political events in those states. Sir William Blair then introduced Dr Manual Monteagudo as the first speaker.

Dr Manuel Monteagudo (HQ) began his presentation by explaining how Latin American has recently experienced substantial economic transformation, with some states implementing sound economic reforms to make themselves less vulnerable to international financial crises. Latin American states undertook these reforms, however, without a centralized legal framework. Thus, Latin America's economic liberalization has been based on a diversified and fragmented system—which included the involvement of international organizations, free trade agreements, and bilateral investment treaties, as well as domestic legislation. Moreover, Latin America's financial reforms reflected the operation of soft law mechanisms, especially in the context of broad involvement by international economic organizations.

Dr Monteagudo then noted that while Latin American states undertook a fragmented approach to economic liberalization, there were some common principles among the states' approaches. Specifically, the states adhered to certain common principles like monetary stability, central bank independence, fiscal responsibility and transparency, non-discrimination, and fair and equitable treatment. Moreover, Latin America's fragmented economic liberalization coincided with the strengthening of the human rights system in Latin America, especially the Inter-American Court of Human Rights. Dr Monteagudo concluded by remarking that international economic law, in

general, is experiencing a period of deep transformation and that parts of Latin America are part of this global transformation. Though Latin America's reforms were not unified, its fragmented system of reform based on soft law is allowing the region to increasingly place itself in a position to demand reforms at the international level.

Sir William Blair, in reference to Dr Monteagudo's remarks, invited an intervention from Mr Cristiano Corzer regarding Brazil's the monetary reform experience.

Mr Cristiano Corzer (Brazil) responded and agreed with Dr Monteagudo's analysis, noting that Brazil is experiencing many of the same movements he sees throughout Latin America. In the early 2000s, Brazil was focused on fiscal policy and a reformed payment system, and now Brazil is in the process of implementing the Basel III accord. Mr Cristiano noted that banks in Brazil are typically not a large source of concern for regulatory bodies because the banks are well capitalized, and Brazil is a net external creditor. Mr Cristiano expressed that Brazil has benefited from its fruitful reform efforts, but he noted that there is still work to be done, such as the creation of a banking resolution law.

Sir William Blair enquired as to the extent Latin America is becoming institutionally similar to the EU.

Dr Monteagudo responded that the Latin America region is not, at the moment, developing towards a supra-national framework like that of the EU because of issues of sovereignty. The idiosyncratic politics of the region make such supra-national convergence difficult. The integration process of MERCOSUR was more rhetoric than a legal system operating like the EU. Even though Latin America does not have an operational supra-national legal framework like the EU, the region does have a soft law framework, which has worked for making the harmonization process in Latin America very close to that of the EU in many regards.

Mr Gopala Krishnan K. Sundaram (HQ) enquired about how the reforms have permeated the system and if they can provide some safety from political intrusion.

Dr Monteagudo stated that there are some political challenges but that the achievements recorded so far were against the background of an unstable political climate. In what he referred to as a paradox, he stated that Latin America experienced growth in both human rights and in economic terms, but there was not a simultaneous growth of strong political institutions. Latin America has not been able to produce an international legal structure because of political immaturity.

Sir William Blair then questioned whether governments accept and implement the human rights decisions even if they are contrary to domestic interests.

Dr Monteagudo replied that, to a certain extent, governments do accept and implement human rights norms that may be contrary to political interests. He pointed to the Peruvian experience as an example of this.

Mr Corzer remarked that soft law mechanisms have worked so well in Latin America states because their financial institutions have deep and broad regulatory powers that enable them to make reforms and regulations without the need to pass laws. He observed a similar pattern in Brazil. Mr Corzer then asked whether such a system that relies entirely on soft law and broad regulatory powers was sufficient, or whether they suffer from a lack of democratic legitimacy.

Dr Monteagudo remarked that Latin America has definitely developed its financial agencies with a lot of regulatory power, which has facilitated economic development in the region. This necessarily places limitations on democracy and political institutions, but, so far, soft law has recorded impressive achievements. Dr Monteagudo observed that while soft law has been effective, it is not entirely sufficient and that there is the need to do more, even though there are significant political challenges.

Sir William Blair introduced Mr Marcus Jewett to speak on the session's second topic: recent developments in approaches to sovereign debt resolution.

Mr Marcus Jewett (Canada) provided a background on sovereign debt crises, noting that they have migrated from developing countries to other parts of the world, especially the Euro-zone. Ongoing litigation involving Argentina, including Argentina v. NML Capital, has raised some additional alarms among market participants. The two primary approaches for reforming sovereign debt crises are the treaty approach and the contractual approach. The treaty or statutory approach proposes to rely on a framework of laws and international treaties to address sovereign bankruptcy. The contractual approach builds on the widespread use of collective action clauses (CACs), which generally permit a supermajority of the holders of an instrument to provide changes to an instrument that would bind all holders, even a dissenting minority. Moreover, aggregated CACs permit the holders of a single bond instrument to be treated much like the creditor class voting procedures under the United States' Chapter 11 proceedings. Mr Jewett concluded by describing the reports from past ILA working groups addressing sovereign debt and by advertising the upcoming moot session debating the contractual and treaty based approaches to sovereign debt workouts.

Sir William Blair opened up the discussion for questions in response to Mr Jewett's presentation.

The Chair asked for more information about the NML Capital cases.

Mr Jewett explained that MNL Capital is a long story with voluminous proceedings. Generally, the MNL Capital cases involve holdout creditors and the interpretation of a clause common in sovereign bonds referring to equal standing. Mr Jewett expressed that, if the US courts' interpretations are valid, it may change the understood meaning of equal standing because if you make a payment to any creditor under the new bonds, you have to make payments to the holdout creditors as well.

Sir William Blair observed that cases like Argentina have been decided in a number of jurisdictions and have been going on for a long time. He then asked if CACs are now the norm and how effective they are in avoiding disputes.

Mr Jewett explained that there are of common use in the EU, although most cases of sovereign debt operate under UK or New York law. CACs have been carried forward and improved over the years with aggregation clauses working to address the holdout issue. Most holdouts issues are resolvable, but endemic holdout issues can erode incentives for creditors. Those arguing the contractual approach will argue that these issues get worked out most of the time, but Mr Jewett pointed out that whether this workout is due to CACs remains up for debate.

Mr Thomas Baxter Jr (USA) then gave some details about the courts holding in the NML Capital case, noting that the United States Court of Appeals decision was very important because the court sustained that a central bank was not responsible for the debts of the public.

Professor Cynthia Lichtenstein (USA) also gave some explanations about the facts of the NML Capital case stating that Argentina attempted to deal with a large bond in default by proposing to the bondholders a voluntary exchange of the defaulted bonds for new bond with a later maturity date and a number of other proposals that would allow Argentina some time to deal with its debt crisis. Over 90% of the bondholders agreed. However, the holdouts claimed that the *pari passu* clause in the old bond meant that the old bond must be paid if the new bond received payments. The case can potentially discourage private resolutions.

Sir William Blair introduced the European Banking Regulation topic and the next three speakers: Mr Bernd Krauskopf, Dr Chiara Zilioli and Professor Christos Gortsos.

Mr Bernd Krauskopf (Germany) gave a background to the current banking harmonization efforts in the EU, which became especially important following the global financial crisis. Some banks that were considered too big or too interconnected to fail were rescued by national taxpayers. In some countries, this led to unsustainable public debt, which can then threaten the stability of banks. The rise of unsustainable public debt caused Europe to try to further harmonize banking practices. As the sovereign debt crisis in Greece became increasingly apparent in 2010 and contagion effects spread to other countries, the romantic illusion of currency union stability eroded. Across Europe, there was a growing feeling that it would be unacceptable to leave supervision competencies with national supervisors when the fallout is felt on such a broad international level. Mr Krauskopf transitioned to a description of the European Central Bank (ECB) and how, under current reforms, it will be legally independent from EU governments and EU Parliament with regard to its new supervisory tasks.

Dr Chiara Zilioli (Italy) spoke on the ECB and the challenges that arise from its implementation. The first issue she addressed was identifying the mandate that had been conferred on the ECB. The ECB is responsible for the functioning of the Single Supervisory Mechanism (SSM) and directly supervising significant credit institutions. The ECB is also responsible for authorizing and withdrawing licensing for all banks in the SSM area. Dr Zilioli noted that the ECB does not operate alone with regard to national supervisory authority; instead, there will be a joint supervisory team for each of the big banks that will be comprised of ECB staff and members of all national supervisory authorities. Cooperation within the SSM and national competent authorities (NCA), particularly the joint supervisory team that supervise significant credit institutions, could raise complications due to multiple applicable laws and language barriers.

Dr Zilioli then turned to the issue of the relevant applicable law. Regulations will come from the EU, but national legislatures or NCA will maintain some discretion to make policy choices. There has been a general harmonization of rules, coupled with a movement away from directives and towards regulations. However, there are still lots of options within these regulations for states to choose one or more direction for action. The ECB will thus have to continue to apply local laws until there is a single harmonized law.

Turning to the issue of separation, Dr Zilioli observed a need to ensure that the ECB's supervisory role does not mix with its monetary powers. A great majority of EU central banks

already had supervisory authority before authority was given to the ECB. She pointed out that there are a number of ways to make this cohabitation possible, such as creating a new decision making body; however, that new body would not be able to legally make final decisions because that would require amendment of a treaty. The main objective should be to keep the ECB's decision-making processes separate from its supervisory tasks. There is also a challenge of accountability arising from whether the ECB, in its supervisory role, can maintain its independence from the EU Parliament, as well as the parliaments of the member states.

Finally, Dr Zilioli addressed the complicated legal challenge the ECB faces with so many competing member states. There is the legal challenge that exists because of the geographical scope of the ECB. Besides supervising banks in the euro area, the ECB is also to supervise banks outside the euro area if a state outside the euro area asks for ECB supervision.

Professor Christos Gortsos (Greece) spoke about the ingredients of the European Banking Union, noting that this part of the report was prepared by Professor Rosa Lastra (Spain), who was unable to attend the session. The European Banking Union is hinged on three pillars: (1) the Single Supervisory Mechanism (SSM); (2) the Single Resolution Mechanism (SRM); and (3) the creation of a common deposit guarantees scheme.

The SSM will be a combination of ECB and national supervisory authorities, with the ECB as the institution in charge. This will create a system of single supervision and prudential regulation within the EU. There is an extensive set of legislation behind the SSM, including 175 technical standards that will be adopted, each of which contains 40 to 50 articles. The SRM will begin operation in 2015. If the ECB determines that a bank is not viable, it will submit such a recommendation to the SRM, which will have 24 to 48 hours to reach a decision. The SRM will operate with a single resolution fund endowed by five billion Euros. The SRM will adopt a risk-based method similar to that employed in the US. There is a possibility that, in the future, the recapitalization by public funds will not be affected at a national level, but instead at the European level.

Rambod Behboodi (Canada) made an enquiry as to the determination of systemically important banks and whether there were any other institutions being contemplated.

Professor Gortsos responded that the applicable regulations specify the criteria for the determination. So far, the idea has been only for banks and some holdings companies to be considered.

Mr Krauskopf went through some the specifics of the criteria for determining a systemically significant bank. If the bank's balance sheet exceeds 20% of the GDP of the member state or 30 billion Euros, then it will be considered significant. The determination, however, is made not only with respect to the size of the bank, but also the size of the market.

Guiseppe Lorenzo Rosa (Italy) asked about what the perception of the ECB and the individual state central banks was about whether voters in the upcoming European Parliament elections will be informed about these developments to aggregate toward a unified system with effective means to mend the banking system.

Mr Krauskopf responded that the representativeness of the parliament is not yet ideal because European Parliament membership does not align with the EU states, which creates a legitimacy issue.

Dr Zilioli added that citizens' response or perception are diverse and vary across the EU. Some citizens do not grasp the scope and importance of this development. There is the need for more enlightenment to make citizens understand the process better.

Professor Gortsos responded that there are several member states with a delegation who might be willing to submit their banks to the supervision of the ECB because they are subsidiaries of other banks in the Eurozone that are going to be subject to the ECB. He also pointed out that there has been a major communication failure because, if you ask a European citizen what the supervision by an ECB or national supervisory authority actually means, they will consider it to be a consumer protection mechanism. This is a failure because consumer protection remains a national competence.

Professor Luc Thevenoz (Switzerland) talked about the relationship was between the SRM and the Banking Recovery and Resolution Directive (BRRD). Noting the complex nature of the system, he raised the issue of complying with a complex body of regulation through an equally complex process for decision-making.

Professor Gortsos agreed with respect to the issue of complexity stating that the BRRD was to build a minimum playing field.

Dr Zilioli also agreed that it was a complex system but that one important benefit was the ability to take action with 24 hours.

Mr Krauskopf stated that what was needed was a clear amendment to the relevant treaty to establish a separate entity for the euro zone.

Mr Gijsbert Ter Kulie (Netherlands) wondered if the expectation was for the ECB and national supervisors to work together on a soft law or hard law basis.

Dr Zilioli responded that the regulation expects cooperation. Under the SSM, these parties must work together. But the ECB may also take hard law measures. For now, hard law measures are not needed, but they may be required with time.

Professor Gortsos noted that one difference between the Latin American region and the EU is that in the latter there is some basic hard law that underlines the system.

James Freis (USA) wondered if changes in the European banking supervision were bringing about any change in the interaction between the supervised banks and the supervisors in terms of dialogue and transparency.

Dr Zilioli observed that, in a way, these changes are inevitable.

Professor Gortsos stated that many of these supervision issues have always existed.

Sir William Blair then, after a brief break in the session, introduced Mr Luis Urrutia Corral as the next speaker.

Mr Luis Urrutia Corral (Mexico) shared Mexico's experience in the area of Free Trade Agreements. Recent discussions of FTAs have led to an interesting debate over the principle of minimum standard of treatment, especially as dealing with foreign investors and how financial services may now be governed by international standards as opposed to domestic law. With the development of fair and equitable treatment standards under customary international law,

domestic laws will no longer be necessarily applied; instead, international law will become the new standard for fair and equitable treatment. He observed that there is broad pressure to move forward towards an international standard for financial services, with an exception to allow for prudential regulations or regulations for financial integrity or security.

Sir William Blair introduced Professor Benjamin Geva and Mr James Freis to discuss Bitcoin.

Mr James Freis (USA) noted that the world is increasingly becoming more complex and that Bitcoin is outside the scope of the traditional legal framework. Using the workings of supply and demand, the internet has changed global commerce such that it is no longer in the nature of person to person. Nonetheless, payment systems have hardly changed, especially across borders. Though these transaction costs are falling, they remain relatively high. Bitcoin offers some insight into change in payment systeMs Bitcoin is trying to find a way of payment that can remove frictions for international payments. One of the areas with the most public attention, and where there is some legal framework extended to Bitcoin, is through concerns over Bitcoin's anonymity. Bitcoin, as a payment system, is nonetheless transparent because of the ability to track spending. This is where we have seen law enforcement shutting down Bitcoin accounts.

Professor Benjamin Geva (Canada) explained that Bitcoin is difficult to define because the system is not physical. Bitcoin is not a thing, nor is it a claim against an individual. It operates on a consensus for a value such that whoever gets it can use it to get something else, but the Bitcoin itself has no intrinsic value. Bitcoin value operates through a peer-to-peer network that uses mathematical algorithms in place of counterparties to intermediate the transaction. The system is underwritten by E-commerce with its concept of a private and public key. Professor Geva observed that there is an ideological appeal to Bitcoin for people who do not like big government or big banks. While Bitcoins may be a means to immediate gains, people are typically more hesitant to put savings or pensions in Bitcoin because of its peer-to-peer nature and extreme fluctuations in value. Ultimately, the more states attempt to regulate Bitcoin, the more it will lost its advantages of low transaction costs because the costs of transactional frictions will transfer to individuals using Bitcoin.

Mr Cristiano Corzer (Brazil) observed that Bitcoin appeals to our emotions with a romanticization of private, unregulated money. Though we tend to think about Bitcoin from a private perspective, there is a deeper public perspective of who is to regulate Bitcoin. Though Bitcoin is small now, it could create big problems later regarding the supply of money. How Bitcoin will affect the money supply, and whether this can be regulated, will be the deeper question that moves beyond consumer protection concerns.

Professor Geva stated that those in free markets argue that Bitcoin is self-regulating, and he observed that the Bitcoin supply is ultimately capped at 21 million units. People will likely be cautious of investing too much money into Bitcoin because of the possibility of spectacular losses.

Isabel Feichtner (Germany) asked what the relationship was, if any, between Bitcoin and the real economy.

Professor Geva remarked that Bitcoin is still such a small segment of the economy that it is hard to determine its relationship. He stated that you can think about Bitcoin as what money would be if money was not linked to central banking because supply and demand would have more direct

effects on the economy. Bitcoin is closer to the era when some people used money while others bartered.

Mr Freis added the relationship is still small because of the difficulty of using Bitcoin as payments for values found in the real economy, such as payment of salaries and wages for labor.

Sir William Blair introduced Mr Ernest Patrikis to speak on the issue of Balkanization of global banking.

Mr Ernest Patrikis (USA) defined "Balkanization" as requiring a foreign bank to convert its branches into a subsidiary bank. The primary reasons for this conversion are that it is easier for a host country to supervise a subsidiary than a branch and that it is easier to limit competition from outside to allow a smaller capitalized subsidiary to operate within the country. Mr Patrikis reminded the audience of recent events in England where Chinese banks sought to establish branches in England by using its branches to build up local deposits. Experiences in the US has gone a step further by creating another form of ring-fencing. In dealing with a branch, local authorities pay local creditors first and repatriate remainders leaving foreign creditors with little options. This creates a level playing field concept of national treatment of foreign creditors. There has also been the requirement of intermediaries as holding companies for foreign banks, which goes against Basel guidelines. Essentially, the US has been ignoring Basel guidelines in favor of its own interests.

Professor Cynthia Lichtenstein (USA) indicated that US requirement of intermediary holding companies is an attempt to deal with problems of the ECB and EU working on harmonizing all of those countries in the Euro along with those not in the Euro but in the EU an US; i.e., how your harmonize resolution of entities that are systemically important. If you do not have harmonization of the laws, it is impossible to regulate large international institutions. The US complications that arose from the case of Lehman Brothers raised the need to harmonize laws applicable to systemically significant corporations. When Lehman brothers said they were going to file for bankruptcy, the Federal Reserve could do nothing via hard law other than try to convince Treasury to bail them out. Lehman's bankruptcy is still ongoing today because Lehman was active in 60 countries. We are now finally seeing that it is vital to the security of the international financial system for the major financial centers to work out harmonized laws for the resolution of global banks, and we must work on a globalized harmonization law to deal with a systemically significant financial institutions that are failing. Professor Lichtenstein pointed to a recent White Paper by the FDIC and the Bank of England on the subject of such resolutions, which points to a requirement of a holding company because it makes it easier to resolve failing global institutions quickly.

Sir William Blair the introduced Dr Peter Follak to speak next.

Dr Peter Follak (Germany) discussed recent occurrences in Ukraine and explained that there at least three important complexities with respect to the financial system in Ukraine: (1) the overall indebtedness of Ukraine; (2) the sanctions affecting the financial area are driven by political issues; and (3) the second round of effects will depend on the degree of interconnectedness with Ukraine and Russia. As of today, Ukraine is the worst economic performer of eastern European countries of the former Soviet Union, and it faces a 50 percent default risk probability within the next five years. However, in terms of size and interconnectedness, the impact of a Ukrainian default on global financial systems should be manageable because its public debt has been

financed by its domestic state-owned banks, and a great deal of Ukrainian FDI has been channeled through local subsidiaries. Neither contractual nor treaty based solutions are in place in Ukraine so far; instead, Ukraine is relying on traditional instruments such as IMF instruments, bilateral support, and coordinated support by EU institutions. This combination of EU support and IMF instruments for a non-EU country is a new development. Dr Follak explained that it was unlikely that a second round of effects stemming from a Ukrainian default would endanger global economic stability.

Sir William Blair then introduced Mr Gopala Krishnan K. Sundaram as the next speaker.

Mr Sundaram gave a general indication that the Thailand's banking system and monetary policies have held on well given the recent political crisis in the country. Although some sectors like tourism are beginning to slow down, the economy generally appears stable. Thailand's problem lies with resolving the political impasse because it may raise problems if it continues, as evidenced by the noticeable tapering in Thailand's GDP growth over the last year. Moreover, some investors have complained that a prolonged weak consumer market in Thailand could cause investors to pursue investments elsewhere in the region; i.e. Toyota. So far, fiscal and monetary management in Thailand has remained relatively calm and sound, and the banking system and equity markets have been stable (other than a brief run on a state bank). The Central Bank has trimmed interest rates to support economic activities. A positive credit rating looks unlikely at this time due to political events but could be developed by: (1) strengthening public sector finances; (2) strengthening external payments position; and (3) achieving improvements in the political climate. Factors that could trigger a negative credit outlook include: (1) a prolonging of the political deadlock into the second half of 2014; (2) proliferation of political conflict within and/or outside Bangkok; (3) protests directed at targets that directly affect economic assets which have long lasting effects on tourism and/or manufacturing; (4) a significant rise in government spending related to political uncertainty or a lapse in financial discipline; or (5) a sharp deterioration of balance of payments and significant loss of internal official reserves.

Sir William Blair spoke next about events that have developed recently with regards to the financial system in the UK. Specifically, he addressed the role of culture and ethics in financial regulation. After the global financial crisis, there was a loss of public trust in the financial system. There is now an understanding that public regulation is insufficient, and banks themselves have maintained that they believe in a more ethical banking culture. A good business case can be made out for ethics in banking because there is a need to restore trust in financial institutions themselves. The key issue is how to implement higher banking standards. He proposed codes of conduct, ethics committees at the board level, and remuneration efforts as means to furthering implementation efforts.

Finally, he thanked the Secretary of the Committee, Mr David Gross, for his remarkable contributions to MACOMILA.

The Chair thank everyone present noting the vibrancy of MACOMILA.

Reporters: Daniel Fullerton and Obehi Okojie