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COMMITTEE ON INTERNATIONAL MONETARY LAW

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Introduction

Since the biennial Conference of the ILA held in The Hague in 2010, the Committee (generally known by its acronym, MOCOMILA) has held four meetings: in Basseterre, St. Kitts (12-13 November 2010), New York, NY, USA (29-30 April 2011), Rome, Italy (22-23 September 2011), and Riyadh, Saudi Arabia (7-8 January 2012). The Basseterre meeting focused on financial stability, and included a presentation by Sir K Dwight Venner, the Governor of the Eastern Caribbean Central Bank, and the Honourable Patrice Nisbett, Attorney General of St Kitts-Nevis. The New York meeting featured a comparison of regulatory reform developments in the European Union and the United States. There were two speakers from the Federal Reserve Bank of New York, and many legal academics from the United States were in attendance. In Rome, we discussed sovereign debt management. The meeting was held at Banca d'Italia, and featured presentations from representatives of the International Monetary Fund, the Spanish DMO, and the Centre for European Policy Studies. Finally, the Riyadh meeting focused on legal aspects of a regional monetary union, and included speakers from the Saudi Arabian Monetary Agency and the Gulf Monetary Council.

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

- I. Resolution of Financial Institutions – Recent Developments (by Dr E Hüpkés)
- II. Sovereign Debt (by Mr L Buchheit and Professor R Lastra)
- III. An Update on Regulatory Issues (by Dr K P Follak)

- IV. European Banking Regulation (by Professor C Gortsos)
- V. Special Drawing Rights – Recent Developments (by Mr S Hagan and Dr Li Bo)
- VI. Extraterritorial Impact in Relation to Iran (by Professor T Kubota)
- VII. Attachment and Turnover of Accounts in Foreign Bank Branches (by Dr G Affaki)

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

I. Resolution of Financial Institutions – Recent Developments

A. Introduction

The “too big to fail” problem is one of the most challenging problems for governments and authorities responsible for financial stability. During the global financial crisis of 2008, governments around the world decided to use taxpayers’ funds to rescue financial institutions rather than allowing them to undergo a value-destroying bankruptcy process and be liquidated at fire-sale prices. Bail-outs with taxpayer funds may restore stability in the short-run, but only at the cost of increasing incentives for risk-taking in the long run. However, governments cannot commit to a “no bail-out policy” unless they have in place resolution procedures that can be applied without creating systemic disruptions. At the Cannes Summit in November 2011, the G20 endorsed the “FSB Key Attributes of Effective Resolution Regimes” (the “FSB Key Attributes”) as a new international standard for resolution.¹ The stated objective is to improve authorities’ capacity to resolve failing or problem financial institutions in a manner that does not cause severe systemic disruption and does not expose taxpayers to loss.

B. The Twelve Key Attributes

The Key Attributes set out 12 essential features that should be part of resolution regimes in all jurisdictions. The resolution regimes for financial institutions should be administered by designated administrative resolution authorities with a statutory mandate to promote financial stability and the continued performance of critical functions. Resolution authorities should have at their disposal a broad range of resolution powers. These include powers to achieve a sale or transfer of the shares in the failing firm or of all or parts of the firm’s business to a third party, either directly or through a bridge institution without such transactions requiring the consent from shareholders or counterparties, and powers to achieve the orderly closure and wind-down of all or parts of the firm’s business with timely payout or the transfer of insured deposits. The Key Attributes also recommend that authorities have the requisite tools to convert debt instruments into equity and achieve a creditor-financed recapitalisation (“bail-in”) by way of recapitalising the entity that is no longer viable, or, alternatively, by capitalising a newly established entity or bridge institution to which the distressed firm’s critical functions have been transferred following closure of the non-viable firm (the residual business of which would then be wound up and the firm liquidated). The concept of bail-in is important as it seeks to minimize the frictions and non-linearities associated with closure and liquidation. It also presents an alternative to temporary government ownership and to solutions, such as a sale or merger, which can increase concentration and thereby exacerbate the “too big to fail” problem. Resolution by means of application of one or a combination of resolution tools should be initiated when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so.

The Key Attributes recognize the importance of enforceability of financial contracts, including the respect of early termination rights. However, the Key Attributes call for limited exemptions and the possibility of temporarily suspending termination rights under narrowly defined conditions (e.g., if contracts are transferred within one business day to a creditworthy third party or bridge institution) where their exercise could result in value-destroying close-outs.

¹ *Key Attributes of Effective Resolution Regimes for Financial Institutions*, October 2011, available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

The Key Attributes stress the need for legal certainty and predictability with regard to the exercise of resolution powers and call for appropriate due process and judicial review mechanisms. They stipulate that resolution powers should be exercised in a way that respects the hierarchy of claims. Authorities should have some flexibility to depart from the general principle of equal (*pari passu*) treatment of creditors of the same class if necessary to contain the potential systemic impact of a firm's failure or to maximise the value for the benefit of all creditors as a whole, provided that all creditors receive at a minimum what they would have received in a liquidation of the firm ("no creditor worse off than in liquidation" safeguard). Whereas bankruptcy processes do not provide for emergency funding, the Key Attributes call on jurisdictions to put in place funding arrangements that can provide temporary financing to continue critical operations as part of the resolution of a failing firm.

Recognizing that cross-border firms remain governed by national laws administered by national authorities, the Key Attributes call on jurisdictions to empower and strongly encourage resolution authorities wherever possible to act to achieve a cooperative solution with their foreign counterparties.

Jurisdictions should have the capacity to give effect to foreign resolution measures, either by way of a mutual recognition process or by taking measures under their domestic resolution regime that support implementation of resolution measures taken by the foreign home resolution authority. This requires national resolution authorities to have the authority to exercise resolution powers with regard to all financial institutions operating in their jurisdictions, including local assets and local branches of foreign firms.

No national authority has the capacity to prevent a foreign authority from ring-fencing assets located in the foreign jurisdiction in order to satisfy local claims, even if this constitutes an obstacle to a resolution that minimizes the systemic risk and maximises value. For that reason, the Key Attributes call on authorities to cooperate pre-crisis in order to identify these ring-fencing risks and develop recovery and resolution plans that induce the authorities not to use ring-fencing powers. The Key Attributes also call on jurisdictions to remove legal, regulatory, or policy impediments that hinder the appropriate exchange of information relevant for recovery and resolution in normal times and during a crisis at a domestic and a cross-border level.

C. Resolution Requirements for Globally Systemically Important Financial Institutions

In November 2011, the FSB released a list of 29 institutions that have been identified as globally systemically important financial institutions (G-SIFIs).² The FSB announced that this list will be reviewed and updated on an annual basis and that it will extend to globally systemically important insurers and non-bank financial entities. These firms are subject to specific resolution planning requirements that include mandatory recovery and resolution plans, regular resolvability assessments, the establishment of Crisis Management Groups (CMGs), and institution-specific cross-border cooperation agreements. National authorities may decide to extend these recovery and resolution planning requirements to other institutions in their jurisdictions.

CMGs should include as necessary the home and key host authorities that are material to its resolution including central banks, resolution authorities, finance ministries, and the public authorities responsible for guarantee schemes of jurisdictions that are home or host to entities of the group. There should be institution-specific cooperation agreements between these authorities that define the roles and responsibilities of the authorities pre-crisis (that is, in the recovery and resolution planning phase) and during a crisis; set out the processes for cooperation information sharing, including with any host authorities that are not represented in the CMG, and for coordination in the development of the RRP's resolvability. Most importantly, they should include commitments to coordinate in the implementation of jointly agreed resolution strategies. The RRP's consists of a recovery plan and a resolution plan: the recovery plan should be prepared by the firms themselves and identify options to restore financial strength and viability when the firm comes under severe stress. The resolution plan should be prepared by the authorities and is intended to facilitate the effective use of resolution powers to protect systemically important functions. For G-SIFIs, the home resolution authority should lead the development of the group resolution plan in coordination with all members of the firm's CMG. Host

² Financial Stability Board, Policy Measures to Address Systemically Important Financial Institutions, 4 November 2011, at http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

resolution authorities may maintain their own resolution plans for the firm's operations in their jurisdictions cooperating with the home authority to ensure that the plan is as consistent as possible with the group plan. RRP's are expected to be regularly updated and evolve over time. They should be subject to at least annual reviews by the relevant CMG. To ensure that key decision makers are sufficiently informed and involved in the process, the adequacy of RRP's of G-SIFIs should also be subject to at least annual reviews by top officials of home and relevant host supervisory and resolution authorities. Regular resolvability assessment should help evaluate the feasibility and credibility of resolution strategies in light of the likely impact of the firm's failure and help identify measures to further improve resolvability.

D. Towards Implementation

Legislative changes will be necessary in many jurisdictions to implement the Key Attributes. In order for the Key Attributes to be utilized for assessment purposes and incorporated into the FSB Compendium of Key Standards,³ the FSB agreed to develop an assessment methodology, with the involvement of the IMF, the World Bank, and the standard setters. The methodology should be designed so that it can be used in multiple contexts, including self-assessments performed by jurisdictions of their existing resolution regimes and of reforms to those regimes adopted to implement the Key Attributes; peer reviews conducted within the FSB framework for monitoring the implementation by member jurisdictions; IMF and World Bank assessments of the quality of resolution regimes, for example in the context of Financial Sector Assessment Programs (FSAPs) and Reports on the Observance of Standards and Codes (ROSCs); and reviews conducted by private third parties such as consulting firms. In the second half of 2012, FSB members will begin in July the first of an iterative series of peer reviews on the implementation of the Key Attributes. This review should provide a fuller picture of progress in implementing the Key Attributes.

E. Conclusions

Agreement on the Key Attributes is a significant step towards putting in place a cooperative framework that can achieve an orderly resolution of failing cross-border firms. To effectively implement the Key Attributes in their national legal and regulatory frameworks and to remove remaining obstacles to cross-border cooperation, authorities and firms will have considerable work to do. Challenges arise from remaining uncertainties regarding the effect of resolution actions in a cross-border context.

Resolution powers, such as debt write-downs and conversions, and suspensions of termination rights, may not be effective with respect to contracts governed by foreign laws or assets located in other jurisdictions in the absence of a mutual recognition regime. Mutual recognition of such powers in different legal systems requires broad agreement between different jurisdictions as to how such powers would operate so that courts in a foreign jurisdiction would not allow enforcement of claims in defiance of the resolution powers exercised in the country administering the resolution. Alternatively, cross-border effectiveness could be achieved by relying on a foreign jurisdiction's own resolution authority and the exercise by this authority of its powers in support of the resolution administered by a foreign authority. A pre-condition for that is that the foreign resolution authority has the powers and capacity to act in support of a foreign resolution proceeding. Legal certainty and predictability could be enhanced by appropriate provisions in contract documentation whereby counterparties agree to be bound by resolution actions taken by a foreign resolution authority.

Existing differences in the treatment and ranking of creditor claims across jurisdictions may affect incentives of authorities to agree to cooperative solution if as a result of deference to a foreign authority, local creditors would be treated less favourably. Impediments to information sharing between members of a CMG may also pose obstacles to joint resolution planning work and hamper effective cooperation in a crisis. Resolution planning will need to be stepped up significantly to address these and other issues so that cross-border cooperation will materialize in times of crisis. Finally, the scope of resolution regimes matters. Institutions that engage in "shadow banking activities"⁴ not only operate outside of the safety net and regulatory perimeter; they also tend to be

³ See http://www.financialstabilityboard.org/cos/key_standards.htm.

⁴ The FSB describes the "shadow banking system" as "credit intermediation involving entities and activities outside the regular banking system". See Shadow Banking: Strengthening Oversight and Regulation,

outside of the special resolution regime perimeter. It is therefore important to ensure that they do not trigger systemic problems and that there are effective resolution arrangements in place for them when they fail.

II. Sovereign Debt

A. Introduction

Sovereign debt problems have been a persistent feature in some Eurozone Member States over the last two years. The crisis that ravaged financial markets in 2008 mutated into a sovereign debt crisis in 2010. As we write these lines, the debt problems, which commenced in Greece and then extended to Portugal, Ireland, and Spain, have not ceased. Indeed, the crisis has suffered yet another mutation in the form of the link between the solvency of the national banking system and the financial standing of the sovereign ultimately guaranteeing such system. Further strengthening of Economic Union, perhaps resulting in a full political union, implying a centralized system of fiscal transfers and budgetary controls (also referred to as a fiscal union) and a sufficiently robust and credible pan-European regime for the supervision and resolution of financial institutions (called a banking union) could contribute to a solution of debt problems in some Euro area member states.

In this paper we explore the peculiarities of sovereign debt and sovereign debt restructuring, and consider some lessons that history teaches us that can be applied to the Eurozone debt crisis.⁵

B. Sovereign Debt

Sovereign debtors are unique. Unlike corporate borrowers and individual debtors, overextended sovereign debtors have no institutional framework, such as a bankruptcy code, that will permit them to obtain debt relief without worrying about hostile creditor actions. Some jurisdictions do provide for orderly arrangements to solve indebtedness of sub-national political entities; these arrangements might provide inspiration for mechanisms of oversight in respect of indebted Member States of the EU.

Sovereign borrowers have a propensity to borrow too much. This propensity is often matched by the zeal of lenders to lend to them too much.

1. How to Restructure Sovereign Debt

The legal context in which any sovereign debt restructuring must proceed assumes that individual creditors of all types (multilateral, bilateral, commercial) will be holding debt instruments that constitute legal, valid, binding, and enforceable obligations of the sovereign debtor. The challenge for the sovereign debt restructurer is to cajole or to bludgeon the holders of these instruments into giving debt relief; the creditors cannot be compelled to grant relief. Broadly speaking, there are two options for achieving this objective: carrots and sticks.

1.1 The Carrots

A variety of techniques can be used to entice a creditor into giving debt relief to a sovereign borrower. For example, in return for a stretch-out of maturities, the interest rate on the debt can be raised. To balance the negative net present value effect of a principal haircut, the sovereign can offer credit enhancements, such as the posting of collateral security or guarantees from creditworthy entities to secure the residual amount of the restructured claim.

The financial problem with sweeteners of this kind is that they are (to use a pharmacological term) contraindicated for a sovereign in deep financial distress. In other words, they are expensive. The

Recommendations of the Financial Stability Board, 27 October 2011, at http://www.financialstabilityboard.org/publications/r_111027a.pdf.

⁵ This paper draws on a chapter by Lee Buchheit on “Sovereign Debt Restructuring: the Legal Context” in *Resolving the European Debt Crisis*, a book edited by William R. Cline and Guntram B. Wolff, published by the PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, Washington, DC, February 2012.

legal problem with sweeteners is that they may run afoul of the sovereign's existing contractual covenants. The posting of collateral security to benefit a new creditor may violate a so-called negative pledge restriction (a promise not to create secured indebtedness in the future). An attempt to give legal seniority to new claims may violate the sovereign's *pari passu* clauses.

1.2 The Sticks

If a sovereign cannot, or does not wish to, pour honey over a debt restructuring proposal, it must find some other method of encouraging creditors to grant a measure of debt relief. There are, by the way, only three types of debt relief – an extension of maturities, a reduction of interest rates, and a haircut to principal. They can obviously be combined in limitless ways.

Over the last 30 years, a number of techniques have evolved to induce less-than-voluntary participation in a sovereign debt restructuring. Among these are the following:

Default, real or threatened. In every sovereign debt restructuring of the last 30 years, the sovereign has either suspended payments on its existing debt before the restructuring was launched or threatened (explicitly or implicitly) a payment default on any debt instrument that did not join the restructuring. Sovereign debt restructurers have gotten quite expert in delivering this “abandon hope all ye who do not enter here” message.

Exit consents. Starting with Ecuador in 2000, debt restructurings implemented through bond exchange offers have frequently used a technique known as exit consents. As participating bondholders tender their existing bonds into an exchange, they give the sovereign a proxy to vote at a bondholders' meeting to strip away features of the old bonds in a way that renders those instruments less attractive to prospective holdout creditors. For example, these voting proxies can permit the sovereign to strip out clauses in the old bonds such as the waiver of sovereign immunity, the choice of foreign governing law, the submission to foreign court jurisdiction, the acceleration provision, and the requirement to keep the bonds listed on an exchange. Because many bonds permit modifications of this kind to nonpayment terms with only a bare majority of the holders consenting, this approach can be an effective coercive technique. It does not make the new instruments being offered to creditors any prettier, but it makes the old instruments a whole lot uglier.

Collective action clauses. Collective action clauses (CACs) are contractual provisions that permit a majority or supermajority of creditors to modify features of an instrument, including its payment terms (maturity, principal amount, or interest rate), with the consequence that the change is binding on any dissenting minority of the holders. CACs have been used in English law bonds since 1879. They were reintroduced into New York law-governed sovereign bonds (after an 80-year absence) in 2003 and now appear in most sovereign bonds governed by New York law. Three countries (Uruguay, the Dominican Republic, and Argentina) have “aggregated” CACs that permit a single vote of all bondholders across multiple series of bonds. CACs make a sovereign debt stock more malleable. In effect, the sovereign needs to win the hearts and minds of only 76 percent, not 100 percent, of its creditor group in order to implement the restructuring. The Treaty Establishing the European Stability Mechanism (signed by 17 euro-area member states on 2 February 2012) requires the mandatory introduction of CACs in all euro area government securities. According to Article 12, paragraph 3 of the ESM Treaty:

Collective action clauses, shall be included, as of 1 January 2013, in all new euro area government securities, with maturity above one year, in a way which ensures that their legal impact is identical.

This agreement to include CACs was already contained in the 2011 version of the ESM Treaty. It implements in law an agreement among all EU Member States from 2003 to adopt CACs⁶ following the 2002 G10 Working Group Report on Contractual Clauses.⁷ The standardised clauses adopted in 2012 have been published on the EU website.⁸

⁶ See: http://europa.eu/efc/sub_committee/cac/old/index_en.htm.

⁷ See: <http://www.bis.org/publ/gten08.htm>.

⁸ http://europa.eu/efc/sub_committee/cac/cac_2012/index_en.htm.

Local law. If a sovereign's debt stock is governed by the sovereign's own law, it may be possible to change features of that law to facilitate a debt restructuring. Emerging-market sovereigns have generally not been able to issue bonds in international markets governed by their own law because investors feared some local legislative mischief down the road. The debt stocks of European peripheral sovereigns like Greece and Ireland, however, are predominantly local-law governed.

C. What Does History Teach?

What lessons can be gleaned from the past 30 years of sovereign debt restructurings, and how might those lessons be applied to the debt crisis in peripheral Europe?

Lesson 1: Don't Let a Sovereign Debt Problem Become a Banking Sector Problem

Sovereign debt crises come in two forms: (1) those that are accompanied by a threat to the stability of the banking sector in the debtor country and/or important creditor countries, and (2) those that are not. Of these, the former are far more difficult and dangerous.

The debt crisis of the 1980s posed a clear and present danger to many of the world's international banks because of their precariously high exposures to emerging-market sovereigns, aggravated by the absence (or limited amount) of prudential reserves against that exposure. As a result, the debt restructuring technique adopted in 1982 (which lasted until the Brady Initiative in 1989) avoided any principal write-downs in order to preserve the accounting fiction that allowed the bank creditors to hold restructured sovereign credits on their books at par. This was an example, as the euro-area peripheral sovereign debt crisis is today, of a situation in which the fragile balance sheets of creditor banks drove a debt restructuring technique that was in many respects artificial and visibly inadequate to deal with the problem. US Secretary of the Treasury Nicholas Brady and his debt reduction plan came along only after seven years had passed, a period during which the creditor banks had built up their loan loss reserves.

Encouraging commercial banks to buy government bonds can be very tempting. This practice allows sovereigns to issue more debt, more cheaply, than they otherwise could. Encouragement can take the form of a zero risk weighting of such bonds for bank capital purposes (like the Basel capital rules), or easy access to a central bank discount window with little or no haircutting of any sovereign bonds offered as collateral. But the clear lesson of the last 30 years is this: when sovereign debt instruments are held predominantly by regulated financial institutions, it may prove impossible to address the sovereign's debt stock in a sensible way without triggering a banking crisis. The result? The sovereign's debt stock will probably be addressed, at least initially, in a less-than-sensible way.

Lesson 2: If It Can't Be Avoided, Don't Try

History tells us that sovereign debtors usually delay too long in facing up to an unsustainable debt stock. Politicians do not like to admit that they have ruined the economy (which is why most sovereign debt restructurings have begun only after a change in administration). Politicians hope that things can be held together until they leave office.

Lesson 3: Keep Track

Even an inept public debt management department is likely to know the extent of the central government's liabilities. The problem often resides in the unmonitored borrowings of ministries, parastatals, and sub-national political units like regions, autonomous communities, provinces, or municipalities. When these entities borrow, particularly from foreign lenders, the creditors are apt to see the loans as "quasi-sovereign" exposure.

An even more widespread problem relates to contingent obligations of sovereigns. Wrapping a government guarantee around a loan incurred by a state-owned enterprise, for example, allows that SOE to borrow on better terms. All will be well until the SOE can't pay the loan back and the once contingent liability lands on the balance sheet of the sovereign guarantor.

Contingent liabilities may not be reported by the sovereign as forming part of its debt stock. Investors and analysts can thus be misled about the real state of the sovereign's financial picture, and this in turn leads to mispricing of credits.

Lesson 4: Ask for Enough Debt Relief

Once a sovereign debt restructuring becomes unavoidable, the worst possible outcome is for the country to endure all of the turmoil of a restructuring only to emerge from the process with a debt stock that prospective investors still view as unmanageable. The sovereign will not regain market access after a half-baked restructuring, thus ensuring that another debt restructuring must surely follow. The classic example is the three or four rounds of rescheduling that each of the Latin American countries limped through in the 1980s. It was not until those debt stocks were cut and the balance of the debt stretched out for 30 years under the Brady Initiative that new lending and investment began to flow back into the debtor countries.

For sovereigns whose debt stocks are too disparate to permit face-to-face negotiations with representative creditors, some neutral umpire must be found to pass upon the reasonableness and proportionality of the country's request for debt relief. By default, this job normally falls to the International Monetary Fund (IMF). An assessment of what a "sustainable" debt stock is for any country requires a balancing of economic, political, and social factors. To be blunt, how far can fiscal austerity be pushed before the social compact breaks down? The IMF has had to strike that balance many times in many places. It may not always get the balance right, but no other plausible candidate now exists to play this role.

Lesson 5: Be Ruthlessly Efficient

Sovereign debt crises never occur in isolation. They are usually accompanied by political, banking, economic, and sometimes social crises. Once they begin, however, it is in everyone's interest to conclude a debt restructuring as quickly as possible. This requires both political will and technical competence.

The Latin American debt crisis that began in 1982 languished for a full decade. The Latins still call it the "lost decade". Even the Brady bond exchange deals of the early 1990s sometimes took years to negotiate, document, launch, and close.

Fortunately, with bondholders replacing commercial banks as the dominant creditors, sovereign debt restructurings have been compressed into shorter timeframes. Mark-to-market institutional holders of sovereign bonds have an incentive to cooperate in a speedy resolution of the situation. For so long as their bonds are in default or near-default status, the market value of the instruments will be depressed. A successful debt restructuring, even one that calls for a principal haircut, can often restore market value to a portfolio. It is this alchemy that has allowed most sovereign bond restructurings to proceed more efficiently than the workouts of commercial bank loans in the 1980s.

Lesson 6: Be Evenhanded

Every creditor group caught up in a sovereign debt restructuring can make a plausible argument for why it should be treated more gently than all the others. Trade creditors, for example, will point to a history of preferential treatment in sovereign debt workouts. Commercial banks may argue that they will be the lenders of last resort when fickle bond markets have closed. Bilateral creditors may play the geopolitical card.

It is very dangerous for a sovereign debtor to begin discriminating among its creditor groups (that is, to hand out different treatment in a debt workout), absent a clear and convincing reason for doing so. In a corporate bankruptcy, once the senior and secured creditors are dealt with, everyone else gets lumped together as "general unsecured". A similar approach is wise in the sovereign context.

Differential treatment is sometimes appropriate – trade and supplier debt is a good example – and other creditors will normally accept the rationale for this. But when a sovereign appears to be picking favorites among its creditors without a compelling explanation, the result will be an aggravated sense of grievance on the part of the disfavored creditors.

III. An Update on Regulatory Issues

As the Committee reported at the Hague conference, there will be a few broad continuous issues dominating the discussion during the next few years. First, there are the lessons to be drawn from the global financial crisis, the driving factors of which had been: (1) the tremendous volume of traded risks, by far exceeding the underlyings in the real economy, due to synthetic structures and index-related products; (2) related leverage, in particular due to the activities of unregulated financial entities; (3) absence of harmonisation of prudential liquidity regulation – liquidity requirements had been reserved for central banks as instruments of monetary policy; and (4) structural deficiencies of supervisory authorities, both national and international. Second, the scope of global regulatory harmonisation has to be taken care of. Third, the rule of law in financial regulation should be re-considered.

As far as lessons to be drawn from the Credit Crisis are concerned, significant progress has been made or is under way in the field of technical regulatory issues: (1) improvement of regulatory requirements addressed to financial institutions (the “micro” level); (2) introduction of macro-prudential components; and (3) regular stress testing of banks.

The first Basel Committee package known as “Basel 2.5” – enhancements to the Basel II framework with a focus on trading books and market risks – has been published in July 2009. This package is part of a broader programme – “Basel III” – finally published in December 2010, to be implemented from January 2013 until 2019. It comprises the following items: (1) strict definition of capital components; (2) raising of minimum core capital requirements, to be implemented by January 2015; (3) introduction of liquidity ratios, to be implemented by 2015-2018, following a test phase; (4) introduction of a capital conservation buffer for use in phases of stress, to be implemented by 2019; and (5) introduction of a leverage ratio (test phase, to be finally implemented in 2018).

The field of macro-prudential components has been tackled by the Financial Stability Board (FSB), including the problem of bail outs or rescues – how can one avoid moral hazard incentives caused by bail out expectations? At the November 2011 G20 Cannes Summit, the FSB framework on systemically important financial institutions (SIFIs) was accepted, including a list of 29 banks, which will have to be extended to institutions of domestic relevance in respect of financial market infrastructures, insurance companies, and other non-banks. These institutions are subject to systemic capital surcharges. Further, several jurisdictions have introduced macro-prudential supervision, in particular the USA with the Dodd-Frank Act and the EU with the European Systemic Risk Board (ESRB, Regulation EU No. 1092/2010).

Regular stress testing of banks is carried out in the US in implementation of the Dodd Frank Act, and in the EU under the guidance of the European Banking Authority.

Both the US and the EU have re-structured their systems of regulatory authorities – the US in implementation of the Dodd Frank Act, and the EU in December 2010 implementing the so-called de Larosière Report with the establishment of the European System of Financial Supervisors, comprising the ESRB, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), the European Securities and Markets Authority (ESMA), the Joint Committee of the European Supervisory Authorities, a European institution of appeal and the competent national supervisory authorities of the Member States. Although the European authorities may prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the financial system, regular micro-prudential supervision in the EU is still carried out by the national authorities, and the corpus of EU banking law has to be adopted by the Commission and by the European Council and Parliament.

The inclusion of so-far unregulated financial entities known as “shadow banks” is not yet finalised. The volume of the sector is estimated at €46 trillion or 25-30% of global financial market transactions. The FSB has supplied a general definition – “credit intermediation involving entities and activities outside the regular banking system” – as well as a list of generally accepted shadow banking entities, including asset backed commercial paper conduits, special investment vehicles, money market funds, exchange traded funds, certain types of finance companies and insurers. Further, the FSB has already

laid down high-level principles and recommendations. The EU has issued a Directive on Alternative Investment Fund Managers, and consultation processes are under way in the US and the EU.

The scope of global regulatory regulation has to be taken care of. We are confronted with two different structures worldwide, both consistent with the Basel frameworks. The first involves application of the requirements stipulated by the Basel Committee to the whole finance industry, or at least to licensed credit institutions and securities firms. Basically, this is the concept of the EU. The second involves application of these requirements to a few systemic cross-border institutions only, whereas the rest of the industry would be subject to national regulation. This is the concept of the US under the Dodd-Frank Act, which will apply the full range of the Basel frameworks including the Advanced Approach only to some 20 of the largest institutions. According to the related US notices of proposed rulemaking (NPR) published in June 2012, only the Standardised Approach would apply to all banking organisations.

In order to foster harmonisation, the Basel Committee has established a regular review process in respect of the implementation of its banking standards across member countries. On 11 June 2012, the latest report to the G20 Leaders was published on the implementation of its banking standards across member countries. These reports comprise: (1) a review of the timely adoption of the Basel frameworks, in particular Basel III (level 1); (2) a regulatory consistency assessment of individual jurisdictions (level 2) (related assessments have been established for the EU, Japan, and the US); and (3) risk-weighted assets consistency (level 3).

According to the report, the implementation process of Basel II has been completed in 22 of 28 jurisdictions, including the EU. In the US, a parallel run is on-going for all Basel II mandatory institutions that have to implement the Advanced Approach. The implementation of Basel 2.5 has been completed in 20 of 28 jurisdictions, including the EU (CRD III). It had been postponed in the US, because under the Dodd Frank Act, Rating Agency-based components have to be substituted by internal assessment processes. In June 2012, the final US rules on Basel 2.5 were released, as well as draft regulation (NPR) regarding Basel III. The final Basel III regulation has been issued only by Saudi Arabia; drafts have been published by 16 of 28 jurisdictions, including the EU (CRD IV, third draft in the end of March 2012, to be finally adopted in June/July 2012). An IMF Working Paper states that "...differences in the detailed application of the Basel standards have brought into question the credibility and effectiveness of the capital framework."

The rule of law in financial regulation should be reconsidered. The crisis has brought to light the limits of soft law regulation. There is no treaty-based authority in the area of financial regulation and supervision. We are still heavily relying on voluntary coordination via multiple non-treaty based forums, such as the Financial Stability Board, the Basel Committee etc. What is necessary? First, minimum harmonisation of regulation to achieve consistency and a level playing field, which is being tackled by the Basel Committee implementation review process. Second, co-operation of supervisors, including mandatory intervention in specific cases. Such co-operation should comprise an early intervention framework, including the authorisation to enforce moratoriums in respect of cross-border transactions of non-compliant institutions.

As Federal Reserve Governor Daniel K. Tarullo said, "...the benefits of international regulatory rules will be realized only if they are implemented rigorously and consistently across jurisdictions. . . . [W]e . . . need effective, collaborative monitoring mechanisms administered by the supervisors themselves and reported to the public. . . . [T]he Basel Committee should not be a purely negotiating forum. . . . [O]ther ways must be found to foster the common goals."⁹

IV. Current Developments in European Banking Law

A. General Overview

The collapse of financial markets in autumn 2008 and the credit crunch that followed can be attributed to multiple, often inter-related, causes, as identified, among others, in the 'de Larosière Report,'

⁹ Gov. Daniel K. Tarullo, Remarks at the American Bar Association Banking Law Committee Fall Meeting, Washington, DC (Nov. 4, 2011).

published on 25 February 2009, and in particular to the accumulation of excessive risk in the financial system. The financial crisis prompted a broad EU and international effort to develop effective policies to tackle the underlying problems. In fact, almost the entire existing banking regulation is being revised as a response to the recent financial crisis. Taking as a point of reference the European banking regulation currently in force, the following amendments have already taken place or are under preparation:

(a) Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (known as ‘CRD’) has been amended by Directive 2009/111/EC (known as ‘CRD II’) and Directive 2010/76/EC (known as ‘CRD III’), while a proposal for a Directive and a proposal for a Regulation are under preparation in order to transpose in European law the Basel III regulatory framework (known as ‘CRD IV’ and ‘CRR’, respectively).

(b) Directive 94/19/EC on deposit-guarantee schemes has already been amended by Directive 2009/14/EC and will also be amended by a proposal for a Directive currently under preparation.

(c) A proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms was adopted by the European Commission on 6 June 2012

(d) Last-resort lending, in principle without a legislative framework, was widely used during the recent financial crisis by the ECB as part of its ‘unconventional monetary measures’. In addition, new elements of last-resort lending were introduced in order to allow the national central banks in certain members states of the Eurosystem (notably Ireland and Greece) to provide also emergency liquidity assistance to commercial banks under their jurisdiction upon the so-called ‘Emergency Liquidity Assistance’ (the ‘ELA’).

The objective of this report is to examine the amendments to take place with respect to each element of the ‘bank safety net’ as it is regulated at the European level. In this respect, the following areas are examined:

- micro-prudential regulation of credit institutions (under B),
- micro-prudential supervision of credit institutions (under C),
- macro-prudential regulation of credit institutions (under D),
- macro-prudential oversight of credit institutions (under E),
- resolution of credit institutions (under F), and
- deposit-guarantee schemes (under G).

It is also worth mentioning that since June 2012 there are discussions on the creation of a ‘banking union’, which would resort to:

- the establishment of a single European banking supervisory authority (by enhancing the powers of the European Banking Authority),
- a single European resolution authority, and
- a European deposit guarantee scheme.

The implementation of such proposals would require a *total overhaul* of the existing European banking law (including the one under amendment), and induce the introduction of new provisions in all of the legislative acts to be issued by the current agenda. The relevant political decisions are not expected to be taken before September 2012.

B. Micro-prudential regulation of credit institutions

In the proposal for a Regulation ('CRR') there are provisions amending the existing regulatory framework governing the capital adequacy of credit institutions (under a), and provisions introducing "innovative" elements and additional rules on micro-prudential regulation (under b).

(a) Amendments to the existing rules governing the capital adequacy of credit institutions

(aa) Provisions on credit institutions' minimum regulatory capital

During the recent financial crisis it was found that the quality of capital instruments required to absorb unexpected losses from risks in the trading book and Tier 3 capital instruments were not of sufficiently high quality. Furthermore, the harmonisation in the EU of the definition of capital was insufficient. The main objective of the proposal is to strengthen further the criteria for eligibility of capital instruments and to introduce harmonisation of the adjustments made to accounting equity in order to determine the regulatory capital that it is prudent to recognize for regulatory purposes. The new requirements would be implemented gradually between 2013 and 2015.

(ab) Provisions on coverage against exposure to credit risk

The crisis revealed a number of shortcomings in the current regulatory treatment of counterparty credit risk arising from derivatives, repo, and securities financing activities. Requirements for management and capitalisation of the counterparty credit risk will be strengthened. Risk weights on exposures to financial institutions relative to the non-financial corporate sector will be raised. The proposal for a Regulation would also enhance incentives for clearing over-the-counter instruments through central counterparties.

(b) "Innovative" elements

(ba) Leverage ratio

In order to limit an excessive build-up of leverage on credit institutions' and investment firms' balance sheets and thus help contain the cyclicity of lending, the Commission proposes to introduce a non-risk based leverage ratio (namely, assets and off-balance sheet items of banks are not risk-weighted as in the case of capital adequacy requirements). The leverage ratio will be introduced as an instrument for the supervisory review of institutions. Its impact will be monitored with a view to migrating it to a binding pillar one measure in 2018.

(bb) Liquidity ratios

Existing liquidity risk management practices were shown by the crisis to be inadequate in fully grasping risks linked to originate-to-distribute securitization, use of complex financial instruments and reliance on wholesale funding with short term maturity instruments. This contributed to a demise of several financial institutions and strongly undermined the financial health of many others, threatening the financial stability and necessitating public support.

To improve short-term resilience of the liquidity risk profile of financial institutions, a Liquidity Coverage Ratio (LCR) will be introduced after an observation and review period in 2015. LCR would require institutions to match net liquidity outflows during a 30 day period with a buffer of "high quality" liquid assets.

After an observation and review period in 2018, a Net Stable Funding Ratio (NSFR) will also be introduced in order to address funding problems arising from asset-liability maturity mismatches. The NSFR would require institutions to maintain a sound funding structure over one year in an extended firm-specific stress scenario such as a significant decline in its profitability or solvency.

C. Micro-prudential supervision of credit institutions

The basic rule, i.e., the exercise of supervision by the competent *national* authorities, remains the same as well as the coordination and the exchange of the necessary information between competent authorities of the Member States in case of cross-border activities of one credit institution. The *novum* in this area is the establishment on 23 September 2009 of the European Banking Authority (the 'EBA'),

the European Insurance and Occupational Pensions Authority (the 'EIOPA'), and the European Securities and Markets Authority (the 'ESMA') as the successors of the Lamfalussy Committees and the new powers and tasks conferred to them.

The EBA is a part of the newly-established European System of Financial Supervisors (the 'ESFS'), which started operating on 1 January 2011. The ESFS is the result of the legislative adoption of the proposals of the 'de Larosière Report' and its legal basis are 4 Regulations of the European Parliament and of the Council and one Regulation of the Council. The EBA, being the successor of the CEBS and a component of the ESFS, has a clearly more important role in ensuring the stability of the European banking system than that of its predecessor, the CEBS, extending beyond the area of micro-prudential supervision, especially during crisis situations. It has been conferred with extensive tasks and broader powers.

Meanwhile, the EBA has also been endowed with tasks and powers on the field of protecting financial services consumers, although it has not become a, literally, European supervisory authority of the banking system in the European Union. The Chairman of MOCOMILA, Sir William Blair, is the first President of the Joint Board of Appeal in respect of certain decisions of the EBA and the two other European Supervisory Authorities. A further appeal lies to the European Court of Justice.

D. Macro-prudential regulation of credit institutions

The term 'financial macro-prudential policies' (of which macro-prudential regulations are a part) refers to the set of policies (mainly of a prudential nature) adopted and implemented to limit the financial system's exposure to systemic risk, ensuing from factors that do not concern individual financial services providers or individual markets and structures of the financial system, but are more general in character. *A systemic risk is defined as the risk of a malfunction in the supply of financial services (and/or failure to supply), due to the weakening of a sector or of the entire financial system, potentially leading to serious negative consequences in the real sector of the economy.*

The relevant rules of the CRD IV, under preparation, are introduced for the first time and they are addressing exclusively the time dimension of systemic risk. In this context, credit institutions are called to create a "capital conservation buffer" in times of economic growth (under a), and a "countercyclical buffer" in times of excessive credit expansion (under b). Both buffers are meant to attenuate the risk of pro-cyclicality and the risk of excessive leverage by building strong "forward-looking provisions" and covering against excessive cyclicality of the minimum capital requirements of credit institutions.

(a) Capital conservation buffer

According to the CRD IV, the Capital Conservation Buffer amounts to 2.5% of risk weighted assets, applies at all times, and has to be met with capital of the highest quality. It is aimed at ensuring institutions' capacity to absorb losses in stressed periods that may span a number of years. Credit institutions would be expected to build up such capital in good economic times.

(b) Countercyclical conservation buffer

According to the CRD IV, the Countercyclical Capital Buffer is set by national authorities for loans provided to natural and legal persons within their Member State, it can be set between 0% and 2.5% of risk weighted assets, and has to be met by capital of the highest quality likewise. This buffer will be required during periods of excessive credit growth and released in a downturn.

E. Macro-prudential oversight of credit institutions

The European Systemic Risk Board (the 'ESRB') is a part of the newly-established ESFS, which started operating on 1 January 2011. The ESRB is responsible for the macro-prudential oversight of the European financial system in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress.

For this purpose, the ESRB is carrying out the following, *inter alia*, tasks:

- determining and/or collecting and analysing all the relevant and necessary information,
- identifying and prioritising systemic risks,
- issuing warnings where such systemic risks are deemed to be significant and, where appropriate, make those warnings public,
- issuing recommendations for remedial action in response to the risks identified and, where appropriate, making those recommendations public,
- cooperating closely with all the other parties to the ESFS; and, in particular, in collaboration with the ESAs, developing a common set of quantitative and qualitative indicators to identify and measure systemic risk, and
- coordinating its actions with those of international financial organisations, particularly the IMF and the FSB as well as the relevant bodies in third countries on matters related to macro-prudential oversight.

F. Resolution of credit institutions

According to the proposal for a Directive establishing a framework for the recovery and resolution of credit institutions, submitted in June 2012, the aim is to provide national competent authorities “*with the tools to intervene sufficiently early and quickly in an unsound or failing credit institution so as to ensure the continuity of the credit institution’s essential financial and economic functions, while minimizing the impact of an institution’s failure on the financial system and ensuring that shareholders and creditors bear appropriate losses*”.

As a first step towards that end, the Commission is developing a legislative proposal for a harmonized regime for crisis prevention and bank recovery, which includes a common set of resolution tools and reinforcement of cooperation between national authorities. The framework of the Commission comprises three (3) classes of measures: preparatory and preventative measures (under a), early supervisory intervention (under b), and resolution tools and powers (under c).

(a) Preparatory and preventative measures are designed to increase the possibility that developing problems will be identified at an early stage, include reinforced micro-prudential supervision by competent authorities, asset transferability, the conduct of recovery and resolution plans (“living wills”) setting out the measures a credit institution or group would take under different scenarios to address liquidity problems, raise capital or reduce risk, and preventative powers of authorities (indicatively, amendments to business operations and operational structures).

(b) Early supervisory intervention measures are designed to address developing problems at the entity and group level at an early stage, prevent them from aggravating and secure recovery, include in particular:

- expanded supervisory powers (indicatively, clear powers to require the replacement of managers or directors),
- implementation of recovery plans in case an institution is failing to meet the solvency and liquidity requirements under the provisions of the European financial law in force, and
- the supervisory power to appoint a special manager to take over the management, or assist the existing management of an institution.

(c) Resolution tools require the adoption of appropriate financial insolvency laws in order to ensure that “failing” financial institutions can be resolved in a way that minimizes risk of contagion and ensures continuity of essential financial services. The resolution tools include a ‘sale of business’, a ‘bridge bank’, an ‘asset separation’, and a ‘bail-in’ tool.

G. Deposit guarantee schemes

The main amendments to the existing framework Directive 94/19/EC as amended by Directive 2009/14/EC are the following:

- (a) The coverage level will be set at EUR 100,000 (Directive 2009/14/EC) at maximum.
- (b) Payout: the DGS must act to repay depositors within one week (from 20 working days according to Directive 2009/14/EC).
- (c) *DGS financing and borrowing between DGS*: according to the proposal for a Directive, DGSs' available financial means should be proportionate to their potential liabilities. The financing of DGSs will be based on the following subsequent steps:
- *First*, in order to ensure sufficient funding, DGSs must have 1.5% of eligible deposits on hand after a transition period of 10 years.
 - *Second*, credit institutions must pay extraordinary (ex-post) contributions of up to 0.5% of eligible deposits if necessary.
 - *Third*, a mutual borrowing facility allows a DGS in need to borrow from all other DGSs in the EU, which, altogether, must lend to the DGS a maximum of 0.5% of its eligible deposits in need.
 - As a *fourth* and last line of defense against taxpayers' involvement, DGSs must have in place alternative funding arrangements, recalling that those arrangements must comply with the monetary financing prohibition laid down in article 123 TFEU.
- (d) *Risk-based contributions to DGSs*: Contributions from credit institutions to DGSs must be calculated according to their risk profiles in a harmonised way. The proposed indicators cover the key risk classes commonly used to evaluate the financial soundness of credit institutions (capital adequacy, asset quality, profitability and liquidity).

V. Special Drawing Rights – Recent Developments¹⁰

A. Background

The Special Drawing Right (“SDR”) is an interest-bearing international reserve asset created under the First Amendment of the Articles of Agreement of the International Monetary Fund in 1969. The SDR was introduced to supplement existing reserve assets, in recognition of the inherent constraints on the supply of reserve assets (gold and the U.S. dollar) under the Bretton Woods system of fixed exchange rates.

The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. SDRs are part of member countries' international reserves and members can voluntarily exchange them for freely usable currencies among themselves (SDR transactions by agreement). In addition, IMF members with a balance of payments need have the right under the Articles to exchange their SDRs for freely usable currencies to be provided by IMF members with strong external positions that are designated by the Fund to purchase the SDRs (“transactions with designation”). The reserve asset status derives from the commitment of members to hold and accept SDRs and honor obligations underlying the operation of the SDR system. In addition to its role as a supplementary reserve asset, the SDR serves as the unit of account of the IMF and some other international organizations. SDRs are held by IMF member countries that are participants in the SDR Department, the IMF (which holds through the GRA) and certain designated official entities called “prescribed holders”. It cannot be held by private sector entities and individuals.

¹⁰ The committee wishes to express its warmest thanks to Gabriela Rosenberg, Senior Counsel of the Legal Department of the International Monetary Fund, for her work on this section.

Under the current valuation rules, the value of the SDR is based on a basket of four currencies consisting of the US dollar, euro, Japanese yen, and pound sterling. The value of the SDR is posted daily on the IMF's website. It is calculated as the sum of specific amounts of the four basket currencies valued in U.S. dollars, on the basis of exchange rates quoted at noon each day in the London market. The SDR interest rate is established weekly and is based on a weighted average of representative interest rates on three-month debt in the money markets of the SDR basket currencies.

Under its Articles of Agreement, the IMF may create unconditional liquidity through "general allocations" of SDRs to member countries participating in the SDR Department in proportion to their quotas in the Fund. General allocations are done for so-called "basic periods", generally of a 5-year duration. The purpose of general SDR allocations, as prescribed by the IMF Articles of Agreement, is to meet a long-term global need to supplement existing reserve assets, while promoting the attainment of the IMF purposes and avoiding economic stagnation and deflation, as well as excess demand and inflation. The Articles of Agreement also require that SDR allocations have the broad support of SDR Department participants. General SDR allocations have only been made three times. The Articles of Agreement also allow for cancellations of SDRs, but cancellations have never been decided.

A number of developments pertaining to the SDR have recently taken place, as discussed below.

B. General SDR Allocation (2009)

On 7 August 2009 the Board of Governors of the International Monetary Fund approved a general allocation of Special Drawing Rights for an amount of SDR 161.2 billion (equivalent to US \$250 billion) to provide liquidity to the global economic system by supplementing Fund member countries' foreign exchange reserves. The general allocation was made in one-step on 28 August 2009 to all IMF members participating in the Special Drawing Rights Departments (all IMF members when the allocation was made), in proportion to their existing quotas in the Fund, which are based broadly on their relative size in the global economy. The allocation provided each participating country with SDRs in amounts equivalent to 74.13 percent of its quota. It was the largest general SDR allocation, as previous allocations amounted to SDR 9.3 billion (allocated in yearly installments in 1970-72) and to SDR 12.1 billion (allocated in yearly installments 1979-81) and it assisted in mitigating the effects of the financial crisis. Although a large part of the 2009 general SDR allocation was received by industrialized countries, emerging and developing countries received about US \$100 billion, of which low-income countries received over US \$18 billion. The allocation was the response to the call by the G-20 Heads of State and the IMFC at their respective meeting in April of 2009.

C. Special One-Time SDR Allocation (2009)

The Fourth Amendment to the IMF Articles of Agreement providing for a special one-time allocation of SDRs entered into force on 10 August 2009, when the IMF certified that three-fifths of the IMF members representing 85 percent of the total voting power had accepted it. The purpose of the Fourth Amendment was to provide for an SDR allocation that was not intended to meet a long-term global need to supplement existing reserve assets but rather to enable members to participate in the SDR system on an equitable basis. The Fourth Amendment provided for a special allocation of SDRs to raise the ratios of members' cumulative allocations relative to quota to a common benchmark ratio. SDRs allocated on 9 September 2009 under the special allocation amounted to SDR 21.9 billion.

D. Review of the Valuation of the SDR (2010)

The valuation of the SDR is reviewed regularly, generally every five years. On 15 November 2010 the IMF completed a review and concluded that the value of the SDR would continue to be based on a weighted average of the values of a basket comprising the U.S. dollar, euro, pound sterling and Japanese yen and approved revised weights for each of these currencies as follows: the US dollar 41.9 percent, the euro 37.4 percent, the pound sterling 11.3 percent, and the Japanese yen 9.4 percent. The weights are based on the relative value of the members' exports and of official reserves held in the relevant currencies by monetary authorities.

The review left unchanged the criterion for the selection of currencies established in 2000 by the IMF Executive Board. Under this criterion, the currencies included in the SDR basket are the four currencies that are (i) issued by Fund members, (or monetary unions that include Fund members),

whose exports of goods and services during the five-year period ending 12 months before the effective date of the revision had the largest value, and (ii) have been determined by the Fund to be freely usable currencies in accordance with Article XXX (f) of the Articles of Agreement. A freely usable currency is a member's currency that the Fund determines (i) is, in fact, widely used to make payments for international transactions, and (ii) is widely traded in the principal exchange markets. The requirement for a currency to be freely usable was added as a formal criterion only in 2000.

The Executive Board concluded that in spite of China's prominent share of global exports, the Renminbi would not at the time be included in the SDR basket, as it did not yet meet the criteria to be determined a freely usable currency. The Board looked forward to further work on the SDR valuation, including consideration of indicators to select new SDR basket currencies.

The Board decided to continue to set the weekly SDR interest rate on the basis of a weighted average of interest rates on specified short-term instruments in the markets of the SDR basket currencies.

E. Discussion on the Criteria for Broadening the SDR Currency Basket (2011)

On 28 October 2011, the IMF Executive Board discussed a staff paper on the criteria for broadening the SDR currency basket. The paper was a response to a call by the IMFC and the G-20 Ministers to develop criteria to broaden the composition of the SDR basket and part of the work program on issues relating to SDR valuation and the SDR interest rate basket. Expanding the basket to major emerging market currencies, such as the Renminbi, was aimed at strengthening the role of the SDR in the international monetary system. Moreover, setting criteria for inclusion of a currency in the SDR basket could provide the issuers of candidate currencies with incentives to accelerate prerequisite policy reforms. The staff paper noted that based on past experience, very few currencies can be expected to attain the status of freely usable currencies, in particular given difficulties to meet the "wide use" requirement inherent to such currencies. The Executive Board considered alternative criteria for the selection of currencies in the SDR basket that would no longer require these currencies to be freely usable, but decided to maintain free usability as a criterion for inclusion of a currency in the basket. Broadly accepted indicators of the "wide use" of a currency underlying the assessment of its free usability were the currency composition of official reserve holdings and the currency of denomination of international debt securities and international bank liabilities, and of "wide trading" the volume of transactions in foreign exchange markets. As part of the review, the IMF confirmed the continued applicability of the exports criterion for inclusion of a currency in the SDR basket, which captures a currency's role in global transactions based on the issuing country's share in world exports. The Board agreed that the number of currencies in the SDR basket should not be pre-judged while noting that a smaller size would avoid undue costs and complexities to SDR users.

F. Prospect of SDR becoming an International Currency

Prominent policy makers have advocated a much more central role for the SDR. For example, Dr. Zhou Xiaochuan, Governor of the People's Bank of China, wrote in 2009 that the outbreak of the crisis and its spillover to the entire world reflect the inherent vulnerabilities and systemic risks in the existing international monetary system. According to Dr. Zhou, the desirable goal of reforming the international monetary system, therefore, is to create an international reserve currency that is not entirely dependent on any one nation's credit and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using fiat national currencies. For this purpose, special consideration should be given to endowing the SDR with a greater role. The SDR has the potential to become a super-sovereign reserve currency. According to Michel Camdessus, the former Managing Director of the IMF, the world is now faced with a pivotal opportunity to establish a brand-new international monetary system. The SDR should play an important role, so as to eventually become a reserve currency that is beneficial to global financial stability and economic growth. A committee convened by Mr. Camdessus, together with Alexander Lamfalussy and T. Padoa-Schioppa, was founded in 2010 to review the international monetary system reform, including the possible contributions of the SDR to enhancing its stability (the "Palais-Royal Initiative"). The G20 Cannes Summit in November 2011 declared that the G20 had committed to working towards a more representative, stable, and resilient international monetary system, and the SDR basket composition should continue to adjust to reflect the changing role of currencies in the global trade and financial system.

As noted above, the SDR is not a currency, but rather a right to access freely usable currencies of IMF members. Although it has the potential to play a more central role in the international monetary system, presently there are a number of factors restricting such expanded role. First, the current allocation mechanism does not support a currency-style circulation. The IMF Articles of Agreement contemplate SDRs as “supplementing reserve assets” based on assessments of long-term global needs. Under the current arrangement, the supply of SDRs cannot adjust in a timely fashion to reflect the changing global environment. An 85 percent majority of the total voting power of IMF members participating in the SDR Department is needed to agree on allocations or cancellations of SDRs. In addition, the quota-based allocation is not a perfect match to the demand distribution (i.e., SDRs are allocated in proportion to members’ quotas in the IMF, with all members receiving the same proportion). Second, the restricted use of SDR limits its attractiveness. The use of SDR is restricted to IMF member countries, the IMF, and official “designated holders,” excluding the private sector. In addition, IMF rules could be simplified to broaden the authority to use SDRs in operations, to relax the current mandatory requirement to use the official rate in SDR operations and to simplify reporting requirements. SDR-denominated financial products once experienced rapid development in the 1970s and 1980s. However, due to the lack of support from the international community, the private SDR market gradually disappeared as markets regained confidence on the U.S. dollar. The appeal of SDR as a reserve asset has been limited by the absence of a deep and liquid SDR market. The third factor is the lack of market mechanism and infrastructure. Under the current allocation and trading mechanism, the IMF as the “broker” plays an important role in the conversion and clearing between SDRs and other currencies, which in essence is still bilateral clearing. For SDRs to play a central role, it is required to develop an SDR market with sufficient depth and liquidity.

VI. Extraterritorial Impact in Relation to Iran

A. Introduction

This section considers the EU/SWIFT bans on providing payment services for Iranian banks in March 2012. It then addresses the New York State Court Order that required the Bank of Tokyo-Mitsubishi UFJ (BTMU), which handles most of Japan’s payments for oil imports from Iran, to freeze transactions with Iranian banks.

B. The EU/SWIFT Sanctions on Iranian Banks

As a further step in Western efforts to deprive Iran of funds needed to develop nuclear weapons, the EU *inter alia* sanctioned rendering money transfer communication services to Iranian banks. In March 2012, the EU substantially broadened its existing ban regarding financial transactions with Iranian financial firms, *inter alia* by banning money transfer communication services for inadmissible financial transactions for such institutions, and the SWIFT (Society for Worldwide Interbank Telecommunication) responded by discontinuing all its global money transfer communications services to Iranian financial institutions.

As the majority of international interbank messages use the SWIFT network, the SWIFT can be considered as a global public infrastructure. It is governed by the SWIFT Board of Directors (out of 25 directors, 17 are Europeans, and there is no PRC representative). It is mainly regulated by the Belgian central bank.

C. Judicial Action: The US State Court Order to freeze bank accounts in Japan

The Bank of Tokyo-Mitsubishi UFJ, which handles most of Japan’s payments for oil imports from Iran, froze transactions with Iranian banks after orders by the New York State Supreme Court in May 2012. The Court ordered the BTMU to disclose details of the accounts that the Iranian Government and central bank have at its branches, not only in the US but also in its Tokyo headquarters, and freeze up to 2.6 billion dollars. This was in connection with a damage suit launched by survivors and victims’ family members of the 1983 bombing of a U.S. Marine barracks in Lebanon. There is a court decision in 2007 that orders Iran to pay damages to the plaintiffs but Iran has so far failed to comply, prompting a seizure of Iran’s assets in support of the damages order in favour of the plaintiffs.

As in other jurisdictions, foreign court orders are only recognized and executed within Japan when they are judged by the Japanese courts to meet the requirements under the Article 118 of Civil Procedure Act and the Article 24 of Civil Execution Act. The BTMU filed an objection in Federal District Court for the Southern District of New York to the New York State Court ruling on freezing accounts within Japan on the ground that it contradicts with Japanese laws. In fact, the federal court decided three weeks later that the order was void, and it is understood that the BTMU resumed transactions with Iranian banks.

If the order had stood, Japanese industry might have faced serious problems in importing oil. Iranian oil accounts for the fourth largest (7.8%) of all oil imports into Japan last year,¹¹ and some worried that this would affect the nation's energy policy. Mr. Edano, the Japanese Minister of Economy, Trade and Industry, said at a press conference after a Cabinet meeting, "What's happened is clearly wrong because a U.S. court decision isn't supposed to apply outside the United States."¹²

VII. Attachment and Turnover of Accounts in Foreign Bank Branches

A resolution concerning the "Principles of Jurisdiction Over Foreign Bank Branches in the Matter of Extraterritorial Attachment and Turnover" is being proposed by MOCOMILA. The Resolution is a formalized articulation of the principles that have long governed international monetary law. It applies only to private enforcement actions, and would not purport to limit or otherwise affect the authority of regulatory or public law-enforcement agencies. Furthermore, the Resolution would not negate or contravene any of the recommendations in the Proposal for a Regulation of the European Parliament and of the Council Creating a European Account Preservation Order.

The draft resolution is dealing with a specific situation, namely the making of an attachment/turnover order (that is, a garnishee order). An attachment/turnover order (by whatever name) is one made by a court ordering that a debt owed by "A" to "B" is paid instead to "C" who has a judgment against B (or is the holder of an arbitration award against B). The court orders A to pay C instead. It is crucial that A obtains a good discharge when making payment to the judgment creditor in accordance with the court order.

Where the debt is a deposit held by B with Bank A, and Bank A is a bank within the court's jurisdiction, but the deposit is held with a branch of the bank outside the court's jurisdiction, the branch is treated as a separate entity for these purposes. The court will not make a garnishee order because, among other things, by paying C in accordance with an order of a foreign court, the bank may not get a good discharge under local law. (If the branch is within a different legal incorporation, then for present purposes the issue does not arise.)

Generally, courts in various jurisdictions have recognized in one form or another that a bank has "in some measure localized its obligation to its customer so as to confine it, primarily at least, to a particular branch."¹³ One manifestation of this principle is the established and longstanding "separate entity" doctrine, which holds that for some purposes each office, branch, or agency of a bank should be treated as a separate entity, lacking possession, custody, or control over accounts maintained by depositors in other branches of the bank or at the home office.

The separate entity doctrine has long been applied in this context as the jurisdictional rule of thumb in a number of financial centres around the world. Under various appellations, this doctrine is recognized in the United States, United Kingdom, Germany, Italy, and Argentina, to name a few. Such doctrines include the private international law doctrine of territoriality or localization of debt – the rule that an

¹¹ The larger exporters than Iran are Saudi Arabia (31.1%), UAE (22.5%), and Qatar (10.2%). In March 2012, the US exempted Japan and 10 EU nations from financial sanctions because they have significantly cut purchases of Iranian oil.

¹² See The Mainichi Newspaper, 18 May 2012, available at the following website: <http://mainichi.jp/english/english/newsselect/news/20120518p2g00m0dm126000c.html>.

¹³ *Rex v. Lovitt* [1912] AC 212 at 219, cited in William Blair, *Making Commercial Law: Essays in Honour of Roy Goode*, 324, Ross Cranston eds., 1997.

asset should be treated as situated at the place of the bank branch where the account is located, and thus that demands on the asset should be made at that branch – and principles of legal certainty.

There are numerous examples where legal autonomy was recognised to branches for specific purposes in national and European law as well as international treaties. For example, certain national laws explicitly require that claims over a deposit account be filed with the court in which jurisdiction the depositary branch holding the account has its place of business. Similarly, several European directives provide as an exception to the home country rule an exclusive jurisdiction to the courts of other member states where an entity has branches to adjudicate enforcement actions and other claims in relation to *in rem* rights in connection with assets held by those branches. This is in particular the case of the European Parliament and Council Directive 2001/24/EC on the reorganisation and winding-up of credit institutions which upholds the principle of universality in empowering the home member state to reorganise or wind up a credit institution, including its branches in other member states, but nevertheless stipulates a number of exceptions including in the case of proprietary rights over collateral if that collateral is located in another member state. In such a case, the law of that other member state shall govern the enforcement of such rights. Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions also mentions that branches may seek refinancing separately from their head office. Directive 2002/47/EC on financial collateral arrangements and Directive 1998/26/EC on settlement finality in payment and securities settlement systems similarly mention the location where the relevant account is maintained. While these two legal acts do not explicitly mention a branch, the second consultation on the Draft Securities Law Directive did mention branches. There is a similar exception in the Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary. This considers for jurisdictional purposes the “office” (in effect, the branch) in relation to an intermediary.

The above examples, amongst many others, are recognised as an exception from the general corporate law rule that a single legal entity is liable for the liabilities incurred by its branches regardless of their location. Hence the emphasis in the introduction on the application of the separate entity rule only to private enforcement actions. Outside private enforcement actions over deposits held with branches abroad, the general principle of corporate law as to the unity of legal persons and the courts’ application of that principle remain unhindered.

In recent years, courts have been confronted with the scenario in which a judgment creditor applies for an order to require a bank (typically not a party to the underlying action) to attach or turn over a judgment debtor’s property, even though the debtor’s assets are held by a branch or office of the bank located abroad. It has traditionally followed that service of an attachment/turnover order should be effective only on the assets located at the branch served, and should not reach outside of the jurisdiction where the branch is located. However, there have been limited instances in which courts have extended the reach of their jurisdiction to order the extraterritorial turnover or attachment of assets held in accounts of the bank located abroad.

The granting of such extraterritorial attachment orders raises policy implications for the financial services industry and, more broadly, affects legal certainty because:

- *First*, if such petitions are granted, judgment creditors, as well as secured creditors and other competing creditors, will be able to file conflicting claims for a single asset in multiple jurisdictions, allowing for the possibility for two or more courts to issue contradictory rulings on an asset’s rightful ownership.
- *Second*, extraterritorial turnover orders expose banks to the possibility of double liability by requiring banks to transfer property without the consent of other entities that may have an interest in such property.
- *Third*, extraterritorial turnover orders may require banks to violate the laws of the countries where assets at issue are held, including bank secrecy laws and other local laws.

For all the above reasons, we commend the resolution to the Association as correctly stating the position in international terms.