

INTERNATIONAL LAW ASSOCIATION

TORONTO CONFERENCE (2006)

COMMITTEE ON INTERNATIONAL MONETARY LAW

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Dedication

The Committee would like to dedicate this report to the memory of Dr Michael Gruson (USA), an internationally-recognized expert in banking and financial law, who served as an active member of MOCOMILA for seven years prior to his death in New York on December 20, 2005.

Michael brought together lawyers in the Americas with lawyers in Europe, and through his close personal and professional ties, had a powerful influence in both places. Born in Berlin in 1936, he was educated in Germany at the University of Mainz and in the United States at Columbia University, and practiced law with Shearman & Sterling in its New York and Frankfurt offices from 1965 until his death. Michael promoted commercial relations between the United States and Germany, and is personally responsible for intercontinental associations of literally thousands of people. Michael had an impact on internationally active banking organizations throughout the world, and led many foreign banks to establish offices in his adopted home, New York. He easily

integrated civil and common law concepts and traditions, and he approached the law with a scholarly zeal. For Michael, borders were opportunities and not boundaries.

Michael seized these opportunities in the various places where our Committee met. Whether the topic was *lex monetae* or how to draft a choice-of-law clause, Michael offered not only the wealth of his deep and refined knowledge, but also his beaming smile and affable demeanor to uplift our meetings. Additionally, he used our travels to learn local culture, which he embraced in a grand style.

All members of the Committee mourn the death of our distinguished colleague and dear friend, and celebrate the life of an incredibly gifted professional. Our Committee, therefore, has dedicated its 2006 Report to the Toronto ILA Conference in memory of Michael Gruson.

Introduction

Since the Berlin Conference of the ILA in 2004, the Committee (generally known under its acronym MOCOMILA) has held three meetings: in London, United Kingdom (22-23 April 2005), Basel, Switzerland (14-15 October 2005) and Malta (3-4 February 2006). The London meeting, the first to be hosted by Chairman Bill Blair, was dedicated to the issue of Islamic Finance. In addition to over 25 members and observers who attended, the meeting included a half-day session hosted by the Bank of England that was opened to invited experts for a seminar discussion on that topic. The Basel meeting had a record attendance of 37 members and observers, reflecting the dual role of its focus at the Bank for International Settlements (BIS) on international financial standards as well as providing a tribute to Mario Giovanoli, who strengthened and reinvigorated MOCOMILA as Chair for the preceding decade. Mario has been recognised as one of the foremost experts in the areas of international monetary and financial law during his nineteen years of service prior to retirement at the end of 2005 as BIS General Counsel and concurrent teaching at the University of Lausanne, and we look forward to his ongoing contributions to the Committee's work. The Malta meeting, at which 18 participants were hosted by the Central Bank of Malta, concentrated on issues relating to preparation for the introduction of the euro in the ten newest accession states to the European Union.

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

- I. International Financial Standards (by Dr K P Follak and Prof C Lichtenstein)
- II. Legal and Regulatory Developments Relating to Clearing and Settlement (by Mr D Devos)
- III. Terrorist Financing (by Messrs T C Baxter, Jr and J H Freis, Jr)
- IV. Regulatory Liability for Bank Failures (by Mr C Proctor)
- V. European Economic and Monetary Union and Single Financial Area (by Messrs A Sáinz de Vicuña, R Smits, J-V Louis, and C Gortsos)
- VI. Islamic Banking and Finance with example of Malaysia (by Mr Gopala Krishnan Sundaram)

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

I. International Financial Standards

In recent years, the Committee has devoted significant discussion to the development and implementation processes of international financial standards. As discussed in MOCOMILA's report to the 2004 ILA Conference in Berlin, in recent years the most important topic in this area has been with respect to "Basel II" — ie, the revision of the 1988 Basel Accord on Capital Standards for internationally active banks developed by the Basel Committee on Banking Supervision (BCBS). The 2004 Report describes the context for the revisions, as the Basel II framework was released shortly before the Berlin Conference. Thus, the most significant developments since then have been to proceed towards implementation.

Background

The purposes of harmonized capital adequacy standards as envisioned in the original Basel Accord were to promote both a "level playing field" for internationally active banks and contribute to international financial

stability. In addition to protecting individual institutions from failure, capital requirements are necessary for three principal reasons:

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

Growing sophistication in the global financial markets had made the relatively simplistic approach of the 1988 Basel Accord outdated, leading to June 1999 announcement that the BCBS would work on a revision. The development of the Basel II capital adequacy framework has been undertaken in a public and transparent way, involving ongoing public consultation, including surveys of the financial industry to determine how the recommendations would work in practice.

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

Implementation

Although the original Basel Accord framework was intended to be mandatory only for internationally active banks, it was applied to the whole banking industry by most national supervisors. In the United States, Basel II will be applied to only approximately 10 national banks, while approximately 10 further banks are expected voluntarily to adopt it. The EU, in contrast, will implement Basel II by a Directive which will be applied to the whole banking industry and not just to internationally active banks.

Within the United States, the federal banking supervisory agencies ("Agencies") have been working intensively with the special group of banking organizations in the process of development of the Basel II methodology. On June 26, 2004, the date of issuance of Basel II by the BCBS — since revised dated 15 November 2005, the Agencies issued a "joint release" outlining the plan for the incorporation of the advanced risk and capital methodologies for Basel II into regulations and supervisory guidance for US institutions. This has since been followed by a series of statements by the Agencies elaborating on their respective thinking; that notwithstanding, such statements have not yet been adopted in the form of regulation with the force of law. They do, however, outline some of the critical elements of the eventual implementation. For example, in keeping with the range of quantitative impact studies organised by the BCBS designed to mitigate sharp changes to the amount of capital in the financial system, one of the statements sets forth limits on the amount by which each institution's risk-based capital could decline with the application of Basel II (Federal Reserve Joint Press Release of September 30, 2005) (95% floor in 2009, 90% in 2010, and 85% in 2011).

Within the EU, the Commission will issue a Directive, followed by legislation of each Member State. On the EU level, legislation will comprise a two-tier structure under the so-called enhanced comitology (Lamfalussy) process: a formal Directive setting general guidelines, whereas technical details will be regulated by annexes to the Directive under the enhanced comitology process. The Capital Requirements Directive (CRD) proposal was passed on First Reading by the European Parliament on 28 September 2005. On 11 October, the ECOFIN ministers reached agreement on the European Parliament's legislative resolution. The European Council, however, will not formally adopt the CRD until a consolidated wording is available in all 20 official European languages, which will probably not be the case until at least mid-2006. The implementation date is scheduled for the end of 2006. In order to allow for reasonable transition arrangements, institutions will be able to continue to use the existing rules as an alternative until the end of 2007.

The Basel Committee itself has recently addressed the issue of international consistency of implementation. In November 2005, the Committee released a new Consultative Document, "Home-host information sharing for effective Basel II implementation," for comment by 28 February 2006. The paper was issued in association with

the Core Principles Liaison Group, a BCBS working group that includes sixteen jurisdictions not formally represented on the committee. This paper includes as its Annex a statement of “high-level principles for the cross-border implementation of the new Accord.” Principle 2 is that “The home country supervisor is responsible for the oversight of the implementation of the New Accord for a banking group on a consolidated basis” and Principle 3 is “Host country supervisors, particularly where banks operated in subsidiary firms, have requirements that need to be understood and recognized.”

While the Basel II reforms were initiated in response to increase in sophistication and complexity of the financial industry, it is probably fair to say that none of the drivers of that effort seven years ago would have anticipated how long it would take to implement any recommended changes. In addition to raising the bar in terms of capital adequacy, that experience has most certainly raised the expectation for the public role in the development of international financial standards.

II. Legal and Regulatory Developments Relating to Clearing and Settlement

The following reports on a number of interesting legal and regulatory developments especially in the clearing and settlement areas but more generally relevant to the book-entry securities business, at both international and EU level. Over the past three years, initiatives have been taken at the international level to enhance legal certainty for transactions on book-entry securities, in terms of applicable law (the finalisation of the Hague Securities Convention end 2002) or with respect to their substantive regime (Unidroit-EU Legal Certainty Project).

A. The Hague Convention

The “*Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary*” (“the Hague Convention”), adopted by the 19th diplomatic session of the Hague Conference on Private International Law ¹ on December 13, 2002, is aiming at providing greater legal certainty and predictability to the securities industry in relation to cross-border transactions on book-entry securities held through intermediaries.

This international Treaty, elaborated during two years with the active support of public authorities, law practitioners, academics and industry representatives, is determining the law applicable to such book-entry securities by reference mainly to the law agreed to govern the account agreement (article 4 of the Convention).

Until now, there has been a considerable degree of legal uncertainty at international level in relation to the determination of the precise national law governing securities credited to an account with an intermediary in a cross-border dimension due to the variety of possible governing laws (law of the issuer, law of the place where the underlying certificates (paper certificates in bearer form) may be physically deposited or held, law of the register, law of the issuer CSD, law of another intermediary at upper or lower level, etc). This legal uncertainty generates in turn legal risks for the securities industry and the investors to the extent that the law governing the book-entry securities will determine the protection offered to the holder in case of insolvency of the intermediary as well as the formalities to comply with to create, perfect and enforce collateral arrangements on such securities. The application of another law than the one expected by the parties to the custody relationship might indeed jeopardise the ownership rights of the investor or invalidate its collateral transactions if the requirements of such other law would not have been fulfilled.

There have been ways to mitigate so far such legal risks (collection of legal opinions confirming the application of the intermediary’s law under the laws of the country where the underlying securities are deposited and/or under the laws of the collateral provider, etc) but they remain, in a number of countries, still uncertain in case of

¹ The Hague Conference is an intergovernmental body established in 1955 to work on harmonisation of private international law (conflict of laws). It is based in the Hague and has produced more than 35 International Conventions on the law applicable to sales, trusts, judicial litigations, torts, agencies, but also family matters. See the text of the Convention and the Explanatory Report prepared by Professors Goode, Kreuzer and Kanda with the assistance of Ch. Bernasconi, on the Hague conference website: <http://www.hcch.net/e/conventions/menu36e.html>.

judicial litigation. At EU level, some Directives have been enacted since 1998² with provisions helping to eliminate this uncertainty but these new rules, even though they are substantially increasing the level of legal certainty at EU level, remain limited to the EU without addressing the rest of the world (USA, Japan, Canada, Switzerland, China, etc), nor all the aspects of securities holdings, nor even all market players. This is what the Hague Convention is aiming at achieving.

This Convention has been “technically”³ signed end of 2002 by delegates of 53 States that are members of the Hague Conference, including e.g. the USA, the EU Member States, Japan, Australia, Argentina, Brazil, China and the Russian Federation. It has now to be formally executed by governments of these States and ratified, where relevant, by their respective Parliament. In the EU, the Hague Convention’s adoption should imply amendments to some EU directives already adopted⁴. However, formal signing ceremony by the EU has been suspended because of the opposition revealed since 2004 by some circles in the EU.

Certain EU Member States (essentially France, Spain, Italy, Sweden and Poland) and the European Central bank are opposed to the Hague because they argue that it could lead to more legal uncertainties (due to the greater flexibility offered by the Convention in the determination of the law governing the book-entry securities, by reference to the law agreed to govern the account agreement, instead of focusing on the place “where the account is (in fact) maintained”).

The EU Council decided in June 2005 to request the Commission to conduct an impact study on the Hague Convention (in relation to its scope, its impacts on third parties, securities settlement systems and public policy legislation). There has been quite an intense debate about the pros and the cons of the Hague Convention in 2005⁵ which might have contributed to this impact study that should be published in the course of 2006. Then EU Member States will have to consider the findings of the study and take a position on the signature and the adjustment of the related EU framework.

B. European Union Developments

In April 2004, the EU Commission published a Communication on Clearing and Settlement⁶ aiming at giving a follow-up to the Giovannini reports⁷ listing a number of barriers (including legal and regulatory barriers) in this domain.

The most significant action the Commission suggested to eventually take was to consider a framework Directive on Clearing and Settlement to ensure freedom of services and full right of access (including by clearing and

² Settlement Finality Directive of 1998 ; Insolvency Regulation of 2000 ; Directives on the Reorganisation and the Winding-up of credit institutions and insurance undertakings of 2001 ; Collateral Directive of 2002.

³ The signature of the Hague Convention on December 13, 2002 was only meant to signify the end of negotiations and to propose a final text to the formal signature of Contracting States .

⁴ See footnote 3.

⁵ See in favour of the Convention : K. KREUZER, « Das Haager Übereinkommen über die auf bestimmte Rechte in Bezug auf Intermediär-verwahrte Wertpapiere anzuwendende Rechtsordnung », in *Le droit international privé : esprit et méthodes, Mélanges Paul Lagarde*, Paris, Dalloz, 2005, p. 523 ; J. ROGERS, « Conflict of Laws for Transactions in Securities Held through Intermediaries », [Boston College Law School, Research Paper N° 108](#), 2005; Bernasconi and Sigman, “Myths about the Hague Convention debunked”, IFLR, November 2005, 31; D. DEVOS, « The Hague Convention on the Law applicable to Book-entry Securities- Relevance for the European System of Central Banks », in *Liber Amicorum Paolo Zamboni Garavelli*, European Central Bank Publications, pp. 157 et s; Degué and Devos, “La loi applicable aux titres intermédiés : l’apport de la Convention de La Haye de décembre 2002”, *Revue de droit commercial belge* 2006, p.5-32 ; Financial Markets Law Committee: “Issue 58-Hague Convention...”, Legal assessment produced in November 2005, available on FMLC website: www.fmlc.org; see against the Hague: Opinion of the European Central Bank dated March 17, 2005 (*OEJC.*, n° C 81 of 2 April 2005, p. 10) ; H. DE VAUPLANE et P. BLOCH, « Loi applicable et critères de localisation des titres multi-intermédiés dans la Convention de La Haye », in *Mélanges AEDBF France IV*, Revue Banque Édition, 2004, p. 469, also published in *J.D.I.*, 1/2005, p. 3; W.A.K Rank, Vaststelling Hague Securities Convention: meer rechtszekerheid in het internationale effectenverkeer?”, *NiPR* 2005, p.249.

⁶ Communication of 28 April 2004 from the Commission to the Council and the European Parliament: Clearing and Settlement in the European union-The way forward”: COM (2004) 0312.

⁷ Alberto Giovannini was complaining recently about the insufficient progress made so far in the follow-up of the recommendations of his group (see F.T., 16 May 2005, p. 17)

settlement competitors) to clearing and settlement services providers⁸. After a deep analysis of the market and active discussion with market players, the Commission is conducting an impact study which should be published in March 2006, with possible conclusions on the need for such a Directive.

In parallel, as complementary exercises, the Commission has set up three advisory working groups:

- The Advisory and Monitoring Group (called “CESAME”) reviewing the barriers listed in the Giovannini reports and discussing with the Commission topics of harmonisation and definitions of certain concepts (such as CSD, settlement, clearing, core or added value services, etc)⁹;
- The Legal Certainty Group (“LCG”; it is composed of experts in each EU country, appointed on a personal basis) aiming at identifying needs for legal harmonisation of substantive securities legislation¹⁰;
- The Fiscal Compliance Experts Working Group (“FISCO”) focusing on the identification of tax barriers such as for example certain national legislations requiring foreign intermediaries carrying out business on a remote basis to still use a domestic intermediary as withholding tax agent¹¹.

Such advisory WGs should produce in the course of 2006 a report identifying barriers, possible ways to harmonise securities and tax regimes in the EU with suggested actions. It will then be up to the Commission to decide whether it will translate all or part of such recommendations into a Community instrument (Recommendation, Directive, Regulation).

Complementary to this, there is now a proposal by the EU Commission dated January 5, 2006 on the exercise of voting rights¹² which presents certain links (see articles 10 and following on proxy voting and split votes) with the works of the LCG with respect to relations between the intermediaries and their clients and the issuer, particularly in intermediated indirect holding patterns. Article 13 of this new proposal is for example stating that omnibus account should be possible in all Member states without the need to segregate (even temporarily) securities in the name of a particular beneficial owner to exercise voting rights and get access to the general meeting.

This would constitute a major improvement in the EU since a number of countries (Greece, Spain, Portugal for example) do not currently recognise the concept of nominee holdings through an omnibus account (which could lead to prohibit voting through nominee), or otherwise prevent or penalise the holding of securities in fungible

⁸ Several EU jurisdictions retain “national-oriented protection” rules relating to the physical location of securities activities such as:

- requirements to open or maintain a local office in order to be entitled to act as withholding agent, act as general clearing member, or to act as a recognised CSD or otherwise provide settlement and custody services to local residents ;
- requirements to locate register (for registered securities) or accounts physically in the country of the issuer;
- requirements (in law or practice) that restricts local membership in CSD to local intermediaries only;

This can be imposed through laws or regulations, but also through disproportionately requirements to be fulfilled obliging de facto a non-resident firm to act in the local market through a local intermediary.

⁹ Documents and minutes of meetings are available on the following website:
http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/cesame_en

¹⁰ Documents and minutes of meetings are available on the following LCG website:
http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/certainty_en.htm.

¹¹ See http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/compliance_en.htm

¹² “Proposal on the exercise of voting rights by shareholders of companies having their registered office in a Member State and whose shares are admitted to trading on a regulated market” adopted by the Commission on January 5, 2006, COM (2005) 685

form, continuing to treat the intermediary as sole shareholder for the total position recorded on the omnibus account, etc. Others, such as Sweden or Denmark, require segregation for voting purposes.

C. Harmonisation of market practices and of related legislation and regulation

Complementarily to these EU official initiatives, market players and infrastructures are also conducting reviews of securities practices (ESCDA, Euroclear, etc) and suggest some harmonization proposals¹³.

On the legal side, barriers relating to nominee holdings, requirements for local presence, direct access to CSDs, treatment of market claims and harmonization of record date (date of entitlement to dividends and right to vote when securities are transferred) are examples of what is currently discussed.

A good illustration of the need for legal harmonization can also be found in the differences in the moment for the transfer of ownership on securities. In a same country, legal transfer of ownership may be treated as taking place on trade date (this was the case until March 2005 in France for stock exchange transactions) while other types of transactions may entail transfer of ownership only on settlement date in the relevant CSD; the latter being the common rule in most EU countries¹⁴. This variety of regimes has a substantial cost impact for market claims and tax processing, as every difference results in a different procedure. This could also generate legal risks to the extent that insolvency of a counterparty occurring between transfer of ownership on trade date according to home stock exchange (SE) rules and settlement date in a foreign settlement system where the settlement of the same transaction actually takes place, may lead to questions about ownership rights.

D. UNIDROIT

Unidroit started in 2002/2003 a project aiming at defining an international convention to harmonise the substantive regime applicable to intermediated book-entry securities. On the basis of a draft Convention prepared by an ad-hoc WG, Unidroit conveyed in April 2005 in Rome a diplomatic conference to discuss a first draft¹⁵. After interim meetings on specific topics organized in Bern, Sao Paulo and Paris, the plenary Unidroit conference will meet again in March 2006 to continue the discussions on the revised draft Convention. As also promoted at EU level by the Commission's Communication of April 2004 and its specific Legal Certainty Project (see above I-2), Unidroit is seeking to further enhance legal certainty in intermediated holdings of securities by addressing at least the following issues:

- Legal protection of account holders enforceable in case of insolvency of the relevant intermediary;
- Determination of the rights of the account holder with respect to the securities credited to its account, in particular vis-à-vis the issuer in terms of economical (cash payments, redemption, etc) and non-economical rights (voting rights, etc), including the recognition of nominee pooled holding of securities;

¹³ See for example the 75 pages Euroclear Consultation Paper entitled "Harmonisation Fundamentals" dated 30 June 2004, in particular section 8 (page 60) and appendix 1 on legal and regulatory barriers especially in the UK, France, Netherlands and Belgium.

¹⁴ In France, the transfer of ownership (TO) for stock exchange trades (the situation depends on the type of trades) is organised by law (French Monetary and Financial Code, article 431-2) by reference to the credit of the buyer's account but "at the date and in the conditions defined by (French) market rules". The Euronext Paris market rules then organised the TO at trade date. Because of the harmonisation discussions, this rule has changed in France with the adoption of a new Decree n°2005-303 dated March 31, 2005, which refers to the settlement date (with the crediting of the buyer's account) as moment for transfer of ownership. This new rule is however still dependent on the revision of the Rules of the French market supervisor ("Autorité des marchés Financiers"-AMF; on this complex regime, see H. de Vauplane, "Transfert de propriété des titres cotés: la réforme achevée ...ou presque !"), Rev. Banque, May 2005, p.87.

In Belgium and in the Netherlands, no specific law has been laid down to organise specifically the transfer of ownership for stock exchange or OTC trades. In these two countries, it is the application of the ordinary rules of commercial legislation which leads to the transfer of ownership at settlement date. Irish and UK laws all provide for transfer of securities based on transfer of legal title on registration. The regulations covering each regime (England and Wales, Scotland, Northern Ireland - all UK - and Ireland) provide for electronic book entry transfer of title effected pursuant to settlement of a properly authenticated dematerialised instruction attributable to one or more members (in accordance with the rules of the securities settlement system). Registration (with associated transfer of ownership) takes place at the point of settlement for the UK jurisdictions. For Ireland, a statutory equitable interest arises in favour of the transferee at the point of settlement and is extinguished (usually minutes – but no more than two hours - later) by transfer of legal title in his favour on an issuer register.

¹⁵ This draft Convention is available on Unidroit website: <http://www.unidroit.org>

- Protection against misappropriation;
- Protection against upper-tier attachment proceedings at the level of the intermediaries of the relevant intermediary;
- Protection of good faith purchasers/transferees;
- The introduction of a specific regime for Collateral transactions (see Chapter VII of the draft Convention: this part has been designed as a model law to be used especially by emerging markets since OECD countries generally have already a sophisticated collateral regime (see article 9 of US UCC; EU Collateral Directive, etc).

At EU level, the adoption of Unidroit Convention would require a correction of possible inconsistencies which would be identified between the various EU legal instruments adopted on book-entry securities matters. The EU Commission will however be negotiating on behalf of the Community on points of “acquit communautaire” (matters already covered by EU legislation: in particular the Directives on Settlement Finality and Collateral arrangements).

It is probably fair to note that on a worldwide basis, only a few jurisdictions offer today an adequate legal framework for holding and transferring book-entry securities in a cross-border environment. For example, most jurisdictions may provide investors with a sound ownership regime on domestic securities held directly with the domestic CSD or with domestic intermediaries. But only a few legal regimes have organized specific rules for holding and pledging **domestically**, under domestic law, securities primarily issued and deposited abroad through an account of the relevant intermediary with the foreign “issuer CSD” or with a local custodian¹⁶.

The current Unidroit draft Convention also defines the duties of the intermediary maintaining a securities account towards the account holder (entries to the account, reversals, finality, securities shortfalls, loss-sharing, etc) in a way which sometimes could overlap with current regulatory regime in place at international (CPSS-IOSCO recommendations for securities systems; see below) or national level.

The ambition of Unidroit is to finalise the adoption of the Convention by end 2006, which seems quite optimistic for such an harmonisation of substantive rules at international level.

E. Regulatory Developments

In November 2001, the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) published a set of standards: the *Recommendations for Securities Settlement Systems*¹⁷. The objective of the 19 CPSS-IOSCO Recommendations is to contribute to the financial stability by strengthening the securities settlement systems (SSS), that are an increasingly important component of the global financial infrastructure. The CPSS-IOSCO also developed an assessment methodology¹⁸ for the Recommendations which aimed at providing a clear and comprehensive methodology for the assessments made on the basis of the Recommendations.

The same organisations have published in November 2004 their “Recommendations (15) for Central Counterparties” (CCP/clearing institutions) following the same design than those applicable to securities systems, with the adaptations required for the activity of a CCP which uses netting by novation to interface traders and manages its credit risk through margin requirements and marking-to-market procedures.

Depending on the localisation, there are two or three types of regulatory standards applicable to a clearing or settlement system:

1. The “**oversight**” standards aiming at regulating securities systems to avoid systemic risk: the above-mentioned *CPSS-IOSCO Recommendations* adopted at G 10 level in 2001 and 2004 ; and the new 19

¹⁶ This generally supposes that the interest in such foreign securities is treated as a specific entitlement governed by the national law of the relevant intermediary (under the Hague Convention rules) distinct from any direct traceable entitlement to the underlying foreign securities which remains governed by local ownership law.

¹⁷ "Recommendations for Securities Settlement Systems", CPSS-IOSCO, November 2001 (available on the web site of the Bank for International Settlements: www.bis.org in the CPSS publication section)

¹⁸ "Assessment Methodology for the Recommendations for SSSs"; CPSS-IOSCO, November 2002 (available on the web site of the Bank for International Settlements: www.bis.org in the CPSS publication section)

ESCB-CESR Standards adopted at EU level in October 2004 (based on CPSS-IOSCO recommendations with EU adaptations) , which are currently on hold because e.g. of divergences of views between regulators concerning the so-called “functional approach” (application of standards to major custodians performing activities similar to those of an SSS, etc).

2. In the Euro zone, the nine **ECB “Users” standards** adopted in 1998 for the use of securities systems in ESCB monetary policy operations. They should be reviewed soon.
3. National regulatory standards, where applicable.

Such standards aim at establishing best practices and minimal features for clearing and settlement operators with respect to legal soundness, clearing or settlement efficiency and transparency, risks management (including credit risks where relevant), cash operations, finality, operational reliability, corporate governance, participation/access, links with other systems, etc.

The oversight standards are not law and are generally not directly binding on securities systems .They are adopted by the community of regulators (central banks as overseers¹⁹ and securities/CSDs supervisors) at G 10 and/or at EU level as the basic common rules to carry out their supervisory functions, without prejudice to any additional national regulatory standards which may exist.

The sanctions attached to the non-compliance with such standards (or with the resulting recommendations made by competent regulators to achieve compliance) are generally of an *indirect nature*:

- **Reputation risk:** Regulators may make public²⁰ the non-compliance which will obviously affect negatively the image of the system vis-à-vis the outside world: clients, foreign regulators, etc,
- **Foreign regulators** may also invoke the system’s non-compliance with international standards to infer negative consequences for the approval of certain projects for which compliance with international standards is required by them.
- Last, under domestic legislation, **specific sanctions** (fines, criminal sanctions) may be foreseen if a system would not comply with the applicable standards.

There is a risk that such co-existence or superposition of different sets of regulatory rules with sanctions could be perceived by the market infrastructures and their clients as a source of confusion and uncertainty in the regulatory treatment of their activities. This possible perception will not necessarily improve if the current text of the Unidroit Convention (which also contains provisions of a regulatory nature) would be adopted as it stands. If proposed, the EU Directive on Clearing and Settlement should probably also contain provisions which will translate all or part of the ESCB-CESR standards adopted in 2004 and which are currently on hold. Hence, in addition to these significant developments in recent years, there are certainly more developments ahead.

III. Terrorist Financing

The Committee first addressed the issue of terrorist financing in its report to the New Delhi Conference in 2002, following upon the tragic events of September 11, 2001. The report to the Berlin Conference in 2004 noted the deadly attacks in Madrid of March 11, 2004. Unfortunately, there have been other subsequent terrorist attacks, including in London on July 7, 2005.

There has been a significant response in terms of financial law in that it has now become internationally accepted that governments and the financial industry have obligations to work together to root out illicit finance, both in terms of money laundering and more recently with respect to the financing of terror.

Anti-terrorist financing efforts seek to prevent terrorist attacks by identifying, disrupting, and dismantling the financial infrastructure of terrorist groups. A successful anti-terrorist financing strategy must recognize that the global financial system is interconnected, and that domestic efforts will likely be ineffective if terrorists can

¹⁹ See the CPSS (BIS) report of May 2005 on “Central bank oversight of payment and settlement systems”.

²⁰ The main conclusions of the assessment of clearing and settlement systems against CPSS-IOSCO recommendations are normally published even though there are not so many assessments currently available. National Bank of Belgium has published its main findings in relation to the Euroclear System in its Financial Stability Review in 2005 (p. 105-113).

obtain financial support through a different point in the international financial system. Terrorist financing networks are global, and consequently, efforts to identify and deny terrorists access to funds must also be global. The measures discussed below represent some of the more effective measures in the global fight against terrorist financing.

A. Financial Action Task Force

Since its creation the Financial Action Task Force ("FATF") has spearheaded the effort to adopt and implement measures designed to counter the use of the financial system by criminals. Established by the G7 nations in 1989, FATF established a series of Recommendations in 1990, revised in 1996 and again in 2003, that set out the basic framework for anti-money laundering efforts. Known as the FATF 40, the Recommendations represent a set of international standards for countries to establish effective anti-money laundering regimes. Following the terrorist attacks on September 11, 2001, the FATF expanded its mandate to include terrorist financing. Specifically, the FATF adopted nine special recommendations which, when combined with the FATF 40 Recommendations, establish a framework to detect, prevent and suppress the financing of terror.

The Committee's review of the FATF recommendations complements its work with respect to international financial standards. These recommendations have been adopted by the International Monetary Fund and World Bank in their respective assessments of member countries' financial systems, and these institutions have devoted increasing resources to technical assistance in this area. Moreover, the IMF and World Bank together with FATF have developed a common methodology for assessing compliance with those recommendations.

Developments with respect to one specific FATF recommendation, Special Recommendation VII ("SR VII"), is of note. SR VII was developed to prevent terrorists and other criminals from having open access to wire transfers for moving their illicit funds and to enable the detection of such transfers when they occur. Specifically, SR VII seeks to ensure that certain basic information about the originator of a wire transfer is immediately available to law enforcement for investigation, to financial intelligence units for analysis, and to beneficiary financial institutions to facilitate the identification and reporting of suspicious transactions.

It is obvious that measures by a single state to combat the flow of terrorist funds can never succeed in the battle against terrorist financing. The FATF Recommendations are especially noteworthy because they represent an international template of techniques that may be employed to counter terrorism. As the measures discussed above illustrate, the most effective tools in this battle are those that, like the funds they seek to detect, travel across borders.

B. Developments in the United States

Section 311 of the USA PATRIOT Act

Section 311 of the USA PATRIOT Act of October 2001, codified at 31 U.S.C. 5318A, is a key legal provision that is used in the United States' anti-terrorism efforts. Section 311 authorizes the Secretary of the Treasury - in consultation with the Departments of Justice and State and appropriate Federal financial regulators - to designate a foreign jurisdiction, financial institution, class of transactions, or type of account as being of "primary money laundering concern," and to impose one or more of five "special measures." Four of the special measures impose information-gathering and record-keeping requirements upon those U.S. financial institutions dealing either directly with the jurisdiction designated as one of primary money laundering concern, or dealing with those having direct dealings with the designated jurisdiction. Under the fifth special measure, a U.S. financial institution may be prohibited from opening or maintaining in the U.S. a correspondent account for a foreign financial institution if the account involves the designee. When this fifth measure is taken, it effectively cuts the designated entity off from the U.S. financial system. It has a powerful effect, not only in insulating the U.S. financial system from abuse, but also in notifying financial institutions and jurisdictions globally of what is seen to be a serious risk.

To date, the United States has used Section 311 to designate a total of three jurisdictions and nine financial institutions, including entities in Macau, Latvia, Burma, Syria, and the "Turkish Republic of Northern Cyprus." On March 9, 2006, the Treasury Department issued its most recent final rule under Section 311 imposing the fifth special measure with respect to the Commercial Bank of Syria ("CBS"), thereby forbidding U.S. financial institutions from holding correspondent accounts for CBS or indirectly processing transactions on its behalf. Among the reasons cited by the Treasury Department for that action was the risk of terrorist financing posed by CBS, which is owned and controlled by the government of Syria. The United States considers Syria to be a state sponsor of terrorism.

The reaction of the global financial community to Section 311 actions, both with respect to designations of primary money laundering concern and final regulations, demonstrates the effectiveness of such measures. Financial institutions around the world pay close attention to such actions and adjust their business activities accordingly. A recent example was the announcement by UBS that it intended to sever its business relationships with Iran and Syria. As a result of the 311 action against Banco Delta Asia for facilitating a variety of illicit activities on behalf of North Korea, an estimated two dozen global financial institutions have limited or terminated their financial dealings with North Korea.

Executive Order 13224

Recognizing the importance of international cooperation, the United States has worked through the United Nations on blocking actions. The United States has developed a range of flexible measures to target persons and organizations who support terrorism, and has designated over 400 individuals as supporters of terrorism through the authority granted by the President of the United States in Executive Order 13224. This authority corresponds with United Nations Security Council Resolutions 1267 and 1373, both of which address the need to isolate and freeze the assets of global terrorists and their support networks.

Resolution 1267 also established a U.N. Sanctions Committee, consisting of all members of the Security Council. The names of individuals and entities designated under Executive Order 13224 are submitted to the Sanctions Committee for inclusion on the Committee's list of terrorist financiers. Once a name is placed on the U.N. list, member States are expected to implement the U.N. action by invoking domestic legal provisions to freeze any funds or assets belonging to the designated person or entity that are located within the member States' respective jurisdictions. As a result, the designees can be isolated from the global financial community.

IV. Regulatory Liability for Bank Failures

Although outright bank failures are relatively rare, the financial losses which can flow from a single collapse may be very substantial. As a result, bank supervisors are naturally concerned about any liabilities which they might potentially incur in connection with any such failure.

The subject has been considered by the courts on various occasions, although the body of case law is not vast. Historically, the courts have been very reluctant to hold the regulator liable for losses suffered by depositors in this type of situation. Some cases have demonstrated a reluctance to transfer the losses from the depositors to the public purse and, hence, to the taxpayer. In addition, market regulators have generally benefited from statutory immunities from suit which have protected them from liability in cases of this kind. Nevertheless, there have been a few recent developments in the field which merit consideration.

A. The Case Law

THE BCCI PROCEEDINGS

The well-known English proceedings arising from the BCCI collapse (*Three Rivers District Council v Bank of England*) came to a close in early November 2005, when the BCCI liquidators were compelled to withdraw their claim following a decision to that effect by the BCCI Liquidation Committee and by the Chancellor of the High Court. From a purely legal perspective, it is regrettable that these extended proceedings will not give rise to a fully reasoned judgement on the whole subject of supervisory liability, but it nevertheless remains relevant to examine some of the unusual factors at play in this case. First of all, it was alleged that the Bank of England acted *ultra vires* the Banking Act when it licensed BCCI in the first place. Secondly, it was alleged that the Bank wrongfully failed to revoke BCCI's licence despite evidence of fraud on a significant scale. In the face of these allegations and perhaps in view of the sheer complexity of the case, the House of Lords allowed the case to proceed to a full trial – albeit only by a 3-2 majority. In order to succeed, the depositors had to prove that the Bank of England officials had been guilty of the tort of misfeasance in public office; in other words, they had to demonstrate that the regulator's supervision of BCCI was tainted by dishonesty. Mere proof of negligence alone did not suffice, because the statutory immunity contained in the Banking Act absolves the Bank of England from liability in damages unless the claimants can prove bad faith. The main obstacle facing the depositors was the lack of any real evidence of outright dishonesty on the part of the Bank of England. The depositors' case thus in large measure depended upon the discovery of such evidence in the course of the examination of the Bank's witnesses. Given that allegations of fraud and dishonesty are subjected to a strict burden of proof, this must be regarded as a fairly high risk strategy on the part of the claimants. The collapse of the claim demonstrates that no such evidence had been forthcoming, even though two senior Bank officials had given evidence over a period of several weeks.

In April 2006, Mr Justice Tomlinson delivered a judgment which was aimed primarily at the extent of the liquidators' liability for the very significant legal costs incurred by the Bank in defending the claim. Nevertheless, the judgment runs to 70 pages and contains a scathing indictment of the liquidators' case. It describes the allegations of dishonesty as "simply bizarre" and notes that the case included "myriad hopeless inconsistencies". The absence of any evidence of dishonesty relieved the court of any obligation to examine the legal issues involved in the case, because no question of liability could arise unless bad faith on the part of the Bank could be proved. The judgment does, however, contain some interesting commentary on the Basle Concordat and its emphasis on supervisory responsibility resting with the regulator in a bank's *country of incorporation*. It may be that there is a degree of inconsistency between that rule and the UK Banking Act, which referred to the supervisor in the bank's *principal place of business*. Once again, however, given the absence of any evidence of dishonesty on the part of the Bank, it was unnecessary for the court to resolve issues of this kind.

Notwithstanding the apparent strength of the regulator's position in what may be described as the "normal" case, a variety of factors have encouraged disappointed depositors and investors to attempt to recover their losses from the regulator. This may in part reflect the facts that the regulator clearly had a relationship with the failed institution and that such relationship existed at least partly for the protection of depositors.

As noted earlier, the body of case law in this field is not vast, but there is sufficient material to justify a brief comparative survey.

EARLIER CASES

England & Wales

In the context of a financial institution facing financial difficulties, it might be thought that the depositors (or an insolvency official on their behalf) would be the most likely claimants. Yet in *Hall v Bank of England* (2000), the claimants were the shareholders of Bradford Investments, an authorised institution. The Bank of England had become dissatisfied with the conduct of Bradford's business and was concerned about the resultant risk to depositors. Accordingly, it required the appointment of new management with a view to running down the business. The Bradford shareholders claimed that the disposal process had caused them loss, and that this flowed from the Bank's refusal to intervene with the new management in the exercise of its regulatory powers. For reasons given earlier, the shareholders had to prove that their losses flowed from a deliberate and dishonest decision by the Bank in the context of its supervisory function. There was no evidence to support such a finding, and the claim was struck out.

Hong Kong

Hong Kong offers one of the earliest decisions in this field, *Yuen Kun-Yeu v Attorney-General* (1988). Although the case was ultimately decided by the Judicial Committee of the Privy Council, the reasoning mirrors that adopted in the judgment of the Court of Appeal of Hong Kong.

The American and Panama Finance Co Ltd was authorised by the Hong Kong Commissioner of Deposit-Taking Companies to accept deposits from the public under the terms of the relevant local Ordinance. The Ordinance was expressed to be made "...to regulate the taking of money on deposit *and to make provision for the protection of persons who deposit money...*". The company became insolvent, and depositors sued the government, arguing that it should have realised that the company was speculating with the funds placed with it.

The claim was struck out because, despite the provision quoted above, the Ordinance did not create a private law duty of care in favour of the depositors. In exercising his powers, the Commissioner had to take into account a number of competing considerations, including the need to preserve confidence in the financial markets as a whole. The imposition of a private law duty of care would thus be inconsistent with the broader duty owed to the public as a whole. A deposit-taking licence did not amount to an official "seal of approval" or a guarantee as to the credit standing of the holder.

The Privy Council also decided a similar case on appeal from the Isle of Man. In *Davis v Ratcliffe* (1990), depositors had lost money in the 1982 collapse of the Savings and Investment Bank. They sued the regulator on the basis that it owed a duty of care to ensure adequate supervision of licensed institutions. The claim failed, for reasons essentially similar to those given in *Yuen Kun-Yeu*. The court did, however, add that the main cause of the loss was fraud within the institution concerned, and that it would be inappropriate to impose a duty of care on a regulator who had, at best, only a secondary degree of control over the business.

Canada

The Supreme Court of Canada had to consider the regulator's liability following the failure of a supervised institution in *Cooper v Hobart* (2001). In that case, the Registrar of Mortgage Brokers (British Columbia) became aware of irregularities at a licensed company in August 1996, but did not suspend its licence until

October 1997. Certain depositors sued the Registrar in negligence, on the basis that their losses would have been minimised if he had acted with greater speed.

The Supreme Court analysed the matter from first principles, and held that, in order to succeed in negligence, the claimants had to satisfy both a “foreseeability” test and a “proximity” test. The first test was easily passed; it was clearly foreseeable that negligent supervision might lead to losses for depositors. The second test, however, proved fatal to the depositors’ claim, because proximity involved a “close and direct” relationship between the regulator and the depositors. The functions of the regulator involved the provision of a general framework for an orderly financial market and thus negated a “close and direct” private law relationship.

New Zealand

There seems to be no decided case in New Zealand which deals with the liability of the banking supervisor in this type of case. It appears, however, that the courts would not hold the supervisor liable in mere negligence following a bank collapse.

This view is reinforced by the decision of the Court of Appeal in *Fleming v Securities Commission* (1995). Investors purchased securities which had been offered for sale by means of newspaper advertisements, and suffered losses as a result. The Securities Commission was responsible for the vetting of such advertisements, but this did not operate to create a private law duty of care; its statutory functions were created for the benefit of the public as a whole, and did not render the Commission liable to cover losses suffered by investors.

The United States

In the United States, deposits of up to US\$100,000 are insured by the Federal Deposit Insurance Corporation. This generous level of cover perhaps explains the relative lack of case law in the field of supervisory liability. It does, however, seem fairly clear that a market supervisor would not be responsible for losses attributable to negligent supervision of a failed institution. The Federal Government enjoys immunity from proceedings in tort and, whilst that immunity has generally been waived by the Federal Tort Claims Act, it remains effective for any liability which is “...based upon the exercise...of a discretionary function or duty...whether or not the discretion involved be abused...”. The decision to grant or to revoke a banking licence must be a “discretionary function” for these purposes, and thus remains within the scope of the immunity. This view is supported by the decision of the Supreme Court in *United States v Gaubert* (1991).

The efforts of the Federal Savings and Loan Corporation to deal with the problems which confronted the thrifts by arranging mergers between the stronger and weaker companies led to claims as between the regulator and the thrifts themselves: *United States v Winstar Corporation* (1996). However, these claims were of a *contractual* nature, based upon agreements made between the thrifts and the regulators themselves. Consequently, the decision would be of no assistance in the context of a claim by depositors against the supervisor.

France

In the *El Shikh* case (1999), which arose out of the collapse of BCCI, the court apparently held that the Commission Bancaire could be held liable for “mere” negligence (*faute simple*) in the supervision of a financial institution.

It seems, however, that this line of reasoning cannot stand in the face of the later decision of the Conseil d’Etat in the *Kechichian* case (2001). The Court held that liability could only attach to the market regulator if he has been guilty of gross negligence (*faute lourde*). The Court reviewed the supervisory history of the failed institution and noted that the regulator had indeed been guilty of serious negligence; in particular, it had been aware of the institution’s difficulties but it had not insisted on adequate injections of fresh capital in a timely way. Nevertheless, the principal cause of the losses was fraud committed within the institution itself, and the liability of the regulator was accordingly fixed at 10 per cent of the lost deposits.

B. Challenges to Regulatory Immunity

It will be apparent that it is the public nature of the supervisor’s duties, coupled with its statutory immunities, which renders it so difficult for depositors to succeed in a claim for compensation against the regulator. Claimants have therefore attempted to undermine regulatory immunity in a variety of ways.

EU BANKING LAW

The development of EU Banking law was thought to have provided the depositors with some extra ammunition. The European Court of Justice recently had occasion to examine the subject in the *Peter Paul Case*, which arose from the failure of BVH Bank in Germany. The collapse occurred at a time when Germany should have implemented the EC Deposit Guarantee Directive, but had not yet done so. As a result, deposits of up to Euro 20,000, which ought to have been covered by such a scheme, were in fact “uninsured”.

The German court found that the Deposit Guarantee Directive imposed clear and identifiable obligations on Member States, and that the failure to comply with the Directive amounted to a serious breach of Community law. On this basis, applying the principles developed by the Court of Justice in the well known *Francovich* case, the Court held that the German State had to compensate depositors for those losses which ought to have been covered by the required Deposit Guarantee Scheme.

The Court of Justice did, however reject the notion that the EC Banking Directives conferred upon depositors a more general right to adequate and effective supervision, and a right to damages in default. The Banking Directives were harmonisation or “single market” measures, which were designed to facilitate the provision of banking services on a pan-European basis. It was not possible to derive from those Directives any specific or enforceable right to a particular level of supervision. The Directives thus did not create individual rights upon which a *Francovich* liability could be imposed and, as a result, Community law did not forbid the supervisory immunity provision which was under attack in that case. The House of Lords had reached a similar decision in the context of the BCCI proceedings.

THE EUROPEAN CONVENTION ON HUMAN RIGHTS

The incorporation of the European Convention on Human Rights into English law offers another avenue of attack on regulatory immunity. Article 6 of that Convention requires that everyone should be entitled to a “fair trial” in the context of any civil proceedings. It may be argued that statutory immunities conferred upon market supervisors are inconsistent with this provision, in that they impose an additional burden of proof – that of demonstrating bad faith – in proceedings against the regulator. It is thought that this argument should not succeed, but the point remains to be decided in this specific context.

The point was not available in the context of the BCCI proceedings, because the events giving rise to the claim pre-dated the incorporation of the Convention into the domestic law of the United Kingdom.

CONSTRUCTION OF THE STATUTORY IMMUNITY

Finally, the Judicial Committee of the Privy Council has recently given judgement in *Gulf Insurance v Central Bank of Trinidad and Tobago*. The central bank had used its statutory powers to amalgamate two banks, with a view to averting insolvency. The arrangements had the effect of depriving one group of shareholders of their assets in a manner which was found to be beyond the powers of the Central Bank under the legislation concerned. The Court thus held the Central Bank liable for its actions, even though it had at all times acted in good faith. The statutory immunity provision relied upon by the Central Bank was brushed aside, on the basis that such provisions should be narrowly construed and should not protect the Central Bank where shareholders’ assets had effectively been confiscated. It is perhaps unfortunate that the matter was not viewed in a wider context; for example, Principle 1 of the Basle Committee’s Core Principles for Effective Banking Supervision calls for effective immunity provisions in the context of the supervisory process. Whatever the merits of the particular decision on the facts, it must be concluded that the traditional statutory immunities do not necessarily cover every aspect of supervisory activity.

C. Conclusions

As noted above, it proved unnecessary to deliver a final judgment in the BCCI proceedings which addressed the principle of regulatory liability in general terms. Nevertheless, market supervisors will no doubt be satisfied with the outcome of the BCCI proceedings; the judgment delivered in relation to the application for costs was very critical of the claim and those responsible for it. As a result, it must be unlikely that such a claim will be launched again in the absence of cogent evidence of actual dishonesty on the part of the officials concerned. The decision of the European Court of Justice in the *Peter Paul* case also serves to confirm that Community law does not interfere with regulatory immunities conferred by national law. On the whole, therefore, recent developments must be regarded as favourable from the regulator’s perspective.

Nevertheless, the regulator must continue to exercise great care in the discharge of his functions because:

- (a) the decision in the *Gulf Insurance* case suggests that the courts may tend to construe the supervisor’s immunity in a relatively narrow way; in particular, the immunity may not be available if the supervisor is found to have acted beyond the powers formally conferred upon it and shareholders or depositors have been deprived of their assets as a result. In some jurisdictions, gross negligence on the part of the regulator could deprive it of immunity;
- (b) the principle of regulatory immunity has been subjected to forceful criticism by academic writers, especially by Professor Michel Tison (42 Common Market Law Review 2005, p639-674). The whole subject is therefore open to reconsideration, especially in jurisdictions which are not bound by the result of the BCCI proceedings; and

(c) European banking law is not static, and continues to develop. As the role of the supervisor becomes more closely defined, a court might in future be able to hold that directly enforceable rights have been conferred on depositors.

V. European Economic and Monetary Union and Single Financial Area

Since the ILA Conference in Berlin in 2004, major developments have taken place in the area of Economic and Monetary Union (“EMU”) and Single Financial Area, which have been monitored and discussed by the committee. This section seeks to give an overview of the legal aspect of those developments.

A. *Integration of the financial services in the European Union*

The efforts to create a single financial area in the EU were reinforced during the period 2004-2005, during which the ‘*Financial Services: Implementing the framework for financial markets: action plan*’ (FSAP),²¹ containing a package of measures to be adopted at Community level for the effective integration of the European financial system, was almost completed. Of the 42 measures which had been provided for, 41 have been adopted, while work on the last is in the final stage.²²

The most important developments which took place during the period under review are the following:²³

1. The Commission has issued in July 2004 a proposal for a Directive²⁴ by which the New Basel Accord on capital adequacy (Basel II) of the Basel Committee on Banking Supervision²⁵ will be incorporated into Community law; the proposed Directive was finalised in early November 2005.
2. In June 2005, the third Directive on the prevention of the use of the financial system for the purpose of money laundering, including terrorist financing, was adopted.²⁶ The main provisions of the text of the Directive chiefly concern the following:
 - (a) A revised definition of beneficial owner for the purposes of due diligence and disclosure.
 - (b) Enhanced protection of employees of the institutions or persons covered by the Directive who report suspicions of money laundering or terrorist financing.
 - (c) Mutual recognition of measures taken in fulfilment of the customer due diligence requirements.
 - (d) Establishment of a Committee to assist the Commission on these matters.

²¹ Communication of the Commission Financial Services: Implementing the framework for financial markets: action plan (COM (1999) 232, 11.5.1999).

²² For a detailed presentation, see: Commission Staff Working Document: Single Market in Financial Services Progress Report 2004-2005, Brussels, 5.1.2006, SEC (2006) 17.

²³ The very important developments that took place in European capital markets law are not being addressed in this report, since another Committee of the ILA is dealing exclusively with those.

²⁴ Proposal for Directives of the European Parliament and of the Council re-casting 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 and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions (COM (2004) 486, 14.7.2004).

²⁵ The Basel Committee on Banking Supervision, a standard-setting body on all aspects of banking supervision, provides a forum for regular cooperation between banking supervisors. The Committee’s members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. The Committee’s Secretariat is provided by the Bank for International Settlements in Basel. See on this: www.bis.org/bcbs.

²⁶ Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (L 309, 25.11.2005, p. 15-36).

3. The Commission published in December 2005 a White Paper setting out its policy with regard to financial services in the years 2006 – 2010. The main novelties being:

(a) Recognition of the need for a “regulatory pause” so that the market is able to assimilate the measures adopted in recent years. Cautious approach to new legislation, made subject to open consultation and impact assessments, in order to ensure the drawing up of sound legal acts aiming at simplification, codification and clarification of existing legislation (“better regulation”).

(b) Emphasis on the proper implementation of new legislation – Level III and Level IV of the “Lamfalussy process” - throughout the financial sector and the reinforcement of cooperation and information exchange between national supervisory authorities, with a continuous ex-post evaluation by the Commission of the proper application of existing Community rules and of their impact on the financial markets of the member states by means of a Financial Integration Monitor (FIM) report.

(c) Address the issue of adequate regulatory and supervisory structures.

As a general comment, it might be said that to the extent that the principle of minimum and partial harmonisation still prevails, regulatory arbitrage within the single market is possible. Under current arrangements, it is the objective of CEBS, CESR and CEIOPS²⁷ to contribute to the consistent implementation of European rules into national legislations in order to minimise the above risk. If a truly single market for financial services is to be created, even though gradually, future initiatives should focus on the gradual implementation of the principle of maximum harmonisation (potentially through a “Single Rulebook”), taking due respect to national peculiarities, as well as adequate supervisory structures for systemically-important financial intermediaries.

Against in general a positive period regarding improvement of the EU internal market, some protectionist tendencies have appeared. In the period considered some signs indicated a tendency towards restricting ‘foreign’ investment in ‘sensitive’ sectors of the national economy. In France, a general decree declaring several sectors sensitive and requiring prior approval of investments from outside France is under scrutiny by the Commission for compliance with EC rules on the freedom of capital movements²⁸. In the financial sector, two well-publicized takeover battles in respect of financial institutions (*Banca Nazionale del Lavoro (BNL)* and *Banco Antonveneta*) saw a biased attitude in the bank supervisor to retain the *italianity* of those banks, which eventually failed. And in Poland, the takeover of a major Polish bank authorised by the Commission²⁹, is still subject to the interference of the Polish Government. The States mentioned are by no means the only ones to face legal proceedings on alleged restrictions of the free movement of capital: for an overview of cases pending, see the Commission’s website³⁰. All of this has led the Commission, at the behest of the Ecofin Council, to study possible amendments to the Consolidated Banking Directive, whose rules require that the authority licensing a credit institution assesses the suitability of its significant shareholders. An amendment to the Consolidated Banking Directive may limit the recipient State’s authority to assess a shareholder’s suitability in case of banking mergers between credit

²⁷ The Committee of European Banking Supervisors (CEBS) (Commission Decision 2004/5/EC of 5 November 2003, OJ L 3, 7.1.2004, p. 28-29), comprises bank supervisors and central banks, to advise the Commission on the draft of implementation measures, to contribute to the consistent implementation of Community legislation and to enhance supervisory co-operation, including the exchange of information. See on this: www.c-eps.org.

The Committee of European Securities Regulators (CESR) (Commission Decision 2001/527/EC of 6 June 2001 OJ L 191, 13.7.2001, p. 43-44), comprises national authorities in the field of securities, to advise the Commission on drafting implementation measures in the field of securities, to improve co-ordination among securities regulators and to ensure more consistent and timely day-to-day implementation of Community legislation in the member-states. See on this: www.cesr-eu.org.

The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) (Commission Decision 2004/6/EC of 5 November 2003, OJ L 3, 7.1.2004, p. 30-31), comprises national public authorities in the field of supervision of insurance, reinsurance and occupational pensions, to advise the Commission on drafting implementation measures in the field of insurance, reinsurance and occupational pensions, to contribute to the consistent implementation of Community legislation and to enhance supervisory co-operation, including the exchange of information. See on this: www.ceiops.org.

²⁸ See “Brussels threat to challenge French law”, *Financial Times*, 4 January 2006.

²⁹ Where the Commission has exclusive competence to vet mergers above certain thresholds under the Merger Regulation (Council Regulation (EC) No. 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation), OJ 2004 No. L 24/1) whereas, pursuant to Article 21 (4), prudential rules are considered valid reasons for member states to take “measures to protect legitimate interests”.

³⁰ http://www.europa.eu.int/comm/internal_market/capital/analysis/index_en.htm.

institutions from several member states³¹. Another necessary amendment would be the abolition of the <prudential carve-out> in the Merger Regulation. In the meantime, the Commission has adopted a Communication on Intra-EU investment in the financial services' sector to make known its reading of the current provisions³². Intriguing questions about the interplay between competition and supervision and about the appropriate attribution of supervisory competences in the single market are central to the solution of the current imperfections of the single market³³.

B. Integration of the financial services infrastructure

1. The project to achieve a Single Euro Payments Area (“SEPA”) aims at making the single currency a reality in day-to-day payments for companies and citizens who are still faced with nationally organized payments systems. In this context, the role of self-regulation as manifested in the work of the European Payments Council (EPC) is particularly important. The EPC was set up in June 2002 by a number of large European banks and the European Credit Sector Associations representing commercial, savings and cooperative banks, with the objective to realise the integration of national payment infrastructures and payment products and achieve the creation of SEPA. In this context, in the period under examination:

- banks have agreed on the appropriate infrastructure for the uniform processing of cross-border small-value payments in euro;
- the EPC will finalise (by the beginning of 2006) specific guidelines in connection with SEPA-compliant credit transfers, direct debits and card payments.

It is expected that the migration of EU banks and their customers to SEPA-compliant payment services will start by 2008 and will be completed by 2010.³⁴

2. In addition, after a consultation on proposed measures in this area in 2003-2004³⁵, the Commission has submitted a proposal for a directive on payment services in 2005³⁶. The aim of the Commission’s proposal is to establish a common framework for payments in the internal market, thus laying down the conditions for integration and rationalisation of national payment systems, and complementing the industry’s initiative for SEPA. It proposes a specific “single licence for providers of payment services which are not connected to taking deposits or issuing e-money”, as well as provisions on access to payment systems, on transparency in conditions governing payment transactions and on the time of payment. Although many national legal provisions on payments remain unaffected by the proposed harmonization considerable progress would be made in overcoming a patchwork of rules relating to euro payments in the single market.

3. The current common European payment system of central banks (TARGET) started its operation in 1999, comprising 15 EU national real-time gross settlement systems (RTGS) and the ECB payment mechanism (EPM), linked among them, and providing credit transfers in euro within 16 EU member states³⁷. The system has a high acceptance in the EU banking industry with the largest turnover – in terms of value and volume – in the euro area; it is the leading payment system in Europe.

³¹ An overview of some changes considered is given in the *European Voice* of 27 October 2005 (“[EU Internal Market Commissioner] McCreevy plots an end to bank-merger protection”).

³² Published under 2005/C 293/02 in OJ 2005, No. C 293/2.

³³ In a decision of the ECJ concerning the remuneration of sight deposits in euros by the French subsidiary of a Spanish bank, the Court found that French interest rate limits could not be applied to the Spanish bank (Caixa Bank France, Case C-442/02, (2004) ECR I-8961).

³⁴ White Paper, May 2002: Euroland: Our Single Payment Area, Roadmap 2004-2010, December 2004.

³⁵ See Communication from the Commission to the Council and the European Parliament concerning a New Legal Framework for Payments in the Internal Market (Consultative Document), document COM(2003) 718 final, at: http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/com/2003/com2003_0718en01.pdf.

³⁶ Proposal for a Directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 97/7/EC, 2000/12/EC and 2002/65/EC (presented by the Commission) {SEC(2005) 1535}, document COM(2005) 603 final, at:

http://www.europa.eu.int/comm/internal_market/payments/docs/framework/com_2005_603_en.pdf.

³⁷ The 15 EU member states of 1999, plus Poland. Other central banks of new member states are in the process of preparing their connection to TARGET.

As TARGET is based on 15 different national RTGS systems working on 15 different technical components applying 15 different national laws, only a limited degree of harmonisation could be achieved to ensure interoperability. Against this background the European banking industry expressly requested a single technical TARGET2 platform.

Under TARGET2, national central banks of the euro area and, to a certain extent, of the other EU member states, will provide a widely harmonised and enhanced service level to the banking community, both domestic and cross border. In TARGET2, the central banks and the banking industry will base their RTGS system activities on one common technical platform; the hitherto existing national platforms which are all based on a different technical infrastructure, different software and hardware solutions will become obsolete.

TARGET2 can be categorised as an advanced real-time gross settlement system. Although payment system operations will be largely concentrated on platforms operated by the German, Italian and French central banks each central bank in the ESCB will continuously remain fully responsible for maintaining the business relations to its own customers. Owner of the TARGET2 System will be the Eurosystem as a whole. It will be designed for the entire European banking industry.

C. *Fiscal discipline in the European Union: Review of the Stability and Growth Pact*³⁸ (SGP)

The SGP, an instrument for fiscal discipline which completes the EC Treaty (articles 99-104) in this respect, has been reviewed through a process which started by a Communication of the Commission presented on September 3, 2004, upon a request expressed by the European Council in a Declaration annexed to the Treaty establishing a Constitution for Europe, on June 18, 2004. In the meantime, the Court of Justice adopted a judgment on July 13, (case C-27/04, *Commission v Council*) which stated that on the one hand the Council should abide by the procedures provided by the SGP, and, on the other hand, benefited of a margin of appreciation in the implementation of the procedure under Article 104 of the Treaty and the Pact.

The modifications to the SGP are included in the Report of the Council of Economic and Financial Affairs (Ecofin Council), as endorsed by a Resolution of the European Council of March 25 and in two Regulations adopted by the Ecofin Council on June 27, 2005.³⁹ These texts are added respectively to the 1997 European Council Resolution and to the 1997 Regulations, which they modify.

The predominant view was that the reform had to introduce more flexibility and, at the same time, more effectiveness to the SGP, in order to ensure a smooth implementation of the fiscal discipline and to remedy to some shortcomings of the Pact. It was felt that the SGP was too rigid in its requirement of a severe recession for allowing a temporary and exceptional derogation (apart from an unusual event outside the control of the member states) to the reference criteria serving for establishing the existence of an excessive deficit, it was asymmetrical in its requirements in good and in bad times, which did not allow for the smooth working of the automatic stabilizers in an economic downturn and the timetable provided by Regulation N° 1467/97 was unrealistic. The revised Pact shows a clear mix of strengthening and weakening from the previous texts, introducing the possibility of variable objectives in the rhythm of deficit reduction.

Limiting ourselves mainly to the corrective arm of the Pact⁴⁰ other major changes are:

- (1) The circumstances which allow for an exceptional and temporary derogation from the reference values (3% GDP for the public deficit and 60% for the debt) are defined in a less stringent way.
- (2) The report of the Commission in case of non respect of the reference values has to take into account relevant factors which are not exhaustively listed in the amended Regulation N° 1467/97, a

³⁸ The SGP was presented in this Committee's reports at the ILA Taipei Conference in 1998 and once again at the ILA Berlin Conference in 2004.

³⁹ Council Regulation (EC) N° 1055/2005 of 27 June 2005 amending Regulation (EC) N° 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, *OJEU*, L174, 7.07.2005, p. 1; Council Regulation (EC) N° 1056/2005 of 27 June 2005 amending Regulation (EC) N° 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, *OJEU*, L174, 7.07.2005, p. 5. The ECB provided its critical advice on the proposed revisions: see the two ECB Opinions dated 03.06.2005 (Official Journal 2005, No. C144/16-17; www.ecb.int).

⁴⁰ There are some interesting novelties as far as the preventive arm of the Pact is concerned. See in this respect Regulation N° 1055/2005 and the Ecofin Council report.

list which includes, in addition to developments in the medium-term economic and budgetary positions, the contribution to international solidarity and the achievement of European policy goals like the unification of Europe, i.e. very open-ended factors. These two points (1) and (2) have to be interpreted following the “overarching principle” that derogation to the reference values are always to be temporary and that figures are to remain close to the reference values.

(3) The deadlines are extended and a greater flexibility is introduced in that field.

The review did not succeed in providing strict rules for the reduction of the public debt and it remains to be seen in how far the application of the SGP will indeed be symmetrical, i.e. succeeding at imposing to the member states to use the “good times” to allow for a reaction within the limits of the reference value of 3% in “bad times”. Some voiced concern that the reviewed Pact would make it considerably weaker and complicate. Much will depend on the way the reform is implemented as the mechanism will still be based on peers’ control and peers’ pressure.

D. The process of enlargement of the euro currency area

In the last committee report to the ILA Conference the EU enlargement process was described. New member states joined the EU with the obligation to adopt the euro as soon as the macroeconomic and the legal convergence criteria were met. For this purpose, the European Union adapted its basic monetary law (Council Regulation (EC) 974/98 on the introduction of the euro) to prepare for the further enlargement of the euro zone, by way of a Council Regulation (EC) 2169/2005 dated 21 December 2005⁴¹. In the amended text, the pre-existing rules are kept but member states entering into the euro area are offered three optional scenarios:

- a transition of up to three years where national currency units are redefined as non-decimal subdivisions of the euro and national banknotes and coins retain legal tender status;
- a single-step transition to the euro, with a very short dual-circulation period (“big bang scenario”);
- a “big bang scenario” together with a “phasing-out period” where some allowance to retain the use of the national currency is given for specific instruments, and for a period of up to one year.

The other EU monetary laws, in particular Council Regulation (EC) 1103/97 on continuity of contracts, conversion rates and rounding rules, are left untouched and remain thus applicable in new changeover cases.

On 28 June 2004 the currencies of Estonia, Lithuania and Slovenia were included in the ERM II. On 2 May 2005 the currencies of Cyprus, Latvia and Malta joined the ERM II. Two-year membership in ERM II without devaluation vis-à-vis the euro is one of the convergence criteria. The national plans for adopting the euro made public so far by the member states foresee the following dates and changeover scenarios:

Member state	Prospective date	Preferred scenario
Cyprus	1 January 2008	“Big bang scenario”:
Czech Republic	1 January 2010	“Big bang scenario with phasing-out period”:
Denmark	No date	No plan
Estonia	1 January 2007	“Big bang scenario”:
Hungary	1 January 2010	“Big bang scenario with phasing-out period”:
Latvia	1 January 2008	“Big bang scenario”:
Lithuania	1 January 2007	“Big bang scenario”:
Malta	1 January 2008	“Big bang scenario with phasing-out period”:

⁴¹ OJ L346 of 29 December 2005.

Poland	No date	No plan
Slovakia	1 January 2009	“Big bang scenario”:
Slovenia	1 January 2007	“Big bang scenario”:
Sweden	No date	No plan
United Kingdom	No date	Transitional period

Denmark and the United Kingdom benefit from an opt-out right and have not decided to move to the third stage of EMU. To be noted that the adoption of the euro is neither automatic nor “on demand” by the concerned member state, but requires:

- an examination by the European Central Bank and the European Commission of the degree of macroeconomic convergence of the candidate countries⁴², as well as of legal convergence;
- a recommendation by the Ecofin Council on fulfilling the conditions for adopting the euro;
- an opinion by the European Parliament; and
- a discussion by the European Council (Heads of State or Government), leading to
- a formal decision by the Council of Ministers of Economy and Finance (Ecofin), by qualified majority of the representatives of the member states having adopted the euro.

Both the ECB and the Commission made their first Convergence Reports in 2004, and are preparing a second one in 2006.

VI. Islamic Banking and Finance

The unprecedented growth in Islamic banking and finance had caught the attention of the Committee. Islamic banking and finance is now practised in over 60 countries around the world, Islamic financial assets of Islamic banks and conventional banks having an Islamic window total over USD400 billion, Islamic mutual funds amount to over USD300 billion, sovereign and corporate Islamic sukuk (bonds) exceed USD15 billion and the global market capitalisation of the Dow Jones Islamic Index is above USD 10 trillion.⁴³ Islamic finance is being increasingly recognised in established financial centres of the world as an industry with great growth potential. The potential for growth in Islamic banking and finance is further fuelled by the transfer of wealth from oil consuming countries to oil producer countries who are largely in the Middle East.

MOCOMILA therefore organised a half day consultation on Islamic Finance in conjunction with the 78th MOCOMILA Meeting in London at the Bank of England on 23 April 2005. Speakers were drawn from the Financial Services Authority of United Kingdom which had recently licensed an Islamic banking institution in the country, an American attorney with experience in Islamic finance products and the Islamic Financial Services Board (IFSB). The IFSB is an international standard setting body for Islamic finance established in 2002 with its headquarters in Kuala Lumpur Malaysia. It has over 84 full, associate and observer members many of whom are central banks or well-known finance houses. The Islamic Development Bank is a full member. The International Monetary Fund, the World Bank and the Bank for International Settlements are associate members. The Asian Development Bank is an observer member.

⁴² Inflation rate, fiscal discipline (measured in terms of budgetary deficit and of public sector indebtedness), stability of exchange rate (2 years in the ERM-2 without devaluation), and convergence in long-term interest rates.

⁴³ Source: CIBAFI (Council for Islamic Banks and Financial Institutions or CIBAFI's Ten-Year Master Plan released in June 2005, based on 2003 figures), World Wealth Report & Dow Jones

Professor Dr. Rifaat Ahmed Abdel Karim, the Secretary-General of the IFSB, in speaking at the MOCOMILA seminar, pointed out that unlike the predominantly borrowing and lending operations performed by conventional banks, business activities of Islamic banks and financial service suppliers include, from the aspect of:

Source of funds:

commercial banking; fund management and investment banking;

Application of funds:

buying of “physical” assets and selling them on credit, direct equity investments in transactions-based joint ventures and capital ventures, leasing, trading in real estate and holding commercial and agricultural inventories for resale.

Dr. Rifaat also explained on how the business activities performed by an Islamic bank predicate that the nature of risks to which an Islamic bank is exposed is not necessarily the same as that of a conventional bank. For example, rather than lending the money, an Islamic bank has to acquire a physical asset and then either sell it on credit or lease it. The fact that the nature of risks associated with assets held for leasing, real estate, inventories (commercial and agricultural) etc., is different from that to which conventional banks are normally exposed to, means that an Islamic bank requires different risk management approaches and different regulatory capital requirements. This also underscores the need for supervisors and regulators to have a sound understanding of the risks involved in such transactions and how such risks are managed.

Furthermore, unlike conventional banks, if an Islamic bank wishes to take the risk off its balance sheet, due to limitations imposed by the Islamic law, it does not have the option to sell at a discount or to repackage and sell off their financial assets (for e.g. receivables) as securities. This type of risks actually represents a high percentage of total assets. Without such option, an Islamic has limited possibilities to diversify or to avoid concentration by spreading its risks, especially at times when an individual institution is vulnerable to shocks. Since an Islamic bank has to hold on to their receivables until maturity and manage the risks associated with them, they may have to carry more of the overall credit risk compared to their conventional counterparts.

In addition to the market risk of leased assets, real estate, inventories, and such, Islamic banks are also exposed to operational risks associated with such assets, which are not typical of operational risks in banking and securities sectors.

The Committee arrived at the view that Islamic banks are more akin to universal banks and the transactions of Islamic banks do not conveniently fit into conventional legal frameworks for financial systems which in the main dichotomise the legal and regulatory framework for the financial system as one for banking and depositary institutions with an emphasis on depositor protection and the other as the securities industry with an emphasis on investor protection. The Committee decided that issues relating to Islamic banking and finance has to be studied in depth to ensure the risks and potential of Islamic banking is fully understood and addressed.

As for countries which practise Islamic banking and finance, many members of the Committee took the initial view that a special legislative and regulatory framework be developed that would adequately encompass the full range of activities of an Islamic banking institution and provide sufficient scope and flexibility to identify and address the risks unique to Islamic banking and finance. While it is beyond the scope of the expertise of the Committee to generalise among the various jurisdictions in which Islamic banking and finance is being practiced, the following case study of Malaysia provides insight into the legal structure of that jurisdiction.

Islamic Banking and Finance in Malaysia

Malaysia is a common law country.⁴⁴ Islam is the religion of Malaysia but it does not preclude other religions from being practised in peace and harmony throughout the country.⁴⁵ The introduction of Islamic banking in

⁴⁴ Section 3(1) of the Civil Law Act 1956: Save so far as other provision has been made or may hereafter be made by any written law in force in Malaysia, the Court shall –

- a) in West Malaysia or part thereof, apply the common law of England and the rules of equity as administered in England on the 7th day of April 1956;

1983 therefore presented special challenges to the legal system, which has since evolved to support and uphold the Shariah consistent banking and finance industry.

The prohibition of “riba” or usury⁴⁶, normally regarded as the prohibition of interest presented a special challenge for the deposit taking, financing and liquidity management activities of Islamic banks. Since both conventional and Islamic banks carry on business in Malaysia, Islamic banks face tremendous competition from the conventional banks. How since 1983, Islamic banking has become an integral part of the financial system in Malaysia and now accounts for 10.5% of the total banking assets of the country.

There are eight full-fledged Islamic banks.⁴⁷ Many conventional banks provide Islamic banking and finance through an “Islamic window”. Islamic banks in Malaysia provide over 40 types of products and services. On the capital market side, Islamic private debt securities have a market share of 42.2% and Shariah based unit trusts constitute 7.7%.

The Islamic bank as a depositary institution:

The Guidelines on the Definition of Deposit issued by the Monetary Authority of Singapore states: In determining whether a product is a “deposit”, the Authority would consider whether the principal amount invested in a product is repaid in full i.e. the person issuing the product (“the issuer”) is under an obligation to return to the investor the full value of the principal at maturity. A product where the principal amount is exposed to any risk, other than the credit risk of the issuer, **would not be considered a deposit**.

As Singapore is another common law country, this Guideline reflects the classic stand of the common law on deposits as expounded in *Foley v. Hill*⁴⁸ and *Joachimson v. Swiss Bank Corporation*.⁴⁹

The requirement, especially a legal requirement, that the repayment of the principal sum of a deposit has to be guaranteed constitutes some difficulty for the Islamic bank. Deposits taken by an Islamic bank in accordance with the principles of the Shariah are not all on the basis of full repayment of the principal. Deposits taken on the basis of *quād* or as benevolent loans or on the basis of *wādiah* or safe custody do guarantee the repayment of the principal amount of the deposit. However deposits taken on the basis of profit sharing or *modaraba* do not

- b) in Sabah, apply the common law of England and the rules of equity, together with statutes of general application, as administered or in force in England on the 1st day of December 1951;
- c) in Sarawak, apply the common law of England and the rules of equity, together with statutes of general application as administered or in force in England on the 12th day of December 1949, subject however to subsection (3)(ii):

Provided always that the said common law, rules of equity and statutes of general application shall be applied so far only as the circumstances of the States of Malaysia and their respective inhabitants permit and subject to such qualifications as local circumstances render necessary.

⁴⁵ Article 3(1) of the Federal Constitution of Malaysia: Islam is the religion of the Federation; but other religions may be practised in peace and harmony in any part of the Federation.

⁴⁶ Surah Al-Baqarah (Chapter 2) verse **275**: Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: "Trade is like usury," but **Allah hath permitted trade and forbidden usury**. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (The offence) are companions of the Fire: They will abide therein (for ever).

⁴⁷ List of Islamic banks as of today:

1. Bank Islam Malaysia Berhad.
2. Bank Muamalat Malaysia Berhad
3. RHB Islamic Bank Berhad
4. Commerce Tijari Bank Berhad
5. Hong Leong Islamic Bank Berhad
6. Kuwait Finance House
7. AM Islamic Bank Berhad*
8. EON Islamic Bank *

⁴⁸ (1848) 2 HLC 28.

⁴⁹ [1921] 3 KB 110.

guarantee total repayment of the principal sum of the deposit. Hence in a common law regime, for an Islamic bank to carry on deposit taking business according to the tenets of Islam, legislative intervention is necessary. One formulation being considered is as follows:

“deposit” means a sum of money received or paid in accordance with the terms of any agreement consistent with the Shariah -

- (a) under which it is repayable in full and, at the discretion of the deposit taker, with or without any consideration in money or money’s worth;
- (b) in safe custody on terms under which –
 - (i) the deposit taker is authorised to use the money; and
 - (ii) it is repayable in full, with or without any consideration in money or money’s worth as may be agreed between the deposit taker and the depositor;
- (c) for purposes of investment, repayable wholly or otherwise, with or without profits in accordance with the terms of any agreement between the deposit taker and the depositor;
- (d) on any basis involving custody, profit sharing, investment, loan, sale, sales and purchase or saving or any combination thereof;

but does not include money paid *bona fide*—

- (A) by way of an advance or a part payment under a contract, other than a contract for financing consistent with the Shariah, for the sale, hire or other provision of property or services, and is repayable only in the event that the property or services is not or are not in fact sold, hired or otherwise provided;
- (B) by way of security for the performance of a contract or by way of security in respect of any loss which may result from the non-performance of a contract;
- (C) without prejudice to paragraph (B), by way of security for the delivery up or return of any property, whether in a particular state of repair or otherwise; and
- (D) in such other circumstances, or to or by such other person, as may be specified.

Deposits taken by Islamic banks for purposes of investment on a profit-sharing basis pose problems of transparency, which again may require legislative intervention. Since such *modaraba* deposits are not guaranteed repayment in full or at all, while any profits from the application of such deposit proceeds would have to be shared between the deposit taker and the depositor, in all fairness, the depositor (sometimes called Investment Account Holders) should have the right of full disclosure on how the investments have fared and the total profits made or losses sustained. Hence there is some thinking in the Islamic banking circles that Investment Account Holders should be given the right to monitor the performance of investments made on their behalf by Islamic banks and the associated risks. Islamic banks, it is thought, should also be placed under a duty to ensure that adequate means exist for these rights of Investment Account Holders to be exercised.

The financing transactions of an Islamic bank

Islamic banking assets are created by the financing transactions of Islamic banks based on the Shariah. Some of the assets of Islamic banks may be inventories held by the banks for purposes of Shariah based financing arrangements to be concluded in the future. The Islamic Financial Services Board or IFSB has come up with a stylised balance sheet⁵⁰ for Islamic financial institutions as follows:

⁵⁰ IFSB Exposure Draft No. 2 CAPITAL ADEQUACY STANDARD FOR INSTITUTIONS (OTHER THAN INSURANCE INSTITUTIONS) OFFERING ONLY ISLAMIC FINANCIAL SERVICES 15 March 2005

ASSETS	LIABILITIES
Cash & cash equivalents	Current accounts
Sales receivables	Other liabilities
Investment in securities	
Investment in leased assets	Equity of Profit Sharing Investment Accounts (PSIA)
Investment in real estate	Profit sharing investment accounts (PSIA)
Equity investment in joint ventures	Profit equalization reserve
Equity investment in capital ventures	Investment risk reserve
Inventories	
Other assets	
Fixed assets	Owners' Equity

The capital adequacy implications and the risk management issues relating to Islamic banking are discussed in the two exposure drafts issued for feedback and comment by the IFSB and are not discussed here.

However it has to be noted that Islamic banking on the asset side of its balance sheet impacts upon a key principle of conventional banking regulatory law i.e. that banks being intermediary institutions in the economy should confine their business exclusively to intermediation activities and should not be a player in the real sector. For example, in Malaysia, section 32(1) of the Banking and Financial Institutions Act 1989 states that “no licensed institution shall engage, whether on its own account or on a commission basis, and whether alone or with others, in wholesale or retail trade, including import and export trade, except in connection with the realization of security given to or held by it for the purpose of carrying on its licensed business.”

Hitherto in Malaysia, while the Islamic banking financing transactions based on various trade based modalities have been permitted by legislation, the type of Islamic banking assets which have been created are still financial assets such as sales receivables, leases and equity. Hence the full impact of the objectives of the Shariah in respect of Islamic banking have not been realised. This is because Malaysian Islamic banks so arrange their financing transactions that they do not hold any non-financial assets or inventory.

In this context, it should be noted that Singapore as recent as 29 September 2005 amended its banking law to allow *murabaha* or mark-up financing. Announcing this at the International Islamic Enterprise Forum, Mr. Heng Swee Keat, Managing Director of the Monetary Authority of Singapore (MAS) said “MAS will finetune our rules to allow, from today, all banks in Singapore to offer an important and common form of Islamic financing known as Murabaha. Previously MAS regulations imposed broad restrictions on banks against conducting non-financial activities. MAS will exempt Murabaha financing, which requires the bank to purchase goods on behalf of its customer and to sell the goods to the customer at a mark-up, from this restriction against non-financial activities.”

The Islamic bank and liquidity management

Since money is not a commodity in Islamic finance and cannot be traded and, since interest is prohibited, money would not have a price, liquidity management by Islamic banks has to be based on investments or on *quad* or

benevolent loans. The Malaysian Government intervened to provide another avenue for liquidity management by issuing Shariah compliant investment papers on tap. Recently the law relating to these papers has been amended and under the new Government Funding Act 1983 (amended in 2005) papers based on various other Shariah principles could be issued by the Government to enhance liquidity management in the Islamic interbank money market. In this respect the corporate sector in Malaysia has also made available a large volume of Islamic private debt securities.