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COMMITTEE ON INTERNATIONAL MONETARY LAW

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Since the Taipei Conference of the ILA in 1998, the Committee has held four meetings: in New York (October 1998), Frankfurt (April 1999), Rome (October 1999), and Amsterdam (March 2000). In addition, Members of the Committee have prepared a collection of essays to be published by Oxford University Press in a book entitled *International Monetary Law: Issues for the New Millenium* (Mario Giovanoli, editor, Oxford, 2000). After an introduction describing

MOCOMILA's fifty years of contributions on international monetary law, the twenty-seven essays are grouped within five parts: I. International Financial Architecture; II. Impact of the European Monetary Union; III. Central Banks, Supervisory Authorities and Deposit Insurance; IV. Impact of Technological Developments; and V. International Monetary Obligations. The book will be unveiled at a public workshop held in conjunction with the London Conference.

This report contains five sections. Section I, by Prof M Giovanoli, addresses the legal aspects of international financial standard setting, which is an important component of global debates over the reform of the international financial architecture. Section II, by Dr K P Follak and Prof C Lichtenstein, discusses developments in the international harmonisation of the regulatory and supervisory frameworks for the financial markets, including with respect to individual financial standards. Section III, Part A by A Sainz de Vicuña and Part B by Prof H J Hahn, collectively address monetary law developments in the context of European Economic and Monetary Union and the introduction of the euro as the single currency. Section IV, by T C Baxter, Jr, reviews developments in the field of electronic money. This report reflects the views of the individual rapporteurs and not necessarily those of any institutions with which they are associated, while the draft resolutions are endorsed by the Committee on the basis of the report. The Committee wishes to acknowledge the assistance of James H Freis, Jr in finalising this report.

Section I

International Financial Architecture: Legal Aspects of International Financial Standard Setting

Since the last conference of the ILA, the broad topic in the monetary and financial arena perhaps most widely under discussion worldwide has been that of the reform of the international financial architecture. Experiences over the past few years, including the respective financial crises in Latin America, Asia and Russia, and the increased awareness of the activities of non-traditional, highly-leveraged financial institutions such as hedge funds, have evidenced how increasingly integrated and interdependent are the world's financial markets, and how quickly a disruption or weakness in one area can lead to the realization of systemic risk elsewhere. Increasingly, the adequacy of existing rules for and oversight of international financial activities and markets has been questioned, leading to calls for reform.

A central focus of the discussion has been the roles of the international financial institutions, in particular, how the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank), created at the Bretton Woods Conference in 1944, can adequately address the challenges and risks to the orderly functioning of the modern, rapidly changing

global financial markets (both with respect to crisis resolution and to crisis prevention). A particular issue in the context of crisis prevention, which would deserve a more systematic approach, is the setting and implementation of international financial standards with a view to fostering international financial stability.

The Committee is interested in the legal aspects of the debate over the reform and strengthening of the international financial architecture, in particular with regard to the rules or standards applicable to transnational financial actors and markets (e.g., principles of best practice for financial operations), as well as the procedures for creation, implementation, and enforcement of the standards. Most of the current legal framework in the international financial arena can be characterized more as a form of "soft law" than the type of clear, enforceable legal rules generally deemed essential for a strong legal basis at the national level. While Section II of this report will examine a few individual standards in more detail, the discussion immediately following will discuss standards on more of a jurisprudential level, focussing on the legal nature of the standards and procedures for development and implementation. But first, a brief word should be said on the sources from which the standards emanate.

A. Standard Setting Bodies

A quick look at some of the institutional bodies involved in discussions over the reform of the international financial architecture and the establishment of international financial standards reveals how different these bodies are as well as the differences in the constituencies they more or less represent. First, at the truly multilateral level are the four international financial institutions (IFIs); (1) the IMF, concerned with oversight of the international monetary system and remediation of short-term payments difficulties, and (2) the World Bank, which makes loans for development projects in emerging economies. Additionally, (3) the Bank for International Settlements (BIS), an international organisation of central banks, serves as a forum for international monetary cooperation and hosts the permanent secretariats of various experts groups involved in standard setting, such as the Basel Committee on Banking Supervision and the Committee on Payment and Settlement Systems (CPSS). Finally among the IFIs is (4) the Organisation for Economic Co-operation and Development (OECD), which hosts the secretariat of the Financial Action Task Force.

Groupings of country representatives that meet regularly have been involved in the process of international financial standard setting – the G-7, G-10, G-20, and G-22. As a complement to the work of the Basel Committee, other cooperative bodies of national experts in the financial arena include the International Organisation of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS). A range of private professional and industry associations with a transnational membership, as well as think tanks, might add to the process of standard setting at the international level.

Additionally, to the extent that the issues are not of a specialised financial nature, input could be sought from those groups such as UNCITRAL, Unidroit, or the Hague Conference, which are active in developing international law.

The non-exclusive list above reveals the variety and range of interested bodies and constituencies in the question of the development of international standards. To the extent that these bodies wish to create truly global standards, they must rise above the backgrounds of their members both in terms of legal frameworks and interests to overcome the problems of legitimacy when expecting countries and actors not represented at the drafting tables to transform recommendations into some type of legally relevant rules. It should also be mentioned that the efforts and interests of these bodies often overlap; historically, cooperation among these various bodies appears mostly to have been on an ad hoc basis. So long as the creation of some sort of overarching global authority remains unlikely in the foreseeable future, the need for better cooperation among these bodies becomes imperative.

The Financial Stability Forum (FSF) was created in February 1999 in part to fill this void, with objectives of enhancing co-operation and co-ordination of initiatives among a broad group of national and international bodies. The 43 members include representatives from the IFIs; representatives of national authorities from the G-7 countries as well as from a few additional important financial centres; and representatives from international regulatory and supervisory groupings such as the Basel Committee, IOSCO, and IAIS. As one of its first tasks, the FSF compiled a Compendium of Standards developed at the international level for the promotion and maintenance of safe and sound financial markets. The FSF also operates a Task Force on the Implementation of Standards, to explore strategies for achieving practical implementation, including with respect to governmental and market incentives for successful implementation. The work of this Task Force in particular is likely to be significant.

B. Scope of International Financial Standards

The scope of the standards developed by the various bodies in the area of international finance varies widely. First, in terms of substance, a distinction can be made between standards embodying substantive rules and those delineating the jurisdiction of national supervisory authorities with respect to cross-border financial activity. A good example of the former is the 1988 Basel Capital Accord (discussed in detail in Section II), which defines capital requirements applicable to internationally active banks. With respect to the latter category, the Basel Concordat of 1975, as revised in 1983 (the principles of which were adopted into the EU's Second Banking Directive of 1989) allocates supervisory responsibilities between authorities of the home country and the host country with regard to cross-border banking activities. Second, the specificity and degree of precision of international standards may vary considerably. From a legal viewpoint, some standards lack the degree of precision necessary for

establishing a legally enforceable rule, to the extent that the results of their application are not predictable. The broad formulation is often a consequence of the need to facilitate acceptance. At the other extreme would be standards that are too precise and, hence, unduly rigid. Third, the scope of international financial standards may be specific to a certain industry sector (e.g., banking, securities, or insurance). Other standards are based on a functional approach, covering areas such as accounting, disclosure, financial ethics or governance; with appropriate adjustments, similar principles could apply across various sectors.

Some challenges raised by the implementation of international standards also deserve mention. There is some risk that the high level experts drafting the standards might not fully appreciate the application of the standards to concrete issues or the unintended results they could cause, particularly when applying the standards in countries other than their own. On a more procedural level, the comparatively small group of experts generally depend upon a much larger group of responsible national officials for implementation, which officials might now share the views of the experts on the merits or meaning of the standards. The greater the divergence between the drafting and implementing groups, the more important it will be that the standards are seen as benefiting all countries, rather than favoring the interests of a small group. In order to facilitate acceptance and promote implementation, proponents of standards might wish to consider including with their recommendations a thorough and reasoned discussion of the advantages and drawbacks of the standards.

C. Standards as Soft Law

One relatively common characteristic of standards on issues of international finance is that few have been implemented into international law in the traditional sense of a multinational treaty. The majority of these financial standards are not legally binding, absent implementation into the law of individual countries, and there is no binding commitment in international law for implementation at a transnational level. These standards are a type of "soft law," alternatively characterised as guidelines for best practices, codes of conduct or a gentlemen's agreement. While it is possible that over time, either at the national or international level, individual standards might be recognized as having reached a status of customary law, generally through recognition in a court decision, this remains a lengthy and unsure process. Hence, at the time of promulgation, from a legal perspective, new standards consist of little more than the recommendations of the experts who have drafted them. The very application of the term soft law to these standards implies a recognition that they are neither self-executing nor enforceable.

At the national level, soft law is often a complement to "hard law", whether as a substitute for or pre-cursor to industry-specific legislation or as a guideline for judicial or supervisory decisions. Particularly within common law countries where judicial decisions can create new law, the soft law standards can be

"hardened" to the extent they form the basis of such decisions. At the international level, soft law rules have often been established in lieu of or in parallel to binding law rules based on proper treaties. A significant difference between the national and international levels, however, is that at the international level there is no overarching legal structure to bind the soft and hard law together. For example, there is no world court to adopt financial standards into its jurisprudence and thereby create precedential effect. In other words, international standards, in particular those relating to international financial stability, exist independently from any global framework of binding law rules.

Another difference between domestic and international soft law relates to the circle of addressees of the norms. The rules of domestic financial soft law often are directed towards the financial institutions and other commercial actors that are active in that field. In the case of international soft law, the relevant arrangements are not concluded directly with or among those actors, but rather, the standards are understandings between comparable national supervisors of those institutions and markets, or recommendations composed by a group of multinational experts. In this respect, the rules of international soft law, although voluntary, resemble European Union directives, which require the domestic authorities to incorporate certain minimum standards into national law. Moreover, at the global level, there is no financial authority which can promulgate financial standards that have direct effect.

D. Evaluation of the Soft Law Approach

The Committee believes that the time is ripe for studying the soft law approach to adopting international financial standards and how this approach can be improved and strengthened, as well as integrated with the underlying framework of international monetary and financial law. These efforts should complement the ongoing work of the Committee with respect to developments in the legal aspects of financial regulation and supervision of transnational financial activities and markets. From a preliminary investigation, it appears that in the area of international finance the soft law approach can offer significant advantages, in particular, with respect to speed and flexibility. In light of the rapid and continuing changes in the financial markets driven increasingly by globalisation and technological improvements, the need for timely adjustments of legal standards takes on a sense of urgency. It is clear that a traditional, formal treaty process alone cannot keep pace with financial developments. At the same time, despite the increase in systemic risks and other undesirable side-effects, few would argue that the globalization of the financial markets does not have overall positive effects; hence, efforts should be made not to stifle innovation by imposing a static legal framework. The fact that soft law standards have been developed largely by experts in the relevant fields also tends to increase both pertinence and speed of development.

It remains unclear, however, especially over the longer term, whether soft law standards alone will be sufficient to establish the required legal underpinnings for international financial standards. Unlike international treaties, there is no clear framework for international financial standard setting. The legal basis for the standards, the authority or even the liability of their drafters, and the prospects for eventual implementation remain largely undefined. Other drawbacks to soft law are not uncommon to those of treaty-making. In the attempt to reach multinational consensus, there is often a gravitation towards least common denominators, some of which could be so general as to provide little practical guidance to the financial markets. Similarly, once the treaty or standards are agreed at the drafting level, they must be ratified or implemented, respectively, under principles of national law. This process may be more difficult in the case of financial standards developed outside of traditional intergovernmental fora, and with respect to third countries who might question the legitimacy of so-called "international" standards, to the extent those third countries were not consulted in the development process.

Nonetheless, the need for national recognition and implementation of international financial standards in order to give them legal effect does not necessarily undermine the value of this standard setting process. The experience with European Union directives suggests the benefits of allowing individual countries flexibility in implementing the principles embodied in the standards in a legislative format consistent with other domestic law. The three basic principles behind the directives of (i) mutual recognition of (ii) home country control on the basis of (iii) minimum standards could be usefully applied at the international level in the context of global banking and finance. Unlike the European Union, however, there is currently no authority in the international arena either to require implementation of financial standards or to monitor the consistency of national implementation and application.

A range of incentives such as mutual recognition at the public level or the potential for market forces to reward or punish compliance with generally accepted standards, together can foster interest in individual countries for adopting international standards. At the same time, inconsistent application could lead to false expectations or even increase the discrepancies which the standard setters sought to alleviate in the first place. Finally, it remains questionable whether the existing bodies and procedures involved in the setting of international financial standards are currently and can remain adequate with respect to the fast-changing needs of the global markets.

E. Ways to harden soft law

As the above discussion has shown, while the development of soft law standards appears to offer substantial benefits in the development of international monetary and financial law, it does not appear to be an adequate alternative to hard law. Perhaps the best approach for increasing the usefulness of soft law

standards would be to combine them more with hard law, for example, by promulgating underlying treaties to provide a background for or give legitimacy to efforts to draft standards.

Although the establishment of a type of supranational World Financial Authority involving a cession of competency by nation states in the fields of international financial standards might conceptually be the simplest approach to addressing some of the drawbacks of the current soft law regime, such an approach appears politically infeasible for the foreseeable future. Nonetheless, some reform to the institutional structure of the international financial architecture might be advisable to increase the effectiveness of soft law standards. One specific step would be to create a limited structural framework by international treaty – a type of hard law umbrella, firstly, for recognition of the most relevant of the myriad, often overlapping standards which have been proposed, and secondly, to invite countries formally to subscribe to specific standards and to commit themselves to implement them at the national level. Consistent with this, the option of establishing a new organisation or entrusting an existing one with a limited role in promoting development, recognition, and implementation of international financial standards may merit further review. Even if such an organisation were not involved in the promulgation of standards itself, it could assume valuable administrative roles in promoting transparency and guidance with respect to the compendium of relevant standards and their respective states of implementation into national law.

F. Conclusion

The establishment of international financial standards can be expected to continue to grow in importance and to have significant implications for international monetary and financial law. While the advantages of the soft law approach, such as with respect to speed and flexibility in comparison to more traditional treaty-based approaches to developing international law, should be maintained, the effectiveness of soft law standards could likely be increased by improving through appropriate international "hard law" the framework for and transparency of the processes of development, promulgation and implementation. The Committee believes that procedural aspects of standard setting merit specific attention in the context of its ongoing work in monitoring developments in the fields of supervision and regulation of international operations of financial institutions and global financial markets.

Section II

International Harmonisation of the Supervision of Financial Services

While the first Section of this Report has discussed at a jurisprudential level the legal aspects of international financial standard setting, the Committee has

for years been monitoring the development of some of the more important standards themselves. This Section provides an overview of recent developments in the area of international harmonisation of the supervision of financial services.

In general, the continuing globalisation of financial markets and the gradual disappearance of clear delimitations between banking activities, financial markets and insurance operations has necessitated increased coordination between the various supervisory authorities concerned, transcending both national and intersectoral limits. While continued progress toward coordination has been made at a bilateral level as individual supervisory authorities have increased contact and signed memoranda of understanding to foster cooperation and information sharing, significant progress has been made at the multilateral level.

Three institutions which continue contribute to international harmonisation (including through standard setting) reflect the three historical financial sectors: (i) the Basel Committee on Banking Supervision; (ii) the International Organisation of Securities Commissions (IOSCO); and (iii) the International Association of Insurance Supervisors (IAIS). One of the more significant cross-sectoral initiatives was the launch in 1999 of the Financial Stability Forum, created with a view towards enhancing cooperation and coordination among the standard setting bodies. The Committee has also followed closely the special case of the European Commission in fostering harmonisation of financial standards within the EU Member States.

A. Proposed Revision of the Basel Accord

The Basel Committee's most far-reaching project was published in July 1988 under the title "International Convergence of Capital Measurement and Capital Standards." It is more commonly known simply as "the Basel Accord." This report proposed minimum capital standards for internationally operating banks based on a risk-weighting approach. Technically, the Basel Accord is not a legally binding document of public international law but rather a committee statement agreed upon by all its members.

The impact of the Basel Accord has proved to be far-reaching, as it has since been implemented into national law or regulation by dozens of countries worldwide, including many countries not represented in the Basel Committee. The principles underlying the EU capital adequacy directive closely followed the Basel Committee's recommendations and have since been implemented into the domestic law of all the EU Member States. Following the ratification of the Treaty on the European Economic Area, these principles have been implemented within the countries of the European Free Trade Area (EFTA) as well. Central and Eastern European countries, in particular the candidates for future EU membership, have made significant efforts to amend their laws accordingly.

While the Accord broke new ground in terms of its broad acceptance and successful implementation, its relatively simple terms no longer adequately

address the needs of the increasingly complex financial markets. The approach of the Basel Accord has been fundamentally criticised for the following reasons: the risk weight categories are only roughly diversified and are not empirically justified; only credit and market risks are covered, without adjustment for the risk and portfolio management activities of individual banks; and, the differential treatment of lending to entities in OECD countries and non-OECD countries led to credit allocation distortions. As an illustration of the latter point, recall that both Mexico and Korea became OECD members subsequent to the implementation of the Basel Accord. The respective financial crises of the last decade involving those countries came to prove that the risk weighting of Mexican government debt and short-term credits to Korean banks were inappropriate.

In an attempt to improve the Basel Accord, taking into consideration these criticisms, in June 1999 the Basel Committee published a consultation paper proposing a new capital adequacy framework to replace the 1988 Accord. The new proposal suggests three pillars for the capital adequacy regime: (i) minimum regulatory capital requirements; (ii) a supervisory review process; and (iii) effective use of market discipline.

With respect to risk weights within the minimum regulatory requirements, the proposal would clarify and broaden the range of asset categories: good quality assets would require risk weightings below 100% whereas significantly riskier assets might require weights above 100%. In contrast to the existing risk weights based solely upon the type of counterparty, under the new proposal, the standard approach would be to base risk weightings upon external credit ratings by recognised rating agencies, which in principle are comparable across different types of counterparties. For some sophisticated financial institutions, at a later stage an alternate approach might be appropriate, under which risk weightings would be based upon internal bank rating models, subject to supervisory approval and adherence to quantitative and qualitative guidelines. Whichever approach is adopted, the following issues must be developed further: examining the capital treatment of a number of important credit risk mitigation techniques (i.e., credit derivatives, collateral, guarantees, netting); considering ways to factor maturity more explicitly into the assessment of credit risk; and considering changes necessary for the consistency of treatment of market risk between banking and trading books.

The proposal to revise the Basel Accord begins with the assumption that credit and market risks are the main risks faced by banks, but also more broadly suggests the inclusion of other risk categories into the assessment of capital ratios. The first such category is that of interest rate risk involved in banking books. Where interest rate risk is significantly above average (so-called "outliers"), additional capital requirements would be triggered. Secondly, the proposal considers the possibility of additional capital requirements reflecting operational risk. The development of capital charges for these other types of risk remains at an early level of discussion.

Apart from the revised minimum regulatory capital requirements, a few comments are due with respect to the other two pillars of the proposed capital adequacy regime. The second pillar's supervisory review process seeks to ensure that a bank's capital position is consistent with its overall risk profile and strategy, and will encourage early supervisory intervention if necessary. The third pillar of market discipline stems from the view that high disclosure standards for banks would enable market participants to assess an individual bank's ability to remain solvent, and would thereby implicitly encourage all banks to maintain adequate capital. It is assumed that banks with a recognisably good risk profile would obtain more favourable terms and conditions in the market. Hence, market discipline would force credit institutions into cautious risk management practices.

Ongoing discussions have focused on the following items. First, reliance upon external rating agencies would serve to transfer responsibilities from the banking industry to companies which have neither a related capital base nor any obligations to those who rely on the ratings, even in cases of negligence. Second, a potential for new regulatory arbitrage could be created between rated and unrated assets of the same basic credit quality, and, on a related note, if one of the proposed distinctions were to be adopted, between assets held by "sophisticated" and "unsophisticated" banks. Third, regarding the quantification of credit risks under bank internal rating models, questions remain as to the reliability of the models themselves. The proposal recognises that "significant hurdles, principally concerning data availability and model validation, still need to be cleared." Finally, the proposed regulatory review could raise questions about equal treatement which had been largely avoided by the previous approach using quantitative standards.

The Basel Committee received a broad range of comments on its proposal from supervisors, industry associations, and individual financial institutions, through the deadline of 31 March 2000. After reviewing these comments, the Basel Committee plans to release more definitive proposals sometime later in the year 2000. Concurrent to the revision of the Basel Accord, the EU Commission is preparing related amendments to the Solvency Directive.

B. Supervision of Financial Services Conglomerates

Increasingly, major internationally active financial institutions no longer operate solely in one financial sector but rather combine under one roof traditional commercial and/or retail banking, investment services and insurance services. This blurring of the lines between "banking," as traditionally understood and regulated, and other forms of financial services, regulated by different regulators and with different regulatory and supervisory approaches, raises the fundamental problem of the "level playing field" for all internationally competing financial institutions, both those with and without banking licenses.

It remains an open question as to whether banking supervision will be extended to a range of financial services or whether there will be separate regulation of various individual business sectors. The splitting up of the supervision of the financial industry as well as different approaches to defining what is a "bank" might undermine the desired harmonisation.

The equal treatment of the same type of business by whomever conducted is a basic principle of fair competition. Interestingly, the original Basel Accord did not serve to apply this principle on a cross-sectoral basis. The capital charge imposed by the banking supervisor to banks' securities positions often differs from the capital charge imposed by the relevant securities supervisor to securities positions held by stand-alone securities houses (i.e., investment banks). The Basel Committee proposal to revise the capital adequacy regime would extend the Accord to include, on a fully consolidated basis, holding companies that are parents of banking groups. Banking groups would be defined as groups that engage predominantly in banking activities.

The most obvious example of the removal of legal restrictions forcing financial institutions to limit their businesses to distinct financial sectors was the repeal in 1999 in the United States of provisions of the Glass Steagall Act and the related amendment of the Bank Holding Company Act. As a result, so-called Financial Services Holding Companies can now combine banking, securities and insurance businesses. From the supervisory side, the US central banking system, the Federal Reserve, will remain the umbrella regulator for the top holding company, while the securities and insurance businesses, respectively, will be required to be conducted in separate subsidiaries outside the so-called banking "safety net." This can be contrasted with the "super-regulator" approach to supervision taken within the United Kingdom. Authority for banking supervision has been transferred away from the Bank of England and to the Financial Services Authority, which in turn was formed out of the former Securities and Investment Board and other UK authorities dealing with financial services regulation.

Coordination is continuing among the supervisory authorities of banks, investment firms and insurance companies. The Basel Committee, IOSCO and IAIS created the Joint Forum on Financial Conglomerates as a successor to the Tripartite Group on the harmonisation of the supervision of financial conglomerates. Additionally, since 1995 a Coordinating Committee of the Basel Committee and IOSCO exists, supplemented by a joint initiative of these two bodies to support the Joint Forum. A press release of IOSCO dated February 19, 1999 announced the release of documents prepared by the Joint Forum and endorsed by the Technical Committees of IOSCO and IAIS and by the Basel Committee. Of the total of seven papers accessible on the IOSCO (http://www.iosco.org) and BIS (http://www.bis.org) websites, one of the most interesting is the Capital Adequacy Principles paper which outlines for the supervisory community measurement techniques and principles to facilitate the assessment of capital adequacy on a group-wide basis for financial conglomer-

ates. The great concern of the paper is to alert supervisors to – and give them techniques to counter – the dangers of what is called "double or multiple gearing," where the same capital is used simultaneously as a buffer against risk in two or more legal entitities. The paper also is candid in that it states, at page 7, "Further progress on the elaboration and convergence of capital adequacy requirements in the insurance sector is however desirable, including for insurance groups." The IAIS is becoming more active and without doubt at some point in the future will be elaborating capital adequacy principles for internationally active insurance companies.

Finally, tucked into the recesses (at page 13) of the Joint Forum's Capital Adequacy Principles paper is a recommendation to supervisors which could have an effect on efforts to improve the efficacy of financial supervisory regimes in emerging markets. The paper suggests to supervisors that the value of a group's participation in a regulated dependent (as subsidiaries or affiliates are called) for calculation of regulatory capital held be set at zero, "if the regulatory competence of the dependent's jurisdiction is uncertain." If this suggestion were to be implemented by supervisors in capital exporting countries, then investment in an emerging market financial entity would be more expensive for the investor from the capital regime point of view, and the country seeking hard currency inflows would have an incentive to improve its supervisory regime.

C. Continuing Harmonisation Within the European Union

The EU remains a special case of harmonisation in the area of supervision of financial services, with a view towards ensuring a single common market within the EU Member States, consistent with Article 14 (new) EC Treaty (=Art. 7A EC old). Nonetheless, the EU experience remains very enlightening with respect to more global attempts at harmonisation and adoption of transnational standards. With respect to financial services, the common market should be seen as a common financial sector with unrestricted crossborder payments and capital transactions. As the Committee reported to the ILA at the Taipei Conference two years ago, the basic regulatory framework for the single banking and securities market in the EU has been completed, while much progress has been made with respect to insurance issues.

Specifically on the topic of the preceding discussion on the supervision of financial services conglomerates, developments within the EU have progressed further than in many other countries represented in the Basel Committee. Since 1993, consolidated supervision has been extended to company groups in cases where the mother company is classified as a holding company in the financial sector. Following the experiences with the BCCI case, the EU Commission prepared a directive on financial conglomerates including credit institutions, investment firms and insurance companies providing reporting requirements as well as specific measures in case of particular group structures. The aim is consolidated supervision of financial groups.

More generally, it can be said that the harmonisation of national regulations in accordance with Article 100a of the EU Treaty are designed to remove regulatory obstacles to market forces. Crossborder supply requires similar conditions for competition; crossborder demand requires similar standards regarding services and products. The principles underlying EU harmonisation can be summarized as follows: (i) harmonisation of minimum requirements only; (ii) homecountry control, on the basis of homecountry legislation and a EU-wide extension of banking licences; (iii) competition between the individual national banking systems; resulting in (iv) mutual recognition rather than mandatory harmonisation of national systems (to the extent the latter is necessary, this process should be driven by the mechanisms of competition); (v) cooperation of national supervisors; and (vi) liquidity requirements, monetary policy and measures of public order remaining within the host country's responsibility.

D. Further Topics on Supervision

The ongoing growth of the global derivatives markets continues to hold the attention of financial supervisors. Broadly speaking, derivatives transactions comprise financial contracts, the value of which depends on an underlying asset or index. Derivatives transactions can be employed as a useful risk hedging mechanism, in that a specific risk can be shifted to the party best able to bear it. Some financial actors invest in the derivatives markets for speculative purposes. The Basel Committee concluded that the risks posed by derivatives transactions do not differ fundamentally from the risks banks undertake in more traditional banking transactions, although the risk of an individual transaction can be more complex and difficult to assess. The Basel Committee has produced a report on risk management with derivatives.

Of particular note are developments in the field of credit derivatives, which consist of the following basic instruments: (i) total return swaps, in which any depreciation risk of an asset including both credit and market risk is transferred to a counterparty; (ii) credit default swaps, in which the counterparty assumes specific, predefined credit risks; and (iii) credit linked notes, whereby the credit risk of specific assets will determine the repayment of the notes. Both the Basel Committee and the EU are studying the subject of credit derivatives, based upon the principle that standard risk weights will only be reduced if there has been a true risk transfer. Interim solutions of bank supervisors (e.g. the 1996 Bank of England paper "Developing a Supervisory Approach to Credit Derivatives" and related regulation in Germany) tend to treat risk transfers like a guarantee from the counterparty. Similar questions regarding transfer of risks have arisen in the context of the more developed area of asset-backed securitizations.

Particularly in the wake of the LTCM hedge fund crisis in the United States in 1998, supervisors have turned attention to largely unregulated highly-lever-

aged institutions (HLIs). While HLIs can be said to contribute to the efficiency of financial markets, for example by seeking to exploit and thereby eliminate market inefficiencies which give rise to arbitrage opportunities, they also hold a potential for destabilisation of the financial markets, due in part to their interrelationship with banks and securities firms. In contrast to regulated banking institutions, which themselves may often be highly leveraged, some HLIs could unwind fairly quickly in times of crisis or extreme market fluctuations, due to their relatively small capital bases. While some arguments have been brought forward for direct supervision of HLIs (as well as for regulation to mandate reporting requirements and capital ratios), implementation seems unrealistic, because many of these institutions act off-shore. Therefore, most supervisors favor an indirect approach via regulation of HLI creditors. The Basel Committee has published a Code of Conduct for Business with Hedge Funds and Sound Practices for Banks‘ Interactions with Highly Leveraged Institutions (January 1999), with specific requirements regarding credit risk analysis. A US joint report on hedge funds by the Treasury Department, the Federal Reserve System, the SEC and the CFTC proposes that hedge funds should submit and publish quarterly reports on their market risks.

The fact that, historically, many sudden bank crises have been unleashed by liquidity problems argues for steps towards adaptation of minimum liquidity requirements. In practice, a financial institution could be required to match the maturity of its income stream with that of its payment obligations in order to prevent liquidity problems in an otherwise sound institution. The supervisory obstacle remains adequate surveillance of maturity matching. Keeping in mind, however, the close connections between liquidity regulation and monetary policy, governments tend to reserve liquidity requirements as their national responsibility. In the EU, the transfer of monetary policy to the European Central Bank has enabled the harmonisation of liquidity requirements. In other countries, experience has demonstrated that liquidity ratios based on matching maturities of assets and liabilities can be kept separate from the minimum liquidity reserve requirements related to central bank monetary policies. Therefore, a basis may be found for harmonisation within the supervisory field.

Finally, while not limited to the fields of monetary, banking and financial law, note should be taken of related harmonisation efforts. UNCITRAL continues its efforts with respect to the harmonisation of bankruptcy law. Additionally, progress has been made with respect to harmonisation of accounting and valuation standards. In the latter area, increased emphasis has been placed on transparency and market discipline as distinct from the earlier command and control style of regulation.

E. Conclusion

The Committee is pleased to be able to report that, although the work is far from finished, significant steps forward have been taken in the area of interna-

tional harmonisation of the supervision and regulation of financial services. The growth of cross-border activities by large financial institutions and breakdown of intersectoral barriers have necessitated progress and served to some extent to spur cooperation by national supervisors. Multinational groupings of supervisory experts are increasingly cooperating with one another, and numerous supervisory and regulatory topics have been identified as candidates for international harmonisation. The experience within the EU and the ripple effects among neighboring states continue to provide valuable experience and support for global harmonisation efforts. As is most clearly illustrated by the proposals to revise the Basel Accord, the process of international harmonisation remains a dynamic one, constantly striving to keep up with developments in the global financial markets.

Section III

European Economic and Monetary Union

While the first two sections of this report have focused primarily upon global developments, over the past few years the most noteworthy regional developments in the area of monetary, banking, and financial law, are undoubtedly those with respect to European Economic and Monetary Union and the introduction of the euro as the single currency. In its report to the ILA at the Taipei Conference, the Committee analysed in detail the two EU regulations defining the monetary status of the euro within the Member States. Subsection A of this report continues that analysis with further discussion of the principle of *lex monetae*. Subsection B then discusses the roles of the European Central Bank and national central banks within the European System of Central Banks, in terms of the legal framework and the experience gained through the early operations.

A. Effects of EMU Upon Monetary Law

Before entering into the legal discussion, it should be useful to review a chronology of important EMU events over the past two years since the Taipei Conference.

1. Chronology of EMU Events

- 1 September 1998, the Exchange Rate Mechanism Agreement (“ERM II”) is signed by all members of the ESCB.
- 26 September, Denmark and Greece decide to link their currencies to the euro by participating in the ERM II.
- 13 October 1998, the ECB decided that “price stability” is defined as a maximum increase in consumer prices of up to 2% per year.

- 3 November 1998, the ECB adopted the decisions necessary for the transfer by the NCBs to the ECB of the statutory amount of official foreign reserves.
- 22 November 1998, the EU Council adopted three regulations on reserve requirements that the ECB may impose on credit institutions, on ECB statistics, and on ECB sanctions.
- 1 December 1998, the ECB decided to fix a maximum monetary growth (M3) of 4.5% per year; it moreover established the full regime of reserve requirements for credit institutions by way of an ECB Regulation (OJ L 356, 30 December 98), and a full regime for the collection of money and banking statistics by way of another ECB Regulation (OJ L 356, 30 December 98); it made the decisions necessary for the subscription by NCBs of ECB's statutory capital.
- 21 December 1998, the Executive Board of the IMF decided that the ECB could send a representative to its meetings with observer status.
- 22 December 1998, the Governing Council of the ECB adopted the terms and conditions for the monetary policy operations of the Eurosystem, setting a main refinancing interest rate at 3%.
- 31 December 1998, the conversion rates at which the euro was to be substituted for the currencies of the eleven participating Member States (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, The Netherlands, Portugal and Spain) were irrevocably fixed, by way of EC Council Regulation 2866/98 (OJ L 359, 31 December 98).
- 1 January 1999, the Third Stage of the European Economic and Monetary Union began, and the single currency started its life.
- 4 January 1999:
  - — the first open market monetary policy operation took place, and since then the Eurosystem has been carrying weekly tenders, in addition to the standing facilities and the reserve requirements.
  - — the real-time payment system of the ESCB, named TARGET, started operations, processing a volume beyond initial expectations and similar to the volumes processed by the US Fedwire.
  - — the ECB received the statutory capital and foreign reserves from the NCBs.
  - — the money market started to quote euro-wide common interest rates of reference: the Euribor and the EONIA.

A huge redenomination of securities of all kinds into the euro took place during the New Year changeover weekend, and new issues of euro-denominated securities were announced to the extent that in January 1999 the amount of new issues of euro-denominated bonds surpassed the amount of new issues in any other currency of the world.

In general, the changeover into the euro was smooth, with no disruptions, no news about disputes over contract continuity, and thereafter no crucial events

merited special attention from a legal perspective. In April 1999 the ECB decided to lower the main interest rates from 3% to 2.5%; in November 1999 the ECB decided to increase them again to 3 %; in February 2000 to raise them to 3.25%; and in March up to 3.50%; and in April further up to 3.75%. These decisions showed a certain normality of the new institutional setup and the euro-wide approach of the Eurosystem decisionmaking bodies.

2. The Scope of the Lex Monetae

As these successive milestones were passed, the Committee was continuing its study of the implications of European Economic and Monetary Union on monetary law. In its report to the ILA two years ago on this topic, the Committee analysed the two Community Regulations related to the euro, namely EC Regulation 1130/97 addressing continuity of contracts, the replacement of the ECU, and the rounding rules; and EC Regulation 974/98 on the introduction of the euro. At the end of 1998 the third monetary regulation was adopted, EC Regulation 2866/98 on the conversion rates between the euro and the currencies being replaced by the euro. A wide interpretation of what is "monetary law" (which, however, is not undisputed) would include the set of these three regulations that have organised the introduction of the euro in eleven European countries.

A traditional approach to the concept of *lex monetae* is to be found in the classical work of the late Francis A. Mann (a long-standing member of the International Monetary Law Committee), *The Legal Aspect of Money* (5th ed., Oxford University Press 1992), where one may read that "the law of the currency determines which things are legal tender of the currency referred to, to what extent they are legal tender, and how, in case of a currency alteration, sums expressed in the former currency are to be converted into the existing one." According to Mann, each sovereign state possesses the exclusive sovereign power to determine what constitutes legal tender within its territory and what the nominal value of that currency is, and to replace the currency by a new one and fix the conversion rate of the old currency in relation with the new.

The European monetary union has given new elements to the traditional doctrine and scope of the *lex monetae*. The traditional view focused on "sovereign states" as the holders of monetary powers: *lex monetae* defined by reference to a certain national state. By executing the European Community Treaties, the Member States transferred to the Community the sovereign right involved in the doctrine of the *lex monetae*, so that the monetary legislators were no longer individual states but rather the Community itself. A closer look into the euro monetary regulations, however, reveals that this distinction is less clear than at first glance. On the one side, the transitory subsistence of national currency units induced the Community legislator to maintain the national monetary laws during the transition period. (Art. 6.1 EC Regulation 974/98: "Subject to the provisions of this regulation the monetary law of the participating Member

States shall continue to apply".) On the other side, the complexity of the introduction of the euro induced the Community legislator to delegate to the Member States the adoption of legislation regarding several aspects of the currency changeover, resulting in eleven national legal acts on the introduction of the euro adopted in the course of 1998 with different solutions to similar problems. (Articles 8.4 and 8.5 of EC Regulation 974/98, authorised participating Member States to legislate on redenomination of securities, of organised markets, of clearing and settlement systems and in other areas.) Finally, the minting of euro coins was only partially transferred to the European level – the power to limit the maximum amount of coins in circulation (ECB) and the power to harmonise denominations and technical specifications; apart from this, minting of coins is left to the Member States.

Another way in which EMU differs from the traditional application of *lex monetae* can be viewed objectively. Currency changes used to be rather straightforward: one new currency unit would replace the old one, and new banknotes and coins would be issued. Again here the European experience has innovated on several counts. First, not only fully-fledged currencies have been replaced by the euro, but also the ECU has been replaced by the euro. A basket of currencies, a "quasi-currency" to use the terminology of some authors, was converted, by way of a Community regulation, into a fully-fledged currency. Second, the "old" currencies did not fully disappear, but coexist with the euro for a rather lengthy period of three years. Legally re-characterised as "nondecimal sub-divisions" of the euro, but keeping their own sub-divisions (essentially decimal form), their banknotes and their coins. In spite of being sub-divisions of the same single currency, national banknotes and coins did not receive legal tender status in the euro zone beyond their original territories. Third, the new currency was a virtual currency, with no physical monetary manifestation. Perhaps for the first time in modern monetary history, a currency did not have its own banknotes and coins. The absence of banknotes and coins evidenced a change from the traditional means for determining legal tender within a territory. In instances where parties had agreed to allow payment and settlement by way of funds transfers to bank accounts, payment by euro would serve to discharge of monetary debts (see Arts. 8.3 and 8.6 of EC Regulation 974/98).

The euro regulations also implemented elements beyond the traditional scope of the *lex monetae*. The monetary regulations of the Community did not confine themselves to the issues that in the traditional view would have pertained not to the realm of the *lex monetae* – i.e., definition of the new currency, its monetary signs, and the "recurrent link" (conversion rates). Rather, the regulations touched upon the realm of contract law, i.e. the *lex causae*. EC Regulation 1103/97 contained a rebuttable presumption about the use of the term "ECU" in contracts. It also contained a presumption of contract continuity (also rebuttable: "subject to anything which parties may have agreed"). EC Regulation 974/98 included provisions entering the domain of contract law when referring to private debt redenomination.

A broad interpretation of the principle of *lex monetae* would include within its domain all rules enacted by the monetary legislator necessary to achieve a currency changeover or substitution. A narrow interpretation, on the contrary, would consider rules pertaining to the *lex causae* to fall outside the scope of the principle. Thus, non-monetary provisions would apply only in those cases where the *lex causae* coincided with the *lex monetae*.

3. Conflicts of Law

F.A. Mann posited: "As each State exercises sovereign powers over its own currency, and as there is no State which would legislate with reference to another country's currency, it must be the law of the currency (*lex monetae*) which determines whether a thing is money and what nominal value is attributed to it". Moreover, "the almost universal practice of the courts adheres to this rule. It is supported not only by the great majority of scholars but also by customary international law." (Mann, page 272). In support of the latter proposition, Mann demonstrated that the conflict of law rules of most countries follow the principle of *lex monetae*.

European monetary law, however, has gone beyond the traditional scope of *lex monetae*, entering into the domain of contract law. This raised a debate within the Committee about whether the principle of the *lex monetae*, as stated by F.A. Mann, would apply to the whole set of rules contained in the EU's three monetary regulations. A broad interpretation of the scope of *lex monetae* as encompassing all rules necessary for a currency changeover would include such EU provisions as those regarding the replacement of the ECU basket or expounding contract continuity. The implication of this broad interpretation is that as conflict of law provisions look to the *lex monetae*, these EU provisions might be considered to apply worldwide. Under a narrow, more classical interpretation of the scope of *lex monetae*, countries outside of the EU would not automatically apply such provisions to contractual matters and may legislate on their own about contracts having as their unit the ECU or currencies merging within the euro.

The EU Counsel, the European legislator responsible for the EU regulations, appears to have favoured the broad interpretation of the scope of the *lex monetae*. Paragraph 8 of the Preamble to EC Regulation 1103/97 states: "Whereas the introduction of the euro constitutes a change in the monetary law of each participating Member State; whereas the recognition of the monetary law of a State is a universally accepted principle; whereas the explicit confirmation of the principle of continuity should lead to the recognition of continuity of contracts and other legal instruments in the jurisdiction of third countries."

Outside of the EU countries, there is evidence that the scope of *lex monetae* is interpreted more narrowly. In some jurisdictions, it can be said that at a minimum there was uncertainty as to the how broadly a domestic court would interpret the scope of *lex monetae* in guiding it to resolve a dispute involving under-

lying obligations somehow affected by the introduction of the euro. Particularly in New York, discussions took place within the legal profession and the financial markets (groups such as the "Wall Street Committee on the Transition to EMU," the "New York EMU Working Group," and major market organisations such as ISDA, PSA-ISMA, and the "Financial Markets Lawyers Group") as to whether continuity of contracts involving a currency for which the euro would be substituted would not be better ensured by local legislation. Legislation was eventually passed in New York and elsewhere within the United States establishing the default rule that the introduction of the euro alone would not lead to discharge or frustration of a contract. (*See, e.g.,* New York General Obligations Law §§ 5-1601 to -1604; 1997 Illinois Laws 268; California 1997 CA A.B. 185; 12 Pennsylvania Consolidated Statutes § 9701; Michigan UCC §§ 440.1210 - .1211.). The only provision of Private International Law (i.e., conflicts of laws) directly addressing the issue of the scope of *lex monetae* is Article 147 of the Swiss Statute on Private International Law, which differentiates the domain of *lex monetae* from the contractual domain, leaving the first to the monetary sovereign and the latter to the *lex causae* jurisdiction. In any case, in examining to what extent European law provisions regarding the introduction of the euro should be given effect in other jurisdictions, it is essential first to consider the relevant conflict of laws rules of those jurisdictions.

4. *Further Developments in Private Law Prompted by EMU*

The Committee also considered the potential further developments in private law in reaction to the monetary union. The new dimension of the financial markets arising from the introduction of a single currency, on top of the important legislative steps taken hitherto by the EU to achieve the single internal market in financial services, is starting to affect the law of contracts applicable to financial relationships. Prior to the introduction of the euro, the financial market organisations adopted common "market conventions" that would apply to financial transactions. More or less informal groupings of major credit institutions (such as the Heathrow Group) adopted common rules for European-wide interbank relationships. Financial industry representative groupings such as the "Giovaninni Group" advised the European Commission on legal aspects of financial integration, namely in the domain of the capital markets. Other market gatherings, such as the ISDA Collateral Reform Group, the European Financial Market Lawyers Group, and the Financial Law Panel, have been active in trying to sort a common legal framework for cross-border securities operations. The European Banking Federation elaborated a standard European-wide master agreement for securities repurchase operations to avoid the use by domestic markets of different contractual instruments and thus to facilitate cross-border repo operations.

The European Commission prepared a "Action Plan for Financial Services" that included a list of projected legislation purported to remove legal and

administrative barriers to the further integration of the single market in financial services. The Action Plan addressed both wholesale and retail markets as well as regulatory and supervisory structures. In order to implement the specific recommendations of the Action Plan with respect to legislation on collateral, the European Commission organised a "Forum Group on Collateral Law Reform," the purpose of which is precisely to prepare legislation harmonising the law of collateral in the financial markets. Finally, the regulators and supervisors of the securities markets organised themselves into a new European-wide association, the Forum of European Securities Commissions (FESCO), which started work precisely with the purpose of promotion of legal harmonisation of securities markets.

The single financial market remains a disjointed one, to the extent that it consists of eleven (and perhaps quite soon more) national jurisdictions and legal systems. Differences in law can have a distorting effect, and it is in the interest of market participants to achieve sooner rather than later a level playing field with a common set of rules.

B. Legal Framework of the European System of Central Banks

In addition to the monetary law issues raised by the introduction of the euro, the structure and roles of the European Central Bank ("ECB") and national central banks ("NCBs") within the European System of Central Banks ("ESCB") raise their own questions of international monetary and financial law. From a legal perspective, the ESCB differs starkly from the central bank structure common to many countries where one central institution operates branches throughout the country's territory. While similarities can be drawn to a federal central banking system such as that of the Federal Reserve in the United States, ESCB remains unparalleled in its transcendance of the legal systems of the 15 EU Member States. This section of the report seeks to outline the more important characteristics and bases of the legal framework for the ESCB with respect to the implementation of monetary policy.

The monetary and exchange rate policy decision-making powers of the national central banks (NCBs) passed to the ESCB on 1 January 1999. As an integral part of the ESCB, the NCBs of the participating member states act in accordance with the guidelines and instructions of the European Central Bank (ECB) (Article 14.3 of the ESCB Statute). These guidelines and instructions are set down by the ECB's decision-making bodies, in particular its Governing Council, to which the governors of the NCBs belong.

1. Monetary Policy Instruments

The primary legislation of the Community explicitly prescribes the monetary policy instruments to be used by the ESCB to maintain price stability. These prescriptions are laid down in the Statute of the ESCB and the ECB. Annexed

as a protocol to the Treaty establishing the European Community (EC Treaty), the Statute shares the Treaty's legal status of primary legislation, as per Article 311 of the EC Treaty (ex Article 239). The Statute mentions open market and credit operations (Article 18) and minimum reserves (Article 19), gives the ECB and the NCBs the right to establish relations with third countries and international organisations, and allows foreign exchange transactions for monetary policy purposes (Article 23). Under Article 107(6) of the EC Treaty (ex Article 106), the EU Council shall define the scope of certain ECB activities under the Statute. The ECB may then supplement the framework thus provided with legislation of its own. According to Article 20, first subparagraph of the ESCB Statute, the ECB Governing Council can, on the basis of a two-thirds majority, decide upon the use of other monetary policy instruments not previously provided for. The ESCB at a minimum should have at its disposal the instruments necessary to fulfil its role of maintaining price stability (Article 105(1) of the EC Treaty).

In September 1998, the ECB Governing Council presented the general documentation on ESCB monetary policy instruments and procedures, which had been prepared by the European Monetary Institute (EMI) in 1997. From this documentation one can infer that open market policy was intended to play a special role among monetary policy instruments, not least because of the commitment to the principle of an open market economy with free competition. Open market policy is also accorded greater significance through the simple fact that the ECB interprets the term more broadly than the national central banks, in particular the Bundesbank, did previously. The Bundesbank used to describe open market policy as simply "the purchase and sale of securities by the central bank for its own account on the open market". The granting of credit by the Bundesbank to the credit institutions by means of the purchase of bills (rediscount credit) and the lending collateralised by securities (lombard credit), on the other hand, were seen by it as part of refinancing policy. The Bundesbank has now recharacterised its refinancing operations consistent with ECB policy.

In the area of refinancing policy in the narrower sense, the ESCB provides two standing credit facilities for the counterparties to draw on. These are the so-called main refinancing facility, used to provide overnight liquidity against collateral, and the deposit facility, which allows credit institutions to make overnight deposits. The prevailing interest rates usually mark the ceiling and floor of the day-to-day money rate and thus influence market activity.

Another monetary policy instrument at the ESCB's disposal is the minimum reserve. According to Article 19.1 of the ESCB Statute, credit institutions must hold deposits with the ECB and the NCBs. The holding of minimum reserves affects the credit institutions' liquidity and thus constitutes a control mechanism in that the ESCB can influence money market rates. In the banking industry, this minimum reserve is regarded as largely competition-neutral, because the deposits earn interest, in contrast to their former non-interest bearing nature under, for example, the relevant Bundesbank regulation.

The use of these monetary policy instruments should be based on a strategy whose main elements are the quantitative definition of price stability and the predominant role of the money supply alongside a broad-based consideration of economic indicators. The relevant decision by the ECB Governing Council defines price stability as a year-on-year increase in the harmonised index of consumer prices (HICP) in the euro zone of less than 2%. In contrast to the previous criteria used by the NCBs, in particular the Bundesbank, which gave priority to the money supply, the ECB's monetary policy strategy is thus also oriented towards an inflation target. Unlike, for example, the central banks of the United Kingdom and Sweden, the ECB does not pursue a direct inflation target.

Article 105(1), third sentence of the EC Treaty acquires particular significance as regards the handling of monetary policy instruments. Under this article, the ESCB acts "in accordance with the principle of an open market economy with free competition". The primacy of market-based instruments is thus clearly expressed. Since 1 January 1999 this has also applied to the activities of the NCBs within the ESCB framework. The above article could be interpreted to mean that a departure from the principle of an open market economy has to be justified, at least in the area of exchange rate policy.

2. *Monetary Policy Implementation*

The definition of the monetary policy strategy and instruments is the responsibility of the ECB Governing Council, within the framework of the stipulations of the primary legislation and the Council (Article 12.1, first subparagraph of the ESCB Statute). The NCBs are thus left with little scope to take their own decisions. The implementation of monetary policy, on the other hand, will largely be the domain of the NCBs. The sheer ratio of staff numbers – some 60,000 at the NCBs versus less than 1000 at the ECB – makes it clear that a centralised implementation of monetary policy would, with few exceptions, be technically impossible. By law, however, monetary policy implementation falls within the competence of the ECB's Executive Board. The Board in this respect acts in accordance with the guidelines and decisions laid down by the Governing Council (Article 12.1, second subparagraph, first sentence of the ESCB Statute). The second sentence of the same provision empowers the Executive Board "in doing so", in other words, in implementing monetary policy, to give the necessary instructions to the NCBs. Article 12.1, third subparagraph of the ESCB Statute adds: "To the extent deemed possible and appropriate and without prejudice to the provisions of this Article, the ECB shall have recourse to the national central banks to carry out operations which form part of the tasks of the ESCB."

The contracting parties to the Maastricht Treaty have thus given the ECB the power to make use of the NCBs and their apparatus. Article 12.1 of the ESCB Statute complements Article 14.3 of the ESCB Statute, which sets out the cor-

responding obligation on the part of the NCBs as a counterpart to the authority of the ECB. This once again highlights the very extensive integration of the NCBs into a hierarchical structure of the Community central bank system, with the attendant changes in and losses of functions. Yet this same Article 12.1, third subparagraph of the ESCB Statute can be understood not just as an authorisation. It also raises the question of the potential right of the NCBs to be involved in the implementation of monetary policy. Referring to the general subsidiarity principle of Article 5 of the EC Treaty (ex Article 3b) does not help us any further in this regard. Despite the involvement of the NCBs, monetary policy falls within the exclusive competence of the Community. However, Article 5(2) of the EC Treaty limits the scope of the subsidiarity principle to precisely those areas which do not fall within the exclusive competence of the Community.

In light of this, one could view Article 12.1, third subparagraph of the ESCB Statute as a special expression of the subsidiarity principle, and, therefore, contemplate a legal obligation on the part of the ECB to involve the NCBs in the implementation of monetary policy. Under that premise, centralised implementation would be permissible only if the participation of the NCBs were deemed to be impossible or inappropriate. This view is not uncontroversial.

Article 12.1, third subparagraph of the ESCB Statute applies only “without prejudice to this Article”. The formulation highlights the primacy of the distribution of competences set out previously. Another factor weighing against the idea of whether a right to participate in monetary policy implementation would ultimately also be legally enforceable is the fundamental relationship between the ECB and the NCBs. The division of responsibilities is an internal process within the ESCB.

Article 237 of the EC Treaty (ex Article 180) makes provision only for the ECB to institute proceedings against the NCBs for failure to fulfil an obligation in the event of a dispute within the ESCB. Otherwise the ECB would not be able to enforce instructions in cases of dispute. The NCBs, on the other hand, can exert substantial influence on the decisions of the ECB owing to the numerical superiority of their governors in the central decision-making body – the ECB Governing Council. This is a point in favour of not regarding internal ECB decisions, or at least not the internal division of responsibilities, as justiciable. Moreover, ECB instructions and guidelines can be contested only when they affect an NCB directly and individually.

As this analysis shows, the legal framework of the ESCB in the context of implementing monetary policy is not only unique, but also based upon extensive provisions of law.

The early experience of the operations of the ESCB have shown this to be a workable framework that has successfully assumed the role of implementing monetary policy at a multinational level. The sole remaining hurdle in the full transition to the euro will be the introduction of euro banknotes and coins from the beginning of the year 2002.

Section IV

Impact of Electronic Money and Finance on Monetary Law

While the experiences with respect to European Economic and Monetary Union have provided the Committee a perfect case study of changes in monetary law, the Committee is also interested in keeping abreast of more gradual and perhaps less immediately visible changes in the field. Although the world is not yet ready for abolition of currency in a physical manifestation (as evidenced by the development of euro banknotes and coins), in value terms, credit transfers, largely by electronic means, have long since surpassed exchange in physical form. The Committee has devoted attention to the rapid growth in the number and outstanding value of different forms of electronic money, such as digital cash and stored value, and various measures designed to ensure the veracity of electronic payments, such as digital signatures. The Committee study recalls many previous stages of technological evolution playing a leading role in the development of the financial markets and the laws that govern them.

Experience has shown that only a few of the new payments products and services will be accepted to become widely available throughout the markets. In this context, it is important that the legal framework does not stifle innovation, and, as such, it is not the role of the Committee to favor any one product or service over another. That notwithstanding, more generally, the evolution of electronic money and increasing focus upon electronic commerce can be expected to lead to changes in monetary and financial law. (This Section of the report was prepared by Thomas C Baxter, Jr, who wishes to acknowledge the assistance of Denley YS Chew.)

A. Electronic Money Developments

We are now at an epochal time in the history of electronic money and electronic payment and funds transfer systems. The previous three decades witnessed a relatively slow evolution in adapting the computer (first the mainframe, then the personal computer) to facilitate, and in some cases replace, existing payment systems to gain efficiencies. This adaptation was particularly successful with the highest value transfers of monetary value. Then, in the five years immediately preceding the Millennium, there was a virtual explosion of practical, usable innovations with respect to the creation of new retail digital currencies and radically redesigned payment systems for lower value transfers, many of them internet-focused. The mere fact that these electronic money products rarely relied upon an implicit or explicit backing of the sovereign, or rarely enjoyed the benefit of laws formally declaring the new digital currencies acceptable as legal tender, did not inhibit significantly new digital currency systems.

At the Millennium change, however, it became more and more apparent that some digitally related predictions had been somewhat less than accurate. The hope for the "new" money proved no match for the reality of the old. Consumers and businesses showed continuing preference for the old way of exchanging paper rather than electrons, or else they migrated to the use of "electronic" money in ways that had long pre-dated the popular growth of the internet, such as vastly increasing their purchases using existing credit card networks. Once highly-touted stored value card systems proved successful only in tightly bounded networks, such as military bases or university campuses, with a single overarching seller of goods and services, and only for relatively small sums. Many of the earliest digital currency pioneers, despite seemingly fail-proof business models, became insolvent, were bought out by competitors, or, in character with true internet organizations, changed almost overnight into entities that devoted themselves to unrelated or marginally-related products.

B. Early Implications

Central banks, financial supervisors, and consumer protection agencies kept a watchful eye on these developments. Their concerns (which the Committee identified in detail in its report to the ILA at the Taipei Conference) became well-known. Central banks focused on conceptual concerns such as their ability to implement monetary policy, loss of revenue from seniorage, loss of ability or accuracy in forecasting and managing national monetary aggregates, as well as loss of economic confidence or genuine national wealth in the case of an insolvency or liquidity crisis suffered by a large private sector issuer of electronic currency. Other supervisors additionally compared new issuers of electronic money with traditional, regulated financial institutions, and raised money laundering and counterfeiting concerns. Consumer protection agencies were concerned about the public's ability to use and monitor the systems easily, and the extent of the risks borne by unknowing users.

In general, a "wait-and-see" approach was followed, allowing the private sector take the lead with respect to creating and experimenting with the newest forms of electronic currencies. Despite some mild entreaties from some segments of the private sector for a governmental or semi-governmental imprimatur, central banks and financial supervisors decided instead to refrain from giving too much explicit direction or instruction. Instead, they gave only unofficial "guidance" in a few instances, particularly when law enforcement concerns arose. Some central banks and government finance ministries did limit the issuance of "electronic money" to licensed credit institutions while adding a few modest regulations. Other sovereigns applied existing deposit-taking rules to new electronic money issuers, but otherwise took no further action. Still others took no action at all. When the first wave of digital currencies receded, the initial reticence to become deeply involved in digital currencies proved prescient. Nonetheless, a high degree of caution and watchfulness remained, and

for some central banks and supervisors, so too did a desire to adopt a decidedly more pro-active policy towards the issuers of electronic money.

C. The Second Generation of Electronic Money

When the early digital currencies failed to take hold, a new set of private sector digital currencies quietly began to emerge. This "second generation" of electronic money innovators began with somewhat less publicity, but only marginally narrower ambitions than their predecessors. In this second generation have been some truly creative innovators whose ideas dealt directly with the perceived flaws of the first wave of digital currencies. Most of the newer digital schemes have based their final clearing and settlement mechanisms on existing payment system accounts, such as bank demand deposit accounts or bank credit card accounts (collectively, "Bank Accounts"), and have then tried to add specific innovations designed to enhance desired characteristics, such as speed and/or privacy. Of these new systems, some require clearing and settlement among existing Bank Accounts for consumers or businesses after each transaction, and so may be characterized as offering a new, enhanced electronic "access" or "instruction" system. Other new systems have required only a periodic net settlement among the Bank Accounts of users. These systems create digital tokens, embedded either in computer hard drives or on stored value cards, which permit users to access and re-transfer value to other users on the system administrator's books. To begin operating, these systems require only the initial transfer of value from a system user's Bank Account to the system administrator's Bank Account.

Other characteristics have varied widely from individual system to system. Among the many digital token systems currently functioning, transfers may be reversible or final when made; transfers may be guaranteed and insured, or not; transferors may be known or anonymous; and transfers may be limited to those between consumers and merchants, or to all users in the system. Transfers of value have also been limited in various systems by medium: from stored value card to computer or card reader, from stored value card to stored value card, from computer to computer, or from some larger combination of the above.

Adding still to the proliferation of new digital currency systems have been electronic currencies that are created and credited without any initial transfer of value from the traditional banking system. The systems behind these electronic quasi-currencies have in effect created a new kind of digital script to be earned, exchanged or redeemed only within a closed system of merchants and consumers. This type of digital "rebate" currency, mostly internet-based and earned through purchases at favored on-line merchants, visits to specified web-sites, or completion of on-line surveys, is usually able to be converted into governmentally backed legal tender or transferable Bank Account credit, but only at something less than par value. The precise terms of convertibility depend upon whatever the currency's issuer is willing to offer to various classes of users. Among

the most innovative of this category of new electronic money systems have been systems designed to convert some of the three trillion unused frequent flier miles that have accumulated since the creation of airline frequent flier programs into direct Bank Account credit, or into expanded merchant discount credit. Among the most unusual of these new systems have been digital payment systems based entirely on the exchange of digital warehouse receipts for gold bullion, thereby satisfying those with a need to anchor their digital currency to a rare physical commodity.

Finally, some pure technologists adopted the goal of first wave innovators in seeking to advance a new, universally accepted digital currency. But instead of creating and managing the currency themselves, these technologists have patented and seek to license to others the technology needed to create a universal digital currency. It is worth noting that, in some of the newest technologically-focused systems, *any* digitally-reducible item, such as confidential information or a new song or movie, is able to use the basic technology of the system for rapid and secure transmission and re-transmission across unsecured open networks, such as the internet. It may be music, more than money, that will determine the success or failure of the technologists and their systems.

D. Differing Regulatory Responses

Unlike the generally muted reaction by central banks and supervisors to the first wave of digital currencies, the response to the second proliferation has been more varied. Even after the first wave of digital currencies were recognized as unsuccessful, a number of central banks and supervisors began the often lengthy processes needed to create and impose a more concentrated regulatory scheme on issuers of electronic currency, focusing on the core areas of concern expressed earlier. In particular, the European Central Bank issued a report on the issuance of electronic money, stating that it would be essential for issuers of electronic money to meet minimum requirements in the following areas: regular banking-type governmental supervision; consumer protection rules such as those that mandate clear and complete disclosure obligations; minimum technical and operational controls; permanent auditability for transactions and other protections against criminal abuse for crimes such as money laundering; reporting requirements to the central banking authorities for relevant economic and statistical data; reserve requirements; and legal obligations to redeem private digital currency for a particular sovereign's legal tender, at par. In addition, two other desirable objectives were listed in the report of the European Central Bank: interoperability requirements with other issuers of electronic money; and insurance, guarantee, or loss-sharing schemes to guard against insolvency or liquidity risk by electronic money issuers. Shortly thereafter, the European Commission proposed a new directive on electronic money, calling for the introduction of a minimum set of harmonized prudential rules for electronic money issuance, and the mutual recognition of home supervision provided for

in the European Commission Second Banking Co-ordination Directive (89/646/EEC) to electronic money institutions. In late 1999, the Council of the European Union adopted two common "positions" with a view toward adopting these Directive.

In contrast, other central banks, notably the Board of Governors of the Federal Reserve System, have informally reiterated the policy position that the market should judge the viability of the newest wave of electronic and digital currencies, and regulation should come later, and then only when the need clearly arises. Given these different views among central banks about electronic money and the improbability of finding a quick consensus, it is not clear what, if any, regulations may be applied to entities located in jurisdictions where the regulatory requirements are minimal, but whose digital currency is widely used across open networks in multiple jurisdictions. Adding to this uncertainty is how central bank or supervisory regulations would apply to the plethora of digital currencies recently launched. Would they necessarily apply to systems based upon airline frequent flyer miles? If so, how should this regulatory framework be reconciled with digital tokens representing value in prepaid telephone stored value cards, which, despite their enormous popularity worldwide, have thus far been unregulated by the world's central banks?

E. Conclusion

These issues point at the very least to a fascinating period in the history of electronic money. Some believe the second wave of electronic money and digital currencies will prove vastly more successful than the first. Others remain far more skeptical. While it is true that neither major success stories nor significant systemic problems have yet appeared, it is also true that the worldwide growth of so-called "e-commerce" is rising at a rate far exceeding the growth rate of most national economies. One senses that digital currencies will soon make some sort of impact on the worldwide economy, either positive or negative, as this growth rate continues to rise.

The Committee believes that these developments will have implications for monetary law. Central banks and supervisors will increasingly be faced with decisions over tradeoffs between the costs of regulating new developments at the risk of stifling innovation and the expected benefits and protections such regulations would bring. Evaluating these decisions will require thinking beyond the realm of traditional categories of monetary, banking and financial law. Furthermore, international cooperation should be encouraged to respond to the electronic money phenomenon which transcends national boundaries.