# Conference on Monetary and Financial Law

On Friday 16 May 2014, the Bank of England's Legal Directorate, in association with the Centre for Commercial Law Studies at Queen Mary, University of London, hosted its second annual Conference on Monetary and Financial Law.[1] The aim of the conference was to give central bankers and regulators, academics and practitioners — both lawyers and non-lawyers — an opportunity to take stock of international regulatory reform, five years after the Pittsburgh Group of Twenty (G20) meeting outlined an international response to the global financial crisis. Participants included staff from across the Bank; lawyers and other staff from financial regulatory bodies and other central banks; senior academics from the United States and the United Kingdom; and lawyers at law firms specialising in financial regulation.[2]

At the start of the conference it was noted that, as a result of the financial crisis, Government and Parliament have given the Bank a significant suite of new powers to protect and enhance the stability of the UK financial system. These powers include macroprudential authority, with the establishment of the Financial Policy Committee as a sub-committee of the Bank's Court; resolution authority for banks, bank holding companies and central counterparties; microprudential regulatory and supervisory responsibilities for deposit-takers, insurance companies and major investment firms through the Prudential Regulation Authority; regulatory responsibilities for central counterparties and securities settlement systems; and statutory oversight of recognised payments systems.

Each of these new regulatory responsibilities is derived from, and constrained by, law. As a result, understanding the legal framework underpinning money and finance is important for the Bank to achieve its mission of promoting the good of the people of the United Kingdom by maintaining monetary and financial stability.

The conference spanned four main sessions with the following titles:

(1) Taking stock of the international regulatory reform agenda;

(2) Divergent approaches in regulatory law — centralisation and diversity;

(3) Resolution as the fourth pillar of Basel III[3] — the impact of recovery and resolution on supervision policy and practice; and

(4) Alternative currencies, payment systems and finance providers.

The conference was held under the Chatham House Rule. The views expressed in this report do not represent the views of the Bank of England.

## Session 1: Taking stock of the international regulatory reform agenda

The first session began with a keynote speaker assessing progress made in the past five years to overhaul the global financial regulatory system. The speaker discussed reform initiatives that have been taken, or are in train.

Global regulatory reform efforts with the objective of promoting financial stability have been spearheaded by the Financial Stability Board (FSB), which provides global surveillance of the financial system. The speaker noted that the FSB operates through setting standards and providing guidance — so called 'soft law' — rather than by making binding legal rules (or 'hard law'). This point was considered again at length during the second session.

The speaker then enumerated many of the regulatory reform initiatives that have been undertaken internationally in the past five years. These include stronger cross-border oversight of financial firms and contingency planning through the establishment of regulatory colleges; the agreement and implementation of Basel III in order to establish new and improved capital and liquidity arrangements for credit institutions; the mandating of central clearing for certain 'over-the-counter' (OTC) derivatives; the development of a maximum leverage ratio as a complement to capital requirements calculated by risk-weighting assets; and the development of a framework to tackle the problem of 'too big to fail', including a framework for identifying global

(1) This report was prepared by Jonathan Grant and Jendy Zibin of the Bank's Legal Directorate, David Bholat of the Bank's Advanced Analytics Division and Sabrina Boukaddour, formerly of the Advanced Analytics Division. The next conference is scheduled for May 2015.
(2) The conference was organised by Rosa Lastra, Professor in International Financial and Monetary Law, Centre for Commercial Law Studies, Queen Mary University of London; Jonathan Grant, Bank of England; and David Bholat, Bank of England.
(3) *Basel III: A global regulatory framework for more resilient banks and banking systems 2010* (revised version June 2011) developed by the Basel Committee on Banking Supervision sets out global regulatory standards on bank capital adequacy and liquidity to strengthen the regulation, supervision and risk management of the banking sector.

systemically important financial institutions (G-SIFIs), ensuring that every jurisdiction has a resolution regime capable of ensuring that the critical functions of these G-SIFIs can continue, while ensuring that they can be recapitalised without recourse to taxpayers (through the use of shareholders' capital and/or through creditors being 'bailed-in').

But further progress on global regulatory reform is still required. Participants noted four main issues currently preoccupying central bankers and regulators:

(1) **Implementation of FSB standards**. The FSB has no power to compel member states to implement G20 commitments — for instance, in cases where domestic political pressures constrain member states' ability to deliver on G20/FSB commitments. Given the scale of the financial crisis, participants debated whether the FSB should evolve into a body with legal powers to enforce commitments.

(2) **Common rules for valuing financial instruments**. Some participants argued there is a need for a consistent approach to the valuation of financial instruments in order to come to a common assessment among regulators about the risks faced by firms. A transparent and consistently applied approach to the valuation of banks' assets, particularly for illiquid and complex assets, might improve confidence in banks' balance sheets and might reduce the potential for mispricing risk. A couple of attendees noted the definition for non-performing loans as a fundamental measure where it might be beneficial to have harmonised definitions.

(3) **Shadow banking**. Some participants noted that, as regulatory scrutiny increases on banks, certain financial activities are likely to be undertaken by non-regulated so-called 'shadow banks'. For example, one participant noted the growth and size of the shadow banking market in China, and the size of assets under management in the investment funds industry.

(4) **Commitment to regulatory reform**. Some participants noted that, in the period immediately after the financial crisis, there was momentum for regulatory reform. Now, as economic growth starts to return and memory of the crisis fades, some participants were concerned that the reform process might stall.

At the same time, a few participants argued that there are too many supervisory and resolution authorities applying too many complex and variable regulations to banks. Some argued that streamlining agencies and regulators would be beneficial (though supporters of this view conceded that it was unlikely to be achieved easily in practice). Other participants agreed that more cross-border co-operation was highly desirable, with the number of cross-border crisis management groups for G-SIFIs as evidence of this intent. However, many participants noted that significant barriers to co-operation remain, including regulators not sharing data and the absence of a global cross-border insolvency regime for financial firms.

## Session 2: Divergent approaches in regulatory law — centralisation and diversity

If the first session focused on *what* has been done, and remains to be done, in terms of international financial regulatory reform, in the second session the focus turned to the issue as to *which* institutional means are best for achieving the ends of monetary and financial stability.

Participants noted that, at an international level, the regulatory reform agenda largely has been pursued through the use of 'soft law' issued by bodies such as the FSB and the Basel Committee.

The alternative to 'soft law' is 'hard law', where international institutions make legally binding rules. International trade rules, made under the auspices of the World Trade Organisation (WTO), are an example of international 'hard law'.

Some participants argued that a 'hard law' approach would lead to greater centralisation in decision-making and therefore greater consistency in financial regulation across countries. The trouble is that, because 'hard law' rules are legally binding, it may be much more difficult to obtain agreement on them.

In contrast, it may be easier to obtain international agreement to 'soft law' that is not legally binding and can be adapted to suit local laws and conditions. The upshot is a diversity of approaches internationally and therefore the opportunity to learn from differences. However, as one participant noted, one jurisdiction's adaptation of 'soft law' to reflect the local environment may be regarded by other jurisdictions as non-compliance.

One participant noted that the 'hard law' versus 'soft law' debate defines a spectrum rather than a rigid dichotomy. International 'soft law' standards are frequently implemented into supranational eg European Union (EU) or national laws via 'hard law' legislation. For example, the 'soft law' standards of Basel III have been implemented in the EU by the 'hard law' CRD IV Regulation[(1)] and Directive.[(2)]

(1) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms (http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN).
(2) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036&from=EN).

Short presentations by various participants considered these issues from four perspectives: (1) in light of the recent European sovereign debt crisis; (2) the current nature of 'soft law' arrangements; (3) the differing approaches being taken in the United States, EU and United Kingdom to deal with the 'too big to fail' problem; and finally (4) in light of the new Single Supervisory Mechanism in the EU.

### European sovereign debt crisis

A principal lesson from the eurozone crisis concerns the growing importance of collective action clauses (CACs). CACs permit a majority of bondholders to agree to restructure the terms of outstanding debt, with binding effect on dissenting creditor minorities. CACs have been a standard feature of bond documentation in English law since the 19th century, and more recently have become a standard feature in US bond issues. Recent developments include CACs having provisions so they can be invoked in aggregate (rather than invoking them separately for each bond issue). Aggregating a sovereign's bondholders into a single class makes it harder for creditors who object to the terms of the restructuring to delay or prevent the restructuring. For this reason, the European Stability Mechanism (ESM) treaty now makes it mandatory for all new eurozone sovereign bonds to include standardised and identical CACs from 1 January 2013.

One speaker suggested that there should be an international legal mechanism for dealing with sovereign debt restructurings. The International Monetary Fund (IMF) has proposed a sovereign debt restructuring mechanism (SDRM), but it is an idea which has yet to gain traction. An alternative to an SDRM, in the EU context, would be to amend the ESM treaty so as to require all sovereign debt issuances to have a clause stipulating that, where a sovereign debt restructuring is supported by the ESM and has 75% bondholder approval, any creditor who declines to participate in the restructuring cannot enforce its security in the eurozone.

### 'Soft law'

On the topic of 'soft law', one attendee argued that the old (post World War II) era of multilateralism is giving way to a new era of 'mini-lateralism' such that historically dominant multilateral organisations no longer monopolise economic affairs. The attendee noted that the previous multilateral era was defined by: aspirations to involve all countries in global initiatives when possible; the use of formal international legal organisations to solve problems; and an international economic system based on the US dollar. Now, the attendee argued, countries are resorting to 'mini-lateral' strategies like trade alliances and informal 'soft law' agreements to manage their stake in the global economy.

### Volcker/Liikanen/Vickers

One area where some participants considered there is potential for divergence internationally is with respect to the structural separation or prohibition of some activities undertaken by banks. In the United Kingdom, the Independent Commission on Banking Standards, chaired by Sir John Vickers, proposed the ring-fencing of vital banking services from investment banking and related activities. These proposals have now been taken forward in the Financial Services (Banking Reform) Act 2013. In the EU, the European Commission, following the Liikanen report, has proposed introducing a ban on proprietary trading activities and powers for supervisors to require the separation of certain trading activities from a deposit-taking entity within the banking group. And in the United States, the so-called Volcker rule, enshrined in the Dodd-Frank Wall Street Reform and Consumer Protection Act, prohibits banks from engaging in proprietary trading, and from owning or investing in certain types of funds. Where there are these differences in approach, some participants wondered how international firms will co-ordinate their compliance with Volcker, Vickers and Liikanen. One speaker also noted that while big banks in these jurisdictions might eventually not engage in proprietary trading, these activities may not disappear. Rather, these activities may migrate to jurisdictions without such rules or be undertaken by non-regulated shadow banks.

### EU Banking Union

One participant noted that EU Banking Union is a good example of an incremental approach to regulatory harmonisation.

Establishment of the Banking Union will see the transfer to the European Central Bank (ECB) of supervisory powers over banks established in EU Member States who are members of the Banking Union (those in the eurozone and those that opt in to the Single Supervisory Mechanism (SSM)). Where, for legal or practical reasons, it has not proved possible to include aspects of the Banking Union arrangements in EU legislation, Member States are now turning to inter-governmental agreements (IGAs) to complete the arrangements. An example of this is the IGA establishing the Single Resolution Fund (part of the Single Resolution Mechanism pillar).

One speaker raised the future role of the European Banking Authority (EBA) given the ECB's expanded SSM powers. In response, another participant stated that the EBA will continue to have an important role in developing technical standards under CRD IV for the whole of the EU, rather than just Banking Union participant Member States. This speaker also noted that the EBA could be a useful mediator between the concentric layers of eurozone and EU Member States if disagreements arise in the course of the application of rules, as such rules (including the EBA's standards) will apply to all EU banks, whereas the Banking Union SSM only applies to a subset of banks where the Member State is part of Banking Union.

### Concluding observations

At the close of the session, there was some discussion about the lack of a WTO-type body in the international financial regulatory arena. Countries (and their regulatory authorities) have no forum where they can make a formal legal complaint if another country is not complying with the agreed international rules. Some attendees argued that a treaty basis or 'hard law' is needed for this to happen, while other attendees suggested the WTO functional approach may be a good model for financial regulators to pursue, which would require identifying which regulatory functions would be most effective at a national level and which would be most effective at an international level.

## Session 3: Resolution as the fourth pillar of Basel III, the impact of recovery and resolution on supervision policy and practice

The session on resolution considered the impact of recovery and resolution planning on supervision policy and practice. The chairperson of this session suggested that resolution had been effectively added as a fourth pillar onto the existing three Basel III pillars (Pillar 1: Minimum capital, liquidity and leverage requirements; Pillar 2: Supervisory review process; and Pillar 3: Market disclosure), but noted that questions remain about how resolution fits with the existing supervisory model.[1]

Many participants identified cross-border issues as critical for effective resolution, such as whether home and host state regulators have confidence in each other and share information. There was a general consensus that an international bank resolution strategy requires co-operation between national regulators and resolution authorities, crisis management groups for each bank, Memoranda of Understanding, and structural decisions regarding how different domestic recovery and resolution plans (RRP) fit together as part of a coherent international strategy. For example, a global firm could have a US RRP and a UK/EU RRP. If the conceptual framework and standards of these were inconsistent, that could pose problems during resolution. Complexity was identified as another potential problem. One participant observed that some RRPs can run to 10,000 pages, and questioned how realistic it was for such a plan to be used to resolve a firm in a short period of time.

In the EU, the Bank Recovery and Resolution Directive (BRRD) is focused not just on depositor interests, but also on the continuity of financial services and minimising the use of taxpayer money to bail out banks. One speaker suggested that this impacts supervisors by moving them from a compliance-based model regarding capital, to a more granular model where supervisors need to consider whether capital enables a bank to withstand shocks. Facilitating resolvability is a judgement-based area for supervisors — and will be a relevant consideration in assessing firms' recovery plans and their overall business strategy.

The BRRD provides for going-concern loss-absorbing capacity (GLAC) in the form of a Minimum Requirement for own funds and Eligible Liabilities (MREL) as a means to recapitalise and stabilise banks when they enter resolution. Three main points were made regarding GLAC: (1) that it needs to be at the right point in the firm structure, being the point of entry into resolution; (2) that adequate GLAC should increase confidence of market participants and prevent host authorities from imposing excessive capital requirements; and (3) that while GLAC may comprise unsecured liabilities that could be converted into equity in resolution, it should not be interpreted as third-tier capital.

The session considered 'single point of entry' (SPE) resolution strategies, where resolution tools are applied to a single entity within a group, usually the group holding or parent company. One speaker noted that, to work well, SPE strategies needed close engagement between the home and host authorities at the planning and implementation level. SPE would be implemented only where host and home authorities co-operate in determining the non-viability point and bail-in levels. With a 'multiple point of entry' (MPE) strategy, there is less reliance on the home state, as both home and host states have a role in the resolution.

One participant stressed that the differences between SPE and MPE resolution strategies can be overdrawn. They argued that the most important issue is whether there is enough GLAC at each point of entry to recapitalise each subgroup. This is an issue of ongoing debate, and the FSB is expected to issue a GLAC proposal at the Brisbane Summit in November 2014.

In summary, most participants felt banks are more resolvable now than before, but policy is still evolving (for example, on GLAC). Some participants argued that while bail-in will work for a domestic bank experiencing an idiosyncratic incident, there may be complications to it working for an international bank owing to complicated home and host state issues.

The session on resolution concluded with broad agreement among attendees that over the past five years resolution has become a key part of the supervisory framework and the supervisor's toolkit. Most agreed that: (1) there remains further policy development work to do on resolution and Pillar 3 of Basel III to determine how transparent disclosures to the market on resolution should be; and (2) effective resolution will depend on the particular international

(1) Llewellyn, D T (2010), 'A framework for crisis prevention and management: where is Pillar 4?', paper presented at Annual Colloquium of the Belgian Financial Forum, November 2010.

home-host relationship, which is based on trust, not law, and so domestic legal changes alone are insufficient.

## Session 4: Alternative currencies, payment systems and finance providers

The final session considered new sources of payment and finance, such as alternative currencies and payment systems that are at the borders of, or outside, the Bank's regulatory perimeter.

The session considered two examples of alternative currencies: 'local currencies' such as those used in Bristol, Brixton, Totnes and other areas; and 'digital' currencies such as Bitcoin.

One participant noted that the Bank considered local currencies in its 2013 Q4 *Quarterly Bulletin* article 'Banknotes, local currencies and central bank objectives'.[1] That article concluded that the size, structure and backing arrangements for local currency schemes meant that they were unlikely to pose a risk to the Bank's monetary and financial stability objectives. However, the article also noted that consumers should be aware that local currencies do not benefit from the same level of consumer protection as banknotes.

Local currencies represent prepayment (like a voucher). If such prepayment schemes fail, local currency holders would face losses. Some speakers expressed concern about whether members of the public might think local currencies are actually banknotes. One participant wondered whether a successful counterfeit attack on a local currency could spill over into reduced confidence in banknotes.

Digital currencies, like Bitcoin, are privately developed, internet-based currencies and payment systems. It was noted that the current UK market in Bitcoin is relatively small (estimated to be around £40 million). One speaker stressed that the payment technology underlying Bitcoin is its greatest innovation, as it appears to allow secure and verifiable payments with a publicly visible, distributed ledger. The speaker observed that such technology could be extended to create a publicly visible register of shares or to identify outstanding derivatives transactions. So such technology might enable regulators to see a chain of derivatives activity on a generally anonymised basis, facilitating the mapping of some financial stability risks while preserving privacy of financial agents.

## Concluding remarks

Graham Nicholson, Chief Legal Adviser of the Bank, delivered the concluding remarks. He noted that following the crisis there was the imperative for governments and regulators to take action to restore financial stability, and prevent such a crisis happening again. This manifested itself in international efforts around resolution, better capital, leverage and liquidity regulation, ring-fencing and better supervision, which, in aggregate, are intended to lead to a safer financial system.

As part of these actions, the UK Parliament has given the Bank more legal powers and responsibilities than at any other time in its history, and as a result, engagement with legal academics and practitioners, both in the United Kingdom and internationally, is increasingly important and valuable to the Bank's monetary and financial stability mission.

Mr Nicholson concluded by thanking the participants for their contributions.

(1) Naqvi, M and Southgate, J (2013), 'Banknotes, local currencies and central bank objectives', *Bank of England Quarterly Bulletin*, Vol. 53, No. 4, pages 317–25, available at www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130403.pdf.