Prof. K. Alexander/ Prof. S. Grünewald | Spring Semester 2014

International Finance Law

19.6.2014

Duration: 120 minutes

- Please check both at receipt as well as at submission of the exam the number of question sheets. The examination contains 1 page and 4 questions.

Notes on marking

- When marking the exam each question is weighted separately. Points are distributed to the individual questions as follows:

Question 1	30%
Question 2	30%
Question 3	20%
Question 4	20%
Total	100 %

We wish you a lot of success!

International Finance Law
19.6.2014

Question 1 (30%)

Discuss how international financial standards are developed and implemented. Which bodies are involved and what is their role in the standard-setting process? In your opinion, are international standards effective in changing the behaviour of financial market participants? Why or why not?

Question 2 (30%)

How has bank regulation become more macro-prudential following the global financial crisis? In your view, are the macro-prudential regulatory reforms adequate to prevent a future crisis, and if not what other regulatory or legal reforms do you think should be adopted to achieve regulatory objectives?

Question 3 (20%)

Explain why you agree or disagree with the following statements:

1) International standards determine the twin peak model as the preferable supervisory model because it is the most effective one.

2) The EU's Single Supervisory Mechanism is a good idea because it confers supervisory powers upon the body responsible for monetary policy decisions.

Question 4 (20%)

How does systemic risk occur in bank payment systems? What measures have bank regulators taken to reduce systemic risk in bank payment systems? What are the strengths and weaknesses of these measures? In your answer, you may mention the specific practices of one or more national central banks to support your argument.

Sample Solutions

Exam: International Finance Law (Spring 2014)

QUESTION 1*:*

Discuss how international financial standards are developed and implemented. Which bodies are involved and what is their role in the standard-setting process? In your opinion, are international standards effective in changing the behavior of financial market participants? Why or why not?

Regarding the development and implementation, students should broadly mention the following points:

- The Group of 20 (G-20), a powerful informal steering group of 19 countries + the EU **(1)**.
- G-20 has developed into the political "roof" in the international standard-setting process **(1)**.
- Discuss its lack of formal legitimacy or powers **(1)**.
- G-20 agrees on policy priorities, develops and publishes common viewpoints **(1)**.
- G-20 guides the work of the standard-setting bodies, on the one hand, and the IMF and World Bank, on the other hand **(1)**.
- Following the amendments to its charter in 2009, the Financial Stability Board (FSB) has emerged as the main coordinator of international financial standard-setting **(1)**.
- Discuss the standards that the FSB develops by itself (e.g., Key Attributes of Effective Resolution Regimes) **(1)**.
- The FSB monitors adherence to international standards by member jurisdictions through peer reviews and progress reporting **(1)**.
- Discuss the FSB's lack of formal enforcement powers **(1)**.
- Like other standard-setting bodies, it is member-driven, lacks a treaty foundation and operates by consensus **(1)**.
- Besides representatives from member jurisdictions (typically Central Bank or supervisory authority officials), the FSB's membership consists of international organizations (BIS, IMF, World Bank) **(1)**.

- Discuss also the other standard-setting bodies (including the BCBS, IAIS, IOSCO), which facilitates its coordinating role **(1)**.

- Members that are national authorities commit to implementing international financial standards within their jurisdiction. The FSB reports regularly to the G-20 **(1)**.

- Most international standards are developed by the "specialist" standard-setting bodies, such as the BCBS for the banking sector, the IAIS for the insurance sector and the IOSCO for the securities sector, under the oversight of and coordination by the FSB **(1)**.

- Analyze the fact that membership in these bodies is diverse, but typically consists of technocrats, i.e. representatives of the relevant national regulatory or supervisory authorities (and partially market participants) **(1)**.

- Those are also the authorities that eventually will have to apply the rules that they developed once they are transposed into national law **(1)**.

- International standard-setting can thus be described as a circular process **(1)**.

- Implementation of international standards in national jurisdictions, besides the peer review and progress reporting exercises by the FSB, is also monitored by the IMF and WB **(1)**.

- An actual institutional enforcement of standard implementation may take place through conditions attached to IMF or WB lending **(1)**.

- Milder versions of such institutional compliance mechanisms include IMF and WB surveillance, in particular, the Financial Sector Assessment Program (FSAP) **(1)**.

- Expand the discussion on the FSAP by analyzing the organizations' possibility of putting pressure on national governments to comply with international best practices **(1)**.

- Technical assistance provided by IMF and WB will also be based on agreed international standards in the field **(1)**.

- Finally, national jurisdictions are in charge of incorporating international standards in national laws, regulation and practice **(1).**

<u>If the European/supra-national dimension (i.e., implementation of international standards by the European legislators via regulations or directives) is discussed, extra points may be considered.</u>

Regarding the effectiveness of international standards, the line of argumentation could be the following:

- Once standards are implemented in national law, they become binding **(1)**.

- As such, i.e. prior to their implementation by national legislator, they constitute non-legally enforceable "soft" law **(1)**.

- That does create the possibility of opportunistic behavior by nation-States in the sense that they may withdraw from previous self-commitment **(1)**.

- However, there are several "compliance" mechanisms that may nevertheless render international standards effective in changing the behavior of the market and non-compliance costly **(1)**
    - Reputational repercussions: compliance with international standards may be perceived as a signal of "best practice" **(1)**.
    - Market discipline: the market may require participants to adhere to standards and national jurisdictions to adopt them **(1)**.
    - Institutional sanctions: naming and shaming, FSB peer review, IMF/WB surveillance and conditionality etc. **(1)**.

MAXIMUM POINTS TO BE ACHIEVED: 30

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QUESTION 2:

How has bank regulation become more macro-prudential following the global financial crisis? In your view, are the macro-prudential regulatory reforms adequate to prevent a future crisis, and if not what other regulatory or legal reforms do you think should be adopted to achieve regulatory objectives?

- The global crisis 2007-09 has led to international standard setting bodies (for example, Financial Stability Board) proposing that financial regulation should include macro-prudential objectives. The Basel Committee capital adequacy standards have evolved under Basel III to become more macro-prudential **(1)**.

- Mention systemic risk definition in book **(1)**.

- Regulatory failure in financial crisis **(1)**.

- Inter-connected markets and the macro-prudential dimension of systemic risk **(1)**.

- Discuss briefly the move from micro to macro-prudential regulation/supervision **(1)**.

- Basel III has requirements that address macro-prudential risks **(1)**.

1) more stringent and enhanced capital levels (SIFIs & Pillar 2 increase for inadequate macro-prudential stress testing models **(1)**.

2) Liquidity requirements (ie asset requirements) **(1)**.

3) Counter-cyclical capital and/or dynamic provisioning **(1)**.

4) SIFIs – too-big-to-fail banks (different SIFIs) **(1)**.

But also enhanced macro-prudential tools to address credit booms **(1.5)**

Using macro-prudential regulatory instruments or tools include**:**

- Loan to value ratios (LTVs) and loan to income ratios **(1).**

- Regulation should look at bank liquidity risks. Especially bank liabilities should consist mainly of retail deposits, followed by equity, with smaller % from securitised finance & repurchase agreements (repos) **(1)**.

- Leverage caps/ratios – linking asset growth to equity growth (Morris & Shin 2008) (bank capital should be a constraint on balance sheet growth) **(1)** or

- Financial stability tax on bank's non-core liabilities or financial transaction tax **(1)**.

<u>Macro-prudential monitoring:</u>

- Could also mention the need to monitor macro-prudential Vulnerabilities:
- Monitor ratio of total credit to GDP **(1)**.
- Ratio of non-core to core liabilities in the banking sector **(1)**.
- For example, core: retail deposits & equity **(1)**.

- non-core: wholesale deposits, bonds, securitization and forex borrowing & repos **(1)**.
- Macro-prudential monitoring **(1)**.
- Ratio of financial liabilities (repos & financial commercial paper to monetary aggregates - M2) **(1)**.
- Macro-prudential role of monetary aggregates should focus on the behaviour and stability properties of these measures – volatilities in asset values, correlations across asset categories and herding by investors **(1)**.

Bank resolution and recovery regulation

- FSB standards on bank resolutions: discussion of Key Attributes on bank resolution **(1)**.
- Key Attribute 11: domestically incorporated SIFIs should have robust, credible, and regularly updated *recovery and resolution plans* (RRP); for *Global* SIFIs (G-SIFIs): group resolution plan + cross-border cooperation agreements + review of resolution strategies by the competent authorities **(1)**.
- Recovery plan: identifies options to restore financial strength and viability when the firm comes under severe stress Resolution plan: facilitates resolution for competent authorities by ensuring effective and feasible resolution of the firm, reducing systemic disruption / taxpayer exposure **(1)**.
- Changes in the firm's management, structure, or contractual obligations **(1)**.
- Transfers of assets and liabilities to a third party or bridge institution **(1)**.
- Writing-down equity and converting unsecured/uninsured creditor claims into equity (bail-in) **(1)**.
- European Recovery and Resolution Directive **(1)**.
- Extra credit: Key Attribute 6: privately-funded deposit insurance and resolution funds to reduce taxpayer exposure.
- Central clearing of derivatives and bank exposures **(1)**.
- Lehman brothers collapse and derivatives exposure **(1)**.
- Bank ownership of CCP/clearing houses **(1)**.
- Can CCP/central clearing of derivatives reduce the risks? **(1)**.
- Critique: risks transferred and still need for central bank support in a crisis **(1)**.
- Discussion of systemic risk in clearing and settlement market **(1)**.

MAXIMUM POINTS TO BE ACHIEVED: 30

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QUESTION 3

Explain why you agree or disagree with the following statements:

1. **International standards determine the twin peak model as the preferable supervisory model because it is the most effective one.**

2. **The EU's Single Supervisory Mechanism is a good idea because it confers supervisory powers upon the body responsible for monetary policy decisions**

- No superior supervisory model has emerged to date. Accordingly, international standards do not identify any such model as the preferred one, but leave it to national legislator to determine the model most suitable for their jurisdiction (**1**).

- The twin peak model is only one out of three "standard" models deployed at State level, the others include the sectoral model and the single supervisor model (discuss) (**1**).

- Analyze the fact that the twin peak model distributes supervisory responsibilities according to objective in that one authority is in charge of business conduct supervision (e.g., rules of behavior, product regulation) and another authority of prudential supervision (e.g., licensing, capital adequacy) (**1**).

- The sectoral model, in contrast, assigns supervisory responsibilities according to financial sectors, i.e. typically to a banking, insurance and securities supervisor (compare and discuss) (**1**).

- According to the single supervisor model, a single supervisory authority is responsible for all financial sectors and supervisory objectives (**1**).

- Compared to the other models, the twin peak model may be perceived as effective because it limits the mandate of each agency, i.e. does not lead to an undue concentration of powers and potential single point of supervisory failure (**1**).

- At the same time, it does not make the nowadays somewhat artificial delineation between different financial sectors (**1**).

- Nevertheless, the objectives of business conduct and prudential supervision may not always be easily separable, and there may be a certain overlap in the mandates of the two supervisory authorities (**1**).

- Under the SSM, certain supervisory powers will be conferred upon the ECB, i.e. the body responsible for monetary policy within the Eurozone **(1)**.

- However, the conferral only concerns the supervision over the biggest and most important (most "significant") banks established within the Eurozone **(1)** (discuss).

- The supervisory tasks assumed by the ECB are also limited and exclude, for example, issues of consumer protections and business conduct **(1)**.

- Discuss possible controversial aspects relating to the conferral of supervisory powers to the ECB **(1)**.

Arguments in favor of CB supervision include:

- Synergies between the monetary policy and supervisory functions **(1)**.
- CBs' macro-view, which enables it to assess systemic risk properly **(1)**.
- CBs' independence from politics **(1)**.
- CBs' resources, reputation and expertise **(1)**.

Arguments against CB supervision include:

- Potential conflicts of interest between the monetary policy and supervisory goals **(1)**.
- Undue concentration of powers within one authority **(1)**.
- Differences in accountability requirements between monetary policy-makers and supervisors, with the latter typically being perceived as more rigid **(1)**.
- Differences in management processes, monetary policy being a bottom-up and supervision a top-down process) **(1)**.

MAXIMUM POINTS TO BE ACHIEVED: 20

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QUESTION 4:

How does systemic risk occur in bank systems? What measures have bank regulators taken to reduce systemic risk in bank payment systems? What are the strengths and weaknesses of these measures? In your answer, you may mention the specific practices of one or more national central banks to support your argument.

- Describe systemic risk in bank payment systems – Payment v Payment risk (PvP) **(1)**.

- Foreign exchange risk – Bretton Woods breakdown – floating of currencies **(1)**.

- Herstatt risks (1970s bank failure involving default of German bank with cross-border exposures to US banks in foreign exchange markets) **(1)**.

Extra credit:

- Systemic risk in Securities payments/settlements **(1)**.
- Delivery v payment (DvP) **(1)**.

- Securities Settlement (DvP risk) **(1)**.
- Dematerialisation and immobilisation of securities markets **(1)**.

- Central bank payment systems - different approaches across countries **(1)**

Examples: multilateral netting.

- Real Time Gross Settlement System (most developed countries) **(1)**.

- Describe instant settlement with finality as soon as a payment order arrives **(1)**.

Specify that:

- 'Settlement' refers to actual transfer of funds from a sending to a receiving bank **(1)**.

- 'Finality' means that the settlement is unconditional and irrevocable **(1)**.

- 'Real-time' means that payment orders are continuously executed **(1)**.

- 'Gross settlement' means that for each payment order, the total gross amount of funds is transferred **(1)**.

Analysis of two approaches:

- New York Fed – daylight overdraft system (pricing of overdrafts) **(1)**.
- Enhanced liquidity but credit exposure **(1)**.

- European Central bank (collateralised overdraft – requires high quality securities – drains liquidity from system but reduces credit risk **(1)**.

- Pros and cons of each approach for controlling systemic risk **(1)**.

- Continuous Linked Settlement System (CLS) Bank-Forex risk **(1)**.

Function of RTGS system

- Clearing houses receives and records all payment orders and checks whether minimum criteria are fulfilled before calculating the net settlement obligations of each participant **(1)**.

- Settlement agent then completes actual transfer of funds **(1)**.

- Clearinghouse can be operated by a private bank or public authority or nonbank organisation Settlement house however needs support of a guarantor, and therefore central banks are usually the guarantor because of access to liquidity and reserve currencies **(1)**.

MAXIMUM POINTS TO BE ACHIEVED: 20