International Financial Law FS 2016
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Case (Question 1)

The Finance Minister of your country is invited to Washington D.C. to meet with high-level representatives of the International Monetary Fund (IMF). Prior to his/her departure, he/she asks you to brief him/her on the work and institutional design of this international financial institution, in particular on

- ***whether and how the IMF could "force" your country to implement international standards; and***
- ***the specific features that distinguish the IMF from the Financial Stability Board (FSB) and other standard-setting bodies.***

(Answer his/her questions in complete sentences and by using examples, where appropriate.)

Question 1.1	**13 Pts.**
The International Monetary Fund (IMF) has certain enforcement tools (such as denying access to IMF's general resources, limiting the voting rights, and to expulse member states). They are, however, limited by the fact that there must be a consensus by the member states to use them. An enforcement of international standards by the aforementioned means is highly improbable. Therefore, other options of the IMF must be considered. In order to do this, two scenarios must be distinguished: A) Country borrows money from the IMF B) Country does not borrow money from the IMF	1 1 1
A) The IMF may lend money to its member states. However, lending is only granted to tackle balance of payments problems, i.e. difficulties in making international payments and maintaining reserves, but not to finance projects (task of the World Bank). Further, the member state seeking IMF lending must be unable to obtain financing on affordable terms on the capital markets. Different lending facilities may be distinguished. The IMF may stipulate lending conditionality which is a set of pre-defined conditions to IMF lending. The conditionality may be *ex ante* or *ex post*. Furthermore, in case of phased lending, the tranches of lending may be subject to performance of the member state with respect to the conditionality. Different types of conditionality are possible: - Financial conditionality - Macro-economic conditionality - Structural conditionality Through this conditionality, the IMF may coerce a member state requiring lending to adopt and implement financial standards.	1 1 1 1
B) If a member state does not face any balance of payments difficulties, the situation is different. Pressure through lending conditionality is no option since the member state does not require IMF lending. However, another principal activity of the IMF is surveillance. This activity may happen in a number of different forms:	1

- Country surveillance - Regional and global surveillance In this case, the surveillance measures on a country scale are of interest. There are three types of country surveillance: - "Article IV Consultations" - Financial Sector Assessment Programmes (FSAP) - Reports on the Observance of Standards and Codes (ROSC)	1
While the latter two may be conducted on a voluntary basis (although a majority of member states do conduct FSAPs and for certain countries the FSAP is mandatory), the Article IV Consultations are mandatorily prepared every year.	1
The scope of surveillance includes exchange rate and monetary policy as well as fiscal and financial sector issues.	1
The surveillance conducted by the IMF might result in "naming and shaming" of member states with deficiencies in the adherence to international standards, or, at least, to peer-pressure from other member states. As, however, the publication of the results of the examination is not mandatory, even for Article IV consultations. Member states may decide to publish only parts of the findings or nothing at all. This reduces the disciplining effect of the IMF's surveillance activities, as most non-compliant countries will opt for non-publication. Thus, even a member state not requiring financial assistance by the IMF may be implicitly forced to adopt and implement international standards.	1
The IMF is also tasked to provide technical assistance upon a member state's initiative.	1
Question 1.2	5 Pts.
The IMF can be distinguished from other international actors by a number of different features:	
▪ Legal foundation: The IMF is a formal international organisation, based on an international treaty pursuant to the Vienna Convention. On the other hand, organisations such as the FSB, G-20, and other standard-setting bodies are not based on an international treaty.	1
▪ Voting: The voting system of the IMF is based on the distribution of its member states' quota subscriptions (250 basic votes + 1 additional vote per SDR 100.000 of quota). The quota reflects a member state's economic power, thus, the IMF is an economic institution. In the other organisations, each member has the same voting power; they are political institutions.	1
▪ Decision-making process: In the IMF, decisions are made by majority, whereas FSB, G-20 and the standard-setting bodies are consensus-driven. Member-driven vs. top-down approach	1
▪ Membership: While the IMF's membership is nearly universal, the membership of the FSB and G-20 is rather exclusive, consisting of developed and economically important countries.	1
Total	**18**

Question 2

"Derivatives are a financial tool to decrease risk."
In your opinion, is this statement true, false or neither? Explain and argue your answer

Derivatives	
Definition: A derivative is an agreement between a buyer and seller (counterparties), based on the future performance of an item (underlier), on or before a certain date (maturity).	1

Purpose:
- to protect from unexpected price shifts (hedging)
    o market risk
    o credit risk
- speculation
- arbitrage
	2

OTC derivatives can model any risk to a counterparty, but contribute to systemic risk: - Lack of transparency, underestimation of risk (collateral) ⇨ Contribution to financial crisis (especially: credit default swaps).	2
Derivatives reform	
G20 2009 Pittsburgh Summit: - All standardised OTC derivatives should be traded on exchanges; - Cleared through central counterparties (CCPs); and - Reported to trade repositories - Non-cleared derivatives subject to higher collateral requirements Other international standard-setters: FSB, CPSS-IOSCO.	1
EU: EMIR (clearing obligation), MiFID II (exchange trading), MiFIR US: Dodd-Frank CH: FMIA/FMIO	1
Reform results	

Benefits:
CCP: novation, netting, collateral collection (initial + variation margin; default fund contributions)
    ⇨ Clear default procedure in case of counterparty default
    ⇨ Central collateral management
    ⇨ Reduction of exposure
    ⇨ Transparency
	2

Drawbacks:
CCP becomes threat to financial system, because of risk build-up within
    ⇨ too-big-to-fail?
No recovery & resolution framework in case of CCP default
    ⇨ CCP default potentially at greater tax-payer cost than AIG default
	2

Conclusion	
Sentence neither right nor wrong. - Derivatives shift risk from one counterparty to another, not remove. - Derivatives reform has shifted risk from bilateral counterparties to CCP.	1
Total	12

Question 3

The Basel Capital Accord has been changed significantly since it was adopted in 1988. Please, discuss.

Discuss the general background of the Basel Capital Accord and why it was adopted: to increase bank capital levels and promote a level playing field internationally in minimum regulatory capital standards. The background to Basel I includes the 1980s sovereign debt crisis and increased cross-border banking. Basel I – a simple 8% capital risk-weight regime – consisted of tier 1 and tier 2 capital. By mid 1990s this was seen as obsolete as banks use more data to calculate economic capital and 1996 Market Risk Amendment applies capital requirement to trading book risk but this is calculated based on bank's risk data.	2
Banks can fund themselves by issuing equity and/or debt (ie., bonds/deposits). Regulation and taxes favour debt so banks issue much more debt to fund their operations as opposed to equity because debt is cheaper(tax deductible and government bailout/deposit insurance). Equity more costly because issuing more shares dilutes the monetary and control rights of shareholders.	1
Describe how Basel II came about – ideally designed to address weaknesses with Basel I's relatively simple risk-weight measures. Basel II relies more on bank economic capital models to measure credit and market risk. led to under-capitalization of banking system. Basel II a more risk-based regime that relied on banks calculating their own regulatory capital based on their models and having it approved by regulators. Only 2% Tier 1 Capital under Basel II.	2
Basel II lobbied for by banks and based on risk data that is viewed to be more risk and banks argue that their risk models are more accurate in estimating risk than regulatory capital classifications.	0.5
Describe the 3 Pillars of Basel II – 1) capital adequacy, 2) supervisory review, 3) market discipline (disclosure). Elaborate a bit on each pillar .	0.5
Weaknesses of Basel II: Excessive focus on bank risk models and by allowing banks to calculate their own regulatory capital they underestimated exposure and inter-linkages between banks and the effects on bank. Credit risk models seek to align regulatory capital with economic capital (not account for externality of bank risk-taking)	1.0
• Pro-cyclical capital requirements	0.25
• Supervisory discretion – ***regulatory capture?***	0.25
• Focuses on individual bank's risk, not aggregate risk for financial system	0.25
• Capital formulae too prescriptive & complex	0.25
• Pillar 2 fails to incentivise bank management to take account of systemic risk (ie., compensation)	0.25
• Micro-prudential instead of macro-prudential	0.25

Basel III is primarily concerned with increasing core tier one equity capital. **Tier 1 equity capital (CET) – requirement of 7% (4.5% minimum plus 2.5% buffer**) – common equity shares only for the 4.5%, and common equity shares and other loss absorbing equity shares can make-up the 2.5% regulatory buffer capital. Basel III requires that Tier 1 capital be largely loss absorbent (ie., mainly common equity shares). Basel III attempts to make bank regulatory capital more 'macro-prudential'. The goal of Basel III is to make regulatory capital more loss-absorbing. Only 2% Tier 1capital required under Basel II. Basel II/Tier 1 capital could have more instruments not as loss-absorbent. As a result, banks not able adequately to absorb losses during the crisis.	2.0
Basel III, they should also add that there would be an **additional (up to) 2.5% counter**-cyclical regulatory capital requirement. If economy in a downturn generally not need to hold the 2.5%.: 'protecting banking sector from periods of excess aggregate credit growth'	0.5
Others include	
➢ Tighter definition of CET 1 capital (common equity) and increased to 4.5% (Tier 1) plus 2.5% (conservation buffer). If breach 2.5% buffer, then regulator can restrict bank remuneration and dividends	0.25
➢ Capital surcharge for systemically-important financial institutions (SIFIs) (1% to 2.5%)	0.25
➢ Less reliance on bank models, but bank models remain the basis for regulatory capital determination	0.25
➢ Limits on maturity mismatches in wholesale funding (NSFR, 2018)	0.25
➢ Liquidity coverage ratios (LCRs, 2015)	0.25
➢ Basel III designed to make bank capital regulation more 'macro-prudential'	0.25
➢ Net stable funding requirement	0.25
➢ Leverage ratio	0.25
In both Basel II and Basel III, it is important to note that **Pillar 2 'supervisory review'** will require that supervisors have **discretion to increase or decrease regulatory capital** based on how strong the supervisor believes the bank's corporate governance and risk management to be.	1
Internal Capital Adequacy Assessment Programme (ICAAP) If the bank demonstrates **strong corporate governance** structures and **robust risk management,** then it will be able to adjust capital levels by **lowering** it. If supervisors believe the bank has weak corporate governance or risk management then it can require higher regulatory capital than what the specific formula provides.	1
Supervisory Review Evaluation Process (SREP) Assessing macro-prudential risks and relationship to bank governance	0.5
Pillar 3 – role of disclosure across markets – making disclosure more comparable and information more meaningful for assessing macro-prudential risks	1

Arguing pro or con if Basel III is really that much different from Basel I. If so, how is it different?	
• Risk weights?	0.25
• Regulatory capital levels?	0.25
• Banks still fund themselves overwhelmingly with debt; is Basel III capital increase really that big a change?	0.25
• Environmental and social risks – carbon risks, financial inclusion	0.25
• Liquidity requirements are new	0.25
• Role of soft law in international law – still the same. How should it change – more binding legal rules?	0.25
Total	**18**

Question 4

Discuss the reasons why countries have implemented deposit insurance. In your opinion, which specific features should a deposit insurance system have? Explain why.

Question 4	
There are several reasons for a country to adopt a deposit guarantee scheme (DGS):	
▪ Financial stability - A DGS enhances the public confidence in the financial sector generally and the banks in particular. - A DGS may prevent bank-runs that might hit not only banks in distress but any bank in a country.	1
▪ Protection of depositors - Depositors may not assess a bank's risk potential properly. - Depositors are hit disproportionately hard in the event of a bank failure. - A DGS spares the depositors from disruptions of pay-outs during a potentially lengthy liquidation process.	1
▪ Compliance with international standards - The International Association of Deposit Insurers (IADI) Core Principles figure amongst the FSB's list of key standards.	1
With regard to the features of a deposit guarantee scheme, it should be noted that a wide variety of DGS models and mandates exist, each containing a number of different features. ▪ "Paybox" (e.g. Switzerland) ▪ "Paybox plus" (e.g. the United Kingdom) ▪ "loss minimiser" ▪ "risk minimiser" (e.g. the United States)	1
The IADI Core Principles contain certain features which are considered by the IADI to be advantageous for a DGS:	1
▪ Operational independence and insulation from external interference. (Principle 3) ➢ Reason: System of checks and balances; ensuring impartiality of the DGS	1
▪ Compulsory membership for all banks in a jurisdiction. (Principle 7) ➢ Reason: avoiding competitive distortions between banks; ensuring an adequate coverage of depositors; depositors do not have to enquire about their bank's membership	1
▪ A limited, credible coverage of a majority of depositors but leaving a substantial amount of deposits exposed to market discipline. (Principle 8) ➢ Reason: Depositor protection and protection of the public confidence in banks; limitation serves to limit moral hazard of depositors and to promote market discipline	1
▪ Funding on *ex ante* basis. While funding shall be the responsibility of member banks, emergency funding arrangements (e.g. through government, central bank, and/or market borrowing) shall be in place. (Principle 9) ➢ Reason: more credible protection; reduced probability of a recourse to public money; the anti-cyclicality reduces the member banks' burden	1
Further features that should be considered:	
▪ Open-ended fund ➢ Reason: a cap of the DGS is a potential caveat to the aforementioned reasons for implementing a DGS and, thus, for its aim	1
▪ Funding by member banks through risk-based premia. ➢ Reason: Proportionality of banks' contributions; the risk-basis approach takes the varying sizes and business models of the banks into consideration	1
Total	**12**