International Financial Law FS 2018
Prof. Dr. iur. Kern Alexander/Prof. Dr. iur. Seraina Grünewald

Question 1: (30%)

a) ***A colleague of yours claims that nothing has been done by the international community to tackle the too-big-to-fail (TBTF) problem. How do you counter?***

b) ***Discuss the role of the Financial Stability Board (FSB) in the international efforts to tackle the TBTF problem. Why is the FSB uniquely placed to deal with the issue?***

c) ***Which role do Deposit Guarantee Schemes play in bank resolution?***

Question 1 a) (10%)	**6 Pts.**
The too-big-to-fail (TBTF) problem refers to the fact that governments cannot let financial institutions fail if their size, complexity, interconnectedness, and/or critical functions would (potentially) cause severe adverse consequences for the financial system and the economy at-large in case of failure. It became one of the main concerns for international financial policymakers as a consequence of the financial crisis of 2007-2009.	1 1
In its capacity as agenda setter and political steering group, the G20 (Pittsburgh Summit 2009) called for action in order to solve the TBTF problem. In response, the Financial Stability Board (FSB) presented two main frameworks addressing the issue:	0.5
• SIFI Framework: It aims to reduce the moral hazard associated with Systemically Important Financial Institutions (SIFIs). In particular, the FSB designates Global Systemically Important Banks (G-SIBs) that must meet higher capital buffers and other supervisory requirements.	1.5
• FSB Key Attributes of Effective Resolution Regimes for Financial Institutions: The 12 Key Attributes are part of the key standards and have become the international benchmark for frameworks for bank resolution outside of pre-crisis court-led general bankruptcy proceedings.	1.5
While the TBTF problem may not be solved today, a lot of progress has been made by international efforts to tackle the issue.	0.5
Question 1 b) (10%)	**6 Pts.**
As a consequence of the crisis, the FSB has emerged as the "operating arm" of the G-20. The FSB takes up policy initiatives in response to G-20 requests, reports to the G-20 regarding progress made, and coordinates the standard-setting process with the specialist standard-setting bodies (such as the BCBS, IAIS and IOSCO). Its membership encompasses representatives not only from member jurisdictions (national Central Banks, Ministries of Finance and supervisory authorities), but also from international financial institutions (incl. the IMF and WB) and the standard-setting bodies. It is the one international forum where all the players come together.	1 1.5 1
With TBTF being a problem that is not confined to sectoral or national boundaries, inclusiveness was of great importance. When developing a framework to combat TBTF, the FSB benefitted from the expertise and input from its broad membership. As all its members had to agree on the framework (consensus), it now enjoys heightened credibility and authority.	0.5 1 1

Question 1 c) (10%)	6 Pts.
The primary aims of Deposit Guarantee Schemes (DGSs) are to protect depositors and to stabilise the banking sector by preventing potentially calamitous bank runs. By extending the promise to (retail) depositors that a certain fraction of their deposits will be kept safe and available in due course even if their bank fails, DGSs support the goal of keeping depositors from retrieving their funds in big numbers once rumours spread – rightly or wrongly – that a bank has entered financial difficulties. Traditionally, DGSs have compensated depositors in case their banks were liquidated by paying out the amount protected under the Scheme.	1 0.5 0.5
Depending on their specific design and mandate, DGSs may also play a role in bank resolution. The FSB distinguishes four models of DGS mandates, which range from the so-called Paybox model to the Risk Minimiser model: The Paybox model only allows for a disbursement of insured deposits in the event of a bank's failure; thus, the scope of this mandate prevents the DGS from playing a role in bank resolution. The Paybox Plus, Loss Minimiser, and Risk Minimiser models enable a DGS to take on responsibilities other than the disbursement of depositors. Therefore, a role in bank resolution is possible. The DGS's involvement ranges from providing certain specific functions (i.e. commonly contributions to the funding of resolution measures) under a Paybox Plus mandate, to partaking in the selection of an appropriate and adequate resolution measure (guided by the principle of cost-efficiency from the DGS's point of view) under a Loss Minimiser mandate, to also supervising banks on top of the aforementioned tasks under a Risk Minimiser mandate.	1 0.5 0.5 0.5 0.5
The DGS's funding mechanism is also pivotal to enable its participation in bank resolution measures since only ex ante funded Schemes may play this role. Ex post funded DGSs cannot rely on pre-existing funds and have to resort to collecting funds only after a bank has failed. Such a DGS would be unable to contribute to the funding of resolution measures in a timely manner (i.e., within a "resolution weekend").	1
Total	**18 Pts.**

Question 2: (30%)

Discuss the similarities and differences in the objectives of banking and securities regulation and have these objectives changed in light of the financial crisis?

Question 2	
Introduction – summary of what the essay will address – main principles of financial regulation – banking regulation mainly stability focused and securities regulation mainly investor protection focused.	0.5
Post-crisis regulation should be seen more holistically combining traditional stability concerns (capital & liquidity) with conduct of business.	0.5
Pre-crisis banking regulation concerned with individual bank solvency and focus on balance sheet risks (micro-prudential risks) – credit, market & operational (Basel II).	0.5
And securities regulation concerned mainly with investor protection – disclosure of information – and market misconduct/integrity (i.e., market abuse)	0.5
Extra credit if the candidate discusses evolution of Basel I – III	*+0.5*
Bank regulation and securities regulation considered different domains. Banking regulation (Basel II) required less loss absorbent capital – 2%-4% Tier 1 capital, and 4% Tier 2 capital. Bank trading books viewed as less risky and required less capital. Bank risk management looked at how the bank is affected by risks from other banks/the market. Bank regulation did not focus on structure and inter-connectedness of financial markets and how size and inter-connectedness of banks can create systemic risks and threaten the financial stability objective. Regulatory philosophy believed that	2

spreading of risk of balance sheet was good and supported stability objective, but not enough focus on where risks were transferred (i.e., shadow banking).	
Securities regulation focused on individual investors and firms, for example, trading rules on exchanges and insider dealing and financial crime. Bank conduct was focused on rules and exceptions and not on judgment. Regulators followed a rulebook (tick the box) and failed to exercise discretion to anticipate where risks were building. Regulators failed to spot systemic risks that were arising in trading markets (i.e., derivatives). Bilateral trades between banks were viewed as a concern for exchanges to ensure transparent and honest behaviour but financial stability inherent in banking trading activity not spotted or considered a problem.	2
Extra credit – Basel II Pillar 2 corporate governance principles under-used by regulators and risk management not scrutinised pre-crisis.	*+1*
Post-crisis. Banking regulation becomes more macro-prudential in focus. Regulators address risks across financial system and inter-linkages between banks/firms and markets. Assess size of bank can affect stability – important systemically important banks/firms different from less/non systemically important firms.	2
Securities regulation begins to focus on systemic risks and macro-prudential risks that can arise in trading systems – central clearing of derivatives and how investment bank trading activity can affect systemic risks (i.e. Lehman Brothers). Also, stock exchange volatility setting off investor panics with systemic implications.	1.5
Basel III takes on more macro-prudential focus on systemic risks by increasing capital and liquidity requirements: Tier 1 4.5% + 2.5% Capital Conservation Buffer (CCB), plus 1-2.5% Countercyclical capital buffer + SIFI surcharge 1-2.5%. Basel III restricts Tier 2 to 25% of Tier 1 for regulatory capital requirement.	2
Extra credit – regulation becomes more intrusive on bank governance – for example, if less than 7% but more than 4.5%, regulator can restrict payments of dividends to shareholders and variable remuneration (bonuses) to bank risk-taking employees	*+1*
Pillar 2 – Internal Capital Adequacy Assessment Programme (ICAAP) develops a new Supervisory Review Evaluation Process (SREP) and stricter stress testing with macro-prudential focus. Forward looking assessment of risks – less relative reliance on internal bank models. Amendments to Basel III (so-called Basel IV) limits the reduction of regulatory capital based on internal models to 70% of what the standardised approach to Basel III would have required. Pillar should also focus on misconduct risks that can also threaten financial stability (i.e., LIBOR).	2
Pillar 2 focus on Misconduct in bank trading that can attract increased capital.	1
Extra credit – Pillar 3 and enhanced disclosure of systemic/structural risks in markets to investors	*+0.5*
Philosophy of regulation for banks and securities becomes more similar – assessing risks across markets and how financial innovation affects risk-taking and can threaten regulatory objectives. Old focus on individual firm efficiency and lower transactions replaced with focus on wider systemic risks.	1.5
Although banking and securities regulation retain separate remits, the underlying philosophy of investor protection/market integrity and financial stability and bank solvency gives way to a broader focus on risks across institutions and markets and what tools most effective to limit these risks and how to identify risks arising from financial innovation.	1.5
Conclusion: Forward-looking assessment of risks across financial sectors and markets.	0.5
TOTAL	**18 Pts.**

Question 3: (20%)

Financial market misconduct should be an important concern of international financial regulation. Do you agree? Discuss what areas of international financial regulation apply to misconduct risk?

<table>
<tr><td>Introduction – International regulation is generally legally non-binding and so it establishes standards and principles that nation states can then implement into their own legal and regulatory framework. On the one hand, international standards of regulation could proscribe certain conduct (insider dealing and mis-selling) but on the other hand it may not be useful to have such standards in this area because market practices and conduct are affected by local and national values and more detailed legal frameworks at the national level. Therefore, although international standards and principles can address market conduct issues, the usefulness of this is not apparent as much more detailed legal frameworks and customary/cultural practices should be addressed at the national level.

➢ Yes or No – both can be correct depending on how you support your arguments</td><td>1</td></tr>
<tr><td>Generally, certain areas of international financial regulation do address market misconduct. Most prominently, financial crime and corruption by Financial Action Task Force (FATF) as discussed below.</td><td>1</td></tr>
<tr><td>Elaborate on argument above whether you agree or not that international financial regulation should address misconduct. Different countries have different criminal laws and administrative law frameworks making it difficult to have uniform enforcement internationally. Traditionally, international regulation concerned with financial stability/banking issues – such as systemic risk and stability of banking sector (Basel agreements), with less emphasis on conduct issues.</td><td>1</td></tr>
<tr><td>However IOSCO in 1990s focuses on investor protection which implicates conduct issues and mentions insider dealing/market abuse. But very general principles and not fully recognised by all countries like the Basel Committee standards on bank capital were recognised and other prudential regulatory standards.</td><td>1</td></tr>
<tr><td>Extra credit – Market Abuse Regulation (MAR or MAD) discussion</td><td>+1</td></tr>
<tr><td>Purpose of misconduct regulation – traditionally investor or customer protection. But post-crisis it has systemic risk/financial stability implications (LIBOR) and anti-money laundering and designation of countries as not compliant.</td><td>1</td></tr>
<tr><td>Utility of countries attempting to enforce misconduct rules uniformly across countries – may create unlevel playing field.</td><td>1</td></tr>
<tr><td>International standard-setters addressing misconduct: FATF, IOSCO, OECD and Basel</td><td>1</td></tr>
<tr><td>Extra credit – Other financial crime risks (terrorist financing/sanctions/tax evasion/Panama Papers)</td><td>+1</td></tr>
<tr><td>FATF important strides to control money laundering and terrorist financing (AML/CTF)
• FATF 40 (1990) Recommendations – discuss how countries required to define and proscribed money laundering. Know Your Customer (KYC) and Suspicious Transaction reporting
• FATF 9 (2001) added to FATF 40 to prohibit financing for designated terrorist groups and stricter customer due diligence for financial institutions and other third parties to focus on third party intermediaries and not necessarily the criminals and requirement that all countries adopt administrative regulations to control AML/CTF.</td><td>1</td></tr>
<tr><td>Other international bodies; Basel III – operational risk (pillar 1) and misconduct control as part of the compliance function in pillar 2. Good AML/CTF required as part of Pillar SREP assessment.</td><td>1</td></tr>
</table>

IOSCO • Market abuse and insider dealing • Fit & Proper Standards for bankers and traders • Approved person standards (for firms) to ensure good governance and conduct IOSCO has no sanctioning powers	1
Difficult to have harmonised implementation of international misconduct standards. But FATF Recommendations show anti-financial crime standards can be developed internationally and implemented in a more or less harmonised way for AML/CTF, and black-listing of non-cooperative countries has served as an effective sanction.	1
Conclusion – International financial regulation traditionally addressed on financial stability issues and local jurisdictions addressed more conduct. But BCCI cases in early 1990s showed how conduct/crime can have stability implications and therefore should be included international financial standard setting. But difficult to have harmonised implementation of international misconduct standards. But FATF Recommendations changes this in area of financial crime (AML/CTF) and black-listing of non-cooperative countries has served as an effective sanction	1
TOTAL	**12 Pts.**

Question 4: (20%)

The surveillance conducted by the International Monetary Fund (IMF) is much more effective than the peer reviews conducted through the FSB.

Do you agree? Describe similarities and differences between the two approaches.

Both the IMF and the FSB engage in surveillance of the implementation of international financial standards by their respective members.	0.5
The IMF's surveillance activities include three main tools: • Article IV consultations • Financial Sector Assessment Programmes (FSAPs) • Reports on the Observance of Standards and Codes (ROSCs)	1
Article IV consultations conducted by the IMF are part of the organisation's country surveillance activity. Participation in Article IV consultations is mandatory for all IMF members on a yearly basis. For the purpose of conducting Article IV consultations, a team of IMF staff members visits members and consults with local representatives of authorities, Parliament, government and civil society, amongst others, to review the country's financial and macroeconomic situation, its financial, monetary and fiscal policies as well as institutional structures. Based on their findings, they draft a report to the IMF's Executive Board for approval. Compliance with financial standards, as internationally accepted best practices, is part of the consultations.	0.5 0.5 0.5
While FSAPs are voluntary for most IMF members, a number of jurisdictions with systemically important financial sectors are obliged to undergo this review. FSAPs focus on the jurisdictions' financial sector and their regulatory frameworks.	1
The IMF's ROSCs provide a summary of a jurisdiction's compliance with 12 internationally recognised key standards.	1
Two types of FSB Peer Reviews can be distinguished: • Thematic reviews • Country reviews	1
The first group focuses on the implementation of a particular set of standards across the FSB's membership and the latter on the implementation of all relevant standards in a specific member jurisdiction. FSB country reviews serve as a complement to the IMF's FSAPs by deploying a different	0.5 0.5

type of surveillance proceeding. FSB members are meant to "lead by example". To this end, they should implement standards in a timely and fully compliant manner since this provides other jurisdictions credible evidence of their commitment to international standards. The goal is to induce a "race to the top". The review is conducted by peers for peers, i.e. at arm's length. Moreover, the FSB may engage in dialogue with countries that show gaps in their ROSCs and issue an implementation report with recommended measures to promote adherence. The surveillance activities of the IMF and the FSB share a number of similarities: • Subject matter of the review (12 key standards) • Both are prepared by technocrats • They share the aim of furthering the adherence to international standards • There are no hard sanctions for failure to comply with the standards However, they differ in certain other aspects: • IMF Article IV consultations will not be published without the examined jurisdiction's approval, whereas the findings of the Peer Reviews will typically be made public. • In consequence, an insufficient adherence to international standards can result in "naming and shaming" and peer pressure within the FSB's membership, while the same is not necessarily the case for IMF members (nevertheless, the refusal to publish the finding from the IMF's surveillance may also be interpreted as a signal) • The IMF surveillance is undertaken by its own staff (top down), whereas the FSB's surveillance (due to a lack of own staff) is undertaken by experts from other member states ("peers").	1 0.5 0.5 0.5 0.5 0.5 0.5 0.5 0.5
TOTAL	**12 Pts.**