<u>International Financial Law FS 2017</u>
<u>Prof. Dr. iur. Kern Alexander/Prof. Dr. iur. Seraina Grünewald</u>

<u>Question 1</u>: (30%)

You are a staff member of the IMF and are sent on a mission to country X in order to conduct an Article IV consultation. The country has just passed a new law that contains the following provision:

"The financial supervisory authority must first obtain the approval of the Ministry of Finance before it takes any action."

a) What are you writing in your report to the IMF's Executive Board about the compliance of the country's new provision with international financial standards? (5%)
b) Discuss the different ways in which the Article IV consultation may or may not induce compliance of country X with international financial standards. (10%)

The country's supervisory authority is organised as a single supervisor.

c) How are you commenting on this supervisory model in your report to the IMF's Executive Board? What if supervision were conducted by the central bank? (15%)

Question 1 a) (5%)	**3 Pts.**
International standards provide for the operational independence of financial supervisory authorities (IAIS Core Principles No 2.4; BCBS Core Principles No. 2; IOSCO Principles A.2; FSB Key Attributes No. 2.5; IADI Core Principles No. 3). That is, supervisory authorities must take their supervisory decisions (e.g., enforcement of capital rules etc.) independent from political or industry interference. The international community believes that this is the best way to ensure objective decision-making that is (solely) determined by the pre-defined supervisory objectives (safeguarding financial stability, market integrity and depositor/investor protection). The Article IV report to the IMF's Executive Board should therefore state that the provision issued by country X is clearly non-compliant with international financial standards. The new law provides for an approval by the Ministry of Finance of operational decisions by the supervisory authority. This interferes with key standards endorsed by the BCBS, IAIS and IOSCO and threatens objective and sound decision-making by the country's supervisory authority.	0.5 1 1 0.5
Question 1 b) (10%)	**6 Pts.**
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 and consults with local members 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. As such, Article IV consultations entail a "learning process" for local political and regulatory/supervisory authorities. Moreover, as reports drafted based on the findings Article IV consultations are expected to get published on the IMF's website, they may result in "naming and shaming" of member states with deficiencies in the compliance with international standards. This, in turn, may lead to peer-pressure from other members (reputational repercussions) or pressure from the market (market discipline). For example, if a country fails to comply with key capital standards, capital cost for financial institutions may rise or credit rating agencies may perceive the	1.5 1

country as more vulnerable to financial instability and therefore downgrade a country's rating. However, since the publication of the Article IV consultation's findings (or parts thereof) depends on the willingness of the country assessed, the disciplining effect is significantly reduced. Non-compliant jurisdictions can therefore opt for non-publication of Article IV reports or have crucial parts deleted.	1 1
The IMF itself has only a limited enforcement toolset. It includes denying access to its general resources, limiting a member's voting rights and, ultimately, expulsion of a member state. These sanctioning powers are, however, limited by the fact that a majority of IMF members must approve such measures, which is highly improbable (for political reasons).	1.5
Question 1 c) (15%)	**9 Pts.**
As Article IV consultations include institutional questions, comments on the supervisory model of a country are, generally speaking, not outside their scope. However, international financial standards do not contain any "best practices" regarding the institutional setup of supervisory authorities. It is perceived as a matter determined by local circumstances (size of financial markets, historical and cultural influences etc.).	1 1
In practice, three supervisory models have emerged: single supervisor, sectoral model and twin-peaks model. They are often combined in one way or another. • Single supervisor: only one authority supervises all financial market participants in a jurisdiction (e.g. Switzerland). • Sectoral model: Different authorities supervise the different market sectors, i.e. banks, insurance, and securities/markets (e.g. EU). • Twin-peaks model: Two supervisory authorities, one for prudential supervision and the other one for business-conduct supervision (e.g. UK).	0.5 1.5
Each of these models has its advantages and disadvantages. The advantages of the single supervisor model include: • Integrated approach ensures that no business model falls "off the radar" • Synergies (e.g. information and data must be obtained only once) • Absence of jurisdictional conflicts among different authorities The disadvantages of the model include: • Broad spectrum of mandate (e.g. is every sector given appropriate attention?) • Risk of the single supervisor's failure (i.e. there is no potential second pair of eyes)	1.5
Empirically, no model has emerged as the superior one.	0.5
The role of the central bank in supervision has been discussed controversially for many years, without any clear result. The following advantages and risks of central bank supervision are often mentioned. Advantages: • Synergies of supervisory and central banking functions • The central bank's capability to assess the build-up of systemic risk in the market • Central bank independence is typically further-reaching than that of supervisory authorities. It is, however, questionable whether supervision requires the same level of independence as monetary policy. • Its expertise and resources Risks: • Potential conflicts of interests (monetary policy vs stabilising failing banks) and reputation risk • Concentration of powers • Differences in accountability requirements, with supervision requiring stronger political accountability than monetary policy • Differences in management processes	1 1 1
Total	**18 Pts.**

Question 2: (20%)

Describe the issue of moral hazard in the context of lender-of-last-resort lending by central banks. How have central banks traditionally sought to mitigate moral hazard when acting in this capacity? What changed due to the recent crisis?

Question 2	**12 Pts.**
Moral hazard means the lack of incentives by market participants to monitor and contain their risk-taking as they are (or feel) protected from its consequences (i.e., their failure). The lender-of-last-resort (LOLR) function of central banks aims to protect (viable) banks from failing by providing them with urgently needed liquidity. Therefore, the issue of moral hazard in the context of LOLR has always been prevalent.	1.5
The traditional measures to reduce moral hazard were put forward by Walter Bagehot in 1837. He established that central banks should (1) lend freely (2) at a penalty rate (3) to solvent institutions (4) against good collateral and that emergency liquidity assistance (ELA) should be provided at the central bank's discretion.	1
(1) By lending freely, the CB could prevent or contain a financial crisis and the consequential fire sales of assets and disruptions of economic activity.	0.5
(2) However, lending against a penalty rate should curb moral hazard as the cost of funding will be higher than obtaining funding on the private market. Therefore, banks have a monetary incentive to avoid ELA.	0.5
(3) In addition, Bagehot's dictum limited the provision of ELA only to institutions that are illiquid but solvent, thus excluding non-viable market participants.	0.5
(4) The requirement for a borrower to provide good collateral was meant to protect the central bank from credit risk.	0.5
In the spirit of Bagehot, many central banks have followed a policy of "constructive ambiguity" regarding the (future) provision of ELA with the aim of avoiding reliance of market participants on ELA while taking excessive risk.	1
Constructive ambiguity entails the possibility that the central bank will decide NOT to engage in any LOLR operations in the event of crisis. The uncertainty over future liquidity provision by the central bank was meant to strengthen market discipline.	1
The financial crisis exposed substantial caveats to the traditional mechanisms against moral hazard.	
• It became clear that lending at a penalty rate could actually make the problems of a troubled bank worse. Furthermore, the penalty rate led to a certain stigmatisation of ELA, thereby reducing its effectiveness. For example, financial institutions in the US were reluctant to seek ELA during the crisis, as they feared that this would be perceived as a sign of weakness in the market.	1
• Central banks had to reduce their collateral requirements during the crisis. As the value of collateral is determined by the liquidity of its market, its market value did not necessarily correspond to its fundamental value. Due to valuation uncertainties, central banks exposed themselves to potential losses, raising questions about a government guarantee.	1
• The distinction between illiquid and insolvent institutions is extremely difficult to make. Particularly, an institution's assets might be worth less than its liabilities at fire-sale prices, but it could be viable as a going concern if a liquidity default could be avoided.	1
• The maintenance of constructive ambiguity was severely impaired if not impossible at a certain point during the crisis, as the financial system became too fragile to withstand the disruption in consequence of a major institution's failure. It would not have been credible anymore to limit moral hazard by indicating that there was a possibility that the central bank would actually withhold ELA that it was legally able to provide.	1
In the aftermath of the crisis, the question of how LOLR operations during the crisis have increased moral hazard has not been checked in subsequent regulatory changes. While there have been a number of policy initiatives aiming at internalising the effects of excessive risk-taking and thus strengthening market discipline and reduce moral hazard, significant questions remain, especially with regard to systemically important institutions.	1.5
Total	**12 Pts.**

Question 3: (30%)

TM Bank is a large global bank with headquarters in a G20 country which has been operating in normal market conditions with 10% Tier One regulatory capital. However, an unexpected economic downturn has caused TM bank's Tier One capital to drop to 6%. Moreover, during the recent stress tests mandated by the regulator, the bank's Tier One capital dropped to 4%. The bank was also involved in the Libor rate-rigging scandal and subject to misconduct fines. TM Bank would like to pay bonuses to its staff and dividends to its shareholders this year. The regulator, however, has demanded that the bank raise more capital to meet its Tier One capital requirements and to increase its capital to 12% to address governance problems. The regulator has also told the bank not to pay bonuses and/or dividends this year.

You are a lawyer in the bank's compliance department. The Head of the Bank's Compliance Department has asked you to write a memo explaining what the bank's obligations are under international banking regulations in response to the regulator's demands and whether or not the bank should comply with all, some or none of the regulator's demands. Also, please comment on whether the bank can increase its Tier One capital by issuing bonds.

Introduction – summary of what the essay will address and all main issues	1
Basel III (or Basel 3) is applicable to TM Bank's operations	0.5
SHORT discussion of evolution of Basel I – III and changes	1
Basel III increases/stricter capital and liquidity requirements: i.e, Tier 1 4.5% + 2.5% Capital Conservation Buffer (CCB), plus 1-2.5% Countercyclical capital buffer + SIFI surcharge 1-2.5%. Basel II only required Tier 1 4% and Tier 2 4%. Basel III restricts Tier 2 to 25% of Tier 1 for regulatory capital requirement + additional discussion	2 (+0.5)
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	2
Pillar 2 of Basel III can increase capital because of corporate and risk governance weaknesses (including conduct risk).	1
TM Bank's LIBOR rate-rigging fines will lead to higher capital. TM bank is probably a global SIFI whose governance practices will attract greater regulatory attention.	1
Pillar 2 – Internal Capital Adequacy Assessment Programme (ICAAP). Can include misconduct risks	0.5 0.5
Pillar 2 – Supervisory Review and Evaluation Programme (SREP). Can include misconduct risks and forward-looking macro prudential risks	0.5 0.5
Tier 1 capital and banks issuing bonds. Bonds cannot count for Tier 1 capital.	1
Extra: Basel II allowed banks to issue lots of bonds for Tier 1 and Tier 2 capital – leading banks to be undercapitalised when the crisis hit.	(+0.5)
Tier 1 should mainly be equity or equity-like instruments that are loss-absorbent	1
However, Tier 2 capital, such as bonds, is generally cheaper for banks to issue (compared to Tier 1 equity-like capital) because tax deductible and potential state bail-out means cost of funding declines because creditors possible state bail-out.	2
Regulators prefer equity capital for increased Tier 1 regulatory capital requirements because banks	

can absorb losses as a going concern and increase their solvency for the market Stress testing of bank capital requirements can happen under either Pillar 2 or Pillar 1 of Basel III. Banks must still hold enough capital to meet minimum requirement under stress test. Regulator can order them to increase capital stress test results. + Discussion Conclusion	1 2 0.5
TOTAL	**18 Pts.**

Question 4: (20%)

Central clearing of Over-the-Counter (OTC) derivatives should enhance the stability of the financial system. Please analyse critically.

Introduction – General intro sentence mentioning what OTC derivatives are and potential risks.	0.5
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).	0.5
What is central clearing? A third party (like a Central Counter Party or Clearing House) that stands between each buyer and seller of derivative contract and ensures that obligations of contract fulfilled.	1
Purpose of derivatives – hedging, speculating and arbitrage. Hedging protects against market risk and credit risk.	0.5
Types of derivatives – Interest rate swaps, foreign exchange swaps, credit derivatives (CDS), and equity derivatives. Credit default swaps a major cause of 2007-08 crisis (especially Lehman Brother's collapse.	1
G20 Head of State Summit Pittsburgh Sept 2009 adopted international regulatory reforms – an importance of clearing derivatives trades to control systemic risk. All standardised OTC derivative contracts must be centrally cleared (CCP or clearing house) and all standardised OTC contracts should be traded on exchanges or electronic trading venues/platforms and linked to repository (providing information on all OTC trades for regulators) and providing a platform that enables more liquidity to be made available for OTC trading.	1
The old way of clearing – bilateral clearing – had higher level of counter-party credit default risk and lower liquidity – because instruments not traded on exchanges where more possible buyers are and the liquidity by option.	0.5
Non-centrally clearing OTC derivatives will attract higher capital charges (both standardised and non-standardised)	0.5
Other international standard-setters: FSB, CPSS-IOSCO	0.5
Central clearing not a panacea, solution to all ill.	0.5
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	1

Disadvantages: 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 Central clearing can increase moral hazard and adverse selection. It can also drain liquidity from the financial markets	1
CCP/clearing houses could become Too big to fail – role of central banking in bailing-out	1
CCP recovery and resolution – some international standards – but still not developed in leading jurisdictions.	0.5
Conclusion – Central clearing reduces counter-party credit risk in bilateral OTC trading But Derivatives shift risk from one counterparty to another, not eliminate risk. Risk lay with CCPs/clearing houses which must manage the risk effectively.	1
Derivatives reform has shifted risk from bilateral counterparties to CCP	0.5
How the CCP is regulated and governed and overseen by its owners will be the main factor in determining whether they increase the stability of the financial system.	0.5
TOTAL	**12 Pts.**