

1) (30%)

BT Bank has its headquarters in State A (a member of the Basel Committee on Banking Supervision) and operates a large subsidiary in State B (also a member of the Basel Committee). BT bank is a systemically important bank under the FSB guidelines in category 1. A recession in the global economy in 2022 caused the bank to incur increased losses in its loan book and its Core Tier 1 capital dropped to 5% of its risk-weighted assets on a consolidated basis, but the bank made some profits in 2021 which it would like to distribute as dividends to its shareholders. Moreover, BT Bank was found by its home country regulator in State A to have committed misselling of financial products to many thousands of its customers in both State A and State B. The State A regulator ordered BT Bank to compensate all of its customers in State A and State B to whom it had missold financial products. Moreover, State A regulator ordered the bank to increase its Core Tier 1 capital to 15% of risk-weighted assets on a consolidated basis for its operations in both State A and State B. However, State B's regulator ordered BT Bank to increase its Core Tier 1 capital to 18% of the risk-weighted assets held by its local subsidiary in State B. Also, State B's resolution authority required the bank to produce a separate resolution plan for creditors of the local subsidiary in State B that would require 20% total-loss absorbent capital (TLAC). In contrast, State A has required the whole banking group (in both State A and State B) to produce a resolution plan that provides 18% TLAC. State A's regulator also prohibited BT bank's board from paying dividends to shareholders until it fully corrects its regulatory violations (discussed above), but the bank was allowed to pay bonuses to its staff. However, State B's regulator ordered BT Bank's local subsidiary not to pay bonuses to any of the bank's staff in State B until all regulatory violations were corrected.

BT Bank's Board of Directors has asked you to advise it, based on the facts above, about whether the demands of State Regulator A and State Regulator B comply with the international standards and norms of banking regulation (as discussed in class and readings). In answering the question, discuss each of the demands by State Regulator A and State Regulator B that are mentioned in the above paragraph.

Extra credit: Can BT Bank fulfil its Core Tier 1 capital requirement by issuing bonds? Why? Or why not?

BT Bank is a globally systemic bank with headquarters in State A (a member of the Basel Committee) meaning the bank must comply with Basel Capital Accord standards and any other applicable international standards.	2
<u>State A regulator's demands:</u> Misselling of financial products: BT Bank can be ordered to compensate its clients if the bank has missold financial products/investments.	1
The demand to increase core tier 1 capital to 15% of risk-weighted assets on a consolidated basis: Basel III requirements:	1
<ul style="list-style-type: none"> • 4.5% minimum core tier 1; • 2.5% capital conservation buffer; • 2.5% countercyclical capital buffer. 	2 1 + 1 extra
Add between 2.5-3% core tier 1 capital because BT bank is a SIFI.	2 2

Add core tier 1 capital for corporate governance failings (misselling) under pillar 2 Basel III	
<i>(As long as the argument is based on the specific requirements for core tier 1 capital, the students get credit regardless of whether they think the 15% is permitted under Basel III or not.)</i>	
State A's requirement that BT Bank not pay dividends to shareholders until it corrects regulatory failures: This is permitted under Basel III, but also could be questioned on the grounds that Basel III only allows a prohibition on dividends for banks in compliance with minimum standards but which have violated the additional requirements of capital conservation buffer and pillar governance requirements. It can be argued either way.	3
State A Regulator has discretion to allow payment of bonuses	2
<u>Extra credit:</u> Tier 2 capital requirement under Basel III is about 1.5-2 % which can be issued in bonds.	1
<u>State B regulator's demands:</u> Host country can increase capital level for local host subsidiary, but this goes against the international soft law principle of home-host country control – which allows host state authority to defer to the home state regulator's prudential regulations (i.e., capital requirements).	2
Discuss Basel Concordat first adopted in 1975 and updated in 1983 and again in 1990s to reaffirm principle of home country control.	1
Bank resolution principles applicable – home-host principle applies. But host state can still require separate resolution plan for local subsidiary based on multiple point of entry approach.	2
State requirement of 20% total loss absorbent capital – exceeds 18% international level, therefore it is questionable.	2
Single point of entry approach – where resolution plan approved by home state resolution authority	2
State B regulator can order BT Bank subsidiary not to pay bonuses until all regulatory failings have been corrected.	1 + 1 extra
Importance of principle of home-host control defers authority to home country supervisor, but does preclude host state authority intervening where regulatory rules are being violated.	2
<u>Extra credit:</u> Core Tier 1 capital generally consists of equity capital. Because bonds are not equity capital they do not count as core equity tier 1 capital. Bonds do not absorb losses as a going concern. Bonds can be issued as part of Tier 1 capital and Tier 2 capital.	1
Total Question 1)	30 + 2 extra

2) (20%)

What type of risks do derivatives contracts pose? How has the regulation of derivatives changed since the beginning of the financial crisis? What are the advantages and disadvantages of these regulatory changes?

Derivatives/futures emerges in 1970s as important for banks to hedge and speculate against interest rate and foreign exchange rate risk in financial markets.	1
Later in 1980s credit derivatives/CDS market develops in response to regulatory capital requirements and housing crisis in US. Derivatives trading increased with banks designing more complicated derivatives contracts for speculation, hedging and arbitrage.	2
Complex financial derivatives instruments trading led to increased complexity and opacity of derivatives markets. Financial institution interconnectedness grew and counter credit risk could be spread rapidly if one inter-connected counter party defaulted.	1 + 1 extra
The G20 proposed central clearing of standardised derivative contracts.	1
It requires novation of derivatives contracts so that a clearing house or central counterparty party (CCP) can legally stand between counterparties to a trade and fulfil remaining obligations of a defaulting counterparty.	2
When trades are novated at a CCP, the resulting multilateral netting benefits can increase the operational efficiency and reduce counterparty credit risk, collateral requirements and liquidity needs of members.	2
By removing the complex web of bilateral exposures into a single net exposure with the CCP, this creates an efficient system to manage financial risks arising these trades.	1
This offsetting of trades reduces the gross exposures significantly, resulting in a more streamlined and manageable trade infrastructure.	1
Key benefits of multilateral netting include: <ul style="list-style-type: none"> • Exposures: Exposures are based on net positions as opposed to the gross positions; • Counterparty credit risk: Since the sum of the outstanding trades are significantly reduced, the counterparty credit risk is subsequently reduced. 	2
Central clearing smooths operations while reducing the value of the obligations, which helps money move more efficiently among traders. In contrast to centrally cleared derivatives, the OTC contracts have higher collateral requirements.	2
Central clearing not a panacea. Too big to fail CCPs can start a financial crisis. CCPs should be subject to prudential regulation including capital requirements and governance standards.	2
CCPs/clearing houses do not eliminate risk – they simply concentrate the risks onto the balance sheets of the CCPs/clearing houses. Therefore, governance of CCPs/clearing houses are important. Decisionmaking and organisational structure. They can be too big to fail in a similar way that large banks are too big to fail.	2
Non-centrally cleared contracts are subject to higher capital requirements. So, by moving away from the OTC to CCP, the bank can reduce its capital	1 + 1 extra

requirements. This in turn makes reporting requirements much easier which also is a large benefit.	
Total Question 2)	20 + 2 extra

3) (30%)

The start-up StopWeapons intends to launch a Decentralized App (DApp), that should serve to track the sale of weapons to teenagers. To finance their project, the founders intend to launch an Initial Coin Offering.

- What are the advantages for them, and what are the risks for the investors?
- Assuming that StopWeapons founders have no reputation, could they launch an IPO? If yes, how can they do that?

After two years, StopWeapons successfully implemented its entrepreneurial project. Together with the main project it also launched a new stablecoin, PeaceCoin, which is listed on the Bellevue CryptoExchange of Zurich, a DLT trading facility falling under the supervision of FINMA.

What are ICOs - Initial Coin Offerings emerged as an alternative to Initial Public Offerings, in the context of capital formation.	5
Differences between ICOs and IPOs & Risks for Investors: <ul style="list-style-type: none"> • Lack or Light Regulation: in the vast majority of jurisdictions ICOs were not regulated, although securities regulators have recently tried to enforce actions, trying to extend securities laws to ICOs; • Lack of Gatekeepers: No gatekeepers mitigate information asymmetries, therefore investors are more exposed to fraud; • Others. 	7 7 up to + 3 extra
Bonus: STOs & IEOs are an evolution trying to mitigate these concerns – STOs are structured to be compliant with existing securities regulations, and IEOs rely on the stronger role of crypto-exchanges verifying information and acting as a sort of gatekeeper	+ 3 extra
These entrepreneurs can launch an IPO, although it would be a more expensive option depending on: <ul style="list-style-type: none"> • Compliance; • Need to hire market specialists, including investment banks. Investors lacking reputation typically rely on the function of underwriters – established investment banks – acting as gatekeepers.	7
What are underwriters and how do they act in the context of an IPO	4
Total Question 3)	30 + 6 extra

4) (20%)

Johnny and Amber are two Swiss-American traders. Via a chat on Telegram, they organize a pump & dump scheme to manipulate the course of PeaceCoin with a group of friends. By artificially determining an increase in the price of PeaceCoin and divesting at the peak of its value, they successfully extract some profits and cause significant losses among the other investors.

- Can FINMA prosecute them?
- Could they be held liable? If yes, what kind of liability?
- What is the difference between market manipulation and insider trading?

New Swiss reforms extended market abuse to DLT trading facilities, beyond traditional market platforms.	4
Pump and Dump schemes are manipulative practices therefore Swiss-American citizens can be held liable for doing this. FINMA has supervisory functions in Switzerland.	4
While exchanges are responsible for monitoring securities markets under their self-regulatory regimes, FINMA investigates violations of the law based on information received from the exchanges and on the basis of its own suspicions.	+ 2 extra
Manipulation in this context consists in altering the course of the price and extracting some value, defrauding the investor community.	4
FINMA can implement enforcement procedures against Amber and John, imposing sanctions. Sanctions are both pecuniary and criminal (depending on the severity of the offence).	4
Insider trading and market manipulation both rely on information, as part of the broader category of market abuse: <ul style="list-style-type: none"> • Insider trading practices rely on insider information, i.e. information on an issuer that is not publicly disclosed yet, and price sensitive (if disclosed, it will directly affect the value of certain financial instruments) • Market Manipulation generally consists in altering the course of financial instruments by disseminating false information or relying on other artifices, affecting the price of such financial instruments. • Both practices pose a threat for investors, who might be exposed to significant financial losses. 	4
Question 4)	20 + 2 extra
Overall Total	100 +12 extra