International Finance Law – Spring 2015

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Model Answer

Question 1	**Points**
Role of National Authorities	
National authorities play a dominant role in the international financial architecture and at all stages of the standard-setting process.	**0.5**
The supervisory authority/authorities are members of the standard-setting bodies such as the BCBS, IAIS, IOSCO, where they formulate sound principles and practices applicable across membership. The standard-setting bodies are members of the FSB.	**2**
Central Banks participate in the Central Bank Committees of the BIS.	**0.5**
National authorities (supervisory authorities, Central Banks and/or Finance Ministries, depending on the economic importance of the respective jurisdiction) also are direct members of the FSB, which oversees and coordinates the standard-setting process, monitors the implementation of standards in national jurisdictions on an ongoing basis and is a standard-setter itself (e.g., Key Attributes).	**1** **1**
As both the standard-setting bodies and the FSB are member-driven and take decisions based on consensus, each national authority de facto has a veto in the standard-setting process.	**1**
The G-20 is an informal political steering group at the highest level of governance that sets the agenda in international financial standard setting. Some countries are represented with their Finance Ministry and Central Bank.	**2**
National finance ministries represent their countries in the IMF and WB, the two treaty-based international financial institutions involved in the surveillance of standards implementation at the national level. Both institutions foster standards implementation via their lending, surveillance and technical assistance activities.	**2**
Finally, it is national authorities that implement international financial standards in their jurisdictions by transposing them into national law and/or applying them in their local practices.	**1**
Opinion on international standard-setting process	
It is good that national authorities have such a strong voice in the setting and implementation of international standards, because they are most familiar with local circumstances and because there is no one-size-fits-all solution in financial regulation.	**4**
or	**or**
The strong position of national authorities bears the danger of national interests (national champions, competitive advantages etc.) outweighing the international interests of financial stability, combating contagion etc. National authorities may not see “the big picture”.	**4**
Extra points for relevant answers	**2ZP**

Question 2	Points
Deposit Insurance vs. Lender of Last Resort	
Both deposit insurance and LOLR lending are crisis management measures. Rather than being alternative, they are complementary measures.	**1**
Deposit insurance comes into play if a financial institution has solvency problems (beyond liquidity problems) and needs to undergo resolution or be liquidated in an insolvency proceeding.	**1.5**
The deposit insurer is typically an (more or less) independent agency.	**0.5**
Deposit insurance aims to (1) safeguard financial stability by forestalling bank runs and (2) protect retail depositors (as a socio-political rationale).	**2**
The design of national deposit insurance schemes varies widely across jurisdictions, but has recently been given more attention at the international level (IAID Core Principles), which may lead to more uniformity of national schemes (e.g., coverage level) in the future.	**2**
Students can argue pro and/or contra the importance of deposit insurance: (+) it ensures a certain level of minimum protection for savers, (-) it is insufficient to cover the losses of large individual financial institutions or multiple financial institutions at once.	**2** **+1ZP**
The LOLR function, in contrast, is executed by the Central Bank in crisis situation.	**0.5**
According to classical theory, LOLR lending is based in the following conditions: (1) the bank (or financial institution) is illiquid, but not insolvent; (2) loans are extended against a penalty interest rate and (3) adequate collateral; and (4) assistance is granted only temporarily at the Central Bank's discretion.	**1**
History has shown that these theoretical conditions cannot always be followed: (1) illiquidity is almost impossible to distinguish from insolvency and (2) some banks are simply too big to let them fail.	**1**
It is therefore crucial that Central Bank liquidity assistance is coordinated with other crisis management measures, e.g., resolution, deposit insurance and – as a last resort – solvency support by the government.	**1**
LOLR lending should not be used to directly safeguard the interests of depositors, but it may have that effect if it stops the liquidity problems of an otherwise sound bank.	**1.5**
However, typically, both deposit insurance (in combination with special resolution regimes) and LOLR lending will be needed to manage a banking crisis.	**1**
Extra points for relevant answers	**+1ZP**

Question 3 (25%) 15 points:

Discuss the general background of the Basel Capital Accord. Its evolution from Basel I – a simple 8% capital risk-weight regime – to Basel II – a more complicated estimate of regulatory capital based on data from economic capital models. The crisis led to conclusion that bank capital was too low and not 'loss-absorbent' enough'. Basel III increases the level of Tier 1 capital and 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'.	1.0
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. Basel II's reliance on bank models to measure credit and market risk led to under-capitalization of banking system. Basel II largely micro-prudential in focus, assessing only risks on bank's balance sheet and not looking at inter-linkages between banks and effect of banks herding together in times of volatility. 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. Describe the 3 Pillars of Basel II – 1) capital adequacy, 2) supervisory review, 3) market discipline (disclosure). Elaborate a bit on each pillar.	1.0 1.0
Weaknesses of Basel II. Excessive focus on bank risk models and by allowing banks to calculate their own regulatory capital they did not calculate enough to cover the social costs (or potential systemic risk) of bank risk-taking. Basel II too complex and pro-cyclical – did not address macro-prudential risks in banking/financial system. Other criticisms include: • Credit risk models seek to align regulatory capital with economic capital (not account for 'externality of bank risk-taking) • Pro-cyclical capital requirements • Supervisory discretion – ***regulatory capture?*** • Focuses on individual bank's risk, not aggregate risk for financial system • Capital formulae too prescriptive & complex • Pillar 2 fails to incentivise bank management to take account of systemic risk (ie., compensation)	0.5 0.25 0.25 0.25 0.25 0.25 0.25

Basel III is primarily concerned with **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. 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'	0.75
Basel III in summary (below)	
➢ 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	.25
➢ Capital surcharge for systemically-important financial institutions (SIFIs) (1% to 2.5%)	.25
➢ Less reliance on bank models, but bank models remain the basis for regulatory capital determination	.25
➢ Limits on maturity mismatches in wholesale funding (NSFR, 2018)	.25
➢ Liquidity coverage ratios (LCRs, 2015)	.25
'Swiss finish' – 3% additional CET, and up to 19% Tier 1 & 2 for Big Swiss banks	1ZP
Liquidity requirements: CVA/capital charge	0.25
Net stable funding requirement	0.50
Leverage ratio	0.50

In both Basel II or 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. 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. Supervisory Review Evaluation Process (SREP): Assessing macro-prudential risks and relationship to bank governance Pillar 3 – role of disclosure across markets – making disclosure more comparable and information more meaningful for assessing macro-prudential risks	1 1 0.75 0.5ZP
Does Basel III achieve macro-prudential aims of regulatory reform? • More can be done? • Links of bank regulation to monetary policy, fiscal policy (taxes) and broader financial sector (ie., shadow banking): • Environmental and social risks – carbon risks, financial inclusion • Existing state regulatory practices to control environmental risks • Role of soft law in international law – should Basel Accord have more legally binding rules to be more macro-prudential	 0.5 0.5 0.5 0.5 0.5ZP

Question 4 (25%) 15 points:	**Points**
Main Objectives of Securities Regulation	
• Investor protection Dealing with the principal-agent problem and reducing information asymmetry • Efficient allocation of capital – market efficiency – competition – reduction of transaction costs – increase of trading speed • Fair and transparent markets • Reducing systemic risk • Financial stability Financial interconnectedness • Market integrity – e.g. market abuse regulation	**1** **1.5** **0.5** **1** **1** **1**
Evolution of the Focus of Securities Regulation Post-Crisis	
Focus on macro-prudential objectives – not only micro-prudential regulation	**0.5**
Stability of the financial system at the heart of the regulatory reform Investor protection remains a significant objective but the regulators put financial stability at the core of the regulatory debate due to the failure of financial intermediaries during the financial crisis *With respect to entities*: financial intermediaries potentially systemically relevant because of their size, complexity and systemic interconnectedness – increased regulation of the systematically relevant entities *With respect to transactions* : securities markets as important channels for systemic risk – how certain types of securities can pose a systemic risk	**1** **1** **1**
Cross-border cooperation among regulators Importance of international standards such as IOSCO standards	**0.5** **0.5**
Your Opinion on the Most Important Concern Post-Crisis	**2.5**
Extra points for relevant answers	**2**

Note:

Points are not allocated for the mentioning of the catchword, analysis and description is necessary.