

International Finance Law - Exam Model Answer

Question 1 – 20%	20 points
<i>Discuss the institutional and legal structure of international financial regulation. In your view, does it need to be reformed? Why or why not?</i>	
The international financial regulatory structure is primarily a system of voluntary standard setting bodies that meet informally to exchange ideas, methods and practices in their approaches to financial regulation.	1
The most prominent bodies are the Financial Stability Board and the Basel Committee on Banking Supervision.	1
Other bodies are important such IOSCO, IAIS and Financial Action task Force (FATF) – some mention of what these bodies do	2
The international legal framework for financial regulation is mainly a soft law system: Voluntary standards where member countries encourage to comply but no legal obligation to do so.	1
But international bodies put political pressure on countries to comply and use naming and shaming to pressure compliance. Other market pressures (lower interest rates for bank/govt borrowing and international institutional (IMF conditionality) pressures to comply.	2
IMF exchange rate regime was fixed to gold in 1950s-1971 until US pulled out of system.	+ 1 EP
FSB handles bank resolution principles that apply to systemically important banks.	2
IMF provides a treaty-based framework for performing its three main functions:	
The system is criticised for its standard setting because often it is not transparent in decision-making and the final standards seem to serve interest of developed countries.	2
Critique on the grounds of accountability, legitimacy and effectiveness. International Standards – discuss and elaborate.	2
Do not seem to be effective because the standards often are criticised as contributing to financial crisis	1
Providing a more legalised international framework supported on grounds of .legal certainty.	1

But criticised that legal rules internationally would be inflexible and not able to allow regulators to respond quickly to developments in financial markets	1
Reforms could also take the form of allowing more countries to be members of the most important IFIs (such as FSB and Basel Committee or FATF)	1
While keeping the soft law framework. But soft law allows countries to depart from standard rules whenever it is expedient – such as US in SVB collapse.	1
Some mention of how Basel Capital Accord was flawed and contributed to 2007-08 – was it the soft law framework that allowed countries to depart from international standards?	1
Or were the standards simply flawed (regardless of hard law and soft law)	1
Total Question 1:	20 points + 1 EP

Question 2 – 30%	30 points
<p><i>BC Banking Company ('BC Bank') is a large systemically-important global bank with headquarters in Switzerland and many subsidiaries operating in multiple foreign countries. BC Bank had a profitable year in 2022. BC Bank operated with 13% Tier 1 regulatory capital in 2022, but the global economic slowdown in late 2022 and 2023 has significantly increased the number of loan defaults and trading losses for the bank causing its Tier 1 capital to drop to 7.5% in mid-2023. Moreover, the bank has a large exposure in its loan book to fossil fuel energy companies and to firms that do business in the fossil fuel energy sector. Also, BC Bank was found liable for having mis-sold investment products to its retail customers through its bank trading platform leading to approximately CHF 100 million in losses for its customers.</i></p> <p><i>The BC Bank Board of Directors has asked you to advise it regarding what the regulator can require it to do to address the above problems. In considering what the regulator can do, discuss the relevant areas of international financial regulation discussed in class and the mandatory readings.</i></p>	
<p>As adviser to bank board of directors, you should point out the following:</p> <ul style="list-style-type: none"> • That the bank is subject to Basel III requirements. • In 2022, the bank's 13% Tier 1 capital probably complied with minimum Basel III requirements. • List the capital requirements. <ul style="list-style-type: none"> ○ 4.5% Core Tier 1 capital 	<p>1</p> <p>1</p> <p>1</p>

<ul style="list-style-type: none"> ○ 2.5% capital conservation buffer ● Probably an additional countercyclical capital charge (depends if local economy in a upturn or not) ● SIFI surcharge for systemically important banks between 1-2.5/3% ● Depending on governance practices of the bank – pillar 2 surcharge but in late 2022/early 2023 economic slowdown causes 	<p>1</p> <p>1</p> <p>1</p> <p>1</p>
<p>Discuss difference between Tier 1 (or Core Tier 1) and Tier 2 capital. Tier 1 capital can also be Core Tier 1 capital that generally consists of equity capital and/or equivalent instruments. Banks cannot issue bonds for Tier 1 (generally) because bonds are not equity capital – Regulators like core tier 1 or Tier 1 equity capital requirements because they enable banks to absorb losses as a going concern whereas bonds generally do not absorb losses unless the bank is taken into resolution or insolvency and so cannot count generally as Tier 1 capital. Bonds can be issued as part of Tier 2 capital.</p>	<p>2</p>
<p>Alternative Tier 1 bonds are bonds that convert to Tier One equity instruments if the regulator determines that the bank is in distress and needs to be recapitalise itself to maintain minimum capital requirements.</p>	<p>1</p>
<p>Economic downturn has caused bank capital to drop to 7.5% in mid 2023. This would still be less than minimum capital because the bank is a SIFI and would be required to hold between 1-2.5/3% additional regulatory capital.</p>	<p>3</p>
<p>But the bank complies with capital conservation buffer at 7.5% because CCb is 7.0.</p>	<p>2</p>
<p>So, because bank is above 7.0 CCb it can still pay dividends, bonuses and share buybacks from its profits.</p>	<p>2</p>
<p>Under Basel (pillar 2), banks should be diversified in their loan exposures and not overly exposed to any one sector.</p>	<p>2</p>
<p>Environmental sustainability has become an important criteria for bank supervisors: Point out possibility of green supporting factor (lower capital requirements for loans to unsustainable industries and/or higher capital (brown penalising factors) for loans to conventional companies in brown economic sectors.</p>	<p>2</p>
<p>Or Pillar 2 risk-based supervision should require that bank business models and governance take account of environmental sustainability (ie., climate change).</p>	<p>2</p>
<p>And pillar 3 bank disclosure requirements should possibly include potential risk exposures to environmental unsustainable sectors.</p>	<p>1</p>
<p>Bank misselling scandal may lead to regulators increasing capital requirements under Pillar 2 of Basel III for market misconduct.</p>	<p>2</p>
<p>Misconduct can also be operational risk</p>	<p>1</p>

Other considerations: BC bank must issue equity capital (or equivalent) for Tier 1 capital 1 requirement. Not bonds, but equity shares or equivalent.	1
But Tier 2 regulatory can take the form of bonds but it cannot exceed 2% of risk-based assets to count as regulatory capital.	1
Also, can point out that alternative tier 1 capital can take the form of bonds but they can be converted if the regulator decided the bank is experiencing difficulties/distress.	1
And the bonds can be converted to Tier 1 equity capital in order to recapitalise the bank.	1
Risk-weighting discussion for extra points: The risk-weights of bank might increase because of economic downturn, causing capital requirement to increase.	+ 2 EP
Total Question 2:	30 points + 2 EP

Question 3 – 50%	50 points
<p><i>Investor protection is a fundamental aspect of international financial regulation. It ensures the rights and interests of investors are safeguarded in the global financial system.</i></p> <p><i>Consider the following scenario and answer the questions that follow:</i></p> <p><i>Country X is a popular destination for foreign investors due to its growing economy and attractive investment opportunities. However, concerns have been raised about the level of investor protection in the country. The regulatory framework in Country X is evolving, but there are still gaps that need to be addressed.</i></p> <p><i>Recently, Investor A, a foreign investor, encountered a significant problem while investing in Country X. Investor A purchased shares in a local company based on false financial statements provided by the company. As a result, Investor A suffered substantial financial losses. The local regulatory authorities have been slow to respond to Investor A's complaints, and it seems that the legal remedies available in the country are inadequate.</i></p> <p><i>Questions:</i></p>	
<p><i>1. Identify and explain two key components of investor protection that should be present in a robust regulatory framework.</i></p>	

<p>Investor protection relies on:</p> <ul style="list-style-type: none"> - Appropriate regulation - Appropriate mechanisms of enforcement <p>(12 Points)</p> <p>They both contribute to foster legal certainty, which is essential for the development of financial markets, and at the international level the attractiveness of a jurisdiction.</p> <ul style="list-style-type: none"> - Potential further developments: consistency with international standards in the area of financial regulation, and banking regulation - Potential Discussions: Market Integrity, Transparency. <p>(6 Points)</p>	
	18 points
<p>2. <i>Analyze the specific challenges faced by Investor A in seeking redress for the financial losses suffered in Country X. What factors hindered Investor A's ability to obtain appropriate legal remedies?</i></p>	
<p>Elaborate on the basis of subquestion 1. Lack of:</p> <ul style="list-style-type: none"> - Appropriate Regulation - Appropriate Mechanisms of Enforcement - Others 	14 Points
<p>3. <i>Suggest two measures that could enhance investor protection in Country X. Explain how each measure would address the existing gaps in the regulatory framework.</i></p>	
<ul style="list-style-type: none"> - Alignment with International Standards - Others 	[15 Points: Bonus Question]
<p>4. <i>Discuss the role of international cooperation and coordination in promoting investor protection. How can international standards and cooperation among regulatory authorities contribute to addressing the challenges faced by investors in cross-border investments?</i></p>	
<p>Discuss:</p> <ul style="list-style-type: none"> - The role of international financial regulation is important for contributing to the development of appropriate standards. - The nature of such standards: Soft Law, The problem of implementing them; regulatory intervention at the national level. - Examples 	18 Points

<ul style="list-style-type: none">- Entities involved and their role: the G20, the IOSCO, OECD, the Financial Stability Board, the European Systemic Risk Board, Financial Stability Oversight Committee, as well as to some extent national securities regulators and central banks.- Examples: (i) financial crisis (the role of the IOSCO, G20); (ii) the development of AML practices and international financial crime (iii) others- [additional topic could be: processes of harmonization within the European Union and the role of ESMA, European Commission, and differences with international soft law mechanisms]	
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