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Spring Semester 2019

International Finance Law

28 June 2019

Duration: 120 minutes

- Please check at receipt of the exam the number of question sheets. The examination contains 3 pages (including cover) and 4 questions.

Notes on solving the questions

- Please answer all four (4) questions.

Notes on marking

- When marking the exam each question is weighted separately. Points are distributed to the individual questions as follows:

Question 1	25 points	25 %
Question 2	30 points	30 %
Question 3	25 points	25 %
Question 4	20 points	20 %
Total	100 points	100 %

We wish you a lot of success!

Question 1 (25%)

"International financial standards should be coherently implemented across all states. The Financial Stability Board (FSB) should have powers to enforce international standards."

Do you agree or disagree with this statement? Please discuss your reasons for agreeing and/or disagreeing.

Question 2 (30%)

Country A is a member of the FSB and a major oil exporting nation. A is grappling with plummeting oil prices that is imposing a severe strain on its sovereign budget. To reduce its budget deficit, A has issued state bonds. A's state bonds are nearly worthless and its budget deficit continues to grow. Rumour has it that A's largest bank F is running out of liquidity. Depositors are beginning to get nervous about their deposits. Indeed, unknown to the public, F is in need of a bail-out. A's central bank is responsible for both monetary policy and prudential regulation and supervision. The central bank's operational and decision-making responsibilities are, however, separated from one another.

A's government wonders how to stabilise its banking sector and bring its fiscal deficit under control. What can they do? Consider the following:

(a) Discuss the relationship between deposit guarantee schemes and bank resolution.
(b) Kim Blunt, special adviser at A's foreign office, recommends that prudential regulation/supervision be united with monetary policy decisions. He says such a step could strengthen crisis management and the controlling of systemic risk, because of the central bank's independence in monetary decisions, which would then extend to banking supervision. Why do you agree or disagree with him?
(c) Discuss the pros and cons of the country requesting a loan from the International Monetary Fund.

Question 3 (25%)

Why do you agree or disagree with the following statement:
“Systemically important banks should not be prosecuted over suspicion of financial crime or misconduct. Doing so could risk triggering a systemic crisis, which would not be in the public’s interest. Large banks are not only ‘too big to fail’, but also ‘too big to jail.’”

Question 4 (20%)

Why is Brexit relevant to international financial regulation?

International Financial Law, FS 2019

<u>Question 1 (25%) – 12 points</u>

The following aspects should be considered as they may shore up either view.	Points max.	Points received
Introduction – International financial standards are usually non-binding rules establishing minimum standards and principles. Nation states can then implement the standards in their own regulatory framework. Even though the FSB, as the G20's 'operating arm,' promotes financial standards and coordinates harmonised implementation internationally, prudential standards and enforcement vary across jurisdictions in several areas of financial regulation (e.g. bank resolution). On the one hand, a more harmonised level of financial standards and enforcement across jurisdictions could make the financial system more sound and safe but on the other hand it could collide with national laws and market practice. Moreover, it could stand in the way of competition, market discipline, and innovation across countries.	1 .5 .5	
Financial regulation aims to maintain financial stability, which is not confined to national boundaries. Since the crisis financial regulation has shifted from a pure micro-prudential focus to a macro-prudential focus addressing risks across the financial system and inter-linkages between banks. Inclusiveness, coherent implementation and systemic risk controlling at the international level are widely viewed as important to the effectiveness of regulation.	1 1	

The G-20 as the major agenda-setter and political steering group put in place the FSB (established London Summit 2009/given legal personality at Cannes Summit, Cannes Communiqué), which coordinated immense efforts internationally, regionally, and nationally to enhance financial regulation and the monitoring of systemic stability. The FSB acts in response to G-20 requests, reports to the G-20 regarding progress, and coordinates the standard-setting in collaboration with specialist standard-setting bodies (such as BCBS, IAIS and IOSCO). The FSB combines expertise in financial stability as it includes members from jurisdictions (central banks, Ministries of Finance, and prudential supervisors). It is the forum, which assembles all important actors. The FSB acts by consensus, thereby reflecting the variety of legal orders in its member states. It collaborates with the IMF in order to link macro-prudential supervisory perspective (e.g. early warning exercises) with micro-prudential regulatory perspective.	.5 1 1	
International financial rules are usually non-binding. Some sets of rules are less recognised internationally than others. For instance, market abuse regulation is less coherently recognised than Basel Committee standards on bank capital and other prudential standards.	1	
To further harmonised implementation of international standards, the FSB carries out peer reviews on a regular basis. The reviews are published, which can result in insufficiently compliant countries facing naming and shaming. It also generates peer pressure disciplining member states to comply.	1.5	

Two types of FSB peer reviews can be distinguished: thematic reviews and country reviews. Thematic reviews concentrates on the implementation of a particular set of rules across the FSB's membership. Country reviews involve assessments on the implementation of all relevant standards in a specific member jurisdiction. FSB country reviews are complementary to the IMF's FSAPs in that they employ a different kind of surveillance proceeding. FSB members are expected to "lead by example". To this end, they are expected to implement standards in a timely and fully compliant manner. It is evidence of their continued commitment. The reviews are conducted by peers for peers, i.e. at arm's length. The FSB can engage in dialogue with countries that show gaps in their ROSCs (by IMF) and issue an implementation report with recommended measures to further adherence.	1 1	
A nuanced way to argue could be the following: The FSB designates global systemically important bank. As the FSB has also become instrumental in coordinating the supervision of global systemically important banks (G-SIBs) e.g. through supervisory colleges, it could be argued that the FSB be given full regulatory and enforcement powers regarding GSIBs. The FSB's institutional capacity would, however, have to be adjusted.	1 extra	

The statement may also trigger legitimacy concerns beyond the FSB's membership. In order to strengthen legitimacy, the FSB/G-20 increased their membership to include twelve additional countries (e.g. BRICS). The FSB-IMF collaboration in macro-prudential regulation also raises concerns about accountability, legitimacy and effectiveness of FSB recommendations. However, the FSB's recommendations are not adopted with non-FSB member countries in mind and therefore may not be appropriate for the regulatory regimes of non-FSB countries. However, the IMF and World Bank attempt to enforce FSB standards through FSAPs and 'conditionality' lending programmes, even though these standards may not be efficient or effective for these countries. Consequently, an argument can be made that the efficiency and effectiveness of G20/FSB standard-setting would be enhanced if these bodies took account or incorporated the views and institutional context of non-G20 countries too.	1	
TOTAL	12 + 1 extra	

Question 2 (30%) – 18 points

Question 2(a) Introduction: To stabilise the banking sector, A could bail out F, utilising, e.g. state owned funds, in other words, taxpayer's money. Bail-outs have, however, proved to be inefficient and morally hazardous. This scenario would mean an even stronger strain on financial stability. If A is to avoid the scenario of moral hazard, A will have to limit the taxpayer's direct financial exposure for having to bail out a systemically important institution such as F. In order to avert a depositor run on F, A could utilise a deposit guarantee scheme promising retail depositors that a certain fraction of their deposits will be unaffected in case of F's failure. Finally, A could let F enter a resolution scheme, thereby unwinding it in an orderly manner and enabling it to continue its intermediary function in support of the wider economy.	1 .5 extra	
Deposit Guarantee Schemes (DGS) aim to protect depositors and to stabilise the banking sector by preventing a bank run. Moreover, DGS aim to prevent depositors from withdrawing their funds in large quantities, once rumour about a bank's financial difficulties has started to spread. The schemes guarantee that (retail) depositors will have a certain amount of their deposits protected and available even if the bank fails. In the pre-crisis era DGS used to compensate depositors in case their banks were liquidated. Through strengthening depositor confidence, the DGS can restore bank Fs intermediary role in support of the wider economy in that it enables the bank to continue their business of borrowing short term and lending long term.	1 .5 extra	

DGS can also play a role in bank resolution if their design and mandate allows it. The FSB distinguishes four DGS models. The paybox model cannot play a role in banking resolution, as it only allows for a disbursement of insured deposits in the event of a bank's failure. A role in bank resolution is, however, possible for the Paybox Plus, Loss Minimiser, and Risk Minimiser models as they enable a DGS to take on responsibilities other than disbursement to depositors. DGS involvement encompasses various roles ranging from providing certain specific functions (i.e. commonly contributions to the funding of resolution measures) under a Paybox Plus mandate, to taking part in the selection of an appropriate and adequate resolution measure (guided by the principle of cost-efficiency from the DGS point of view) under a loss minimiser mandate, to supervising banks on top of the mentioned tasks under a risk minimiser mandate.	1 1 extra	
A DGS's funding mechanism is also key to enabling its participation in bank resolution measures, as only ex ante funded schemes may play this role. Ex post funded DGSs (like Switzerland) do not come with pre-existing funds and have to resort to collecting funds only after a bank has failed. The latter would not be able to contribute to the funding of resolution measures in a timely manner (i.e., within a "resolution weekend").	1	

In general, resolution regimes are designed to provide a more comprehensive legal and regulatory framework for a bank to be taken into administration or liquidation without causing a serious disruption to the banking system. Resolution regimes have the objective to protect financial stability by addressing systemically important banks, by enabling banks to continue their functions, and by making limited use of public funds and balancing investor rights and regulatory objectives. The latter of which are vital to the wider economy. As A is a member of the FSB, the FSB's Key Attributes of Effective Resolution Regimes (KA) will find resonance in A's resolution regime. Resolution regimes apply to all financial institutions that could be systemically significant or critical (KA 1). The bank can enter resolution if it is no longer viable and there is no reasonable prospect of becoming so, but it is not yet insolvent (KA 3). As a matter of principle, creditors must not be worse off than in liquidation (KA 5). The resolution authority's resolution powers include for instance the right to remove and/or replace the bank's management and/or the board of directors, to appoint an administrator, to restructure and wind down the firm's operations, and to override shareholders' rights (KA 3). The latter have important legal implications, which have to be balanced (KA 5).	 1 .5 .5 extra 1 .5 extra .5 extra	

To resolve a bank, the resolution authority has several resolution tools at hand, all of which aim to limit the use of public funds and help restructure/unwind the bank "from within." The sale of business tool is the method in which the bank is completely or partially sold to another entity, preferably a private buyer. The bridge institution tool is the method in which the viable parts of a bank in resolution are transferred to another bank that is established for this purpose until a new buyer can be found (temporarily usually 2 years). The bridge institution tool does not require the shareholders' consent. In combination with other tools, the asset separation tool aims to achieve the orderly management and run down of non-performing loans or difficult-to-value assets. It transfers these assets to an asset management vehicle ("bad bank"), which is under the resolution authorities' supervision. The remaining parts of the bank ("good bank") can thereby continue its operations.	.5 .5 extra .5	
The bail-in tool stands out in that it has the strongest impact on shareholders and creditors. Losses are primarily borne by them in order to incentivise shareholders' and creditors' interest to monitor their bank's performance during normal circumstances. (See for instance bail-in tool laid down in the BRRD). The DGS may contribute to the bearing of losses to the extent it would have contributed in an insolvency proceeding. Insolvency ranking applies according to the pari passu treatment. In pursuit of the "no creditor worse off principle" certain bank liabilities are usually exempted from bail-in, including retail deposits covered by the DGS (see e.g. BRRD), secured liabilities, liabilities that result from a fiduciary relationship, etc. …. .	1 .5 extra .5 .5	
The bail-in tool is particularly relevant in the winding down of systemically important banks. Extra credit: If discussion of the bail-in's potential contagious effect related to the resolution authority's wide range of discretion.	1 extra	

Question 2(b) The answer should include a discussion of: monetary policy objectives, regulatory supervision objectives, the relationship between accountability and independence, and the principle of the rule of law.		
Introduction: The policy move would mark a significant institutional change.		
The exercise of these powers would raise serious questions regarding the central	1	
bank's accountability for supervisory decisions to banks and financial		
institutions under its supervision. On the one hand, such a step could mean	.5	
pooling responsibilities coming with the objectives of crisis prevention and	extra	
crisis management. In the short term, this change could lead to the objectives	.5	
and financial stability being strengthened. On the other hand, it could conflict	.5	
with the central bank's objective of price stability and threaten financial	extra	
stability. Such a step would also mean restricting banks' and individual firms'		
rights to contest supervisory decisions. This could seriously harm the central	.5	
bank's credibility as basic principles of the rule of law would be ignored. In the	extra	
long term, it could even mean threatening financial stability.		

Monetary policy aims to ensure price stability. It involves only a few macro-economic instruments i.e. interest rates and the quantity of money. To achieve price stability, the more or less predictable economic trade-off between unemployment and inflation has to be considered. For this mandate to work, central banks are usually given great independence with only limited accountability mechanisms. Supervisory objectives are far more various involving financial stability, investor and depositor protection, consumer protection, and addressing financial crime. It is hard to measure whether these objectives have been achieved or not and what the economic implications are. Bank supervisors can also restrict and restructure property rights and contractual rights belonging to individuals firms, depositors, creditors. For instance, in banking resolution they can restructure or restrict shareholder rights. For this mandate to be in line with the rule of law, banking supervision is subjected to far greater accountability mechanisms, e.g. by allowing that firms be consulted before they are subject to controls or that regulations are ascertainable in advance.	.5 1 extra 1 .5 extra .5	
If the central banks become responsible for supervisory decision, it could take supervisory decisions in order to ensure stability in the banking sector. This in turn could conflict with price stability. The central bank could, for instance, lower capital adequacy standards, thereby enabling banks to lower terms of credit. This in turn could turn into price instability. On the other hand, according to post-crisis macroprudential regulation theories central banks should be involved in supervising banks to ensure that banks implement broader monetary policies and that controls over monetary and payment systems by CBs are necessary to fully carry out supervisory and regulatory mandates.	1 1 extra	

Question 2(c) Introduction: To bring its fiscal deficit under control, A could turn to the IMF and apply for a loan. The IMF's recipients of loans are states which are unable to fund their deficit positions in the market and must resort to the IMF for support. On the one hand, such a move could come with renewed creditworthiness and the prospect of becoming able to re-enter the international capital market. On the other hand, A would have to agree to the IMFs strictly conditional programme and terms of credit coming with strict monetary and fiscal policies.	1 .5 extra	
To receive a loan, the country's authorities must agree with the IMF on a programme of policies aimed at meeting specific, quantified goals regarding external viability, monetary and financial stability, and sustainable growth. Details of the programme are defined in a letter of intent from the government concerned to IMF's Managing Director.	1	
IMF lending is conditional upon the acceptance of this IMF programme of policies to correct the Country's balance of payments problems and the borrower country and the IMF must agree on specific economic policies that are required.	.5	

IMF's lending programme aims to address balance of fiscal deficits and excessive current account (trade deficits). In contrast, Longer-term loans for project finance and economic policy restructuring granted by the World Bank. The member state in need of finance must be unable to obtain financing on affordable terms on the capital markets. The IMF may define a set of conditions to its lending. The conditionality is either ex ante or ex post. In case of phased lending, the tranches of lending are conditional upon the performance of the member state as regards the conditionality. The conditionality is divided into different types: (1) financial (2) macro-economic conditionality (3) structural conditionality. The conditionality puts the IMF in a position to force a member state into adopting and implementing financial standards. The Articles of Agreement do not expressly define the condition on which loans are disbursed. This means that conditionality is mainly determined by the IMF's general purpose according to Art. 1 of the Articles of Agreement. The conditionality of payments is not an obligation of public international law but rather is considered to be an obligation incurred transactionally under IMF's legal framework for repayment The interpretation of conditionality must take Art. 1 into account: it refers to the need for adequate safeguards in the temporary provision of resources by the Fund. This means that the broad definition gives a large degree of discretion to define the policies on the use of their funds. The IMF published the guidelines on conditionality in 2002, which are, however, not legally-binding.	.5 .5 extra 1 extra .5 .5 .5 extra	

The IMF has repeatedly been subject to criticism on grounds of legitimacy and accountability. This has partly to do with their allocation of special drawing rights and the related allocation of voting power. Their strict requirements on bail-outs too added to their image of an organisation that is governed by and for the interests of industrialised economies. Critics say that their lending policy doesn't give emerging economies appropriate room in implementing international financial standards. The keyword here is austerity. For instance, the IMF helped Asian countries in the 1970s and countries such as Ireland and Greece with their sovereign debt crisis. In all of these examples the IMF insisted on the implementation of standards used in industrialised economies. The consequence of their strictly austere policies was then that countries were struggling to stimulate economic growth. Greece, for example, is still in the process of recovering, with high unemployment rates, strained sovereign budget, etc. It is suggested that the IMF Executive Board should adopt internal governance reforms to enhance its accountability and legitimacy. It is suggested that they re-orient their financial policy advice to support alternative financial regulatory frameworks that give emerging economies more discretion implementing financial regulatory standards. To date, many developing countries think that IMF's policies give industrialised countries a competitive advantage over developing countries.	.5 extra .5 extra .5 extra .5 extra 1 extra .5 extra	
TOTAL	18 + 15.5 extra	

Question 3 (25%) – …12 Points

The answer should involve: the significant role of systemically important banks, the conflict of interest between the public's interest to prosecute perpetrators of misconduct or crime and the public interest to ensure financial stability, the principle of proportionality, the principle of separation of powers.	.5	
If financial institutions are considered to be "too big to jail" it will most likely generate moral hazard and the perception that large banks enjoy immunity from being executed. The public's loss of confidence in the financial system could, in turn, threaten financial stability. On the other hand, prosecuting a large institution could cause a destabilising hit to the confidence of its creditors with a potential spill-over effect on the safety and soundness of the financial system. In that scenario, it would not be in the public's interest to go ahead with the prosecution.	1 1 1 extra	
Large financial institutions are defined as systemically important because of their size, complexity, or inter-connectedness. Their systemic role has been repeatedly recognised by the G20 and the FSB. At the Pittsburgh Summit the G20 agreed to address cross-border resolutions and systemically important financial institutions and, through the FSB, to propose possible measures including more intensive supervision and specific additional capital, liquidity, and other prudential requirements.	1 2	

For instance, the SIFI framework aims to reduce the moral hazard associated with systemically important banks. In particular, the FSB designates global systemically important banks. They are required to meet heightened supervisory requirements and higher capital buffers. As part of their mandate, the FSB supported the establishment of supervisory colleges for almost all G-SIBs. They are required to coordinate and cooperate on cross-border risk assessments and crisis prevention. Alongside the Basel III framework G-SIBs must have financial in instruments available to absorb losses in resolution and recapitalise (TLAC requirement / MREL adopted by the BRRD).	1 1 extra 1	
Most countries have civil procedures in place, which are designed to sanction financial institutions' or individual bankers' misconduct. As their standards of proof do not require proof beyond reasonable doubt, institutions are easier to prosecute. When weighing up whether to bring charges against an institution the administrative body can take other public interests into account such as the safety and soundness of the bank at stake. It is certainly a matter of individual circumstances whether or not to go ahead with a prosecution. The decision should certainly involve a careful consideration of all interests involved based on the principle of proportionality.	1 .5 1	
A more nuanced approach could be to prioritise charges against individual employees or bankers and to drop charges against the bank itself should there be a serious threat to its soundness if news about criminal behaviour spread.	1	

Particularly in criminal proceedings, another legal question is whether the decision not to prosecute a bank would be in breach of the principle of separation of powers. The judiciary/prosecution authority is supposed to decide independently from influence and concerns outside its remit. If the country's prudential supervision authority intervened in the prosecutor's decision-making it would interfere with the principle of separation of powers. Some states still assign prerogative powers to the government over prosecutors. However, this is subject to an ongoing debate as recent case law of the ECJ shows.	.5 extra 1	
TOTAL	12 +2.5 extra	

Question 4 (20%) – …8 Points

The answer should address what principles of financial regulation and inter-state coordination in applying regulatory rules that have arisen in the Brexit debate are also relevant to international financial regulation, and also what principles of international financial regulation are relevant to a post-Brexit settlement.	.5	
Financial business is highly regulated. IN Europe/UK, it is largely structured for regulatory purposes on membership of, and access to, the EU single market, and in particular passporting rights The content of financial regulation in the UK largely derives from EU law UK is a full participant in the governance structure of the European Supervisory Authorities (ESAs) and EU and UK in international standard setting bodies In these circumstances, the effect of Brexit on financial services and their regulation is a cause for concern, not just for the UK, but for the EU also. Current international principles of financial regulation provide a model or benchmark for how financial relations may be conducted between the UK and EU post-Brexit. Principle of home country control based on mutual recognition by host countries of home country oversight and ensuring compliance with minimum international standards.	.5 1	

Alternative post-Brexit models: 1) Norway model – EEA Model 2. Relocation model – business moving ‘shell’ offices to EEA/EU states in case of hard Brexit Model 3 – Free trade agreement (ie., Canada ++) Model 4 – Crash-out of EU on WTO/GATS rules	.5 .5 .5 .5	

What is in the interest of global financial markets?		
• The crisis of 2007-8 shows the importance of having a coherent regulatory system working in partnership with other countries. International soft law can be criticized for weaknesses.		
• The EU and UK have led the way in the formulation and adoption of international standards	1	
• It has succeeded in accommodating the different position of States which have adopted the euro, and those which have not	.5	
• The ESAs provide the foundation for further development on a European basis and for implementing EU financial legislation that aims to apply international standards. A race to the bottom because of Brexit would be destructive.	extra .5	
• The EU and the UK therefore should recognise that they have a mutual interest in maintaining the essentials of Europe’s and international financial regulatory system, based on, for example, applying certain principles post-Brexit, such as	1	
Equivalence (other versions of equivalence, Substitute Compliance and Mutual Recognition based on minimum international standards	1	
• Could/should EU-UK free trade agreement incorporate international standards?	extra 1	

Conclusion based on main principles that may serve as a basis for a future relationship – Equivalence and/or Substitute Compliance, Mutual Recognition based on minimum international standards. And summary of overall argument about competitive factors and importance of international standards	.5	
TOTAL	8 + 1.5 extra	