International Monetary and Financial Law

MILE Program 2019

Prof. Dr. Susan Emmenegger, LL.M.
International Monetary and Financial Law

- Objectives, Scope and Instruments of Financial Regulation
- International Financial Regulatory Architecture
- International Financial Regulation in Action: Capital Standards and Too Big To Fail/Cross-Border Resolution
Objectives, Scope and Instruments of IMFL

Prof. Dr. Susan Emmenegger, LL.M.
The archetypical financial actor: banks and what they do

What is a bank?
What is a bank?
## Balance sheet

**USD million**

<table>
<thead>
<tr>
<th>Note</th>
<th>31.12.18</th>
<th>31.12.17</th>
<th>1.1.17</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and balances at central banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans and advances to banks</td>
<td>10</td>
<td>16,868</td>
<td>14,094</td>
</tr>
<tr>
<td>Receivables from securities financing transactions</td>
<td>10, 25</td>
<td>95,349</td>
<td>91,951</td>
</tr>
<tr>
<td>Cash collateral receivables on derivative instruments</td>
<td>10, 25</td>
<td>23,602</td>
<td>24,040</td>
</tr>
<tr>
<td>Loans and advances to customers</td>
<td>10</td>
<td>320,352</td>
<td>326,746</td>
</tr>
<tr>
<td>Other financial assets measured at amortized cost</td>
<td>10, 17a</td>
<td>22,563</td>
<td>37,815</td>
</tr>
<tr>
<td><strong>Total financial assets measured at amortized cost</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial assets at fair value held for trading</td>
<td>12, 24</td>
<td>104,370</td>
<td>129,407</td>
</tr>
<tr>
<td>of which: assets pledged as collateral that may be sold or repledged by counterparties</td>
<td></td>
<td></td>
<td>32,121</td>
</tr>
<tr>
<td>Derivative financial instruments</td>
<td>11, 24, 25</td>
<td>126,210</td>
<td>121,285</td>
</tr>
<tr>
<td>Brokerage receivables</td>
<td>24</td>
<td>16,840</td>
<td></td>
</tr>
<tr>
<td>Financial assets at fair value not held for trading</td>
<td>13, 24</td>
<td>82,690</td>
<td>60,457</td>
</tr>
<tr>
<td><strong>Total financial assets measured at fair value through profit or loss</strong></td>
<td>330,110</td>
<td>311,148</td>
<td>310,269</td>
</tr>
<tr>
<td>Financial assets measured at fair value through other comprehensive income</td>
<td>14, 24</td>
<td>6,667</td>
<td>8,889</td>
</tr>
<tr>
<td>Investments in associates</td>
<td>31b</td>
<td>1,099</td>
<td>1,045</td>
</tr>
<tr>
<td>Property, equipment and software</td>
<td>15</td>
<td>9,348</td>
<td>9,057</td>
</tr>
<tr>
<td>Goodwill and intangible assets</td>
<td>16</td>
<td>6,647</td>
<td>6,563</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td>8</td>
<td>10,105</td>
<td>10,056</td>
</tr>
<tr>
<td>Other non-financial assets</td>
<td>17b</td>
<td>7,410</td>
<td>7,830</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>958,489</td>
<td>939,279</td>
<td>918,906</td>
</tr>
</tbody>
</table>
## Income statement

<table>
<thead>
<tr>
<th>USD million</th>
<th>Note</th>
<th>31.12.18</th>
<th>31.12.17</th>
<th>31.12.16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest income from financial instruments measured at amortized cost and fair value through other comprehensive income</td>
<td>3</td>
<td>10,121</td>
<td>10,437</td>
<td>10,375</td>
</tr>
<tr>
<td>Interest expense from financial instruments measured at amortized cost</td>
<td>3</td>
<td>(6,494)</td>
<td>(5,468)</td>
<td>(5,002)</td>
</tr>
<tr>
<td>Interest income from financial instruments measured at fair value through profit or loss</td>
<td>3</td>
<td>6,974</td>
<td>4,056</td>
<td>3,579</td>
</tr>
<tr>
<td>Interest expense from financial instruments measured at fair value through profit or loss</td>
<td>3</td>
<td>(4,653)</td>
<td>(2,418)</td>
<td>(2,495)</td>
</tr>
<tr>
<td>Net interest income</td>
<td>3</td>
<td>5,949</td>
<td>6,607</td>
<td>6,457</td>
</tr>
<tr>
<td>Other net income from fair value changes on financial instruments</td>
<td>3</td>
<td>5,977</td>
<td>5,067</td>
<td>5,018</td>
</tr>
<tr>
<td>Credit loss (expense) / recovery</td>
<td>23</td>
<td>(117)</td>
<td>(131)</td>
<td>(38)</td>
</tr>
<tr>
<td>Fee and commission income</td>
<td>4</td>
<td>19,632</td>
<td>19,390</td>
<td>18,425</td>
</tr>
<tr>
<td>Fee and commission expense</td>
<td>4</td>
<td>(1,703)</td>
<td>(1,840)</td>
<td>(1,781)</td>
</tr>
<tr>
<td>Net fee and commission income</td>
<td>4</td>
<td>17,929</td>
<td>17,550</td>
<td>16,644</td>
</tr>
<tr>
<td>Other income</td>
<td>5</td>
<td>905</td>
<td>952</td>
<td>749</td>
</tr>
<tr>
<td>Total operating income</td>
<td></td>
<td><strong>30,642</strong></td>
<td><strong>30,044</strong></td>
<td><strong>28,831</strong></td>
</tr>
</tbody>
</table>
Financial Intermediaries/Insurances

- diversification and pooling of risks
- compensation of specific risks
- selling insurance packaged in a financial product
Facilitating the buying and selling of securities between a buyer and a seller
Financial Intermediaries/Investment Funds

Investor A | Investor B | Investor C | Investor D
---|---|---|---
Equity | Foreign exchange | Real Estate | Commodities | Others

Collective investment scheme
Financial Intermediaries: Many more players

- Asset Managers, Investment Managers and Advisors
- Rating Agencies
- Financial markets (exchanges)
- Payment, Central Clearing, Settlement and Custody Systems
Objectives of Regulation: What are the risks of financial intermediation

<table>
<thead>
<tr>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>- liquidity risk</td>
</tr>
<tr>
<td>- solvency risk</td>
</tr>
<tr>
<td>- contagion risk (bank runs)</td>
</tr>
<tr>
<td>- moral hazard risk</td>
</tr>
<tr>
<td>- counterparty risk (securities markets)</td>
</tr>
<tr>
<td>- transparency risk (financial products)</td>
</tr>
<tr>
<td>- Risk of fraudulent behavior</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Asymmetries</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Lack of alternatives (saving, loans)</td>
</tr>
<tr>
<td>- Information deficits</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>- High overall economic costs of bank failures (negative externalities)</td>
</tr>
</tbody>
</table>
## Objectives of Regulation/Whom or what are we protecting?

<table>
<thead>
<tr>
<th>Risks</th>
<th></th>
</tr>
</thead>
</table>
| • liquidity/solvency risk  
  • contagion risk (bank runs) | • **depositors/investors** [consumers] |
| • moral hazard risk | • **proper functioning of the financial market(s)** |
| • risk of fraudulent behaviour  
  • transparency risk | • **depositors/investors** [consumers]  
  • proper functioning of the financial market(s) |

<table>
<thead>
<tr>
<th>Asymmetries</th>
<th></th>
</tr>
</thead>
</table>
| • lack of alternatives (saving, loans)  
  • information deficits | • **depositors/investors** [consumers]  
  • proper market functioning |

<table>
<thead>
<tr>
<th>Costs</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• High overall economic costs of bank failures (negative externalities)</td>
<td>• economy as a whole (<strong>financial stability</strong>)</td>
</tr>
</tbody>
</table>
In accordance with the financial market acts, financial market supervision has the objectives of protecting creditors, investors, and insured persons as well as ensuring the proper functioning of the financial market. It thus contributes to sustaining the reputation and competitiveness of Switzerland’s financial centre.

(2) The FCA's strategic objective is: ensuring that the relevant markets function well. (3) The FCA's operational objectives are: (a) the consumer protection objective, (b) the integrity objective, (c) the competition objective.

(2) The PRA's general objective is: promoting the safety and soundness of PRA-authorised persons.
<table>
<thead>
<tr>
<th>Objectives of Regulation/The other (sometimes hidden) objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risks</strong></td>
</tr>
<tr>
<td></td>
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</table>
Drivers for Regulation

Financial Regulation is Crisis-Driven:

- Panic of 1907 (US)
  - e.g. Glass Steagall Act; establishment of SEC; banking codes and new national supervisors (e.g. CH)

- Great depression (1929-1939)

- WWII
  - cross-border banking scandals (1975-1992)
  - Basel Committee on Banking Supervision; cross-border banking regulation; capital adequacy standards

  - e.g. Enron, WorldCom; Sarbanes-Oxley Act, Public Accounting Oversight Boards

  - G20 (new role), Financial Stability Board; macro-prudential oversight board; Consumer protection bureaus (US); financial conduct authority (UK), European Central Bank (additional role as supervisor)
  - Regulation of hedge funds, private equity funds, rating agencies (enhanced), OTC derivatives trading
  - Basel III Capital Standards, FSB Cross-Border Principles, MiFiD conduct Regulation (EU), EMIR/Dodd-Frank Infrastructure regulation, Fatca/AIE tax transparency regulation
The Cynic's seven eternal rules of regulation (by Urs Zulauf)

1. Crises provoke new institutions
2. The old institutions remain, the new ones come on top
3. Current institutions will always find new topics
4. Crises open the locks for logged institutional reforms (not always with reasonable links to the crisis' triggers
5. Crises provoke regulation – regulation provokes crises
6. Big crises provoke heavy regulation
7. If a regulation has no impact, it is hardly ever abolished – instead, the dose is increased
International Financial Regulation

- Need to create a level-playing field*
- Interconnectedness of globalized markets

- Financial crisis: New regulatory standards
  - Crisis of 2008: cost of ca. 7'000 bn. Euro -> Regulatory reaction
  - Formally: National legislation
  - In substance: Work of international institutions (e.g. Basel Committee on Banking Supervision, Financial Stability Board)

*disputed by some authors
The obvious reason: financial globalization has undermined the ability of individual states to regulate effectively
- But remember: The beginnings of IFR do not lie in globalized activities of private actors, but in economic disorder after WWII → Bretton Woods

Securing cross-border coordination of enforcement and supervision
- Government supervision and enforcement is limited to its national borders. Lack of the "whole" picture with regard to globally active firms
  - Principle of consolidated supervision, On-site inspection by home country supervisor

Liberalizing international finance by harmonizing regulatory requirements
- Inconsistencies in regulations impose costs and delays in international finance
  - e.g. different accounting standards
Collective Action puts pressure on states with low regulatory standards to improve their financial regulation

- Countries with low regulatory standards pose a financial risk to all other countries (contagion effect of a financial crisis); low regulatory cost distorts the level playing field. Unilateral raising of standards puts national industry at a disadvantage (problem of the first mover)
  - e.g. Capital requirements (Basel standards)

Securing credible commitment *ex ante*

- In times of crisis, international cooperation and coordination is hindered by national interests (cooperation needs practice)
  - *e.g.* FSB Key resolution framework (recognition of foreign resolution measures, Crisis management groups [home and key host authorities]*
Instruments of Financial Regulation: General Perspective (Recap)

<table>
<thead>
<tr>
<th>Statutory Licencing rules</th>
<th>registry rules for financial firms, infrastructures, activities, services of products</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prudential supervision rules</td>
<td>for financial firms in order to safeguard their safety and soundness, capital, liquidity, processes, risk, controls and governance standards,</td>
</tr>
<tr>
<td>Conduct rules and markets standards</td>
<td>for professional and private market participants (e.g. rules on insider trading, market manipulation, suitability)</td>
</tr>
<tr>
<td>Disclosure and reporting rules</td>
<td>e.g. for financial firms regarding their capital or listed companies</td>
</tr>
<tr>
<td>Rules on Financial Products</td>
<td>e.g. warning information for investors, distribution restricted to professional investors</td>
</tr>
</tbody>
</table>
Instruments of Financial Regulation: Institutional Perspective

**Market Entry**
- authorization/licensing

**Supervision stricto sensu**
- monitoring
- soundness of financial intermediaries and the financial system (e.g. capital adequacy, liquidity, risk management, corporate governance, market integrity)
- increasing focus on **conduct of business** (incl. product reg.)

**Enforcement**
- restore compliance with the law
- sanctions

**Crisis Management**
- resolution
- insolvency proceedings
- [rescue actions]

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**Supervision**

Regulation: Legal Framework
(often an implementation of international standards)
Instruments of Financial Regulation/International Level

Supervision stricto sensu
- monitoring
- soundness of financial intermediaries and the financial system (capital adequacy, liquidity, risk management, corporate governance, market integrity)
- increasing focus on conduct of business

Enforcement
- restore compliance with the law
- sanctions

Crisis Management
- resolution
- insolvency proceedings
- [rescue actions]

National Legal Framework

International Soft Law Framework

Market Entry
- authorization/licensing

BCBS Core Principles. Essential licensing criteria


BCBS Capital Standards. Financial resilience.

BCBS Core Principles. Corrective and Sanctioning Powers of Supervisors

FSB Key Attributes for Effective Resolution
Instruments of Financial Regulation/International Level/Soft Law

- Exceptional Instrument: Treaties (hard law)
  - GATS (market access); IMF (loan conditionality)

- Main Instrument: Standards (soft law):
  - what are widely accepted as good principles, practices or guidelines in a certain area (FSB/Financial Stability Board).
  - Financial Stability Board (FSB) publishes a Compendium of Standards = Standards that are internationally accepted as important for well functioning financial systems. Appr. 270 documents.
  - Within the standards, FSB distinguishes between
    - principles (broad)
    - practices (more specific)
    - methodologies/guidelines (detailed guidance, specific enough for objective assessment of observance).
In reality, the terminology is much more diverse. Examples from the Compendium of Standards:

- BCBS Core **Principles** for Effective Banking Supervision.
- FSB **Key Attributes** of Effective Resolution Regimes for Financial Institutions (= principles)
- BCBS Sound **Practices** for Loan Accounting
- FSB Key Attributes **Assessment Methodology** for the Banking Sector
- FATF **Guidance**: Implementation ... of UN Security Council Resolution
- FATF **General Guide** to account opening
- FSB **Recommendations** of the Task Force on Climate-Related Financial Disclosures
- **Best Practices Paper**: The Use of the FATF Recommendations to Combat Corruption
- FSB Global Systemically Important Insurers: **Policy Measures**
- IMF Monetary and Financial Statistics **Manual**

Significance of the Compendium:

- Point of reference for peer reviews, black lists, IMF loans
- -> strong incentive for countries to implement the standards
Focus on the individual actor: micro-prudential regulation

Focus on the financial system as a whole: macro-prudential regulation (post GFC)

- Micro- and macro-prudential regulation are intertwined: The focus on individual firms takes systemic risks into account.
- The different lies in the objective. The goal of macro-prudential regulation is the stability of the financial system rather than the protection of individual depositors/investors/policy-holders. What matters is not a firm's own exposure to risk, but:
  - the assessment of the macro-prudential regulator (boom or bust phase?); on the risk of the entire financial system; the importance of the firm to the financial system and the costs to the economy as a whole if the system fails.
Regulatory Approaches

- **Micro-prudential regulation, e.g.:**
  - capital adequacy rules (e.g. prudential assessment of credit risks determines capital cushion)
  - corporate governance: fit and proper tests of senior executives by supervisors, say on pay, necessity of a chief risk officer as member of the board
  - conduct of business/consumer protection: suitability of products, product (risk) information; increased prudential and civil liability

- **Macro-prudential regulation, e.g.:**
  - control over and special rules for systemically important institutions (testament, contingent capital [bonds into equities in times of crisis]; higher capital standards), special macro-stability watchdogs (European Systemic Risk Board, US Financial Stability Oversight Board)

- Any risks connected to those forms of regulatory approaches?
International Financial Regulatory Architecture

Prof. Dr. Susan Emmenegger, LL.M.
The main players

- **International Monetary Fund (IMF)**
- **G20**
  - **EU**
  - **Bank for International Settlements (BIS)**
  - **Financial Stability Board (FSB)**
    - **Basel Committee on Banking Supervision (BCBS)**
    - **International Association of Insurance Supervisors (IAIS)**
    - **International Organization of Securities Commissions (IOSCO)**
  - **International Monetary Fund (IMF)**
  - **World Bank**
- **OECD**
  - **Fiscal Affairs**
  - **Financial Action Task Force on Money Laundering (FATF)**

*Standard setters*
The players’ characteristics

- Political
  - G20; EU (Council, Parliament)

- Half-Political
  - FSB, IMF, FATF, OECD, EU (Commission)

- Technocrats: Standard Setters (Soft Law)
  - BCBS, IOSCO, IAIS, IASB/FASB

- International Organisations
  - IMF, World Bank, OECD, EU
History, Current Status, Outlook

- **The Era of Treaty Making: Bretton Woods**
  - Bretton Woods Conference (1944)
  - Establishment of international organizations (IMF, World Bank, later GATT = WTO)
  - Treaty approach: binding agreements
  - Dominant role of politics

- **The Rule of the Technocrats: Rise of the BCBS**
  - Post Bretton Woods (1974)
  - Informal meetings of national regulators
  - Soft law approach: non binding
  - Dominant role of the regulators/technocrats (not only BCBS, but also IOSCO, IAIS, IASB/FASB)
The Dominance of Politics: The G20 and the FSB
- Great Financial Crisis (2007/2008)
- Summit meetings by heads of states
- Establishment of FSB as new coordinating body
- Soft law approach: non binding
- Dominant role of politics

The Future: Towards a World Financial Authority?
- Post FSB (20??)
- New treaty approach: binding agreements on global enforcement, or:
  - Conflict of laws regime (national regulators apply foreign law)
  - Return to technical regulation
  - Unilateral extraterritorial regulation?
Current Status: G20 driven International Financial Architecture

FSB coordinates development of financial sector policies

- **Standard Setters** develop sector specific standards
- **IMF and World Bank** assess implementation of standards
- **National authorities** implement standards and policies
- **BIS** Supports and hosts committee work

IMF and World Bank assess implementation of standards
G20/Introduction

Permanent Guests
IMF, World Bank
FSB
UN, ILO
WTO
OECD
„some guest countries“ (eg Spain)
Established in 1999 in the aftermath of the Asian (Financial Crisis). Dormant until the Great Financial Crisis 2008

Financial Crisis: Calls for a ”New Bretton Woods” by French President Sarkoszy and British Prime Minister Gordon Brown

Washington Meeting, November 2008. First G20 meeting at leader’s level. Parallels to Bretton Woods:
- Reclaiming public authority over financial markets (?)
- Hosted by US
- Commitment to be more inclusive regarding membership/voice in the international regulatory arena

We, the Leaders of the Group of Twenty, held an initial meeting on November 15, 2008, amid serious challenges to the world economy and financial markets. We are determined to ... work together to restore global growth and achieve needed reforms in the world’s financial systems.

Starting point for new regulatory initiatives on a global scale (2nd wave after Bretton Woods)

Starting point for a governance reform of the international standard setters to include a greater number of countries
What is the G20
The Group of Twenty (G20) is the premier forum for international cooperation on the most important issues of the global economic and financial agenda.

The objectives of the G20 refer to:

1. Policy coordination between its members in order to achieve global economic stability, sustainable growth;
2. Promoting financial regulations that reduce risks and prevent future financial crises;
3. Modernizing international financial architecture.

G20 Website 2013: WHAT IS THE G20
- The Group of Twenty (G20) is the premier forum for international cooperation on the most important issues of the global economic and financial agenda.

THE OBJECTIVES OF THE G20 REFER TO:

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2. Promoting financial regulation that reduce risks and prevent future financial crisis
3. Modernizing international financial architecture
G20/Focus on Current (new) Issues

- No permanent secretariat. Countries take turns to organize G20 meetings. No permanent website. Each country designs new one (often using it for self-promotion of the hosting country).

2018 summit: Financial Regulation one of many points in the agenda

2019 summit: Financial Regulation not among the main points in the agenda
G20/Focus on Current (new) Issues


While the G20 was originally established in response to the global financial crisis, its core mission today is to establish economic fundamentals for realizing sustainable and inclusive growth of the global economy. From this perspective, first, the G20 discusses the impact of structural factors on the global economy, such as global imbalances and aging, in addition to monitoring major risks through surveillance of the global economy.
G20/What remains

Institutional Reform

- International Regulation has become more inclusive: Moving from G8 to G20, Enlargement of Financial Stability Board, Basel Committee on Banking Supervision and other Standard setters

Setting in motion of regulatory initiatives (with lasting impact)

1. Increase the banks’ capital
2. Introduce central clearing and trading of OTC derivatives
3. Regulation of hedge funds, rating agencies, benchmarks (LIBOR) and shadow banking sector (special purpose vehicles)
4. Build a robust framework for cross border bank resolution

- Reinforcement of existing regulatory initiatives (but giving these initiatives a sense of urgency and priority)
G20 Summit Meeting in Pittsburgh (September 2009)

- Agreement to establish the Financial Stability Board (FSB) as successor of the FSF (including: extension of membership to G20, Spain, European Commission)
- G20 assigns missions to the FSB; FSB reports to G20 (on developments of int. financial regulation, on progress of regulatory issues); FSB takes part in G20 summits
Policy development: Key Regulatory topics of the G20
FSB/Implementation: What makes the FSB work?

- Direct involvement of principal decision makers of relevant authorities and standard setters in the policy making process
- Working “through its members” - joint diagnosis, policy development, Co-ordination and co-operation across policy areas
- FSB Secretariat facilitating the process
- Flexibility and ability to adapt to change
- ... and: peer reviews

Article 5. Commitments of Members

(1) Member jurisdictions commit to:

   (a) pursue the maintenance of financial stability;

   ......

   (d) undergo periodic peer reviews, using among other evidence IMF/World Bank public Financial Sector Assessment Program reports.

   The FSB will report on these commitments and the evaluation process.
Instruments to secure "Commitment" to the soft law standards in general:

- Black listing (FATF)
- Conditionality (IMF loans)
- Assessments (IMF Article IV-Assessments)
- Publication of peer reviews (FATF, FSB)
G-20/FSB Initiatives: Are we safe now?

Mark Carney, Chairman of the FSB, Governor of the Bank of England
(previously Governor of the Bank of Canada)

Press Conference in the Wake of the G-20 summit meeting 2017

We have fixed issues that caused financial crisis, says Mark Carney

https://www.youtube.com/watch?v=gS7TH7ICMRk

Letter to the G20 Leaders (3 July 2017)

G20 reforms are building a safer, simpler and fairer financial system ...

Despite this immense progress, there are nascent risks that, if left unchecked, could undermine the G20’s objective for strong, sustainable and balanced growth. In particular, giving into reform fatigue could erode the willingness of G20 members to rely on each other’s systems and institutions and, in the process ..., reduce competition and diminish cross-border capital and investment flows...
International Financial Regulation in Action: Capital Standards

Prof. Dr. Susan Emmenegger, LL.M.
The Basel Committee of Banking Supervision

Basel Committee of Banking Supervision (1974)

- Cross-Border Banking
- Capital Standards

Founding members: G10

- Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, UK, USA. Plus Luxembourg (important Euromarket center)
  - G-10 Origins: IMF. Agreement allowing the IMF to borrow money from major industrial countries. These countries agreed to supplement the Fund's resources.
- Today: G-20 (plus). **27 countries**, represented by their central banks and/or their supervisory authorities
The authority of its Standards

- Art. 3 BCBS Charter:
  - The BCBS does not possess any supranational authority. Its decisions do not have legal force. Rather, the BCBS relies on its members commitments ... to achieve its mandate.

  ➔ International financial soft law

- Art. 12 BCBS Charter:
  - The BCBS expects full implementation of its standards by BCBS members and their internationally active banks. ... The Committee expects standards to be incorporated into local legal frameworks through each jurisdiction's rule making process ....

  ➔ National (hard) law
Incentives for implementation worldwide:

- Pressure on banks through credit rating agencies
- Financial Sector Assessment Program of the IMF
- Market access for banks in major financial centres (New York/London/Zurich)
- Top league regulatory and supervisory authorities want to comply with Basel standards

→ For countries who refuse to comply with Basel's soft law, the consequences are anything but soft
BCBS Capital Standards

Basel III

Pillar I
Enhanced Minimum Capital & Liquidity Requirements

Pillar II

Pillar III
Enhanced Risk Disclosure & Market Discipline
Banks: High risk, high importance for the economy, high impact of failure
Capital: Absorbs losses, reduces risk of failure
Why is capital important?

Balance Sheet Basics

- In any balance sheet, assets and liabilities have to be equal.
- Capital/Equity is always on the liabilities side of the balance sheet.
- Debts must always be covered by assets (otherwise, the bank/business is insolvent).
## Balance sheet

<table>
<thead>
<tr>
<th>CHF million</th>
<th>Note</th>
<th>31.3.18</th>
<th>31.12.17</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and balances at central banks</td>
<td></td>
<td>92,800</td>
<td>87,775</td>
</tr>
<tr>
<td>Loans and advances to banks</td>
<td></td>
<td>13,338</td>
<td>13,739</td>
</tr>
<tr>
<td>Receivables from securities financing transactions</td>
<td></td>
<td>77,016</td>
<td>89,633</td>
</tr>
<tr>
<td>Cash collateral receivables on derivative instruments</td>
<td>11</td>
<td>24,271</td>
<td>23,434</td>
</tr>
<tr>
<td>Loans and advances to customers</td>
<td>9</td>
<td>316,195</td>
<td>318,509</td>
</tr>
<tr>
<td>Other financial assets measured at amortized cost</td>
<td>12</td>
<td>19,129</td>
<td>36,861</td>
</tr>
<tr>
<td><strong>Total financial assets measured at amortized cost</strong></td>
<td></td>
<td>542,749</td>
<td>569,950</td>
</tr>
<tr>
<td>Financial assets at fair value held for trading</td>
<td>10</td>
<td>105,554</td>
<td>126,144</td>
</tr>
<tr>
<td>of which: assets pledged as collateral that may be sold or repledged by counterparties</td>
<td></td>
<td>34,536</td>
<td>35,367</td>
</tr>
<tr>
<td>Derivative financial instruments</td>
<td>10.11</td>
<td>113,333</td>
<td>118,227</td>
</tr>
<tr>
<td>Brokerage receivables</td>
<td>10</td>
<td>20,250</td>
<td></td>
</tr>
<tr>
<td>Financial assets at fair value not held for trading</td>
<td>10</td>
<td>97,532</td>
<td>58,933</td>
</tr>
<tr>
<td><strong>Total financial assets measured at fair value through profit or loss</strong></td>
<td></td>
<td>336,669</td>
<td>303,304</td>
</tr>
<tr>
<td>Financial assets measured at fair value through other comprehensive income</td>
<td>10</td>
<td>6,758</td>
<td>8,665</td>
</tr>
<tr>
<td>Investments in associates</td>
<td></td>
<td>1,037</td>
<td>1,018</td>
</tr>
<tr>
<td>Property, equipment and software</td>
<td></td>
<td>8,860</td>
<td>8,829</td>
</tr>
<tr>
<td>Goodwill and intangible assets</td>
<td></td>
<td>6,235</td>
<td>6,398</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td></td>
<td>9,729</td>
<td>9,844</td>
</tr>
<tr>
<td>Other non-financial assets</td>
<td>12</td>
<td>7,324</td>
<td>7,633</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td></td>
<td>919,361</td>
<td>915,642</td>
</tr>
</tbody>
</table>
### Balance sheet (continued)

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Note</th>
<th>31.3.18</th>
<th>31.12.17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amounts due to banks</td>
<td></td>
<td>9,024</td>
<td>7,533</td>
</tr>
<tr>
<td>Payables from securities financing transactions</td>
<td></td>
<td>9,167</td>
<td>17,044</td>
</tr>
<tr>
<td>Cash collateral payables on derivative instruments</td>
<td>11</td>
<td>29,426</td>
<td>30,247</td>
</tr>
<tr>
<td>Customer deposits</td>
<td></td>
<td>398,604</td>
<td>408,999</td>
</tr>
<tr>
<td>Debt issued measured at amortized cost</td>
<td>14</td>
<td>137,883</td>
<td>139,551</td>
</tr>
<tr>
<td>Other financial liabilities measured at amortized cost</td>
<td>12</td>
<td>5,911</td>
<td>36,337</td>
</tr>
<tr>
<td><strong>Total financial liabilities measured at amortized cost</strong></td>
<td></td>
<td>590,014</td>
<td>639,711</td>
</tr>
<tr>
<td>Financial liabilities at fair value held for trading</td>
<td>10</td>
<td>34,747</td>
<td>30,463</td>
</tr>
<tr>
<td>Derivative financial instruments</td>
<td></td>
<td>10,117</td>
<td>116,133</td>
</tr>
<tr>
<td>Brokerage payables designated at fair value</td>
<td></td>
<td>10,793</td>
<td>49,502</td>
</tr>
<tr>
<td>Debt issued designated at fair value</td>
<td></td>
<td>10,12</td>
<td>34,438</td>
</tr>
<tr>
<td>Other financial liabilities designated at fair value</td>
<td></td>
<td>10,12</td>
<td>16,223</td>
</tr>
<tr>
<td><strong>Total financial liabilities measured at fair value through profit or loss</strong></td>
<td></td>
<td>267,983</td>
<td>212,322</td>
</tr>
<tr>
<td>Provisions</td>
<td></td>
<td>15,044</td>
<td>3,133</td>
</tr>
<tr>
<td>Other non-financial liabilities</td>
<td></td>
<td>7,016</td>
<td>9,205</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td></td>
<td>868,056</td>
<td>864,371</td>
</tr>
</tbody>
</table>

### Equity

<table>
<thead>
<tr>
<th>Equity</th>
<th></th>
<th>385</th>
<th>385</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td></td>
<td>385</td>
<td>385</td>
</tr>
<tr>
<td>Share premium</td>
<td></td>
<td>25,262</td>
<td>25,942</td>
</tr>
<tr>
<td>Treasury shares</td>
<td></td>
<td>(1,520)</td>
<td>(2,133)</td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td>33,807</td>
<td>32,752</td>
</tr>
<tr>
<td>Other comprehensive income recognized directly in equity, net of tax</td>
<td></td>
<td>(6,692)</td>
<td>(5,732)</td>
</tr>
<tr>
<td><strong>Equity attributable to shareholders</strong></td>
<td></td>
<td>51,243</td>
<td>51,214</td>
</tr>
<tr>
<td>Equity attributable to non-controlling interests</td>
<td></td>
<td>62</td>
<td>57</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td></td>
<td>51,305</td>
<td>51,271</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td></td>
<td>919,361</td>
<td>915,642</td>
</tr>
</tbody>
</table>
Capital is a portion of the bank's assets which does not need to be repaid.

Capital/Equity acts as an equalizer (cushion) between assets and liabilities.

If assets diminish, capital/equity is diminished, leaving the assets/liability balance intact.

Balance sheet is "shorter" (but debts are not bigger than assets).
Capital is a portion of the bank's assets which does not need to be repaid.

Capital/Equity acts as an equalizer (cushion) between assets and liabilities.

If debts increase: the debts can "eat" the capital/equity and the assets/liability balance remains intact.

Debts are not larger than assets (as long as they remain in the "capital portion" of the liabilities).
## UBS example – Assets diminish

<table>
<thead>
<tr>
<th>Original Balance Sheet</th>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td><strong>311’000</strong></td>
<td>Due to customers</td>
</tr>
<tr>
<td>Others</td>
<td><strong>631’000</strong></td>
<td>495’000</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
<td>57’000</td>
</tr>
<tr>
<td></td>
<td><strong>942’000</strong></td>
<td>942’000</td>
</tr>
</tbody>
</table>

## Diminished Assets Scenario

<table>
<thead>
<tr>
<th>Diminished Assets Scenario</th>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td><strong>300’000</strong></td>
<td>Due to customers</td>
</tr>
<tr>
<td>Others</td>
<td><strong>631’000</strong></td>
<td>495’000</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
<td>57’000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- <strong>11’000</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>=46’000</strong></td>
</tr>
<tr>
<td></td>
<td><strong>931’000</strong></td>
<td>931’000</td>
</tr>
</tbody>
</table>
### UBS example – debts increase

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Loans</td>
<td>Due to customers</td>
</tr>
<tr>
<td></td>
<td>311’000</td>
<td>390’000</td>
</tr>
<tr>
<td>Others</td>
<td>631’000</td>
<td>Others</td>
</tr>
<tr>
<td></td>
<td></td>
<td>495’000</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
<td>57’000</td>
</tr>
<tr>
<td></td>
<td>942’000</td>
<td>942’000</td>
</tr>
</tbody>
</table>

**original balance sheet**

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Loans</td>
<td>Due to customers</td>
</tr>
<tr>
<td></td>
<td>311’000</td>
<td>400’000</td>
</tr>
<tr>
<td>Others</td>
<td>631’000</td>
<td>Others</td>
</tr>
<tr>
<td></td>
<td></td>
<td>495’000</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
<td>57’000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- 10’000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>= 47’000</td>
</tr>
<tr>
<td></td>
<td>942’000</td>
<td>942’000</td>
</tr>
</tbody>
</table>

**increased debts scenario**
...comparatively speaking: small capital/high leverage
The Mechanics of Capital Regulation

Example: Rockaway Bank, credit of USD 1 Mio. to several counterparties

<table>
<thead>
<tr>
<th>Assets</th>
<th>Risk weight</th>
<th>Risk weighted assets (RWA)</th>
<th>Equity ratio</th>
<th>Required Equity capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central bank</td>
<td>0%</td>
<td>0</td>
<td>8%</td>
<td>0</td>
</tr>
<tr>
<td>UBS</td>
<td>20%</td>
<td>200’000</td>
<td>8%</td>
<td>16’000</td>
</tr>
<tr>
<td>AIG</td>
<td>100%</td>
<td>1’000’000</td>
<td>8%</td>
<td>80’000</td>
</tr>
<tr>
<td>General Motors</td>
<td>100%</td>
<td>1’000’000</td>
<td>8%</td>
<td>80’000</td>
</tr>
<tr>
<td>res. mortgage</td>
<td>35%</td>
<td>500’000</td>
<td>8%</td>
<td>28’000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Basel II</th>
<th>Basel II</th>
</tr>
</thead>
<tbody>
<tr>
<td>AIG</td>
<td>AAA</td>
</tr>
<tr>
<td>General Motors</td>
<td>BBB</td>
</tr>
</tbody>
</table>
...from a different perspective...
Basel III: The new framework

**Tier-1 Capital**
- Basel II
- Basel III

**Common Equity-Tier-1 Capital**
- Basel III

**Additional Tier-1 Capital**
- Basel III

**Better Capital**
- Common equity (total loss absorbing capital)
- Preferred shares
- Contingent convertible securities (CoCos)
Basel III: The new framework

- Predominant form of core capital must be fully loss-absorbing: common shares and disclosed reserves. No hybrid capital.
- Minimum of 7% and up to 9.5% of total capital must be common equity (vs. 4% under Basel I + II).
Basel III: The new framework – Leverage Ratio

- Cash, Gov.: 0%
- Banks: 20%
- Res. mortgage: 35%
- Retail: 75%
- Private sector: 3%

Leverage Ratio
Basel III: The new framework – **Leverage Ratio**

- Relationship between the bank's total consolidated assets and the Tier 1 capital
- Simple, transparent, independent measure of risk
- Minimum leverage ratio: Total Assets (exposure) : Tier 1 capital
- Different numbers: Basel III: 3% (test phase); US Fed: 6% for SIBs, 5% for bank holding companies; CH: 4.5 to 5% for SIBS (by end 2019) and 3% for all banks (by Jan 2018)
New liquidity standards for a sufficient liquidity buffer in crises

- Liquidity Coverage Ratio: Short-term resilience of liquidity risk. Requires a bank to hold sufficient high-quality liquid assets to survive an acute stress scenario for one month
- Net Stable Funding Ratio: Longer-term resilience through more stable sources of funding over a one year period.

Special rules for systemically important financial institutions (SIFIs)

Implementation dates: Different dates for different rules (2015-2019)
Basel II: Three Pillars. 347 pages

More risk sensitive capital requirements (incl. securitizations). Adding operational risk (legal risks). Possibility to use internal models for credit risks and operational risks. Much enhanced possibility to use credit ratings to determine risk weight.
Basel III: Three Pillars. 616 pages (see above). Leverage Ratio. Liquidity Ratio. Special rules for SIFIs (last will)
Basel IV (not yet implemented)

- Risk-weighted-assets: floored with 72.5% of requirement under a standardized approach
- Higher Leverage Ratio (not yet decided)

Are we safe now?
OF COURSE SUCH AN ABSOLUTE WORST-CASE SCENARIO SHOULD NEVER EVER HAPPEN AGAIN...!

BUT STILL – SWITZERLAND HAS GOT THE HIGHEST SAFETY STANDARDS...

IN OUR COUNTRY THE RISKS ARE NEGLIGIBLY LOW...

NUCLEAR POWER DEBATE?

NO, BANK REGULATION...

Source: Tages-Anzeiger, Zurich, 34.03.2011; Translated by FINMA
Too Big to Fail and Cross-Border Resolution

Prof. Dr. Susan Emmenegger, LL.M.
Why cross-border bankruptcies are a challenge

Reminder: bank bankruptcies come at a great economic and social cost, and they can destabilize the financial system (bank runs)

The bankruptcy of internationally active banks creates an even bigger challenge, because:

Banks are global in life, but national in death

Mervin King, governor of the Bank of England (now NYU professor)
Example: The disruptive effects of the Lehman Brothers bankruptcy

- Lehman: Fourth largest investment bank in the US, with worldwide operations
- Lehman Holding (US) declared bankruptcy on September 15, 2008
- Relatively orderly outcome in the US (Chapter 11, sale of Lehman investment arm to Barclays)
- But chaos created abroad: Highly integrated structure of Lehman, all the substantial cash resources were managed centrally at the holding company
- After Lehman Holding declared bankruptcy, the cash could not be swept out again to the subsidiaries, leaving them illiquid and unable to continue operation (not even to operate the employee cafeteria in UK)
Lehmann did not only put into evidence the difficulties of cross-border resolution. Ultimately, the Lehman bankruptcy triggered the great financial crisis. Governments had to intervene to save those banks considered too big to fail (e.g. UBS, AIG (insurance))
Why is saving big banks a problem?

Distorted competition, higher risk appetite, loss of the disciplinary effect of bankruptcy, roll-over of financial risk on the tax payers, government bail-out contradicts free market principles
Regulatory response

Regulatory Response to the contagion effects of Lehman and the government bail-outs in the GFC:

**Too big to fail and cross-border resolution framework**

**Policy steps:**

1. Reduce the probability of failure of G-SIFIS
   - require more capital and liquidity
     - special requirements for G-SIFIS
   - intensify supervision
     - e.g. crisis management colleges (includes all important regulators of a bank on a world wide basis)
Regulatory response

2. Reduce the extent or impact of a failure of G-SIFIS

- ring-fence systemically relevant functions

  Systemically important functions are, in particular, the domestic deposit and lending business as well as payment transactions

- make resolution a realistic option
The mechanics of the regulatory response

- G20 requests that FSB addresses tbtf issue (Pittsburgh Summit 2009)
- FSB and BCBS establish a list of Global Systemically Important Financial Institutions (G-SIFIs)
  - Note: BCBS takes the role of a technical/expert support of the FSB
- The G-SIFI list is published by the FSB; G-SIFIs: requirement of higher level of core capital. Endorsed by the G20 at Seoul Summit (2010)
- FSB designes **Key Attributes for Effective Resolution regimes** (October 2011): New international standard. Goal: To make *national* bankruptcies look alike, foster cooperation between resolution authorities. Endorsed by G20 at the Cannes Summit (2011)
TBTF: Are we safe now?

- Cross-border resolution has not been tested yet
- 10 years after the crisis, memories become dim:

  Trump orders review of ‘too big to fail’ regulations
  Financial Times, April 21, 2017

  Limiting Too Big to Fail
  The feds narrow the rules for naming firms ‘systemically important.’
  Wall Street Journal, March 18, 2019