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INTRODUCTION

International Financial Law – Dr Philipp Paech (LSE)

Chapter 1 – The Financial Market

a) Function of the Financial Market

The function of the financial market is to organise the flow of funds between market participants, more precisely from those wanting to invest to those seeking money. Hence, from the perspective of the party that is cash-driven, the financial market facilitates obtaining financing for investment. For instance, a small manufacturer may take out a loan from a bank to make investments in machinery. A blue-chip corporation may issue bonds to the public to raise finance for a new production plant. A bank may obtain short-term refinancing by entering a repurchase transaction with an investment fund. It is important to note that the motivation for raising finance may be different types of investment, i.e. investment into machinery and similar 'real' things, or investment into financial assets or commodities for 'speculative' purposes. In the above example of the bank, the latter will typically re-invest the money: For instance, it may provide a loan to a big book-retailer with thousands of employees. Or, it may enter risky derivative contracts with another bank to make gains linked to certain movements of the market price of other assets, the social use of which is not immediately apparent. It is impossible to neatly distinguish between 'real' or 'useful' investments on the one hand and 'speculative' ones on the other. Relevant attempts often have a politically driven moralistic undercurrent.

Seen from the opposite perspective of the party that is return-driven, the financial market provides the opportunity to take a risk for a return. Referring to the above the example of a bank providing a loan to a manufacturer, from its perspective the bank takes the risk of default of the manufacturer and consequential loss of money. The interest that parties to a loan or similar contract agree upon reflects that risk. In our example, the interest paid by the manufacturer constitutes the bank's motivation for taking the risk of providing a loan.

Hence, market participants enter financial transactions by different motivations. As these motivations are only partly opposed, in particular as regards the interest rate, financial transactions lead typically to mutually beneficial outcomes. This beneficial effect at the micro-level, i.e. between the parties, translates into an overall beneficial effect at the macro level, meaning for our national economies and the world economy overall.

b) Capital Market and State Finances

The idea of the financial market closely connects to the concept of the 'capital market'. The latter is a subset of the former and relates exclusively to financing through the issuance of securities, such as shares and bonds.[1] Whether a corporation should use loans or rather share or bond issues as its financing source is a science in its own right, called corporate finance. The mechanics of issuing shares are within the area of corporate law. Neither is within the remit of this course. Bond issues will be addressed in Chapter ….

States and other public entities are regular and important participants in financial markets. First, they are the biggest issuers of bonds. These are generically called 'sovereign bonds' and often carry specific names such as US 'Treasuries', German 'Bunds', English 'Gilts', Italian 'BTPs' and French 'OATs'. The fact that banks hold a large part of them may create political tensions in times of financial crisis. Sovereign bond issues are not significantly different in legal terms from corporate bond issues.

Central banks participate in the financial market in two different ways. First, as supervisors of commercial banks and other financial institutions – this activity pertains to the area of financial regulation and is therefore not addressed in this course. In addition, central banks behave in many respects very much like commercial banks – in particular, they engage in borrowing and lending activity with commercial market participants, in their context of implementing their monetary policy, or as a so-called lender of last resort, providing liquidity in the form of secured loans to banks in difficulty.

c) Internationalisation

The financial market has always been international to some extent. However, since the gradual abolishment of capital controls starting in the 1970s, capital increasingly travels the Globe. This fact, in combination with the emergence of modern communication networks have led to a global financial market, in economic and operational terms. However, the legal underpinnings are still national.

[1] This course uses 'shares' as a synonym for 'stock' and 'equity'. It uses 'bonds' to refer to what is often imprecisely called 'debt' or 'fix income' or 'notes'. See below Chapter … .

Chapter 2 – The Nature, Functions and Threshold Concepts of Financial Law

a) *Financial Law and Financial Regulation*

The terminology is confusing, as both financial law and financial regulation are 'law'. Financial law is concerned with the *enforceability* of rights, i.e. whether a party can enforce a contractually created right in court, in particular in the case of insolvency of the counterparty. By contrast, financial regulation is designed to allow state authorities to control the behaviour of market participants, to further public goals such as stability or consumer protection. The core of financial regulation consists consequently of behavioural rules in the form of orders and prohibitions, easily comparable to, e.g., traffic rules. For example, market participants are bound to treat retail clients in a fair way; they are obliged to lay out their accounts following a specific method; they must create and keep certain minimum liquidity reserves; they must hire qualified managers; they cannot concentrate retail and investment business within the same legal entity, etc. As regards the consequences of non-compliance, financial law and regulation are markedly different. In case of incompatibility with financial law standards, a party's right is unenforceable, i.e. potentially worthless. The possible effects of non-compliance with regulatory rules are typically fines or the withdrawal of the relevant authorisation, e.g. a bank's license. Financial law concerns the 'horizontal' relationship between market participants, whereas regulation refers to a rather 'vertical' relationship between the state and its market participants, characterised by subordination. In many jurisdictions, the distinction between private/commercial law on the one hand, and public/administrative law on the other hand pretty much refers to the same dichotomy.

Despite their different nature both areas are connected and studying one of them requires a certain basic understanding of certain aspects of the other. This interdependency exists because in both worlds 'risk' is at the centre of the relevant rationales: whereas one of the main concerns of financial regulation is that banks should not become too risky overall (so that their failure cannot provoke financial crises), it is the financial law that is at the centre of the question of how this risk is created, of what exactly it consists and how it can be mitigated. For instance, a bank may provide a significant loan to a generally risky counterparty. However, if it obtains good security, for example, a mortgage over a portfolio of government bonds, the risk is in reality very limited. The question of whether the mortgage is enforceable is a question of financial law, which is taken into consideration when assessing the riskiness of a bank for purposes of financial regulation. The famous 'Basel Accord', the main international regulatory text, and its national implementations, therefore rely considerably on the proper functioning of financial law. Therefore, this course will put financial law into the context of financial regulation where useful, despite the fact that financial regulation itself is not its main subject.

b) *The Function of Financial Law and Counterparty Credit Risk*

Financial law is the commercial law of the financial market. Like commercial law in general, it is an amalgam of what we call contract, property and insolvency law. The nature of the financial market has led to the development of specific characteristics of this body of law that are unique and specific to finance.

The financial law provides the parties to a transaction with the necessary legal means to create enforceable claims and property interests, which correspond to what is called their 'assets'. Rules of general commercial law apply to the creation and discharge of contractual obligations, to transfer of such obligations, and related aspects. The rules of property law play an important role as financial assets (in particular shares and bonds, in Common Law jurisdictions also claims) may be treated, in legal terms, as movable property and are transferred and used as security or collateral by the rules of property law.

Insolvency law is the third component of the amalgam we call financial law. As discussed above, taking the risk of losing money in exchange for receiving interest or a similar return is one of the two basic functions of the financial market. In the wholesale context, i.e. as far as banks, brokers and investment funds etc. are concerned, this risk stems from two main situations. First, changes in the market value of assets create a certain risk ('market risk', see below). Besides, risk reflects the situation in which the counterparty defaults on its obligation, for instance, does not repay a loan.

Counterparty credit risk is the linchpin of the function of financial law. First, it is important to note that wholesale parties such as banks, investment funds or brokers, typically perform on their obligations for fear of reputational damage. Hence, non-performance is provoked by the inability to perform rather than by any other reason. Leaving aside fringe cases, the inability to perform is typically caused by the opening of insolvency proceedings over the obligor's estate. Insolvency (or bankruptcy) proceedings are a judicial procedure, aiming at the liquidation of the obligor (hence they are to be distinguished from restructuration or stabilisation procedures, see Chapters …). Insolvency proceedings aim at taking a corporation out of business and distributing all its remaining assets amongst its existing creditors. However, creditors typically only receive a small fraction of their original claim and usually with a significant delay which can sometimes amount to years. This means that a party's assets consisting of rights against its counterparty are basically invalidated in the event of the counterparty's insolvency. This is the moment in which the counterparty credit risk materialises. Parties, therefore, strive to use the various devices of financial law to create rights which would remain enforceable in the event of the relevant counterparty's insolvency. In other words, parties aim at effectively mitigating their counterparty credit risk.

c) The Tension between Efficiency and Enforceability and between Risk and Return

Throughout the centuries, in particular since the 1970s, financial market players have become increasingly creative in mitigating their risk while at the same time striving to increase their returns. However, risk and return relate to each other in an inverse proportional way. The core issue is that risk does not disappear until the obligation that created the risk is settled. Parties may move the risk away to other parties, for example, to an insurer that insures the risk, but this naturally comes at a cost, as, in our example, the insurer will ask a fee for taking over the risk. Hence, parties aim at using the law to shift risk to other parties without overall wiping out their returns. They may try to obtain a favourable deal with a third party protecting them against the relevant risk. Here, reputation, size, specialisation and commercial instinct are the parameters determining whether a party can 'hedge' its risk at an acceptable price, ie without wiping out the return.

The law can become an important factor in structuring a transactional environment in a way such that the risk-return relation remains attractive. Notably, parties strive using the existing law in a creative manner. This process could be regarded as akin to creative tax planning where the intended boundaries of the tax law are pushed to an extreme, while still trying to steer clear of illegality. In the context of finance, a similar phenomenon occurs. Parties shape their contracts in the way they regard most favourable, trying to mitigate the risk while at the same time keeping high levels of return. The classical example under English law is the creation of a fix charge over assets of a borrower while at the same time allowing the borrower to continue dealing in the assets, so that it can continue its business and make money. However, fix charges do not permit this in principle. It is rather the device of a floating charge that offers this flexibility. However, the latter offers a weaker position to the security taker (see Chapter …). As parties try to get the advantages of both but not the disadvantages, the disadvantages are shifted to third parties, in this case, the other creditors of the debtor. It is only natural that this and similar cases regularly end up in courtrooms because the other creditors demand protection against the creative use of security interests and of other legal risk-mitigation devices. This continuous cat-and-mouse game comes at the cost of considerable legal uncertainty because the more efficient or creative the contractual arrangements are, the more uncertain is the outcome of future court decisions initiated by those frustrated that the risk has been shifted to them (see Chapter …).

Where the market pushes for changes to the set of available legal risk mitigation devices, the legislator might even consider law reform. In that case, the law itself may become more 'efficient'. It occurs that the market develops certain practice over some time, the enforceability of which is however unclear. As a consequence, the legislator may (or may not!) bring relevant changes, in particular to the insolvency rules or the property law.

This occurs in particular where governments perceive economic advantages in allowing risk shifts from one group of economic actors to another group of economic actors. To take the most basic example: we are used to the existence of security interests, but why does the insolvency law accept them? The answer is that the possibility of taking security over assets of a borrower encourages lending which, in turn, bolsters investment. In other words, insolvency privileges are afforded to lenders because states consider lending a crucial prerequisite for economic growth. Or, in certain jurisdictions, employee wages are privileged and paid first in the insolvency of an employer – here to maintain social peace and to keep the cost for the social security systems under control. In the context of this course, we will see that legislators sometimes introduce similar privileges for the benefit of the financial industry, for reasons of protecting the economy against systemic risk and economic crises. However, may be unclear whether these measures truly serve the common good or are geared more towards increasing the returns of the financial industry (see Chapter …).

To sum up: risk and return are inversely proportional. Risk cannot disappear, it can only be mitigated by distributing it. Parties, in their contractual arrangement, attempt to be creative, so that they can optimise the risk/return relation. These very efficient contractual designs, however, bear a certain degree of uncertainty, because they typically go at the expense of third parties (other creditors) which may challenge the legality of such creative contractual arrangement in court (see Chapter …). The law accepts risk mitigation, such as security interests, only to a certain degree, as legislators balance the interests of the privileged creditors with those of the general creditors. However, risk mitigation devices will be *enforceable* in the event of insolvency of the borrower only to the extent accepted by the law.

d) The Parties and Ancillaries to Financial Transactions

Financial transactions are mostly bilateral relationships, i.e. they occur between two parties. Loans (see Chapter …) are the most obvious example. Equally, insurance and derivative contracts (see Chapters … and …) are bilateral contracts, and security or collateral over assets is precisely arranged between the relevant provider and the relevant taker (see Chapters … and …). Financial institutions may enter financial positions for their own account ('proprietary trading') or for the account of their clients. The latter case requires an analysis of the relevant arrangements: the standard case is that the relevant financial position is in legal terms attributed to the financial institution, at least temporarily, before being transferred further on to the client. Here, one could say that transactions are stacked or in chain order. Some situations may give the impression of involving more than two parties in a transaction but consist in reality of a bundle of different bilateral relationships. Securitisations (see Chapter …) represent such case of a complex transactions, i.e. a collection of different transactions, such as loans, security interests and derivatives, that are designed to produce a common effect.

There are only few types of transactions that are truly multilateral, i.e. they genuinely occur between a multiplicity of parties, in particular syndicated loans (see Chapter …) and multilateral clearing (see Chapter …). It is important to realise that the parties to a financial (or any commercial) transactions are only those that are bound by the relevant contractual obligations.

Further, there are market participants that provide infrastructure services to others. Banks, in particular, provide cash and securities accounts to their clients. Stock exchanges and similar structures provide the infrastructure for others to trade their assets. Clearing, settlement and payment systems cater for the transfer of financial assets between the parties. Infrastructure services rely on very potent IT systems that together form a highly complex technical network on which our modern economy is built. However, from the perspective of financial law, infrastructure providers pose complex legal problems. While their primary economic function is to facilitate the transactions of other market players they may become parties themselves in legal terms (comparable to entities trading for client account, above). For instance, holding money in a bank deposit is a service that reminds us of safekeeping. However, in many jurisdictions the bank will become owner of the cash and an obligor towards the depositor in the amount originally deposited. In the same vein, when sums of money are send from one person to another, the infrastructure providers that intervene in this process (the payor's bank, the payee's bank, and anybody in between the two) may become parties to separate transactions – which means that what appears at the surface as one transaction (a payment from A to B) in reality rather a process and involves a chain of transactions between the various players intervening. This issue exists in the context of settling cash and securities transactions, with the latter being much more complex in legal terms (see Chapter …).

There may be other players that are closely involved in a transaction without qualifying as a party – they have ancillary functions. In particular, they may act as advisors to parties. For instance, investment banks provide advisory services in mergers and acquisitions and other investments. There is the business of giving investment advice more generally, be it as a fund manager or retail investment advisor. There are entities that provide public information on investments, the rating agencies. And lastly, there are law firms, accountants and management consultants that provide their services. The provision of advisory services alone does not entail issues pertaining to financial law and is therefore outside the perimeter of this course. By contrast, certain aspects of it, for instance, the conduct of credit rating agencies and fund managers, are prominent issues in the context of financial regulation.

Participants in financial markets are retail and wholesale parties. Different distinctions are used, distinguishing between retail/wholesale, consumer/non-consumer and natural/moral persons. They are broadly congruent while differences do exist in detail. They are used in different contexts and for different purposes. The distinction is largely irrelevant in the context of financial law because the effects of commercial, property and insolvency law are generally universal. As wholesale financial transaction are much more complex by nature, this course is largely geared to this market segment. However, there is one important issues where the distinction between 'big' and 'small' plays a crucial role. Notably in insolvency banks and other financial institutions have rights and obligations which differ considerably from the rights and obligations of retail, SME and non-financial corporations (see Chapter …).

e) National, EU and International Law

The international nature of the financial market entails that international financial law actually consists of the various national commercial, property and insolvency laws, *plus* the rules that determine how these different laws interact with each other. The latter issue is addressed by each jurisdiction's conflict-of-laws rules – which may also differ. Hence, a major concern is to arrange international financial transactions in a way that they are enforceable under all laws concerned.

It is true that English law, and to some extent New York law, are regarded as the legal backbone of international finance. However, parties are able to freely choose the law applicable to their transactions only in respect of certain aspects of their dealings. In many respects the law of their incorporation, the law where performance takes place or where assets are located will be mandatorily applicable. In particular, the law applicable to the insolvency of a party cannot be chosen – it is typically the law of the seat of the company. Hence, the relevant jurisdictions' conflict-of-laws rules are crucially important. While they all follow the same principal logic, there are stark differences in detail. The interaction of various laws within a given transactional environment may cause significant uncertainty, see Chapter ….

Whereas large parts of financial regulation are harmonised in the EU the picture is different in relation to financial law. There are two significant EU directives which are geared to financial transactions.

The EU Settlement Finality Directive[2] protects ongoing processes within clearing and settlement systems against freezing orders issued by courts to the extent that these processes have already started. This directive has a very sectoral scope of application but is regarded as crucially important. The second significant EU Directive is the Financial Collateral Directive[3], which introduces a harmonised framework regarding the enforceability of collateral and close-out netting in the EU. It is equally regarded as crucially important for the competitiveness of the EU financial market. In terms of law it introduces wide-ranging changes for some jurisdictions, see Chapter … . In addition, there are EU laws of general application which are relevant for financial transactions, in particular the EU legal framework regarding questions of the applicable law[4], and regarding insolvency proceedings,[5] see Chapter … .

On the global scale, there is the Hague Securities Convention regarding the law applicable to proprietary aspects of securities.[6] The UNIDROIT Geneva Securities Convention regarding the material law of securities transactions has not yet been implemented.[7] Further, there are several UNCITRAL model laws regarding secured transactions and insolvency which however do not exert binding force. See Chapter ….

f) The financial crisis and financial law

The 2007-2010 financial crisis is mainly analysed from the perspective of financial regulation. However, also issues of financial law play an important role, and the legal debate and court decisions that emanated from the insolvency of Lehman Brothers and other financial institutions contributed significantly to the development of financial law, see Chapter …

g) The Different Types of Transactions

In order to better understand in legal terms the various forms of financial transactions we categorise them in four groups, following *J. Benjamin*: funded, simple, asset-backed and net positions.[8] 'Funded position' means the risk taker transfers a sum of money upfront, thereby risking not being paid back, as is the case, for instance, with a simple loan. 'Simple financial position' means the risk taker assumes a risk of having to pay later, as is the case, for instance, with insurance contracts. 'Asset backed position' means that the risk taker is entitled to materialise the value of an asset and apply it to its claim, should the obligor default, as is the case, for instance, with a traditional pledge. 'Net position' means that the risk taker is only exposed to the difference in value of mutual dealings between the parties, as is the case, for instance, where the risk taker has the right to set off.

Any financial transaction can be classified into one of these categories. The purpose is to establish that even the most complex transactional environments, such as a synthetic securitisation (see Chapter …) can be broken into single transactions which belong to one or the other of these four different types, which can and must be analysed separately. Also, it allows to compare the legal and regulatory advantages and disadvantages of different legal devices that functionally provide for the same result. For instance, a CDS and insurance have the same effect, and parties generally choose the former, because it is subjected to a much lighter legal and regulatory framework.

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[2] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems.
[3] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.
[4] Regulation (EC) No 593/2008 of 17 June 2008 on the law applicable to contractual obligations (Rome I).
[5] Regulation (EU) 2015/848 of 20 May 2015 on insolvency proceedings (recast).
[6] Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary ('Hague Securities Convention'), www.hcch.net/index_en.php?act=conventions.text&cid=72.
[7] UNIDROIT Convention on Substantive Rules for Intermediated Securities ('Geneva Securities Convention'); unidroit.org/english/conventions/2009intermediatedsecurities/main.htm.
[8] Benjamin J, Financial Law (Oxford University Press. 2007), 3-46.

Chapter 3 – Banking and Risk Management

a) *Bank balance sheets*

The balance sheet of banks features funded positions of all kinds. On the liabilities side, i.e. as instruments through which a bank raises money, the balance sheet will show the following financial assets: deposits from clients, loans from other banks, from the central bank or from other cash-rich financial institutions (these loans are often structured as 'repos', see Chapter …), or own bonds or own shares issued (we disregard other balance sheet items here). On the asset side of a bank balance sheet there are basically the same types of transactions but here the bank acts the fund provider: deposits with other banks or the central bank, loans to businesses and other banks (including in the form of repo), bonds and shares of other issuers, and, lastly, cash in the form of notes and coins. The balance sheet of other types of financial institutions are similarly structured, except that only banks are authorised to raise funds in the form of deposits.

The basic idea of the business of banking consists of raising funds on the one hand and investing them on the other hand. Considering the items on a bank's balance sheet is interesting because the balance sheet is the mirror of risk taking and risk mitigation. Accordingly, banks' dealings and how and why they choose to intervene on the financial market can often be explained against the background of their balance sheet. Also, financial regulation takes the balance sheet as a starting point for the most important chunk of rules – the prudential supervision. It is therefore fair to say that the balance sheet of banks is the pivot of financial law, together with another phenomenon: the rank of claims against an insolvent bank once insolvency proceedings have been opened. We will come back to this subject a number of times and expand our understanding of the complexities step by step.

b) *Capital requirements*

Banks *must* maintain a certain minimum capital ratio to avoid intervention by their supervisors which may ultimately lead to the withdrawal of the relevant authorisation. The relevant capital rules, often called the 'Basel rules' or 'Basel Accord', are a matter of regulation and hence not within the remit of this course. However, it is important to understand that capital requirements create a strong interconnection between the spheres of (commercial) financial law and financial regulation.

Capital requirements are expressed as the ratio between regulatory capital (basically share capital) of the relevant institution, divided by assets on a balance sheet. This ratio must not drop under the relevant capital rate (the current standard rate is 10.5%).[9]

Financial law is extremely relevant as regards the outcome of the calculation. This is because the rules take into account that assets may be supported by a risk mitigation device, such as a pledge or guarantee. E.g., a loan to another bank may by backed by financial collateral in the form of a portfolio of US government debt. As US governments are considered cash-like (there is no doubt about the solvency of the US, and there is stable high liquidity for US bonds in the market), the risk for the lender is close to zero, provided that it is certain that the right under the financial collateral agreement can be enforced in case of default of the borrower. As a consequence, such an asset-backed loan would be counted as risk free, or neutral for in terms of capital requirements. In other words, risk mitigation allows banks to expand

[9] To take a simplified example: a bank has a share capital of 1000GBP. The applicable capital ratio is 10.5%. To know the amount of assets the bank is allowed to hold ('x'), the relevant equation reads $1000\text{GBP}/x \geq 10.5/100$. Solving the equation for x the result is $x \leq 9{,}523.81\text{GBP}$. Note that the rate and the share capital are non-variables (unless the bank decides to increase its share capital which is a lengthy process). Hence, the ratio has the function of *limiting* lending and similar activity. If the bank *de facto* was holding more assets than that amount (i.e. $x > 9523.81\text{GBP}$) it would be violating its minimum capital requirements.

their lending on the same capital basis – provided that it is clear *ex ante* that the risk mitigation tool will be enforceable in the evnet of insolvency.

c) The different types of risks

In addition to counterparty credit risk financial institutions face a variety of other types of risk. Settlement risk, market risk and legal risk are matters relevant to financial law.

The term 'counterparty credit risk' (or, short, 'credit risk') describes the position of the relevant party in which it potentially faces immediate loss from the definitive default of a counterparty to perform on a payment or delivery obligation. The risk materialises at the moment at which the default is definitive, and the loss occurs. The paradigm situation is the insolvency of the counterparty. Further, counterparty credit risk also materialises where debts are restructured (i.e., abated) either by way of voluntary party agreement or in a judicial or administrative restructuring procedure. Beyond these two situations, there is not much room for counterparty credit risk to materialise in the corporate environment. Corporations cannot flee to foreign countries and cannot die - except they are liquidated in insolvency proceedings.

Counterparty credit risk can occur at two different stages during the life of a contract (loan, derivative or other). The first situation is the less fatal one. The contract between the parties exists, but neither party has performed yet, i.e. the contract is still fully executory. For instance, the loan amount has not even been advanced by the lender to the borrower. If one of the parties fails at that moment, the other party loses the profits it would have made. For instance, in case of insolvency of the borrower, the lender would lose its contractual right of being paid interest. This loss varies depending on the value that a transaction has for each party. The party that managed to strike a very favourable deal (as compared to similar deals in the same market – so called 'replacement value' of a transaction) will suffer a significant loss. A party that entered a transaction which was unfavourable as compared to current market conditions is not exposed to counterparty credit risk in that situation (still it might suffer other disadvantages if the counterparty fails, for example a liquidity shortage, or an unhedged risk).

The second variety of counterparty credit risk is fatal. Here, the inability to pay, typically caused by the opening of insolvency proceedings over one of the parties, occurs after the other party has already paid or delivered. The former will not receive consideration or, more generally, performance in return. Also, in the subsequent insolvency proceedings, it is restricted to receiving the quota which will be paid only with a significant time lapse, sometimes years later.

In the context of unilaterally failed delivery obligations, e.g. in the foreign currency market, this variety of counterparty risk is often called settlement risk. However, that term does not necessarily refer to non-performance regarding default. It refers more broadly to the danger of not receiving what one ought to receive at due date, following any problem: liquidity problems, technical failure, or the consideration.

The term 'market risk' refers to losses occurring as a consequence of changing market values. That is, the price at which a specific precious metal, share, bond, standard derivative or another type of asset is currently traded on the market, changes. Market risk is relevant where market participants invest into and hold on to an asset. It is also a crucial consideration where market participants accept assets which are subject to price movements as security or financial collateral to cover their risk flowing from a loan or derivative contract: if the market value drops they may be under-secured.

Besides, financial institutions are as exposed to operational risk as much as are other businesses, i.e. situations in which a human error or technical failure cause damage. Famously, banks' IT systems tend to fail from time to time, and bank employees make 'fat-finger' mistakes, inadvertently transferring enormous amounts of money, thereby confusing the market. Operational risk is not precisely a matter of financial law but rather connected to tort and unjust enrichment rules. It is however relevant in the context of regulation, as operational failures can have systemic repercussions.

Regulatory risk refers to a potentially changing legal and regulatory framework for doing business, and the associated cost. This risk is smaller in countries with established constitutional values such as separation of powers, the rule of law, including the right to property, and the protection against retroactive effects of legal acts. Banks and other financial institutions are as exposed to regulatory risk as are other types of highly-regulated businesses. The term political risk is to some extent connected to regulatory risk but typically refers to the dangers associated with sweeping political changes, such as coups, abolishment of the rule of law or similar situations in a given jurisdiction.

Required reading:

- Benjamin, Financial Law, 3-46
- Wood, Law and Practice of International Finance (University Ed.), 3-14; 45-64

Background reading:

- Valdez/Molyneux, An Introduction to Global Financial Markets, 8 ed., 2-9 (this reading provides market background but no legal insights)