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I

Ensuring financial stability is a key objective in financial regulation. Please explain what we mean by financial stability, why financial stability is important, factors that could threaten financial stability, and how financial stability is sought by different regulatory interventions and institutional solutions in financial regulation and governance.

II

In addition to financial stability, several other objectives underpin financial regulation. Goal conflicts in financial regulation have been suggested in literature. Please discuss how different objectives might interfere with the objective of ensuring financial stability.

Answer both Part I and Part II.

Din fil ble lastet opp og lagret i besvarelsen din.

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1 Question 1: Financial stability

1.1 Introduction

There are many different definitions of the term “financial stability”. Most of them have in common that financial stability is about the “absence of system-wide episodes in which the financial market fails to function”, and about the “resilience of financial systems to stress”.[1] What is defined as “stability” or “instability” may vary depending on who’s perspective is adopted, and whether one is involved in risk as a decision-maker or as someone affected by the discission.[2] It is therefore difficult to define “financial stability” in other than broad and general terms.[3]

1.2 Why financial stability is important.

Financial stability plays a key role when it comes to maintaining macroeconomic and monetary stability, sustainable economic growth and reducing vulnerability in the system that potentially could lead to crises.[4]

A stable financial system should be able to efficiently allocate resources, assess and manage potential risks and maintain the employment.[5] When the system dissipates financial imbalances, absorbs the shocks by using its self-corrective mechanisms and prevents events from having a disruptive effect on the economy or other financial systems, is stabilizes itself.[6] During these periods we often experience a sustainable economic growth and liquidity caused by a healthy relationship between the participants on the financial market when it comes to risk management, maintaining savings, investments and payments.

But it’s during periods of financial instability, that the true importance of the financial stability appears. The system does not function as intended. The banks are often reticent to finance

[1] The World Bank (w.y)
[2] Luhman (1993) p. 3
[3] Andenæs and Chiu (2014) p.28
[4] Armour (2016) p. 65
[5] The World Bank (w.y)
[6] The World Bank (w.y)

projects, the asset price will differ from its actual values, the savings stops and payments won't arrive on time.[7] The instability can lead to bank runs, inflation and market crashes that affects the financial system as whole[8]. This was especially highlighted during the crisis in 2008 where failed mortgages led to market collapse, the confidence in the financial markets plummeted and it became difficult to get credit.[9]

1.3 Factors that could threaten financial stability.

1. Lack of trust and confidence

A factor that is important when it comes to ensure financial stability and a well-functioning market, is the importance of trust and confidence in the financial market. Participants who have trust and confidence to the market, are more willing to participate and invest long term and ensure economic growth. Inadequate information can potentially lead to lack of trust and confidence, which can contribute to bank runs and financial panics. If people believe that a bank or market is insolvent, they might rush to withdrawal their money all at the same time, which potentially can cause the bank to fail since the bank depends on stability between loans an investment funds.

2.Excessive risk-taking

Another important factor that could lead to financial instability is excessive risk-taking. There is no doubt that access to liquid funds is important for economic growth. People need to borrow to invest, while lender gets a profit from the repayment. The problem occurs when lenders are willing to offer risky loans. These high-risk loans will often give the lenders a higher reward when everything goes well, and the lenders might think that they will be bailed out by the government if the lending turns into a crisis. Since it`s difficult to predict the market and the consumers often have little information about the risk they are taking when participating in these loans, this has proven to be a potential risk to the stability several times, e.g. in 2008.

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[7] The World Bank (w.y)

[8] The World Bank (w.y)

[9] Notaker (2018)

3. Sovereign debt

Sovereign debt is an important way for many countries to finance investment in growth and development.[10] Financial crisis can destabilize a state and cause a sovereign debt and crisis, but unstainable sovereign debt that the state can't pay can also cause a financial crisis vice versa. This can affect both the state and the lender. [11] The bank holds the sovereign debt as a «safe asset». If the value is crashing, it will make the financial institution unstable and can contribute to systemic risk[12]. If the state fails to pay back, it will also affect the banks economy. The debt can affect other markets, which can lead to concerns among investors losing trust and wanting to withdraw, both globally and locally.

4. Climate

The development against low carbon economy effects the economy in oil/gas reliant countries. In Norway e.g. it's an ongoing discussion on whether we should stop pumping oil. The economy in Norway is largely built up based on "oil money", and it`s great uncertainty how this climate change will affect the financial stability.

The climate change also creates physical and transition risks[13]. When it comes to the physical effects such as droughts, sea level change e.g. it affects the people living in the area but also investments. For instance, a random person who has bonds in a hydroelectric power station that no longer has access to water. When it comes to transition risk, it will come new regulation associated with emissions, such as taxes, and new capital requirements[14]. These factors will also potentially threaten the financial stability for both consumers, companies, and states.
Specially for poor countries that might need to raise more debt.

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[10] IMF (w.y)
[11] Iversen (2023)
[12] Iversen (2023)
[13] Iversen (2023)
[14] Iversen (2023)

1.4 How financial stability is sought by different regulatory interventions and institutional solutions in financial regulation and governance.

The primary purpose of financial regulation is to improve the functioning of the financial system.[15] The government has moved towards economic liberalism in an attempt to stimulate the economy, which led to more focus on market competition.[16] Under this new philosophy, the regulation has to be justified by the present of market failures.[17] For banks and the securities markets, things are a bit different and we see the need for regulatory to prevent bank runs, protect investors and increase the information support. [18]

1. Requirements for banks and securities markets

The main directives for regulating these firms are the CRD IV, MiFID II, Solvency II and accompanying secondary legislation. These directives demand requirements on capital, authorization, organizational rules, on personnel/owners, internal risk management and independent controls of conflicts. All these requirements have a purpose so secure stability and make sure that the companies don’t operate with poor management and excessive risk they can`t handle. The regulation also require publicity, which promotes market discipline.

In addition to increase the transparency in the market, the purpose of the MiFiD II is also to increase investor protection. MiFiD II demands strict information rules which plays an important role when it comes to the investor’s ability to make good investments and their protection. It requires that the company get to know the consumer before giving investment advice and places the responsibility with those who have the power and knowledge. This can eliminate the risk for asymmetric information, increase trust and confidence in the market, and prevent bank runs and financial instability.

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[15] Armour (2016)

[16] Myklebust (2022) p.33 - 34

[17] Myklebust (2022) p. 34

[18] Myklebust (2022) p. 34

To make sure that the companies meet these requirements, there are different supervisors that monitors the companies, such as the ESFS, the Norwegian FSA and Central banks[19]. Any deficient routines or breaches of internal guidelines will be followed up through the supervisory activities.

2. Central banks

According to The Norwegian central bank act section 1 and 2 the central banks activities are to maintain monetary stability, promote stability of the financial system and an efficient, secure payment system and contribute to high and stable output and employment[20]. As mentioned, the central bank also plays an important role when it comes to supervise financial institutions.

To ensure this stability, the central bank seek to target a 2 % inflation every year and a low unemployment. [21] Their main tool is the interest rate. When the inflation is high, the central bank raises the interest rate to prevent "bubbles". High rates, means expensive loans and less money for other stuff. Therefore, the inflation will sink, and the economy will stabilize. When the inflation is low, they lower the interest rate to stimulate the economy to growth.

Central Banks have also traditionally held the role as a "lender of last resort" (LOLR).[22] . Banks typically turn to LOLR when they cannot get the funding and need extraordinary liquidity.[23] This can prevent problems from spreading broader and save the bank from bankruptcy, and therefore secure stability.

3. Other governance

[19] Finanstilsynet (2022) and Norges bank 2021
[20] Norges bank, 2023
[21] Norges bank, 2021
[22] ECB, 2019
[23] ECB, 2019

The Norwegian Central Bank has only jurisdiction in Norway, but there are other Central banks with a broader jurisdiction, such as the European Central Bank (EBC). According to art. 127 this bank also aims to maintain a financial stabile market. Together with the BID and BCBS (Basel 1 og 2) they all seek to secure financial stability, but on a more globalized level than the Central bank. There are also other comprehensive EU-regulation that affects the stability. Due to the world limit, I will not go into this any further.

2 Question 2: Goal conflicts

2.1 Introduction

Goal conflicts occurs when participants on the financial market have different interest that stand against each other. Since the market consist of actors who aim to secure the best benefits for themselves, this can create an imbalance that can interfere with the objective of ensuring financial stability.

2.2 How different objectives might interfere with the objective of ensuring financial stability.

1. Efficiency and financial stability

The rise of the GFC is a great example of this type of goal conflict. In the years leading up to the GFC, the economic conditions were strong and housing prices increased. Lenders were willing to give a large amount of high-risk loans to get ahead of the competition since it seemed to be profitable at the time. Unfortunately, there were recession and people were not able to pay their loans which lead to a crisis. This shows how the efficiency affects the financial stability.

2. Efficiency and consumer protection

Information plays an important role for markets when it comes to perform their economic function, but there is an asymmetric relationship between the lenders and borrowers on the market[24]. On the one hand, you have the lender with professional knowledge of the financial market and the risk connected with the loan/investment. On the other hand, you have the borrower who is often a consumer with little knowledge. The lender often seeks to maximize its profit, and by exploit the consumer they seek efficient capital. The consumer on the other hand trusts the lender and does not detect that they are been exploited and enters the bad deal. This can also lead to lack of trust and confidence and cause consumers to withdrawal from the market.

3. Competition and financial stability

Good competition contributes more cost-effective operations, lower prices and financial stability.[25] This was one of the arguments that Konkurransetilsynet emphasized when considering the purchase of Danske bank.[26] Excessive competition on the other hand can cause actors to take on greater risk in order to get an advantage on the market. This could cause the bank to give out high-risk loans or exploit the system to survive. While lack of competition will create increased market power for a few actors and give the banks to much freedom. Increased or decreased competition between the banks can therefore affect the financial stability.

4. Market integration and financial stability

Higher market integration tend to lead to more competition and increased efficiency, but it can also create a so-called domino effect where instability can spread across the markets. For example, the war in Ukraine has due to market integration effected the financial stability in other countries, such as Norway. This has caused inflation and insecurity in the economy[27].

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[24] Armour (2016) p. 55
[25] Finansdepartementet (2023)
[26] Konkurransetilsynet (2023)
[27] SSB (2022)

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