UNIVERSITETET I OSLO

KANDIDAT

xxxxxx

PRØVE

JUR1880 1 Financial Market Law and Regulation

Emnekode	JUR1880
Vurderingsform	Hjemmeeksamen
Starttid	28.11.2024 08:00
Sluttid	29.11.2024 08:00
Sensurfrist	19.12.2024 22:59
PDF opprettet	05.01.2025 20:15

Seksjon 2

Oppgave	Tittel	Oppgavetype

⍰	Exam information	Informasjon eller ressurser

Seksjon 1

Oppgave	Tittel	Oppgavetype
1	JUR1880 Autumn 2024	Filopplasting

The Financial Markets Must Always Be Rescued

It is the rich, those who own most of the stocks and real estate, who are always rescued by the central banks.

These days it has been ten years since the now mostly forgotten movement Occupy Wall Street began, with the demonstration in Zuccotti Park in New York. The slogan was "We are the 99 percent," and the idea that the economy is rigged in favor of the richest one percent. Now with a more left-leaning parliament here in Norway, it's time to ask: Do the next decades belong to the one or the 99 percent?

A new economic world order was established during the financial crisis in 2008 and cemented during the corona pandemic in 2020: Every time the financial markets fall sharply, central banks print money in unheard-of proportions to buy securities.

The result is that the prices of financial assets rise, eventually past the level before the crisis, and the rich get richer. This system gives market participants incentives to take on ever more risk, so the crises get bigger, and the medicine therefore stronger with each round.

Imagine you're playing Monopoly. You've always made sure to keep a bit of cash for unexpected expenses. Your aunt, on the other hand, has stretched her limits to the fullest—hotels on the entire side before the start, but not a penny left. Then she draws the chance card "Your houses and hotels are burning." But this is the latest edition of Monopoly—updated with a powerful central bank. At a negative market shock, money is pumped into the markets to, as stated, "prevent systemically important institutions from collapsing, and ensure that the game continues."

Everyone is paid 8,000 kroner per street they own. Your aunt's hotels remain standing. Regular stops on Trosterudveien and Rådhusplassen [expensive streets in the Norwegian version of Monopoly] gradually drain the other players, and she's left as the winner.

Since March 2020, central banks in wealthy countries have printed money like never before and used them to buy up the new government debt issued to pay for corona support schemes. As everyone became convinced there was a lot of money in circulation, private demand for securities also increased. When the vaccine came, the result was new stock and housing price records.

This is actually the same as what happened in the years after the financial crisis. The roots go all the way back to the crash in 1987 and the dot-com crisis in 2000. The socalled "Greenspan put" was an unspoken guarantee that stock prices would never be allowed to fall too much without the central bank coming to the rescue. However, it has proved difficult for central banks to sell off again and return to a kind of normal state. When Fed Chief Bernanke hinted in 2013 that the pace of bond purchases should be slowed, he gave up after the markets fell in the so-called "taper tantrum."

The most likely scenario is therefore that each new major crisis in the coming years will once again double the balance sheets of the central banks. The markets will be flooded with money, and all asset prices will set new records.

As the British central bank explains on its website, quantitative easing works by raising stock prices, so households and companies that own stocks become richer. Thus, they spend more money, which stimulates the economy.

Ironically, it is the owning class, which so often advocates for individual self-reliance and against government intervention in the economy, that benefits more than anyone else from government help. Because the rich, those who own most stocks and property, are the winners. It is their fortunes that were primarily at stake in 2000, 2008, and 2020. But the wellbeing of the financial markets is so crucial for financial stability, and so intertwined with the rest of the economy, that there is no longer any choice but to step in with newly printed money and save the day every time a crisis threatens.

A rational dictator would say this cannot go on. The payment system, businesses' access to credit, and households' access to mortgages are as vital elements of a modern society as water, sewage, and electricity. They must therefore be separated from the casino that modern finance has become so markets can crash, and investors lose everything, without taking the entire economy down with them.

But we have no such dictator. Thus, there is no way around it. The markets must always be rescued. Moral hazard will cause everyone to take as much risk as they can. This mechanism we know from the Norwegian housing market: Since prices always go up, you'll become poor if you're afraid to borrow too much. The result will be as in Monopoly: to those who have, more will be given, and they will have an abundance; but from those who do not have, even what they have will be taken away.

Øyvind Thomassen, Norwegian School of Economics (Handelshøyskolen)

Dagens Næringsliv, 21 September 2021

1 JUR1880 Autumn 2024

Please read the accompanying opinion piece with the title ‘The financial markets must always be rescued’.

Please answer the following questions (all questions 1. – 3. shall be answered):

1. What rationale and reasons can you think of that underpin the main tenet of this opinionpiece; that the financial markets always must be saved?

2. Policy makers try to counteract financial crises through a variety of policy measures, someof which are in the form of (1) regulation targeting financial market participants directly and (2) other types of governing measures, for instance through establishment of institutions that operate different mandates with the aim to prevent financial crises. Please choose two examples of each category ((1) and (2)) and explain how they contribute towards the goal of preserving financial stability.

3. The author uses the phrase ‘moral hazard’. Please explain what this expression means.Can regulation or other policy measures unintentionally exacerbate moral hazard among financial markets participants?

Bonus question:

Are you aware of any incidents occurring after this opinion peace was written (September 2021) that illustrate the point made by the author?

Din fil ble lastet opp og lagret i besvarelsen din.

Last ned Fjern Erstatt

Filnavn:	Exam JUR1880.pdf
Filtype:	application/pdf
Filstørrelse:	426.42 KB
Opplastingstidspunkt:	28.11.2024 23:00
Status:	**Lagret**

UiO : Det juridiske fakultet

Exam JUR1880

Financial Market Law and Regulation

Kandidatnummer: xxxxxx

Antall ord: 2000

Table of Contents

Question 1: Rationale for Saving Financial Markets

The main goal of financial regulation and supervision is to ensure a well-functioning and stable financial system[1]. The primary rationale for rescuing the financial markets lies in their foundational role in the functioning of the broader economy.[2] Financial markets are the backbone of modern economic systems, enabling the flow of capital between savers and borrowers, facilitating investment and underpinning the credit systems essential for business and households alike.[3] When these markets falter, the repercussions can be viewed across the entire world's economy, threatening livelihoods, social stability and long-term growth.

Maybe the most important reason for saving the financial markets is to prevent a systemic collapse. Financial systems are interconnected networks where the failure in of one institution can trigger major effects, leading to widespread insolvencies and economic paralysis. For instance, following the bankruptcy of Lehman Brothers during the crisis of 2008, it both jeopardized its customers, but also the network of financial institutions dependent on it.[4] Failure of one financial institution can quickly spread and harm the entire economy, making it necessary to act fast to stabilize the system. Øyvind Thomassen illustrates this with his Monopoly analogy, where a shock to one player triggers intervention to keep the game going, showing how central banks step in to prevent a total collapse when crises hit.

Additionally, financial markets are necessary to ensuring access to credit, which is vital for sustaining economic activity[5]. Businesses relies on credit to fund operations, expand and invest in new opportunities, while households depend on credit for mortgages, education and consumer spending. Without function markets, access to these critical financial services can be severely disrupted. This was also highlighted during the crisis in 2008 where failed mortgages led to a market collapse and it became difficult to get credit.[6]

[1] Myklebust 2022, p. 7
[2] Armour (2016) p. 65
[3] Hayes, 2014
[4] Norges bank
[5] European Central Bank
[6] Notaker (2018)

Another key rationale is the need to stabilize public confidence. Financial crises often lead to panic, with investors pulling funds from markets and ordinary citizens withdrawing deposits from banks[7]. This panic can worsen the crisis, as seen during the Great Depression and the 2008 financial crisis. By stepping in to rescue financial markets, policymakers work to calm the public and stop fear from making the economic situation worse.

Moreover, there are also positive effects that can be gained from a stable financial system which leads to a long-term economic growth[8]. Financial systems enable investment in innovation, infrastructure and human capital – key factors of economic progress. Allowing the markets to collapse would hold back these opportunities for growth, setting back economic potential for years or even decades.

Finally, there are also political and social reasons to avoid the fallout of financial market failures. History has shown that severe economic downturns can lead to political instability, social unrest and a rise in extremist movements[9]. By rescuing financial markets, governments seek to maintain stability and uphold social order, even if it means bearing short-term political criticism.

Thomassen's opinion criticizes the practice of consistently rescuing financial markets, arguing that it disproportionately benefits the wealthiest market participants. However, in my opinion, policymakers argue that the alternative—unchecked financial collapse—would pose an even greater risk to society as a whole. The systemic importance of financial markets, coupled with their deep integration into the broader economy, leaves policymakers with little choice but to intervene during crises.

Question 2: Examples of Policy Measures

As mentioned, financial crises threaten the stability of the economy and the well-being of society. Policymakers use a combination of regulatory measures and broader governing strategies to reduce risks and keep the financial system stable. These measures can be

[7] Myklebust (2024)
[8] Myklebust, Andenæs (2023)
[9] World Economic Forum

categorized into: (1) regulations targeting financial market participants directly and (2) institutions with specific mandates to prevent and manage financial crises.

2.1 Regulations Targeting Financial Market Participants

These are specific rules imposed on individual financial institutions and markets participants. The aim is to directly influence the behavior of these entities.

Example 1: Capital requirements (Basel)

In Western countries, the collapse of Herstatt Bank in 1974 prompted international coordination, leading to the establishment of the Basel Committee on Banking Supervision and the development of the Basel Accords.[10] Capital requirements, particularly under the Basel III framework, mandate that financial institutions, especially banks, raise the level and quality of their capital.[11] These requirements are designed to strengthen the resilience of the banking system while promoting stability within national financial systems. Key elements include the capital conservation buffer and the countercyclical buffer, which help absorb losses during periods of economic stress. The Basel III requires financial institutions to maintain stronger financial reserves, reducing risks and building confidence among market participants.

Example 2: The Markets in Financial Instruments Directive (MiFID)

Three other significant directives regulating the financial market are CRD IV (2013/36/EU), MiFID II (2014/65/EU), and Solvency II (2009/138/EC). Due to the word limit, I will not discuss them in detail.

[10] Andenes and Chiu (2014) p. 18 [11] Andenes p. 219

MiFID, implemented in the European Union, is a comprehensive regulatory framework aimed to increase protector investors in financial markets.[11] The framework regulates financial market participants by setting requirements for how investment firms operate, including rules on clearness in pricing, client protection and fair competition.[12] For instance, it mandates that firms provide clear and detailed information to clients about the cost and risks of financial products, ensuring that investors can make informed decisions. By holding financial institutions accountable for fair practices and improving clearness, MiFID reduces the likeliness of market manipulation and budling trust among market participants. This also contributes to a more stable and reliable financial market.

To make sure that the companies are meeting these requirements, there are different supervisors that monitor the companies, such as ESFS, the Norwegian FSA and Central Banks[13]. This again builds trust among market participants.

2.2 Governing Measures and Institutional Mandates

Governing measures and institutional mandates are broad, systemic interventions implemented by governmental or quasi-governmental institutions to ensure financial stability.

Example 1 Central Banks as Lenders of Last Resort

Central banks, such as the European Central bank or the Central bank of Norway, act as lenders of last resort during financial crises[14]. They provide emergency liquidity to financial institutions that are facing short-term funding pressures but are otherwise solvent. This intervention ensures temporary liquidity shortages do not escalate into insolvency, which stabilizes the financial system. By supporting institutions critical to the economy, central banks could prevent a chain reaction of failures that could harm credit access and the entire economy.

[11] Directive 2014/65/EU.
[12] Andenæs p. 156
[13] Finanstilsynet (2022) and Norges bank (2021)
[14] Iversen, 2023

The Norwegian Central Bank operates exclusively within Norway, with the primary objectives of maintaining stable monetary value and promoting stability in the financial system.[15] In contrast, the European Central Bank (ECB) has a broader jurisdiction, aiming to maintain stability across the financial markets of the Eurozone. Together with the Basel Accords, they work towards ensuring financial stability on a more global scale than the Norwegian Central Bank.

Example 2 Deposit Insurance Schemes

Deposit guarantee schemes are also an important tool for maintaining public confidence in the banking system and ensuring financial stability[16]. In the European Union, it is the Directive 2014/49/EU on deposit guarantee schemes standardizes the framework across member states. By ensuring depositors' funds are secure, these schemes play a critical role in preventing systemic crises and preserving the integrity of the financial system - especially during periods of financial turbulence. Norway, although not an EU member, adheres to similar principles under its deposit insurance system[17].

In addition to these measures, frameworks like the Capital Requirements Directive IV (CRD IV) and institutions such as the European Stability Mechanism (ESM) also play pivotal roles in safeguarding financial stability.

Question 3: Can regulation or other policy measures unintentionally

[15] Sentralbankloven § 1-2
[16] Myklebust 2024
[17] Ibid.

exacerbate moral hazard among financial markets participants?

3.1 Explaining Moral Hazard and its implications

"Moral hazard" refers to the risks that someone or something becomes more inclined to take because they have reason to believe than an insurer will cover the costs of any damages[18]. In financial markets, moral hazard often arises when market participants expect government or central bank interventions to protect them in the event of a crisis[20]. This expectation reduces their incentives to act responsible, as they believe the safety net will absorb potential losses.

For example, if a large bank knows it is considered "too big to fail", it may engage in riskier investments, assuming that it will be rescued to avoid destabilizing the economy. Similarly, investors might overextend themselves in the stock or the real estate markets, expecting central banks to intervene and stabilize during downturns.

3.2 How Policy Measures Can Exacerbate Moral Hazards

While regulations aim to stabilize financial markets and prevent crises, they can unintentionally increase moral hazard among financial market participants. Two ways this can happen are:

3.2.1 Quantitative Easing and Market Guarantees

Quantitative easing is a type of monetary policy that involves central banks purchasing securities, such as government and corporate bonds, on the open market in order to increase the money supply and spur economic growth[21]. This approach can help stabilize asset prices during economic downturns but may also contribute to moral hazard. These interventions signal to investors that asset prices will be supported, encouraging speculative behavior[22].

3.2.2 Bailout

A bailout is when a government provides money and/or resources (also known as capital injection) to a failing company[23]. This intervention aims to prevent the potential collapse of

[18] Havard. What does 'moral hazard mean' [20]
Thomassen. 2021.

the business and mitigate its broader economic consequences. Knowing that they will likely be rescued, large financial institutions may engage in excessive risky behavior, such as overleveraging or investing in high-risk assets, without fully considering the consequences[24]. This will create a cycle where repeated bailouts reinforce reckless behavior.

3.3 Addressing Moral Hazards

To reduce moral hazard while preserving financial stability, policymakers can implement measures that strike a balance between inventions and accountability. The first is to encourage the risk-taking party to act more responsible by offering them incentives[25]. For example, during the 2008 financial crisis, some bailout packages in the U.S. required banks to repay funds with interests[26], ensuring accountability. Also, encouraging market discipline by

21 Cattlin. 2022.
22 Ibid.
23 Investopedia. Twin.
24 Myklebust p. 10.
25 Investopedia. Kenton
26 Investopedia, Kenton.

allowing smaller, non-systematic institutions to fail can reduce moral hazard. This approach sends a clear message to market participants that reckless behavior carries consequences. A final solution could be to regulate capital requirements and leverage limits which forces financial institutions to maintain adequate buffers, ensuring they can absorb losses without requiring public assistance. This framework incentivizes careful decision-making by holding institutions accountable for their risk exposure.

Bonus question: The Silicon Valley Bank Collapse of 2023

Several incidents since September 2021 align with Øyvind Thomassen's arguments, including the case study of the 'mini-budget" debacle in the UK in 2022 and the collapse of Credit Suisse in 2023. However, the most compelling example of the systematic risks and policy dilemmas discussed in Thomassen's opinion piece is the collapse of Silicon Valley in March 2023. The Silicon Valley Bank, faced a collapse due to a combination of poor risk management, market volatility and rising interest rates[27]. This event illustrates the mechanisms of moral hazard and the challenge posed by a financial system that frequently relies on government interventions.

2.1 Link to Thomassen's argument

The intervention primarily benefitted business and individuals with large, uninsured deposits, many of whom belonged to the tech and venture capital sectors[19]. Critics can argue that this reinforced the perception that the financial system disproportionately protects the wealthy.

By guaranteeing all deposits, policymakers signaled to depositors and bank that risky behaviors might not have significant consequences. This decision could encourage further risk-taking, because it sets a precedent that depositors might always be bailed out in future crises.

27 Bøe. 2023.

[19] Silicon Valley Bank, Wikipedia

Literature:

- **Andenæs, Mads.** *Regulating and Supervising European Financial Markets*. 2016.
- **Andenæs, Mads, and Myklebust, Trude.** 2023. *Note to Markers*. Available from: Link
- **Armour, J.** (2016). *Principles of Financial Regulation*. Oxford University Press.
- **Bøe, Eivind.** *Bankkollapsen i USA: Oljefondet har tapt milliardbeløp*. 13 March 2023. Downloaded 28 November 2024. Available from: Link
- **Cattlin, Rebecca.** *What is Quantitative Easing and How Does It Impact Markets?* 25 August 2022. Downloaded 27 November 2024. Available from: Link
- **European Central Bank.** Available from: Link
- **Finanstilsynet.** (10 August 2022). *Samfunnsoppdraget*. Downloaded 28 November 2024. Available from: Link
- **Funke, Manuel.** *How Is Politics Affected by Financial Crises?* 2015. Downloaded 27 November 2024. Available from: Link
- **Havard, Cassandra Jones.** *What Does 'Moral Hazard' Mean?* 21 March 2023. Available from: Link
- **Hayes, Adam.** 2024. *Financial Markets: Role in the Economy, Importance, Types, and Examples*. Downloaded 28 November 2024. Available from: Link
- **Iversen, Astrid.** *Central Banks*. 2023. Available from: Link
- **Kenton, Will.** *Emergency Economic Stabilization Act (EESA) of 2008*. 12 June 2022. Downloaded 28 November 2024. Available from: Link
- **Kenton, Will.** *Moral Hazard: Meaning, Examples, and How to Manage*. 24 June 2024. Downloaded 28 November 2024. Available from: Link

- **Myklebust, Trude.** 2022. *Fair, Orderly and Sustainable Financial Markets?* Doctoral thesis, University of Oslo. Available from: Link

- **Myklebust, Trude.** (2024). *Lecture 6. JUR1880*. Available from: Link

- **Myklebust, Trude.** (2024). *Lecture 11. JUR1880*. Available from: Link

- **Norges Bank.** Available from: Link

- **Notaker, U.** (17 September 2018). *Finanskrisen i USA 2008-2009*. In *Store norske leksikon*. Available from: Link

- **Silicon Valley Bank.** Wikipedia. Downloaded 28 November 2024. Available from: Link

- **Thomassen, Øyvind.** *Innlegg: Finansmarkedene Må Alltid Reddes*. 21 September 2024. Downloaded 27 November 2024. Available from: Link

- **Twin, Alexandra.** *What Is a Bailout? Definition, How They Work, and Example*. 16 March 2024. Downloaded 27 November 2024. Available from: Link

---

EU Directives, Regulations, and Other National Statutes:

- **MiFID II.** Markets in Financial Instruments Directive 2014/65/EU.

Norwegian Acts:

- **LOV-2020-12-18-146.** *Sentralbankloven*