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PRØVE

JUR1880 1 Financial Market Law and Regulation

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Seksjon 1

Oppgave	Tittel	Oppgavetype
1	Exam JUR1880 Autumn 2025	Langsvar

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Answer *all* four questions below.

(1) Discuss if there may be more risk-taking by individuals and firms, and systemic risk in the financial sector than in other sectors, and also why systemic risk should be more of a concern for the authorities in the financial sector than in other sectors.

(2) Then discuss the role of central banks relating to systemic risk, including in the handling of insolvent banks.

(3) Discuss also how regulation may counter or mitigate systemic risk, but how certain regulatory measures could increase risk-taking.

(4) Finally, discuss non-bank lenders or shadow banks in relation to the three questions (1)-(3) above. If you wish to (*NB! this is not mandatory or obligatory*), you may also include in your discussion large corporates as Microsoft or Evergrande.

Write your answer in the box below. Changes are saved automatically.

Introduction

This exam poses 4 key questions relating to systemic risk in the financial sector. To answer such questions, the term systemic risk must first be defined.

Risk is an inherent part of growth in the financial system, as the financial sector normally funds themselves through debt instead of equity. Spurts of instability in the markets or at singular institutions, do not mean that the financial system is instable from a macro-prudential view. There is no single standardized definition of systemic risk. Systemic risk can however be a cumulation (horizontally or vertically) of such risks in a way that makes them significant. It has been described by Horsch as "the risk that a certain incident triggers events that endanger the stability of the (financial) system as a whole." (Andenæs, 2016).

One of the key objectives with financial regulation lies in mitigating systemic risk and thereby creating financial stability (Cranston, 2003). The terms systemic risk and financial stability are in this way integrally

connected. Luhmann uses the term "disaster threshold" to define financial stability: it is the perception of an intolerable imbalance of risks, and will vary depending on the affected, or unaffected, persons involved (Luhmann, 1993). This statement shows that reaching a consensus upon what should be considered systemic risk also will depend on the disaster threshold in the eyes of the beholder. In financial market regulation, there will in many cases be a clear divide between sophisticated wholesale actors and the general public in reaching a tolerable threshold for financial stability should be.

Question 1.

Discuss if there may be more risk-taking by individuals and firms, and systemic risk in the financial sector than in other sectors, and also why systemic risk should be more of a concern for the authorities in the financial sector than in other sectors.

The core purpose of the financial sector is to allocate capital - by matching investors with savers so that money can be utilized in the most effective manner - and managing risk. Schinasi argues that in this way that the financial sector becomes a "clearing house" for risk (Schinasi, 2012); different risks in the economy are pooled together, interchanged and later redistributed across the market.

The financial market can also be described as "self-referential" which means that it operates in reference to itself and not underlying industry or production. The self-referential characteristic can cause prices, expectations and leverage cycles to spiral exponentially in either direction as it is not grounded in the real economy.

Combination of a self-referential character and being a clearing house for risk, indicates that risk could have a quicker potential for growth or loss in the financial sector as opposed to other sectors. Not only does the financial market attract risk, it will in many cases reward it. An example of this is highly leveraged financial institutions: the higher the leverage, the larger the opportunity for financial gain. On the other side of the transaction lies also the opportunity for financial loss which is magnified by high leverage. Individuals and firms who choose to 'go big' are also vulnerable to shocks in the volatile market. The knowledge of possible bail-out from the state can furthermore incentivize bigger risks from firms deemed to big to fail.

Greed for quick growth became especially fervent in the financial sector during the rise of financialisation and liberalization. When stripping back regulation and following the "no intervention" form of governance (recommended in Better Regulation Task Force UK 2004), participants in the market could give themselves better rules to boost competitiveness in the market. The result of trust in market discipline, lack of regulator oversight and financial firms wanting to grow at any cost resulted in the 2008 financial crisis. Today, the gained financial power in the industry from this time makes certain groups harder to regulate. An example of this is the AIFM Directive in which Andenæs argues is fraught with compromises due to the strength of industry voices (Andenæs, 2014).

The impact of widespread systemic risk is greater in the financial sector because its failure has been proven to lead to destabilization of the entire economy, ref. the global financial crisis of 2008. This resulted for many in feeling the effects of financial instability, which Davies and Green described as the "loss of normalcy" or "harm to bystanders" (2010). The public good aspect of financial regulation can not be preserved by market discipline as it has an intrinsically different incentive, and therefore must be enacted by regulators.

Mitigation of systemic risk serves an integral role in preserving the economy as a whole. Financial regulation should for this reason be of greater concern for authorities in the financial sector than other sectors.

Question 2.

Then discuss the role of central banks relating to systemic risk, including in the handling of insolvent banks.

There are many ways in which the central banks affect systemic stability.

The first is by direct interaction and macro-prudential coordination. The primary role of the central banks is primarily tied to monetary policy, ref. "to maintain price stability" Article 127 TFEU. Prior to the financial crisis, monetary policy was seen in isolation from financial stability as a whole. The general assumption was that by keeping prices low that financial stability would ultimately follow (Kern, 2019).

Today, it is recognized that keeping prices low also affects financial stability by encouraging people to take larger risks in form of debt-taking, search for yield, increase of asset prices and thereafter credit expansion. This forces market actors in to pro-cyclical risk taking, increasing systemic risk. Due to this link, monetary policy can also be used as a to in macro-prudential regulation to alleviate systemic risk by regulating money supply, interest rates and exchange rates.

The ECB's responsibilities now include macro-prudential supervision to strengthen oversight of systemic risk in the EU. This mandate is clearly set forth in Article 127 TFEU as "support the economic policies in the union with a view contributing to the achievement of the objectives of the union." In this

regard, monetary policy no longer stands alone, but as a compliment to gaining financial stability within the European economic area.

The ECB's role in financial stability does however raise certain democratic concerns. Concentration of regulatory power, especially in times of crisis, in the hands of technocrats could remove governance too far from the affected peoples and the social aspect of financial policy. Although it is positive to protect monetary policy from short term political and industry interference, over the long term the public good objective of financial regulation may go lost. Without robust accountability channels or engagement of wider civil society, the increased power of the central banks can lead to elitism and a loss of social perspectives in financial stability.

The second way central banks relate to systemic risk as a lender of last resort. Central banks intervention is one of their critical roles in times of crisis. During the financial crisis the central banks provided liquidity to many banks, which pushed the narrative of banks being too big to fail. Knowing that bank failure would result in the central banks stepping in as a lender of last resort could lead to perverse incentives.

Ex post the Banking Recovery and Resolution Directive (BRRD) formalized the lender of last resort function to try and mitigate risk. The objectives are describes in article 31 as ensuring continuity, avoiding systemic impact and protecting public funds (bail-in principle). The conditions of the BRRD set out that resolution must be necessary in public interest.

Question 3

Discuss also how regulation may counter or mitigate systemic risk, but how certain regulatory measures could increase risk-taking.

Regulation can mitigate systemic risk by preventing bank runs, contagion, and liquidity freezes.

One example is adequate investor protection, which ensures that investors are protected from unfair practices in the financial market. Such rules are important in preventing contagion risks as investor trust prevents a collective run on the market. Where investors know that their rights are highly protected, they will be more willing to invest in the financial system thereby expediting growth.

Another type of regulation which can mitigate systemic risk in the form of contagion is the EU Directive on short selling. The directive imposes rules for both notification and stop of short selling in certain cases to prevent the market from acting too reactively in cases of economic fall. This prevents herd mentality from taking effect and can lead to the slow down or prevention of loss in certain cases.

A third example is regulations on outsourcing and delegation. In the AIFM Directive delegation and outsourcing of certain functions, such as risk management requires approval by member states. This regulation ensures that the managers of alternative investment funds always have the sufficient knowledge required, even in cases of more complex supervision.

On the other hand there are drawbacks with certain regulatory measures that could increase risk-taking. The main examples have already been mentioned above as knowing that the central banks will step in as a lender of last resort for institutions which are considered too big to fail, and monetary policy leading to pro-cyclical systemic risk.

Another issue with certain regulatory measures is the risk of supervision in becoming too procedural. Where regulators force information into a standardized template, two problems may arise. The first being that regulators have a false sense of security based on procedural supervision. The mapping of micro-prudential information without both supervision that inspects and compares it from a birds eye view may not be able to catch systemic risk. The second that without actual channels for accountability such as civil litigation, the industries will lack incentives to properly supervise in place of the regulators.

Regulatory arbitrage as an example of regulation increasing systemic will be examined below.

Question 4.

Finally, discuss non-bank lenders or shadow banks in relation to the three questions (1)-(3) above.

A relevant example of regulatory measures that increase risk taking is private credit, which is a part of the non-bank financial intermediation sector.

Whereas banks are heavily regulated, private credit is not even though it has bank-like functions. Within the last 10 years the amount of money in private credit has grown exponentially and it can be argued that this is incentivized by the lack of regulation of the NBFIs sector. The sheer scale of private credit loans can pose as a systemic risk if left unregulated. This could be an example of regulatory arbitrage which increases systemic risk.

Although private credit deals with wholesale sophisticated actors and is relatively regarded as "close-ended" they are highly interconnected with banks, have limited transparency and can transmit stress to the financial system as a

whole. The AIFMD extends oversight to private credit but relies heavily on oversight and reporting, in line with the arms-length principle. Wholesale actors can still face asymmetric information where the products are especially complex. In these cases trust may be placed on credit rating agencies, such as in the build up to 2008. Additionally, there have been recent pushes to open more up to retail investors and talks of rating agencies "falling asleep at the wheel" (FT Article).

There is a balance that must be struck between market efficiency, and the argument that over-regulation can curb competition, and the ex ante regulation that must be made before another 2008 crisis arises.

Losses in private credit can amplify volatility in the market and therefore pose a systemic risk potential. It can be argued that they should be integrated further into macro-prudential regulation to reduce systemic risk.

Sources

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