

Financial Regulation under Incomplete Law

Katharina Pistor

Columbia Law School

NIPFP & INET, 28-30 September

Note: Part of this research was funded by INET

Theorizing about Law, Regulation and Markets

- Conceptual frameworks shape our view
- How we think of markets will determine how we regulate them
- Role of law is central in complex social systems, including finance
 - Law is “*in*” Finance
 - It codes claims and interests as legally enforceable assets with priority rights that can be defended “against the world”

Incomplete Law

- Contracts are Incomplete (Grossman & Hart)
 - Parties can neither anticipate nor provide for all future contingencies
 - Transaction Costs
 - Fundamental Uncertainty (Knight)

- Law is Incomplete
 - Lawmakers cannot anticipate or provide for all future contingencies
 - Laws are purposefully stated in general terms
 - To applied to many cases in the future

- Delegation of interpretation & application to future law enforcers

Enforcing Incomplete Law

- Courts
 - Reactive, case-by-case law enforcers
- Regulators
 - Proactive, general law enforcers
- Under incomplete Law deterrence is imperfect
 - Becker, Crime and Punishment, assumes complete law
 - Probability of detection and level of punishment
 - If law is incomplete, deterrence is weak
- Answer: Regulators (Pistor & Xu, 2003)

Powers and Limits of Regulation

- Proactive lawmaking powers
 - Rules and regulations
- Impediments to continuous updating of regulation
 - *Delegated* lawmaking powers
 - Resources
 - Capacity
 - In
 - Information asymmetries
- Pro-active law enforcers
 - Within scope of delegated lawmaking powers
 - Subject to rule-of-law constraints

Financial Development & Innovation

- Financial systems are coded in law
 - Private law = tool kit
 - Public law & regulations = scaffolding
- Incomplete law and regulation is the breeding place for legal innovation
 - New Intermediaries, New Assets
 - Designed to fit within the gaps of existing laws and regulation
 - Analogy, gap filling, interpretation, transposition
 - Deliver comparative advantage to private actors without losing stamp of 'enforceability'

Legal Theory of Finance

BLOCK
1



Legal construction:
Finance is legally constructed; it does not stand outside the law.

BLOCK
2



Essential hybridity:
Financial systems are not state or market, private or public, but always and necessarily both.

BLOCK
3



Law and finance paradox:
Finance is legally constructed, but the enforcement of all predetermined rules and commitments can bring down the system from which it can be rescued only by suspending the full force of the law, which in turn undermines the legal commitment that construct the financial market.

BLOCK
4

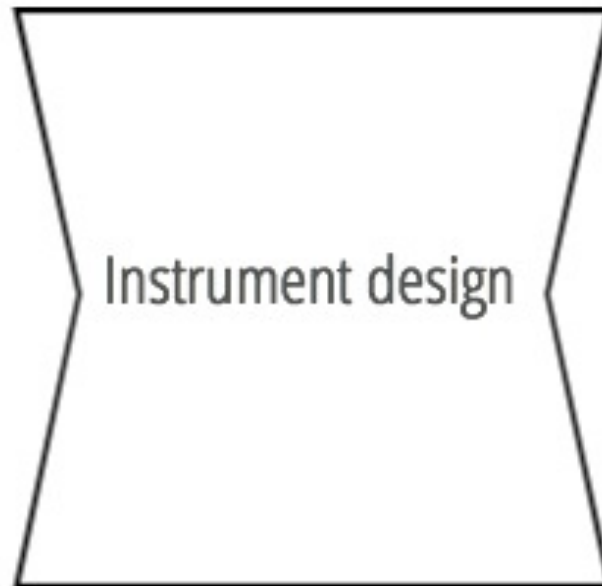


Law's elasticity and finance's hierarchy:
In general, law tends to be relatively elastic at the system's apex, but inelastic on its periphery.

GLOBAL FINANCIAL CAPITALISM

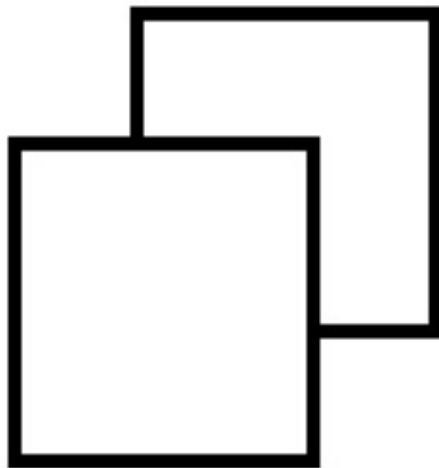
Legal Construction

Foundations:
Property
Contract
Bankruptcy
Money



Regulation:
Functional
Structural

Essential Hybridity



Financial systems are not state or market, private or public, but always and necessarily both.

Describing finance as a system of private/private commitments subject to some (external) constraints that may enhance market efficiency misses much of what is unique to contemporary finance: It is based on money as the legal tender, relies on the legal enforceability of private/private commitments and in the last instance depends on backstopping by a sovereign.

Law and finance paradox

Legal commitments

Uncertainty

Liquidity volatility

Self-destruction

Law's elasticity and finance's hierarchy

Elasticity as applied to hierarchy

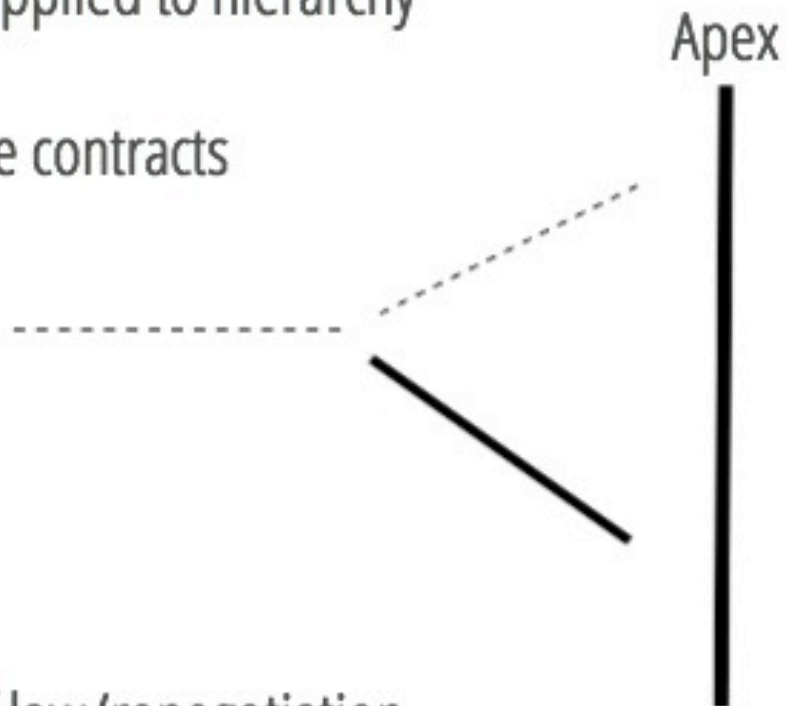
Ex ante

Incomplete law/incomplete contracts



Ex post

Suspension of the force of law/renegotiation



Explanatory Powers

- Great Financial Crisis
 - Origins in securitization, repo and derivatives markets
 - “shadow banking” that grew in the gaps of regulated financial markets
- East Asian Financial Crisis
 - Not crony capitalism or herd effects
 - Institutions structures similar to GFC
 - Exacerbated by foreign exchange risk
- Mexico’s Tequilla crisis 1994, Russia’s default 1998

Preliminary Inferences for India's Regulatory Reforms

- Finance = product of private law coding and public law regulation
 - Relative power varies across legal systems
 - In India public regulation dominated in the past
 - The country seems to be catching up with the coding technologies known in the west
- Liberalization of regulation is creating more space for the private sector
- Capital account liberalization will bring even more capital and more coding techniques to India

Regulating Dynamic Systems

- Trade-off between Adaptability & Accountability
 - Degree of Incompleteness of Laws & Regulations
 - Scope for private innovation
 - Accountability of both public and private actors
- Scope of Delegated Lawmaking Powers
- Adaptability
- Emergency Powers

Is the Regulatory Structure Resilient?

- Draft Indian Financial Code
 - Comprehensive financial architecture
 - State of the art in international comparison
 - Open questions
 - Is international 'best practice' sufficient?
 - Even if it is, is this enough for countries on the periphery

Vulnerabilities

- Regulatory Coverage
 - Financial products & services broad
 - Division of regulatory powers (banking vs. financial services)
 - Adaptation to legal/financial innovation
 - Credit arrangement flipped into asset sale....
 - Equal treatment of 'similar' investments by foreigners
- Timing and systemic effect of regulatory intervention
 - Thresholds: "imminent risk" & "critical risk"
 - Capacity and risk aversion of regulators
 - Relative to size and complexity of entities

Cont'd

- Shift from entity to market based debt finance
 - Systemic risk may manifest itself outside entities
- Contingent foreign exchange risk with capital account convertibility
 - Emergency liquidity assistance by RBI
 - Against 'adequate' collateral

Concluding Comments

- Regulatory objectives
 - De-regulation
 - Regulatory Accountability
 - Clarity/Predictability of regulatory powers and actions
- Going forward
 - Take inherent instability of finance seriously
 - Including the ability of law and legal arrangements to destabilize the financial system.

Thank you