

The Law-Finance Paradox

Notes for the Blue Sky Lunch on
“Governing under Conditions of Uncertainty”
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Incorporating fundamental uncertainty into the analysis of finance has major implications for understanding of how markets operate, how stable they are, and how law and finance relate to one another. Rather than a device that helps markets achieve their efficient outcome or distorts markets by imposing costs on them, under conditions of fundamental uncertainty law can be shown to hasten an endogenous crash of the financial system. This is the very essence of the Law-Finance Paradox:

Legal commitments are indispensable for making financial contracts credible and supporting large-scale financial markets; yet, enforcing all contracts as written ex ante irrespective of intervening changes that invalidate the assumptions made at the time of contracting will bring down the system.

Fundamental uncertainty means that we cannot rely on probability calculus or other scientific means to predict the future (Knight, Keynes, et al). When we do not know the distribution of events judgment calls is the best we can do. If liquidity was a free good fundamental uncertainty would not be such an unsettling feature of financial markets: we could always refinance when it turns out that the present differs from what we thought it would be. If instead, liquidity is a scarce good – available sometimes but unattainable at others -- uncertainty is can reek havoc in financial markets. The more dependent a system is on access to liquidity on demand the more vulnerable to crisis it becomes. This is the core of Minsky’s well-known “Financial Instability Hypothesis”.

If one adds to uncertainty and liquidity volatility the fact that contemporary markets rely extensively on non-negotiable and legally enforceable commitments, one has the perfect mix for an endogenous financial crash. The Law-Finance Paradox is most relevant in financial systems that rely extensively on credit finance, especially in contemporary market-based credit systems have replaced entity and relational credit finance.

Creditors cherish the fixed returns loans offer and the bankruptcy stick credit contracts entail. Yet, under conditions of fundamental uncertainty the value of these claims is precarious: By the time the creditor gets to enforce her claim, the assets of the debtor's assets may have been depleted or have lost value – if only because too many creditors sought enforcement against too many debtors at the same time, thereby forcing them into asset sales that drives down prices. Knowing that the creditor may wish to monitor the debtor to detect signs of distress that allow her to enforce her claims before anybody else; or she may defer enforcement or offer refinancing in the expectation that this will increase the likelihood of being repaid. In short, relational finance can serve as a safety valve to guard against the danger inherent to uncertainty: In the event the debtor is unable to repay for reasons beyond his control, the creditor assumes the liquidity risk.

Moving from relational to entity-based finance formalizes lending relations and adds – quite intentionally – rigidity to them. Regulated banks must watch their balance sheet more closely and may be less willing to offer additional liquidity when needed. Yet, there are still more likely to do so for the sake of self-preservation than arms-length investors holding a financial asset that was sold to them with the assertion that all legal commitments embodied therein would be enforceable in a court of law. The shift from relational to market based finance thus entails greater reliance on formal legal commitments. Only if investors know that the financial commitments embodied in the assets they acquire will be enforced without further inquiry into the debtor's current state of liquidity will they be willing to buy.

Indeed, contractual commitments scaled up to marketable instruments often include additional features that are meant to protect one of the parties: They specify contingencies that pose additional obligations on one of the parties in the form of guarantees, collateral or margin calls. From the investor's perspective this makes perfect sense. He benefits from shifting the uncertainty risk to the other party. From the perspective of the system as a whole another layer of rigidity has just been added that is bound to have pro-cyclical effects in times of market down turns. If the contingencies embodied in these contracts do indeed materialize, they can trigger a chain reaction of payouts, a scramble for funds to finance them, which becomes scarcer as more seek new funds, forcing some to revert to asset sales and others straight into bankruptcy. The more rigid the legal or contractual commitments, the more likely such a run on liquidity will ensue and will trigger a full-blown financial crisis. It follows that the more market based

the system the greater its dependence on the states as its ultimate backstop – marketization having resulted ironically in the socialization of finance.

On the path to self-destruction relief can come from adding liquidity to the system or by relaxing (suspending) the full force of the law. Functionally these are two sides of the same coin: New liquidity softens the hard budget constraint and alters the contracts to include a third-party guarantor; and relaxing the legal commitments affords the debtor new sources of liquidity.

The global financial crisis has demonstrated that relaxing binding commitments or offering new liquidity can be effectively employed to fend off a full-blown crisis. (Obviously, not all countries are capable of pulling this off – but that is a topic for another discussion). By buying assets nobody else was willing to hold central banks infused new liquidity into the system. From the perspective of the Law-Finance-Paradox the suspension of legal commitments in times of crises makes sense. Yet, the very act of relaxing the law undermines the credibility of law's power to add credibility to commitments made. As a paradox this complicated relation between law and finance cannot be easily resolved. The key governance question is therefore not whether or not to relax the law at all but whether only those at the core of the financial system – the too-big and the too-interconnected to fail – should benefit from it.

Several measures come to mind, some of which well known and equally well known to be impossible to implement. They include, for example, a restructuring of the financial system to make it less prone to crisis, in particular less dependent on instant refinancing, or forcing critical intermediaries to add safety buffers in the form of equity capital and liquidity buffers.

Alternatively, one might consider creating safety valves further down in the system, to allow those on the periphery of the system to make a pitch for the relaxation of the legal commitments they made earlier. The model that comes to mind is the right of contractual parties to seek adaptation of their contracts by a court of law in the event that circumstances changed in ways neither party anticipated at the time the contract was entered into and that would render the enforcement of the contract irrespective of the changes in circumstances unjust (*clausula rebus sic stantibus*, now codified as Section 313 of the BGB).

Court proceedings might be too slow to bring effective relief in times of financial crises suggesting that alternative procedures must be found. The point is that if the Law-Finance Paradox is endemic to contemporary finance we should not close our eyes to the consequences of privileging the core over the periphery

when law is indeed relaxed. These consequences are distributional, structural, and political in nature. Distributional, because they shift the burden of dealing with uncertainty from the core to the periphery – and incidentally to parties in the system that are less able to deal with it. Structural, because they will lead to the concentration of finance at the core – which seems consistent with what we can actually observe. And political, because where law is relaxed or suspended, power rears its head. As such, fundamental uncertainty in conjunction with the law-finance-paradox offers an entry point to a new political economy of finance.