LAW & LIQUIDITY

ECMI Conference: A New Action Plan for Europe's Financial Market

Keynote for Panel on Law and Finance

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Basic Claims

- In contemporary financial markets liquidity is produced primarily by lending the privilege of property to promises for future pay
- This practice is of social concern because the inevitable liquidity crunch that follows lopsided liquidity creation can destabilize the financial system
- Governing liquidity is challenging, since private liquidity creation is difficult to observe, protected by legal autonomy, and aided and betted by regulators, legislatures and central banks for various policy objectives
- Overlapping and competing regulatory frameworks provide new opportunities for *propertization* that defeat regulations aimed at taming liquidity

Assumptions

- Financial assets are IoUs and without innate value
- Their value, riskiness and liquidity is determined *in relation* to other assets
- In a competitive market economy with commitment to hard budget constraints *not* all claims will always be realizable (even if legally enforceable)
- Some assets are more equal than others: those issued or backed by entities with a soft(er) budget constraint enjoy greater liquidity esp. in crises
- It follows that finance is *hierarchical* not flat and that markets for different financial assets are *interdependent*

Impact of Regulatory Reforms on Liquidity?

- Law/property privileges enhance liquidity
- Regulatory reforms seek to
  - Create liquidity cushions
  - Tame the production of liquidity
- Liquidity cushions are only as good as the regulators' assessment of liquidity exposure
  - Private autonomy; decentralized propertization
- Taming production of liquidity
  - Haircuts
  - De-propertization

Analytical Framework: 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

Liquidity Defined

- Liquidity is the expectation that a given asset or class of assets can be exchanged at will for assets of similar or higher quality
- Illiquidity is the inability to do so
- Quality
  - Enforeability
  - Performance OR Cash put

Credibility, Performance & Liquidity

- Financial assets are contractual claims (IoUs) for future pay in cash or kind
- Their credibility can be enhanced with the privilege of property (*propertization)*
- Property claims are legal privileges that manifest at the enforcement stage
- Property right enhancement fuels liquidity ex ante but destroys it ex post when it turns out that the propertied asset is only another IoU and relentless enforcement drives down asset value

The Alchemy of Liquidity

- **Asset Shielding** *against*
  - Contributors (no withdrawal right)
  - *Their* creditors (entity shielding)
  - Tax authorities
- **Bankruptcy Remoteness** *from*
  - Sponsor, manager, or current asset holder
  - *Weak form*: floor or insurance against losses
- **Transferability**
  - Without consent
  - *Weak form*: assigning demand rights

Liquidity Creation as Propertization

	Asset Shielding	BKR Remoteness	Transferability
Trust MMF, Securitization Vehicles, SPVs, etc.	⟨✓⟩	✓	✓
Corporation MMFs, banks and bank holdings	✓	⟨✓⟩	✓
Financial **Collateral** & **Repos**	✓ ✓	⟨✓⟩ ✓	✓ ✓
Derivatives **Claims against trust assets**	✓	✓	✓
Bank Deposits **Simple loan contracts**	✗	✗	✓

Legal Vindication

- Lest enforceability is impaired propertization must be vindicated by law
  - Law enforcers (courts or regulators)
  - Legislatures amending law to vindicate existing practices
- Propertization of financial claims is the joint work of financial intermediaries, their lawyers, regulators, legislatures and central banks
  - At times with the explicit purpose of creating or deepening liquidity
  - At others to increase “legal certainty” or “create a level playing field”
  - Or to enhance the competitiveness of one financial sectors vis-à-vis others

Actors	Actions	Effects
Regulators/	Exempting MMFs from laws applicable to banks	Dual banking biased towards non-banks
NRSROs	Credit Rating of Structured products	Propertization improves risk rating
Legislatures	RMBC securitization 1968 Treasury Amendment 1974 Financial collateral creation privatized BKR safe harbors Tax exemptions for trust structures	Market constituting OTC market Expansion of privately minted collateral, repos Derivatives outpace other forms of credit Key for financial viability
Central Banks	2004 Fed rule Re Capital adequacy for guarantees Collateral guidelines	Dual banking system; fuels shadow banking Liquidity put
International Regulators	Basel Accords risk weighing	Dual banking biased towards non-banks

The (Self-) Destruction of Liquidity

- Declining demand for porpertized claims
  - Excess supply due to legal privileges meets falling demand
  - Underperforming assets question credibility of propertization
  - Enforcement of PR claims fuels downward pressure on asset prices
  - PR privileges shift burden of distress to other creditors a/o debtor
- Deflation of credibility based on propertization
  - Propertization helps inflate asset values
  - Deflation affects all assets with similar legal privileges
    - Contagion effect manifests in run on assets/markets

Governing Liquidity

- Liquidity production is largely decentralized
- Protected by private law autonomy (contracts) and enabled by malleable legal institutions (trusts, corporate form, collateral post privatization)
- Shielded by well organized interest groups
  - Financial intermediaries and their lawyers
- Benefits of liquidity induce regulators and legislatures to vindicate liquidity enhancing practices
  - access to credit, growth, crisis avoidance
- Dual-track regulatory regime fuels regulatory arbitrage
  - Banks vs. non-banks
  - Lending vs. selling claims against securitized assets
  - Transnational frictions

Liquidity Reforms

- Liquidity cushions
  - Function of exposure to propertized claims
- Liquidity stress test
  - Efficacy dependent on regulators' ability to assess exposure to propertized claims
- Weakening Propertization to slow Liquidity Build-up
  - Haircuts for collateral, repos, etc.
  - Weakening BKR remote options in ISDA Master Agreements
  - New strategies?
- Central Bank Puts
  - Privilege for propertized assets
  - Substitute

Concluding Remarks

- Liquidity production is a highly decentralized process that relies extensively on private law
- To be effective it requires vindication by a state (lawmaker) – but not necessarily all state where the asset is traded
- In an interdependent financial work, assets can travel and lead to liquidity expansion far away from home
- Any sustained attempt to manage liquidity therefore requires extensive policy coordination and self-monitoring
- Harmonization ex ante is not a substitute for coordination ex post