Journal of Comparative Economics 41 (2013) 401–419

Contents lists available at SciVerse ScienceDirect

Journal of Comparative Economics

journal homepage: www.elsevier.com/locate/jce

Toward a supply-side theory of financial innovation ☆

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ARTICLE INFO

Article history:
Available online 15 March 2013

JEL classification:
A12
B26
D86
G5
G18
G28
G38
K22

Keywords:
Financial innovation
Modigliani and Miller
OTC derivatives
Securitization
Structured finance
Swaps
Collateral swaps
Synthetic exchange-traded funds
ETFs
Dodd-Frank Act

ABSTRACT

Awrey, Dan—Toward a supply-side theory of financial innovation

Innovation. The word is evocative of ideas, products and processes which have somehow made the world a better place. Prior to the global financial crisis, many viewed *financial* innovation as unequivocally falling into this category. Underpinning this view was a pervasive belief in the self-correcting nature of markets and their consequent optimality as mechanisms for allocating society's resources. This belief exerted a profound influence on how we regulated financial markets and institutions.

This paper examines the influence of this market fundamentalist thinking on the regulation of OTC derivatives markets in the US during the pivotal period between the enactment of the *Commodity Futures Trading Commission Act* (1974) and the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (2010). More specifically, it traces how the conventional 'demand-side' view of financial innovation played an important role in blinding policymakers to a host of pressing regulatory challenges. The objective of this paper is to start us down the path toward a more complete theoretical account of the nature, sources and potential private and social welfare implications of financial innovation. It also aspires to move us incrementally toward a more constructive equilibrium between the important insights of financial *theory* and how we conceptualize and pursue the objectives of financial *regulation*. *Journal of Comparative Economics* **41** (2) (2013) 401–419. University of Oxford, Faculty of Law, Linacre College, St. Cross Road, Oxford OX1 3JA, United Kingdom .
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1. Introduction

Innovation. The word is evocative of ideas, products and processes – the printing press, the light bulb or penicillin, for example – which have somehow made the world a better place. Prior to the global financial crisis (GFC), many viewed *financial* innovation as unequivocally falling into this category. Underpinning this view was a pervasive belief in the self-correcting nature of markets and their consequent optimality as mechanisms for allocating society's resources (Johnson and Kwak, 2010). Perhaps nowhere was this market fundamentalism more clearly reflected than in connection with the emergence,

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0147-5967/$ - see front matter © 2013 Association for Comparative Economic Studies Published by Elsevier Inc. All rights reserved.
http://dx.doi.org/10.1016/j.jce.2013.03.011

precipitous growth and regulation of over-the-counter (OTC) derivatives markets: swaps, structured finance, and structured investment products. Prevailing dogma prior to the GFC viewed the insatiable demand for many species of OTC derivatives as a rational response to market imperfections. Supply, in turn, was a rational response to this demand. That supply met demand within the marketplace was then generally interpreted as being dispositive of these instruments' private and social utility. This view was deeply rooted in the neo-classical framework underpinning the canonical theories of financial economics.

Conventional financial theory has exerted a profound influence on how we regulate modern financial markets. In the case of OTC derivatives, for example, it provided the historical rationale for why public regulatory intervention was not necessary to ensure the safe and efficient operation of these burgeoning markets. This rationale was grounded in the conviction that rational and fully informed market participants – utilizing sophisticated quantitative methods and the innovative financial instruments these methods made possible – had both eliminated uncertainty and effectively mastered risk.[1] This view was seemingly bolstered by the emergence of private actors such as the International Swaps and Derivatives Association (ISDA), along with various execution, settlement and clearing platforms, to provide the legal and operational infrastructure vital to the development and growth of these new markets. Public regulatory intervention, by implication, was largely relegated to a supporting role: namely, the provision of private property rights and efficient contract enforcement necessary to support private risk-taking (Frydman and Goldberg, 2011). Markets, after all, supposedly knew best.

The GFC has revealed the folly of this market fundamentalism as a driver of public policy. It has also exposed the intellectual framework underpinning conventional financial theory as incomplete. More specifically, the conventional 'demand-side' view of financial innovation played a role in blinding policymakers to a host of pressing regulatory challenges ranging from uninformed contracting; to fraud and other opportunistic behavior, to the build-up of systemic risk. The objective of this paper is thus to start us down the path toward a more complete theoretical account of the nature, sources and potential welfare implications of financial innovation. In the process, it also aspires to move us incrementally toward a more constructive equilibrium between the important insights of financial *theory* and how we conceptualize and pursue the objectives of financial *regulation*.

This paper yields two related critiques of the prevailing equilibrium. The first is an *institutional* critique stemming from the failure of the conventional demand-side view of financial innovation to incorporate the important role played by financial intermediaries as suppliers of financial innovation. The second is an *informational* critique stemming from the broader failure of conventional financial theory to reflect structural limits on the availability of information within various markets; the existence of asymmetric endowments of information amongst market participants, and the presence of Knightian uncertainty. As we shall see, both critiques hold important insights for public policy and, more broadly, for how we might go about re-conceptualizing the relationship between law and finance in the wake of the GFC.

Importantly, the analysis and case studies presented in this paper also run counter to the dominant view which understands the *law* as fundamentally exogenous to *finance* (La Porta et al., 1998). More specifically, and in line with the emerging legal theory of finance (Pistor, forthcoming), this paper explores how the law – in the form of both public regulation and private contractual arrangements – is in fact an important catalyst for financial innovation: shaping the way financial markets emerge and evolve. In the process, it highlights the extent to which markets are legally constructed and, as a consequence, the reality that the law is very much endogenous to finance.

This paper proceeds as follows. Part II describes the conventional demand-side view of financial innovation. Part III then explores its influence on public policy through the lens of a single case study: the regulation of OTC derivatives markets in the U.S. between 1974 and 2010. Building on the lessons from this pivotal period, Part IV tentatively advances a more complete theoretical account of financial innovation which seeks to re-conceptualize it as a process of change influenced by, amongst other factors, the supply-side incentives of financial intermediaries. Moving from theory to practice, Part V examines three case studies illustrating the importance of these supply-side incentives as drivers of financial innovation. Part VI then examines what insights this framework might hold in terms of the potential benefits and shortcomings of the embryonic post-crisis regulatory regime governing OTC derivatives markets under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.[2] It also canvasses a number of (more radical) options for further regulatory reform. Part VII concludes.

Ultimately, this paper does not seek to indict conventional financial theory for its role in the GFC or dismiss all financial innovation as socially undesirable. Indeed, conventional financial theory has done much to enhance our understanding of the economic world. Simultaneously, however, it is merely a lens and – like all lenses –magnifies some features of the landscape and obscures others. By examining the contours of this lens, along with the resulting blind spots, this paper aspires to provide the foundations for a more thoughtful debate about financial innovation and the role of law within financial markets.

2. Financial innovation: the conventional demand-side view

Economists employ the term 'innovation' in a strictly technical sense to describe unanticipated shocks to an economy (Tufano, 2003). Beneath this veneer of objectivity, however, there survives a tendency within the relevant literature to con-

[1] Employing the terms in the Knightian sense, whereas risk is susceptible to measurement (e.g. using stochastic methods), uncertainty on the other hand is fundamentally not; Knight (1921).

[2] Pub. Law No. 111-203 (2010) [the "*Dodd-Frank Act*"].

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