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Administering Systemic Risk vs. Administering Justice: What Can We Do Now that We Have Agreed to Pay Differences?

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Abstract

Professor Stout's brilliant concept of disagreement-based speculation calls for further developments and studies concerning implications for stability and resilience of the financial system over time. Moreover, it also suggests rediscovering and situating the socio-economic function of finance (and financing) in the economy and society. To complement this approach, we recall the European acceptance of "paying differences" since late nineteenth century. Derivative assets were traded in Europe, but the underlying assets (stocks and bonds) on which derivatives are built were authorized beforehand. Marteau and Morand (2010) recently appealed for reintroducing an *a priori* authorization procedure before new derivative assets can be marketed: this view thus inherits a century-long tradition. Eventually, it seems that *a priori* authorization allows for administration of systemic risk while common law-inherited rejection of disagreement-based speculation is a strong foundation for both supervisory and legal (*a posteriori*) decisions.

KEYWORDS: financial regulation, derivative assets, systemic risk

JEL Classification Codes: B10, G18, K22

Professor Stout brilliantly addresses both the ideological content of economics *and* a real-world problem at the same time. From an ideological point of view, Professor Stout recalls the time when the first “economists” gave a fresh new look at a subject which had hitherto belonged to ethics. Bernard Mandeville and Adam Smith over-turned pre-Enlightenment common sense, showing that socially useful actions do not necessarily derive from virtue. Hence their paradoxical praise of greediness and speculation that, while morally abject, benefit the commonwealth. Their demonstration drew somewhat on Machiavelli’s provocative rhetoric. Since then, the morality argument has seemed irrelevant in economics, and many a citizen has been disappointed by how cynical economists can be. Professor Stout has restored a moral perspective in economics, showing that not all forms of greediness are useful: if “by pursuing his own interest” the speculator contributes to the ruin of all; then such action should be reputed immoral.

How immoral? This is a real-world problem: speculation, if fuelled only by *disagreement* about (the likelihood of) future events, leads to a zero-sum game that both takes labour away from socially useful activities and raises systemic risk. As a ban on derivative instruments would deter “useful” speculation, Professor Stout suggests reverting to the common law tradition, in which the gains arising from pure betting are not publicly enforceable. Ultimately, something of this tradition can be recognized in the Dodd-Frank Act of 2010.

I must confess I fully agree with the first part of the demonstration: economic paradoxes can obscure a problem as much as individual morality. We cannot be satisfied with partial equilibrium reasoning. But I think some generalisation might be added to the second one.

The demonstration that something should be done to prevent the collapse of a financial system might seem incomplete to economists, who are used to reviewing articles surveying all theoretical arguments (Capelle-Blancard 2009), or empirical studies (Mayhew 2001). This is precisely where the argument is powerful: as *a priori* reasoning about speculation is inconclusive, the issue becomes one of whether *disagreement based* speculation implies now a *risk of systemic significance*. Professor Stout suggests measuring “speculation systemic riskiness” by a leverage ratio (the notional value of derivative contracts divided by the amount of underlying assets). The current value of this measure shows that the underlying risk is covered more than four times. This suggests that derivatives are not used as insurance, but for speculation of the perverse kind (*i.e. disagreement based*). Unfortunately, Stulz (2004, p. 178-9) has shown how the notional amount can be biased. The measure cannot then be taken as fully reliable; although it indicates that *moral hazards produced by individual speculative behaviours (of firms and people) are of systemic significance*. In fact, beyond problems with measurement, the disagreement based model of speculative

trading is insightful and calls for further developments and studies concerning implications for stability and resilience of the financial system over time. Moreover, it also suggests rediscovering and situating the socio-economic function of finance (and financing) in the economy and society.

Once this premise is agreed upon and policy recommendations are addressed, Professor Stout cites the common law principle not to enforce debts that derive from bets. In fact, this is *not just a common law* principle: it is a general law principle in Western Europe since the Roman Republic. As an example of Continental law, the French Civil Code featured the well-known Article 1965: “the law does not enforce any debt related to gambling or betting”, which was opposed to derivative transactions resulting in “paying differences”. It should then be recalled that this “gambling exception” was relaxed earlier in Continental Europe than in common law countries: Italy in 1873-75; France in 1885; Germany in 1896, the Netherlands in 1903, the United Kingdom in 1909... and as late as 1974 in the United States (Riva-Lagneau Ymonet, 2010). How was it possible that the financially archaic countries of Europe relaxed Roman law principles sooner? There is a simple answer, namely that the underlying assets (stocks and bonds) on which derivatives are built were authorized beforehand in Europe. As a consequence, Lagneau-Ymonet and Riva have shown that the 1885 reform in France played a significant role in adding liquidity and stabilizing the market after the turmoil of 1882. Why not then generalize this *a priori* authorization? Marteau and Morand (2010) have asked whether it is not appropriate to

“create an authority, such as the FDA in the United States, in charge of authorizing the emission of derivatives [in absence of clearing house or when the condition of replicating by arbitrage is impossible]” (p. 50-51)

An alternative to the *common law* rule might then be an *a priori* decision to authorize by the relevant authority.

This possibility has to be emphasized, because Professor Stout does not consider it. Moreover it is not a purely fictitious hypothesis: we all remember how the SEC forbade short selling in September 2008, precisely to avoid destabilizing speculation against the banks. Then some countries maintained the ban to fight speculation against the sovereign debt of states distressed by the financial crisis. As Riva and Lagneau Ymonet have shown, speculation using short selling is a special case of *disagreement based* speculation: a short seller communicates to the market that he/she evaluates the stock less than the buyer, but without implying that each holder of the same stock evaluates it at the same price (as is theoretically the case in a “covered” transaction). The short seller takes his/her risky positions in order to make a profit by a repurchase at a lower cost, hence the short seller

must find a holder who evaluates the stock at a lower price than the one of his/her sale. It may be argued then that short selling, although it does look like a spot transaction, is in fact a *special case of derivative trading*.¹ Agreeing to this statement only makes the question more compelling: why then forbid short selling and let the alternative derivative forms of trading continue? Why not ask for a preliminary authorization of *every* single derivative instrument (not traded via organized exchanges nor amenable to unambiguous marking to model)?

Professor Stout overlooks that possibility and concentrates on the relics of the common law principle visible in the Dodd-Frank Act

“the bill requires that swaps and other financial derivatives that do not hedge against a ‘commercial risk’ must be traded, if they are traded at all, on a registered exchange or a “clearinghouse” that performs a similar private enforcement function...”

Although this looks like the old common law principle, it must be emphasized that the *modus operandi* here is very different: the difference contract is valid and enforceable. Only the *rise in transaction costs* might deter perverse speculators.² Firms in need of a genuine hedge will be ready to pay for it, hence they might find a speculator of the “useful” type as a counterparty. The principle is then used metaphorically. As in Europe, no court will have to decide whether differences should be paid: there is simply too much at stake (not just the value of a deal but the consequences for the whole industry of a court decision). In consideration of the potential consequences, the administration of justice, as inherited from the common law principle, has then been replaced by administration of systemic risk. In the current setup, the Financial Stability Oversight Council created by the Frank-Dodd Act has extended and discretionary powers to monitor both financial instruments (Section 120) and financial corporations (Section 113). Section 120 enables the Council to “provide for more stringent regulation of a financial activity by issuing recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards”. Although this might seem vague, the interpretation by Skadden *et al.* is clearly that *the Council might rule out a financial instrument by raising transaction costs*. The termination issue is even explicitly addressed by Section 115, as the Council might exact a “resolution

¹ See FDA [2009] p. 7: “For example, a short position can be taken through single stock futures, index futures and options, spread bets, CFDs and total return swaps (based either on a particular share or on an index).”

² See e.g. Skadden, Arps, Slate, Meagher & Flom p. 55: “market participants could be affected by increased costs and increased regulatory oversight and reporting. The impact on some thinly capitalized, leveraged investment funds and structured finance vehicles could be significant and may make certain structures unfeasible.”

plan”. One might then say that the Frank-Dodd Act is ahead of the Europeans’ expectations: instead of relying on one-shot prior authorization as called for by Marteau and Morand, the American regulation introduces a discretionary authority with significant powers over instruments and firms. It might not be that easy to deal with both the responsibility for acting discretionarily and the “too big to fail” issue when acting *a posteriori*. There is no doubt that the typology of speculation and the common-law principle recalled by Professor Stout will prove extremely useful in vindicating the Council’s future interventions.

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