Lorenzo Bini Smaghi: Legal system and financial markets

Opening remarks by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the conference "Legal issues related to the financial markets", Frankfurt am Main, 26 October 2007.

* * *

Ladies and Gentlemen[1]:

It is with great pleasure that I open this conference on a topic which is of fundamental importance and also of some additional interest in the most recent times in the light of the market turmoil, as I will explain in a moment.

1. Legal systems and economic growth

The economics literature has emphasised that institutions in general, and the legal system in particular, represent a fundamental determinant of economic growth, especially in connection to financial development.[2] By the "legal system" I mean not only legislation and rule books, but also the infrastructure of the civil courts and the market regulators.

In cross country analyses, the quality of institutions and the efficiency of the legal system often overshadow other classical determinants of growth such as the availability of national resources (which in itself tends to be more a curse than a blessing[3]), country size, physical capital, and so on. This is a consideration that we, as economists, perhaps need to take more seriously into account than we currently do.

The link between law and finance is inextricable. It would be unconceivable to think of a financial system and indeed of any financial instrument without a legal system to support it. The keyword for economists in this context is "asymmetric information": the lender, in particular, does not know if the borrower is trustworthy or not, or whether the investment project the latter is undertaking is worthwhile. A financial asset is ultimately a claim in the form of piece of paper or even, and increasingly so, an account entry. In any credit relationship – and this includes almost any economic transaction beyond simple barter – the possibility of default is always looming and this inherent complication cannot be solved without a precise system of norms that protects both the creditors and the debtors.

For the creditor to consider entering in a financial relationship, the legal system must not make it too easy for the debtor to walk away from his obligations. At the same time, the legal system cannot be too taxing for the debtor, as Shakespeare's Merchant of Venice reminds us. The legal system has thus to develop along a fine line between protecting the rights of the borrowers as well as those of the lenders. No wonder that developing a sound legal system to support financial markets is a very complicated matter and we hope to learn something from today's conference.

2. Legal systems and competitiveness of financial centres

Fundamentally, the legal system should ensure that contract and property rights are sufficiently clear and predictable; if there is a dispute, participants in the contract do not feel

---

[1] I wish to thank L. Stracca, M. Svoboda, S. Kerjean, F. Recine and C. Zilioli for their contribution.

[2] Mishkin (2005).

[3] Precisely through its negative impact on the quality of institutions and law enforcement.

the need to take legal action unless as a last resort. Moreover, if there is litigation, the court is independent and able to resolve the claim effectively and in a reasonable time. Furthermore, the judgment, once delivered, has to be quickly enforced.

To underline the importance of this aspect let me give the example my own country. There is a growing literature suggesting that one of the reasons for the relatively slow pace of financial development in Italy is the slowness of the civil courts, with the result that, for example, mortgage debt is still a fraction of what it is typically in other advanced countries.[4]

At this point it should be clear that an efficient legal system is a key ingredient of competitiveness among financial centres. One of the reasons of the traditional lead of US financial markets over Europe (and the rest of the world) is greater standardisation of legal norms and systems, while the European financial system is still characterised by considerable fragmentation of legislation, regulation and enforcement.

Without a proper legal system, it becomes harder to trade in almost any financial instrument. Two distinct effects may be considered. On the one hand, yields may rise and consequently asset prices fall. In other words, asset yields may incorporate a "legal risk premium". It is interesting to note that under the Basel II system legal risk is a part of operational risk, which implies that it is taken seriously by the regulators. On the other hand, an inefficient legal system may simply lead business to move elsewhere, namely influence the quantities rather than prices.

The importance of the legal environment was recognised most notably in the January 2007 Bloomberg-Schumer report, "Sustaining New York's and the US's global financial leadership", which reported that "a firm and predictable legal environment was the second most important criterion determining a financial center's competiveness."

An efficient legal system does not, of course, always imply more (and more restrictive) rules. A balance needs to be struck between restrictive rules and a lighter approach, which may be important for the overall competitiveness of financial centres. The current debate about the competitiveness of the US marketplace (in particular in relation to its British competitor) emphasises that this balance is not always easy to find.

3. Financial globalisation and innovation

Let me now turn to some issues related to the impact of financial globalisation and innovation on legal systems. In my opinion the protection of the rights of debtors and creditors becomes more – and not less – difficult with the development of financial markets, both in a geographical sense as well as in the range of available products (financial globalisation and innovation). The challenges posed by financial globalisation are not difficult to understand: a financial instrument originated in country A, traded in country B by an intermediary whose headquarters are in country C and purchased by an investor who is resident in country D, to what legal system will it be subject to? How will the citizen of country D be able to enforce his rights, which courts will be responsible for any dispute, what kind of legal redress will it be available on citizens of country A and B? These are questions that lie at the very heart of financial globalisation. From the simple observation that the bulk of cross border capital flows still takes place among advanced countries, one may easily surmise that such legal uncertainties (arguably more important in emerging economies) play a fundamental role in the allocation of financial flows and financial capital worldwide.

Over the last years, quite a number of initiatives dedicated at enhancing legal certainty regarding such cross-border financial transactions have been undertaken on a global as well as on a European level. International bodies dedicated to the harmonisation of laws [such as

[4] Muellbauer et al.

UNIDROIT or UNCITRAL] have turned the focus of their activities on financial market issues, such as secured transactions or cross-border holdings and transfers of securities. This focus is mirrored by a multitude of complementary initiatives on the European level, where I would just like to mention the various legislative projects aimed to enhance the integration of the EU financial markets that were combined in the so-called Financial Services Action Plan as well as the more recent attempts to enhance efficiency and integration in the EU post-trading industry, that is the clearing and settlement of cross-border securities transactions.

4. Lessons of the recent market turmoil

Turning to more recent events, the emergence of structured products, where the creditor is separated from the debtor by a complex financial infrastructure that transforms and re-packages the underlying asset, might create significant legal challenges and this might become an important concern in the light of the recent market turmoil. Who pays if debtor A defaults, in case his debt has been repackaged by bank B, sold to the non-bank intermediary C and finally to investor D? These are legitimate questions that need to be addressed carefully. But answers have to be given if the uncertainties surrounding the current environment are to vanish.

As you know, a number of policy initiatives have been launched at the global level since the summer, for instance by Financial Stability Forum[5] or by the Porto informal ECOFIN[6] and it is still difficult to anticipate precisely the legal aspects which will be examined more particularly by the various international and European fora and bodies involved in this discussion. However, these initiatives provide an indication of possible legal considerations which might emerge, in particular in the European context.

Legal certainty should go hand in hand with transparency. The focus on the transparency of complex financial instruments, of institutions and vehicles and on the appropriate disclosure of information on securitised debt and other structured financial products indicates that there is a need for regulatory and supervisory authorities to have a closer look on the legal frameworks applicable to securitisation transactions and market standards and how special purpose vehicles are currently regulated and supervised in the various EU Member States and at also at the international level. The report of the European Financial Markets Lawyers Group (EFMLG) of May 2007 on legal obstacles to cross-border securitisations in the EU[7] contains recommendations for further convergence of securitisation laws in the EU and invites the Commission to consider the adoption of a EU directive on specific legal aspects of securitisations which would enable Member States to adopt a certain number of principles common to all jurisdictions to ensure a high level of transparency, efficiency and legal certainty with regard to securitisation transactions.[8]

---

5 See Financial Stability Forum, FSF Working Group on Market and Institutional Resilience, Preliminary Report to the G7 Finance Ministers and Central Bank Governors, 15 October 2007, available at: http://www.fsforum.org/publications/publication_24_88.html.

6 The informal ECOFIN of Porto considered that, while enhancing market efficiency, financial innovation also raises obvious challenges to the regulatory and supervisory authorities. In this context, the Economic and Financial Committee (EFC) was invited (i) to review how to further improve transparency of complex financial instruments, of institutions and vehicles, as well as how to improve valuation processes, risk management and liquidity stress testing. The EFC is also invited to consider the role of rating agencies in structured finance.

7 Available at www.efmlg.org. In its Report on Financial Integration in Europe (March 2007), the ECB indicates that it has been active in various initiatives of the EFMLG to overcome legal barriers to financial integration, such as through the closer harmonisation of securitisation laws in the EU and contributed in particular to the EFMLG report on cross-border legal obstacles to securitisation.

8 In two opinions concerning draft laws on securitisation in Luxembourg and France, the ECB indicated that it stressed that, looking beyond the Commission’s Financial Services Action Plan, it saw merit in a strategy of increased harmonisation in the area of securitisation at the EU level (See in this respect ECB Opinion

In the context of the current financial turbulence, another issue which is often mentioned is the methodologies followed by rating agencies in the field of structured finance and the need to benefit from legal opinions assessing in an appropriate manner the legal risks related to the securitisation deal's core components and identifying properly the rights of investors.

At this point, let me not abuse of your time any longer. I hope that I have effectively conveyed the message that we, as policy-makers, care that the global financial system is put on a solid legal footing. I wish you all the best for this conference in contributing to this endeavour.

Thank you for your attention.

CON/2004/30 of 14 September 2004 at the request of the French Ministry of Economic Affairs, Finance and Industry on a draft decree concerning fonds communs de créances (securitisation funds) and ECB Opinion CON/2004/3 of 4 February 2004 at the request of the Ministry of Finance of the Grand Duchy of Luxembourg on a draft law on securitisation).