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Global network finance: Institutional innovation in the global financial market place

Katharina Pistor

Michael I. Sovern Professor of Law, Columbia Law School, United States

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ABSTRACT

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The global financial crisis that began in 2007 revealed a fundamental weakness in the global financial system: extensive financial interdependence of financial relations unmatched by a governance regime of similar reach. As multinational banks sought to fortify their capital base in the wake of the unfolding crisis, Sovereign Wealth Funds (SWFs) and the banks' home governments have become mutual stakeholders in some of the largest financial intermediaries with global reach. From the multitude of individual transactions has emerged a network of equity ties that spans the globe. These ties bridge institutional practices and governance regimes that previously operated largely independently of each other. They have the potential of fostering the emergence of a new governance regime for the global financial market place that deviates from earlier prognoses that globalization entails convergence on a single governance model. Instead, the newly created ties that jointly add up to a global financial network enable institutionally and organizationally diverse players to contribute their own perspectives as joint stakeholders in selected financial intermediaries, and indirectly, in the global financial system. This is likely to have important implications for the behavior of these actors in the future and the emergence of new governance solutions for the global market place. The paper discusses two recent cases of collaborative re-capitalization events to illustrate how this regime is evolving in practice. *Journal of Comparative Economics* **37** (4) (2009) 552–567. Michael I. Sovern Professor of Law, Columbia Law School, United States.

1. Introduction

The paper suggests that this emergent pattern is part of a broader reorganization of global financial markets with important implications for their future governance. Governance in this context is defined as the set of practices and institutions that form the basis for the collective expectations about how to operate in a given environment.[1] It consists of formal rules and regulations adopted by lawmakers and regulators, but also of practices developed by market participants in response to these rules and regulations. Governance regimes often emerge and collapse without legal change. Conversely, legal change may aspire to shape or change governance, but may fail to do so. Only when law and other formal institutions become part of the collective expectations can one speak of governance, or an emergent governance 'regime'.

E-mail address: kpisto@law.columbia.edu

[1] This definition follows Aoki (2001) and Greif (2006) and their emphasis on institutions as actual determinants of behavior.

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The need for a new governance regime for global finance has become apparent with the onset of the credit market crisis of 2007. This crisis revealed several fundamental problems of the existing global financial system. First and foremost, the crisis represents a case of massive market failure as indicated by the rise and fall of the shadow banking system and the inability of market actors to stem the increase of systemic risk.[2] Secondly, the global financial crisis exemplifies a case of regulatory failure of a similar magnitude, as is evidenced by the patchwork of regulators within and across nation states that competed for attracting finance business, but lacked the political will and legal instruments to contain the systemic risk of interdependent global finance. Thirdly, the immediate policy driven responses to the crisis have been driven primarily by domestic concerns in affected countries with cross-border and global implications of such measures taking second place. Governance mechanisms at the global level were eventually mobilized, but in a rather ad hoc fashion. The meetings of the G20 in November of 2008 and April of 2009 signaled a growing recognition of the importance of global coordination; the organization of this particular group of countries suggests broad agreement that the institutional structures that in the past were mobilized in similar situations – the G8, the BIS, the IMF, and even the Financial Stability Forum (FSF) established in the aftermath of the East Asian financial crisis – were either ineffective or obsolete in their current incarnation.[3]

Historians of financial markets have long argued that the history of financial markets is a history of crises (Kindlegerber, 2005). Equally important, the history of financial crises is the basis too for the history of institutional change and governance reforms in response to such crises. It is no coincidence that the overhaul of the governance regime for securities markets in the United States in 1933–1934 was preceded by a stock market crash (Seligman, 1983). In the past, governance solutions have typically been devised at the national level. Even when global agents, such as the IMF or the Bank for International Settlement (BIS), were involved in designing governance regimes, their tasks were largely confined to promoting standardized solutions that had to be implemented at the national level. An open question is where solutions for a new governance regime will come from this time – given the truly global scope of the crisis and given the extent to which the crisis has undermined the credibility of the predominant governance model that preceded it. The most recent international financial market crisis prior to the current global crisis—the East Asian financial crisis of 1997–1998 and the subsequent emerging market crises in Russia (1998) and Latin America (2001)—did not face a similar dilemma. At the time it seemed obvious that the institutional solutions should be derived from 'best practices' in developed market economies, spearheaded by the US and the UK (IMF, 1995, 2003). This belief formed the basis for policy advice by the International Monetary Fund (IMF), the World Bank, the US Treasury and others given to afflicted countries.[4]

In the current crisis, distinguishing between good and bad governance practices has become as difficult as distinguishing between good and bad assets. As Ben Bernanke, chairman of the US Federal Reserve following the announcement of a massive bail-out plan by the Federal Government on September 19th, put it, "there are no atheists in foxholes and no ideologues in financial crises".[5] While the political debate in the US Congress that surrounded the adoption of the "Troubled Assets Rescue Plan" (TARP)[6] and subsequent measures may suggest otherwise, the lack of a dominant ideological paradigm is one reason for the lack of a simple blue print for a new governance regime. Instead, policy makers have turned to ad hoc measures to stem the fallout from the crisis (Davidoff and Zaring, 2008). The absence of a ready-made solution leaves open the question where to look for the material or the actors that will form a new governance regime for global finance.

One place to look is to the actors themselves, that is, to the afflicted financial intermediaries and those that have come to their rescue. These parties did not have the luxury of postponing reforms until a political compromise could be reached, but had to respond to fend off the threat the crisis posed for their future and the future of financial markets. They include private banks from the West, their home governments, and Sovereign Wealth Funds (hereafter referred to as SWFs) from the Middle and the Far East. Beginning in early summer of 2007, a number of SWFs began to take substantial equity (or convertible debt) positions in what at least used to be some of the largest financial intermediaries in the West. In the fall of 2008 SWFs received company from the banks' home governments. As a result of a series of bail-out transactions these governments have become sizeable shareholders in large banks located within their respective jurisdiction.[7] Cumulatively these responses have created a network of equity ties linking the world's largest financial players, i.e. financial intermediaries and sovereign investors 'of last resort',[8] effectively giving the latter not only a stake in selected financial intermediaries, but through them—a stake in the global financial market. These network relations are therefore likely to affect how these markets will be governed in the future, even if the specific configuration of the network will change or most ties will be severed once the crisis has receded. This is the case, because the new cooperative governance solutions brought about by the crisis have set a precedent and as such are likely

[2] See Martin Wolf, "The Rescue of Bear Stearns marks Liberalisation's Limits", The Financial Times, 26 March 2008.

[3] To be sure, the IMF emerged strengthened from the G20 meeting in London, but any larger role it might play in the future will be contingent on further reforms of its voting arrangements. See The Economist "Banking on the Fund", The Economist, 8 April 2009 (Leader).

[4] Neither the belief nor the policy advice that followed from it was undisputed. For a critical review of the reforms in South Korea following the East Asian crisis, see, for example, Shin and Chang (2005).

[5] Peter Baker, "A Professor and a Banker Burry Old Dogma on Markets", The New York Times, 20 September 2008, p. A1.

[6] The House of Representative rejected TARP with over 50% of Republican voting against it, in part because government intervention on this scale was deemed to be un-American. See "The bail-out failure and blame game", The Financial Times Editorial, 30 September 2008, available on www.ft.com.

[7] As part of a re-capitalization strategy, the US and the UK government have taken substantial equity positions in several of their largest banks. See infra Section 5 for details.

[8] In the aftermath of the bail out transactions undertaken by the US government, governments have been recognized not only as lenders of last resort for deposit taking banks, but as investors of last resort for any financial institution that is too large to fail. See Edmund L. Andrews, "A New Role for the Fed: Investor of Last Resort", the New York Times, 18 September 2008, B1.