The Reform and Development of the U.S. Legal and Financial System

—A Reflection on the 2008 World Financial Crisis

*ZHU Daming**

I. PREFACE

In 2008, with the bankruptcy of Lehman Brothers Holdings Inc. ("Lehman Brothers"), American International Group ("AIG"), *etc.*, the financial crisis caused by the US subprime mortgage spread around the world instantaneously, giving rise to the global financial and even the economic crisis worldwide. No more than one year after the crisis, the total market value of the world's major bourses fell by $35 trillion. It was the first time since the World War II that the world's total GDP shrank.[1] The total loss of financial institutions (if broadly defined) was up to $1.1 trillion; another $9 trillion were supplied by the U.S. and European authorities in an emergent effort to provide necessary liquidity.[2] It is safe to say that a financial crisis of such scope and scale would only happen once a hundred years. Apart from the United States, many countries, including China, are reflecting on this crisis.

The most intuitive cause for this global financial crisis is generally considered to be the burst of the bubble economy under a distorted global economic system. The market-oriented financial system enjoyed rapid development under this circumstance. At the same time, with the acute changes of the financial system, the systematic risks amounted to an extent that eventually led to the financial crisis. However, existing regulations and relevant theories to prevent systematic risks cannot cope with the newborn systematic risks stemmed from the market-oriented financial system. Moreover, they could even contribute to the so-called

* Associate Professor at Peking University School of Transnational Law.

1 Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 967 (2009).

2 *Id.* at 968.

pro-cyclical problem to the effect that the crisis would be exacerbated. Thus, a new significant issue rises as how to guard against systematic risks arising from the market-oriented financial system. This paper aims to study and organize the relevant theories to such issue among the United States and other countries, so as to provide references for the development and improvement of China's financial system reform.

II. BACKGROUND OF THE 2008 WORLD FINANCIAL CRISIS

It is generally believed that the 2008 financial crisis was resulted from the great changes occurred in the world economy and finance sector. If so, the crisis just evidenced how incapable the current theories about finance and financial regulations are to cope with the economic operation. By contrast, the part of human nature that produces economic bubbles and causes financial crisis almost remains unchanged. Therefore, it is necessary to re-examine the direction of financial development and financial regulation in light of the changed and the unchanged.

As for the cause of the financial crisis in 2008, it is generally believed that the excessive liquidity resulted from the bursting bubble economy ultimately led to the global financial crisis of such a magnitude. The further inquiry into the liquidity excess, however, witnesses diverged opinions. These views can be summarized as two main categories: the first attributes to the long-term loosened financial regulation carried out by the U.S. Federal Reserve Board system;[3] the other blames other countries who either manipulate forex to a low level for domestic employment, or have a substantial surplus from natural resources trade. In both of the situations, these countries would have a slew of capital reserves. What ensued the huge amount of dollars in 2008 was the recession in the U.S. and the financial crisis around the globe.[4]

---

3 Anna J. Schwartz, *Origins of the Financial Market Crisis of 2008*, 29 CATO J. 19, 19 (2009).

4 Ben S. Bernanke, *The Global Saving Glut and the U.S. Current Account Deficit*, FED. RES. (Mar. 10, 2005), http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/. *See also* Henry M. Paulson, *Remarks at the Ronald Reagan Presidential Library*, U.S. DEP'T OF THE TREASURY, (Nov. 20, 2008), https://www.treasury.gov/press-center/press-releases/Pages/hp1285.aspx. *See also* Herbert Grubel, *Who is to Blame for the Great Depression?* SOC. SCI. RES. NETWORK (June 15, 2010), http://ssrn.com/abstract=1569848.

In addition, there are some thoughts about the fundamental issues underlying those problems of loosened financial regulations and imbalances of the international payment. Specifically, among developed countries, like the U.S., their international competitiveness in manufacturing sectors has been declining because of the rise of China and other emerging countries, thus huge deficits in trade balance appear in those developed countries. Since 1995, the annual growth rates of GDP in those countries were only 2 to 3 percent. Moreover, financial assets (debts) has gone upward at more than 10 percent per annum. For example, from the period of 1995 to 2006, housing loans (debts) increased from $3.727 trillion to $10.921 trillion in the United States, and consumer credit increased from $1.123 trillion to $2.387 trillion. As a result, the proportion of liabilities in disposable income surged from 89.8 percent of annual income to 135 percent.[5] Another set of data that illustrate the problem is the proportion of income and consumption in GDP. For a long term, both the ratios stayed at around 64 percent in the United States, the EU and Japan. Between the two ratios, usually the income ratio would be slightly higher than that of consumption. However, around 1982, consumption in those countries began to increase. By 2008, the proportion of income in GDP dropped to 61 percent; in contrast, consumption rose to 72 percent (the change is more significant in the U.S).[6]

What fills the increasing discrepancy is the returns from the rising value of various assets. Among all these returns, the profits in real estate have been twice as much as the returns from financial markets.[7] Basically this is why real estate bubbles occurred in the U.S., the UK and other EU countries in the context of excessive liquidity assets. In the U.S., subprime mortgage granted to persons with low credit records grew rapidly [in light of the rocketing prices in real estate]. Despite the low credit ratings, the greater risks can still be hedged through a variety of mechanisms including securitization and derivatives. Many players in these transactions were hedge funds as well as international investors

5 DONALD RAPP, BUBBLES, BOOMS, AND BUSTS: THE RISE AND FALL OF FINANCE ASSETS 78–80 (2009).

6 Didier Sornette & Ryan Woodard, *Financial Bubbles, Real Estate Bubble, Derivative Bubbles, and the Financial and Economic Crisis*, SOC. SCI. RES. NETWORK (May 2, 2009), http://ssrn.com/abstract=1596024.

7 *Id.* at 14–17.

whose funds would be tied with subprime mortgages. Consequentially the scale of housing finance witnessed a steep increase,[8] propelling a further climbing in real estate prices.[9] Facing the huge trade deficits, the United States tried to balance the deficits through capitals gains that extracted from China and oil-rich countries in the Middle East by offering high-yielding financial instruments. The previous strategies supported the United States to maintain the value of dollars as well as its domestic prosperity. Among foreign investors, a substantial portion of them were central banks. As such, the financial sector and relevant industries have become the prime industry to drive the American economy.[10] As the financial sector has the ability to de facto re-distribute the capital around the globe, we can say that financial development has become the pillar of American economy in lieu of the traditional manufacturing sector. In addition, instead of banks, institutional investors such as pension funds were becoming the major players who invest in financial assets in developed economies because they were driven to these presumably high-yield financial instruments by the demanding beneficiaries and/or clients.

III. SECURITIZATION, SHADOW BANKING SYSTEM, ETC., AND FINANCIAL CRISIS

A more direct cause to the global financial crisis is generally considered as the shift of the financial system from a bank-centered one to a market-oriented one, where instruments like securitization, derivatives, and *etc.* are traded. On the one hand, the financial regulators were not able to supervise the new-born financial model effectively; on the other hand, a functioning market mechanism that had been anticipated turned out to

---

[8] Patrick Artus, *La finance peut-elleseuleconduireàunecirse grave?*, 416 FLASH ÈCONOMIE 2 (2008). *See* Kawamura Tetsuji, *A Study of the Transfiguration of Economic Globalization Under the Impacts of the Current Global Financial Crisis: With a Special Focus on the U.S. and Emerging Economy Relationship*, 46 ECON. THEORY 4 (2013); OKINA YURI, THE FINANCIAL CRISIS AND THE PRUDENTIAL POLICY 6 (2010).

[9] Maureen F. Maitland & David M. Blitzer, *S&P/Case-Schiller Home Price Indices: 2009, A Year in Review*, Chart 1, CME GRP. (Jan. 2010), https://www.cmegroup.com/trading/real-estate/files/SP-CSI-2009-Year-in-Review.pdf; Artus, *supra* note 8, at 4.

[10] Sornette & Woodard, *supra* note 6, at 18 (in addition, 40% of those main American companies' earnings are the return of financial investment).

be a failure where the market prices failed to faithfully reflect the intrinsic risks of ABS instruments. Thus, the ill-functioned market where risks abounded eventually led to excessive liquidity and bubble economy.[11]

In the tide of securitization, commercial banks were overshadowed by investment banks, structured investment vehicles and other suppliers of short-term (or long-term) liquidity assets, all of which have been referred to as the shadow banking system.[12] Yet the existing financial regulatory regime had been put in place chiefly in order to prevent systematic risks in settlements in a world of commercial banks while regulations on investment banks was in a laisser faire manner. The unleased shadow banking system, however, became paralyzed to the lethal detriment of its purported function to provide liquidity when Lehman Brothers went bankrupted at the beginning of the 2008 crisis. And it was this new type of systematic risks that became the thin end of the 2008 financial wedge. From the crisis the necessity to regulate the shadow banking becomes evident. Moreover, the bankruptcy of AIG, who subscribed credit derivatives, and the consequent government aids could partly indicate that such systematic risks in the securitized financial markets and the ineffectiveness of laws in the field of these new-born systematic risks.

Why had this kind of new financial regulation been imperfect or vacant for a long time? There may exist two reasons.[13] One is due to the novelty of this financial model and the other is due to the excessive trust to the market. Specifically, when America was faced with the depression of the manufacturing industry, it adopted the above new financial model to develop the financial industry, the IT industry, risk industry and *etc.* so as to revive a prosperous economy recovery based on a loosely regulated market. Further, the development of the financial industry

---

[11] Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 493, 537 (2009); Okina Yuri, *Macro-prudential Perspective in Financial Supervision and Regulation Policy-Exploration on New Regulation System After the Financial Crisis*. 12 BUS. & ECON. REV. 157, 161 (2009).

[12] Gary Gordon, *Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007*, SOC. SCI. RES. NETWORK (May 9, 2009), http://ssrn.com/abstract=1401882.

[13] John Ryan, *The Greenspan Federal Reserve Role in the Financial Crisis* (Dep't of Econ. Ca' Foscari Univ. of Venice, Working Paper, No. 04/WP/2009, 2009), http://ssrn.com/abstract=1345802.

and the IT industry promotes investment opportunities, the risk industry, and the demand and development of real estate industry, which raises people's expectation of developing the real economy (known as the "New Economy" theory). At the same time, the self-discipline ability of the financial market was overestimated. People believe that market liberalization is the basis of development and the progress of the financial technology has overcome market failure and other problems in the financial market. Behind this trend of thought, it is important to note that from the 1980s, with the rise of the New Liberalism Economics and other related economic (or political) thoughts, the market omnipotence theory has been widely accepted.

The expectations of this new financial model is an important cause of the real estate bubble. These bubbles are resulted from the over optimistic expectation towards future earnings. The IT bubble from 1996 to 2000 was resulted from over expectation of the improvement of the economic efficiency and the development of the real economy such as the increase in demand. Real estate bubbles can also be considered resulting from the expectation of the new financial model's effect in increasing the value of assets. The United States is maintaining its economic vitality and the circular flow of the global capitals through a cycle from the collapse of expectation, which ultimately leads to the collapse of bubbles, to the creation of an expectation, which satirically leads to a new round of bubbles.[14]

IV. THE REFORM AND DEVELOPMENT OF FINANCIAL REGULATION

A. Extending the Scope of Regulation

The financial crisis of 2008 witnessed the imperfection of the financial supervision system and related regulations on the new financial model. Therefore, many countries, centered by the United States and other countries that deeply trapped into the financial crisis, started to reexamine their financial law and fi-

[14] Sornette & Woodard, *supra* note 6, at 17–20; Andrew W. Lo, *Regulatory Reform in the Wake of the Financial Crisis of 2007–2008*, SOC. SCI. RES. NETWORK (Mar. 10, 2009), http://ssrn.com/abstract=1398207 (pointing out that the bubble and burst cannot be entirely avoided if the enterprises combine homization with liberty).

nancial regulatory regime.[15] Since many details of the reform are not yet crystalized, this Article only introduces the possible direction of the reform on related regulations.

First, the extension of the scope of regulation should be discussed. Focusing on the systematic risks of paralytic clearing function, the traditional regulation regime regards deposit-soliciting banks as its primary objects. However, this worldwide financial crisis is originated from the bankruptcy of investment banks such as Lehman Brothers Holdings Inc. and American International Group (AIG) who sell derivatives such as CDS. They act as part of the shadow banking system under the market-oriented financial mechanism. The result of the discussion is that, in addition to banks, those who are subject to new systemic risks, such as investment banks and monoline insurance companies, should also be regulated.

Specifically, some scholars advocate dividing the financial institutions into four categories on the basis of measured value-at-risk. The first includes those individually systematic financial institutions which are too big to fail. They enjoy numerous affiliations and are even capable of representing the nation. It is hard for this kind of establishments to go bankrupt because of political considerations. To these companies, regulations need to be made from two aspects. One is to require the macro-prudential regulation. The other is to require the micro-prudential regulation that guarantees financial soundness in financial institution.[16] The second category refers to the financial institutions which are systematic as part of a herd. Like hedge funds who are characterized by short-term debt burdens, high asset-liability ratio, and holding assets with low liquidity, if each of them functions as a single institution, their systematic existence does not need to be considered because they are unimportant. But once they function as a part of a big group (the collective operation of hedge funds), they will possibly be operating systematically. For that reason, it is necessary to introduce some kind of macro-prudential regula-

---

[15] *See* Kanda Hideki, *The Improvement of Law After Financial Crisis*, 1399 JURISUTO 2 (Apr. 15, 2010) (the Dodd Frank Wall Street reform and Consumer Protection Act enacted by United States abolishes relief from public funds, strengthen the regulation on the capital, asset-liability ratio, liquidity and risk management of financial institutions. So it does attach much importance to regulation).

[16] OKINA, *supra* note 8, at 86.

tion, e.g., regulating the asset-liability ratio, cyclic disorder, and the expansion of credit supply. Whereas the micro-prudential regulation can be strictly confined to a minimum range. The third category includes non-systematic large financial institutions with low asset-liability ratios, represented by insurance companies and pension funds. It is not necessary to require a macro-prudential regulation. But a complete micro-prudential regulation is needed. The fourth category concerns the tiny financial institutions. Only a minimum amount of business regulations is necessary to be imposed on them.[17]

B. Macro-Prudential Analysis

A lesson is learned from this financial crisis that despite the dominant capital market efficiency hypothesis as the financial theory,[18] the bubble economy still occurred.[19] The occurrence of bubble economy was the reason for several financial crises.[20] Although a macroscopic policy is the key to preventing the bubble economy, it is considerably difficult to design an effective macroscopic policy.[21]

Another lesson learned is that the basic system of the modern financial regulations, such as BIS (Bank for International Settlements), market-value accounting, and risk management of enterprise, increase the probability that the burst of bubble induces the systemic market risk in the market-oriented financial system. This is a pro-cyclical problem. Therefore, many scholars observe that it is necessary to adjust this financial regulation system to a counter-cyclical one, taking the macrosopic prudence into account; introduce the macroscopic policy which includes liquidity risk; correlate the tier 1 ratio of the Basel Accord II with the asset-liability ratio, cyclic disorder, assets growth rate, *etc.* All these measures were designed to harmonize the macrosopic prudence with the micro-prudential regulation such as BIS rules.[22]

---

[17] *Id.* at 95.

[18] *See* IKEO KAZUHITO & IKEDA NOBUO, WHY WOULD THE WORLD INTO DEPRESSION 132 (2009).

[19] MARKUS BRUNNERMEIER ET AL., THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION, 30 (2009); *See* FRANKLIN ALLEN & DOUGLAS GALE, UNDERSTANDING FINANCIAL CRISIS 35–259 (2007).

[20] BRUNNERMEIER ET AL., *supra* note 19.

[21] MASAAKI SHIRAKAWA, MODERN FINANCIAL POLICY 399 (2008).

[22] OKINA, *supra* note 8, at 125.

Specifically, aside from adjusting the abovementioned BIS data through the coefficient among macroscopically evaluated value-at-risk, it is still necessary to improve the following systems through which financial institutions could easily finance itself facing operational difficulty. These systems mainly include limitations on the asset-liability ratio, introducing linked settlement into the fund-raising period system, limitations on the speed of asset expansion, compulsive requirements on enterprises to increase their capital reserve during well-managed periods, improving asset insurance and contingent capital, introducing Spanish dynamic allowance for doubtful accounts, *etc*. These suggestions are thought to be practically difficult in terms of institutionalization, thus lack practicability. Even so, it is still necessary to discuss the feasibility of a systematic reform.

V. Conclusion

The global financial crisis of 2008 revealed the limitation of the market finance model. If we fully recognize this limitation, we will conclude that we should gradually reform the financial system and the financial regulation regime along the process of reforming the social and economic system. Besides, the role of finance (the financial industry) should be to support the fully functioning of the real economy rather than to drive economy growth, as overly expected by the United States.