

## Tragedy, law, and rethinking our financial markets

David A. Westbrook\* [University at Buffalo, State University of New York, USA]

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The twentieth century man of affairs and pivotal corporation law scholar Adolf Berle is said to have aspired to be the Marx of the capitalist classes. What we need now is more like the Walter Benjamin of the capitalist classes. Benjamin was a painfully insightful critic, and a great interpreter of, among other things, Berthold Brecht, who wrote *Threepenny Opera*, a scathing attack on capitalism that was a huge commercial success. All of which is meant to suggest that current events present financial policy intellectuals not least with problems in interpretation, issues of how to engage or interrogate – literally how to begin thinking about – the largest financial crisis in several generations.

### The collapse of a way of thinking

Former Chairman of the Federal Reserve Alan Greenspan was right, in his famous testimony to the U.S. Congress: the modern risk management paradigm collapsed. At one level, Greenspan was merely pointing out that the emperor had no clothes. In a wave of insolvencies, households, commercial institutions, regulators and more than one sovereign government demonstrably failed to manage risks. The modern risk management paradigm, however, is an expression of what variously might be called an imaginary, ideology or *Weltanschauung*, a way of looking at the world that, in its time and place, makes sense to a group of people. So, at another level, Greenspan's remark invites us to consider if, and how, recent events might be significant as a matter of intellectual history. A way of thinking collapsed; in 2007 and 2008, financial policy elites witnessed the embarrassment of financial policy. So how, if at all, will financial policy thinking change?

One of the purposes of this essay is to suggest ways to think about financial policy – and so financial markets, and even political economy – as a set of intellectual traditions, with aspirations and vulnerabilities, and implicitly, possibilities for reformulation, evolution, development. The transformation of received ideas about finance is of considerable academic interest, of course, but also could be of substantial practical significance. Intellectual history and social history are intertwined. After all, the “modern risk management paradigm” served as the basis for economic policy on both sides of the Congressional aisle, and indeed in public and private institutions around the world. What would seriously rethinking finance mean for the shape of our financial markets, and so our society? Thus, at a third level, Greenspan (of all people) raises the possibility of a fundamental renewal in not just our thinking, but our conduct of financial policy, which, in a capitalist global society, amounts to a constitutional opportunity. The possibility of rethinking and even redoing our capitalism is slim, to be sure, but nonetheless worth exploring.

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\* Floyd H. & Hilda L. Hurst Faculty Scholar and Professor of Law, University at Buffalo, State University of New York. This essay is rooted in a series of talks given as it became clear that this financial crisis was historically significant, notably at San Diego School of Law, on October 10, 2008; at the London School of Economics and Politics, January 19<sup>th</sup>, 2009; at the China Banking Regulatory Commission, the Chinese Academy of Social Sciences, Peking University, and elsewhere across China, as part of the State Department's U.S. Speakers Program, in February and March of 2009, and for the Tobin Project (White Oak, Florida, April 24, 2009). My thinking on these matters is more fully expressed in [Out of Crisis: Rethinking Our Financial Markets](#) (Paradigm 2009). Insofar as this text overlaps with that of *Out of Crisis*, Paradigm's permission to reproduce is gratefully acknowledged.

Caution is in order not least because, without being in any way unkind, there is little reason to believe that this generation of policy thinkers, who were trained in the old, now largely discredited, paradigm, really knows how to tackle the problems before them. Nor, for that matter, is it clear how to teach finance. The ways, or many of the ways (but which ones?) that these problems have been considered are compromised, perhaps simply wrong. That is what it means to say a paradigm is broken. For much the same reason, various contemporary efforts at “fixing” the situation, from the isolation of toxic assets to fights over executive compensation or proprietary trading by commercial banks, are unlikely to be very successful, even heroically assuming the existence of political will. Our real problems lie deeper, in our understanding and practice of finance, and so political economy.

### **The possibility of new thought**

There seem to be two general prerequisites for a fundamental renewal of policy thought: first, a big event or set of events, and second, the emergence of a substantively new consensus.

The week of Monday the 15th of September, 2008, should have provided sufficiently big events to occasion rethinking. To recall: Lehman Brothers, an ancient firm with global operations, was bankrupt, and its failure to trade would trigger a global wave of insolvencies. AIG, which recently had been world’s largest insurer, was failing, and received the first tranche of many billions of dollars. Merrill Lynch, the nation’s largest securities broker, was sold under duress. An entire financial industry, investment banking, was essentially abolished, at least in form. During and after that unreal week, a slew of rationalizations issued, efforts to preserve the traditional way of seeing things, like the epicycles used to square the Ptolemaic model of the solar system with observations of planets that were not where they were “supposed” to be. Despite the efforts at rationalization, the week closed dramatically – the largest bank collapse in U.S. history, followed by the government’s failure to authorize a \$700 billion dollar rescue package nominally agreed upon by both parties, a failure met by the largest point drop in New York Stock Exchange history. Such drastic changes, especially the death of prestigious institutions, many of which had survived for a century or more, would seem to require a fundamental reconsideration of what the financial policy communities think they understand – and what we teach students – about our capital markets.

The second requirement for a substantial rethinking of our financial markets, the emergence of a new consensus, remains elusive. Thinking is hard, and innovation is by nature unpredictable (that much, at least, of the efficient capital markets hypothesis is correct). And as hard as ideas are to come by, it is not enough to have new ideas, even good new ideas. Ideas are not politically significant until powerful parties believe them. Thus, in order to rethink our financial markets, we need new ideas that members of the various financial establishments can espouse – even though they were trained and have made their careers on the basis of different understandings of the world. As has already been suggested, such wholesale self-denial does not happen very often. Establishments are conservative.

In the abstract, of course, the shock of recent events would seem not only to demand fundamental rethinking on the part of policy intellectuals, but also to demand the formation of a new policy consensus, what we teach in schools and place on op-eds and expect in

confirmation hearings and professional luncheons, the imaginations that inform our policies, institutions, laws. But there is no guarantee that such consensus will form, that people will agree on a relatively consistent set of new ideas, especially in times of stress. The loss of confidence in a shared intellectual framework, and the construction of a new one, like changes in confidence in a given market, raise questions of collective psychology, and it is difficult to know how such questions will be answered. It is therefore difficult to know whether communities of discourse will develop new paradigms. As of this writing, the news is not too good.

And yet, even here, there is reason for hope. The pressure of events does require public explanation; surprising circumstances may impel us to rethink our old assumptions. Perhaps events cannot force us to be creative, or to reach agreement. But events certainly can give us plenty to talk about, can keep issues “on the table.” Intellectual discourse, and hence policy discourse, can be transformed by changing social realities, sometimes quite suddenly. Thus in the very seriousness of this crisis, and particularly its surprising aspects, we may look for intellectual and political opportunities.

### **Finance and fear**

So how might we begin thinking about the intellectual tradition that has ruptured, and what may arise in response?

In contrast to much critical analysis, let me begin sympathetically. What makes finance so irresistibly seductive is that it gives individuals and institutions purchase on the future. So, in borrowing money to get an education or offering equity to start a company, finance is used to create a better future. Of course, the future may not work out as planned. Bad things could happen. But the riskiness of the world makes finance all the more irresistible: in investing for retirement, or simply buying insurance, we all use financial instruments to cope with our all too human fears. Indeed, investment is sometimes defined as being paid to bear risk, defined as deviation from expected return. Finance is at its most compelling not when it promises us riches, but when it tells us that we need not simply fear the future: risk can be managed, hence risk management. Indeed, one who can quantify risk can make a lot of money.

But the story is a bit too good. “Risk” – as used in academic finance and the phrase “risk management” – is something of a euphemism. One who knows they are playing a game with a fair coin knows quite a lot, more than most people, even most sophisticated investors. In the current crisis, the problem has been uncertainty rather than risk. “Uncertainty” is a statement about a mind confronting the world, a mind that does not know enough to decide on a course of action, and therefore, as a practical matter, refuses to spend money. The “counterparty risk” so spectacularly in evidence during the Lehman Brothers collapse – and the associated unwillingness to trade – demonstrates the uncertainty of actors whose models have failed, who are not managing risk, but are merely guessing.

Uncertainty is an old idea, at least old for finance, associated with Frank Knight at the University of Chicago in the 1920s. In the academy, uncertainty implies a skeptical stance, an intellectual claim that “you don’t know as much as you say you do.” In contrast, “risk” is a statement about the probability of outcomes in the world. One speaks of expected returns, and (more or less expected) deviations from the norm. Risk is an essentially objective

conception, and hence amenable to quantitative discussion. One way to understand managerial finance, including risk management, is the effort to make business into an essentially objective, if probabilistic, science, that may be taught in graduate schools. If devotees of uncertainty have tended to be skeptical of the quantification beloved by the adepts of modern finance, then such adepts have tended to respond by dismissing uncertainty as not yet quantified risk: uncertainty is a sloppy civilian notion, waiting to be understood as risk, quantified, modeled, and priced.

As difficult and downright scary as it is to think about uncertainty, there are negative consequences of not thinking about it. America's policy-makers have not handled the current crisis in a way to suggest any sustained thought about how to address uncertainty or restore confidence, especially among the consumers and small businesses that make up so much of the real economy. Political and policy elites have nonetheless repeatedly told the nation that it is necessary to spend taxpayer's money, because this crisis is really important, and there will be no more business as usual. Indeed. Consumers, employers, and entire markets have responded accordingly.

In the interest of clarity, instead of "risk" or even "uncertainty," for present purposes, let us employ the simple and direct term, "danger." We might view finance generally, and financial policy in particular, as a succession of ways to anticipate and avoid dangers, or at least ameliorate harms. Capitalism's cheerleaders, including most economists, usually explain finance in terms of investment, growth, and so material progress, while acknowledging that a degree of risk is, at least temporarily, unavoidable. This is an unduly sunny view of the matter. Historically, insurance markets arise at the same time as stock markets. So while the hope of progress is a very real carrot offered by capitalism, fear is the stick. And these days, it behooves us to think carefully about fear, danger, lack of confidence generally.

### **Coping with marketplace danger: transparency and portfolio management**

While fear is part of life, some dangers come not from the world (the ship sinking, the business going broke, life ending and who will protect the children?), but from the financial system itself – the bubble bursting, the market failing. Let us call this marketplace danger, because it arises from within the structure of the marketplace.

Financial policy (including the web of so-called "private" arrangements that constitute the financial markets) can be understood as three fundamentally different responses to deep, often somewhat unarticulated, conceptions of marketplace danger: transparency, portfolio management, and constructed markets. Each conception of, and response to, marketplace danger dominates and so defines an era, though it can be found at other times, too. The current crisis is significant because it marks the end of the second era of modern financial policy, and, one may hope and think, the beginning of a third, the era of constructed markets.

*Transparency.* Since the early part of the 20th century, and particularly since the 1930s, the U.S. federal government has responded to marketplace danger with massive amounts of public law and regulation, financial policy. In particular, if we look to the founding of modern securities law in the '30s, we find a great deal of worry about what was and still is called "fraud." But this is more than fraud in the old common law sense of a buyer's reliance on a lie told by a seller. The stock markets of the 1920s were national markets on both the

sell and the buy sides. Companies had national operations, and investors – shareholders – were dispersed across the country. Thus we had strangers, trading at distances, through intermediaries, with other strangers, in companies that were everywhere and so almost nowhere. The “fraud,” so-called, was that investors bought or sold without knowing the economic reality of their investment, and therefore under false pretenses.

The Depression-era solution, of course, was a mandatory disclosure regime, or what today would be called a requirement of transparency. The notion is that people who are buying and selling stock have some idea about how the company is doing, and therefore, what their stock is worth. The mandatory disclosure regime is thus intended to work like the glass in a telescope: investors should be able to “see” what they are buying, even though it is a long way away. Prices on Wall Street should, therefore, accurately reflect the value of activity on Main Street. The function of language, then, is lucid description or representation of the business investment, or, as the SEC has styled it, “Plain English.”

Obviously, this is a gross simplification, but the basic idea of a mandatory information disclosure regime remains the fundamental idea behind the regulation of US securities markets (and information remains the heart of all talk of marketplace efficiency). The latest grand effort to achieve transparency is the Sarbanes-Oxley Act, passed a few years ago in response to Enron and other accounting scandals. And now, we have a huge financial crisis, in which sophisticated institutions have proven opaque to themselves, which has not played well in the markets. So, since the 1930s, the U.S. financial markets have been about to be transparent. But plain English, much less real transparency, and one must ruefully conclude, informational efficiency, has never quite arrived. Why not?

Now for poets or philosophers or anthropologists, that question is laughably naïve. Think how hard it is to say one true thing. Law can require disclosure, reporting, and can urge that the reporting communicate in effective fashion. However, this is a little like saying “do a good job.” Disclosure, as such, is not transparency. But if demanding disclosure does not ensure transparency, then how can actual, effective, communication be ensured?

Simply put, it cannot. Remember that the problem that transparency is trying to address – how do we know what we cannot see (a certain theological ring is intended) – is enormously difficult. Corporations are abstract, distant. And their operations are very complicated, and language is a virus . . . To make matters much worse, in a sophisticated financial environment, the bounds, the borders, of the corporation are not so clear. Assets and liabilities are regularly shifted to special purpose entities, or hedged, or otherwise transferred, with intentions of retaining more or less risk, and it can become unclear what risks should be recognized, by whom, and when. That is, the boundaries of a corporation’s business, say Citigroup’s, are often badly defined, and hence the value of the business is hard to assess. Most intriguingly, and as the SIV mess in the fall of 2007 demonstrated, the boundaries of Citigroup’s business were unclear to Citi itself. Citi could not figure out which liabilities it would actually be held responsible for . . . reasonable minds could disagree. In short, transparency seems to be at best a partial way to address what was understood to be the fundamental problem of marketplace danger, called in securities law, “fraud,” but more deeply, not knowing. Thus regulatory talk of transparency, like related talk of efficiency, masks epistemological difficulties at the heart of financial policy, and consequently, social choice.

*Portfolio Management.* In light of such epistemological difficulties, it is fortunate that finance offers another, very different, approach to the problem of not knowing and the resulting marketplace danger. Developed since the 1950s, but from ancient roots in probability theory, portfolio theory understands risk and return together, as flip sides of the investment coin. Investors are compensated for bearing increased risk, that is, risk is something to be embraced, at least under the right circumstances. Portfolio management copes with marketplace danger through strategies of diversification, and kindred strategies of hedging.

The construction of portfolios – and hence the need for portfolio management (including risk management, but I want to stress that the practice is not restricted to banks) – has become ubiquitous. Understanding the basic ideas at the root of both diversification and hedging is required of the middle classes, who are asked to set up defined contribution retirement plans, plan for their children's education, and diversify and insure their major assets.

For all its familiarity, however, a slightly more theoretical conception of portfolio management is critical to understanding what has gone so wrong, and more specifically, why the problem is far more fundamental than implied by the parade of very specific financial horrors that we have witnessed in recent years. Greenspan is right that the paradigm broke, but we need a more sophisticated description of “the paradigm” than “what we used to do before this mess started,” if we are to figure out what we want to preserve in our reconstruction of financial markets.

First, what is being managed, in a portfolio, is not a business, but a profile of risk and return – comprised by abstractions, slices, of a business or set of businesses. Taken together, these slices are designed to provide the investor with a cumulative return in line with its appetite for risk, but the slices generally do not in themselves represent anything in the world. It is therefore almost meaningless to talk about the transparency of a portfolio. A portfolio is not an image of anything in the world; a portfolio is synthetic.

Second, danger is managed not by superior knowledge of the underlying assets, but by other investments, diversification or hedging strategies, so that the portfolio constructed in such a way so as to be internally balanced. That is, portfolio theory accepts a degree of the ignorance that the transparency approach works to avoid. And so buyers in China or Europe are persuaded to buy interests in real estate in places they may have never seen, like Nevada. A portfolio is thus, in a very literal sense, speculative.

Third, portfolio theory assumes, or contemporary finance creates, instruments that convey bundles of risk/return to investors – hence financial engineering. In theory, these instruments can be specified to the degree necessary. As a result, a portfolio is, on its own terms, in principle infinitely precise, and, as importantly, infinitely extensible, and therefore universally applicable, or even virtual.

Investment in a contemporary financial instrument can be articulated to whatever degree of precision the parties desire. Compare, if you will, a sole proprietorship. The owner may understand all about the business, the transactions may be as transparent as can be, but the proprietor remains exposed to whatever the world throws at the business. Investment in a sole proprietorship is obviously somewhat uncertain. In contrast, a pension fund buying a synthetic Treasury so that it can meet expected obligations may model, and specify, its

expected risks and returns with a great degree of precision. So fourth, in its push toward rational articulation, portfolio management is modern, in a very Weberian sense.

Fifth, when the noun, security, became a verb, securitize, we crossed a line. What is significant is not just, as Marx had it, that all social relations are abstracted into property rights. What matters here is that the institutions of property are transformed. Rights in things become rights to make financial claims. But claims cannot be answered bilaterally; recourse must be had to courts. And the risk of claims is assessed, and insured against, through third parties, who themselves tend to spin off risks. And when there is insolvency, then claimants – and their claimants – are affected jointly. More generally, if a portfolio consists of claims, then the value of the portfolio depends on whether those claims can be successfully made, and that cannot be assessed by reference to the portfolio or even to its underlying assets. Thus the modern risk management paradigm, by encouraging the use of contract to employ and protect assets most efficiently, integrated enterprises, and is essentially social.

A modern financial portfolio, then, is like a glass, a vessel, that holds the pooled interests (net worth) of its owner. Recapitulating my description, the portfolio may be described as synthetic, speculative, virtual, modern, and social. The function of language, especially the language of contract, is analytic and contractual, slicing and recombining interests so that risks and returns are balanced against one another.

The sophistication of portfolio management masks serious weaknesses that, taken together, provide one account of the current crisis. First, and well recognized in portfolio theory, diversification does not work against those dangers known as systemic risk. In particular, many assets that were thought to be unconnected, and hence to offer investment opportunities that were uncorrelated, are in fact connected. In such circumstances, models that assume diversification, or simply do not consider the possibility of correlation, will tend to underestimate the danger.

Second, reliance on ever more extended representation and elaborate abstraction inevitably compromises transparency. As long as the models seem to hold, investors may assume that what they see – the model – is an abstract but fair representation of the world. But suppose the models do not make sense, either singly or in conjunction? A landscape painting need not represent an actual place; a financial model need not describe a business reality. At some point, the model may reveal itself to be not an abstraction from a complicated reality, but simply a devilishly complex formal structure. Such structures may nonetheless remain obligatory . . . betting on unicorns does not necessarily mean that one does not owe money.

A third, and heretofore hardly recognized, cost of systematic reliance on portfolio management: hyperintegration magnifies uncertainty. Spreading risk contractually to those best able to handle it is a good idea, and for many years we heard that the widespread use of derivatives had made the financial system more “robust.” If aggressive risk management becomes well-nigh universal, however, and if it suddenly becomes unclear whether insurers are solvent, then counterparty risk becomes both widespread and difficult to assess, a lesson we should have learned from Long Term Capital Management.

To recapitulate: we have at least three rather fundamental reasons that the risks to portfolios, however sophisticated, are difficult to manage. First, diversification, the point of portfolio management, may not be achieved effectively, particularly in a world of widespread if

often unseen connections. Second, the models individually, and certainly collectively, may not represent business reality, and hence cannot be transparent. Third, and in tandem with the first two, the integration of legal structures may generate a crippling and contagious uncertainty about the likelihood of payment.

*From Transparency to Portfolio Management.* We now have enough on the table to compare our two approaches to confronting marketplace danger. If the first paradigm and even era of financial policy confronts marketplace danger, understood to be ignorance, by requiring information, in what we might call the era of transparency, and language is understood to be descriptive (naively representational), then the second paradigm confronts marketplace danger, understood as risk, through the contractual construction of diversified and hedged portfolios. Let us call this the era of portfolio management. In this era, language is understood to be analytic and contractual (naively obligatory and determinate). And if you want dates, let us say that the era of transparency in the U.S. ran from the Securities Act of 1933, mandating disclosure of information as a requirement for the offering of securities to the public, to the passage of the Employee Retirement Income Security Act (ERISA) in 1974, which had the unintended consequence of transforming retirement planning from pensions (defined benefit) to tax-deferred investment (defined contribution), so that most middle class Americans were turned into part-time portfolio managers. And, again by way of heuristic, we might say that the era of portfolio management runs from 1974 until the fall of 2008, when it became clear that risk management had failed at systemically important institutions, and the sovereign powers to print money and tax would be required to avert catastrophe.

### **Tragedy and law**

Portfolio management could not have failed so spectacularly if it had not been so widely adopted. In important ways, the current crisis expresses the *success* of portfolio management, and therefore has an essentially tragic structure: portfolio management's virtues, carried to excess, constitute a flaw that leads to the system's undoing, a tragic flaw. By managing risk with unprecedented sophistication, global portfolio management left itself wide open to the far more damaging problem of uncertainty.

The financial crisis may also be understood on the analogy of tragedy in a deeper way, as a play among conflicting, even inverse, financial virtues. Understood as a tragedy, what is at issue here are two fundamentally different imaginaries, two different ways of thinking about marketplace danger: transparency and portfolio management.

If transparency is the answer to market danger, then language is a medium, meant to disappear. We speak of understanding: put all your eggs in one basket, and watch the basket. And we legislate disclosure and other information driven conceptions of regulation.

If we respond to market danger through portfolio management, however, then language is used to set up barriers, vessels, entities, and to move economic interests from one to another in mechanized fashion. We speak of putting eggs in different baskets, of financial engineering. And natural language is supposed to function with literally mathematical necessity, permitting ever greater reliance on leverage.

These imaginaries – transparency and portfolio management – are not just different. They are antagonistic. The inadequacy of transparency made portfolio management



necessary; the widespread adoption of portfolio management made transparency impossible. Portfolio management accepts a degree of ignorance – the evil transparency was designed to address – as the cost of diversification. Once diversification fails, however, there is no fundamental understanding to fall back upon, and the system violently contracts due to uncertainty (counterparty risk leads to refusals to trade).

In a simpler world than the one we inhabit, it might be possible to pick just one strategy, portfolio management or transparency, to cope with marketplace danger. Due to the legal nature of finance itself, however, neither portfolio management nor transparency can ever be completely successful, and so there will always be a need for a complementary strategy – and the conflict that implies.

(1) *The precision of contracts is limited in principle.* Contract law is often implicitly and not implausibly understood as a predictable set of relations, much like the laws of mechanics, which is why we can model derivative obligations with mechanical precision. And people can rely on such modeling, except when they cannot. The laws of contract are considerably more flexible than those of nature. The idea that a bunch of engineers and physicists should have been effectively writing contracts that they fundamentally did not understand – not being lawyers, much less bankruptcy lawyers, nor even corporate managers– may be remembered as one of the more amusing follies of our time.

Again, from the perspective of a transactional lawyer, this proposition should have been banal. Except that it was not – for a long generation, we seem to have forgotten the simple fact that derivatives are contracts, and hence inescapably rather imprecise. In particular, whether a set of documents creates a “legal, valid, binding and enforceable obligation” is a question that lawyers are regularly asked to opine upon. Indeed, lawyers are asked to be liable for the substance of their opinions. And as any transactional lawyer knows, the largest standard exclusion in such an opinion letter is for bankruptcy, insolvency, and other situations where the contract might be reformulated by a court of equity (e.g., the ongoing Lehman Brothers litigation). To generalize: the contractual nature of financial instruments imposes theoretical limitations on the possibility of risk management.

(2) *The legal rights of financial actors limit the possibility of transparency.* Consider, by way of example, the municipal debt chapter of the present crisis. A municipal bond issuance is insured by a monoline with a good credit rating, and sold on that basis. If, due to its other investment activities, the monoline loses its credit rating, the bondholders’ trustee is required to protect the interest of the bondholders, which may be done in various ways, all of which cost the issuer, the municipality, a lot of money in a short amount of time. As a result, the municipality runs a risk of insolvency, even though it has never defaulted on a payment.

Transparency is not much use here. As a practical matter, municipalities, much less the purchasers of municipal bonds, are not in a position to monitor insurer’s other investments. Even if the municipality could somehow negotiate the right to monitor the investment activities of the monoline, another creditor of the municipality could not, because it would not be in privity of contract with the insurer. A party to a transaction cannot, as a matter of due diligence, demand to see the books of the other party’s insurers and debtors. Hence the widespread if now obviously foolish reliance placed upon credit rating agencies.

To generalize: a networked web of contracts among discrete entities cannot be fully understood on a bilateral basis; we cannot know everything about our partner’s partners. (In

law, this is the ancient English notion of privity.) Consequently, legally and in principle, a risk-sharing network cannot be fully transparent to its actors.

It would be simplistic to attempt to “solve” the conflicts between transparency and portfolio management in principle, to declare a master virtue for the conduct of financial policy. In the abstract, the problem is insoluble – hence tragedy, the sense of being trapped. Moreover, we cannot do without either transparency (knowledge) or portfolio management (insurance) as ways of handling marketplace danger. Thus the conflict is not soluble for reasons internal to contemporary financial thought, and more importantly still, practice. And for the same reason, reforms of the regulatory structure, even the creation of a prudential macroeconomic systemic risk regulator, one ring to rule them all, as it were, will not make the problem go away.

Some problems are managed rather than solved. The political question – implicitly asked by most tragedies – is how are conflicts among goods, goods that we cannot do without, to be managed? Specifically, how can we think about financial regulation that encourages both transparency and diversification, while understanding that the two are fundamentally in conflict, and neither can ever be fully achieved? What does this tragic perspective mean for restructuring the financial system?

Since Aeschylus law has been associated with tragedy, in part because law often deals with conflicts among virtues, like tragedy. So, in understanding the financial crisis on the intellectual frame of the tragedy, we might turn somewhat more seriously toward law. In attempting to apply a discipline, economics, that understood itself as a science, financial policy over the last few generations has failed to understand in any but superficial fashion that financial instruments, and so financial markets, are legal down to the bone, that is, political. Rephrased, thinking tragically encourages us to focus on the law in “law and economics.”

From this perspective, the question is how do we construct markets that not only balance between transparency and portfolio management, but, more generally, are as sound as possible?

### **Rethinking financial regulation as market construction**

A place to start: the U.S. government is no longer regulating many financial institutions in the traditional sense, because it owns controlling interests in them. At the same time, the government believes that it must, for good political reasons, (re)establish markets in, for example, commercial credit, securitized debt, and so forth. The United States believes, in short, that certain important social questions – who gets commercial credit, for example – should be governed by markets. This commonplace has important intellectual consequences: we should acknowledge that our financial markets are not prior to politics, not natural. Instead, markets are now most obviously what they have always been, a form of social organization, political contexts understandable only in terms of their legally-defined constituent parts.

From this perspective, we should not think of financial policy as “a regulatory response” to the failure of a market, always belated. We instead should think of financial policy in architectural terms, like the glass windows that face skyscrapers or typify cathedrals. If law sought to ensure the provision of information, transparency, in the first era, and to

facilitate contract, portfolio management, in the second era, then the third era will be about the construction of edifices, in legal terms, the chartering of institutions and the regulation of their interconnections. We have witnessed a shift from descriptive, to contractual, and now to constitutive uses of language to confront marketplace danger. As a corollary, this crisis may mark the beginning of the end for the Enlightened imagery of “left” and “right,” echoed in talk about regulatory responses, government intervention, moral hazard, and so forth. Financial regulation should not be so bashful as it now is – not because markets fail, but because reasonable minds should disagree about good architecture.

There is a great deal to be said about weaknesses and improvements to many U.S. markets, ranging from markets for health care to student loans, but for present purposes, let me restrict myself to two very basic points: the expectation of failure, and hence the need to focus on limiting the harms caused by a crisis, and the responsibility of bureaucrats.

(1) *Limiting Harms.* If transparency and risk management are neither fully achievable nor dispensable, and law is left to manage the contradictions between the two, we can expect to see – as we have throughout the history of capitalism – manias, panics, and crashes. In the medium to long view of the regulator, financial market failure is to be presumed. So while regulators should try to encourage transparency, and sensible risk management, but they should do so in the knowledge that their efforts will not always be successful. Like cars, markets must be designed to crash – much more regulatory thought should be devoted to mitigating the harms caused by crises to people.

Efforts to manage risk, the sort of thinking that informs Basel II, are necessary but insufficient. We have a good chance of avoiding the risks we can assess. But whatever the limitations, moral and ontological, of former U.S. Secretary of Defense Donald Rumsfeld’s geopolitical vision, he is epistemologically correct: there are unknown unknowns, and they can be very dangerous. Financial regulation needs to ensure that when such dangers unexpectedly materialize, as they now have, then the regulatory structure operates to limit the transmission and scope of harm. Our regulatory structure has failed to do that.

(2) *Taking Responsibility.* If we think of the coming era of financial policy in architectural terms, of self-consciously building markets, we should remember that architectural glass retains some of the characteristics of telescopes and drinking glasses. We still need to be able to see through the windows. We still need a sense that we are investing in something real. So we will not outgrow transparency. And a building’s windows define spaces, separate the inside from the outside. We need to separate ourselves from one another, so that we may contract, and we may allocate responsibility. So we will not outgrow risk management, either.

Managing such contradictions will require judgment on the parts of regulators. Regulators should not be able to claim, under the banner of efficiency or some other master principle putatively derived from economic science, that a given decision is simply right, and therefore beyond political contestation. As we have seen, academic economics has been all too useful for bureaucracies, and entire governments, that wish to disclaim responsibility. So it might be hoped that we all come to understand that regulators make judgments – and should be judged accordingly.

## Rethinking the discipline of finance

Much financial policy has been philosophically and linguistically naïve, simply unaware of what has been happening in much of the rest of the world of ideas. Unlike most all the social sciences and the humanities – and if financial policy is neither social nor humane then we have problems indeed – financial policy did not take what is sometimes called the turn to interpretation. Perhaps more bizarrely still, and especially in the U.S. legal academy, financial policy has been willfully insensitive to law. Mistakes were made, not only practically, but intellectually.

However, this is a new day. Greenspan was right; the paradigm collapsed. And understood as an intellectual crisis, this is a time of tremendous opportunity, a chance to think anew. The opportunity is nothing less than the effort to think, seriously and publicly, about finance as a form of politics, indeed socially constitutive politics.

The shift in paradigm, from the objective science to which Friedman and Marx aspired to the cultural awareness exemplified by Benjamin, entails a shift in the role and the self-consciousness of both the scholar and the regulator. Experts should talk to one another because that is how imaginaries are socially constructed, especially now, with our vast distances and instantaneous communication. Language is neither transparent nor determinate, but endlessly subject to interpretation and construction. And there is a certain comfort here, in the necessity of conversation among experts rather than the objective demonstration and forceful argument to which financial policy has long aspired. Worldly philosophy may remain dismal, but it should become less lonely.

**Editor's note:** This paper's ideas are explored more fully in Westbrook's [\*Out of Crisis: Rethinking Our Financial Markets\*](#)

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