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Book review: *Innovation and the State. Finance, Regulation, and Justice*

Christie Ford

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*Reviewed by Israel Cedillo Lazcano**



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In 2018 we “commemorated” the tenth anniversary of the collapse of Lehman Brothers, an event that has been a source of inspiration for a myriad of academic works on topics relating to the Great Financial Crisis (GFC), lending disruption, financial regulation, governance, innovation, just to name a few. If one decides to read this body of literature, immediately, it is possible to find a *leitmotif* structured around the role of deregulation, financial innovation, and the emergence of unregulated institutions, popularly known as “shadow banks”, in the development of this financial failure.

In the middle of this academic production, Cristie Ford offers us a rather interesting analysis focused on the complex interaction between innovation and regulation. In this analysis, she presents social challenges that go beyond the traditional arguments structured around the GFC, which in turn, have fostered the emergence of more “democratic” innovations, such as, FinTech. Of course, one can argue that innovation fosters socioeconomic developments, but something that this book highlights accurately is that innovation also fosters the development of market failures. Based on this argument, the author recognises that while these innovations represent interesting opportunities, they also pose regulatory challenges. Thus, she introduces the *leitmotif* of her argument, focussing on the process of financial innovation itself, and asks, “[h]ow [do] we intend to deal with the effects of innovation in our societies”? (p. 2) After all, the responsibility for the GFC can be found, first, in the private sector’s failures rather than the regulators’. Consequently, to start the development of the argument referred to above, she offers us a potential answer: flexible regulation.

This solution represents a refinement of several regulatory approaches developed in the 1990s and 2000s among different academic areas. Through these approaches, States started to foster innovation, in clear contrast to the rigid regulations that characterised the models developed under the Welfare State, following the increased role of the market and the civil society in the

development of public policies, as explained by authors, such as, Susan Strange¹ under her “Westfailure”. Along those lines, in Chapter 1, the author follows a popular path designed around the analysis of legal structures. For some readers this effort might feel repetitive, but it is actually necessary. As we have seen in different works, such as, *The Economic Consequences of Legal Origins* by La Porta, Lopez-de-Silanes, and Schleifer,² law is essentially interpretation, one that follows the spirit of its own social and political context. However, the author highlights the difference between recognising that our legislators anticipate a level of change in these contexts, and trying to put in place regulatory efforts that are capable of reacting and adapting to evolutionary trends that are becoming faster and more complex given the nature of new technologies.

As an illustration of these complexities, Ford appeals to our memories through four “moments” that show us the suboptimal interaction between the private and the public sector regarding innovation and regulation: 1) the Enron debacle, 2) the 2007 Asset-Backed Commercial Paper (ABCP) Crisis in Canada, 3) the framework developed under the Basel II Accord, and 4) the public comment process relating to the Volcker Rule. These “moments” will appear in different parts of the book as examples of each element developed in the following chapters. The conclusion that emerges from this exercise is that most of the assumptions that contributed to the constitution of these “moments” can be traced to suboptimal reactive regulations, and it is even hinted that the rapid evolution of Distributed Ledger Technologies (DLT) could pose some risks for our financial systems and other sectors in absence of more pragmatic paradigms.

¹ Susan Strange, “The Westfailure System” (1999) 25 *Review of International Studies* 345-354.

² Rafael LaPorta, Florencio Lopez-de-Silanes, and Andrei Shleifer, “The Economic Consequences of Legal Origins” (2008) 46 *Journal of Economic Literature* 285-332, at p. 285.

With that in mind, Chapter 2 opens a set of four chapters focused on the history and roots of the author's argument, in which it is possible to see a transition that takes us from the traditional idea of the Welfare State to a more horizontal interaction among the State, the market and the civil society. This is a helpful approach considering that, after the failures that unleashed the GFC, we are witnessing how different proposals are taking form around old regulatory models that aim for old-school solutions, among which one can find a recurrent argument in favour of a twenty-first-century Glass-Steagall Act.

However, as introduced in Chapter 2 and developed in Chapter 3, the "deregulation" argument that is found in most of the works mentioned in the beginning of this review and used for the proponents of old-school regulations, has been significantly abused. Although certain sectors were deregulated at one level, it is possible to see how they were "re-regulated" through other mechanisms at another level. The real problem, as presented in Chapter 1, are the unsupported assumptions. Accordingly, following the author's argumentative line, we are in need of new regulatory strategies that include a broader range of actors and elements, such as, innovators and business interests. This latter is justified based on the gradual inclusion of certain private-realm values that, in turn, have opened our eyes to a wider variety of risks that goes beyond the Welfare State's natural risk.

To put this process under a new light, Ford presents a picture of how different academic perspectives relating to responsive regulations, reflexive laws, smart regulations and current governance models, look for a multidimensional paradigm "within the State, by the State, without the State, and beyond the State".³ For that purpose, in Chapter 4, the reader will find how the search for

³ David Levi-Faur, "Big Government' to 'Big Governance'" in David Levi-Faur (ed.), *The Oxford Handbook of Governance* (New York: OUP, 2012), pp. 3-18, at p. 3.

new sources of normative authority has resulted in the rise of the use of the term “governance.” In the book is possible to find an effort similar to that developed by Avinash Dixit,⁴ in which he shows how this term emerged from obscurity to worldwide fame within the timeframe covered by most of the literature. Thus, Dixit found only five mentions of “governance” in the 1970s’ economic literature, while, by the end of 2008, he shows how this term was mentioned 33,177 times. Among this academic production, Ford presents several interesting findings. For example, she shows how the number of financial and corporate governance articles rose steadily from the late 1990s onward (despite the fact that financial regulation scholarship does not tend to advocate for flexible strategies), as an expression of the spirit of our disruptive times in which “innovation is a potential regulatory challenge, almost by definition” (p.119).

At this point, some readers might start questioning if a flexible model, as described by Ford, is excessively dependent on the logic of the market, leaving aside such elements as political context and cultural traits. After all, it would result rather contradictory to the points set in the introductory part of the book and to those developed later in Chapters 8 and 9. However, as the author points out, imperfection lies with not only sovereign institutions, but also the market and the civil society as well. As a result, she presents an argument by which she concludes that flexibility offers better solutions than the rigid regulations featured in the Welfare State.

Once the author has set the precedent ideas, in Chapter 5, she puts the citizen (not the consumer) — following a Classical Republican ideal — at the core of a decentralised model based on the complexity of our times and the suboptimal results of “flexible” regulations pre-Lehman Brothers. On this point,

⁴ Avinash Dixit, “Governance Institutions and Economic Activity” (2009) 99 *The American Economic Review* 3-24, at p. 5.

some readers might disagree and, just as Mathew McCubbins⁵ did, we could argue that through this form of decentralisation, States create for themselves a problem of agency, given that a conflict may exist between the goals of the private sector and the preferences of different administrations of the government over different time lines. Of course, one could also argue that this happens only under rigid paradigms. It is an interesting topic for further discussion.

In Chapter 6, Ford focuses on innovation as a regulatory challenge as we have witnessed in contexts, such as, the Gebroeders de Neufville crisis of 1763, the Overend, Gurney & Co. panic of 1866, and the collapse of Lehman Brothers in 2008. As one could expect, we have faced each challenge with a myriad of proposals that range from those “not radical” enough to those that we could consider “too radical”. A lesson can be learned from previous experiences that both extremes tend to be based on a certain lack of understanding of financial innovation. Innovation, as seen in the case of Fintech, holds enormous potential but also poses significant risks. However, given that some authors argue that financial innovations like “cryptoassets” could change our understanding on what “money” and instruments like a “share” are, we are facing problems in determining the boundaries regarding which regulators should be in charge. At the same, as seen in different regulatory forums around the orb, we do not know which products and services could fall under traditional models; thus, extending existing regulatory regimes to new technologies in absence of a proper understanding of the legal effects of the latter. This should worry us. After all, given the Schumpeterian trend composed by inventions, innovations and diffusion of these innovations, one must keep in mind that, given the complexity of these developments, the next great crisis could be unleashed at the level of

⁵ Matthew McCubbins, “The Legislative Design of Regulatory Structure” (1985) 29 *American Journal of Political Science* 721-748.

these markets and products. In the particular case of financial innovation, for the author, this process is difficult to analyse due to the weak or ineffective IPRs regimes structured around patents. However, she pays attention to patents like those developed by Bank of America relating to DLT, while she leaves aside copyright practices that are becoming relevant for FinTech developments.⁶ A deeper effort on this line would have been interesting and could have strengthened the argument.

Among the different patterns of innovations analysed in the innovation scholarship, in Chapter 7, the author focuses on seismic innovations. These innovations are associated to developments that cause transformative consequences, like those that we are facing as result of the developments related to the Fourth Industrial Revolution (FIR), which are requiring new markets for their use. The diffusion of seismic innovations requires high amounts of managerial, technological skill and financial support that only the most dominant firms can provide, as shown through the cases of the American railroads and J.P. Morgan, deep water oil drilling in the Gulf of Mexico, and the financial engineering behind the GFC. Accordingly, it can be argued that, in the context of the FIR, we are witnessing the same process through the emergence of digital units of second generation like Ethereum's Ether and Ripple's XRP, or Bank of America's DLT patents. Ford makes a very accurate description regarding the challenges posed by these innovations in a way that it is possible to make clear connections with our own reality in which we lack data about innovations (which in turn evolve and diffuse in rather short periods of time) and our understanding is infused with our own subjective beliefs about the future.

⁶ An example of these practices is the development of DLT projects around open source software licenses, which are designed to make the developments available for everyone who wants to work on them.

Consequently, the question arises that, having in mind the suboptimal proposals that have emerged during the last 10 years, what would be the sensible regulatory responses to seismic innovation?

In Chapter 8, the author analyses other forms of innovation: sedimentary innovations. This is an interesting approach in that, considering the nature of the technologies behind current seismic innovations and their potential systemic risks, we tend to leave aside incremental improvements developed through innovation systems. Furthermore, it is argued that this form of innovation could be helpful in our efforts to put in place a flexible regulatory paradigm, as it is possible to see through the case of the sandboxes introduced by the United Kingdom's Financial Conduct Authority. However, there seems to be a warning here. Despite the benefits offered by these models, their structure could allow private parties to impose (taking advantage of the fact that we struggle to see sedimentary change) their priorities over our public regulatory needs. With that in mind, Ford argues that a potential solution is the analysis of innovation using network schemes to understand how particular innovations and risks are presented, considering elements like geography, institutional-regulatory framework and demographics of the market. Based on these components, regulatory measures can be improved.

Finally, Chapter 9 highlights the weaknesses of our innovation systems, which tend to constrain the egalitarian distribution of knowledge and resources between developed and developing countries. In the case of financial innovations this has an additional challenge to be addressed, considering that these developments are as much legal innovation as they are strictly financial ones, subject to legal traditions as described by La Porta, Lopez-de-Silanes and Schleifer. Based on this, the author closes the book returning to the relationship between innovation and regulation, both structured around our own cognitive shortcomings, so we can infer that innovation will keep pushing our regulatory

boundaries which, in turn, will never be sufficient or perfectible to achieve our social goals. Ford ends with a call for a “regulatory structure that worries about technique but not only technique, and that remains attuned to the equality-seeking and justice-oriented priorities that current political moment demands.” (p. 238).

The content of Ford’s book presents the reader with a transition within the existent literature that, as it has been set here, opens several discussions that, certainly, will be covered in other works and regulatory proposals. The structure of the work eases its understanding, independently of the area of expertise of the reader. As result of this latter, one can say that this book is a useful resource for researchers and policymakers that currently are in charge of generating different frameworks for the implementation and diffusion of technologies like Artificial Intelligence (AI) and DLT throughout different sectors.