<u>Chapter 4 – Legal Institutions</u>
(Lecture on 10APR)

Legal system carefully lays out the rules of the game. This is to increase the certainty with which an investment outcome (return) will take place. Without a good legal system that carefully defines the rules, there would be a risk that any investment will turn out the way it is expected (for legal reasons). Thus, in addition to a premium for inflation, default risk, liquidity risk, and exchange rate risk; there would have to be a premium associated with the ability to realize a return due to the legal system not performing well (e.g., country risk indicators – indicates the cost of doing business the country).

In this sense, a well-developed legal system encourages the holding of financial assets and therefore encourages development of the financial system. In this sense, developing the legal system is a type of financial liberalization.

A. Rule of Law, in general – the Foundations behind the ability of the Legal System to perform the above effectively – i.e., this sets an environment conducive to business (there is a high probability of knowing the outcome of any decision).
    1. Property Rights well defined
    2. Contracts enforced at low cost (Indonesia and cost of bringing a borrower to court – Ben Dennis' solution)
    3. Little Corruption – costly unless there is a stable system of corruption
        a. Democracy – well-understood economic and political rights
        b. Fairly enforced law - to prevent individuals from circumventing the law or enforcing it arbitrarily.
        c. Evidence: Your book shows the relationship between corruption and GDP growth/financial system development.

B. Financial Regulation
    1. Anti-fraud laws
    2. Regulation of Information: Disclosure Laws/Accounting practices
    3. Creditor Protection: Bankruptcy Laws (Do they favor creditor or borrower? There must be a balance.)
    4. Prudential Regulation
        a. Capital Regulation (cornerstone of prudential regulation)
        b. Lending Restrictions (size and to any one borrower)
        c. Risk Management Procedures (make sure procedures are in place to allow management to access risk)

C. Corporate Governance
    1. Anti-fraud (prevent tunneling – managers and/or controlling owners expropriate assets of firm)
    2. Disclosure of information (principal/agent problem)
    3. Shareholder rights – so that shareholders can take control of the firm (particularly minority shareholders) (principal/agent problem – next chapter). Voting rights and takeovers (need enforcement behind them) to prevent expropriation of minority shareholders interests.