Law as a Source of Financial Instability

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Why Law?

- Law as a stabilizing factor
  - Commitment device
  - Clarity of rights and obligations

- Yet, *private* law also operates as a source of financial instability
  - Source of innovation
  - Strategic tool for regulatory arbitrage
  - Protected by “private autonomy”
  - Empowered state enforcement
The Power of Law

- Transformation of simple claims into tradable assets
  - Specificity of claims
  - Transferability
- Priority rights
  - Property rights
  - Collateral law
  - Acid test: bankruptcy
- Durability
  - Legal shields
  - Trust & Corporate Law
- Convertibility
  - Into alternative private assets
  - Into state-money
- Universality
  - Enforceable “against the world”
  - State backing for “legal” coding strategies
From Bills to CLOs

“Old Wine in New Bottles”

- Securing future cash flows
- Unimpeded by too many creditors
- With minimal regulatory costs and tax liabilities
- Shifting the costs of uncertainty to others
Historical Examples

- Crédit Mobilier (1850-60s)
  - Leveraged finance of infrastructure investments

- Long-Term Capital Management (1990s)
  - Leveraged investments in emerging market sovereign bonds

- Lehman Brothers (2000s)
  - Leveraged investments in ABS, derivatives, etc.
Legal Ingredients

- Multiple legal entities
  - Separate asset pools
  - Legally shielded

- Debt instruments
  - Backed by different asset pools
  - Insulated from secondary creditors

- Credit enhancements
  - Collateral, guarantees, credit lines and other liquidity puts
Integration

Integrate Firm

Operation A

Operation B

SH

SH

SH

CR
Separation of Assets & Liabilities

Cash Mgr Debt Guarantor

Asset Pool A

Asset Pool B

UBO UBO UBO UBO
On the Upside

- Ease of Monitoring & Specialization
- Risk diversification
- Lowering costs of credit
On the Downside

- Aggregate debt levels difficult to monitor
- Unknown contractual contingencies
  - Private placement
  - Contractual autonomy
- Volatility of assets that back debt
- Contagion channels
  - Interdependence of creditors
  - Creditors & shareholders
  - Toxicity of assets, financial structure
Current Challenges

• Migration of Shadow Banking Practices to the Corporate Sector
  • Splitting entities into asset pools
  • Expansion of debt finance
  • Cross-guarantees by parent
  • Off-balance sheet financing structures

• Role of banks
  • Creditors, including CLOs

• Role of asset managers
  • Exposure to banks
  • Possible creditors or shareholders of firms at risk
Risks are magnified by Globalization

- Expanding scope of financial relations
- Menu of *national* laws to choose from
  - Choice of law & forum
  - Regulatory arbitrage
  - Preferred jurisdictions: UK, US
- Lack of supra-national regulatory coordination
Financial relations are coded in law
The basic modules have been remarkably stable over time
Their combination and recombination poses ever new challenges
Private legal ordering is protected from public oversight outside specific regulatory domains
Lawyers as master coders

- “There is an estate in the realm more powerful than either your Lordship or the other House of Parliament, and that [is] the country solicitors.”
  - Lord Campbell (late 19th century)