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, <u>*private*</u> 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

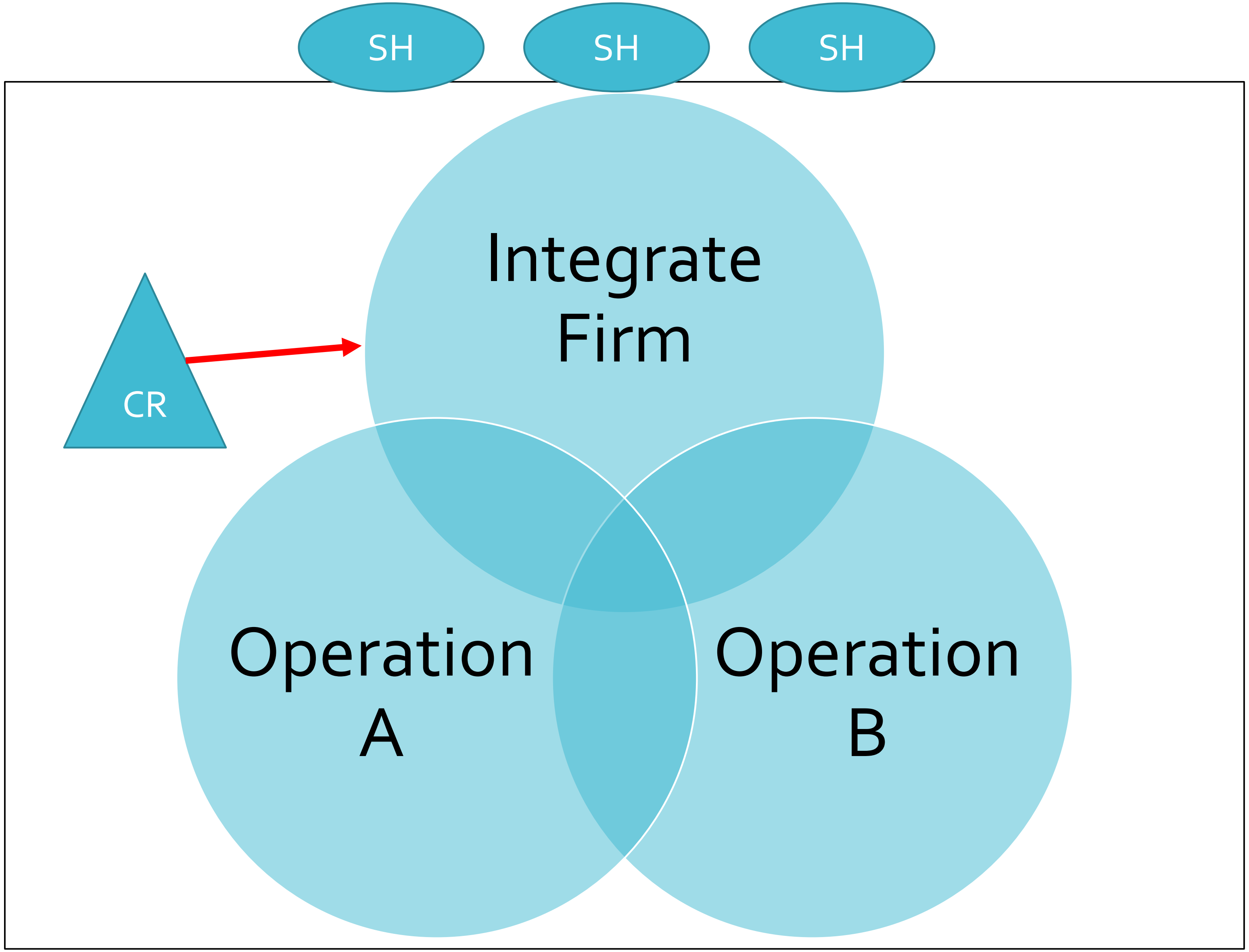
Historical Examples

- 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.

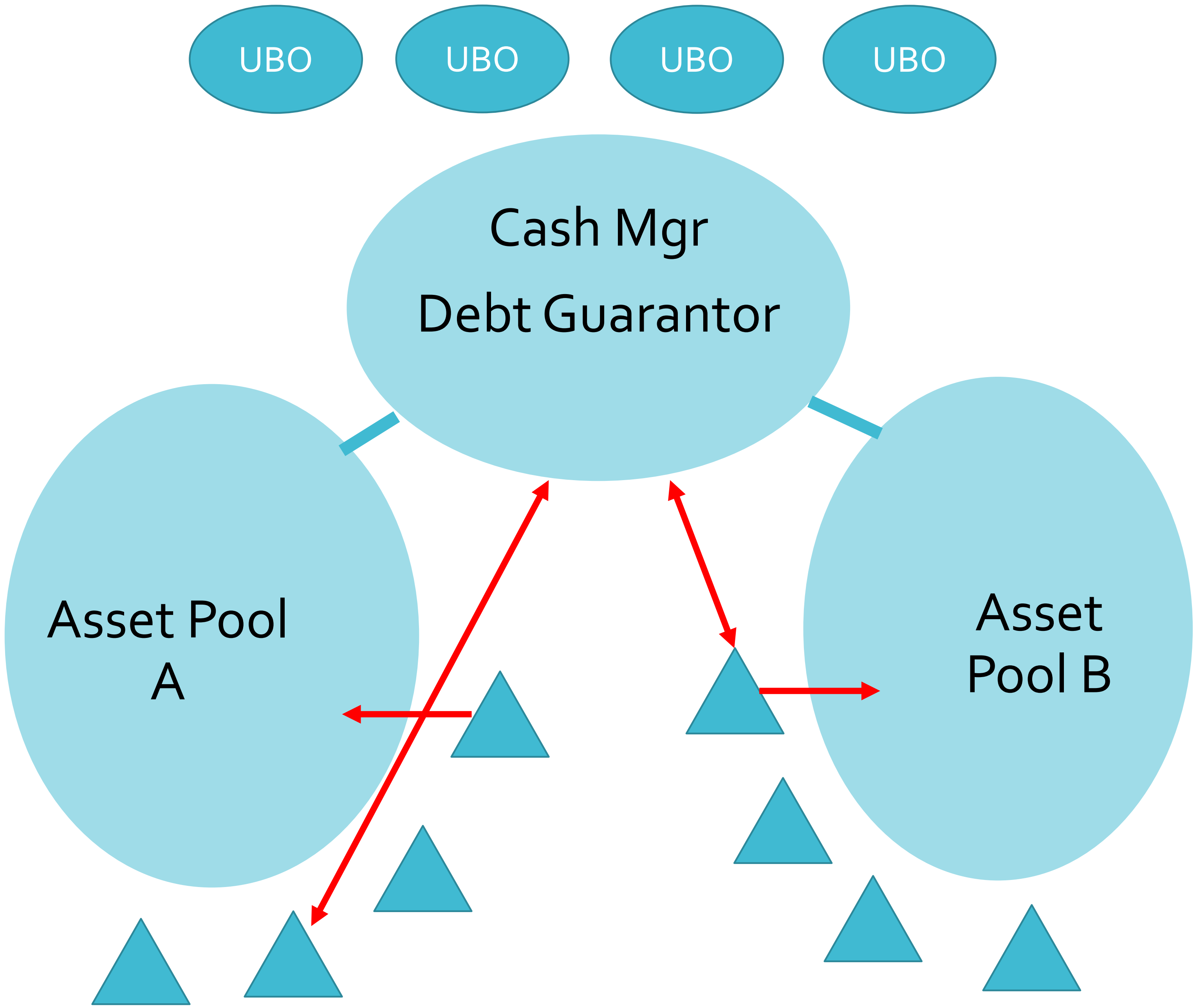
Legal Ingredients

- Multiple legal entities
  - Separate asset pools
  - Legally shielded
- Debt instruments
  - Backed by different asset pools
  - Insulated from 2ndary creditors
- Credit enhancements
  - Collateral, guarantees, credit lines and other liquidity puts

Integration



Separation of Assets & Liabilities



On the Upside

- Ease of Monitoring & Specialization
- Risk diversification
- Lowering costs of credit

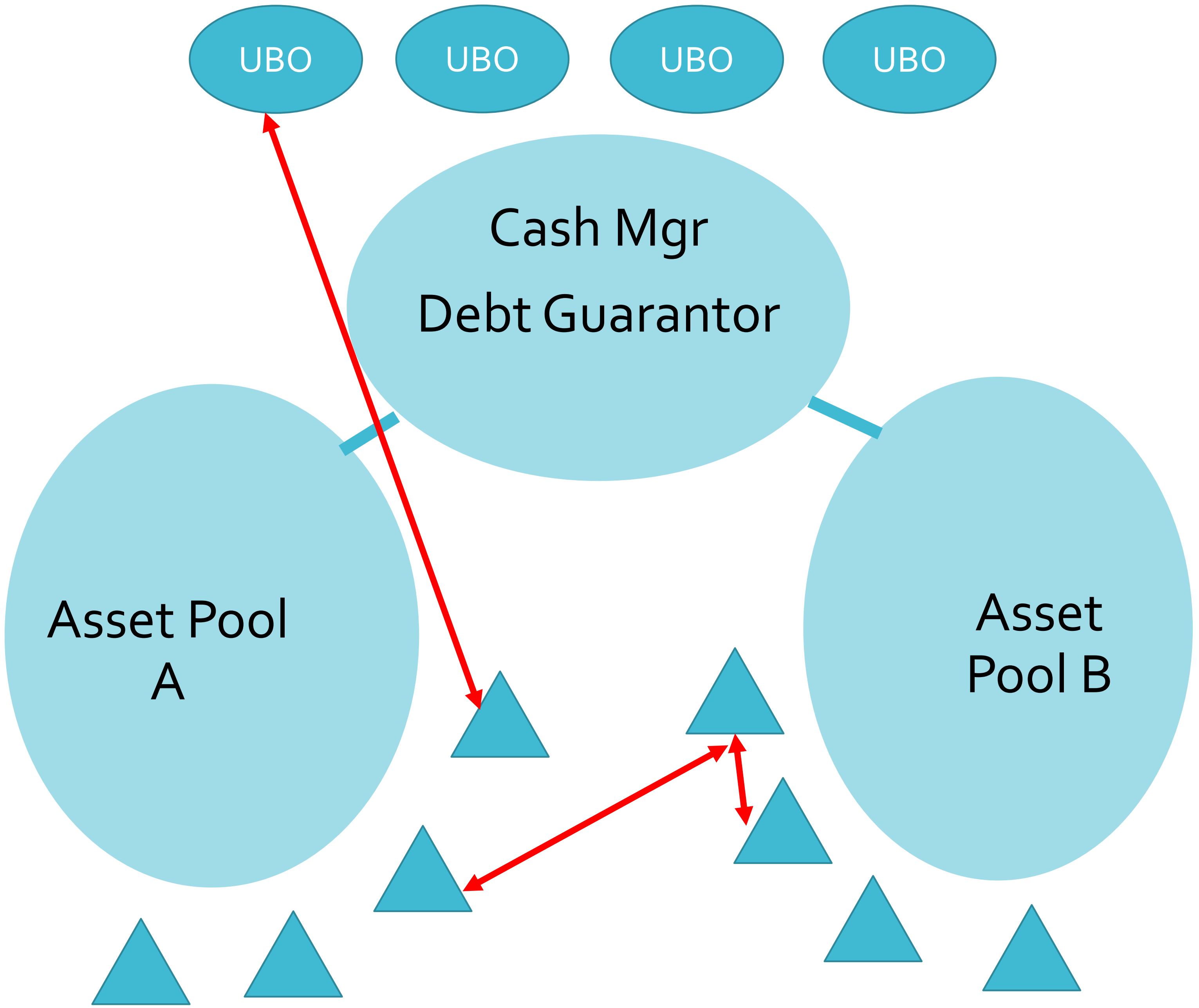
On the Downside

- 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

Financial Stability



Risks are magnified by Globalization

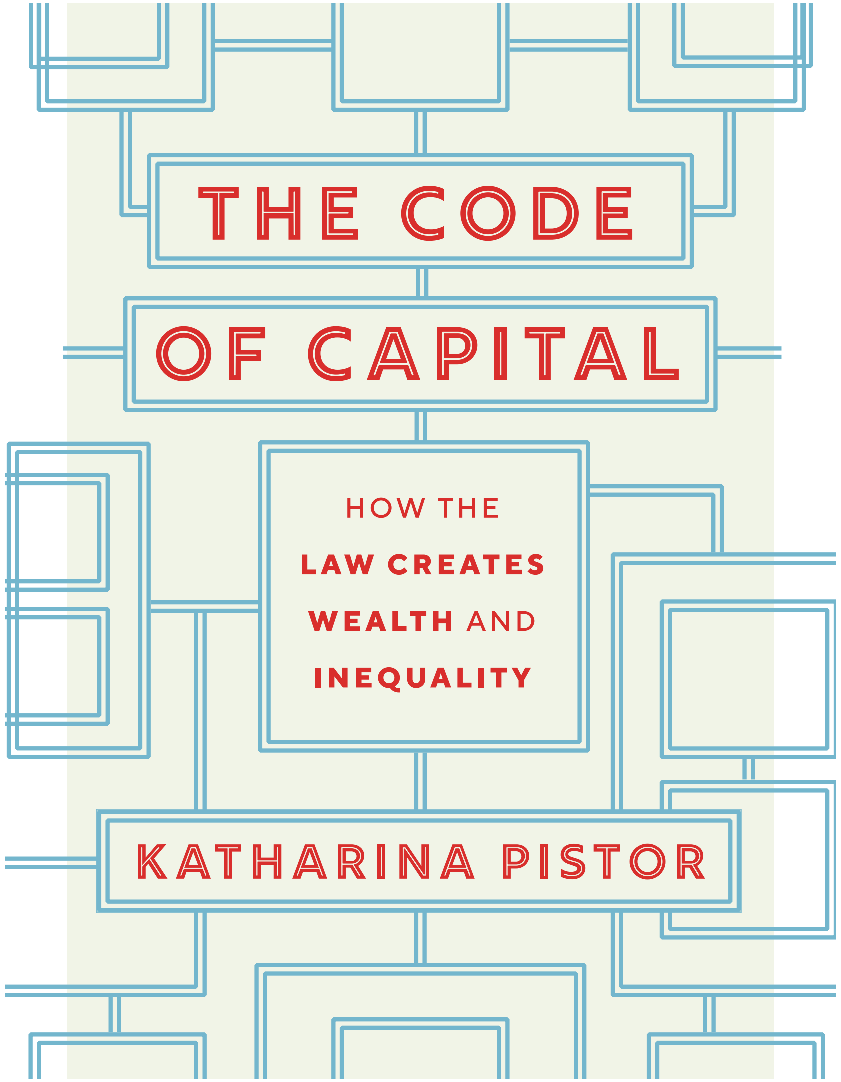
- Expanding scope of financial relations
- Menu of *national* laws to choose from
  - Choice of law & forum
  - Regulatory arbitrage
  - Preferred jurisdictions: UK, US
- Lack of supra-national regulatory coordination

Concluding comments

- 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)


THE CODE
OF CAPITAL
HOW THE
LAW CREATES
WEALTH AND
INEQUALITY
KATHARINA PISTOR