

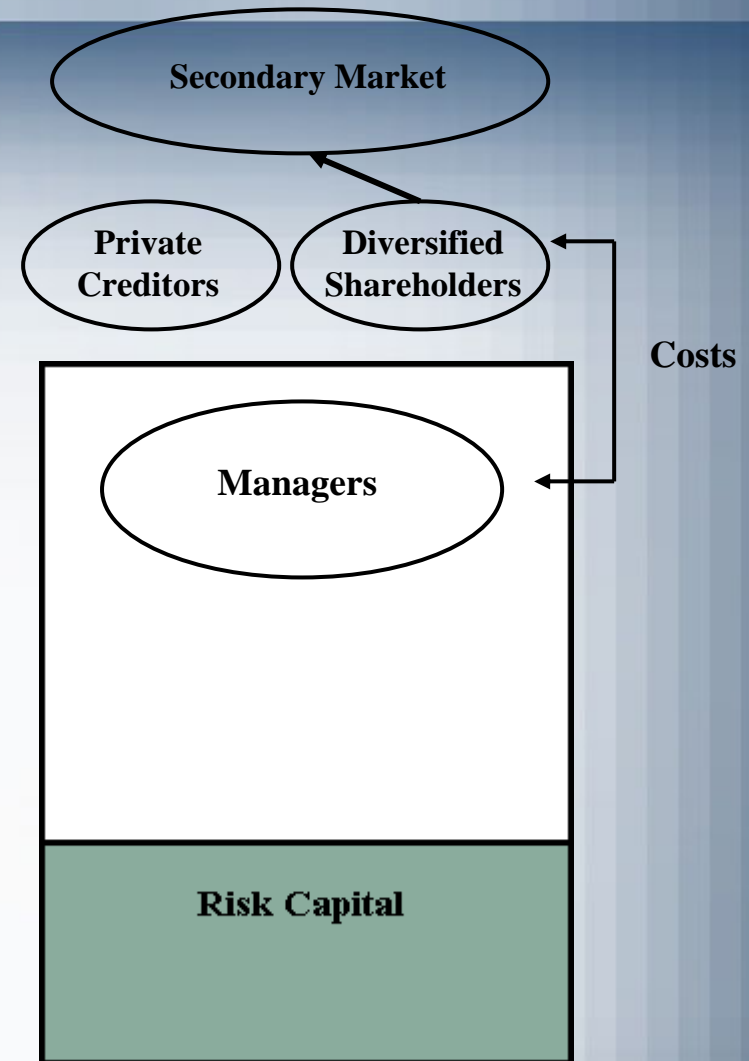
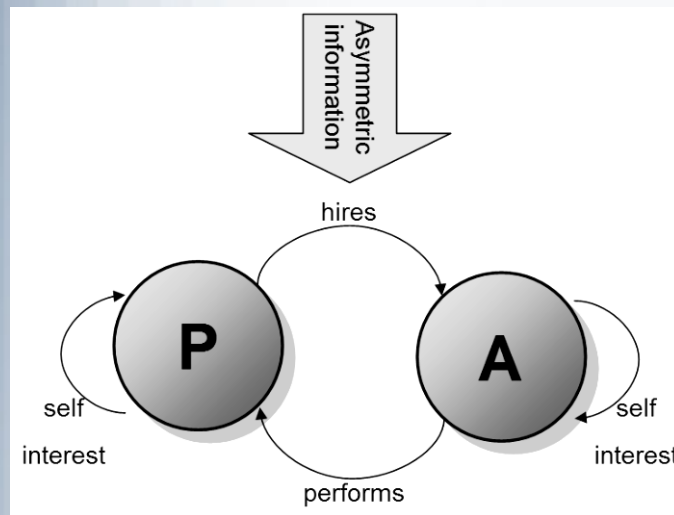
The Evolution of Debt

Capital Markets Board of Turkey

Charles K. Whitehead
Boston University School of Law
January 2009

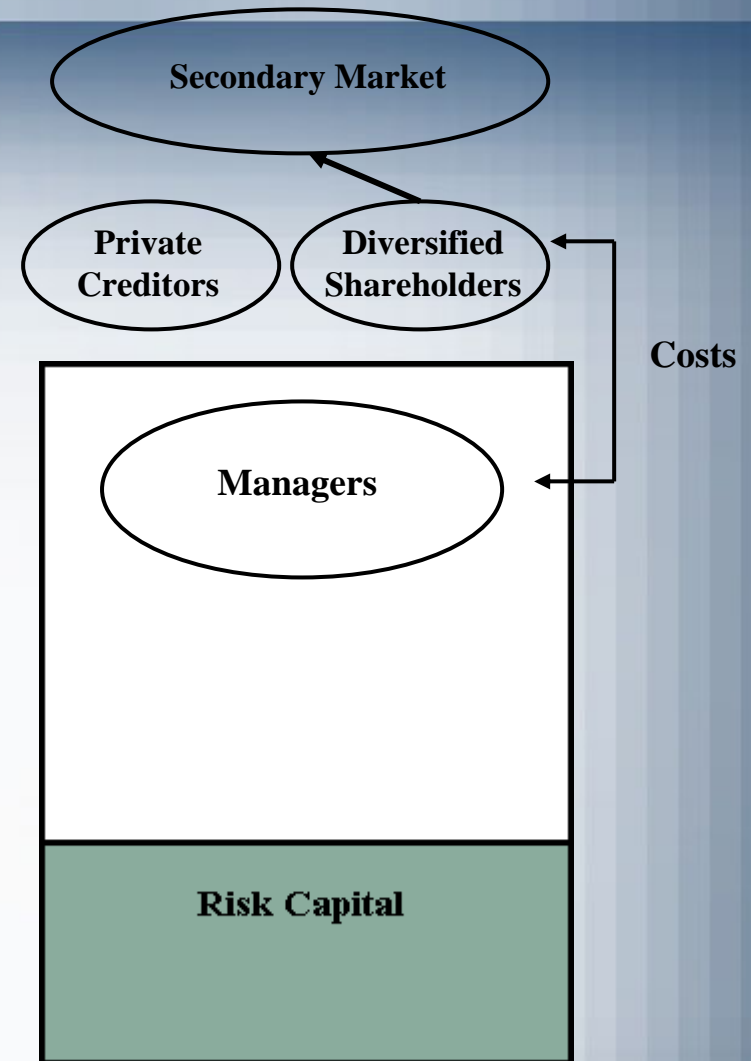
Traditional U.S. Model

- ✓ Risk capital – diversified shareholders provide the lowest cost risk capital, managing risk through the purchase and sale of shares
- ✓ Creditors – private lenders manage risk through covenants and monitoring, resulting in loan illiquidity



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- ✓ Premised on existing instruments and techniques in the capital markets

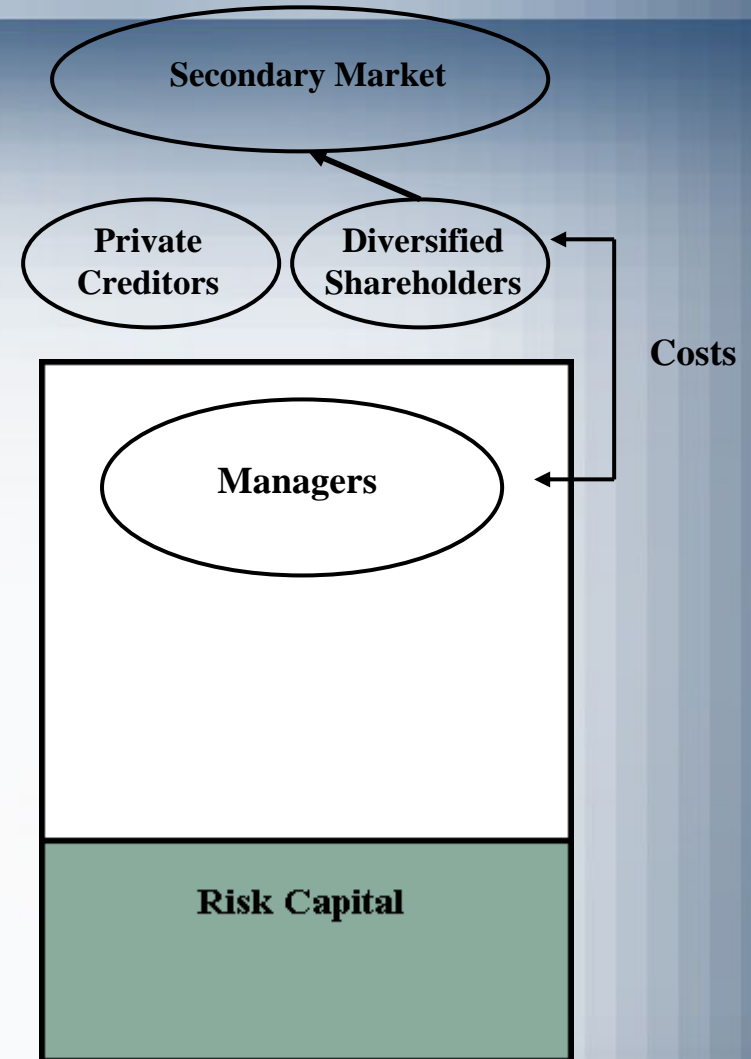


Traditional U.S. Model – Evolution of Risk Capital

- Growing corporate risk, in the 1970s, prompted a search for new means to manage or transfer risk
- Private and exchange-traded derivative instruments
- Expanding coverage – foreign exchange, oil prices, and interest rates → weather, catastrophes, and credit risk

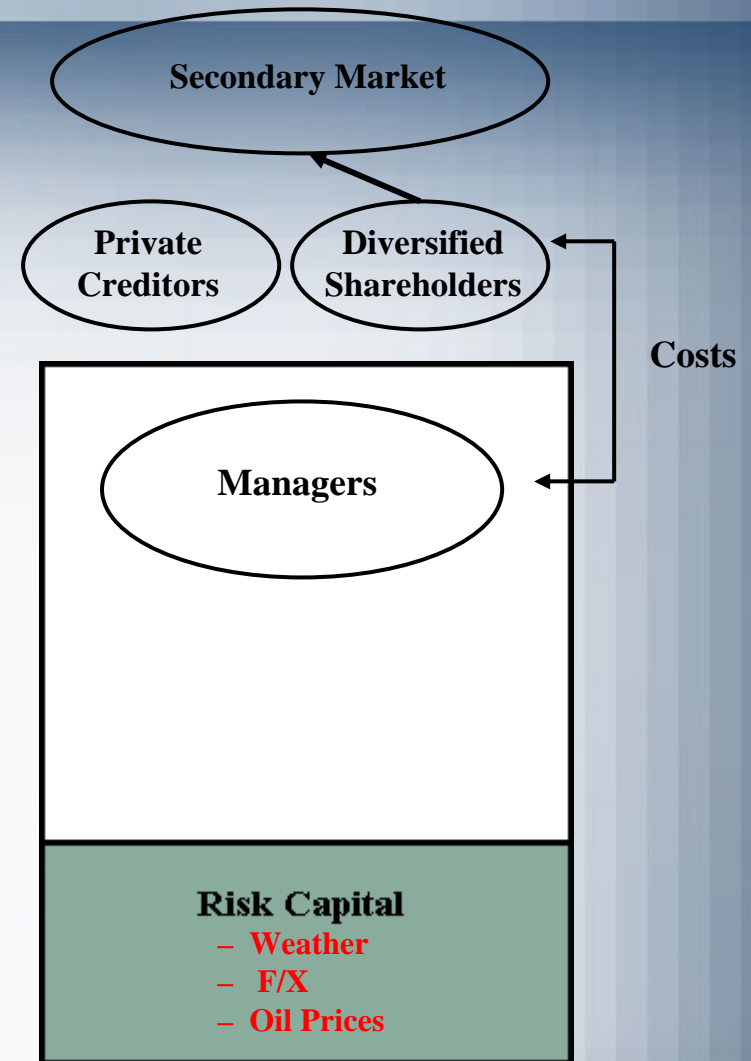
Traditional U.S. Model – Evolution of Risk Capital

- ✓ Greater ability to manage and transfer risk as capital markets grow increasingly complete



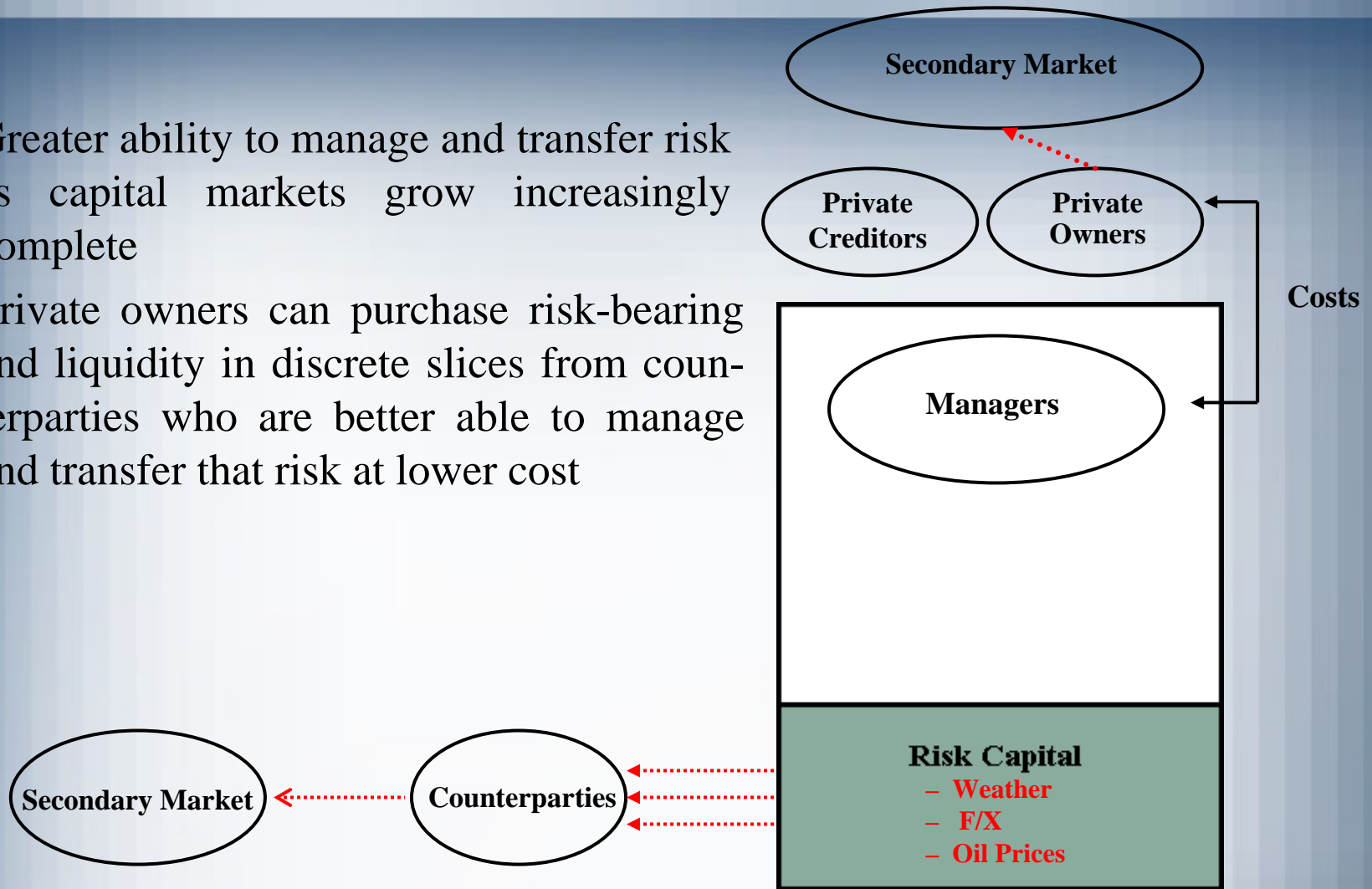
Traditional U.S. Model – Evolution of Risk Capital

- ✓ Greater ability to manage and transfer risk as capital markets grow increasingly complete
- ✓ Private owners can purchase risk-bearing and liquidity in discrete slices from counterparties who are better able to manage and transfer that risk at lower cost



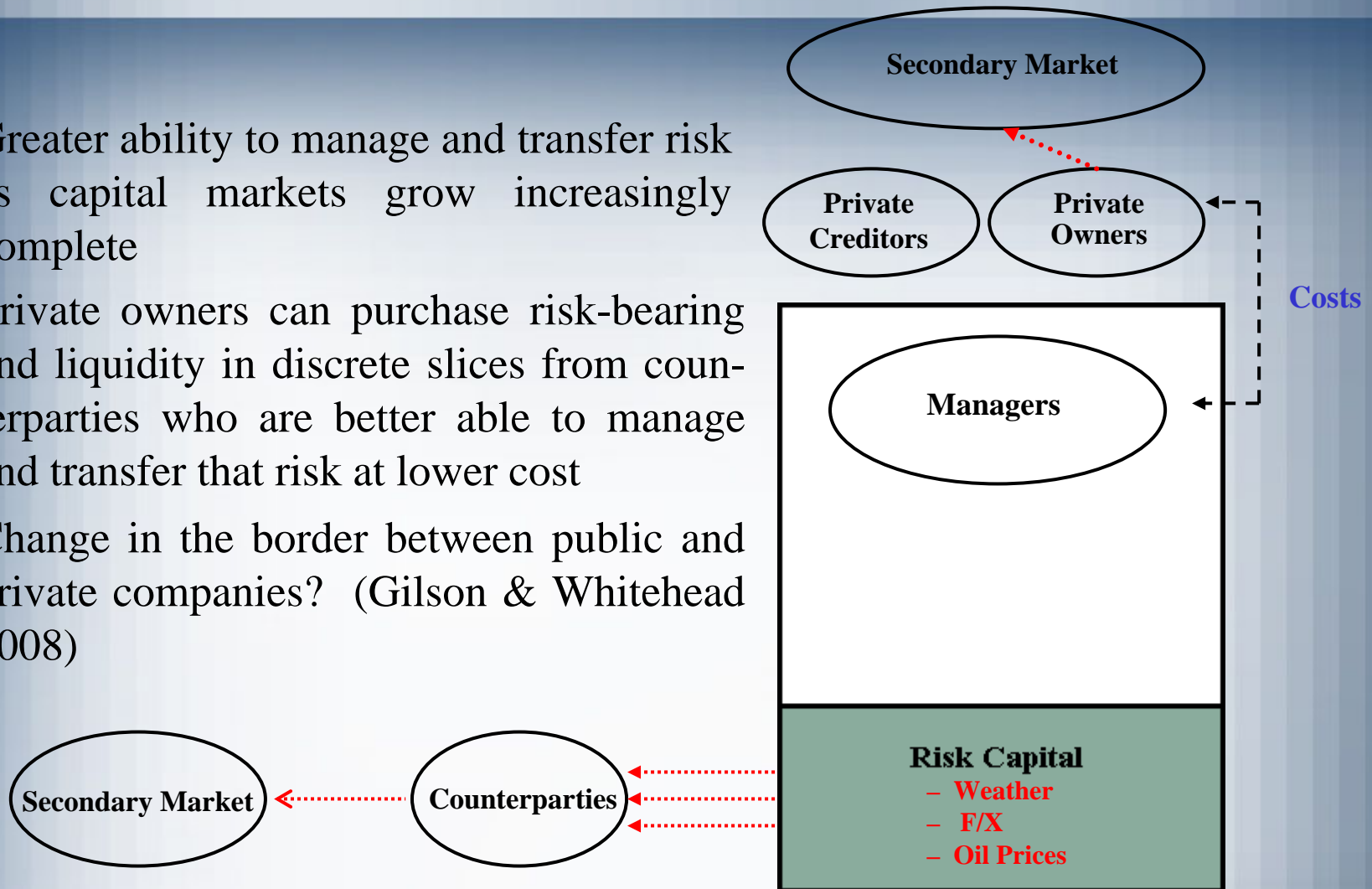
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- ✓ Change in the border between public and private companies? (Gilson & Whitehead 2008)



Traditional U.S. Model – Evolution of Debt

- From the late 1980s – Regulatory and market changes prompted innovation in how banks assess and manage risk, resulting in new and increasingly liquid credit instruments
 - ✓ Loan syndication and sales & trading
 - ✓ Credit derivatives – CDOs and credit default swaps
- *But* – Agency problems in the face of an increasingly liquid private credit market (Partnoy & Skeel 2007; Hu & Black 2008)
 - ✓ Decline in monitoring
 - ✓ Decline in covenant levels
 - ✓ Potential to manipulate the market – moral hazard

Traditional U.S. Model – Evolution of Debt

“A band of hedge-fund managers accuse Wall Street’s Bear Stearns Cos. of attempting to manipulate the market for securities backed by subprime loans by purchasing shaky mortgages. Bear retorts that it has the right to repurchase mortgages and that sometimes it can help a struggling borrower. Meanwhile, an industry association that oversees derivatives trading has been drawn into the middle of the matter. . . .

*“Bear is one of Wall Street’s largest players in the market for credit default swaps, or CDS, instruments that act as insurance policies on various kinds of bonds, including those backed by subprime mortgages. **Many hedge funds have bought these swaps, effectively making a bet on an acute downturn in subprime home loans. Bear is widely believed to have taken the opposite position . . .**”*

*The Sure Bet Turns Bad,
Wall Street Journal, June 7, 2007*

Traditional U.S. Model – Evolution of Debt

- Market response to the resulting agency costs –
 - Syndicate structure (Diamond 1984; Gorton & Haubrich 1987)
 - Reputation (Diamond 1991)
 - Covenant levels (Drucker & Puri 2008)
- Informativeness of private credit instruments (Norden & Wagner 2007)
 - Impact on a borrower's cost of capital

Traditional U.S. Model – Evolution of Debt

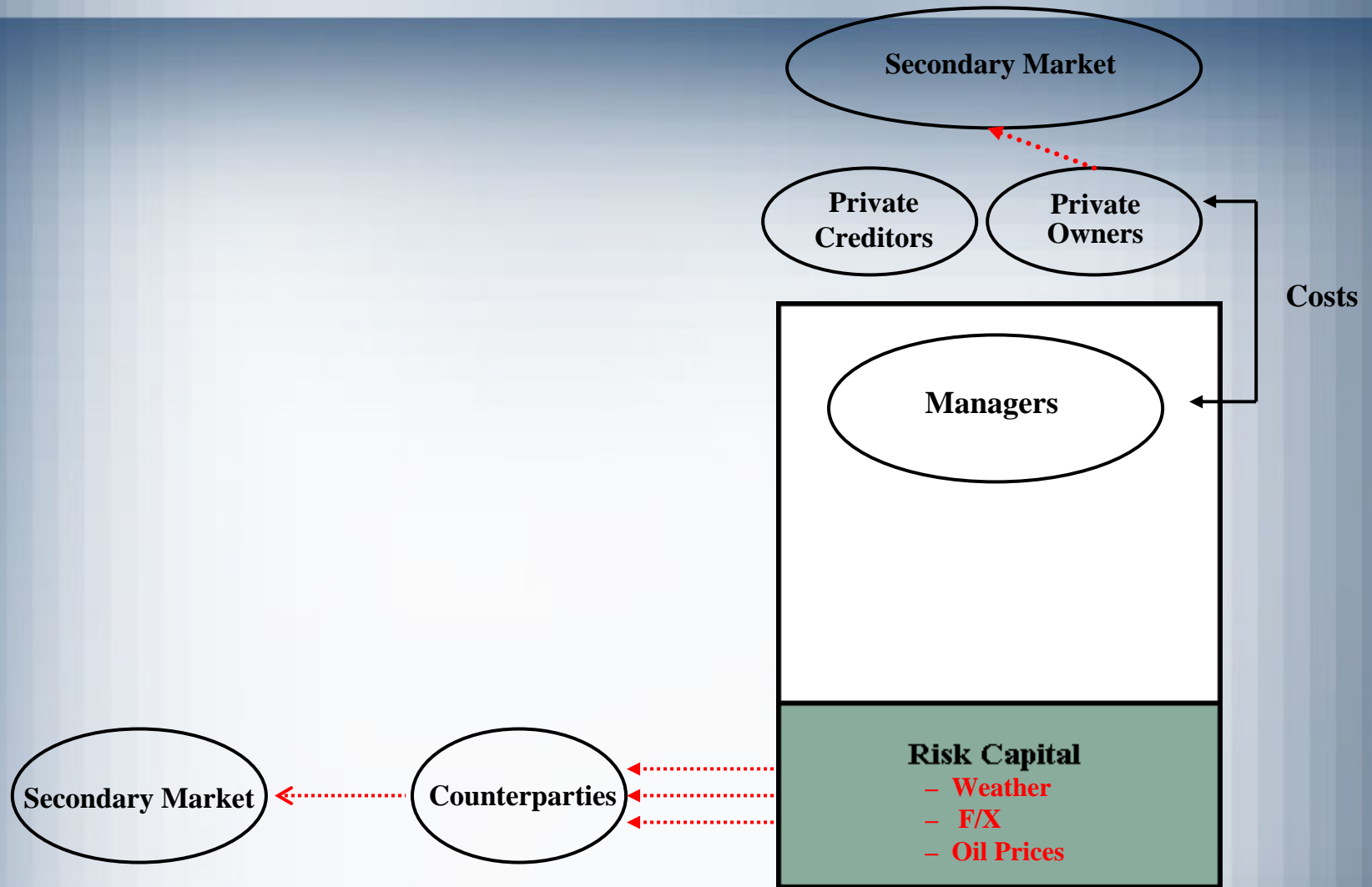
Citigroup Inc. and Credit Suisse Group AG are among banks *tying corporate loan rates to credit-default swaps*, raising borrowing costs and exposing companies to derivatives accused of crippling the financial system.

Nestle SA, the biggest food producer, Nokia Oyj, the largest mobile-phone maker, FirstEnergy Corp., the Ohio-based owner of electric utilities, and at least three other companies bowed to banks' demands to link the interest rate on credit lines to the swaps, which are used to bet on borrowers' likelihood of default. . . .

Concerns that *Libor may not truly reflect borrowing costs* helped bring about the change. The rate came under scrutiny as the debt-market seizure deepened. . . . Banks are also seeking to *shift from a reliance on credit ratings* amid concern Moody's Investors Service and S&P have been too slow to act when credit quality deteriorates.

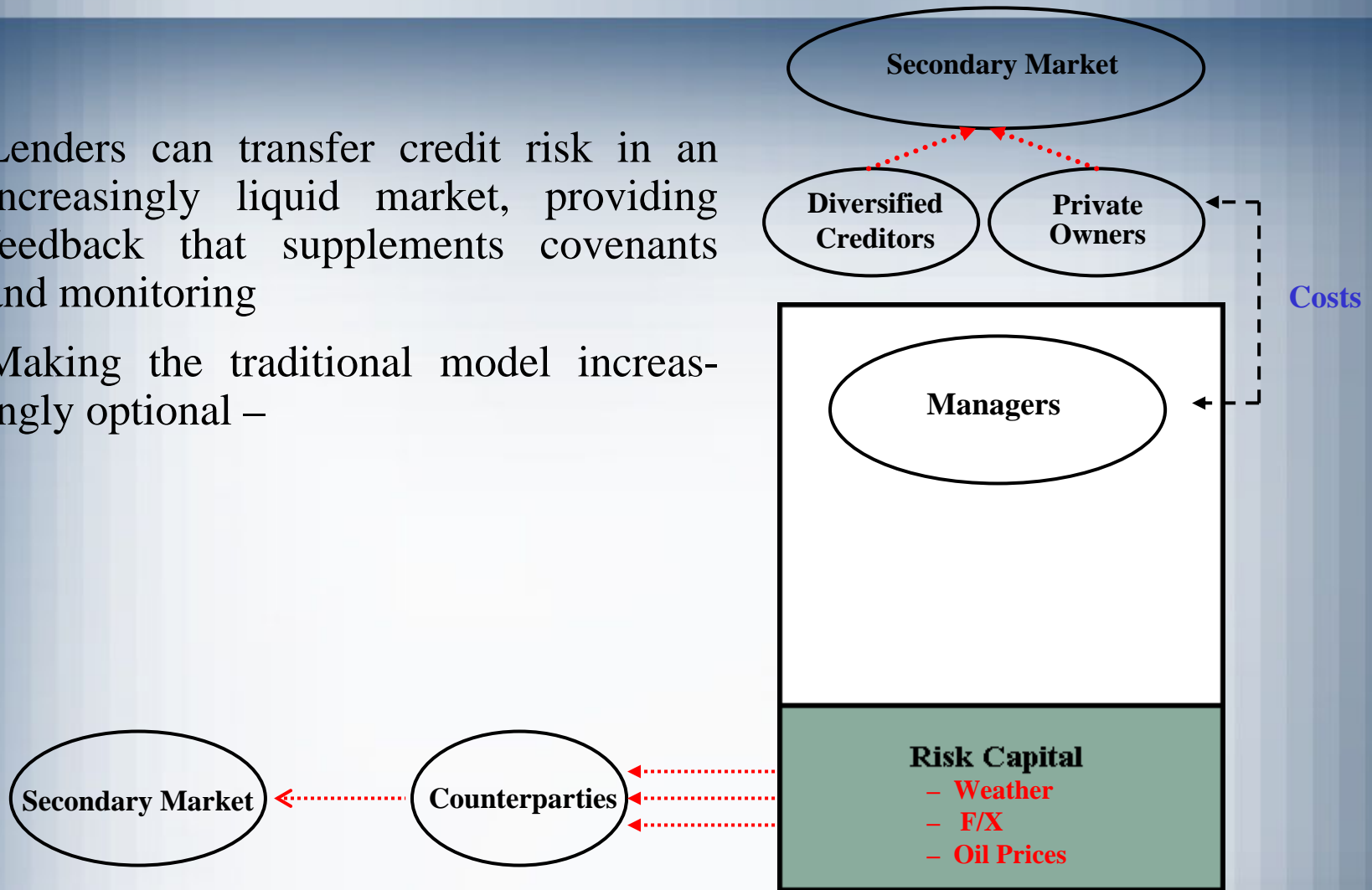
Citigroup, Credit Suisse Link Loans to Swaps in Shift
Bloomberg, October 29, 2008

Traditional U.S. Model – Evolution of Debt



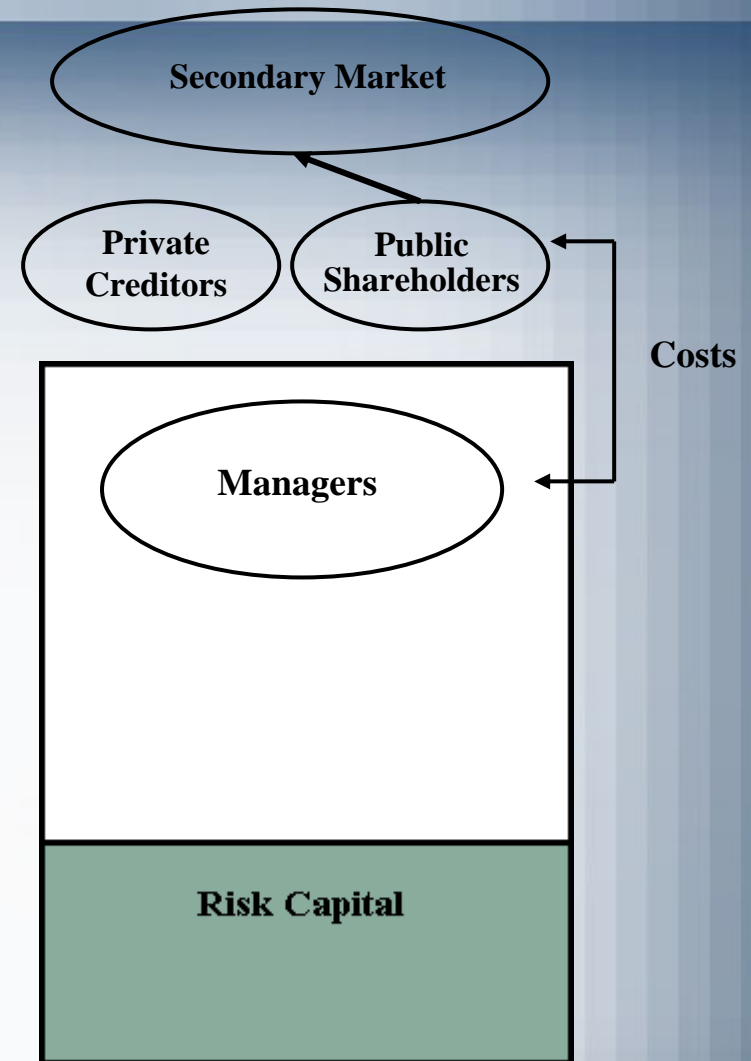
Traditional U.S. Model – Evolution of Debt

- ✓ Lenders can transfer credit risk in an increasingly liquid market, providing feedback that supplements covenants and monitoring
- ✓ Making the traditional model increasingly optional –



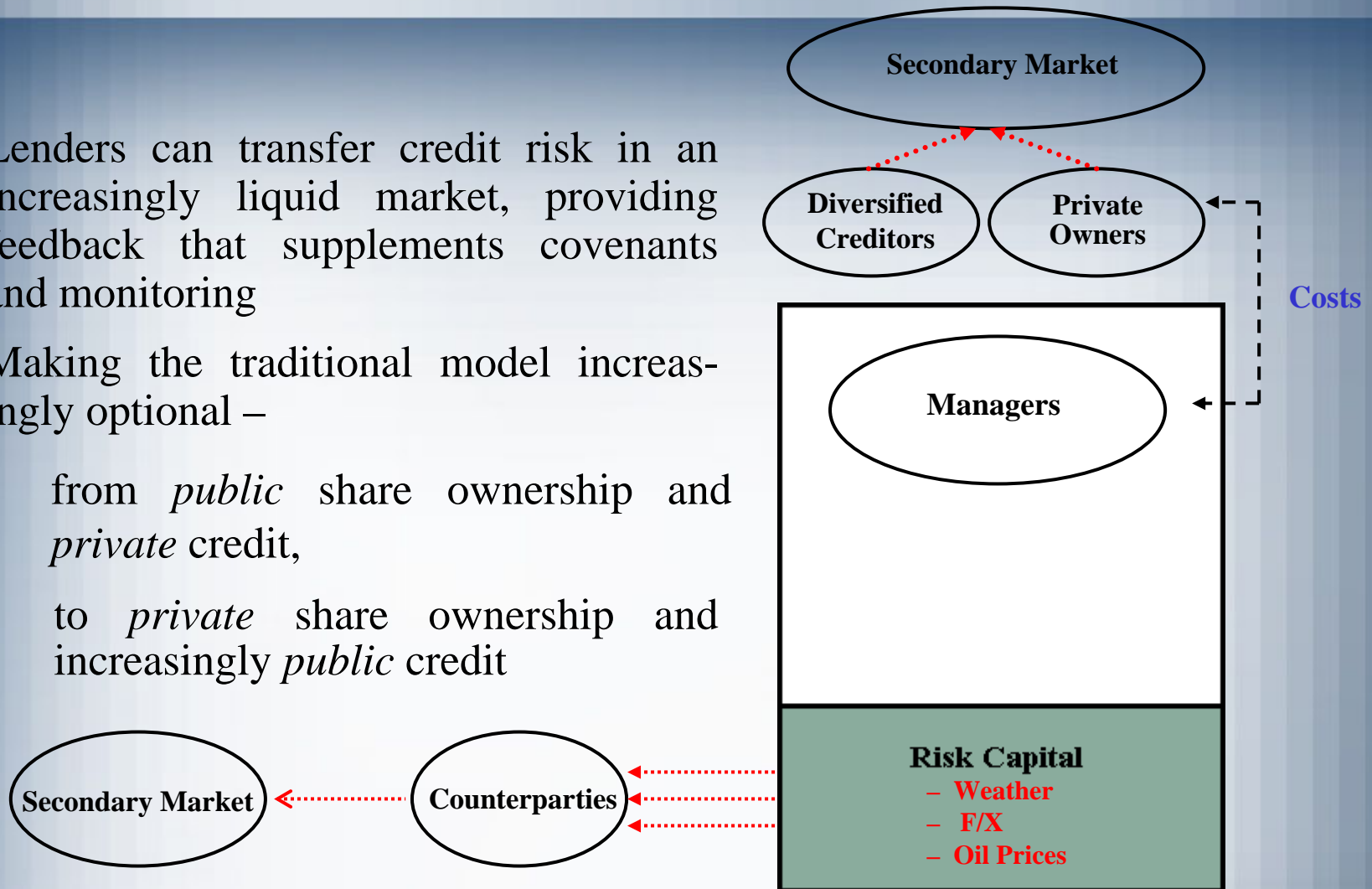
New Governance Function?

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 - to *private* share ownership and increasingly *public* credit



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