Centre for Banking & Finance Law
Faculty of Law

CBFL SEMINAR SERIES

Debt Capital Markets, the Genesis of Crises and the Role of Regulation

24 February 2023, 4.00pm to 5.15pm (SGT)
NUS Law, Lee Sheridan Conference Room and via Zoom

from left: Dr Vincenzo Bavoso, Associate Professor Sandra Booysen

On 24 February 2023, the Centre for Banking & Finance Law (CBFL) at NUS Law hosted the seminar, "Debt Capital Markets, the Genesis of Crises and the Role of Regulation", by Dr Vincenzo Bavoso, Senior Lecturer at the University of Manchester. The seminar was moderated by CBFL's Deputy Director, Associate Professor Sandra Booysen, and was conducted both in person and online via Zoom.

Debt Capital Markets and the Genesis of Crises

The seminar cast light on the causal links between abuses of debt capital markets and the financial crises of the last three decades. Dr Bavoso illustrated the importance of this question by drawing attention to the exponential growth of debt capital markets since the 1980s. He traced the trend of increasing total debt issuance over recent years, particularly since 2014, when the lessons of the 2008 financial crisis appear to have receded in the minds of policymakers. He pointed out that global debt has since reached massive levels, outpacing world gross domestic product (GDP) growth.

In contextualising the discussion, Dr Bavoso contrasted these recent decades with the period following the New Deal, which ushered in over five decades of relative financial peace, and demonstrated the importance of law and regulation. He argued that from the 1970s, however, there has been a transformation of the financial markets, encompassing two main developments: the liberalisation of markets, and innovation in products. These were facilitated by a changing intellectual orthodoxy and enabling regulatory frameworks. This changing nature of financial markets in the 1980s was reflected in new products and transactions (such as the surge in junk bonds) and a sharp increase in risk-taking (including through regulatory arbitrage). It corresponded with a new era of financial instability that saw a number of crises and shocks, from Black Monday of 1987 to the "Panic" of 2020. In light of these developments, the contention of the seminar was that capital markets, as they have evolved along the lines of debt transactions, have become the main source of financial instability and crises.

A Taxonomy of Crises

To address the central contention of the seminar, Dr Bavoso put forward a taxonomy of crises and manias. He drew on Minsky's financial instability hypothesis to illustrate how excessive credit supply can lead to instability. With pro-cyclical supply of credit by financial institutions, optimism leads to expansion of the credit supply. Lenders become less cautious; the level of borrowing increases; and asset prices rapidly increase. When asset prices increase at a higher rate than GDP, asset bubbles form. Once the economic cycle shifts, defaults are likely on debt contracts entered into during the boom period, given their riskiness; and in a self-reinforcing dynamic, financial institutions are likely to adjust their lending terms and withdraw from riskier investments. Asset prices fall drastically because investors exposed to short-term payments are forced to sell their assets in order to make payment.

Dr Bavoso argued that the key to understanding instability is that it is cyclical and endogenous – driven by financial institutions' behaviour, and originating within the financial system. It begins with a euphoric period, driven by optimism and a will to innovate. Speculative fevers are likely to develop in this period due to a wider availability of financial arrangements, and the belief that interest payments on debt are lower than profits from assets. However, after levels of indebtedness soar, credit conditions worsen due to underlying defaults. Dr Bavoso drew links, therefore, between euphoria, innovation, debt, and instability.

Conceptualising Financial Innovation

He then focused particularly on financial innovation, that together with light regulation, have been chief driving forces for the growth of debt capital markets. He pointed out that in principle, financial innovation is welfare neutral; the question, then, is how to distinguish bad financial innovation from good financial innovation. However, over the past forty years, it appears that a dark side has emerged. Financial innovation has appeared to proceed with little consideration for social welfare goals. Dr Bavoso questioned why there has been an acceptance of this style of market-based financial innovation, when regulatory and policy questions warrant a more precise definition of social benefits of financial innovation vis-à-vis its risks. He pointed out that the justification for facilitating financial innovation rests on the neoclassical idea of efficiency; yet, empirically, this has not been thoroughly proved. Deep debt markets have been hailed as an ideal platform for risk diversification and capital allocation, and innovation in debt markets has created huge amounts of leverage; however, questions remain as to whether these levels of leverage are indeed optimal for banks or conducive to market discipline.

Dr Bavoso suggested that this impact of financial innovation in debt capital markets was possible due to changes in the regulatory environment since the 1980s. Such changes facilitated, among other consequences, the emergence of the megabanks and universal banks behind innovation processes; the legalisation of speculation through the liberalisation of derivatives; and a more prominent role for private ordering in regulatory discourses. Additionally, technological advancements are also at the heart of any process of financial innovation, with the FinTech phenomenon being the latest stage of the symbiosis between technology and finance. However, it is essential to assess the ultimate functions, aims and merits of new-FinTech based processes, as well as the risks they pose to systemic stability.

Dr Bavoso highlighted that the traditional goal of financial innovation is to maximise the effectiveness of resource allocation, risk sharing and risk diversification – with the function of the innovated product being closely linked to the commercial reality (such as in the cases of factoring or the floating charge). However, he found it difficult to reconcile the last wave of financial innovation with this fundamental goal. He illustrated this point by reference to the examples of financial innovation in derivatives and securitisation, discussing in particular the "alchemy" of special-purpose vehicles (SPVs), a key component of financial innovation since the 1980s.

In conclusion, Dr Bavoso emphasised the importance of developing a conceptual framework of crises. He pointed out that the ferment of finance is never asleep, from the new wave of financial innovation post-2008, to "cryptomania", to increasing levels of private debt. He argued that the role of law and regulation therefore needs to be much more central in attenuating the dynamics of financial cycles and creating financial peace.

The seminar closed with an animated question-and-answer session. Issues raised included: the risk outlook given the present rising interest rate environment; the extent to which derivatives markets might be the locus of crises; the role of central banks, especially in flooding markets with liquidity and indirectly contributing to rising inflation; the efficacy of regulation and regulatory reforms, given the industry's creativity in structuring products around regulation; improving access to credit in developing countries without current abuses of debt capital markets; and differing approaches to financial innovation and regulation in Anglo-American jurisdictions, as compared with Asian jurisdictions like China and Singapore.

Dr Bavoso is currently completing a monograph on the law, regulation and policy of debt capital markets. The issues raised in this seminar will be discussed in one chapter of the monograph, which is forthcoming with Oxford University Press.