Has the Development of the structured Credit Market affected the Cost of Corporate Debt?

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What Happened?

- In the 1990s emergence of credit derivatives, the notational value of which is massive.
- Not the only thing that was happening: also explosive growth of loan sales

In this paper

- "Has the development of this market been associated with a reduction in the cost of debt financing?"
- Matched samples

- Three states, $\{s_1, s_2, s_3\}$ with state prices $\{\pi_1, \pi_2, \pi_3\}$
- Suppose the firm has cash flows of $\{1, 2, 3\}$
- Value of the firm is determined by the state prices
- No combination of promised payment tomorrow affects the firms' value

- Changes in price of debt or equity depending on the value of the claim, but no change in the sum of the two.
- Suppose someone else offered a contract that pays off in a particular state $\Longrightarrow$ no effect on the value of the firm, or on the value of debt.

Why?

- Why did this market arise ?
- What friction or cost was eliminated?

Frictions?

- "A firm that has a trading CDS in essence has given investors added opportunities to diversify their exposure to the firm,"
- If this is true, then investors were undiversified before $\Longrightarrow$ difficult to understand why?
  - Systematic Risk?
  - Equity values $\Downarrow$ put options

What frictions?

1. Cost to replicate debt contracts suddenly reduced.
2. Cost to access the market? (relative price of equity markets would be important)
3. Moral hazard in loans ? (Whole value of the firm would have changed)

Matched What?

- Corporate has trouble identifying why firms have particular capital structure
  - Probably difficult to identify what causes changes
- What are the appropriate dimensions along which to match the samples?
- Very Dangerous to use book/market as a proxy for Q

Suggestions

- Why should the introduction of the CDS have an effect?
  1. Constraint faced by the market that is now relaxed. For example, a fixed cost of buying corporate bonds
  2. Increase in a Constraint faced by the firms in issuing bonds (now issued privately)

- A few theory working papers that might be of interest.