It’s Not (Just) The Banks

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Bank/capital view vs. risk premium/security view

Bank Capital View

Want to borrow, make loans; can’t because undercapitalized and “debt overhang”

Risk premium view

Banks don’t want to lend.

JC: The government guarantees your debt, and injected lots of capital. Why isn’t BofA Lending?
BofA: We didn’t want the capital, we had plenty. We don’t lend and hold. We lend to sell. Noone wants to buy (securitized) loans.

JC: Why not buy debt at these high yields? Various: “We’re selling everything” “It’s all in private equity” “I’m just an equity guy” “all our clients are panicked”
Bank/capital vs. risk premium: Evidence

1. Credit spread is huge, for non-intermediated, non-financial borrowers
2. “Fixing” bank credit spread did nothing to the other rates
Bank/capital vs. risk premium: Evidence

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2. “Fixing” bank credit spread did nothing to the others
3. Banks paying dividends, buying other banks rather than lend.
4. Banks can and did raise capital, despite “overhang”
   - $590b loss, $432b capital raised before Treasury (Bloomberg)
   - Citigroup alone raised $71b capital, $61b writedowns.
5. Banking system debt is small (20% flow of funds), steady (H8)
6. Mortgage and other debt declines sharply ($669.8b 2007 $80.8b Q2 2008)
7. Securitized debt declines
Global CLO Issuance
1Q1999 - 3Q2008YTD

Note: 3Q2008YTD issuance is through September 4, 2008
Source: Thomson Financial SDC New Issues Database
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>> Decline, “frozen market” is in securitized lending not bank lending
>> “Deleveraging,” disappearance is nonbank intermediaries – hedge funds, money market funds, auction-rate, SIVs etc.

Big Question: Is “Fear,” risk aversion real or is it because intermediaries of securitized debt have vanished?

Is there a “wedge,” but not in the banks?
Saving Banks Investment Deposits, Debt Loans Equity

Investment Banks Saving

Banks, Brokers, other originators

SIV, CDO, CLO, ABS, Hedge fund, Money market funds, Investment banks

Pension fund, Insurance co., Endowment, High wealth individual.
We’re asking for a large disintermediation
Is this “risk aversion”?

Investment

Loan, simple securities

Pension fund, Insurance co., Endowment, High wealth individual.

SIV, CDO, CLO, ABS, Hedge fund, Money market funds, Investment banks

Banks, hold on books

Much more equity, debt
Risk premium and securitized debt: the future

• If it’s just “risk aversion”, it can pass quickly. “Fix?”
• If it’s probability of default, ?
• If “risk aversion” comes from non-bank disintermediation
  • Eventual financial system is healthier
  • How do we get there? No quick fixes.
• Contagion of bailouts, regulation, regulatory uncertainty, debt, inflation could make things much worse