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# Downunder Daily

## Undisintermediation

**Securitization and disintermediation have grown hand-in-hand through the past two decades and have been important to the leveraging-up process that has supported asset markets.** The stress in credit markets may, at least for a while, signal a set-back in these two trends.

Securitizing loans – initially mortgages, but subsequently almost anything – offered a number of advantages to traditional lenders, most importantly it freed up capital to make more loans and the fees they generate. But once it became clear that a loan didn't need to stay on a balance sheet, it likewise became clear that you didn't need a balance sheet to make a loan. Hence, the securitization process opened up the door to a range of non-bank intermediaries, or for potential borrowers to directly tap capital markets.

There was a second factor at work encouraging securitization: banks and other deposit-taking institutions needed an alternative source of funding to deposits. That's because in a world of falling household saving, there were fewer deposits for intermediaries to intermediate.

Exhibit 1, from colleague David Greenlaw, shows the substantial disintermediation of traditional lenders in the US. It shows the percentage of private sector debt intermediated through deposit-taking institutions versus security markets. Exhibit 2 shows the share of domestic commercial banks' lending funded by deposit growth. Through the past 15 years deposits have grown fast enough to fund only 62% of commercial banks' loan growth.

Exhibit 1
### Credit Intermediation

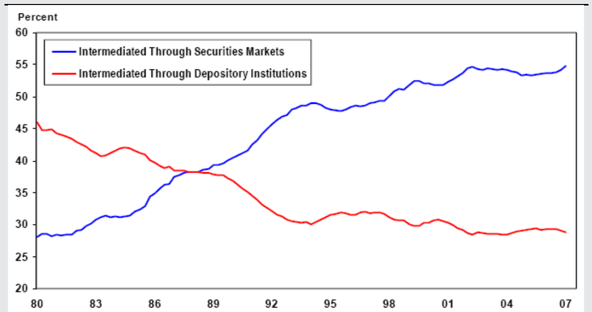
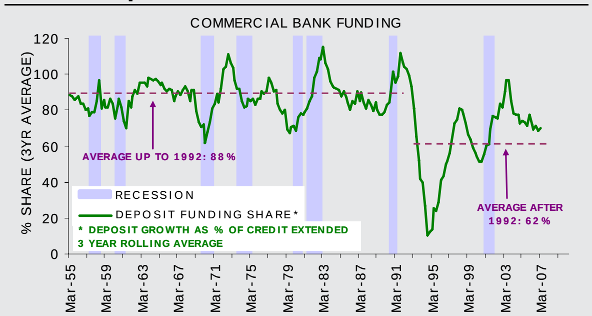



Chart shows share of private non-financial debt outstanding
Source: David Greenlaw, Federal Reserve; Morgan Stanley Research

Exhibit 2
### Fewer Deposits To Lend

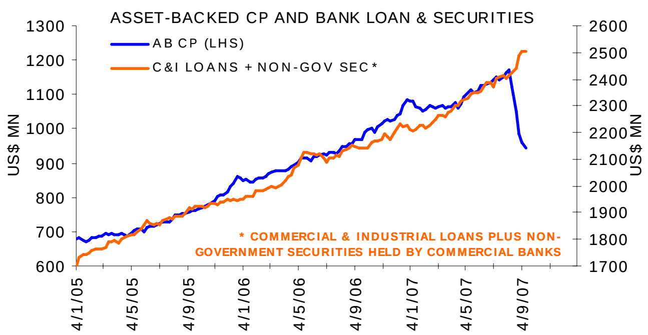



Source: Federal Reserve; Morgan Stanley Research

The rise of securitization has arguably contributed to some of the problems now evident in financial markets. First, the separation of loan origination from the (debt) asset may have been a factor behind the evident drop in lending standards. Second, the reliance on capital markets, rather than traditional lenders, introduced the risk of a credit crunch originating not with banks, but in capital markets. If markets wouldn't buy the securities, then the lending has to be curbed.

For now, the restraint is tightest in the commercial paper market, specifically the asset-backed CP market. Borrowers that have been using this market for funding now have four choices: 1) pay the higher funding costs (if funds are available); 2) find alternative funding sources – say, from a bank; 3) sell the asset that the borrowing was supporting; or 4) go broke.

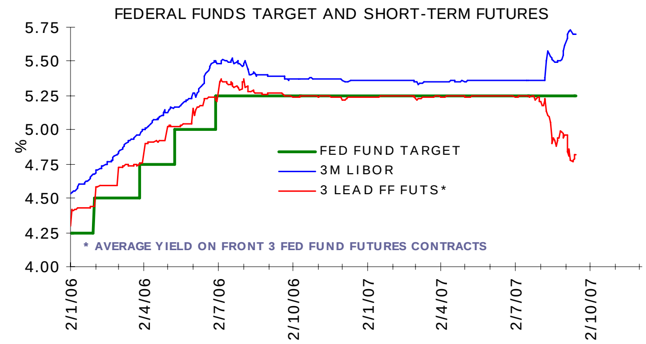
Exhibit 3
**Back On The Balance Sheet?**




Source: Federal Reserve, Morgan Stanley Research

There is a hint that some of the funding may be returning to banks' balance sheets. Exhibit 3 shows that there has been an acceleration in commercial bank commercial lending and their holding of non-government securities. However, the increase in these funds is still far smaller than the decline in ABCP outstanding – which implies that the assets on the other side are being sold or alternative funding sources are being found (including from non-US banks). As those loans are brought back onto the balance sheet, it limits the scope for banks to provide finance elsewhere.

Exhibit 4
**I'm Not Lending It Because I Might Need It**




Source: Bloomberg; Morgan Stanley Research

For now it's unclear how much longer this reintermediation may persist. However, that uncertainty seems to be a factor behind the sharp lift in inter-bank rates: banks are less willing to lend to each other in part because they may need the funds if some outstanding loans get brought back to their balance sheet. Exhibit 4 shows the extreme spread between the 3 month inter-bank rate and both the overnight funds rate and the fed funds futures (which are pricing in easier policy – implying that the rise in LIBOR is not a matter of markets expecting higher funds rate).

In fact, colleague Ted Wieseman has noted an unusual kink in the LIBOR curve, with the 2 week rate at 5.45% and the 1 month at 5.75%. Given this straddles the quarter-end period, it's a hint that banks are aiming to build cash reserves around the quarter-end roll of CP. If the quarter-end passes without incident then short-end rates may start to normalize. But it also seems that while ever the short-end markets continue to show such high risk aversion there remains a higher-than-usual (but hard to calibrate) risk of a borrower running into serious cash-flow difficulties.

What's not clear is how much the current turbulence will set-back the securitization/disintermediation process over the medium term. My hunch is that what we are seeing now is a foretaste of bigger problems that would arise if the US hard-lands, and that that the resultant problems may lead to a material change in these trends.

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|---|---|---|---|---|---|
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