

Two Monetary Tools: Interest-Rates and Haircuts*

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Abstract

We study a production economy with multiple sectors financed by issuing securities to agents who face capital constraints. Binding capital constraints propagate business cycles, and a reduction of the interest rate can *increase* the required return of high-haircut assets since it can increase the shadow cost of capital for constrained agents. The required return can be lowered by easing funding constraints through lowering haircuts. To assess empirically the power of the haircut tool, we study the natural experiment of the introduction of the legacy Term Asset-Backed Securities Loan Facility (TALF). We estimate that the TALF program reduced required returns by more than 0.70% using a triple difference-in-difference regression. Further, unique survey evidence suggests the effect could be more than 3% and provides broader evidence on the demand sensitivity to haircuts.

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“If it is known that the Bank of England is freely advancing on what in ordinary times is reckoned a good security – on what is then commonly pledged and easily convertible – the alarm of the solvent merchants and bankers will be stayed. But if securities, really good and usually convertible, are refused by the Bank, the alarm will not abate, the other loans made will fail in obtaining their end, and the panic will become worse and worse.”

— Bagehot (1873), p. 198.

Financial institutions play a key role as credit providers in the economy, and liquidity crises arise when they become credit constrained themselves. In such liquidity crises, financial institutions’ ability to borrow against their securities plays a key role, as Bagehot points out. In the private markets, it can become virtually impossible to borrow against certain securities, and, more broadly, the “haircuts” (also called “margin requirements”) on many securities increase in crises.¹ Furthermore, security prices dropped significantly, especially for securities with high haircuts. Central banks globally tried to alleviate the financial institutions’ funding problems using monetary policy tools such as interest rate cuts, lending facilities with low haircuts, and asset purchases.

This paper tries to model these effects to shed light on the links between haircuts, required returns, and real activity, and to evaluate the different monetary policy tools. Further, we try to assess empirically how powerful the haircut tool is by estimating how much haircuts affect required returns.

We model a competitive over-lapping generations (OLG) production economy with agents that differ in their risk aversion and face margin requirements. An agent’s margin requirement is simply that the sum of all his securities’ margins/haircuts cannot exceed his capital. While this is a single constraint, it affects securities differently depending on their margin requirements. This is the key constraint for real-world financial institutions. For instance, Bear Stearns, Lehman, and AIG collapsed when they could not meet their margin constraints.

In the model, risk-tolerant agents take levered positions in equilibrium, and, as we will see, they play a role that resembles that of the real-world financial institutions described above. When these levered agents’ margin requirements become binding, equilibrium required returns increase, especially for high-margin assets. This mechanism lowers investment and output, and leads to persistent effects of i.i.d. productivity shocks, thus exacerbating business cycle swings, especially in high-margin sectors. The margin-constraint business cycle is driven by risk-tolerant agents’ wealth as the key state variable, which falls whenever asset values and labor income do. The consequences are disproportionately severe for the high-margin sectors because constrained investors reallocate capital towards assets that can be financed more easily (i.e., levered).

Central banks often fight low real activity by reducing the interest rate to lower the required return on capital. However, one of our central findings is that a reduction in the

¹To understand the meaning of a haircut, suppose that before the crisis, a financial institution could borrow \$98 with a \$100 bond as collateral. The \$2 difference is the lender’s extra margin of safety and is called a 2% haircut. This allows a 50-to-1 leverage. If the haircut went to 20%, the institution would need to finance \$20 of the position with its own capital and could only support a 5-to-1 leverage.

risk-free interest rate can, in fact, *increase* the required return on high-margin assets. To understand why, consider first how the required return is determined in an economy with margin constraints. The required return on a security is its systematic risk (i.e., its CAPM return beta) multiplied by the risk premium, plus its haircut multiplied by the shadow cost of the capital constraint. In normal times — when constraints are not binding — the shadow cost is zero, but during a crisis it can be high.²

What happens when the interest rate is reduced? Outside of financial crisis, this clearly reduces required returns and spurs economic activity in *all* sectors. However, in a crisis during which margin constraints bind, lowering the interest rate increases the shadow cost of capital. This steepens the required return-haircut relation and, thus, can *increase* the required return on high-margin assets and thus *lower* the economic activity in these sectors.

To understand this effect, consider an agent who is already constrained in how levered he can be. If the interest rate is lowered, he feels even more constrained because the low rate increases his desire to borrow. Everything else equal, he will switch to lower-margin securities so that he can increase his leverage, and then the substitution effect increases the equilibrium required return of high-margin assets.

So what can be done when lowering the interest rate does not help high-margin sectors (or when the nominal interest rate is already zero)? As Bagehot points out, the central bank can lend against a wide range of securities and, we might add, at a modest yet prudent haircut. We show that if the central bank decides to accept a particular security as collateral at a lower haircut than otherwise available, this always lowers its required return. The required returns of other securities either all increase or decrease, depending on what happens to the shadow cost of capital. The most intuitive case is that the shadow cost of capital decreases due to the new source of funding, thus helping other securities as well, and we show that this happens when the haircut is reduced sufficiently.

Further, the shadow cost of capital decreases if the margin on enough securities can be lowered. This observation is relevant for the debate about whether central banks should extend their lending facilities to legacy securities or restrict attention to new issues. The Term Asset-Backed Securities Loan Facility (TALF) program was initially focused on newly issued securities, since these imply new credit provided to the real economy. Lowering the haircut on these securities helps reduce their required returns, but does little to ease the overall funding constraints in the financial sector. The legacy TALF program applied to existing securities and therefore had the potential to alleviate the funding problems more broadly — and flatten the haircut-return curve as a result.

Finally, we show that the shadow cost of capital can be reduced through asset purchases or capital injections. Hence, these policy tools also lower required returns and stimulate real activity, but they may be associated with significant longer term costs and risks.

Empirically, we find that central-bank-provided loans at modest haircuts can be a powerful tool for lowering yields and stimulating economic activity. We arrive at this conclusion by studying the introduction of the legacy TALF that provided loans with lower haircuts and

²Gârleanu and Pedersen (2009) report deviations of the Law of One Price corresponding to a shadow cost of more than 10%, consistent with what we here as discussed below.

longer maturity than otherwise available. Yields went down significantly when the TALF program was announced, yields increased when Standard and Poors (S&P) changed their ratings methodology in a way that would make a number of securities ineligible for TALF, and yields went down further when TALF was implemented. While suggestive, this does not provide conclusive evidence since so many other things went on at the same time. We use two approaches to isolate the effect of TALF: (1) We study evidence from a survey conducted in March 2009 (before legacy TALF was introduced) asking market participants about their bid price for securities without TALF, with access to high-haircut TALF loans, and with access to low-haircut TALF loans; and (2) We study market prices adjusting for non-TALF effects using a difference-in-differences approach.

The survey indicated that participants would pay 6% more for a super senior CMBS bond if they had access to a 3-year loan with a high haircut than they would pay if they had no access to term leverage. The bid price was higher for lower haircuts and longer maturities, reaching 50% above the no-TALF bid for the longest-term loan with a low haircut. This provides evidence of significant demand sensitivity to haircuts. To make sure that the higher bid reflects the value of financing, not the value of being able to default on the loan, we focus on super-senior commercial mortgage-backed securities (CMBS), as these are the safest bonds. The participants in the survey were asked to estimate the losses on the pool in a stress scenario, and, even in the stress scenario, the estimated losses on the pool imply no losses on the safest super-senior tranches. We can also express the effect in terms of yields. Without access to term leverage, these securities were valued at a yield of 15% (by the participants and in the market). Having access to a 3-year loan with a low haircut (similar to what was actually implemented in TALF) lowered the required yield to 12%, and for 5-year loans, the implied yield was 9.5%. Hence, according to this survey, low-haircut term leverage similar to TALF had the potential to lower yields by 3-5% for super senior bonds.

The survey evidence is corroborated by transaction-price data. In an attempt to isolate the marginal effect of legacy TALF on prices, we use as an instrument whether a CMBS bond was rated by S&P or only rated by other agencies. We consider a change in S&P's rating methodology, which lead to downgrades that left some bonds ineligible for TALF, thus helping us identify statistically the effect of TALF. The change of methodology was announced a few weeks before being implemented. When it was implemented, the S&P bonds that ended up *not* being downgraded saw their yields go down relative to similar bonds not rated by S&P. In other words, when it was clear that a bond would remain eligible for TALF, its yield went down. This suggests that TALF was priced, but it could potentially also be due to other rating-related effects. To adjust for such other effects, we compare the S&P/ non-S&P yield spread for so-called A2 CMBS bonds, well suited for the TALF program, to that of A1A CMBS bonds, which were not well suited for TALF. We estimate that the increased likelihood of TALF eligibility led to a yield reduction of 70 basis point for the A2 bonds, controlling for other effects. The full effect of TALF on these bonds is likely much larger for several reasons: First, TALF had already been announced and the bonds already seemed likely to be eligible before the S&P action. Second, we are controlling

for the yield change of other bonds that we not directly affected by TALF. However, our theory suggests that TALF could flatten the haircut-return curve for all the bonds, and this effect is removed by our difference-in-differences approach. (We only capture the effect of moving the A2 bonds down the haircut-return curve.)

Our evidence suggests that the haircut tool is a powerful one, consistent with our model. To put the magnitude in perspective, recall that the Fed lowered the Fed funds rate from 5.25% in early 2007 all the way to the zero lower bound (0-0.25%), a 5% reduction. Since we estimate that TALF lowered CMBS yields by well in excess of 0.70%, perhaps around 3%, it appears to be a very powerful tool.

Our paper is related to several large literatures. Borrowing constraints of entrepreneurs and firms affect business cycles and collateral values (Bernanke and Gertler (1989), Bernanke, Gertler, and Gilchrist (1998), Detemple and Murthy (1997), Geanakoplos (1997, 2003), Kiyotaki and Moore (1997), Caballero and Krishnamurthy (2001), Lustig and Van Nieuwerburgh (2005), Coen-Pirani (2005), and Fostel and Geanakoplos (2008)).³

Rather than focusing on borrowers' "balance sheet effects" (or "credit demand" frictions), we consider the lending channel (or "credit supply" frictions), following Holmström and Tirole (1997), Repullo and Suarez (2000), and Ashcraft (2005). The impact on the macroeconomy of financial frictions has been further studied recently by Kiyotaki and Moore (2008), Adrian and Shin (2009), Gertler and Karadi (2009), Gertler and Kiyotaki (2009), Cúrdia and Woodford (2009), Reis (2009), and Adrian, Moench, and Shin (2009). Also, Lorenzoni (2008) shows that there can be inefficient credit booms due to fire-sale externalities with credit constraints.

Our asset-pricing implications are related to Hindy (1995), Cuoco (1997), Aiyagari and Gertler (1999), and especially Gârleanu and Pedersen (2009). Required returns are also increased by transaction costs and market-liquidity risk (Amihud and Mendelson (1986), Longstaff (2004), Duffie, Gârleanu, and Pedersen (2005, 2007), Acharya and Pedersen (2005), Mitchell, Pedersen, and Pulvino (2007), and He and Krishnamurthy (2008)). Market liquidity interacts with margin requirements as shown by Brunnermeier and Pedersen (2009), who also explain why margin requirements tend to increase during crises because of liquidity spirals, a phenomenon documented empirically by Adrian and Shin (2008) and Gorton and Metrick (2009a, 2009b).

We complement the literature by generating cross-sectional predictions in a multi-sector model with credit supply frictions due to margin constraints, by showing how interest rate cuts may be ineffective for high-margin assets during crises, and evaluating the effect of another monetary tool — haircuts — theoretically and empirically.

Given the central role of haircuts in the paper, one may wonder whether this is a special institutional feature of passing importance. To the contrary, we would argue that loans secured by collateral with a haircut have played an important role in facilitating economic activity for thousands of years. For instance, the first written compendium of Judaism's Oral Law, the Mishnah, states:

³See also the related literatures in corporate finance and banking, Shleifer and Vishny (1992), Holmström and Tirole (1998, 2001), and Allen and Gale (1998, 2004, 2005).

*“One lends money with a mortgage on land which is worth more than the value of the loan. The lender says to the borrower, ‘If you do not repay the loan within three years, this land is mine.’”*⁴

— Mishnah Bava Metzia 5:3, circa 200 AD.

The rest of the paper is organized as follows. Section 1 lays out the model, Section 2 derives the economic dynamics and effects of haircuts and interest rate cuts, Section 3 presents the empirical evidence, and Section 4 concludes.

1 Model

We consider a simple overlapping-generations (OLG) economy where firms and agents interact at times 0, 1, 2,... At each time t , J new young (representative) firms are started and there are J old firms that were started during the previous period $t - 1$. Old firm j produces output Y_t^j depending on its capital K_t^j , labor use L_t^j , and productivity A_t^j , which is a random variable. The output is

$$Y_t^j = A_t^j F_i(K_t^j, L_t^j), \quad (1)$$

where $F_i(K_t^j, L_t^j) = (K_t^j)^\alpha (L_t^j)^\beta$ is a Cobb-Douglas production function with $\alpha + \beta \leq 1$. The productivity shocks A_t^j have mean $\bar{A}^j$ and variance-covariance matrix Σ_A . Each type of firm uses its own specialized labor with wage w_t^j . Given the wage, firm j chooses its labor demand to maximize its profit $\bar{P}$:

$$\bar{P}(K_t^j, A_t^j, w_t^j) = \max_{L_t^j} A_t^j F_i(K_t^j, L_t^j) - w_t^j L_t^j \quad (2)$$

Each young firm invests I_t^j units of output goods, which become as many units of capital the following period: $K_{t+1}^j = I_t^j$. Capital cannot be redeployed once productivity shocks are realized — in effect, it is specific to a type of firm (and depreciates fully each period as in Bernanke and Gertler (1989)).⁵ The firm chooses investment to maximize its present value, which is computed using the pricing kernel ξ_{t+1} :⁶

$$\max_{I_t^j} E_t \left(\xi_{t+1} \bar{P}(I_t^j, A_{t+1}^j, w_{t+1}^j) \right) - I_t^j. \quad (3)$$

⁴The Talmud provides further detail on how the haircut should be treated in the event of default:

“ Rav Huna: If this condition was made when the money was given, then it is binding, even if the field is worth more than the loan. If the condition was made after the money was given, then the borrower can only take the portion of the land equivalent to the value of the loan.”

— Babylonian Talmud Bava Metzia 66a-66b.

⁵If depreciation is only partial and disinvestment is costless following production, then the results are qualitatively the same.

⁶Since markets are incomplete, different types of agents may employ different pricing kernels, but since they agree on the current price of the firm they also agree on the optimal investment policy.

Each young firm j issues shares in supply θ^j , which we normalize to $\theta^j = 1$ in most of the paper. These shares represent a claim to the firm's profit $\bar{P}_{t+1}^j$ next period, $t+1$. The shares are issued at a price of $P_t^j = E_t(\xi_{t+1} \bar{P}(I_t^j, A_{t+1}^j, w_{t+1}^j))$. (Note that we use the notation P_t^j for the price of a young firm at time t and $\bar{P}_{t+1}^j$ for the price of the same firm when old.) The firm uses the proceeds from the sale to invest the I_t^j units of capital. The balance (which we show to always be non-negative) $P_t^j - I_t^j$ represents a profit to the initial owners of the technology.

Each time period, young agents are born who live two periods. Hence, at any time, the economy is populated by young and old agents. Agents differ in their risk aversion; in particular, a agents have a high risk aversion γ^a , while b agents have a lower risk aversion γ^b .

All agents are endowed with a fixed number of units of labor for each technology and part of the technology for new firms. Specifically, a young agent (or "family") of type $n = a, b$ inelastically supplies η^n units of labor to each type of firms, where the total supply of labor is normalized to 1, $\eta^a + \eta^b = 1$, and owns a fraction ω^n of each of the young firms. At time t , a young agent $n \in \{a, b\}$ therefore has a wealth W_t^n which is the sum of his labor income and the value of his endowment in technologies

$$W_t^n = \sum_j w_t^j \eta^n + \sum_j (P_t^j - I_t^j) \omega^n. \quad (4)$$

Agents have access to a linear (risk-free) saving technology with net rate of return r^f and choose how many shares θ to buy in each young firm. Depending on an agent's portfolio choice, his wealth evolves according to

$$W_{t+1} = W_t(1 + r^f) + \theta^\top (\bar{P}_{t+1} - P_t(1 + r^f)). \quad (5)$$

Shares in asset j are subject to a margin requirement m_t^j , which limits the amount that can be borrowed using one share of asset j as a collateral to $P_t^j(1 - m_t^j)$. We can think of haircuts/ margin requirements as exogenous or as set as in Geanakoplos (2003). Hence, each agent must use capital to buy assets and is subject to the margin requirement

$$\sum_j m_t^j |\theta^j| P_t^j \leq W_t^n. \quad (6)$$

The agents derive utility from consumption when old and seek to maximize their expected quadratic utility:⁷

$$\max_{\theta} E_t(W_{t+1}) - \frac{\gamma^n}{2} \text{var}(W_{t+1}). \quad (7)$$

An equilibrium is a collection of processes for wages w_t and pricing kernels ξ_t so that markets clear.

⁷The results do not rely on this utility function. Indeed, preferences are mainly used below to derive the required return as a margin CAPM, and an almost identical margin CAPM relationship is derived with constant relative risk aversion in continuous-time in Gârleanu and Pedersen (2009), and with general convex constraints and general preferences in Cuoco (1997).

1.1 Haircuts, Credit Supply, and the Required Return

To solve for the equilibrium, we first take the firms' investments as given and solve for the agents' optimal portfolio choice and the equilibrium required return. Agent n 's portfolio choice problem can be stated as

$$\max_{\theta} W_t(1 + r^f) + \theta^\top (E_t(\bar{P}_{t+1}) - P_t(1 + r^f)) - \frac{\gamma^n}{2} \theta^\top \Sigma_t \theta, \quad (8)$$

where $\Sigma_t = \text{Var}_t(\bar{P}_{t+1})$. The first-order condition is

$$0 = E_t(\bar{P}_{t+1}) - P_t(1 + r^f) - \gamma^n \Sigma_t \theta - \psi_t D(m) P_t, \quad (9)$$

where ψ_t is a Lagrange multiplier for the margin constraint, and $D(\cdot)$ makes a vector into a diagonal matrix.⁸ Hence, the optimal portfolio is

$$\theta_t^n = \frac{1}{\gamma^n} \Sigma_t^{-1} (E_t(\bar{P}_{t+1}) - P_t(1 + r^f) - \psi_t D(m) P_t). \quad (10)$$

Market clearing means that the total supply $\bar{\theta}$ equals the sum of the demand by a and b :

$$\bar{\theta} = \theta_t^a + \theta_t^b \quad (11)$$

which implies that

$$\bar{\theta} = \frac{1}{\gamma} \Sigma_t^{-1} (E_t(\bar{P}_{t+1}) - P_t(1 + r^f)) - \psi_t \frac{1}{\gamma^b} \Sigma_t^{-1} D(m) P_t \quad (12)$$

where we use the notation γ as the representative agent's risk aversion,

$$\frac{1}{\gamma} = \frac{1}{\gamma^a} + \frac{1}{\gamma^b}. \quad (13)$$

and ψ_t is agent b 's Lagrange multiplier. We assume that we are in the natural case in which the risk averse agent is unlevered and therefore has a zero Lagrange multiplier. (This arises naturally with endogenous interest rates, see Gârleanu and Pedersen (2009).) We also let $x = \frac{\gamma}{\gamma^b}$.

These calculations yield the equilibrium price

$$P_t = D(1 + r^f + \psi x m)^{-1} (E_t(\bar{P}_{t+1}) - \gamma \Sigma \bar{\theta}). \quad (14)$$

Prices can be translated into returns $r_{t+1}^j = \bar{P}_{t+1}^j / P_t^j - 1$, giving rise to a modified CAPM. To state such a result, we let $r_{t+1}^{mkt} = q_t' r_{t+1}$ be the market return, where $q_t^i = \left(\sum_j \theta^j P_t^j \right)^{-1} \theta^i P_t^i$ is the market-capitalization weight of asset i , and define the market beta in the usual way, i.e., $\beta_t^j = \text{cov}_t(r_{t+1}^j, r_{t+1}^{mkt}) / \text{var}_t(r_{t+1}^{mkt})$.

⁸For any vector $v \in \mathbb{R}^J$, $D(v)$ is a diagonal $J \times J$ matrix with (i, i) entry v_i .

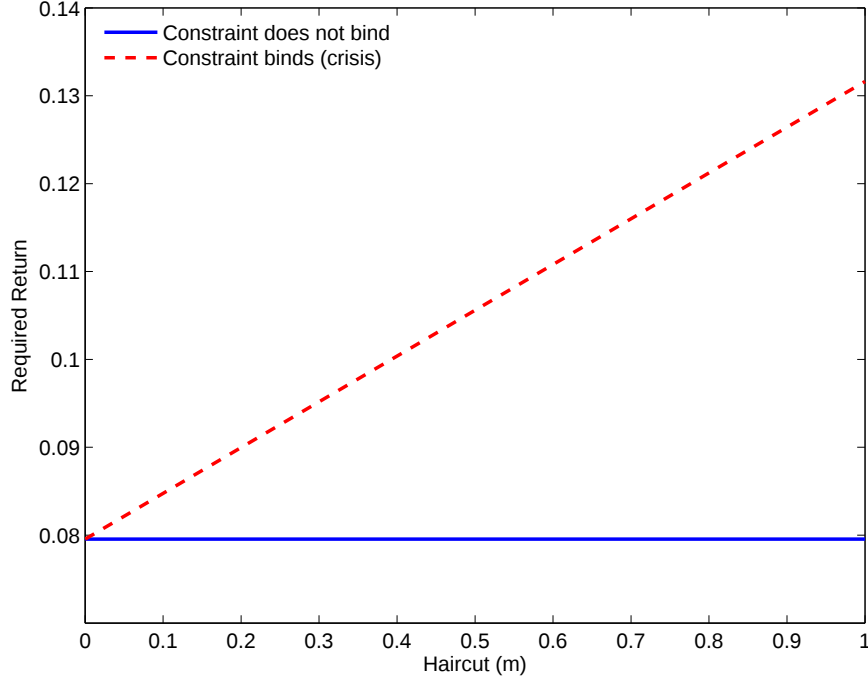


Figure 1: Required Return Increases in the Margin Requirement (or Haircut).

Proposition 1 (Margin CAPM) *The required return on security j depends on its market beta and its margin requirement:*

$$E_t(r_{t+1}^j) - r^f = \lambda_t \beta_t^j + m_t^j \psi_t x, \quad (15)$$

where the market risk premium is $\lambda_t = E_t(r_{t+1}^{mkt}) - r^f - \left(\sum_j m_t^j q_t^j\right) \psi_t x$, m_t^j is the margin requirement on asset j , and ψ_t is the shadow cost of agent b 's margin constraint.

The positive relation between the required return and beta is a central principle in finance (called the “security market line”). With margin constraints, the required return also depends on the margin requirement when constraints are binding, since the risk-tolerant agents cannot hold as many securities as they would otherwise. Importantly, the effect of the constraint differs in the cross-section of assets: Assets that have high haircuts/margins use a lot of the investors’ capital and, therefore, are associated with higher required returns.

Example. Figure 1 illustrates graphically the dependence of the required return on haircuts (the “haircut-return line”) when the constraint is slack, as well as when it binds. In the former case, the haircut levels do not affect the required returns, but when the constraint binds, i.e., during crises, the required return increases with the haircut.

The figure depicts the solution to the model with parameters described as follows. In next sections, we consider a number of other economic properties with the same parameters. All

firms have production-function parameters $\alpha = 0.3$ and $\beta = 1 - \alpha = 0.7$, and productivity shocks are identically distributed and independent with $\bar{A} = 3.3$ and $\Sigma_A = 0.67$. There are 40 firms with relatively low haircut levels ($m = 0.1$), and 10 more firms with evenly spaced haircuts $m \in \{0.1, 0.2, \dots, 1\}$. We assume that the absolute risk-aversion coefficients of the two agents are $\gamma^a = 28.5$ and $\gamma^b = 1.5$. In the “crisis” state when b is constrained, we set his wealth to $W^b = 7.7$, and the “non-crisis” state captures any wealth level $W^b > 8.09$. Finally, the base-case interest rate is $r^f = 0.02$.

1.2 Investment, Income, and Output

Now we turn to the firm’s optimal labor choice and investment. First, when the old firm j optimizes over its labor choice L_t^j , we get the first order condition

$$\beta_j A_t^j (K_t^j)^\alpha (L_t^j)^{\beta-1} = w_t^j. \quad (16)$$

Given that 1 unit of labor is supplied inelastically, the equilibrium wage is

$$w_t^j = \beta_j A_t^j (K_t^j)^\alpha, \quad (17)$$

since it gives rise to a labor demand of $L_t^j = 1$. Importantly, a lower capital stock K — due to a lower investment in the previous period — results in lower wages, a phenomenon that plays an important role in the later analysis.

When young, the firm chooses its optimal investment I_{t-1}^j in a competitive environment and hence takes the wage at time t as given. Hence, to solve the young firm’s investment problem at time $t - 1$, consider first the optimal labor choice when the firm arrives at time t with a capital of I_{t-1}^j , while wages are set based on capital at time K_t^j (due to the “other” firms of this type so not necessarily equal to investment, although $I_{t-1}^j = K_t^j$ in equilibrium):

$$L_t^j = \left(\frac{\beta_j A_t^j (I_{t-1}^j)^\alpha}{w_t^j} \right)^{\frac{1}{1-\beta}} \quad (18)$$

$$= \left(\frac{\beta_j A_t^j (I_{t-1}^j)^\alpha}{\beta_j A_t^j (K_t^j)^\alpha} \right)^{\frac{1}{1-\beta}} \quad (19)$$

$$= (I_{t-1}^j)^{\frac{\alpha}{1-\beta}} (K_t^j)^{-\frac{\alpha}{1-\beta}} \quad (20)$$

Equation (16) shows that the profit is a fraction $1 - \beta$ of the output (due to the Cobb-Douglas production function), so the profit is

$$(1 - \beta) A_t^j (I_{t-1}^j)^\alpha (L_t^j)^\beta = (1 - \beta) A_t^j (I_{t-1}^j)^{\frac{\alpha}{1-\beta}} (K_t^j)^{-\frac{\alpha\beta}{1-\beta}}, \quad (21)$$

which gives the young firm’s investment problem as

$$\max_{I_t^j} \left\{ (1 - \beta_j) E_t \left[\xi_{t+1} A_{t+1}^j (I_t^j)^{\frac{\alpha_j}{1-\beta_j}} (K_{t+1}^j)^{-\frac{\alpha_j\beta_j}{1-\beta_j}} \right] - I_t^j \right\}. \quad (22)$$

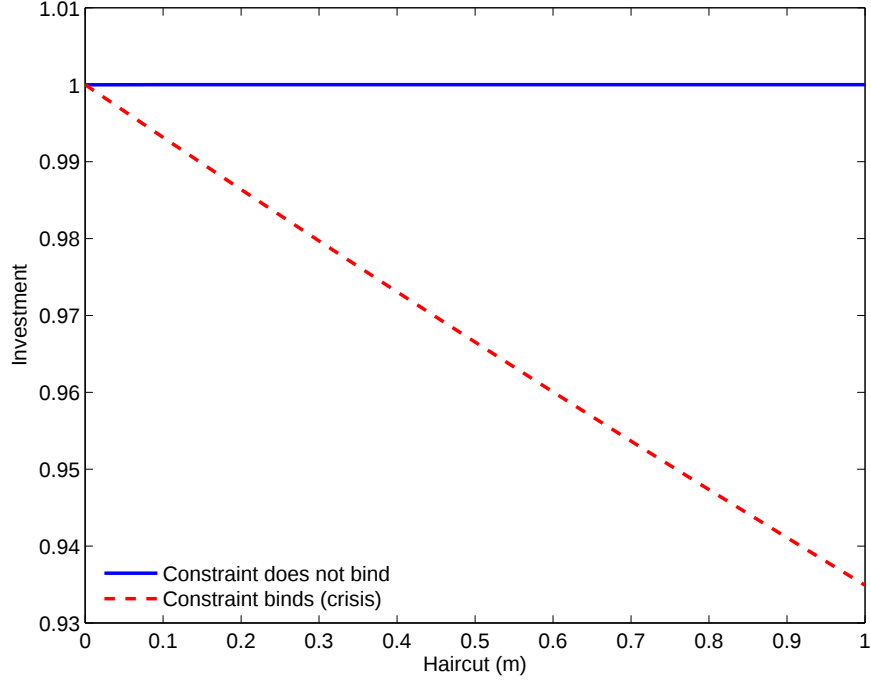


Figure 2: Less Real Investment in High-Margin Sector when Constraints Bind.

The first-order condition is

$$\frac{\alpha_j}{1 - \beta_j} (1 - \beta_j) E_t \left[\xi_{t+1} A_{t+1}^j (I_t^j)^{\frac{\alpha_j}{1 - \beta_j} - 1} (K_{t+1}^j)^{\frac{-\alpha_j \beta_j}{1 - \beta_j}} \right] = 1, \quad (23)$$

which implies

$$P_t^j = \frac{1 - \beta_i}{\alpha_i} I_t^j \geq I_t^j. \quad (24)$$

A direct implication is that the firm's initial value (before the shares are issued) is non-negative.

In equilibrium, $I_t^j = K_{t+1}^j$, so that (23) yields

$$I_t^j = \alpha_j^{\frac{1}{1 - \alpha_j}} (E_t [\xi_{t+1} A_{t+1}^j])^{\frac{1}{1 - \alpha_j}}. \quad (25)$$

Investment decisions determine profits (i.e., the value of old firms), whose moments can be calculated explicitly given that $\bar{P}_{t+1}^j = (1 - \beta) A_{t+1}^j (I_t^j)^\alpha$:

$$E_t [\bar{P}_{t+1}^j] = (1 - \beta) \bar{A}^j (I_t^j)^\alpha \quad (26)$$

$$\Sigma_t = (1 - \beta)^2 D(I_t^\alpha) \Sigma_A D(I_t^\alpha). \quad (27)$$

In turn, these moments determine the required return as discussed in Section 1.1. Hence, combining (26)–(27) with (14) gives the equation that determines investment:

$$(1 + r^f + \psi_t x m) \frac{1}{\alpha} = D(I_t^{\alpha-1}) E_t(A_{t+1}) - \gamma(1 - \beta) D(I_t^{\alpha-1}) \Sigma_A I_t^\alpha. \quad (28)$$

To see the intuition behind this formula, consider as an example the case when productivity shocks are independent across firms and $\alpha = 1/2$. Under these assumptions,

$$(I_t^j)^{1/2} = \frac{\frac{1}{2} E_t(A_{t+1}^j)}{1 + r^f + \gamma \frac{1-\beta}{2} \text{var}_t(A_{t+1}^j) + \psi_t x m_t^j}. \quad (29)$$

Naturally, investment increases in expected productivity $E_t(A_{t+1}^j)$ and decreases in productivity risk $\text{var}_t(A_{t+1}^j)$. Further, investment decreases when the required return is elevated by ψ due to investors' binding margin constraint, especially for assets with high margin requirements m_t^j . This cross-sectional effect is illustrated in Figure 2.

2 Haircuts, Business Cycles, and Monetary Policy

We now turn to the model's economic properties. The model is set up to generate no business cycles in the absence of the credit frictions. However, when the margin constraints of the risk-tolerant agents become binding, required returns increase and business cycles arise.

Proposition 2 (Margin-Constraint Accelerator) *Absent margin constraints, output is independent over time. With margin constraints, output, income, investment, consumption, wages, and required returns are correlated over time. The correlation is due to the propagation of a productivity shock sufficiently severe to make the risk-tolerant investors' margin requirement bind: binding constraints raise the required return, reducing real investment, which reduces the following period's expected output and income, which in turn makes the financing constraint harder to satisfy, and so on.*

The margin-constraint-driven business cycles is propagated through the persistent effect on the wealth of the risk-tolerant agents. As seen in Figure 3, lower real investment reduces labor income and the value of technologies, leading to lower real investment in the future, until the risk tolerant agents are recapitalized.

Next, we consider the effect of a reduction in interest rates. While, in New Keynesian models, monetary policy acts through a reduction in the nominal interest rate, which in turn reduces the real rate because of sticky prices, we take a short-cut and consider the effect of reducing the real rate directly. To concentrate on the margin constraint as the only channel through which different assets interact, we assume throughout this section that productivity shocks are independent in the cross section and that the constraint is binding at time t .

Proposition 3 (Interest-Rate Cuts) *Consider a cut in the current interest rate r_t^f . Then there exists a cutoff value $\bar{m}_t \in (0, 1]$ such that the required return on asset i decreases, and*

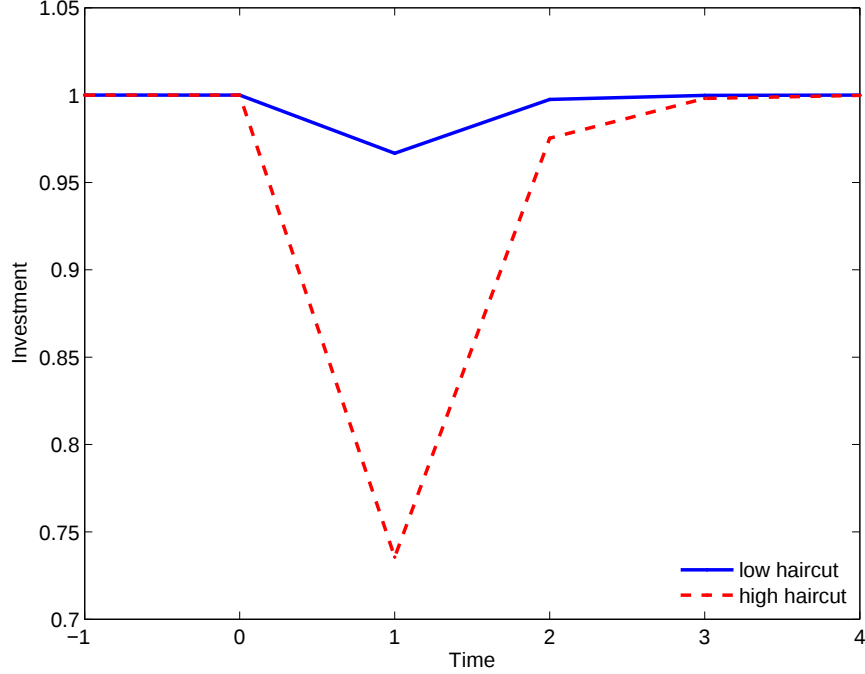


Figure 3: Real Investment Following a Shock that Makes Margin Requirements Bind.

investment I_t^i increases, if and only if $m_t^i \leq \bar{m}_t$. In addition, if agents are sufficiently risk averse, then the interest-rate cut increases the shadow cost of capital ψ_t and $\bar{m}_t < \max_i m_t^i$, meaning that the required return of high-haircut assets increases.

The effect of an interest rate cut is illustrated in Figure 4. A reduction in the interest rate lowers the required return for assets with low margin requirements, but it increases the required return for high-margin assets. This outcome obtains because risk-tolerant investors' desire for leverage increases with the lower interest rate, elevating the shadow cost of capital. The higher shadow cost of capital increases the required return, and this effect overwhelms the direct effect of the interest rate cut for high-haircut assets. As a result, the real investment and output decrease in high-margin sectors.

Hence, to increase investment and output in illiquid, i.e., high-haircut, sectors, a central bank needs to either move them down the haircut-return curve, or flatten the entire curve. Said differently, it needs to either (a) target these assets to make them more liquid, or (b) improve the overall liquidity of the system:

Proposition 4 (Haircut Cuts) (a) *If the margin requirement on asset j is reduced, then the required return for that asset decreases and real investment in the asset increases. The real investments in other assets either all increase or all decrease.*
(b) *The real investment in all assets increases if m_t^j is decreased sufficiently or if the haircuts on sufficiently many assets are decreased by a given fraction.*

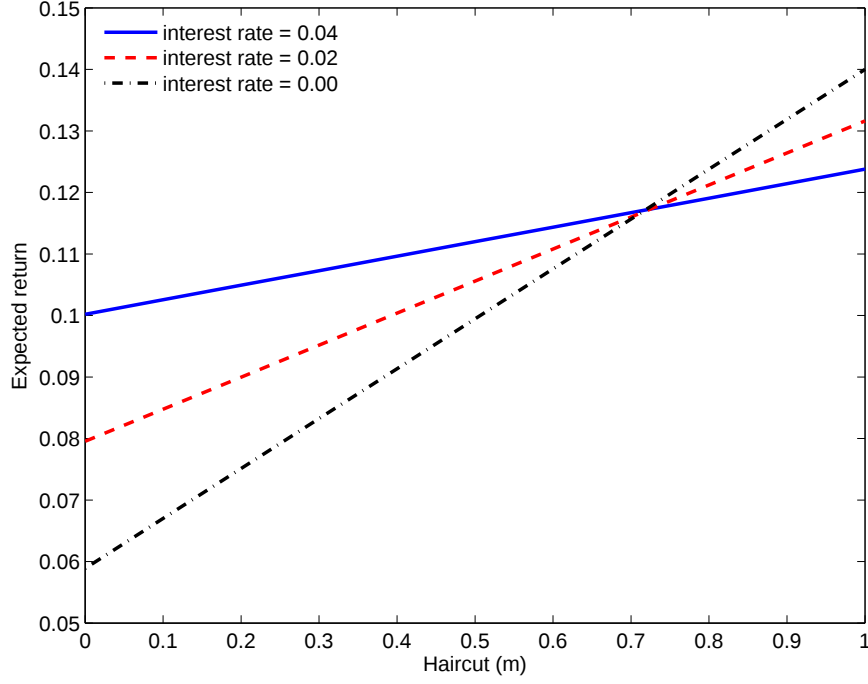


Figure 4: Interest Rate Cut: The Steepening of the Required Return-Margin Relationship.

Figure 5 illustrates the statement of this proposition. The margin constraint on one of the assets is reduced from $m^j = 0.7$ to $m^j = 0.5$, which has two effects. First, if asset j is infinitesimal, aggregate quantities remain the same, but the required return on asset j decreases (and investment increases). Second, the reduction in haircut relaxes — this is the typical outcome, although the converse is theoretically possible — the margin constraint of agent b , i.e., reduces his shadow cost of capital ψ , which flattens the required return-haircut line, further reducing the required return for asset j as well as that of other assets.

Just as is the case with productivity shocks covered by Proposition 2, the effects of policy intervention are persistent. For instance, reductions in interest rate or in haircuts, as well as asset purchases, change the real investment and therefore future labor income and investment. Indeed, lowering haircuts sufficiently or for sufficiently many assets increases output both in the current and future time periods.

In addition to modifying interest rates and haircuts, the government can promote capital injection in the institutions whose investment ability is constrained by margin requirements, or invest directly in assets in which it wants to promote investment. We consider these policy options in the following two propositions.

Proposition 5 (Capital Injection and Asset Purchases) (a) *If agent b 's wealth is increased, required returns go down and investment increases for all assets.*
(b) *If the government buys shares in asset i , then the investment in that asset increases and the investments in all other assets either all increase or decrease. If the government purchase*

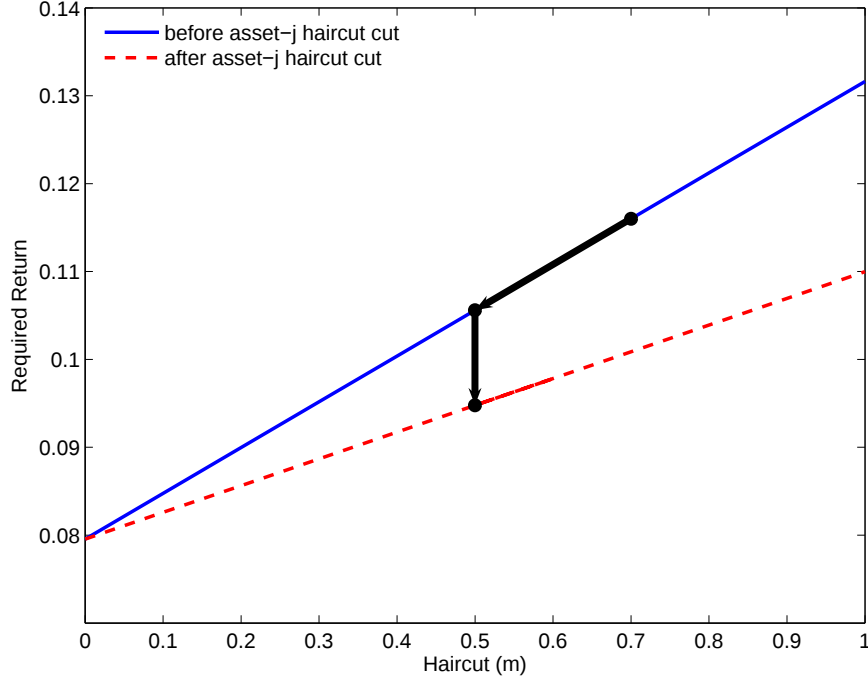


Figure 5: Haircut Cut for One Asset.

is sufficiently large, then all investments increase.

3 Haircuts and Prices: TALF as a Natural Experiment

Our theory suggests that haircuts play an important role in liquidity crises and their resolution. Consistent with this, central banks around the world have provided a number of lending facilities that provide collateralized loans at lower haircuts than what is otherwise available during a crisis, but often higher than the market-provided haircut during good times. The Term Asset-Backed Securities Loan Facility (TALF) is a good example. TALF was put in place in 2009 to provide loans against asset-backed securities (ABS) at a haircut, motivated by the credit supply frictions that underly our model:

“New issuance of ABS declined precipitously in September and came to a halt in October. At the same time, interest rate spreads on AAA-rated tranches of ABS soared to levels well outside the range of historical experience, reflecting unusually high risk premiums. The ABS markets historically have funded a substantial share of consumer credit and SBA-guaranteed small business loans. Continued disruption of these markets could significantly limit the availability of credit to households and small businesses and thereby contribute to further weakening of U.S. economic activity. The TALF is designed to increase credit availability and support economic activity by facilitating renewed issuance of consumer and small busi-

Date	Announcement
3/19/2009	Legacy securities will be part of TALF
5/19/2009	Super senior Legacy fixed-rate conduit CMBS eligible for TALF
5/26/2009	S&P considers methodology change for fixed-rate conduit CMBS
6/26/2009	S&P implements new methodology
7/16/2009	First subscription for Legacy TALF

Table 1: Key announcement dates concerning how TALF affects CMBS.

ness ABS at more normal interest rate spreads.” — Press Release, November 25, 2008, Board of Governors of the Federal Reserve System

The original TALF was directed at lowering the haircut only on newly issued securities, because these securities are related to the new loans provided to the real sector of the economy. This makes it difficult to assess the price effect of the program since these yet-to-be-issued securities were naturally not traded when the program was announced.

TALF was later extended to legacy securities, that is, securities that had been issued before 2009. The extension of TALF to legacy securities sought to remove the liquidity discount from these securities, improving the balance sheet of financial institutions which held them, and to lower the opportunity cost of making new loans. In the spirit of our model, the new-issue TALF sought to move newly issued securities down the haircut-return curve, while legacy TALF sought to flatten the curve itself.

We next describe the events surrounding the introduction of legacy TALF, and then we empirically test its effect.

3.1 The Introduction of Legacy TALF

The first indication that the Federal Reserve would attempt to support legacy CMBS market was made in a joint announcement by the Federal Reserve and Treasury on 19 March 2009, suggesting that legacy CMBS with a current AAA rating and legacy RMBS with an original AAA credit rating were being studied for inclusion in the TALF program. The new-issue TALF program had its first subscription on the same date, and provided investors with term non-recourse leverage against eligible collateral in order to stabilize funding for non-banks who relied on the term ABS market. The US Treasury also announced details around the securities public-private investment program (PPIP) program, where the taxpayer would take an equity stake in a joint venture with selected asset managers in order to purchase legacy securities. As illustrated in Figure 6, CMBS prices rallied significantly across the capital structure in the following two months. The vertical lines in the graph correspond to this key date as well as four others, summarized in Table 1, that we discuss next.

On 19 May 2009, the Federal Reserve Bank of New York confirmed that the legacy TALF program would move forward for CMBS and released preliminary terms. In particular, eligible collateral was limited to super senior fixed-rate conduit CMBS bonds with a AAA

credit rating from at least two rating agencies and no lower rating. Despite the fact that the program did not make junior AAA bonds eligible collateral, Figure 6 illustrates that spreads for all original AAA bonds continued their rally following the announcement. This broad affect is consistent with the TALF lowering the shadow cost of capital (ψ in our model) by relieving financial institutions' capital constraints as intended by the Fed.

However, on 26 May 2009, Standard and Poors released a "Request for Comment" on proposed changes to its fixed-rate conduit rating criteria. In the release, the rating agency suggested that these changes would not only put junior AAA-rated bonds on negative downgrade watch, but also a significant fraction of super senior bonds just made eligible for the TALF program. While the statement contained no new information about the credit risk of the bonds (it was simply a change in ratings methodology), AAA CMBS spreads retreated broadly following the announcement, since a downgrade would make the bonds ineligible for TALF. Research groups affiliated with CMBS dealers complained in their weekly reports about the action, and encouraged the Federal Reserve Bank of New York to drop Standard and Poors as a rating agency for the program.

On 26 June 2009, the rating agency went forward with its proposed changes to criteria, and put much of the fixed-rate conduit universe on rating watch negative. Over 90 percent of junior AAA bonds were placed on watch, and more than 20 percent of super senior bonds were also placed on watch.

One week later, on 2 July, the Federal Reserve announced the final program details for the Legacy program, which had its first subscription on 16 July 2009. These details clarified that investors would have to have acquired the bond in an arms-length transaction in the 30 days before the subscription date, a requirement meant to facilitate price discovery. In addition to a standard three-year TALF loan maturity, the program permitted investors to take out a five-year loan, which was better suited to the longer-dated CMBS collateral. However, the loans came with a carry cap that limited the amount of income that an investor could receive immediately to ensure that the Federal Reserve was paid in full before investors received one dollar of upside.

3.2 Price Sensitivity to Haircuts: New Survey Evidence

Figure 6 already provides suggestive evidence on the effect of TALF on market prices: Yields go down after the announcement that TALF is being considered, they go down further when TALF is decided, they increase when S&P makes the program less applicable, and finally go down as the program is implemented. However, during this time period, many other things went on so it is difficult to determine whether the price changes were caused by TALF or merely happened at the same time by coincidence. We attack in two ways the central questions of whether TALF caused yields to narrow and, if so, by how much: (1) we examine unique survey data on these specific questions, and (2) we examine market prices using an instrumental variable approach. We start with (1).

In March 2009, a survey was conducted among market participants, including both investors and dealers, about how they would value term nonrecourse collateralized loans provided for the purchase of certain CMBS securities. The respondents indicated that lowering

haircuts could have a large effect on price and liquidity in the CMBS market. The price effect could be driven by both the value of access to capital, consistent with our model, and the participants' option to walk away from the loan. Since we are interested in the value of access to capital, we focus on the safest securities, which, according to our estimates, had very small risk on a hold-to-maturity basis.

These CMBS bonds are securities backed by a pool of commercial real-estate loans. The cash flows from the securities are split into various tranches. We focus on the most senior tranches, those that have priority in case there is not enough money to pay all the tranches. In particular, we focus on the tranches that were rated AAA. Even within the AAA securities, there are differences in seniority, however. The most senior ones — the so-called super-senior ones — are called A1, A2, A3, A4, A5, and A1A, the next most senior are called AM (mezzanine within those originally rated AAA, but relatively senior more broadly), and the least senior ones are called AJ (junior within AAA). The A1 and A2 receive cash flows earlier than A3 and A4, but have the same seniority, while A1A receive payments from a different part of the pool as explained in more detail in Appendix A.

Losses in Stress Scenarios. Market participants were asked about their expectations for credit loss on each of the tranches in both a base case and stress scenario, each defined by the respondent. Figure 7 shows distribution of the participants stress losses for each pool, illustrated using a box plot. The top of each box is the 75% percentile, the bottom of the box is the 25% percentile, the middle line is the median, and the largest and smallest observation are indicated with whiskers.

The figure shows that the median market participants generally thought that pool stress losses would be around 20%, and less than 10% for the MLMT pool. These overall pool stress losses are small enough that the super senior CMBS bonds would avoid any losses. Indeed, for the super senior bonds to incur losses, each pool must lose more than 30% of its value, except the 2004 MLMT pool which was only subordinated at a 20% rate. Given that these loans often have recoveries of at least 50%, a 30% loss requires that more than 60% of the pool ultimately default.) Focusing on the most pessimistic market participants, only super senior bonds from the 2007 vintage seemed vulnerable to loss. However, the figure also illustrates that many of the AJ bonds were at risk of loss in a stress scenario, and recent vintage AM bonds are wiped out in the median stress scenario.

Prices and Haircuts. The key part of the survey asked market participants about the amount they would bid for the bond without a Fed facility (their “cash bid”), the amount they would bid under a number of alternative financing arrangements, and their guess at the seller ask price. In particular, the possible financing arrangement in the survey was a Fed-provided collateralized loan with either a low or a high haircut (15 and 25 percent for super senior bonds; 33 and 50 percent for other bonds) using a loan rate of swaps plus 100 basis points, and loan maturity of 3, 5, or maturity-matched term financing.

Table 3 details the mean survey responses for each bond and our main finding is illustrated more simply in Figures 8, 10, and 11. In particular, Figure 8 shows the price of the super-senior (A4) bonds. The x-axis has three different haircut options, from low to high: The low haircut proposed in the survey, the high haircut in the survey, and the case of no TALF

program (i.e., the market-provided haircut, which is higher than the high survey haircut, often 100% at that time, meaning that the collateral was not accepted, certainly at those maturities). For simplicity, we normalize the prices by dividing by the no-TALF price (i.e. the cash bid). This is illustrated for 3-year loans, 5-year loans, and maturity-matched loans (approximately 10 year loans).

We see that lower haircuts are associated with substantially higher prices, and, the longer the loan, the larger the effect. With a 3-year loan with a high haircut, respondents say they are willing to pay 6% more for these securities. If the haircut is lowered, their bid increases to 18% over their cash bid, a strikingly large effect. If the loan is extended to 5 years, the price premium increases to 33%, and a maturity-matched loan has a 51% premium. This strong price sensitivity to the maturity of the loan is consistent with a fear of having to refinance the collateral in a bad market, which was expressed by the investors in follow-up discussions.

These prices can also be expressed in terms of annualized yield to maturity as we do in Figure 9. The average yield of these bonds was around 15% at the time of the survey (about 12% above the swap rate at that maturity). Having access to a 5-year term loan lowers the yield to 11% with a high haircut, and to 9.5% at a low haircut. To put these numbers in perspective, recall that during the crisis the Fed had lowered the Fed funds rate from 5.25% in early 2007 all the way to the zero lower bound (0-0.25%). If the TALF could lower the yields by several percentage points as our survey suggests, then it is a very powerful tool.

Figure 10 shows that the effect of access to leverage is much stronger on the lower priced AJ bonds. In some extreme cases, the bid price more than doubles with the TALF program relative to the bid price without it. This stronger effect could be to the fact that these bonds were even more difficult to finance in the market, or because of the value of walking away from the loan.

To really focus on the shadow value of capital, Figure 11 focuses on only the safest super senior bonds that were significantly over-collateralized even beyond the most pessimistic respondent's stress scenario. Taking the responses at face value, this means that any losses on these bonds would be unlikely, and in the unlikely event of a loss, recovery rates would likely be high.

We see that the price effect of lowering haircuts is large even in this case of the safest super senior bonds, consistent with the program relieving a binding margin requirement for financial institutions. Consistent with this, in following up with market participants to describe their methodologies, the typical firm used cash flows on the bond from the stress case and a discount rate in the mid-20s in order to assess the value of leverage. In fact, even risk free cash flows that had to be completely funded with the firm's own capital were discounted at such high rates, despite the low Treasury rates.

Finally, Table 3 also shows that survey-based ask prices were significantly above cash bid prices, illustrating market illiquidity.

3.3 Do Haircuts Affect Market Prices? A Triple Difference-in-Differences Test

Having established a strong link between haircuts and prices in survey data, we next consider how market prices reacted to the program. As discussed above, yields narrowed significantly around the introduction of the program, but many other events occurred at the same time. Hence, to assess the causality of haircuts on market prices, we need a finer statistical tool. For this, we use as an instrument whether or not a bond was rated by S&P *ex ante*. Further, we use the June 26 event in which S&P decided which bonds to put on watch. Clearly, this event only affected S&P rated bonds. Hence, if TALF affects prices, S&P rated bonds that were *not* put on watch should see their yields narrow relative to bonds that were not rated by S&P (i.e., not in immediate risk of being put on watch).

Figure 12 documents that this was indeed the case. When the S&P action happened, S&P rated bonds that were *not* put on watch saw their yields decline to the level of non-S&P rated bonds, consistent with our theory.

However, one could argue that this is still not convincing: Since being downgraded is arguably always a negative, with or without a TALF program, perhaps all we are documenting is that yields go down when a downgrade is avoided due to other things (even if, in this case, the downgrade contains no information). In other words, being put on watch could be bad for two reasons: (i) a downgrade would make a bond ineligible for the TALF program; and (ii) a downgrade leads to selling pressure or other non-TALF effects. How do we know whether it is (i) or (ii)?

In order to isolate the impact of Legacy TALF on super senior CMBS prices, we study the differential effect of this announcement on spreads across so-called A2 bonds that are well suited for the program versus A1A (or A4) bonds which were eligible but less applicable. (See Appendix A for more details on these tranches.)^{9,10} Hence, we can compare the effect on the A2 CMBS bonds studied in Figure 12 to that of the less applicable A1A or A4 bonds studied in Figure 13. Figure 13 shows the yield of A4 bonds that were not put on watch, respectively, for S&P rated bonds and not-S&P rated bonds. We see that there is little difference in reaction of A1A/A4 bonds across S&P and not.

This is helpful statistically for the following reason: the A4 bonds capture the potential price effect related to knowing that a bond is not about to be downgraded without including (much of) the TALF effect, whereas the A2 bonds includes both the general effect in the A4 bonds as well as a TALF effect. Figure 14 shows the time-series of the double difference:

$$\text{yield}^{\text{A2, S\&P}} - \text{yield}^{\text{A2, not-S\&P}} - (\text{yield}^{\text{A1A, S\&P}} - \text{yield}^{\text{A1A, not-S\&P}}), \quad (30)$$

⁹Almost half of the loan requests submitted by TALF investors have been for A2 tranches, very few have been for A1A tranches, and a modest fraction for A4 tranches. This is because the final TALF program allows loans of at most 5 years maturity, matching the maturity of A2 bonds, but not that of A4 bonds, among other reasons.

¹⁰We note that both A2 and A4 bonds were among the safest super senior bonds. On the margin, A2 bonds were safer, so if the effect of TALF was due to credit risk transfer — as opposed to relieving capital constraints as we believe — then the effect would go the other way than what we find.

which is meant to isolate the effect of TALF on yields. We see that the introduction of TALF appears to lower the A2 yields, controlling for other effects.

We test the statistical significance of this result with a triple difference-in-difference regression presented in Table 4. The regression considers the differential effect of S&P rated bonds vs. non-S&P, A2 vs. A4 bonds, and the third difference is the indicator of whether the time is before or after the S&P action. The regression adjusts the standard errors for heteroskedasticity and includes a full set of time effects (suppressed the reporting). The second column repeats this regression, but using A1A bonds as control instead of A4 bonds. (A1A bonds are another class of super senior bonds that were less affected by the TALF than the A2 bonds.) The coefficient estimates suggest that the benefit of access to leverage was between 50 and 75 basis points on the A2 bonds, over and above the effects of the control groups.

This effect is highly statistically significant and the economic magnitude is large, especially given the fact that we are controlling for the effects of other securities that also benefitted from the TALF. In particular, while the TALF program effectively moved the A2 bonds down the haircut-return curve, it may also have flattened the curve, helping all securities including A4's. Since we "difference out" the flattening of the haircut-return curve, our estimate only captures the marginal effect of moving the A2 bonds down the curve. In any case, effectively lowering the interest rates on securities that are crucial for the credit supply to the real economy by more than 50 to 75 basis points is an effective policy tool, especially when the zero lower bound binds.

4 Conclusion: Two Monetary Tools

We model how required returns increase when credit-suppliers hit their margin constraints, reducing economic activity and propagating business cycles. The effect is largest for assets that are difficult to finance in a crisis, that is, assets with high haircuts.

Surprisingly, while an interest rate cut reduces the required return for liquid low-margin assets, it can increase the required return for illiquid high-margin assets. This is because the lower interest rate increases the desire for leverage and, as a result, increases the shadow cost of capital. This effect increases the required return for high-margin assets, countervailing the direct effect of the interest rate cut.

A haircut cut, on the other hand, always reduces the required return on the affected asset and stimulates real activity in that sector. This can be achieved if the central bank accepts such securities as collateral in exchange for loans. Hence, haircuts provide a second monetary policy tool in addition to the standard interest-rate tool.

While haircuts can be decreased in crises by offering loans at moderate haircuts, they cannot be similarly increased in good times when credit might be excessive (Lorenzoni (2008)). Indeed, if a central bank offers collateralized loans at high haircuts, borrowers can simply get their loans elsewhere. However, in addition to the market-imposed margin constraints, financial institutions also face regulatory capital requirements that can be captured in our

framework in a straightforward way.¹¹ Hence, to reduce business cycles, a central bank may need binding capital requirements in good times and lending facilities that stand ready in periods of liquidity crisis.

Studying the natural experience of the introduction of the TALF lending facility, we find strong effects of providing collateralized loans at low haircuts. Survey evidence shows that yields on affected securities might drop as much as 5% during the height of the crisis. Further, an instrumental-variable estimation using market prices suggests that the actual effect was above 0.50-0.70% and likely much larger.

¹¹Regulatory requirements are mathematically of a similar form:

$$\sum_i m_t^{Reg,i} |\theta^i| \leq W$$

where $m_t^{Reg,i}$ is the regulatory capital requirement for security i .

A Appendix: Background on CMBS Securities

CMBS bonds are securities backed by a pool of commercial real estate loans. The cash flows from the securities are split into various tranches. We focus on the most senior tranches, those that have priority in case there is not enough money to pay all the tranches. In particular, we focus on the tranches that were originally rated AAA (and, as we will see, continued to be rating AAA for the most part). Even within the AAA securities, there are differences in seniority, however. The most senior ones — the so-called super-senior ones — are called A1, A2, A3, A4, A5 and A1A, the next most senior are called AM (mezzanine within AAA, but relatively senior more broadly), and the least senior ones are called AJ (junior within AAA). The A1 and A2 receive cash flows earlier than A3 and A4, but have the same seniority, while A1A receive payments from a different part of the pool as explained below.

The real estate loans in the pool underlying fixed-rate conduit CMBS have a fixed interest rate, a maturity of 5, 7, or 10 years, and amortization schedule over 30 years (implying a principal payment at maturity). The loan pool typically includes more than 100 loans, but the largest 10 loans can represent 40 percent of the overall balance. While the pool can be diversified by geography and property type, given the balloon nature of the loans there is correlated refinancing risk. The so-called super-senior tranches generally had 30 percent subordination at issue in the most recent vintages (i.e. starting in 2005), but had as little as 20 percent subordination in earlier vintages. In contrast, the AM and AJ tranches, each which also had AAA ratings at issue, only had 20 percent and 12 percent subordination, respectively. These bonds have structural leverage given their subordination to the super senior class, which makes it possible for investors to incur losses of 100 percent.

The loan pool underlying fixed-rate conduit CMBS is often tranching into one pool of multi-family loans and another pool of all other loans. Principal payments from the multi-family loans are directed to the A1A tranche. Given the involvement of the GSEs in agency-sponsored multi-family CMBS issue, it should not be surprising that loans in this pool are generally adversely selected from the multi-family universe. Cash flows from other property types (office, retail, industrial, etc.) are directed to sequential-pay super senior classes, which generally included A1, A2, A3, and A4. Upon receipt, principal is first distributed to the A1 tranche until it paid in full, and then to the A2 tranche. This time-tranching makes the A1 and A2 bonds have shorter average lives (5 years) and the A3 and A4 bonds longer average lives (10 years). Despite the time tranching, all of these bonds are structurally senior. In particular, if credit losses on the overall loan pool rise above 30 percent, the allocation of losses and principal from that point in time goes pro-rata among the super senior tranches.

The survey instrument focused on AAA-rated tranches from five fixed-rate conduit CMBS deals illustrated in Table 2.

B Appendix: Proofs

Proof of Proposition 1. Equation (14) can be rewritten as

$$E_t [r_{t+1} - (r^f + \psi x m)] = \gamma D(P_t)^{-1} \Sigma \bar{\theta} \quad (\text{B.1})$$

$$= \gamma P_t^{mkt} Cov_t(r_{t+1}, r_{t+1}^{mkt}). \quad (\text{B.2})$$

Aggregating (B.2) gives

$$\begin{aligned} E_t [r_{t+1}^{mkt} - (r^f + \psi x m_t^{mkt})] &= \gamma (P_t^{mkt})^{-1} \bar{\theta}^\top \Sigma \bar{\theta} \\ &= \gamma P_t^{mkt} Var_t(r_{t+1}^{mkt}), \end{aligned} \quad (\text{B.3})$$

where m_t^{mkt} is the market-value weighted haircut m . Combining (B.2) and (B.3) yields the result in the proposition. ■

The proofs of Propositions 2-5 are based on the following three kinds of equilibrium restrictions.

$$\begin{aligned} 0 &= -(I^i)^{1-\alpha} (1 + r^f + \psi x m) + \bar{A}^i - \gamma \Sigma_A^i (I^i)^\alpha \bar{\theta}^i \\ &\equiv G(I^i, \psi, m_t^i, \gamma, \bar{\theta}^i) \end{aligned} \quad (\text{B.4})$$

$$\begin{aligned} 0 &= -(I^i)^{1-\alpha} (1 + r^f) + \bar{A}^i - \gamma^a \Sigma_A^i (I^i)^\alpha \theta^{i,a} \\ &\equiv G(I^i, 0, 0, \gamma^a, \theta^{i,a}) \end{aligned} \quad (\text{B.5})$$

$$\begin{aligned} 0 &= \sum_i m_t^i (\bar{\theta}^i - \theta^{i,a}) \frac{1-\beta}{\alpha} I^i - W^b \\ &\equiv H(I, m, \theta, W). \end{aligned} \quad (\text{B.6})$$

The first two equations state the optimality of aggregate demand and of the demand of agent a , respectively, while the third equation states that the margin constraint of agent b binds. These equations are written taking into account the dependence (24) of the share prices on investment levels and the fact that $\theta^{i,a} + \theta^{i,b} = \bar{\theta}^i$. An important observation for the solution is that the two demands decrease with the investment I^i , given that the function G decreases with both I and θ .

Proof of Proposition 2. Let $\bar{W}^b$ denote the wealth invested by agent b in the risky assets when not constrained. If the realization of the productivity vector A_t is low enough, then $W_t^b < \bar{W}^b$, i.e., agent b becomes constrained and investment in all sectors decreases. Consequently, the reduced output due to the low productivity shock predicts lower than-average output. ■

Proof of Proposition 3. Equation (B.5) implies that a decrease in the current interest rate r^f results in either $\theta^{i,a}$ or I^i increasing, for each i . The margin constraint (B.6) implies that the product $(\bar{\theta}^i - \theta^{i_0,a}) I^{i_0}$ increases for some i_0 , which means that I^{i_0} increases —

otherwise, $\theta^{i_0,a}$ increases, so that $(\bar{\theta}^i - \theta^{i_0,a})I^{i_0}$ decreases. The equilibrium required return on asset i_0 is a constant multiple of $(I^{i_0})^{\alpha-1}$, and therefore decreases.

If ψ decreases as r^f decreases, then all terms $r^f + \psi x m_t^i$ decrease, and I^i increases for all i (Equation (B.4)). If ψ increases, on the other hand, then $r^f + \psi x m_t^i$ decreases only for $m_t^i \leq \bar{m}$, where $\bar{m}$ is defined by the fact that $r^f + \psi x \bar{m}$ does not change when r^f does.

Finally, consider two extreme cases. First, suppose that the constraint binds with $\psi = 0$ and let r^f decrease. If the constraint does not become strictly binding, i.e., if $\psi = 0$, then Equations (B.4) and (B.5) imply that the individual investments of the two agents do not change — risk-sharing remains perfect — in addition to the fact that I^i increases for all i . It follows, however, that the constraint is violated. This contradiction implies that $\psi > 0$ once r^f decreases. By continuity, ψ decreases with r^f also when ψ is sufficiently close to 0.

Second, suppose that $\gamma^a = \infty$, i.e., agent b is the sole investor in risky assets. A decrease in r^f must reduce $r^f + \psi m_t^i$ for m_t^i low enough and increase $r^f + \psi m_t^i$ for m_t^i sufficiently high, as this is the only way to increase some values I^i while decreasing others, which is necessary to continue satisfying the margin constraint. Invoking continuity again, we infer that when the risk tolerance $(\gamma^a)^{-1}$ is close enough to zero, ψ decreases with r^f and investment in high-margin assets is reduced to allow for increased investment in low-margin assets. ■

Proof of Proposition 4. A decrease in m_t^j implies that $(1 - \theta^{i,a})I^i$ increases for some i , so that I^i increases. If $i \neq j$, Equation (B.4) then implies that ψ decreases, so that I^i increases for all i . If I^i decreases for all $i \neq j$, which implies that ψ increases, then it must be the case that I^j increases (and therefore ψm_t^j decreases).

If m_t^j becomes 0, then $(1 - \theta^{j,a})I^j$ increases for some $i \neq j$, which, following the first steps above, leads to a decreased ψ and higher investment in all assets.

Finally, if all haircuts m^i are lowered by the same fraction $\epsilon \in (0, 1)$, then some product $(1 - \theta^{i_0,a})I^{i_0}$ increases, so that ψm^{i_0} decreases, which implies that ψm^i decreases for all i . ■

Proof of Proposition 5. (a) Equation (B.6) implies that an increase in W^b must be accompanied by a decrease in $\theta^{i,a}$ or an increase in I^i for some i . Equation (B.5) implies that $\theta^{i,a}$ and I^i are negatively related to each other, so that, for some i , both $\theta^{i,a}$ decreases and I^i increases.

Finally, from (B.4) it follows that the increase in I^i must be offset by a decrease in ψ . For all $j \neq i$, therefore, I^j must also decrease.

(b) If $\bar{\theta}^i$ goes down, then either $\theta^{i,a}$ or $\theta^{i,b}$ must decrease. If $\theta^{i,a}$ decreases, then I^i must increase (by (B.5)). If $\theta^{i,b}$ decreases, then either I^i increases or $\theta^{j,b}I^j$ increases for some $j \neq i$. In this case, then, I^j increases, and therefore ψ decreases, which implies that $\theta^{i,b}$ increases, which is a contradiction. We conclude that I^i increases. Note that investments in the other technologies either all increase or all decrease. If $\bar{\theta}^i$ becomes 0, then $\theta^{j,b}I^j$ increases for some $j \neq i$, so that ψ must decrease, implying that I^j increases for all j . ■

C Appendix: Data sources

The survey was conducted by one of the authors in mid-March 2009 of eight market participants, including CMBS dealers as well as money managers who traded CMBS.

The econometric analysis exploits a proprietary data set on end of week prices for more than 2,000 originally-rated AAA tranches of the outstanding fixed-rate conduit universe for 2009, as well as credit ratings actions on those tranches for the same time period.

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Deal	Issue Date	Class	CUSIP	Maturity	Ave. life	Coupon	Moodys	Fitch	S&P	Real-point	% 60+ delinquencies	% foreclosure	Orig. subordination	Cur. subordination	% pool loss base	% pool loss stress
JPMCC 2006-CB15	6/1/2006	A-4	46627QBA5	6/12/2043	7.08	5.81	Aaa	AAA	NR	Perf	6.64	1.78	30.00	30.44		
		AM	46627QBC1	6/12/2043	7.23	5.86	Aaa	AAA	NR	Perf	6.64	1.78	20.00	20.30		
		AJ	46627QBD9	6/12/2043	7.24	5.89	A2	AAA	NR	Perf	6.64	1.78	12.25	12.43	10.72	21.97
WBCMT 2005-C21	10/1/2005	APB	9297667F4	10/15/2044	2.89	5.17	Aaa	AAA	AAA	Outperf	1.36	0.00	30.00	35.14		
		A-4	9297667G2	10/15/2044	5.88	5.21	Aaa	AAA	AAA	Outperf	1.36	0.00	30.00	35.14		
		AM	9297667J6	10/15/2044	6.50	5.21	Aaa	AAA	AAA	Outperf	1.36	0.00	20.00	23.43		
		AJ	9297667K3	10/15/2044	6.56	5.21	Aaa	AAA	AAA	Outperf	1.36	0.00	13.38	15.67	4.67	11.43
CSMC 2007-C3	6/1/2007	A-2	22544QAB5	6/15/2039	3.06	5.72	Aaa	NR	AAA	Perf	2.04	0.94	30.00	30.07		
		A-4	22544QAE9	6/15/2039	8.01	5.72	Aaa	NR	AAA	Perf	2.04	0.94	30.00	30.07		
		AM	22544QAG4	6/15/2039	8.16	5.72	Aaa	NR	AAA	Perf	2.04	0.94	20.00	20.05		
		AJ	22544QAH2	6/15/2039	8.16	5.72	A1	NR	AAA	Perf	2.04	0.94	12.50	12.53	13.47	24.24
CD 2007-CD4	3/1/2007	A-2B	12513YAC4	12/11/2049	2.76	5.21	Aaa	AAA	AAA	Perf	3.69	3.42	30.00	30.10		
		A-3	12513YAD2	12/11/2049	4.82	5.29	Aaa	AAA	AAA	Perf	3.69	3.42	30.00	30.10		
		A-4	12513YAF7	12/11/2049	7.63	5.32	Aaa	AAA	AAA	Perf	3.69	3.42	30.00	30.10		
		AMFX	12513YAH3	12/11/2049	7.83	5.37	Aaa	AAA	AAA	Perf	3.69	3.42	20.00	20.06		
		AJ	12513YAJ9	12/11/2049	7.90	5.40	A1	AAA/*	AAA	Perf	3.69	3.42	11.13	11.16	11.14	20.40
MLMT 2004-BPC1	11/1/2004	A-2	59022HEU2	10/12/2041	0.46	4.07	NR	AAA	AAA	Outperf	0.44	0.00	20.00	21.00		
		A-3	59022HEV0	10/12/2041	2.47	4.47	NR	AAA	AAA	Outperf	0.44	0.00	20.00	21.00		
		A-5	59022HEX6	10/12/2041	5.40	4.86	NR	AAA	AAA	Outperf	0.44	0.00	20.00	21.00		
		AJ	59022HFT4	10/12/2041	5.57	4.92	NR	AAA	AAA	Outperf	0.44	0.00	12.38	13.00	3.16	6.58

Table 2: Descriptive statistics on the CMBS securities used in the survey. These statistics are as of the time of the survey in March 2009.

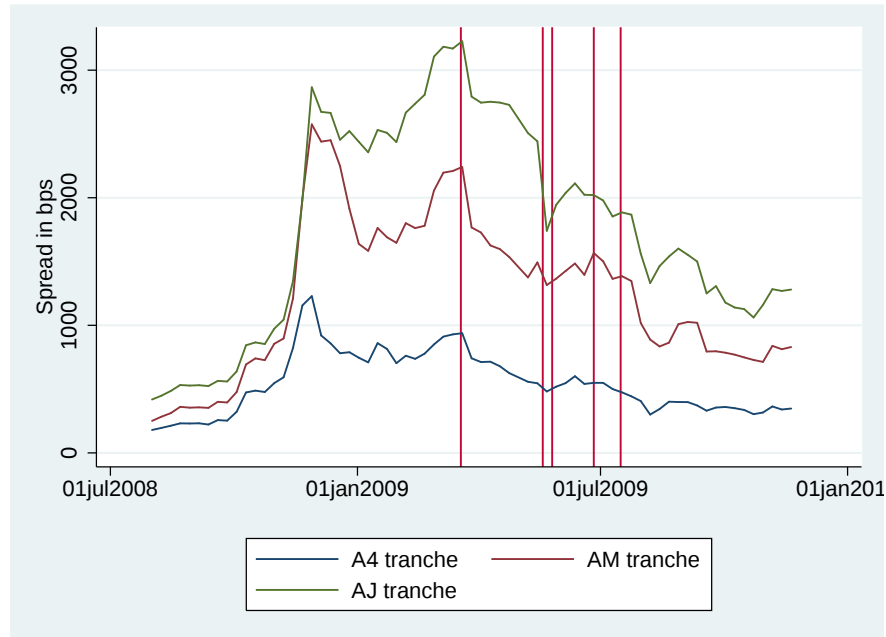


Figure 6: The yield spread on super senior A4 CMBS bonds, riskier mezzanine AM bonds, and even riskier junior AJ bonds.

Deal	Issue Date	Class	Ask price	Cash bid	3-year loan		5-year loan		Maturity- matched loan	
					high haircut	low haircut	high haircut	low haircut	high haircut	low haircut
JPMCC 2006- CB15	6/1/2006	A-4	61.97	56.96	62.75	70.84	74.43	82.23	84.79	92.51
		AM	42.14	33.69	34.12	45.39	37.97	51.12	49.18	63.04
		AJ	25.07	21.03	24.72	30.40	27.32	39.12	31.44	44.79
WBCMT 2005-C21	10/1/2005	APB	86.33	84.81	88.60	92.14	88.51	93.14	90.55	95.15
		A-4	76.48	73.58	72.00	77.09	80.81	85.95	86.57	92.51
		AM	54.10	46.41	46.04	52.61	51.53	59.41	63.62	72.05
		AJ	40.42	34.82	33.94	43.31	38.06	48.33	47.27	60.42
CSMC 2007-C3	6/1/2007	A-2	77.45	73.83	84.57	89.40	85.35	90.08	88.04	92.56
		A-4	58.39	52.94	59.31	66.79	69.71	76.35	81.27	89.68
		AM	39.99	31.02	34.79	39.39	39.81	44.31	47.24	60.42
		AJ	22.03	17.77	22.90	28.14	26.04	31.07	29.70	43.40
CD 2007- CD4	3/1/2007	A-2B	78.75	76.63	85.30	88.56	85.55	89.11	88.52	93.32
		A-3	66.28	61.58	74.78	80.08	81.07	86.79	85.89	91.61
		A-4	62.55	57.40	62.37	68.74	70.26	75.88	80.89	88.37
		AMFX	41.47	33.20	35.03	39.81	41.37	44.94	49.38	59.05
		AJ	23.84	19.99	23.21	28.87	26.63	33.02	30.37	43.62
MLMT 2004- BPC1	11/1/2004	A-2	95.91	96.86	95.20	96.05	92.46	94.11	93.65	95.06
		A-3	84.31	84.27	87.35	90.68	86.39	89.27	88.84	92.35
		A-5	77.91	76.04	77.60	80.83	82.54	86.80	85.30	90.55
		AJ	46.23	43.56	48.27	53.47	53.21	61.47	61.81	72.33

Table 3: Mean survey response across participants for each security in the survey.

	1	2
1(S&P)	-47.32 (7.96)	-111.75 (9.71)
1(A2)	-7.54 (11.34)	-87.95 (12.50)
1(SP)*1(t>26June2009)	13.59 (8.80)	33.48 (10.94)
1(A2)*1(t>26June2009)	-41.51 (12.04)	-19.09 (13.54)
1(S&P)*1(A2)	96.62 (12.76)	161.06 (13.93)
1(S&P)*1(A2)*1(t>26June2009)	-53.39 (13.51)	-73.28 (14.99)
Constant	434.19 (3.35)	499.54 (4.36)
Time fixed effects	YES	YES
Control group	A4	A1A
Observations	16,081	14,025
R-squared	52%	53%

Table 4: Regression: does TALF affect prices? The data includes weekly spreads on bonds that were not put on downgrade watch from April 2009 to November 2009. The left hand side variable is the yield spread of CMBS bonds, and the right-hand side variables are dummies for whether a bond is rated by S&P, whether it is an A2 bond (i.e., suitable for TALF), and whether the time is after the S&P action on June 25, 2009, as well as all double and triple interactions, and a full set of time effects. Each column represents a regression, showing the coefficient estimates and with t-statistics in parenthesis. The first column includes only A2 and A4 tranches, while the second column includes only A2 and A1A tranches. The coefficient of interest is the triple interaction term (in bold) showing that TALF-suitable A2 bonds' yield narrowed 53 to 73 basis points following an S&P action that increased their likelihood of being TALF eligible, controlling for other effects.

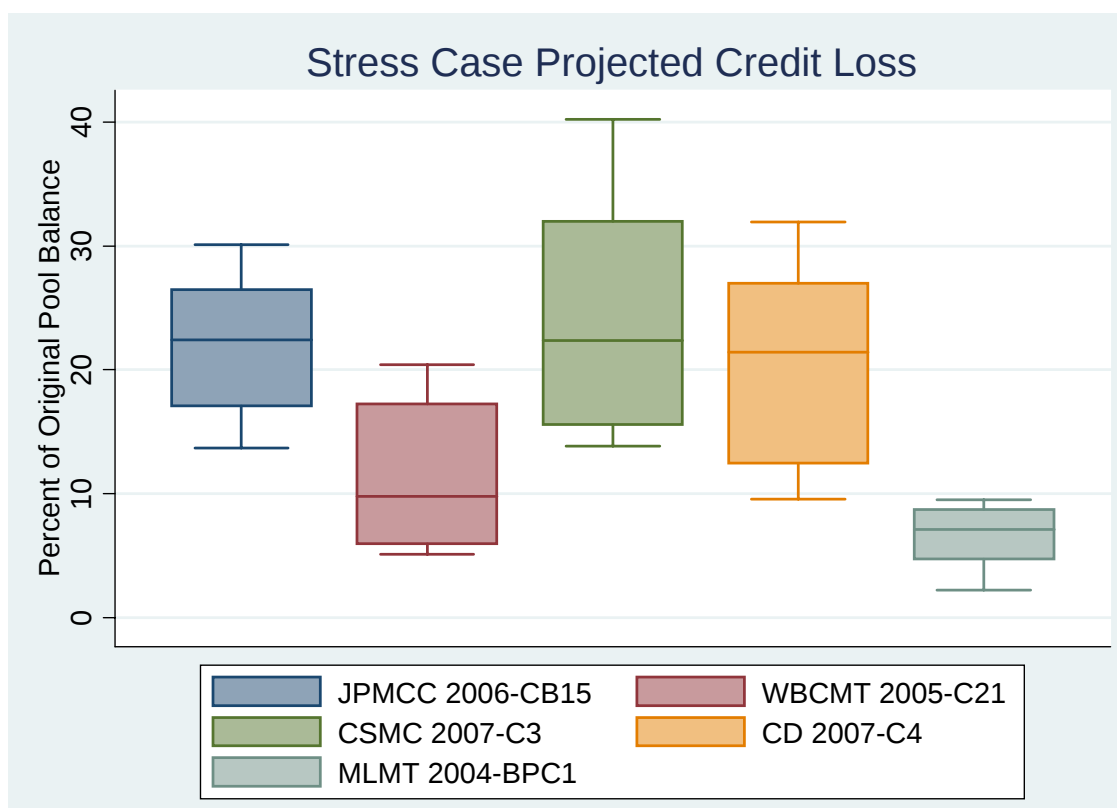


Figure 7: Distribution of survey responses regarding the potential stress loss of each CMBS pool. In this box plot, the top of each box is the 75% percentile, the bottom of the box is the 25% percentile, the middle line is the median, and the largest and smallest observation are indicated with whiskers.

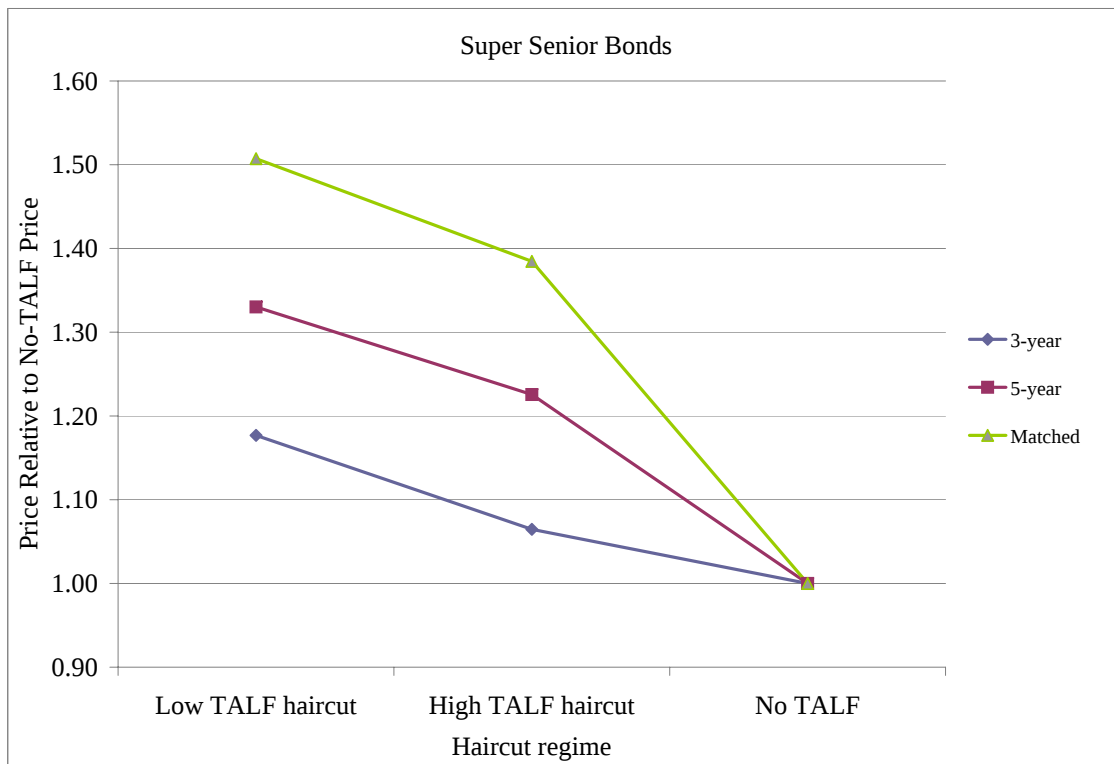


Figure 8: The figure shows the average survey bid price of super senior CMBS A4 bonds by haircut group. The participants bid the highest price if they have access to a TALF loan with a low-haircut TALF, lower if the TALF loan has a high haircut, and lowest if they don't have access to TALF. All prices are normalized by the no-TALF price. The three lines correspond to a 3-year TALF loan, a 5-year TALF loan, or a maturity-matched TALF loan (longest).

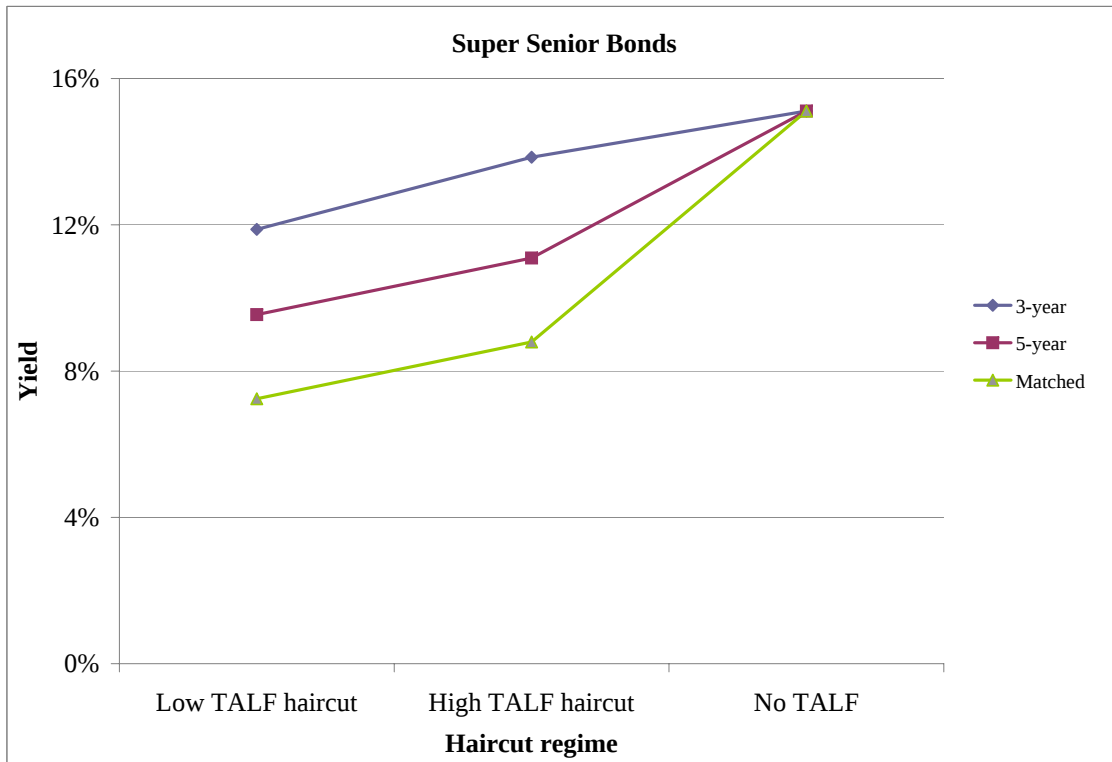


Figure 9: The figure shows the annual yields corresponding to the average survey bid price of super senior CMBS A4 bonds by haircut group. The yield (i.e., the required return) is lowest with a TALF loan with a low-haircut TALF, higher if the TALF loan has a high haircut, and highest if there is no TALF. The three lines correspond to a 3-year TALF loan, a 5-year TALF loan, or a maturity-matched TALF loan (longest).

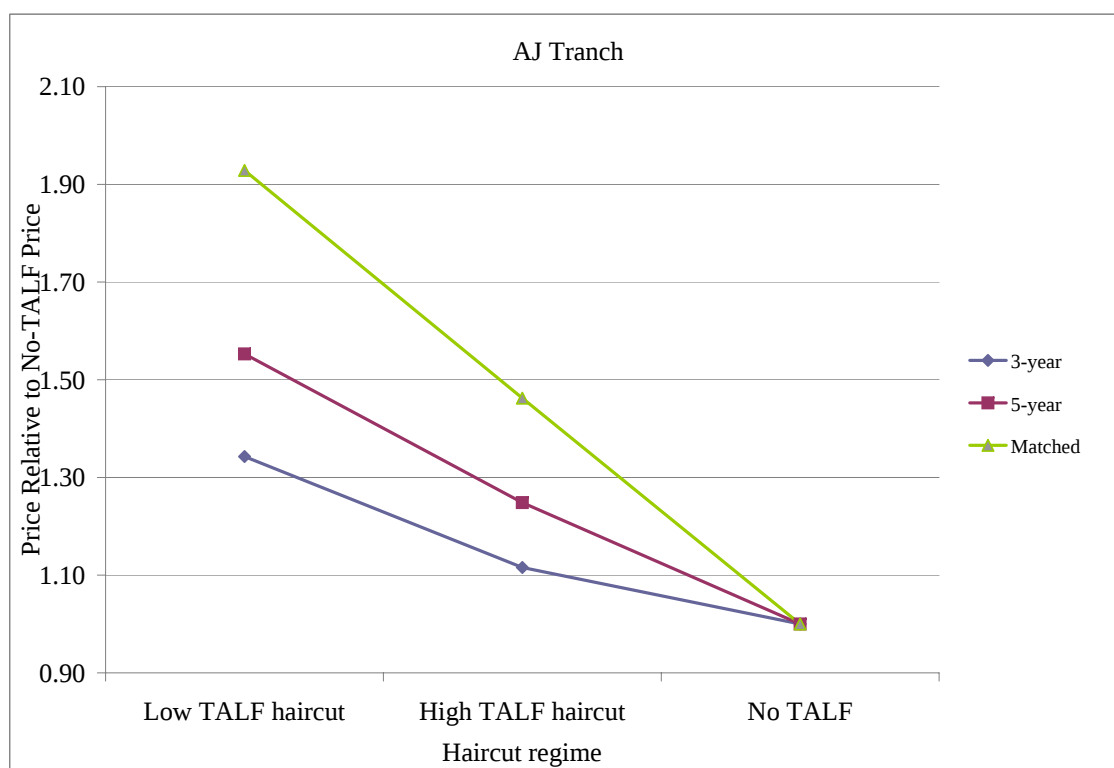


Figure 10: The figure shows the average survey bid price of CMBS AJ bonds by haircut group. The participants bid the highest price if they have access to a TALF loan with a low-haircut TALF, lower if the TALF loan has a high haircut, and lowest if they don't have access to TALF. All prices are normalized by the no-TALF price. The three lines correspond to a 3-year TALF loan, a 5-year TALF loan, or a maturity-matched TALF loan (longest).

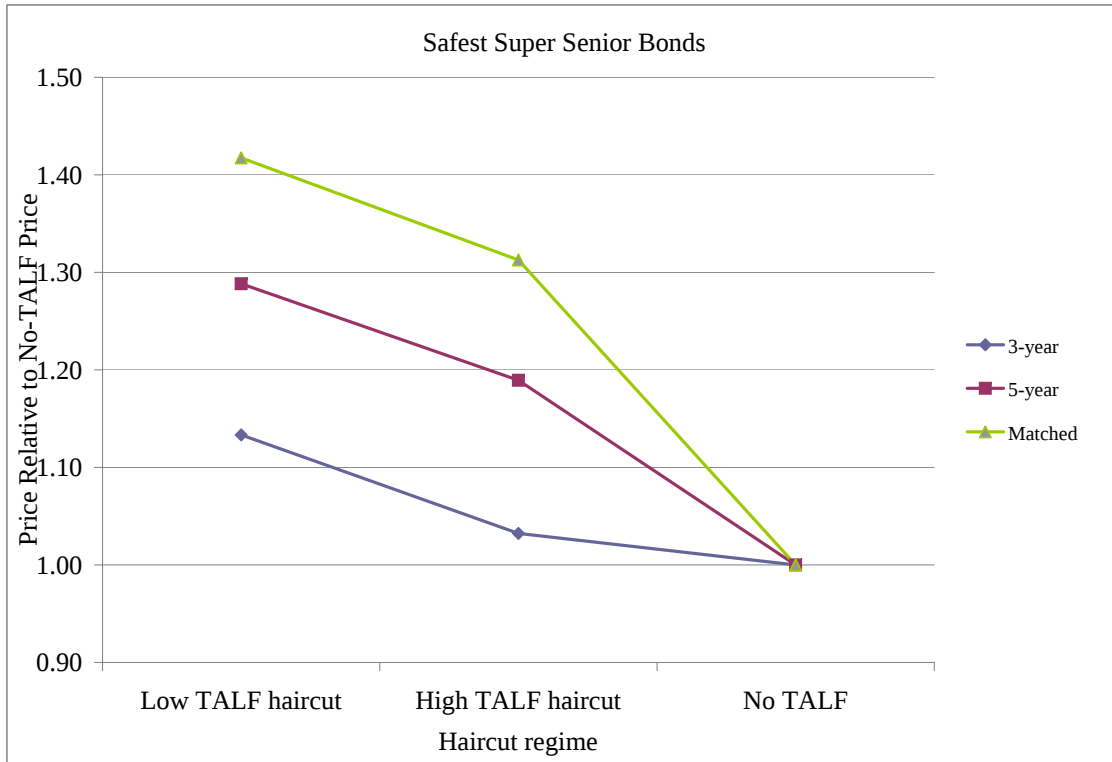


Figure 11: The figure shows the average survey bid price of the safest super senior CMBS A4 bonds by haircut group. The participants bid the highest price if they have access to a TALF loan with a low-haircut TALF, lower if the TALF loan has a high haircut, and lowest if they don't have access to TALF. All prices are normalized by the no-TALF price. The three lines correspond to a 3-year TALF loan, a 5-year TALF loan, or a maturity-matched TALF loan (longest).

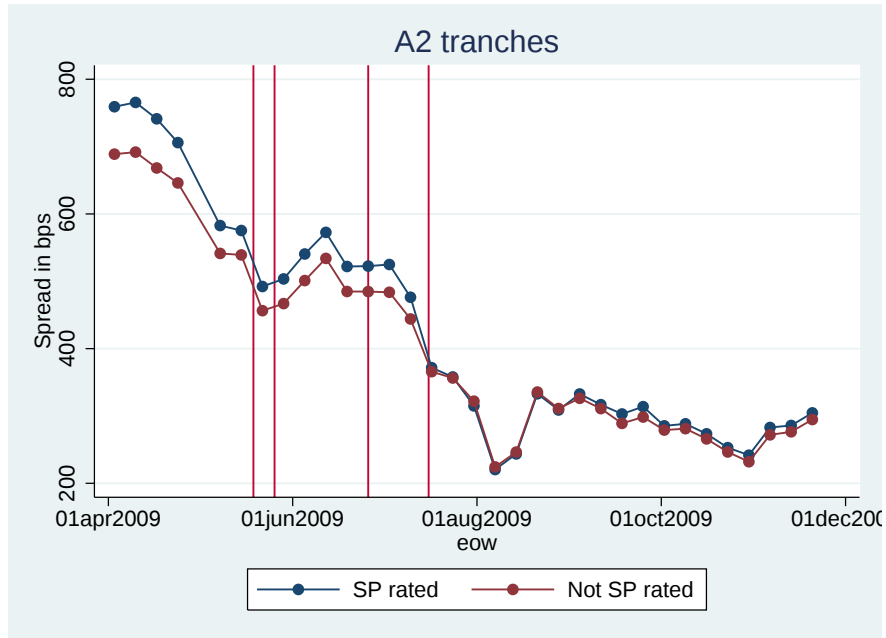


Figure 12: The yield spread on S&P rated A2 bonds, and A2 bonds not rated by S&P. Here we show the yield spread only on bonds that were not put on ratings watch negative throughout the sample.

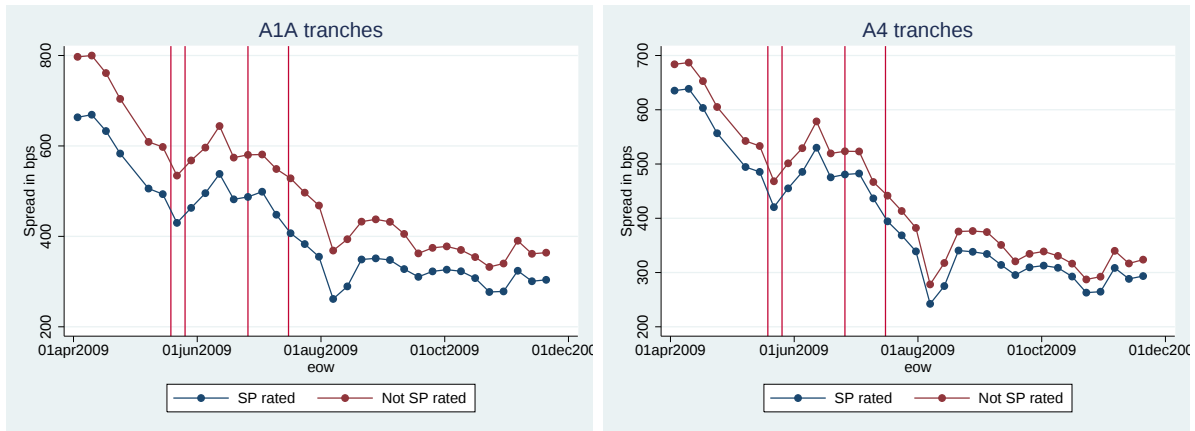


Figure 13: The yield spread on S&P rated A1A (or A4) bonds, and A1A (A4) bonds not rated by S&P. Here we show the yield spread only on bonds that were not put on ratings watch negative throughout the sample.

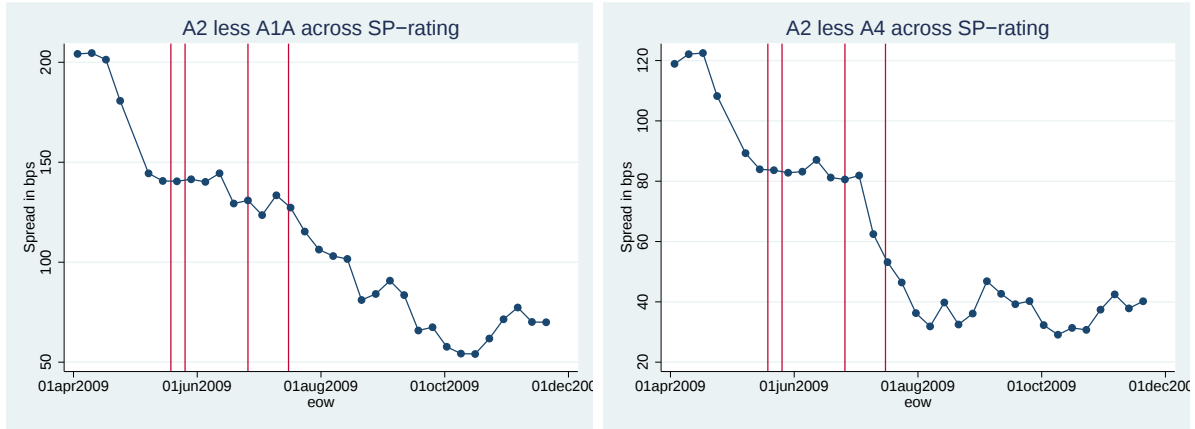


Figure 14: The time series of the TALF effect. The figure shows the double difference: $\text{yield}^{\text{A2, S\&P}} - \text{yield}^{\text{A2, not-S\&P}} - (\text{yield}^{\text{A1A, S\&P}} - \text{yield}^{\text{A1A, not-S\&P}})$ which it meant to isolate the effect of TALF on CMBS A2 yields, controlling for other effects. The S&P action only affected S&P rated bonds, so subtracting non-S&P yields removes other time-series effects. The S&P action improved the TALF eligibility of A2 bonds under consideration, but could also have other effects on these bonds. Subtracting the same difference for A1A (or A4) bonds is meant to eliminate the other non-TALF effects since the A1A (A4) bonds are not as suitable for TALF. We see that the introduction of TALF appears to lower the A2 yields, controlling for other effects.