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The Consumer and Business Lending Initiative

United States: Department of the Treasury

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A Note on Efforts to Address Securitization Markets and Increase Lending

Overview

The Obama administration along with the Federal Reserve, the FDIC and the Comptroller of the Currency announced on February 10 a comprehensive package intended to restore stability to the financial system. An important goal of this program is to strengthen the economy by getting credit flowing to families and businesses throughout the country. The recently released Capital Assistance Program and the Homeowner Affordability and Stability Plan are important components of this package, and should help improve lending conditions in the economy. Another key component of the President's package directed at increasing lending is the Consumer and Business Lending Initiative. The Term Asset-Backed Securities Loan Facility, a joint program of the Federal Reserve and the Treasury, is a program that falls under this initiative, and its goal is to improve credit market conditions by addressing the securitization markets. Taken together, these actions are a multi-pronged effort to unlock the credit markets in the U.S. economy.

Importance of Securitization Markets

Over the past two decades, the markets for securities backed by loans and other assets have grown rapidly, and so-called asset-backed securities (ABS) have become an important means by which financial institutions fund loans to businesses and households. Strong investor demand for securities structured for different risk appetites allowed banks and other financial institutions to sell consumer and business loans in the form of asset-backed securities at relatively low yields. This in turn allowed lenders to increase the availability of credit and lower the rates at which they extended credit to consumers and businesses throughout the economy.

Consumer Asset-Backed Securitization Process

To create ABS, a lender sells a pool of loans to a bankruptcy-remote special purpose vehicle (SPV). The SPV funds the purchase of the underlying loans by selling various classes of securities with different levels of seniority and risk. These securities sold by the SPV are secured by the pool of loans in the SPV. By creating separate securities with different levels of risk, the SPV can appeal to different investors and thereby broaden its investor base, which in turn lowers the cost of funding for the original lender. That reduced cost of funds results in lower interest rates for the businesses and households that receive the underlying loans.

According to Federal Reserve data, over the past few years around a quarter of all non-mortgage consumer credit – including loans used to purchase cars or pay for college tuition - has been funded through this process. In fact, most non-mortgage related ABS is backed by consumer credit and is rated AAA by the rating agencies. The primary consumer-ABS markets include ABS backed by auto loans, credit card receivables and student loans. Similar ABS structures are used to finance small business lending. In Table A at the back of this document, a list of consumer and business loans that have historically been financed in the securitization markets is provided. Many of these asset classes will be included in the TALF in the coming months, subject to a risk analysis.

Consumer Securitization Markets Have Become Extremely Dislocated

With the onset of severe dislocation in the credit markets, new issuance of consumer ABS declined precipitously in the third quarter of 2008 before coming to a virtual halt in October. Issuance of consumer ABS has remained near zero since October, which has significantly reduced the amount of credit extended to consumers throughout the economy. At the same time, interest rate spreads on AAA-rated tranches of consumer ABS have increased to levels well outside the range of historical experience, reflecting unusually high risk premiums.

The problems in these markets reflect three developments. First, many traditional investors in AAA-rated tranches of ABS have exited the market. The remaining traditional investors have suffered substantial mark-to-market losses on their ABS portfolios, are adversely impacted by the loss of liquidity and value on their portfolios, and have little appetite to increase their ABS holdings until their existing positions trade at more normalized levels. Second, nontraditional investors such as hedge funds, which may otherwise be willing to invest in these securities, have been unable to obtain funding from banks and dealers because of a general reluctance to lend. Third, investors are increasingly concerned about the prospect of a deep recession and resulting correlated defaults on loans to households and businesses.

Continued disruption of the ABS markets could result in a reduction in the availability, and an increase in the cost, of credit for consumers and businesses. Although some lenders that relied heavily on securitization for funding might be able to fund new credits on their balance sheets, many are seeking to ration their capital by not acquiring any new assets or extending new loans. In the current environment, those lenders that fund new credits on their balance sheet are only willing to do so at markedly higher interest rates.

The reduction in availability and increase in cost of credit is one of the causes of the deepening recession. While part of the decline in borrowing and lending in these markets reflects the general reduction in demand for credit that always accompanies a recession, a portion reflects the historically intense pressures bearing on participants in these markets. Restoring more normal functioning to these markets and to other segments of the financial system is an essential step toward establishing a solid recovery of economic activity.

Rationale for Action: TALF Will Promote New Credit Extension

To address these problems, Treasury and the Federal Reserve launched the Term Asset-Backed Securities Loan Facility (TALF). Under the first phase of the TALF, the Federal Reserve Bank of New York will lend up to $200 billion on a collateralized, non-recourse basis to holders of eligible ABS. The objective of the program is to stimulate investor demand for these securities, and thereby to reduce the funding costs of the issuers of the loans in the eligible classes. Ultimately, the program should bring down the cost and increase the availability of new credit to consumers and businesses.

Eligible ABS includes newly issued AAA-rated tranches of securitizations backed by auto loans, credit card loans, private and government-guaranteed student loans, and loans guaranteed by the Small Business Administration. The allocation of lending between these asset classes will be determined by investor demand. TALF loans will have a three-year term, and will be open to a large number of investors who have not traditionally had access to Federal Reserve liquidity.

The mechanics of the TALF program are as follows. Once a month investors can request Federal Reserve funding for loans against eligible consumer or small business ABS. Assuming that the borrower and the ABS it plans to pledge as collateral meet Treasury and Federal Reserve requirements, the investor will receive funding to purchase the ABS. Given that the loan is non-recourse, if the borrower does not repay the loan, the Federal Reserve Bank of New York will enforce its rights in the collateral and sell the collateral to a SPV established specifically for the purpose of managing such assets. The SPV is funded, in part, by a $20 billion investment by Treasury under the Troubled Assets Relief Program.

U.S. Government Credit Protection

The Treasury and Federal Reserve have structured the TALF to minimize credit risk for the U.S. government to the greatest extent possible, consistent with achieving the program's purpose of encouraging lending to consumers and small businesses. Several structural features of the program protect taxpayer dollars.

First, with the exception of ABS that are fully guaranteed by the SBA, TALF eligible ABS must satisfy several credit rating requirements. Eligible securities must have received two AAA ratings from the major rating agencies, and none of the major rating agencies can have rated the security below AAA or placed the security on watch for downgrade. Moreover, each ABS issuer must hire an external auditor to offer an opinion that supports management's assertion that the ABS is TALF eligible.

Another source of credit protection is the requirement that private investors unrelated to the ABS issuer must supply risk capital in the form of "haircuts." For example, the haircut on a two- to three-year private student loan is 10 percent, meaning that in order to receive a $90 loan, the investor must give the Federal Reserve $100 in collateral. The haircuts vary across asset types, depending on Treasury and the Federal Reserve's assessment of the riskiness of the ABS. Haircuts will be higher for riskier assets, thereby limiting the risk that the asset will decline in value over the life of the loan by enough to induce the purchaser to not repay the loan and leave the ABS with the Federal Reserve.

Further protection is provided by the risk premium included in the TALF loan rates. The interest rate spread will accumulate as a first loss position for the SPV established to hold ABS surrendered to the facility in lieu of repayment.

Extension of TALF Eligible Collateral Underway

As announced on February 10, work is underway on the expansion of TALF. The Treasury and the Federal Reserve are analyzing the appropriate terms and conditions for accepting commercial mortgage-backed securities and are evaluating a number of other types of AAA-rated newly issued ABS for acceptance under the expanded program, which could lend up to $1 trillion against eligible ABS. Focus remains on including securities that will have the greatest macroeconomic impact and that could most efficiently be added to the TALF at a low and manageable risk to the government. The Federal Reserve and Treasury currently anticipate that ABS backed by rental, commercial, and government vehicle fleet leases, and ABS backed by small ticket equipment, heavy equipment, and agricultural equipment loans and leases will be eligible for the April funding of the TALF. Other types of securities under consideration include private-label residential mortgage-backed securities, collateralized loan and debt obligations, and other ABS not included in the initial rollout. Treasury and the Federal Reserve expect to announce which additional classes of ABS will be eligible under the expanded program as soon as the analysis is completed.

Table A – Asset Classes That Have Historically Been Funded in Securitization Markets

Categories	Lending Examples	Assets Funded Through Securitizations
Auto Lending	Consumer loans and leases. Dealership funding programs	Automobiles, light trucks, motorcycles and recreational vehicles (RVs)
Student Loans	Federally guaranteed student loans (including consolidation loans) and private student loans	Students and education providers
Small Business Administration Loans	Loans, debentures, or pools originated under the SBA's 7(a) and 504 programs	Small businesses
Credit Cards	Consumer and corporate credit cards	
Vehicle Leases	Rental, commercial and government fleet leases	Automobiles and other fleets including forklifts, taxis, and long-haul trucks
Equipment Loans and Leases	Small ticket equipment loans and leases	Phone systems, computers and copiers to small businesses
	Heavy equipment loans and leases	Cranes, excavators, and a range of other construction equipment
	Agricultural equipment loans and leases	Harvesters, specialty grape harvesters, and a variety of other agricultural equipment
Other Floorplan Securtizations	Floorplan loans and dealer inventory programs	Small equipment showrooms, heavy equipment showrooms, certain lots of used car dealers
Residential Property (RMBS)	Non-agency residential mortgages and loans	Residential property
Commercial Property (CMBS)	Commercial mortgages, commercial loans	Industrial, office, retail and multi-family residential property

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