6-4-2009

A Preliminary Assessment of the TALF

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SPEECH

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June 4, 2009

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Remarks at the Securities Industry and Financial Markets Association and Pension Real Estate Association's Public-Private Investment Program Summit, New York City

I thank you for this opportunity to speak to you today about what we at the Federal Reserve have been doing to improve market function and credit market access. Since August of 2007, the Fed has introduced a wide range of special facilities designed to improve market functioning, increase the availability of credit and bring down borrowing costs for households and businesses.

Today, I am going to focus my comments on the Term Asset-Backed Securities Loan Facility (TALF), which in my view is one of our most innovative programs. This facility is a complement to the Public-Private Investment Program efforts being undertaken by the Federal Deposit Insurance Corporation and the Treasury, which are the primary focus of today's conference.

In what follows, I would remind you that my comments reflect my own views and opinions and not necessarily those of the Federal Open Market Committee or the Federal Reserve System. I will discuss how the securitization markets broke down last fall creating the need for TALF, how the TALF works and what it already has accomplished, where we see it evolving going forward, and finally, some preliminary thoughts on the future of securitization markets.

As you know, one of the origins of this crisis was the poor lending standards and lax risk controls that led to significant losses among many of the firms that dominate the financial industry. As the magnitude and widespread nature of these problems became evident in the early part of 2007, there was an abrupt loss of confidence and a sharp and sustained increase in risk aversion among investors. Liquidity in short-term funding markets seized up as concerns over the viability of many bank and non-bank financial institutions increased. Many of the Federal Reserve's early efforts—including the Term Auction Facility, Term Securities Lending Facility and the Primary Dealer Credit Facility—were directly aimed at restoring the ability of financial firms to obtain access to liquidity. And while it is still too soon to declare victory on this front, there have been significant improvements in interbank financing markets.

The next leg of policy intervention focused more directly on shoring up the strength of our financial institutions with programs such as the Treasury's Capital Purchase Program and the FDIC's Temporary Liquidity Guarantee Program, and here too there has been progress in a number of dimensions. Most notably, perhaps, is that in the wake of the release of the results of the recent stress test, the largest U.S. bank holding companies have shown an increased ability to raise capital and issue debt without government support. The major securities firms have deleveraged and have built up significant liquidity buffers.

Although conditions in interbank funding markets and capital markets more broadly have shown signs of improvement, securitization markets are still significantly impaired. This is particularly true of the asset-backed securities markets, in which much of household and business credit is intermediated between borrowers and investors.

What has transpired in the asset-backed securities market over the past two years has been dramatic. Prior to August 2007, as much as 60% of private credit creation in the U.S. was not held on the books of depository institutions but was instead distributed onwards through the ABS markets into the so-called "shadow banking system." Through the use of ABS, banks were able to package consumer loans, credit card receivables, student loans, residential and commercial mortgages, as well as other types of loans into securities that were then sold to investors.

However, since August 2007, the ABS market collapsed in a series of stages—first subprime mortgages, then alt-A mortgages and non-agency Residential Mortgage Backed Securities, and finally consumer ABS and Commercial Mortgage Backed Securities or CMBS. The collapse spanned every area outside of the agency mortgage-backed securities market, which is supported by the government-sponsored enterprises, Fannie Mae and Freddie Mac.

The final stage of collapse of the ABS markets occurred following the failure of Lehman Brothers last fall, when the yields on outstanding ABS issues soared and new originations virtually disappeared. This increase in yields did not solely reflect an increase in credit risk; it also reflected a genuine loss of confidence and an accompanying increase in risk aversion. Yield spreads on even the very safest ABS obligations soared hundreds of basis points. This can be seen in the fact that AAA-rated student loan tranches, with underlying loans 97% guaranteed by the federal government, climbed to yield levels as much as 400 basis points over LIBOR.

With the spike in yields, the economic incentives to issue evaporated—issuance was just too costly and there was no active market. After averaging around $50 billion per quarter of new originations in 2007 and the first three quarters of 2008, consumer ABS issuance plunged to only $4 billion during the fourth quarter of 2008. Issuance of commercial mortgage backed securities ground to a complete halt and this market currently remains closed.

So why did the ABS market collapse? There are many reasons.

One factor was that in some areas, the risk management incentives of banks and other issuers of ABS were misaligned with those of the end investors in these securities. This misalignment manifested itself in the overall deterioration in lending standards that took place across the economy beginning during the middle part of this decade. Some originators did not do an adequate job of due diligence because the underlying loans were swiftly moved off their balance sheets through the securitization process. This dynamic should have been mitigated to some extent by the rating agencies as they assigned ratings to these new securities, but that process too proved inadequate, especially for residential real estate-related securities. The problems associated with these misaligned incentives for issuers and inadequate rigor on the part of the rating agencies became apparent as the housing sector turned down and the economy weakened. The result was a dramatic spike in credit losses and an almost complete loss of investor appetite for non-agency, residential mortgage-backed product.

A second factor contributing to the collapse of the ABS market was that the benefits of pooling and distributing risk more widely proved to be somewhat illusory. In practice, the performance across different loans that collateralized the securities was much more highly correlated than was anticipated, and the risks associated with these securities was significantly more concentrated than had been assumed. Some banks that were unable to sell the highest-rated tranches kept them on their books. In other cases, the sales were made to off-balance sheet vehicles, in which the banks retained residual risk. This correlation contributed to the aversion of investors to the asset class as a whole.

A third contributing factor was the fact that these securities were often complex and heterogeneous and, thus, hard to value. In a stressed economic environment, this complexity exacerbated the erosion in market liquidity conditions, which in turn led to a vicious circle of falling prices and even further diminished liquidity. The result was that some bank conduits and buyers of securitized products such as SIVs became distressed and failed as mark-to-market losses increased. In the post-Lehman bankruptcy world—when liquidity was paramount—securitized products were very difficult to trade, in part, because they were very difficult to value.

The cessation of new asset-backed securitizations has been problematic because banks have not had the capacity to keep credit flowing freely. This is especially true given that bank balance sheets were already under strain—bank capital has been depleted by credit losses and bank balance sheet capacity has been strained by an inability of banks to securitize new loan originations and by the need for banks to honor their off-balance sheet obligations.

For all these reasons, the Federal Reserve determined that it was important to augment the balance sheet capacity of the financial system by supporting the ABS market. This was the purpose of the TALF. By providing non-recourse, term financing for new AAA-rated consumer asset-backed securities to investors, the TALF essentially provides the balance sheet capacity necessary to facilitate the continued flow of credit to households and businesses.

The TALF offers three attributes that the private sector has had difficulty providing during this time of financial and economic distress: 1) leverage to purchase highly-rated, low-risk assets, 2) term financing and 3) protection against very adverse economic outcomes. TALF loans are leveraged—haircuts against the AAA-rated collateral average about 10%; the loan terms are three or five years; and the loans are non-recourse, which means that if the economy performs very badly and the securities fall sharply in value, an investor can put the collateral that secures its TALF loan back to the Fed, only losing the collateral haircut. The loan is then extinguished.

Because term, non-recourse financing is not readily available from the private sector currently and the spreads on asset-backed securities remain elevated, TALF provides an opportunity for investors to purchase AAA-rated consumer asset-backed securities and earn relatively high returns. Although some observers are concerned by the prospect of TALF investors achieving relatively high returns, I think that concern is misplaced. Investor participation is absolutely essential in order for the TALF to improve the availability of credit and to bring down the cost of credit for households and business. The prospect of relatively high expected risk-adjusted returns is precisely what gives investors an incentive to participate in the program. As investors begin to take advantage of the attractive TALF terms, spreads on ABS securities contracts, and rates of return go down, and most importantly, the costs of funds for the issuers of the underlying securities falls. Investors' actions to seek attractive returns lead to lower borrowing costs for households and businesses.

Does the possibility of attractive returns for TALF investors mean that the Federal Reserve is taking on large credit risks? I think the answer is a clear "no," principally because the returns earned by investors primarily are due to the absence of sufficient private balance sheet capacity rather than underlying credit risk. In fact, from the Federal Reserve's perspective, the risk of loss is very low. Indeed, there are three layers of protection that stand between the Federal Reserve and losses.

First, the underlying securities are AAA-rated, which means that losses on the underlying loans have to be unusually large to move that high up in the capital structure. And although some of the rating agency models have not held up well in the crisis, the consumer ABS models have proven to be reasonably robust. In other words, a AAA-rating still means quite a bit in this market. This is in contrast to the collateralized debt obligation or CDO market , where AAA-rated securities often used subprime and Alt-A mortgage loans as their raw ingredient.

Second, as noted earlier, the Fed has taken additional haircuts against the underlying securities averaging about 10%. These haircuts provide additional protection to the Fed.

Third, if the underlying collateral is put back to the Fed, the Fed puts the collateral into a special purpose vehicle. In such a situation, the Fed would be protected by the excess spread earned on the TALF loans and Treasury-provided TARP capital. Only if those buffers were wiped out, would the Fed suffer losses.

We have done stress simulations on the underlying loans. We think it is unlikely that the Treasury will lose money on this program, and it sits ahead of the Fed in terms of its loss exposure. The risk posed to the Federal Reserve therefore seems quite remote. Instead, we expect that the program will be profitable for the taxpayers and will be successful in pushing down yields and increasing credit availability.

Turning from the issues of design and risk to issues concerning implementation and effectiveness, we have been rolling the TALF out in stages—first the consumer ABS market, with the first subscriptions for TALF loans in March; second, new CMBS securitizations that will start in early summer; and third, legacy CMBS and, possibly legacy RMBS, later this summer.

By legacy assets, we mean highly-rated existing securitized assets that are already outstanding. The legacy TALF program will help support asset-backed-securities prices. This should help aid market liquidity and make financial firms that hold such assets less vulnerable to the risk of further losses.

So far, the evidence indicates that the program is working as designed.

First, the issuance of consumer ABS securities has been gradually reviving. In March, four deals came to market worth $8.3 billion. In April, there were another 4 deals worth $2.9 billion. In May, there were 8 deals worth $13.6 billion and this week, there were 13 deals worth $16.4 billion. We're not back yet to the $200 billion annual rate of issuance before the crisis and we don't expect to get there, but we are making a good start. Moreover the type of deals has broadened out to include a wide range of asset classes. For example, this month's deals included credit card, auto loan and lease, equipment leasing, insurance premium and mortgage servicer securitizations.

Second, the market for such deals is not wholly reliant on TALF financing. TALF loans have accounted for a bit more than half of total issuance volume of ABS, with considerable variability from subscription to subscription period. We view this as a good thing. This means that the TALF is helping to restart the market, rather than the TALF being the market.

Third, and most importantly, spreads on consumer ABS have been coming down sharply from their peak levels reached late last year. For example, the spreads on AAA-rated credit card ABS have narrowed from a peak of about 600 basis points over LIBOR to slightly above 200 basis points currently. Encouragingly, spreads of even lower-rated ABS—securities that are not TALF eligible—have also narrowed quite significantly. Although it is still too early to say the TALF has been a resounding success, we at the Fed are encouraged by the results so far.

While we are generally pleased with how the TALF program has been evolving, many challenges remain. One challenge is in striking the appropriate balance between sufficient protections against abuse of the program, on the one hand, and a degree of red tape and restrictions that could make the program unattractive to issuers and investors, on the other. To the extent that issuers and investors are unwilling to participate in TALF because of fears that their involvement might lead to unforeseen complications at a later date, this would lead to the unattractive outcome of underutilization and the achievement of only a portion of the potential benefits.

Of course it is of critical importance in this facility and in all the programs instituted in response to this crisis that the interests of the taxpayer be protected, and the safeguards and restrictions on the use of TARP funds are designed to achieve this. However, I think it is fair to say that TALF got off to a relatively slow start because investors were worried that the use of TARP funds in TALF could restrict their ability to conduct their business activities more broadly, perhaps in unanticipated ways and potentially retroactively. Put simply, to the extent that the use of TARP monies creates stigma, this may limit the effectiveness of TALF and other programs that use TARP funds. Although we think these fears among market participants that use TALF are misplaced, such anxieties have had an impact on the program.

Another challenge faced by the TALF is to increase the participation of real money investors (such as mutual funds, pension funds and insurance companies), many of whom are not permitted to use leverage. We at the Fed are working through a number of highly complex issues to enable the creation of vehicles that will make it easier for a broader range of investors to have access to financing for ABS securities. The broader the investor base, the greater the demand for the securities, the lower the yield levels and the greater the improvement in credit availability.

The rollout of TALF to the Commercial Mortgage Backed Securities market this summer will be important in determining the overall success of the program. The revival of the CMBS market is essential to stabilizing the commercial real estate market. As you know, commercial real estate values are under pressure for several reasons. Capitalization rates have climbed significantly, reducing commercial real estate valuations. In addition, the income generated from commercial property has diminished due to the contraction in overall economic activity. If the availability of funding for this market is not restored, the downturn in commercial real estate valuations and the losses for the holders of these assets will be greater. This will, in turn, likely further constrain credit availability.

A revival of the CMBS market is also important to accommodate the demand for funds to refinance commercial mortgage loans that will be coming due over the next few years. If the CMBS market remains shut down, it is unclear where these funds will come from. After all, in recent years, the CMBS market has satisfied about 40% of the credit needs of the commercial mortgage sector. If this market is closed, then the refinancing of maturing mortgages will be exceedingly difficult and this will exacerbate the drop in commercial real estate prices, loan defaults and the pressure on bank capital.

Finally, I want to consider briefly whether TALF will turn out to be a band-aid—providing temporary support to otherwise defunct securitization markets—or a bridge to an ultimately revived and vital securitization market. I think it is too soon to reach a firm conclusion one way or the other. I suspect that we will discover that some parts of the securitization market will return and prove viable even without government support. But other parts of these markets were fundamentally flawed, and they will not survive, nor should they.

On a positive note, the fact that there has been an increase in investor demand for consumer ABS that does not use TALF financing is an encouraging sign. This indicates that more traditional investor classes, such as pension funds and insurance companies that don't usually use leverage, are starting to stick a toe in the water. However, it is hard to believe that there will not be significant changes to the structure of this asset class in the wake of the recent crisis.

So what are some of the changes that I foresee or otherwise feel are required?

First, there needs to be a better alignment of incentives between the lenders and securities dealers that originate and securitize the loans and the investors that purchase these securities. One suggestion that has received significant attention is for banks to retain a portion of the securitization on their balance sheets. The notion is that with "some skin in the game," those making the loans will show greater due diligence in terms of the underwriting standards applied to the underlying loan originations. In some ways, the TALF program is already facilitating this outcome, with the highly-rated AAA-rated securities sold to investors and the lower-rated tranches generally retained by the issuers.

Second, I suspect that investors will become less reliant on the rating agencies—conducting more due diligence themselves.

Third, I believe there will be a greater focus among investors on standardized, homogeneous, easy-to-evaluate products. This will improve the underlying liquidity of securitizations, which should result in lower lending costs and should make the assessment of the risk of the assets easier.

Fourth, I think the overall securitization market will be smaller. The demise of parts of the shadow banking system such as the SIVs and the fact that banks are likely to have to consolidate some off-balance activities back onto their books at the end of this year should reduce the overall demand for and supply of securitized product.

Developing and implementing the TALF has been challenging. As the program enters into a new phase with the financing of CMBS and legacy CMBS, we will encounter further hurdles that we will have to overcome, adjusting and modifying the program as needed in order to make it more effective. Nevertheless, I am confident that we will continue to build on our initial success, reopening credit channels to consumers and businesses.

Thank you very much for your attention.