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Securitization was a major source of credit to the economy, and its resurgence will likely contribute to our overall economic recovery.

TALF: Jump-Starting the Securitization Markets

by Kenneth J. Robinson

Securitization — the pooling and packaging of loans into securities for sale to investors — increases the availability and improves the terms of credit. Rather than holding loans on their balance sheets, financial intermediaries can use the proceeds from securitization to originate new loans. Investors gain diversity from the pooling process and liquidity from the markets for asset-backed securities (ABS).

Securitization grew rapidly for most of this decade, with ABS outstanding rising from \$3.4 trillion in first quarter 2000 to \$8.4 trillion at their peak in mid-2008. At that time, ABS markets funded almost two-thirds of residential mortgages. Besides housing, ABS are an important part of providing credit for automobiles, credit card receivables and student loans. They also help fund small business loans. All told, these securities financed about a quarter of non-mortgage consumer credit during the boom times. Given securitization's impor-



tance, any major disruptions in activity could have a significant impact on the economy.

In the financial crisis that began in August 2007, securitization activity virtually dried up. For years, ABS had become increasingly complex, with the rise of exotic securities like collateralized debt obligations and securities issued by commercial paper conduits. Now frequently referred to as “toxic assets,” these securities proved much riskier and more difficult to value than issuers or investors originally assumed.

When the housing bubble burst, the value of the collateral backing much of the ABS declined sharply, and so did the value of the securities themselves. Not surprisingly, investors shunned ABS, and this important source of credit grew scarce.

The Federal Reserve responded by creating the term asset-backed securities loan facility, or TALF. Its purpose is to boost securitization by providing loans to people holding certain highly rated ABS. These loans will then support new ABS issues and help thaw out the securitization markets. Judging from both new issues and spreads in

secondary markets, the TALF appears to be meeting its objective of jump-starting the securitization markets.

Crisis and Response

The financial crisis started in the summer of 2007 with the collapse of two Bear Stearns-managed hedge funds engaged in highly leveraged subprime mortgage ABS investments. The failure set off a chain of events that spread beyond ABS associated with mortgages.¹

Net issuance of ABS fell off sharply (*Chart 1*). In fact, the private-label market virtually shut down in 2008. Traditional investors shunned ABS and exhibited a flight to quality by turning to safer U.S. government securities. Treasury yields edged close to zero.

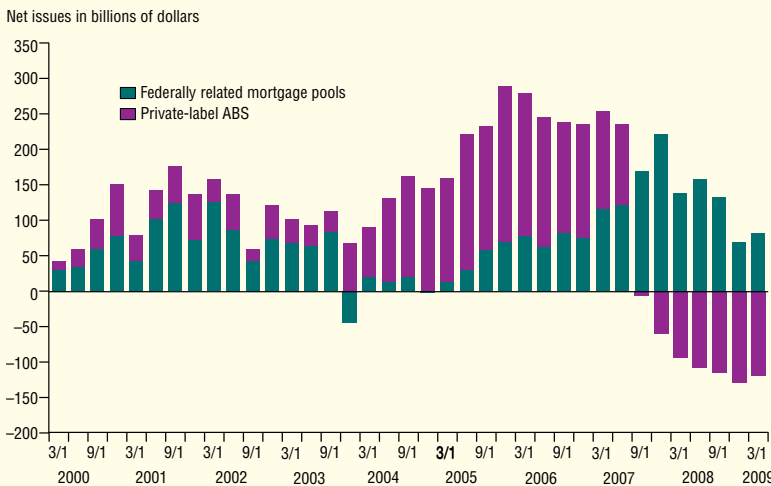
There were also sharp increases in the cost of credit. Spreads soared to unprecedented levels, even on highly rated tranches of ABS—a reflection of unusually high risk premiums (*Chart 2*). As the financial crisis deepened, the Fed responded in traditional ways, lowering the federal funds rate and increasing discount window lending. Interest payments on reserves, scheduled for 2011, were pushed forward.

When it became clear these conventional responses wouldn’t stem the crisis, the Fed turned to a new set of policy tools to provide liquidity and direct funding to borrowers and investors in key credit markets. The result was a veritable alphabet soup of new facilities: TAF, TSLF, PDCF, AMLF, CPFF, MMIFF.² To address securitization markets’ problems, the Fed created the TALF in November 2008.

In its announcement, the Fed said the facility “will help market participants meet the credit needs of households and small businesses by supporting the issuance of ABS collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration (SBA).”³ A number of modifications and expansions have been implemented, increasing the TALF’s potential size and widening the types of collateral

Securitization markets were hit hard by the financial crisis. Net issuance fell off sharply. There were also sharp increases in the cost of credit.

Chart 1
Financial Crisis Crimps ABS Market



SOURCE: Federal Reserve Board Flow of Funds.



borrowers can use (see the box titled “TALF Chronology” on p. 7).

The TALF has characteristics that set it apart. Unlike the other facilities, the TALF isn't solely for provision of liquidity. Instead, it will provide investors with term loans of up to five years against highly rated securities. And, unlike other lending programs, the TALF combines Fed liquidity with capital provided by the Treasury. Finally, the possible increase to \$1 trillion makes the TALF potentially one of the Fed's largest programs.

The initial program authorized the New York Fed to lend up to \$200 billion to holders of certain highly rated ABS backed by newly and recently originated consumer and small business loans. These would be nonrecourse loans, which limit borrowers' potential losses to the initial amount of ABS put up as collateral.

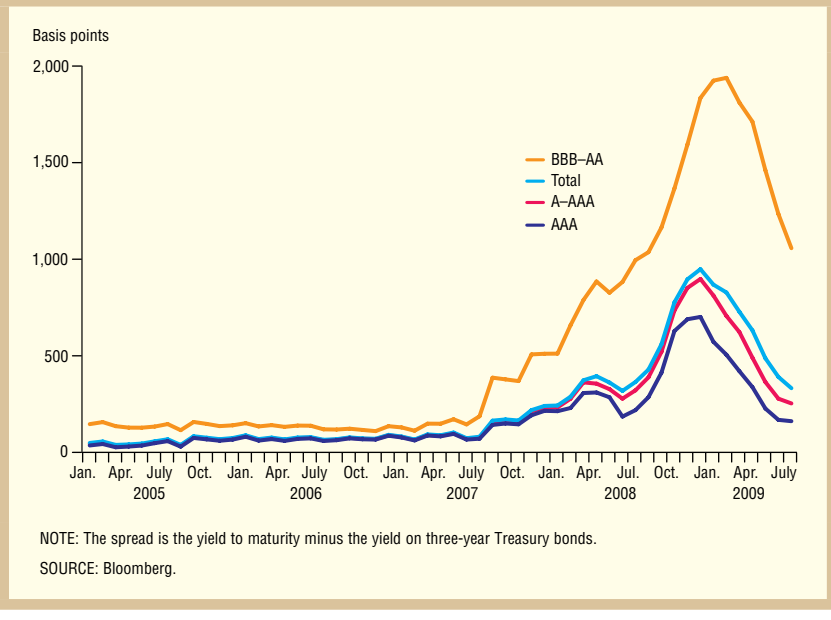
Granting nonrecourse loans created the need for an entity—called a special purpose vehicle (SPV)—to purchase and manage any assets received from the TALF loans in the event of a default. Financing for the SPV comes initially from the Treasury's Troubled Asset Relief Program (TARP), which will purchase \$20 billion in subordinated debt from the SPV.

If this proves insufficient, the New York Fed will lend to the SPV. This loan will be senior to the TARP. Cash flows from SPV assets will first pay off the loan from the New York Fed, with proceeds then going to the TARP. Furthermore, the New York Fed grants recourse loans to the SPV, allowing it to recoup losses beyond initial collateral.

Any U.S. company that owns ABS-eligible collateral may borrow from the TALF. The companies pay a small administrative fee of 10 to 20 basis points (0.1 to 0.2 percentage points), depending on the type of collateral. Borrowers are offered a floating-rate or fixed-rate loan, also depending on the collateral.

Interest rates vary with the collateral securing the loan, but the Fed

Chart 2
ABS Spreads Soar During Crisis



stipulated that they should be “set with a view to providing borrowers an incentive to purchase eligible ABS at yield spreads higher than in more normal market conditions but lower than in the highly illiquid market conditions that have prevailed during the recent credit market turmoil.”⁴

The TALF is structured to minimize the Fed's risk. With the exception of securities fully guaranteed by the SBA, TALF-eligible ABS must have the highest investment-grade rating from two or more nationally recognized rating agencies. In addition, the security must not have been rated below investment grade or placed on watch for a downgrade.

So-called haircuts will be applied across asset types. These haircuts represent the difference between the ABS's value and the dollar amount of the loan extended. The minimum size of a TALF loan is \$10 million, and haircuts vary with the type of collateral.

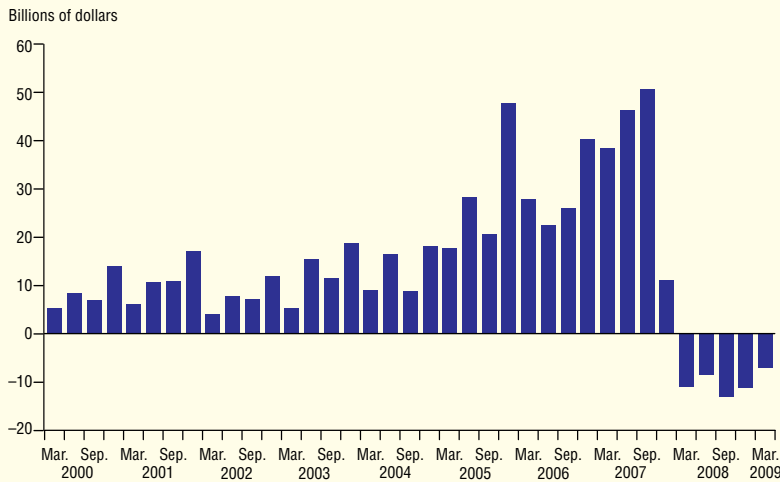
Initially, eligible collateral included ABS backed by recently issued automobile, credit card and student loans, plus SBA-guaranteed small busi-

The possible increase to \$1 trillion makes the TALF potentially one of the Fed's largest programs.



Chart 3

Net Issues Turn Negative in CMBS Market



SOURCE: Federal Reserve Board Flow of Funds.

ness loans. The criteria for “recently issued” vary. For example, substantially all the credit exposures underlying eligible auto loan ABS must have been originated on or after Oct. 1, 2007. The eligible ABS themselves must be issued on or after Jan. 1, 2009.

The Fed significantly increased the TALF’s scope in May 2009, announcing the eligibility of highly rated commercial mortgage-backed securities (CMBS). CMBS outstanding increased steadily throughout the past decade, rising from \$200 billion in early 2000 to a peak of almost \$800 billion at the end of 2007. Since then, the market has faltered, with net issues turning negative in 2008 (Chart 3).

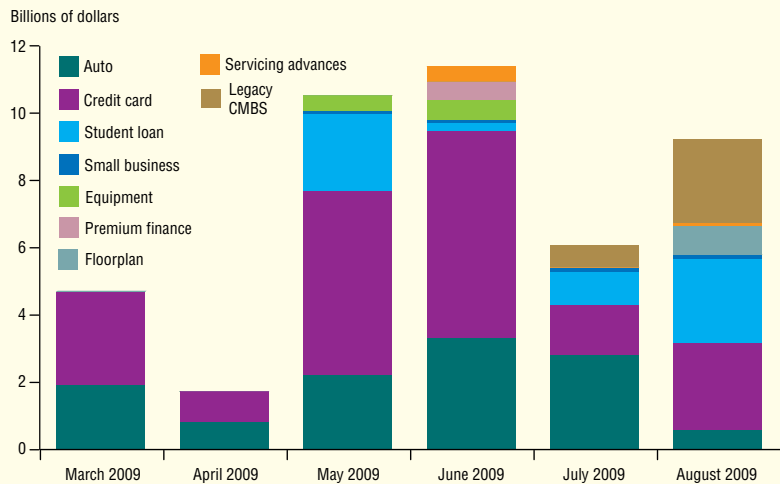
Including CMBS as eligible collateral should help strengthen the commercial property market. Easing the credit crunch in this market, the Fed said, “will help prevent defaults on economically viable commercial properties, increase the capacity of current holders of maturing mortgages to make additional loans, and facilitate the sale of distressed properties.”⁵ Successful refinancing of commercial mortgage loans maturing over the next few years will likely be greatly assisted by a revived CMBS market.

TALF operations are conducted monthly with separate operations for ABS and CMBS. March and April elicited interest from ABS backed by autos and credit cards (Chart 4). May and June showed an increase in the amount of loans requested as well as expansion in the types of collateral that investors offered. The July operations resulted in a little more than \$6 billion in loan requests; August operations received \$9.2 billion in loan requests.

The TALF had been slated to end on Dec. 31, 2009, but the Fed has extended it until June 30, 2010, depending on the collateral offered.

Chart 4

TALF Loan Requests Vary in Initial Months



SOURCE: Federal Reserve Bank of New York.

Securitization Markets Respond

Like other Fed actions in the financial crisis, the TALF fits with the central bank’s broad macroeconomic goals. Reviving securitization markets



will help lenders meet the credit needs of consumers and small businesses, providing stimulus to the overall economy. New securitization activity and interest rates on securities tell us how financial markets are responding.

The first signs of a comeback began even before the first TALF operation in March. Student loan ABS, which had disappeared in late 2008, reappeared in February (*Chart 5*). Credit card ABS, also dormant for months, followed in March. As TALF operations got under way, all markets showed signs of recovery—with the exception of CMBS. It continued to exhibit weakness until June—most likely reflecting the fact that the TALF’s first CMBS operation didn’t occur until the middle of that month.⁶

During the crisis, interest rate spreads on ABS reached unprecedented levels as investors demanded higher and higher risk premiums. Among the highly rated ABS initially targeted by the TALF—credit card, auto and student loans—the secondary market yield spreads were elevated even before the sharp increases beginning in fall 2008. By the time the TALF was announced, spreads had increased to between 400 and 700 basis points (or 4 to 7 percentage points).

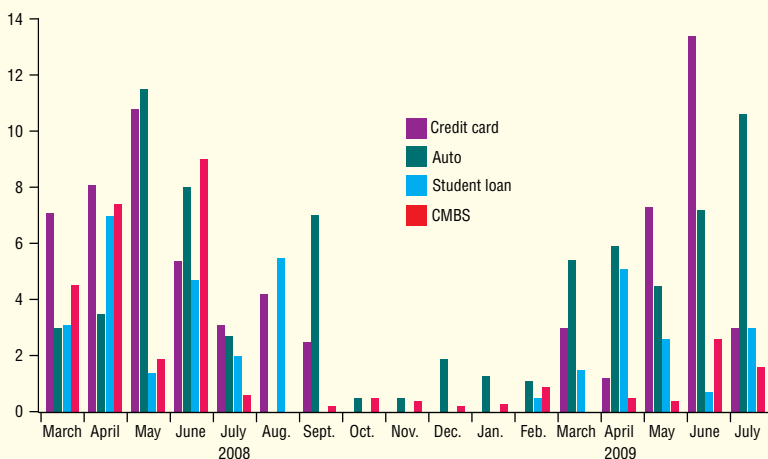
Soon after the Fed addressed these difficulties, spreads peaked, and they’ve been on a fairly sustained downward trend since (*Chart 6*). By contrast, the spread on highly rated home equity loan ABS continued to widen even after the TALF’s announcement. Securitized home equity loans aren’t eligible for the TALF, providing some indication of the positive impact on securitization markets for TALF-eligible ABS.

The early February announcement that the TALF could increase to as much as \$1 trillion was accompanied by the continued downward trend in risk spreads for assets that are the focus of the TALF’s operations. The lack of a similar response for home equity ABS affirms that the TALF played a role in improving the prospects for

Chart 5

After TALF, ABS Markets Stage a Comeback

New issues in billions of dollars

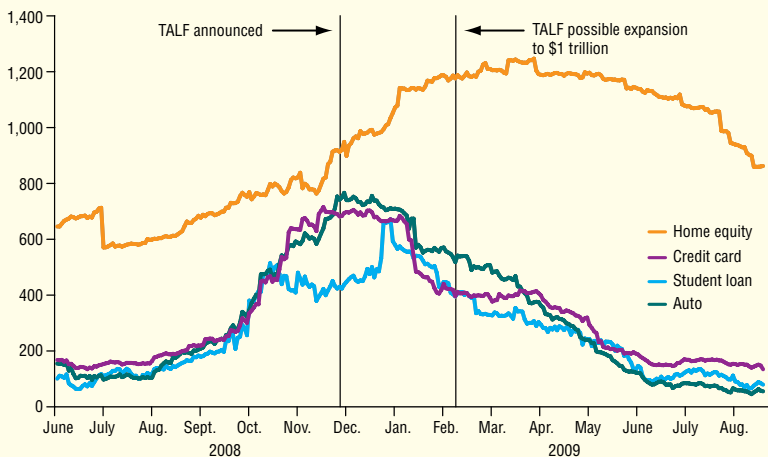


SOURCE: Bloomberg.

Chart 6

Highly Rated ABS Spreads Narrow After TALF

Basis points



NOTE: The spread is the yield to maturity minus the rate on three-year Treasury bonds.

SOURCE: Merrill Lynch (via Bloomberg).



Chart 7
Spreads on Highly Rated CMBS Decline

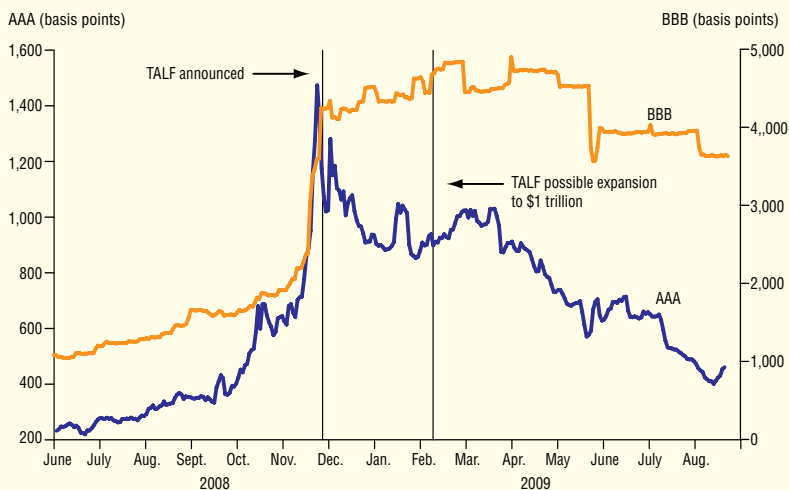
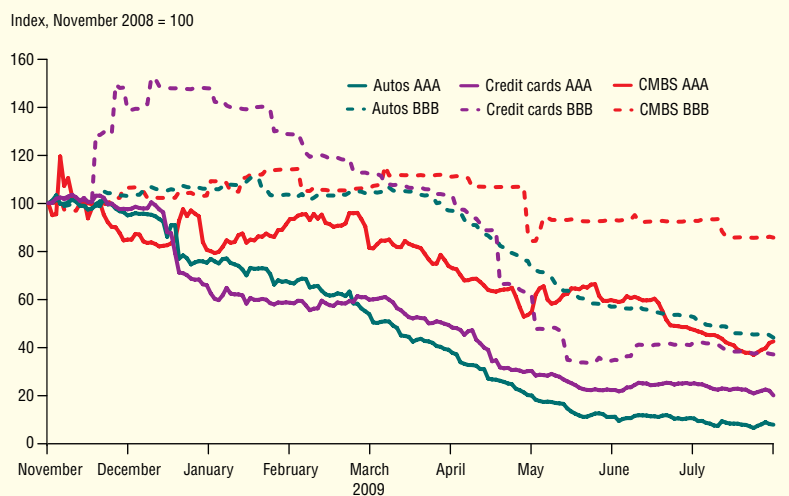


Chart 8
Spreads Decline Faster for Highly Rated ABS



securitization markets.

What happened after CMBS became TALF-eligible? The Fed facility focuses only on the highly rated segment of the market, so it's not surprising that the response differs between AAA-rated CMBS and lower-rated BBB CMBS. The spread on highly rated CMBS peaked immediately before the TALF announcement in November 2008 (Chart 7). Although the CMBS market wasn't initially part of the TALF, investors most likely viewed the Fed's support as positive for securitization markets in general.

The possibility of a larger TALF including newly issued CMBS also seemed to exert a positive effect. Soon after the February announcement, the risk spread on AAA-rated CMBS began a fairly steady decline. The spread on lower-rated CMBS showed little or no improvement. Lower-rated CMBS aren't TALF-eligible, so the CMBS market's riskier segment hasn't seemed to benefit from the potential increase in the TALF's size.

Finally, comparing relative movements in spreads also points to the TALF's potentially positive influence. The TALF only accepts highly rated ABS, and this segment has seen the largest relative declines in risk spreads (Chart 8). Consistent with earlier results, CMBS markets have shown the least relative improvement in spreads so far.⁷

On the Road to Recovery

The importance of the securitization markets and the TALF's potential size make it one of the most significant Fed policy actions undertaken in the aftermath of the financial crisis. Securitization was a major source of credit to the economy, and its resurgence will likely contribute to our overall economic recovery.

Initial findings suggest ABS markets are in the early stages of a recovery. Some investors are re-entering the markets with new issues. While still high by historical norms, risk spreads have shown a sustained decline over the past few months. However, impor-



tant changes may be in store for these markets as their recovery continues. Securitization isn't likely to grow as rapidly as it did earlier in the decade, largely because of restructurings at hedge funds and other nonbank lenders, which had fueled much of the expansion in securitized assets.

Investors may have lost their taste for the complex and difficult-to-value products that grew explosively early in this decade. The TALF itself could lead to an unintended credit allocation by favoring certain types of ABS—the highly rated segment—over other segments.

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TALF Chronology

Nov. 25, 2008	Fed announces the creation of the term asset-backed securities loan facility (TALF) under the Federal Reserve Act's Section 13(3), a Depression-era provision that allows the central bank broad powers to make loans in difficult economic times.
Dec. 19, 2008	TALF loan maturities are increased from one to three years. TALF loans will be distributed to all eligible borrowers rather than through an auction process.
Feb. 10, 2009	The Fed announces its willingness to expand the TALF to as much as \$1 trillion. Eligible collateral could be broadened to include highly rated commercial-mortgage-backed securities (CMBS) and private-label asset-backed securities (ABS) backed by residential mortgages.
March 3, 2009	Fed puts the TALF into operation, with subscriptions accepted beginning March 17.
March 19, 2009	Fed expands the eligible collateral to include ABS backed by loans or leases related to business equipment, vehicle fleet leases, floorplan loans and mortgage servicing advances.
March 23, 2009	Fed and Treasury expand eligible collateral to include legacy securities to complement the Treasury's Public-Private Investment Program.
May 1, 2009	Fed announces that newly issued CMBS and securities backed by insurance premium finance loans would be eligible collateral, beginning in June. TALF loans with maturities of five years are also authorized.
May 19, 2009	Fed announces that certain high-quality CMBS issued before Jan. 1, 2009, (legacy CMBS) would become eligible collateral beginning in July.
Aug. 17, 2009	Fed and Treasury announce that the TALF is extended through March 31, 2010, for loans against newly issued ABS and legacy CMBS. TALF lending against newly issued CMBS is extended through June 30, 2010.

Federal regulatory proposals that would require originators to keep a certain percentage of any credit risk on the assets they're securitizing could also dampen the size of such activity. Changes to accounting standards will also likely impact securitization. These new standards will require a greater amount of disclosure about securitization transactions and companies' continuing exposure to risks related to the transfer of assets. In particular, accounting for off-balance-sheet entities set up by banks will become subject to enhanced guidance.⁸

These changes point to an ABS marketplace that may be less dynamic but more stable than earlier in the decade. Even a smaller, more homogenized securitization sector is important for reviving lending for both consumers and small businesses and for contributing to an economic recovery.

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Notes

¹ See "The Financial Crisis of 2007–2009: Causes and Remedies," by Viral V. Acharya, Thomas Philippon, Matthew Richardson and Nouriel Roubini, in *Restoring Financial Stability: How to Repair a Failed System*, Viral V. Acharya and Matthew Richardson, eds., Hoboken, N.J., John Wiley & Sons, 2009, pp. 1–56.

² TAF is the term auction facility, TSLF is the term securities lending facility, PDCF is the primary dealer credit facility, AMLF is the asset-backed commercial paper money market mutual fund liquidity facility, CPFF is the commercial paper funding facility, and MMIFF is the money market investor funding facility. For more on the Federal

Reserve's response to the financial crisis, see "Credit and Liquidity Programs and the Balance Sheet" at www.federalreserve.gov/monetarypolicy/bst.htm.

³ See Federal Reserve press release, Nov. 25, 2008, www.federalreserve.gov/newsevents/press/monetary/20081125a.htm. The Board authorized this credit facility under Section 13(3) of the Federal Reserve Act.

⁴ See "Term Asset-Backed Securities Loan Facility: Frequently Asked Questions," Federal Reserve Bank of New York, www.newyorkfed.org/markets/talf_faq.html.

⁵ See Federal Reserve press release, May 1, 2009, www.federalreserve.gov/newsevents/press/monetary/20090501a.htm, and "A Preliminary Assessment of the TALF," speech by William C. Dudley, president and chief executive officer of the Federal Reserve Bank of New York, June 4, 2009, www.newyorkfed.org/newsevents/speeches/2009/dud090604.html.

⁶ The June 16 TALF CMBS operation received no requests for loans. This is similar to what happened with the early TALF operations, where investor interest was somewhat weak, as shown in Chart 4.

⁷ Perhaps the ABS market's highly rated segment was improving relative to the lower-rated segments even in markets not covered by the TALF. If so, this would cast some doubt about the TALF's efficacy. However, spreads for highly rated and lower-rated home equity ABS have shown little movement, once again providing evidence consistent with a positive impact from the facility.

⁸ See "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," Department of the Treasury, www.financialstability.gov/docs/regs/FinalReport_web.pdf. For accounting changes, see "Statement of Financial Accounting Standards No. 166," Financial Accounting Standards Board, June 2009.

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