

Liquidity, Securitization, and Policy

Til Schuermann*

Federal Reserve Bank of New York

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Liquidity and the magic of securitization

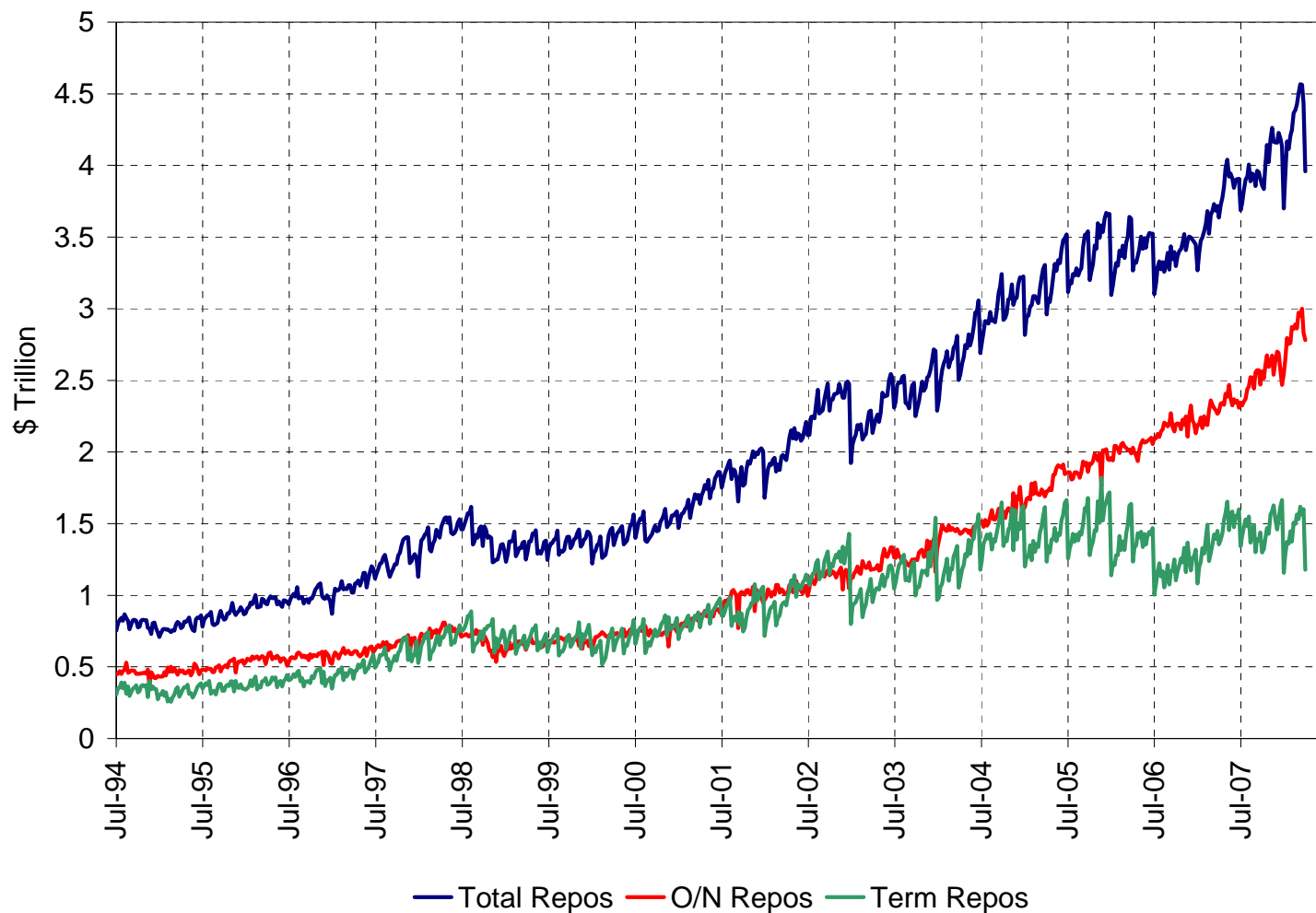
- Credit assets have traditionally been illiquid
 - Try trading a single mortgage, or credit card receivable
- Securitization helped “liquify” these assets
 - Bundle, slice and sell
- Need to solve significant information problems to get this done
 - How is an investor to efficiently evaluate a tranche of an ABS?
 - Can’t re-underwrite every credit in the pool
 - Credit rating agencies help address this information friction

Questioning the magic . . .

- When it works, very efficient way of allocating credit risk / capital
- Growth of securitization paralleled growth of repo markets
 - Efficient financing mechanism
- But what if market participants feel the need to re-underwrite every credit asset in an ABS/MBS?
 - Mis-assessment of risk
 - Mis-valuation
- Machine can grind to a halt

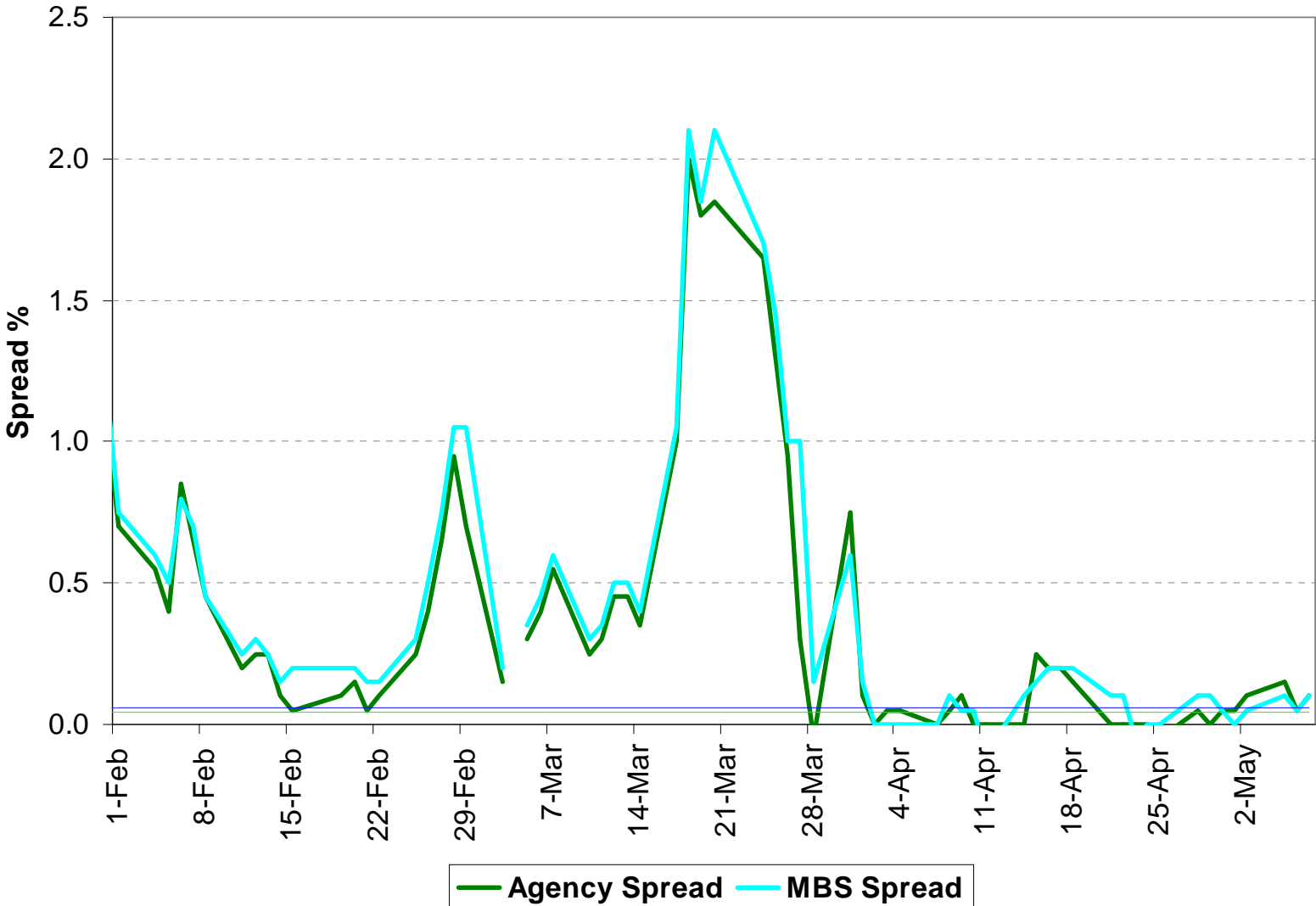
Outstanding dealer repos

Reliance on overnight repo financing has been growing



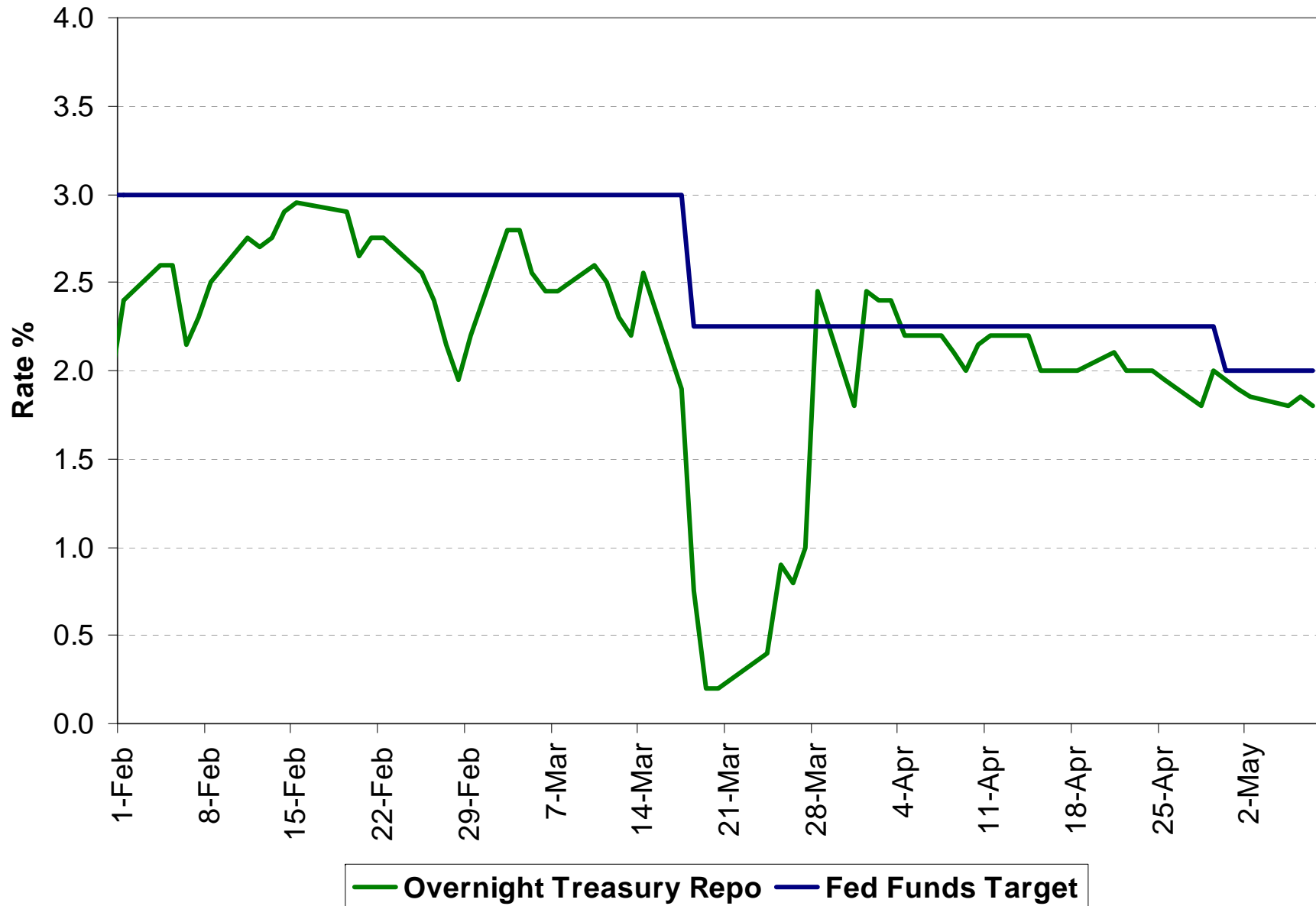
Source: FRBNY

High overnight agency and MBS spreads to Treasury



Source: Bloomberg

Abnormally low overnight Treasury repo rates



Source: Bloomberg, FRBNY

Liquidity: what is it?

- Typically we think of two types of liquidity
 - Market liquidity is the ease with which an asset is traded
 - Funding liquidity is the ease with which a bank can obtain funding
- The composition of the Fed's balance sheet can influence both types of liquidity
 - Fed can lend to banks and use assets as collateral

Problems addressed by new lending facilities

	<u>Depository Institutions</u>	<u>Primary Dealers</u>
Backstop Standing Facilities	Discount Window	Primary Dealer Credit Facility (PDCF)
Auction Facilities	Term Auction Facility (TAF)	Term Securities Lending Facility (TSLF)

- TAF: illiquid term markets and the stigma that accompanies discount window borrowing.
- TSLF: illiquid functioning in repo funding markets—illustrated by abnormal rates and high haircuts.
- PDCF: the lack of market-based back-stop credit in repo markets.

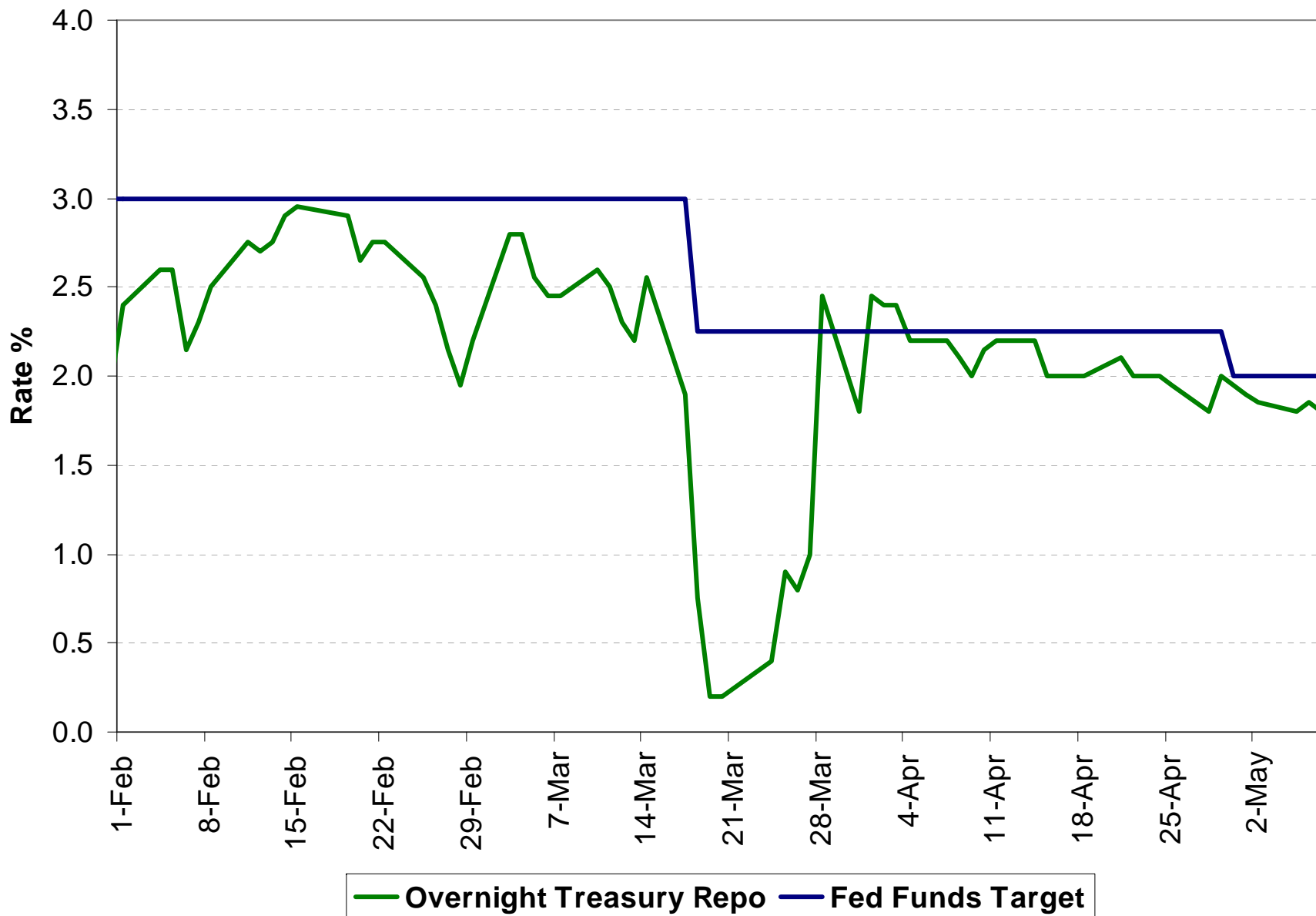
Illiquid repo markets

- The TSLF addresses the illiquid functioning in various repo financing markets, including abnormal rates, wide bid-ask spreads, and large and increasing haircuts on collateral.
- The PDCF provides an alternative source of financing to a dealer that has difficulty financing a security in the market
- It was necessary to provide such an alternative in the unusual and exigent circumstances surrounding the near-failure of Bear Stearns.

What can you pledge at the TSLF & PDCF?

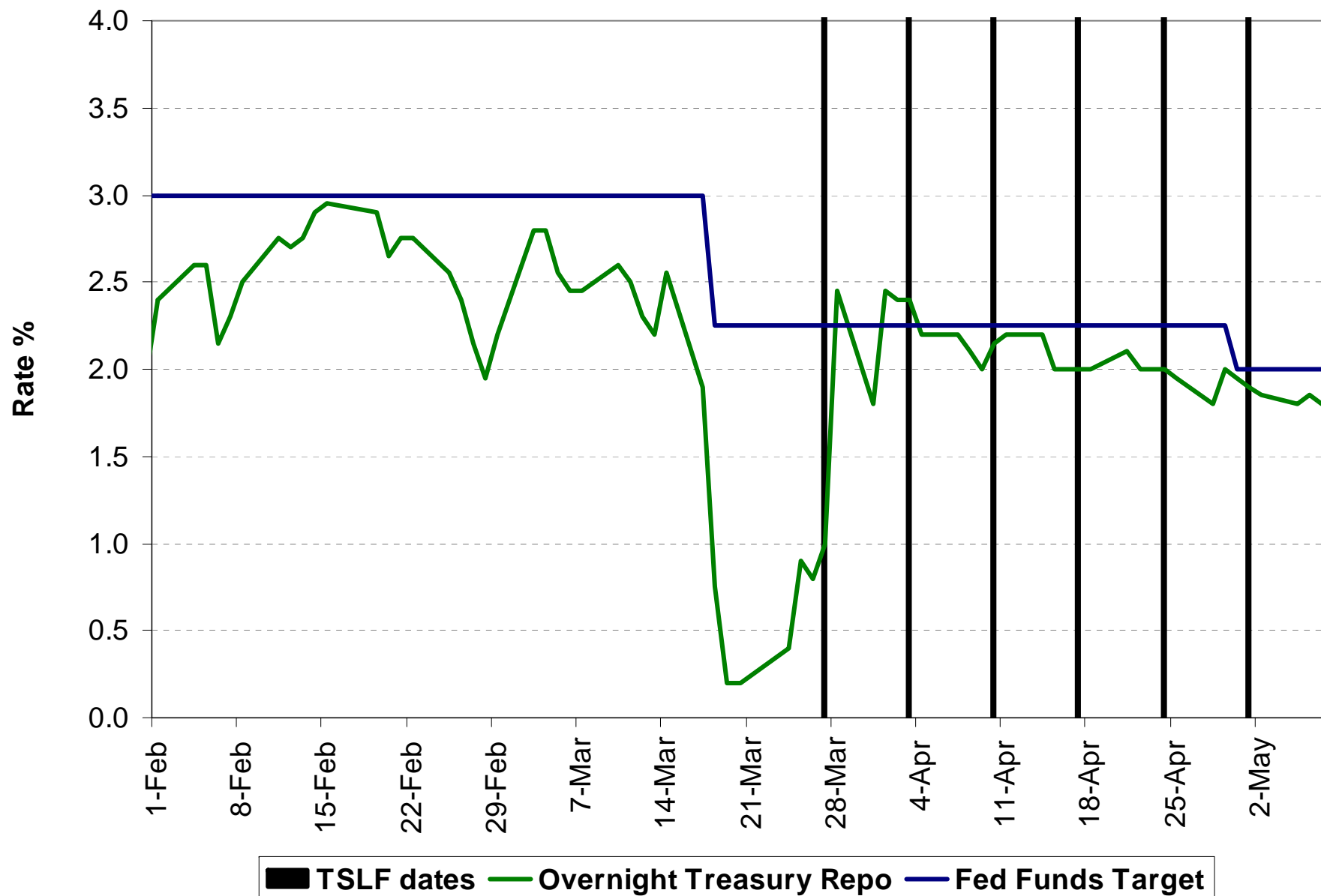
- TSLF: Aaa securities: private label RMBS, CMBS, Agency CMOs, ABS such as CDOs, CLOs
- PDCF: above plus investment grade securities: corporates, munis, MBS (R and C), ABS
 - So long as it can be priced by the clearing banks
- Importantly, previously repo-able securitized instruments are no longer “stuck” on firms’ balance sheets
 - Facilities designed as liquidity vehicles

Abnormally low overnight Treasury repo rates



Source: Bloomberg, FRBNY

Abnormally low overnight Treasury repo rates



Source: Bloomberg, FRBNY

Future use of the facilities

- Use of the auction facilities—the TAF and the TSLF—should decline as market conditions return to normal. The Federal Reserve will have the option to adjust many features of the auctions, including reducing their size based on market conditions
- The PDCF is an emergency facility, authorized for at least six months. Other alternatives for back-stop liquidity support for primary dealers can be explored during this time. The Federal Reserve has taken quick steps to monitor the condition of the primary dealers

Thank You!

<http://nyfedeconomists.org/schuermann/>