Comments on “Structuring for Leverage” by Joe Mason

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* Any views expressed represent those of the author only and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.

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

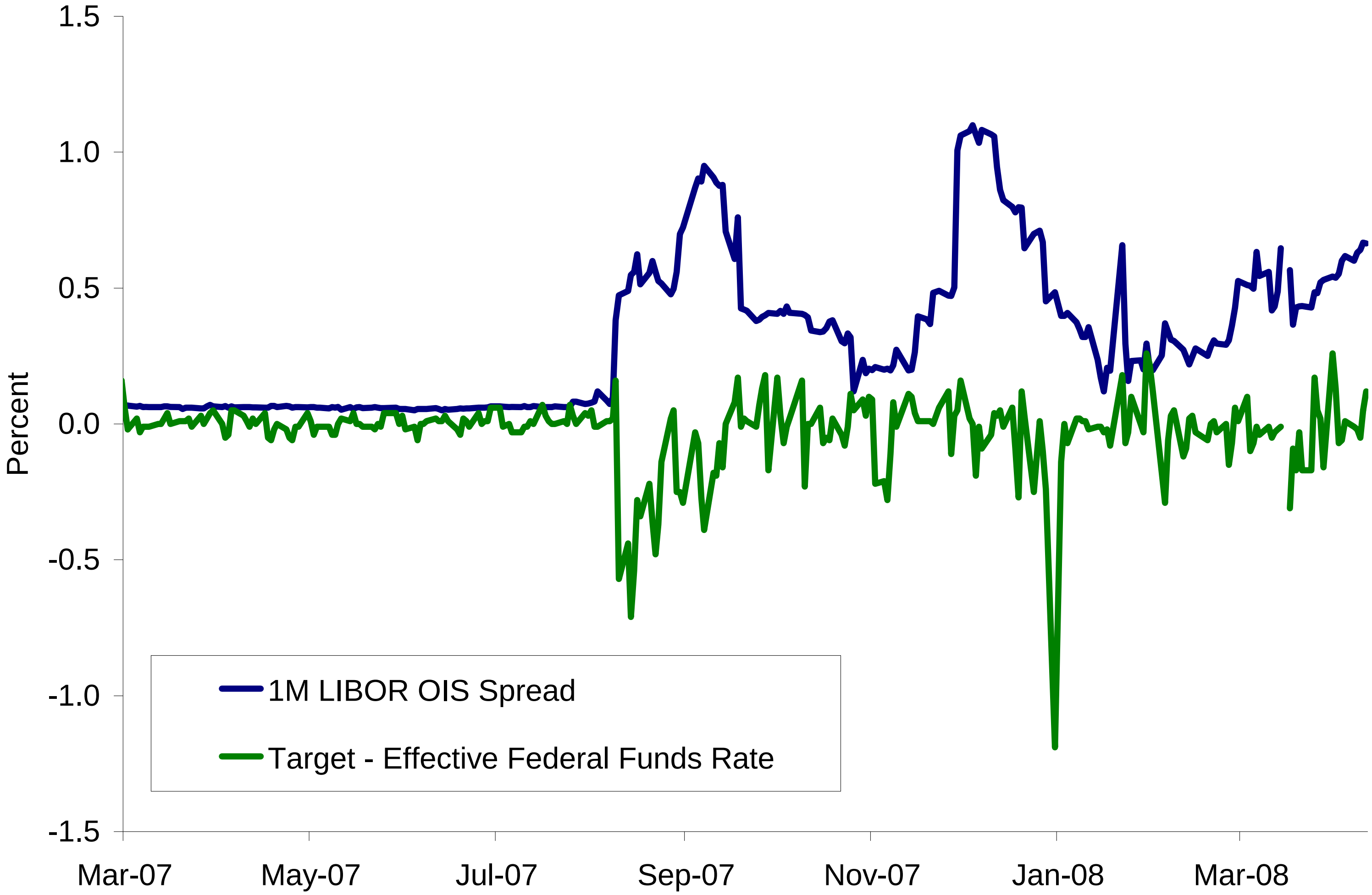
Questioning the magic . . .

- 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

Mason: Structuring for Leverage

- Lucid, clear explanation of some of the riskier structured products: CPDO, SIV, and ARS
- New security vs. old securities in new clothes
- Embedded leverage
- Liquidity and credit risk
- Diversification, concentration, correlation
- Flexibility vs. hard wiring (“brain dead”)

Illiquidity in interbank funding markets



Source: Bloomberg, FRBNY

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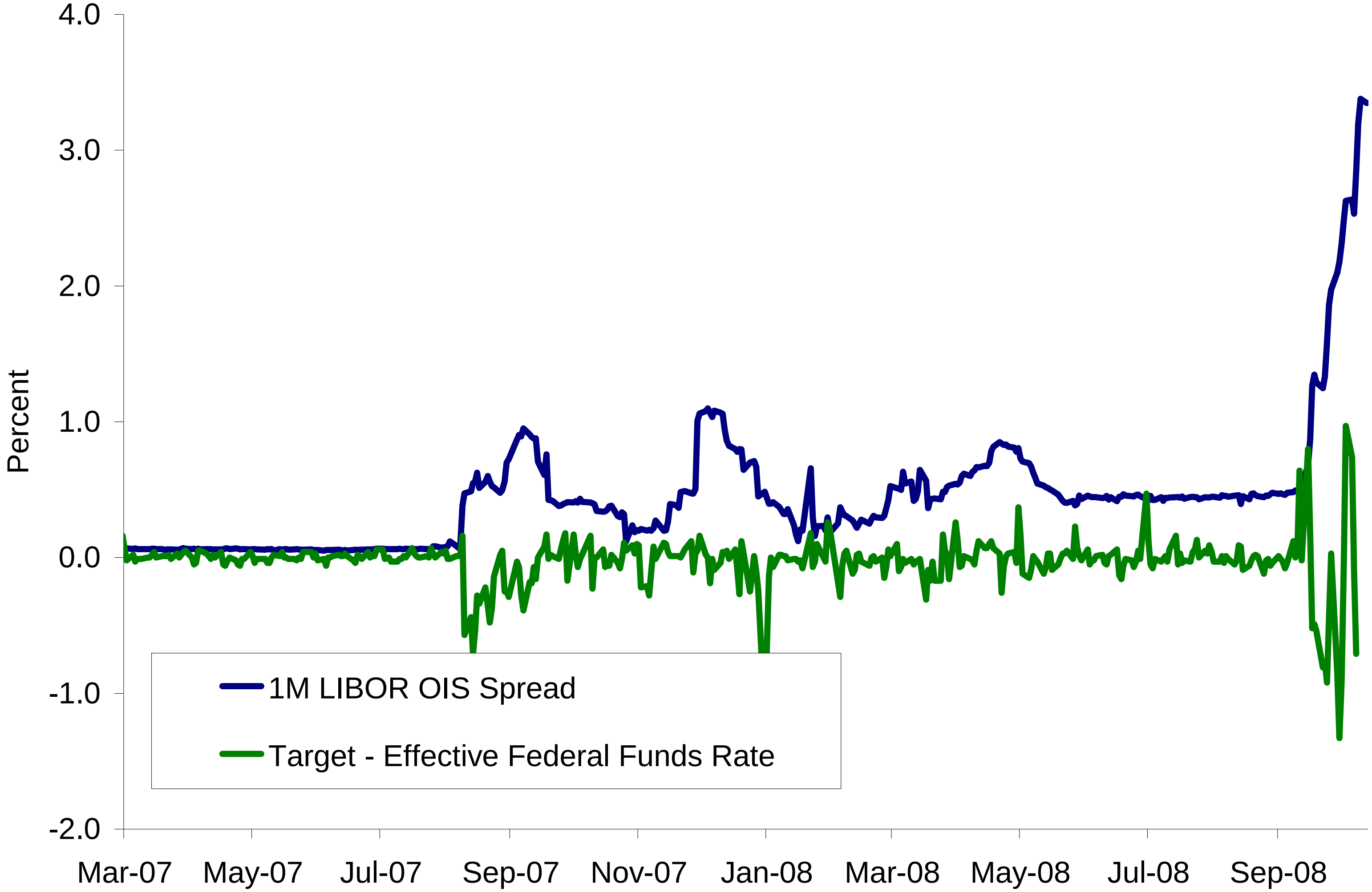


Source: Bloomberg, FRBNY

Problems addressed by new lending facilities

Choose		Depository Institutions	Primary Dealers
Q	**Backstop Standing Facilities**	Discount Window	Primary Dealer Credit Facility (PDCF)
P	**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.

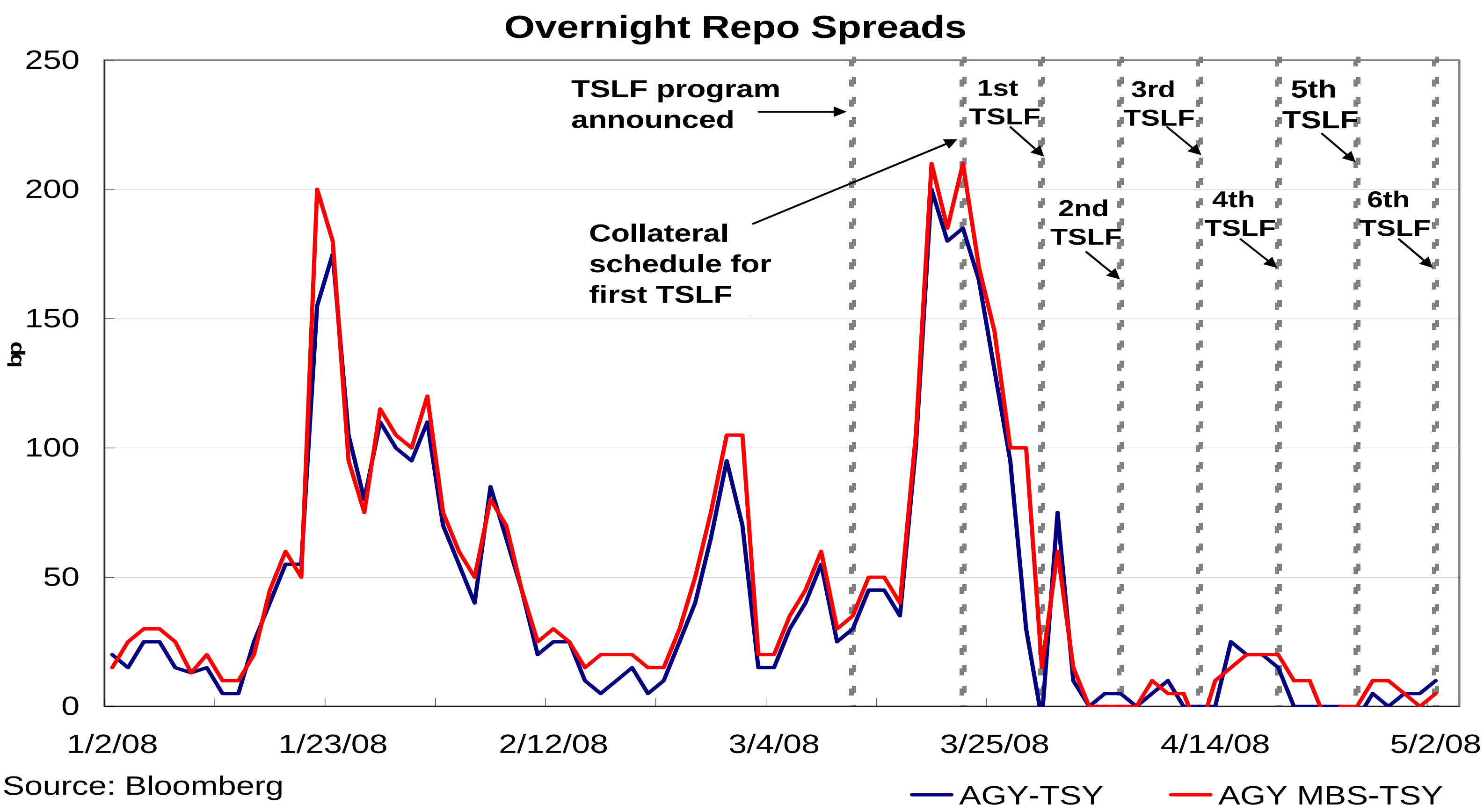
What can you pledge at the TSLF & PDCF?

- TSLF: OMO collateral plus investment grade securities: private label RMBS, CMBS, Agency CMOs, ABS such as CDOs, CLOs, corporates, munis, MBS (R and C), ABS
  - So long as it can be priced by the clearing banks

- PDCF: above plus sub-investment grade securities plus equities

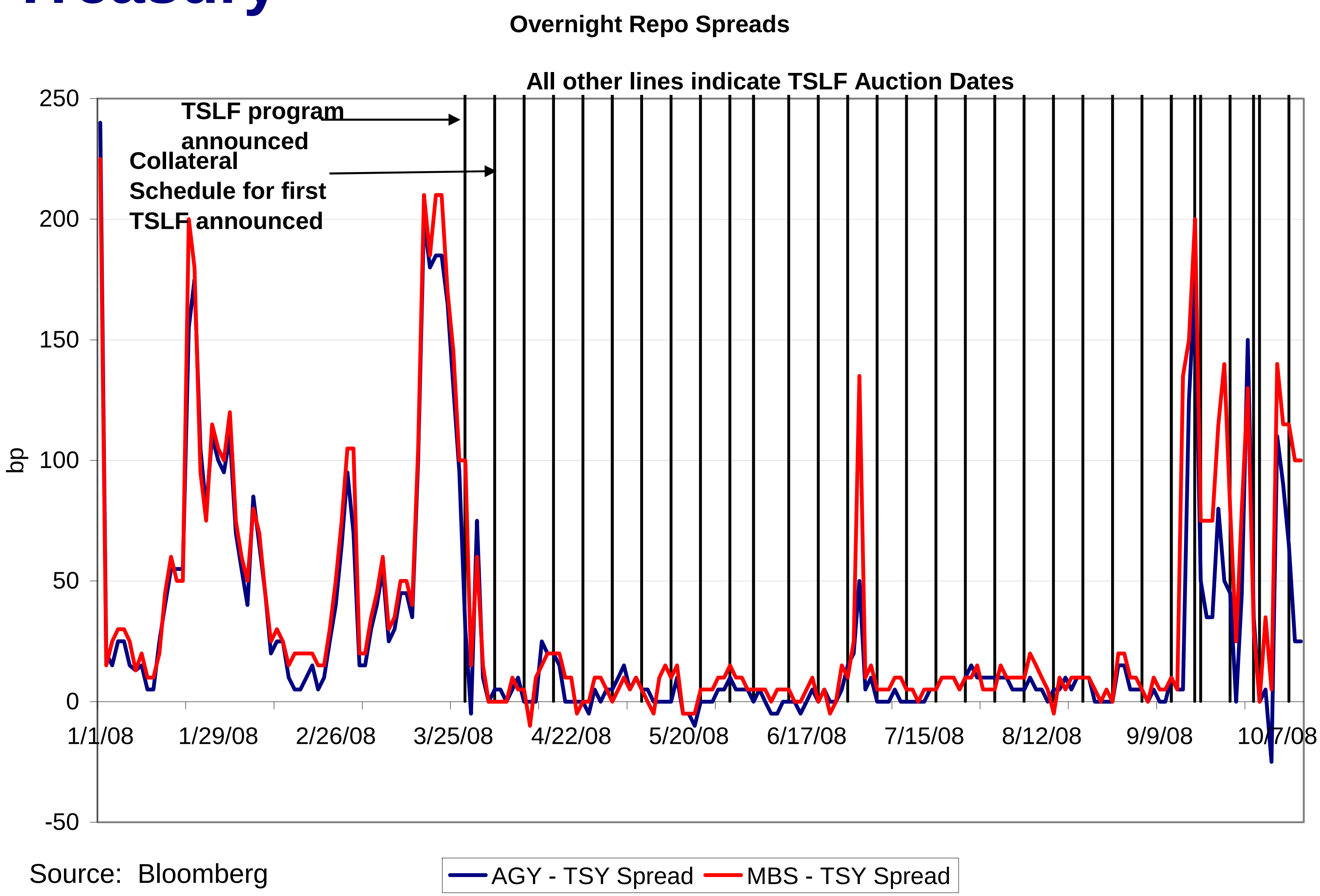
- Importantly, previously repo-able securitized instruments are no longer “stuck” on firms’ balance sheets
  - Facilities designed as liquidity vehicles

High overnight agency and MBS spreads to Treasury



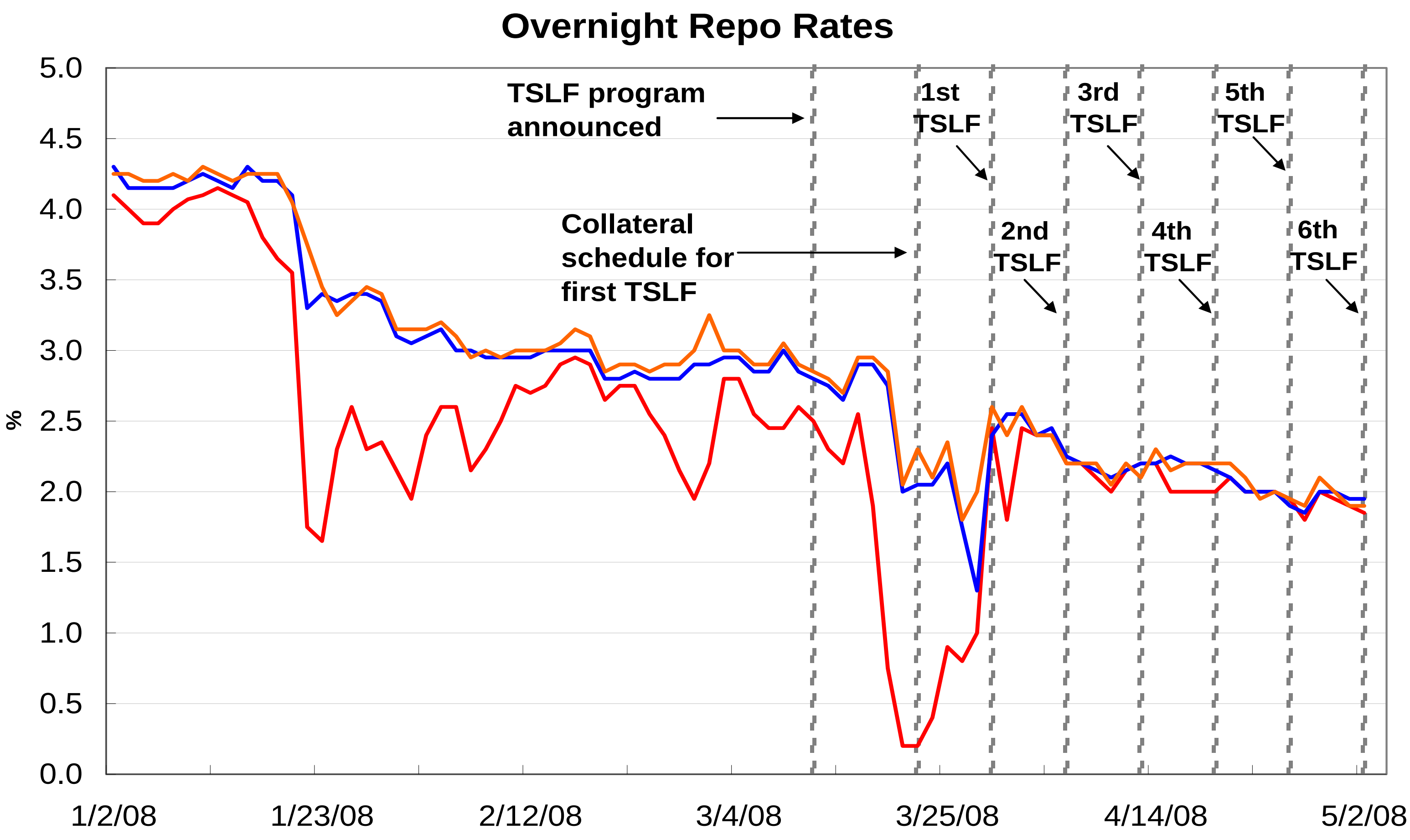
Source: Bloomberg

High overnight agency and MBS spreads to Treasury



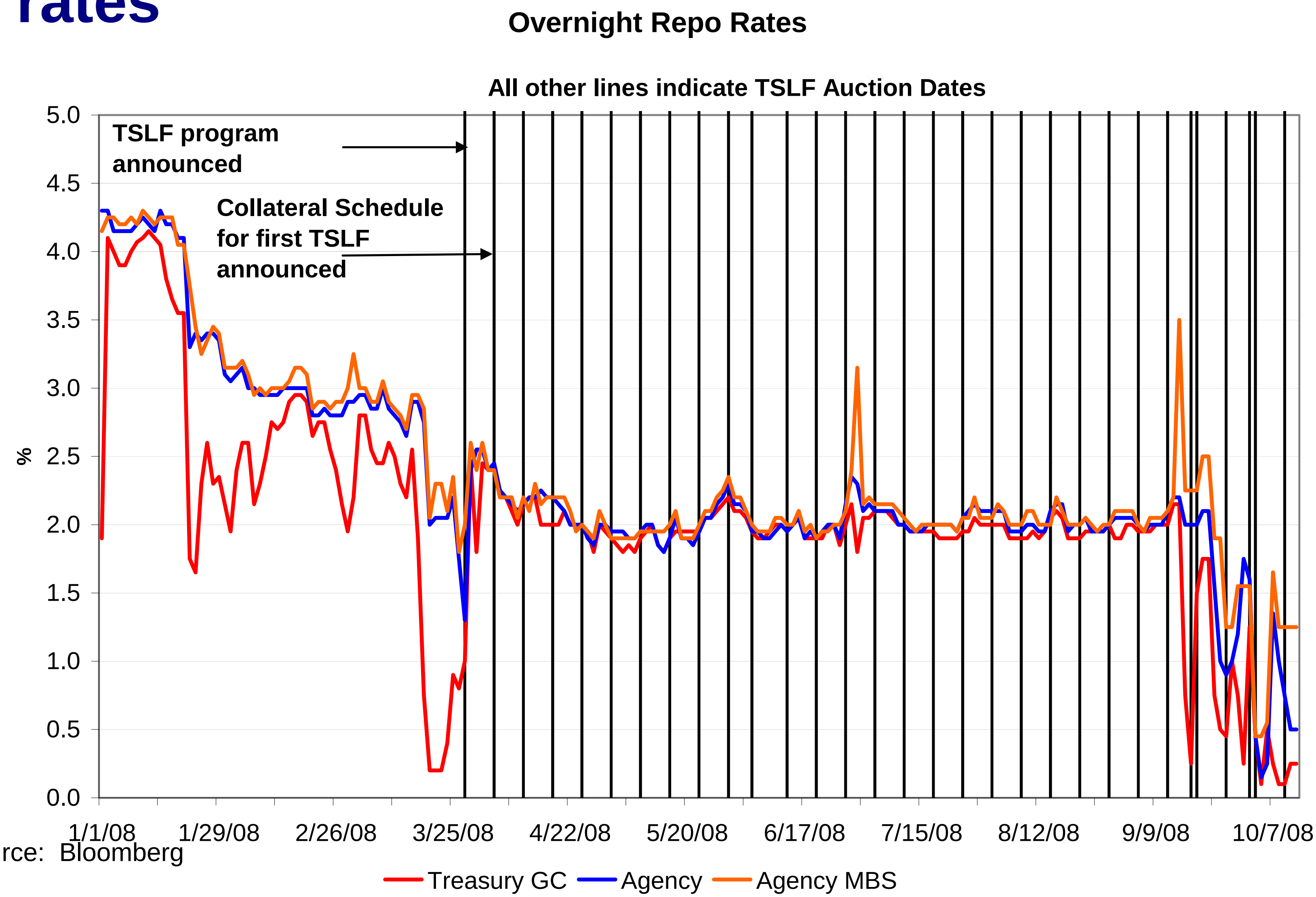
Source: Bloomberg

Abnormally low overnight Treasury repo rates



Source: Bloomberg

Abnormally low overnight Treasury repo rates



Source: Bloomberg

Yet more facilities…..

- Swap lines: illiquid money markets that became segmented across countries and time zones
  - BoE, ECB, and SNB will conduct tenders of U.S. dollar funding at 7-day, 28-day, and 84-day maturities at fixed interest rates for full allotment. Funds will be provided at a fixed interest rate, set in advance of each operation.
- Commercial Paper Funding Facility: illiquid functioning in short-term commercial paper funding markets.
  - Under the CPFF, the FRBNY will finance the purchase of unsecured and asset-backed commercial paper from eligible issuers through its primary dealers. The CPFF will finance only highly rated, U.S. dollar-denominated, three-month commercial paper

Thank You!

http://nyfedeconomists.org/schuermann/

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 TSLF

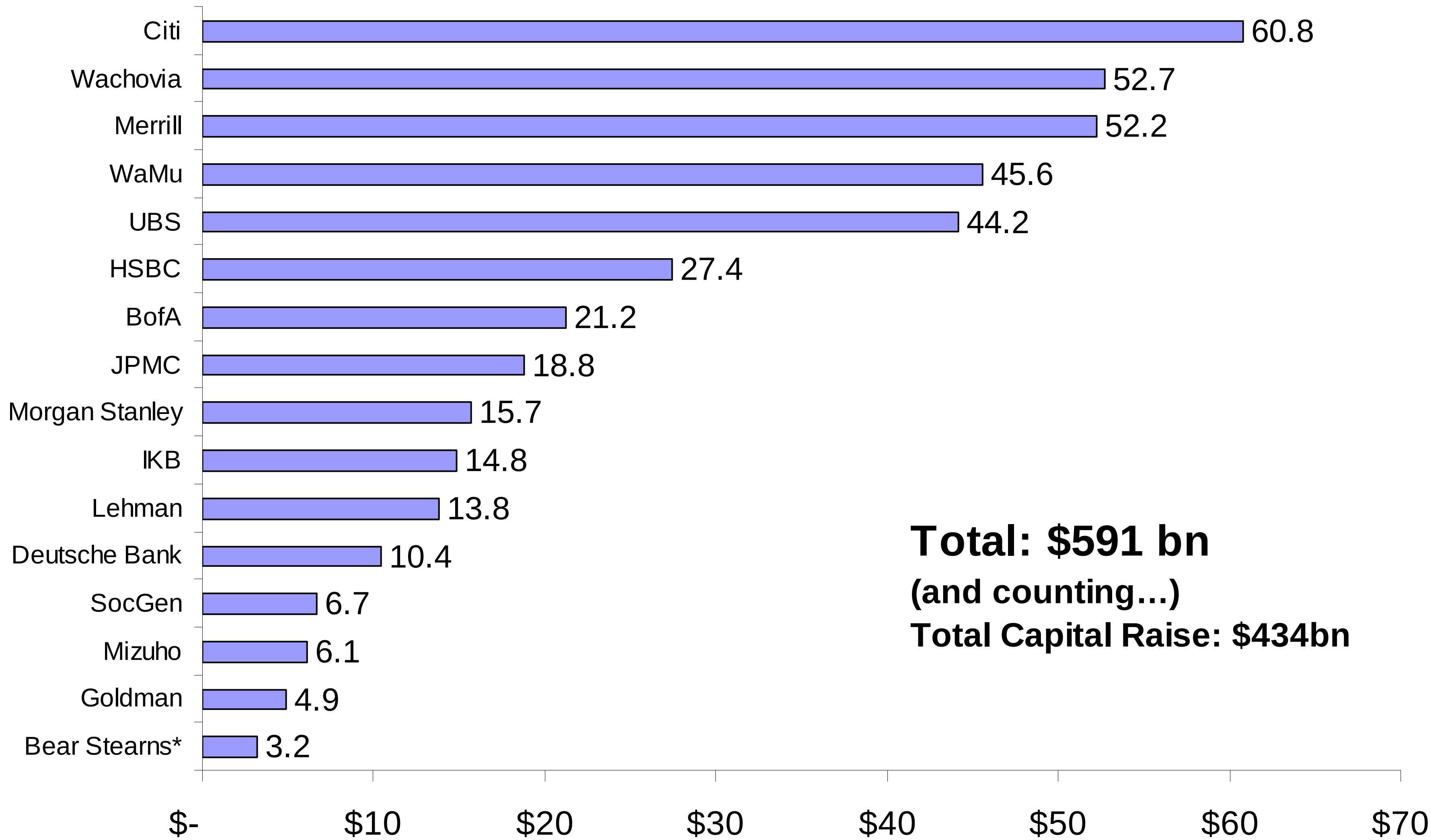
- adds Treasuries to dealers’ portfolios, reducing their scarcity in the repo market.
- reduces the roll-over risk for dealers in their financing of the alternative assets used as collateral.
- format assists in setting the right price for the Treasuries lent.
- avoids any reserve management problems.

Risk and subprime mortgages

- During the recent subprime boom, everyone was betting on continued home price appreciation (HPA)
- Subprime mortgages have shown up under every rock – e.g. in most structured credit products like CDOs
- Effectively everyone has been long (and levered to) 1 risk factor: HPA
  – If it goes down, everything goes down

Bank Write Downs

billions; through September 29, 2008



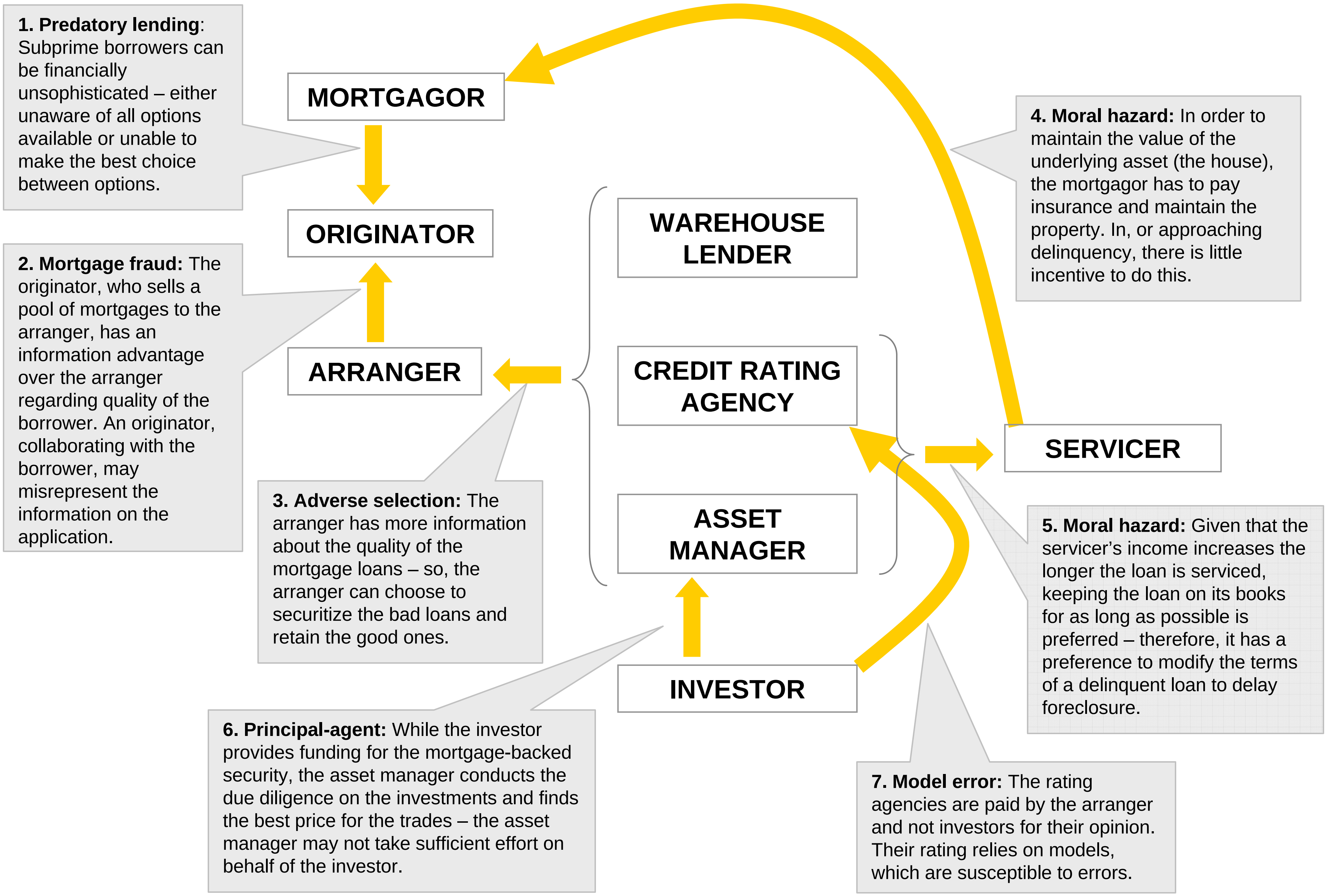
Total: $591 bn

(and counting…)

Total Capital Raise: $434bn

Source: Bloomberg

7 Frictions in Subprime Mortgage Credit Securitization



Source: Ashcraft and Schuermann (2007): "Understanding the Securitization of Subprime Mortgage Credit"