LORD ABBETT

Can the Economy Recover without the Securitization Markets?

Although the recession may have ended in the third quarter of 2009, a number of threats to the recovery continue to loom. Some believe that one of these is the stagnation of the securitization market. As the *Financial Times* reported last year, "Securitized markets—which financed more than half of all credit in the United States in the years immediately preceding the crisis—are essential for the U.S. economy. Without a recovery in these markets, the flow of credit will not return to more normal levels, even if U.S. banks overcome their problems."

If this source of credit is so critical to the U.S. economy, can full recovery occur as long as the securitization markets remain depressed? Lord Abbett Partners Rob Lee, Director of Taxable Fixed Income, and Milton Ezrati, Senior Economist and Market Strategist, assess the situation.

FUELING THE ECONOMY

Since the first mortgage-backed security (MBS) was issued 40 years ago, securitization has become a major source of credit for the U.S. economy. Today, even with the decline in issuance since the subprime crisis, outstanding securitized assets amounted to $11.5 trillion in 2010, according to data from the Securities Industry and Financial Markets Association (SIFMA).

Of that, $6.9 trillion, or 60%, consists of mortgage financing packaged by Fannie Mae (Federal National Mortgage Association [FNMA]), Freddie Mac (Federal Home Loan Mortgage Corporation [FHLMC]), and Ginnie Mae (Government National Mortgage Agency [GNMA]). The remaining $4.6 trillion went largely into consumer spending—student loans, credit cards, auto loans, and home mortgages—though equipment leases and commercial mortgages were also funded.

Until the subprime crisis, securitization had been extraordinarily successful at connecting borrowers with lenders on terms acceptable to both. "Securitization, in my opinion, is a good thing, when done properly," said Lee. "It allows borrowers to achieve better rates of financing, and it frees up balance sheets to allow banks to make new loans. With a non-agency mortgage-backed security, the investor gets various forms of credit enhancement that provides some protection against default, and the underlying loans have a real property attached. So if default occurs, there is typically some recovery of assets for the investor."

Securitization started with Ginnie Mae in the late 1960s and later with its sister organizations, Fannie Mae and Freddie Mac. These organizations issued "agency" MBS that pooled together home loans that conformed to certain underwriting standards.

In the late 1990s, private parties jumped in to issue "non-agency" MBS comprising loans made to borrowers who fell short of these standards. This led to similar efforts with other forms of credit, such as credit cards, auto loans, and student loans, resulting in the creation of the asset-backed securities (ABS) market.

"Securitization made an impact by lowering the cost and increasing the availability of credit," said Lee. "It is one of the most significant financial innovations of the past 40 years."

NOT HITTING ON ALL CYLINDERS

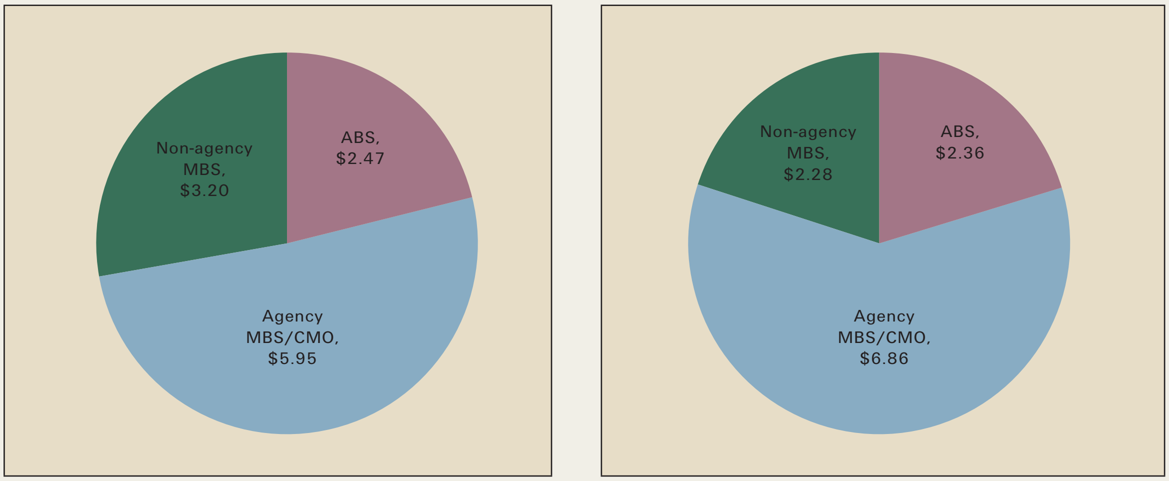
Today, however, the securitization market is struggling. While the packaging and selling of residential mortgages by Fannie Mae and Freddie Mac continues at a healthy pace, some have raised concerns that the subprime problem is repeating itself.

Citing a report by the inspector general of the Department of Housing and Urban Development, *The Wall Street Journal*

Chart 1. Agency Securities Now Make Up a Larger Part of the Securitized Market

Securitized Product Outstanding, 2007
($ in trillions)

Securitized Product Outstanding, 2010
($ in trillions)



Source: GSEs, Bloomberg, American Corelogic Loan Performance, Fitch Ratings, Moody's, Standard & Poor's, Thomson Financial, and Securities Industry and Financial Markets Association.

Note: Agency MBS/CMO includes GNMA, FNMA, and FHLMC mortgage-backed securities and collateralized mortgage obligations (CMO). Non-agency MBS includes commercial mortgage-backed securities (CMBS). In non-agencies, total does not account for overlap of collateral. Non-agency outstanding securities in non-agency numbers include resecuritizations and ReREMICs (Resecuritization of Real Estate Mortgage Investment Conduit securities).

reported in 2009 that in addition to Fannie Mae and Freddie Mac, there is growing risk at Ginnie Mae, the government agency that securitizes mortgages insured by the Federal Housing Administration (FHA). Ginnie Mae's exposure to mortgages is expected to exceed $1 trillion by the end of 2010, the *Journal* reported.

The problem is, "The FHA's standard insurance program today is notoriously lax. It backs low-down-payment loans, to buyers who often have below-average to poor credit ratings, and with almost no oversight to protect against fraud. Sound familiar? This is called subprime lending."[1]

Fannie Mae and Freddie Mac have also increased their exposure since the subprime crisis. To bolster the housing market, Congress has lifted the caps on the amounts the two government-sponsored enterprises (GSEs) may own, but many are calling for reform, and even privatization.

"Critics who argued that Fannie and Freddie posed a risk to the financial system turned out to be right," Lee said. But "the government, considering the current state of the economy and the housing market, faces significant and difficult decisions on Fannie and Freddie," he added.

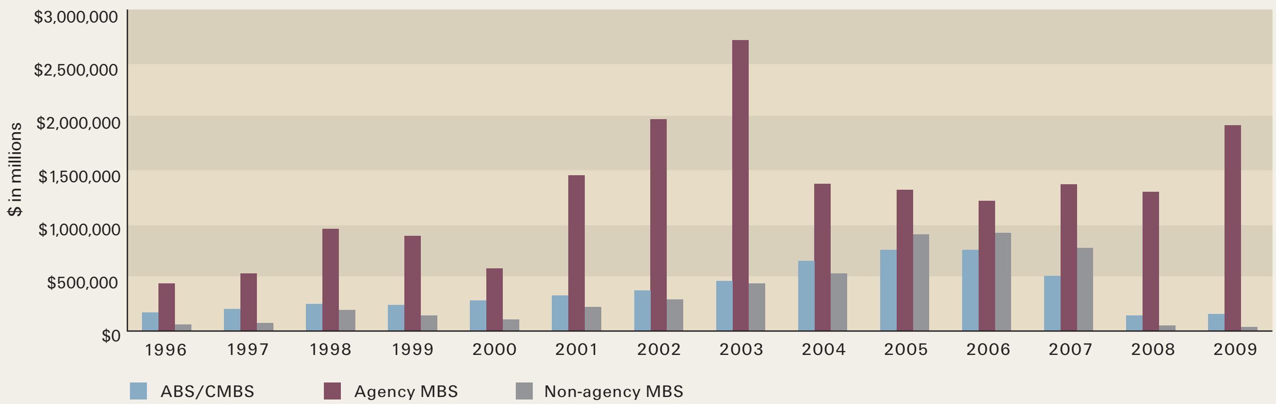
Outside the agency MBS market, the story is different. The government's support program, the Term Asset-Backed Securities Lending Facility (TALF), ended on March 31, 2010. The program involved purchases of asset-backed securities by the Federal Reserve and was intended to stabilize the asset-backed securities (ABS) market. Spreads on ABS securities relative to Treasuries had widened dramatically late in 2008, making new securitizations impossible. Since this market provided substantial financing to consumers, the Fed believed that restoring it to normal was critical for the economy.

While spreads on ABS securities relative to Treasuries widened when the TALF program ended, this coincided with the sovereign debt crisis in Europe, which widened credit spreads across the board. Since then, ABS spreads have narrowed again along with those in many other credit markets.

Issuance, however, remains frozen, or nearly so. Non-agency residential mortgages, commercial mortgage-backed securities (CMBS), and parts of the ABS market have yet to fully recover from 2008's meltdown. "There's a clear dichotomy between the markets that are being supported by the government and those that are not," said Lee. "So, agency MBS are still being issued in large volumes, but on the non-agency side, markets are much more impaired." (See Chart 2.)

In 2009, new ABS securitizations were off 80% from the peak in 2006. In the credit card receivables segment, issuance

Chart 2. ABS and Non-agency MBS Issuance Remains Depressed



Source: Securities Industry and Financial Markets Association.

has fallen from nearly $100 billion in 2007 to less than half that in 2009. In 2010, new issues in this segment amounted to just $4.8 billion through the first half of the year. Issuance in the ABS segment as a whole in the first half of 2010 fell more than 44% versus the first half of 2008. Though it is a smaller market, the commercial mortgage market has experienced a similarly dramatic drop in new issues. (See Chart 3.)

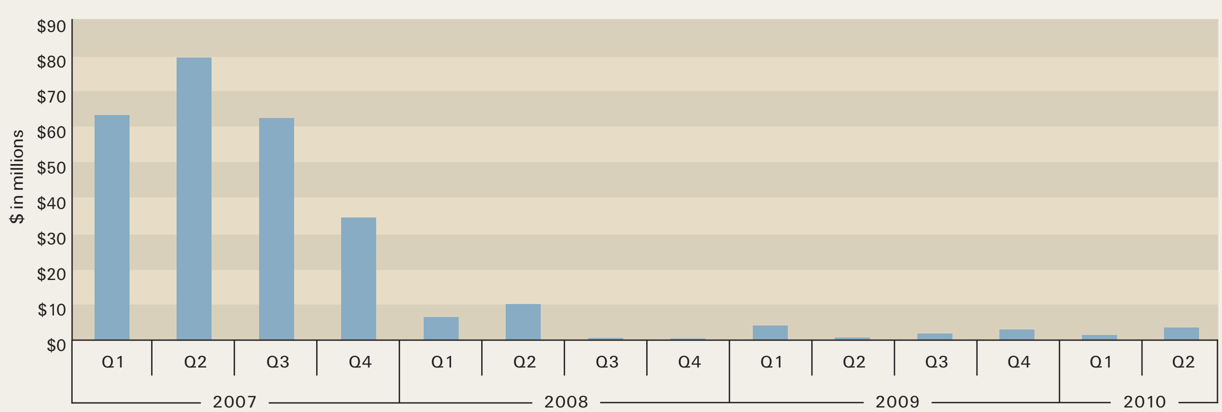
REASONS FOR THE SPUTTERING

The securitization engine has faltered for a variety of reasons. At the height of the subprime crisis, spreads on MBS and other securitized products relative to Treasuries rose to unprecedented levels. This made securitization uneconomical. The interest rates required to meet the market's demand for such high yields would have made borrowing unattractive, so in most segments, as the credit crisis worsened, the packaging and selling of loans ground to a halt.

Another cause of the slowdown, according to Lee, was regulatory. As Congress considered wide-ranging financial reforms, including new rules on securitization, banks became reluctant to undertake new deals. Now that reform has passed, those may begin to come together, though some glitches remain.

One glitch is the increased exposure of credit rating agencies to greater liability, which has caused these agencies to balk at allowing their ratings to be used in ABS sales documents.[2] But on the whole, the new financial reform law should have little effect on securitization, according to Lee. The new regulations do call for issuers of securitized assets to retain a portion of the

Chart 3. Issuance in the CMBS Market Has Almost Disappeared



Source: Securities Industry and Financial Markets Association.

issuance in order to have some "skin in the game," but Lee believes this isn't likely to significantly affect the process.

The continued impairment of some portions of the market, on the other hand, has inhibited some deals by making hedging more difficult. Packaging and selling loans requires time, ranging from one to six months, which exposes the originators of the loans to risks. Typically, they'll hedge these risks, but market conditions have made this less feasible. "With some of the hedging instruments that were used, volatility is much higher," said Lee. "So, hedging is more difficult, and loan originators now bear more risk."

Another major reason for the stalling of the market is a lack of demand. Investors remain wary of securitized assets, and while pension funds and other institutional players are still buying, foreign investors have pulled back.

In fact, some of the largest customers are no longer in the market, now that credit has dried up. Hedge funds and investment vehicles that were financed by banks, for example, were major investors in securitized products. Many have disappeared or have seen their financing reduced.[3] "Is there less leverage in the system? Yes," said Lee. "Does that reduce demand for all kinds of instruments, including securitized product? Yes."

Securitization and Consumer Spending

Investors weren't the only ones using leverage. As many economists noted at the time, the "wealth effect" led consumers prior to the collapse in real estate prices to increase their spending and in many cases to take out home equity loans, "using their homes as ATM machines." Borrowing against ballooning home values, consumers helped fuel the economic growth that occurred after the recession of 2001.

In 2005, Alan Greenspan, then-chairman of the Fed, and Fed economist James Kennedy attempted to gauge just how much this wealth effect contributed to economic growth. They assumed that consumers could tap into their rising real estate wealth in three ways: 1) selling their homes; 2) refinancing their mortgages for higher amounts, and taking cash out; 3) securing a home equity loan.[4]

Greenspan and Kennedy estimated that, combined, the cash produced by these three methods amounted to hundreds of billions of dollars. In 2004 alone, consumers had nearly $600 billion more to spend, equivalent to almost another 7% in disposable income.

Consumers may not have spent all of this cash; they may have invested some of it. But citing consumer surveys, Greenspan and Kennedy estimated that as much as two-thirds of it could have been spent on home remodeling alone.

Adding to the wealth effect from home prices was the rise in stocks. Between 2002 and mid-2007, the stock market rose by approximately two-thirds, augmenting consumers' feeling of financial well-being. Economists estimate that for every $100 of increased stock market wealth, consumers spent $2–3, adding further to the economic growth.[5]

With the collapse in home prices and the stock market, the wealth effect went into reverse. Many consumers were no longer able to borrow against their home equity, and securitizations in this and other consumer-backed segments dried up.

No longer feeling flush, consumers pulled back. Personal consumption expenditures and retail sales began falling in late 2008 and continued to drop through much of 2009. Consumers began paying down debt, and the savings rate rose from 1.2% in the first quarter of 2008 to 5.4% in the second quarter of 2009.

This collapse in securitizations caused alarm among some analysts. A group known as the "liquidity movement," consisting of economists from top-notch schools and the New York Federal Reserve, questioned whether the economy could recover at all. Prior to the credit crisis, the group had correctly identified highly leveraged banks as a systemic threat, and now they were worried about securitization. "If we don't resuscitate securitization, I predict we won't be able to resuscitate the economy," a Yale economist told *Barron's*.[6]

If returning securitization to full health means returning immediately to pre-crisis volumes, however, that would mean a reinflation of the credit bubble. "We don't want the securitization market to be 'fully recovered' if that means a return to 2004–07 when there was clearly too much of it," said Ezrati. "Back then, there was an excess of liquidity, and securitization was used to build a bubble."

Economic Recovery Has Proceeded Without a Fully Functioning Securitization Engine

If the economic expansion after the recession of 2001 was fueled by consumer borrowing, can recovery continue over the long term without a return to those levels of leverage?

The National Bureau of Economic Research (NBER) has not made an official announcement as to the end of the recession, but many believe recovery began in the second half of

Table 1. Rising Home Values Contributed to Consumer Spending

($ in billions)

Year	Money	Disposable Personal Income (%)
2000	$204	2.8%
2001	262	3.5
2002	398	5.1
2003	439	5.4
2004	599	6.9

Source: realclearpolitics.com.

2009. Gross domestic product (GDP) grew 1.6% in real terms in the third quarter, followed by 5.0% in the fourth. Growth continued at a pace of 3.7% in the first quarter of 2010, followed by 1.6% in the second.

So the economy has begun to rebound even without a completely healthy ABS market. While the 5.0% surge in GDP that occurred in the fourth quarter of 2009 came largely as a result of the restocking of business inventories, consumers have contributed as well. Personal consumption expenditures accounted for 0.69 percentage points of the fourth quarter's performance, and 1.33 percentage points of the 3.7% growth in the first quarter of 2010. In the second quarter of 2010, personal consumption added 1.38 percentage points to the 1.6% expansion.[7] This suggests that the consumer, though devoting more resources to paying down debt, has not retrenched as drastically as many had expected.

In fact, the decision to pay down debt or continue to spend is not "binary," according to Ezrati. Consumers can do both. Consumers began adjusting their spending during the panic of 2008–09, and now they're reducing their debt by about 4% a year. In addition, personal income has been trending upward since the first quarter of 2009. "If income rises by 1–2%, consumers can increase their spending by 1–2% and still continue to pay down their debt. So they're deleveraging even as they continue to spend," Ezrati said.

Securitization Is Here to Stay

Eventually, however, the securitization market will need to recover more fully. As a source of funding, it is irreplaceable. A return to the traditional banking model, with banks keeping loans on their books, is not likely. This would mean bringing billions in off-balance-sheet loans back onto the books. This in turn would require massive infusions of equity capital.

Returning to the traditional model is untenable, according to Richard Herring, professor of finance at the Wharton School at the University of Pennsylvania. "There's no prospect of putting enough capital back into banks to be able to support that kind of lending again," he said.

Moody's Investors Service ties the recovery of securitization to a rebound in employment and home prices, but many expect this may be years away. The alternative, however, would not be pleasant, according to Herring. "Unless the flow of securitizations is restored, we're going to see a credit crunch the likes of which we've never experienced before."[8] ■

—*Reported by Ron Vlieger*

1 "The Next Fannie Mae," wsj.com, August 11, 2009.

2 Anusha Shrivastava, "Bond Sale? Don't Quote Us, Request Credit Firms," wsj.com, July 21, 2010.

3 Gillian Tett, "Securitisation Grinds Down," *Financial Times*, May 10, 2010.

4 Robert Samuelson, "So Long to the Wealth Effect?" realclearpolitics.com, October 12, 2005.

5 Ibid.

6 David Adler, "Economists Known as the 'Liquidity Movement' Predicted the Financial Crisis. Now They Say We Strangle Securitizations at Our Own Peril," *Barron's*, December 29, 2009.

7 Bureau of Economic Analysis, National Income and Product Accounts, Gross Domestic Product: Second Quarter 2010 (Advance Estimate), July 30, 2010.

8 "Unfreezing Securitization: Restoring the Market's Confidence in Itself," Knowledge@Wharton, September 2, 2009.

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