"Unwinding Emergency Federal Reserve Liquidity Programs and Implications for Economic Recovery"

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Chairman Frank and members of the Committee:

Thank you for the opportunity to address you on the topic of the unwinding of the Federal Reserve's emergency liquidity programs and the implications for economic recovery. Unwinding is the operative word - the goal should be for the Fed to return to its focus on monetary policy and in particular to remove itself from the sensitive issues of involvement in private credit markets and portfolios. The Federal Reserve's interventions were explicitly emergency in nature.

In order to unwind these actions, both the size and the composition of the Fed's balance sheet are at issue. The balance sheet has more than doubled to over $2 trillion, and about half of this is mortgage backed securities (MBS). Shrinking the Fed balance sheet to near pre-crisis levels necessarily entails touching that MBS portfolio. Seen from the other side of the transaction, there is also about $1 trillion in excess reserves in the banking system. In a normalized banking system, the Fed would re-absorb the excess reserves and the private sector would hold the Fed's MBS. But this is the crux of the problem. While the Fed could reabsorb the $1 trillion in reserves, credit markets have not normalized, so there is great unease about the private market's ability to swallow the Fed's MBS portfolio, which is roughly 25% of agency MBS outstanding.

In my comments I will focus on credit markets and the withdrawal of the emergency liquidity programs. I will return briefly to the issue of reserves at the end of my remarks, though this will not be my main focus.

It is exceptionally difficult to speculate about the impact of the Fed stepping away from the MBS market because it is currently so deeply engaged in both the flow of new transactions and in holding the stock outstanding. The Fed has purchased between 75 and 100% of recent issues of agency mortgages, and holds about 25% percent of the outstanding stock. The agencies themselves hold another 25%.

The Fed has disengaged from other credit markets, however, and those credit markets provide useful information about the liquidity and risk appetite of investors and lenders. This is also important information in its own right, since these markets provide financing for households' spending on consumption and firms' spending on investment, which fuel the economic recovery. To summarize before going into more detail below, spreads have returned to near pre-crisis levels in many of the safer markets with short maturities. Volume is very low, however. While the reduction in spreads is encouraging that liquidity has returned to at least some markets, the low volume suggests that the risk appetite of investors and the capital levels of lenders are still of concern.

A new equilibrium in credit markets is slowly evolving out of the market disruptions, particularly intense in the fall of 2008. At that point, credit spreads on a broad variety of consumer and business debt widened significantly. Even relatively safe securities, with backing by government guarantees such as FFELP student loans, saw spreads increase from less than 50 bp over LIBOR to over 300 bp and higher. The markets ceased to function, since the cost of capital became prohibitive to borrowers. The Fed stepped into these markets with emergency liquidity programs, providing funding for commercial paper (CP) and then early in 2009, to asset-backed securities (ABS) more generally through the TALF. Through this program, the Fed engaged markets in credit card, automobile, equipment, leasing, private student loans, and commercial real estate

debt. These programs peaked in early 2009 with the CP programs at over 350 billion. The CP programs have now largely run off, and the aggregate TALF program is peaking at $50 billion and is now scheduled to wind down as well in March and June of 2010.

As these programs close, some markets have continued to function with low spreads - comparable to those in 2007. The yield curve for commercial is relatively flat, and under 25 bp for most maturities and categories. In some sense, though, the CP market tells the most positive story for credit markets, since it is all short term (under 90 days) and selects for the strongest firms. The reduction in volume, still about one-third of its 2007 peak, suggests that the highest quality credit is being funded, which then trades at modest spreads.

This raises the question of how much of the return to modest spreads is a return of liquidity, and how much is the selection of high quality credit? That is, has liquidity really returned to the market? - or just to a few select borrowers?

Consumer credit and the longer-maturity asset-backed security market tell a richer story. In contrast to the very short term commercial paper market, there are both legacy debt and new issues in ABS, which have had very different market experiences.

Before the financial crisis, the ABS market peaked at about $100 billion in new issuances per month in 2006. Issuances shrank to about $20 billion per month in 2007 and to essentially zero by 2008. Lenders, fearing that they would not find financing for new loans, and to the extent they could not finance loans on their own balance sheets, cut back on new lending. The Fed's TALF program was initially focused on this paralysis of new lending. While the facility was approved at much higher levels, it never exceeded its current level of $47 billion, even when it was expanded to accommodate more types of debt after its initial launch. In December 2009, however, the amount of non-TALF ABS surpassed TALF-eligible ABS for the first time since the program began.

While there are many types of debt placed in the TALF and outside it, student loans are a useful benchmark for several reasons. First, demand for student loans did not fall with the recession - indeed lending has risen over the financial crisis. The Federal student loan programs do not credit score student borrowers: any eligible student can borrow up to a given maximum. Hence, the argument that markets froze and then thawed because of deterioration and then improvement in selection of borrower quality does not apply in this market. Nonetheless student loan ABS issuance fell from 62 billion in 2007 to 28 billion in 2008 to 18 billion in 2009. This collapse in Student Loan ABS issuance occurred even with a government guarantee of at least 97%. Despite this apparent safety, spreads spiked by over 300 bp in October through December of 2008. Since early 2009, spreads have returned to 2007 levels. This decline indicates a return of liquidity to the market, even without a change in credit standards. Thus, while credit standards have clearly risen in many markets, liquidity has at least begun to return to guaranteed student loans even without a more stringent credit standard.

Recently some volume has resumed in the ABS market. Sallie Mae completed an $840 million FFELP transaction in December 2009, not using the TALF, at 75 bp over LIBOR. Private loans, without the government guarantee, have been financed through the TALF at 185 bp over LIBOR in the same period. Because of the credit risk and absence of government guarantee, these loans are riskier and more information-intensive. For the private loans, the more generous terms of the TALF are valuable, and hence the riskier loans have been utilized TALF funding. TALF terms are especially valuable to holders of opaque legacy securities with complex structures (e.g., many tranches, difficulty in assessing credit risk).

Summarizing, spreads on relatively safe securities have returned to levels pre-crisis. This reflects a return of liquidity to the markets, not just a selection of a few very safe transactions. The volume in the markets remains low, however, suggesting that lenders are also being very selective, consistent with the reports of loan officers that credit standards continued to rise until December 2009. Spreads on riskier assets remain high

where any transactions occur, and the volume of trade in riskier assets is extremely low. Many such assets are simply sitting on the balance sheet of the lender, waiting for the cash flows to reveal their quality and then either written down (if the risk reveals negatively) or taken as income (if the risk resolves positively).

The relatively weaker situation of riskier assets supports the notion that the current vulnerability in financial markets is more due to capital than to liquidity. To the extent that lenders hold the riskier assets, these positions compromise their capital and their ability to lend - reinforcing the weak supply of credit and the increase in lending standards. Moreover, the balance sheet risk of banks holding risky assets reinforces their desire to hold excess reserves at the Fed against potential future losses. These precautionary holdings further reduce lending, which might otherwise go to the commercial paper or other short term markets.

Given these weaknesses in credit markets, is it appropriate for the Fed to close its emergency liquidity programs? There is both a qualitative and a quantitative answer. Principally, these programs were put in place to foster liquidity when markets failed, even for the safest assets. Spreads in those safe assets have returned to more moderate levels. The issues that remain are volume in all types of lending, as well as spreads for the riskier assets. These are not emergency liquidity problems. Lending standards generally tighten during a recession and loan performance deteriorates. This is a known cyclical dynamic in banking. Credit deterioration has been severe in magnitude, but the phenomenon is not unprecedented. This is in sharp contrast to the conditions that led to the implementation of the Fed's emergency credit measures, when markets shut down.

Quantitatively, the Fed is already closing and announced intentions to close most of the emergency liquidity provisions. Private transactions are present, but far from abundant. The largest by far of the remaining programs is the mortgage purchase program and associated portfolio holding. How would the elimination of Fed conventional mortgage

purchases affect housing affordability? The monthly cost of a conventional mortgage is driven by two major factors - the amount borrowed and the interest rate. A decline in house prices feeds directly in to the amount borrowed, so the 30% average decline in house prices we've seen on average has improved housing affordability, measured by monthly payments, commensurately. A 50 bp increase in mortgage rates, for example, increases monthly payments by far less - under 6 percent. To be concrete, for a $275,000 house with a 20% down payment, the fall in housing prices reduces the monthly payment by over $350, while the increase in interest rates raises it by less than $50. Hence, measures of housing affordability are less sensitive to a modest increase in mortgage rates than they are to the large decrease in housing prices we have already seen.

Finally, let me return to the large quantitative government lending program that I referred to earlier - which has not created any problem for monetary policy. The student loan market was understood to be an established policy concern of the Department of Education, with a precedent for direct government provision of credit. The Congress enacted the Ensuring Continued Access to Student Loans Act (ECASLA) in early 2008 to allow the DE to purchase privately originated loans as the ABS market shut down. Through this program, plus direct lending, the government now holds 60% of the student loans originated in 2008-09, replacing funding for much of the dwindling ABS market. Overall, the Federal government's position in non-revolving debt ($186 billion, 2009) now exceeds that of private pools of securitized assets ($176 billion, 2009). The purchase of student loans was a fiscal policy decision. It does not contribute to up-sizing of the Fed's balance sheet and the associated increase in bank reserves - avoiding the conundrum faced by the Fed as it now desires to down-size its balance sheet in the face of a weak ABS market. Student loans are clearly of smaller scale than mortgages, but it illustrates the road not taken with respect to the government's role in purchasing private debt.

Without an existing government loan program in place, the Fed's flexibility in initiating and implementing a purchase program for mortgages was necessary to intervene in a timely way. Ironically, the resulting MBS portfolio position is now a liability to the Fed's future flexibility.

Going forward, cessation of new purchases is already widely expected. Ideally, the remaining portfolio will be removed from the Fed's balance sheet. Given the fragility in long-maturity risk markets, a rapid market sale seems ill-advised – even though the Fed's agency portfolio is relatively safe among mortgage securities. A refinancing within the government would accomplish the same goal of removing the MBS from the Fed's balance sheet, preferably in return for Treasuries. The MBS could then be held outside the Fed and the central bank could rapidly return to more conventional monetary policy. If the Fed continues to hold the MBS, they will run off, and could be eventually sold as the portfolio becomes a smaller share of agency debt outstanding. This scenario is less challenging to the fiscal deficit and the mortgage market, but keeps the Fed in the MBS business longer and slows its ability mop up reserves. In this case, the various strategies for managing excess reserves, such as term deposits, would be useful; however reserve management does not solve the ultimate problem of the excess reserves themselves. In any of these cases, as the Fed unwinds its positions its strategy for doing so should be clear and predictable, so as not to add an unpredictable trader to an already-uneasy market.