Thoughts on the Future of Credit Markets

Remarks by Dennis P. Lockhart,
President and Chief Executive Officer
Federal Reserve Bank of Atlanta

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I'm honored to speak this morning at the Association for Corporate Growth's Capital Connection Conference.

Today I want to focus most of my remarks on the future of credit markets, which have been affected by recent financial turbulence. However, let me begin with a very brief summary of a subject that is likely top of mind for many of you. And that subject is the state of the economy and recent Federal Reserve actions.

Current economic and market situation
In recent months, there has been a sharp deceleration of economic growth. The pace of job creation has slowed. And at 4.9 percent, unemployment was higher in January than last summer.

Troubles in the housing sector have been well publicized, with house prices declining in many parts of the country. Also, with the surge in energy prices last year, recent measures of inflation have been elevated and above my comfort zone. In recent months, there's been speculation from some quarters that the economy is going into recession.

Interpretation of recent policy actions
In response to recent economic circumstances, the Federal Open Market Committee (FOMC) acted decisively. Over a period of nine days, from January 22 to January 30, the FOMC lowered the fed funds rate 125 basis points, from 4.25 to 3 percent. Since last August, the committee has dropped the fed funds rate 225 basis points.

These actions were taken to avert a deep and protracted economic downturn. In the face of economic weakening, the FOMC acted to avoid a restrictive posture and get rates to a level I believe will support movement toward trend growth by the second half of 2008.

You may also be aware that in response to recent strains in financial markets the Fed has injected liquidity into the financial system. In December, the Fed introduced the Term Auction Facility as another way to address immediate liquidity needs in financial markets.

I believe recent actions helped address the risks to the economic forecast I just referenced—that is, weakness in the first half of 2008 followed by improvement in the second half, with inflation moderating from recent levels. The liquidity injections and easing of monetary policy should help housing and financial markets stabilize and avoid an "adverse feedback loop" in which a continuing decline in housing prices fuels financial market volatility with spillover to the broader economy.

Adjustments leading to a new normal
As you know, problems with subprime mortgages triggered the ongoing episode of financial and economic uncertainty. The recent experience with subprime lending has shaken credit markets. Market participants are making adjustments in the face of a weakening economic environment. By adjustments, I'm referring to a reduction and writedown of exposures, deleveraging, changes in underwriting standards, and a revision of risk management policies and practices, among others. These adjustments have been painful, but necessary.

With so much uncertainty about the outcome of the ongoing financial turmoil I thought it would be helpful to share some of my thoughts on what's in store for credit markets once the dust from the subprime fallout finally settles. Before entering the treacherous terrain of predictions, I must emphasize that the views I'll present are mine alone. I do not speak for the Federal Reserve or my colleagues on the FOMC.

Trends in credit markets
To gain some perspective on the question of the future of credit markets, I think it's useful to review some of the key evolutionary trends in banking and credit over the last 20 years. The choice of 20 years of hindsight is arbitrary, but I do remember discussion of these directions in the mid-1980s—when I was a corporate banker working for Citicorp here in Atlanta.

I will cite four trends I see as formative of our current context.

First, credit intermediation has evolved from being bank-centric to market-centric. To a substantial extent, the modern model of the banking business—at least for the larger banks—is that of originate to distribute. Larger bank balance sheets have become heavier in securities, particularly since the distinction between commercial and investment banking has become blurred.

Second, the business of credit has evolved from one of on-balance-sheet whole loans to one involving substantially off-balance-sheet securitized loans. Securitization has been one of the major financial innovations of the last two decades. Charles Sanford, when he was heading Bankers Trust, wrote of "particle finance." As I recall, he meant that credit risk would be parsed, tranched, and transformed into derivatives to match the exact risk and return preferences of diverse lenders/investors. Along with securitization, the growth of derivatives—very recently including credit default swaps—has been a major innovation of our age.

Third, for many banks, particularly our larger banks, lending to corporations has evolved from corporate lending to leveraged lending. We recognized back in the 1980s that loans to investment-grade corporations couldn't pay the cost of capital. The ascendance of the private equity industry offered a lending alternative with better fees and

spreads. Financing sponsor-led buyout transactions has become a big business for many banks and nonbanks alike. Loans are originated for syndication as well as bridges to high-yield debt issuance and, in recent years, as raw material for collateralized debt obligations, or CDOs.

Fourth, credit to American corporations and consumers has evolved from domestically funded to global distribution of securities and loans. There is little argument that capital markets—including credit markets—have become global. To some extent, this is in response to the accumulation of large pools of dollar capital held offshore.

The long-term trends I have just described have a lot of momentum, but the recent turmoil has raised legitimate questions about the future of credit finance. In particular, four questions seem appropriate about the continuing evolution of financial markets.

Are banks going to make a comeback, regaining their old share of the credit intermediation market and reverting to on-balance-sheet lending?
Is securitization dead or dying?
Are we going to see a permanent shrinkage of the leveraged loan market with the attendant consequences for private equity?
Will foreign investors flee U.S. credit markets?

As a practitioner in the credit industry for the better part of 30 years, I will offer some tentative, but I believe informed, views on these questions. With regard to the role of banks in credit markets, there has been much discussion in recent years of the shrinking market share of banks and the emergence of a "shadow banking system." I'm referring, of course, to the universe of off-balance-sheet special purpose vehicles, nonbank loan origination and lending companies, commercial paper-financed conduits, hedge funds, and other entities.

I think the recent turmoil has shown that, in fact, banks retained a central role in the originate-to-distribute credit intermediation model. Banks may not have held the complete range of securities from risk bearing tranches to triple A, but they did—as it turns out—hold substantial super senior exposure, and they *did* create many of the conduits that directly owned the securities. Also they provided back-up liquidity to the conduits that served as intermediaries to the ultimate investors, and they often helped the ultimate investors finance their holdings of the securities. Moreover, when problems arose the markets turned to the banks to use their superior access to liquidity—both market-sourced and official—to provide funding. In securities markets where banks have recently substantially scaled back lending, we have seen decreased liquidity as some investors depended on bank-supplied leverage to obtain their target rates of return.

While banks have taken hits in the recent turmoil, their central role has been reconfirmed and their inherent strengths accentuated. The scale and scope of our larger banks and their broad earnings power have cushioned the losses. And their franchise strength has aided recapitalization.

While I see banks recovering, I see little chance that we will revert to the old approach of originate-to-hold-in-portfolio model. Market-based credit intermediation provides substantial gains from diversification and transparency that are not available in the old model. And I see little chance banks in their various forms won't remain the cornerstone institutions of our financial system.

Second, is securitization dead or dying? Here I think the answer is an unambiguous no. Securitization is not a new and untested financing tool. Rather, securitization has been around for decades providing fee income to originators, diversification benefits to lenders, and lower costs to borrowers. The logic of securitization—done prudently—is too compelling, and the market infrastructure is advanced. I have heard anecdotal comments to the effect that major investors have latent demand that will return to the markets once volatility has subsided.

But it's clear to me that participants in the securitization process must address certain weaknesses.

Accusations have flown about irresponsible mortgage origination practices—that is, the lowering of standards or even fraudulent behavior of originators who carry minimal risk in the ultimate performance of a loan. Actual practices no doubt covered a wide spectrum, but it's clear that there were problems, and, in my opinion, this perverse incentive must be addressed.

In reaction to troublesome opacity and complexity, I expect that financing structures will become less complicated. I don't believe investors will be willing to invest in structures that would require their lawyers days to figure out cash flows in the event of problems. Simpler, more transparent securities will facilitate somewhat reduced reliance on agency credit ratings. Ratings will remain an important part of the process because all investors cannot be expected to do their own thorough due diligence on every security. Rating agencies are already undertaking their own reforms, but ratings are unlikely to be as singularly dominant as they have been in some markets in recent years. Moreover, investors and rating agencies will not soon forget the lessons of recent months in evaluating pool probabilities. Tail events *can* materialize and, given recent experience, seem to do so with higher frequency than was contemplated by the models employed—models that were built for other purposes and products.

Third, are we going to see a permanent shrinkage of the leveraged loan market with the attendant consequences for private equity? Clearly, some shrinkage—especially in the large deal category—has happened already, but is it permanent? A year ago there was talk of a private equity "golden age." Like the four-minute mile before Roger Bannister, there were predictions of the $100 billion deal. Lender terms—with covenant-light structures and equity bridges—were collecting critical commentary.

What a difference a year makes! I believe the private equity industry will continue to operate, but at more modest levels of deal size, leverage, and loan terms. The recent repricing of risk and strengthening of terms should be healthy in the longer term. However, a cautionary note: Leveraged lending tends to go through cycles of tighter, then looser, underwriting standards. The pressures of competition for loan origination—including competition from nonbanks and hedge funds—may play through once again.

Finally, should we expect the disappearance of foreign investors from U.S. credit markets? As you've probably read, foreign institutional investors have not avoided the recent problems. Indeed, one of the realities exposed by the recent turmoil has been the geographic spread of investors, their direct exposure to subprime and CDO securities, and the scale of their losses. Given their losses, some pullback is predictable. There has been a widespread retreat from the subprime market, and I would not be surprised if this persists for some time. But as regards the broader credit markets, including mortgage-backed securities, it's more likely foreign investors will be more selective and rely more on carefully vetted expert intermediaries in the selection process.

The fact of such substantial foreign exposure to the current problems suggests both the importance of foreign investors to the U.S. mortgage markets and the extent of the dollar recycling problem faced by foreign investors. I do not see permanent impairment of foreign investor participation in our credit markets. After a pause, the fundamental need will reassert itself—owners of surplus capital must put their dollars to work.

So, as we move out of the current turmoil, I see the U.S. markets headed toward a "new normal," not a return to normal. The recent turmoil has discredited the more dubious innovations of the past few years. But the foundation of earlier innovations over the past three decades delivered too much value for us to return to the "old-old" ways of finance.

I believe the contours of the new normal will be:

a reformed, market-based system with a strong role for banks;
the continuation of securitization more narrowly applied and with strengthened origination, structuring, and risk evaluation practices;
better investor practices with more self-reliance, along with a substantially reformed rating agency industry;
simplified and standardized instruments; and
much refined risk management practices on the part of all market participants.

As I hope you detect, I am optimistic that the trauma of recent months will pass and our credit capital markets will be better for the lessons learned. Thank you.

Contact: Jean Tate 404-498-8035

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