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The worst trouble-spot in the US credit infrastructure is finally being addressed.

Update to strategic view

US MACRO, US BONDS: The conventional wisdom that "banks aren't lending" is wrong. Securitization markets are under real distress, but two new government programs to fix them are coming online shortly. While the economy remains frozen for fear of systemic credit collapse, the reality is that the credit infrastructure is in the process of being rebuilt. This should facilitate the ongoing contraction of credit spreads.

[see Investment Strategy Dashboard]

It's accepted wisdom that the economy is being severely hobbled because the borrowing and lending mechanisms of the financial system have essentially shut down, from plain vanilla bank lending, to asset-backed securitization, and even commercial paper issuance. In fact, though, as we have noted, bank lending continues to grow (see "Rescue Remix" January 20, 2009) as does commercial paper issuance. After the implosion of September and October saw the CP market contract by $187 billion, it has grown by more than 16% over the last three months.

There are reasons to believe government policies and programs now being put in place will foster further revival of the credit-creation function. For one, recovery of lending activity should be given a boost with a forthcoming FDIC program that will guarantee collateralized debt with maturities of up to 10 years. Though it was little noted at the time, in the announcement last week that Treasury, the Fed and FDIC were providing nearly $140 billion to protect Bank of America against losses arising from its acquisition of Merrill Lynch, the FDIC said its Temporary Liquidity Guarantee Program would be changed to extend the maturity of the guarantee to up to 10 years "where the debt is supported by collateral and the issuance supports new consumer lending."

The TLG program was first announced in mid-October (at the same time as the Treasury announced the Capital Purchase Program under TARP), guaranteeing senior unsecured debt with maturities up to three years. It has yielded encouraging results, fostering issuance of more than $200 billion in guaranteed bonds. These modifications are an effort to deal with the big hole in credit creation caused by the breakdown of the asset-backed securitization market.

By applying its backing to debt supported by collateral, the FDIC is seeking to promote establishment of a "covered bond" market as an alternative to securitization. Unlike asset-backed securities, which are issued by a special purpose entity that holds the collateral backing

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the debt, covered bonds are issued by banks, and the collateral remains on the banks' balance sheets. That makes the banks liable for the value of the underlying assets, but with the FDIC guarantee, investors would face no default risk in providing financing to support more such lending activity.

Although covered bonds are a $3 trillion market in Europe, providing the primary source of financing for home mortgages and other credit needs, they have been little used in the US. Among US. institutions, only Bank of America and the now-defunct Washington Mutual have issued covered bonds. Former Treasury Secretary Henry Paulson and Fed chair Ben Bernanke last year encouraged the creation of a covered bond market as a tool to help support mortgage financing given the grim condition of the securitization market. Now, with TLG and its expansion, FDIC chair Sheila Bair is stepping into the breech.

As far as securitization is concerned, the Fed is preparing next month to start up its Term Asset-Backed Securities Loan Facility (TALF), announced in November two days after the rescue of Citigroup, under which it will lend up to $200 billion to holders of certain AAA-rated ABS "backed by newly and recently originated consumer and small business loans." Backed by a $20 billion default guarantee issued by the Treasury under TARP, it amounts to a buyer of last resort, and has the potential to reinvigorate the ABS market, much as the Fed's commercial paper facility helped lead to the recovery of that market.

In his speech last week at the London School of Economics, Bernanke said that TALF will "effectively substitute public for private balance sheet capacity, in a period of sharp deleveraging and risk aversion in which such capacity appears very short." The program, he said, should lead to lower rates and greater availability of consumer and small business credit. "Over time," he added, "by increasing market liquidity and stimulating market activity, this facility should also help to revive private lending." Also, Bernanke indicated the program would not necessarily be limited to the $200 billion of the initial announcement -- a small fraction of this large market -- stating that its "basic framework can be expanded to accommodate higher volumes or additional classes of securities as circumstances warrant."

BOTTOM LINE: The widespread impression that the credit creation facilities of the financial system have basically become inoperative is a myth. Bank lending is still growing, and commercial paper issuance is bouncing back. The securitization market, a vital source of liquidity to finance lending activity, remains in deep distress. The FDIC is establishing a debt guarantee program under which it will promote the establishment of a "covered bond" market to serve as an alternative to securitization. Also, the Fed will soon initiate operation of TALF, a buyer of last resort for asset-backed securities.