SPINNING AROUND TED AND LIQUIDITY

by Steve Brown

Regulators have been talking about bank liquidity for some time now and we get asked all the time for metrics that bankers can use to proxy up risk in the system. One of those metrics is the so-called TED Spread. Exactly who TED is and how TED works is detailed below, but suffice it to say that if you want to get a quick snapshot of liquidity and credit conditions in the universe, it isn't a bad proxy.

In general, the TED spread is the difference in yield between Libor and Treasury Bills. Roughly speaking, Libor represents the base lending rate to a corporate borrower, while the Treasury rate represents the "risk free" rate. When the TED spread gets wider, it indicates investors think risk is increasing, more defaults will probably occur and they begin to shift money to safer places to ride out the storm (i.e. Treasuries). Conversely, when the spread tightens, it tends to indicate that corporations are doing well, the economy is strong and default risk is lower. When that happens, money flows into corporations, out of Treasuries and the spread between the two compresses.

To calculate the TED spread, you can take the difference between 3 month Libor and 3 month Treasury Bills. Luckily, we provide that each morning for our readers in the box below. While not officially the TED spread (for the data hounds out there it is really the difference between 3 month futures contracts for U.S. Treasuries and 3 month futures contracts for Eurodollars, but you get the point), it is a good proxy for what is happening that day. So, using yesterday's Libor rate of 2.79% and yesterday's Treasury rate of 1.87%, we calculate an approximate TED spread of 92bp when business began yesterday. As the market moves around, this spread moves around and it shifts in and out.

As with most things in life, nothing is perfect, and the TED spread certainly suffers from the same problem. To begin, the Treasury only has so many billions of dollars of Treasury Bills in circulation at any one time, while the Libor market is trillions of dollars deep. Investors are notoriously skittish, so when small tremors occur and there is little liquidity in Treasury Bills, the spread can move quickly and violently.

Another issue to consider is that comparing Treasuries and Libor is one way investors demonstrate how much they are willing to accept in return for something that has zero or low risk. The problem is that big investors (especially technical ones) are also lemmings. When the TED spread indicates the market is undergoing significant stress, these investors all roll in and hide in Treasuries, crossing their fingers that the next FRB move will be to cut rates. This fans the fire and leads to further stress, which left unchecked can drive things to extremes.

Finally, there is one more thing to consider when thinking about TED. If bankers perceive future economic growth looks bad and credit risk is going to rise, the TED spread would likely widen. However, the wider TED spread and less willingness to lend may not indicate bankers are experiencing something unexpected from outside the system. Put another way, while the collapse of Bear Stearns certainly widened the TED spread, the spread can also become wider during periods where bankers perceive future credit may be deteriorating (and not necessarily are experiencing a Bear Stearns event).

If this isn't enough to get you thinking this morning you probably aren't trying hard enough, since just writing it made us spin like a child holding onto their parent's hands as they whirled around in a circle.

BANK NEWS

The Fed

As FOMC Chair Bernanke said, "Next week, the Federal Reserve Board will issue new rules on mortgage lending, using its authorities under the Home Ownership and Equity Protection Act. These new rules, which will apply to all lenders and not just banks, will address some of the problems that have surfaced in recent years in mortgage lending, especially high-cost mortgage lending... We are currently monitoring developments in financial markets closely and considering several options, including extending the duration of our facilities for primary dealers beyond year-end, should the current unusual and exigent circumstances continue to prevail in dealer funding markets."

Fannie and Freddie

The 2 largest GSE's have to place back onto their books as much as $3.7B in off-balance sheet mortgage backed securities under the FASB's revision of rule FAS 140. Both companies are still adequately capitalized despite the change.

Lending Cap

The NCUA may ease LTV requirements on construction and development lending. The NCUA is making the move to help credit unions compete better, despite rather risky present conditions of such loans.

FHA

The FHA announced $4.6B in losses last year. Dating back to 2002, FHA loan delinquencies rates have been nearly double that of all mortgages. The Senate is currently working on a bill that would double the agency's loan limit and lower requirements on down payments.