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THE MARKET GYRATIONS OF LIBOR, FED FUNDS & TED

by Steve Brown

Today, you will notice we modified the grid at the bottom of this publication ever so slightly. We dropped the less relevant Treasury repurchase rate and have replaced it with the more critical overnight Libor (see "yellow" box below) rate everyone has been hearing so much about. We did this for a number of reasons that we'll try to explain here.

We begin with a description of Libor itself. Libor rates are set each day in London and are the rates at which banks overseas will lend to each other. Libor is important because it represents the rate where the world's very best borrowers (banks) can borrow and because it is also widely used as a reference point for the vast majority of short-term interest rates.

The next level of our review delves into the difference between overnight Libor and the overnight target Federal Funds ("FF") rate. When we see the spread between the two widen, it indicates cash is becoming scarce. Wide spreads mean banks are hoarding money and are unwilling to lend to each around the world (we'll cover the US market by itself in a moment). In short, banks are keeping excess funds for themselves, just in case unexpected issues occur. That leads them to sit on excess funds instead of redistributing it among themselves. In a "normalized" situation, the average rate between overnight Libor and the overnight Target FF rate is usually about 15bp. As of this morning, it had contracted to 68bp (2.18% - 1.50%), well down from the 359bp point it reached last Thursday. Clearly, the efforts of the central banks to flood the market with liquidity are working, but overseas banks still remain stingy about sharing funding they receive.

Now let's get back to the US overnight market. As many community banks have recently experienced first hand, global stress may or may not translate directly to the US FF market. In fact, the Federal Reserve has done an outstanding job at keeping the FF rate low by flooding the system with liquidity. The problem is that they have been so aggressive that just a week or so ago rates traded as low as zero percent. That indicates US banks are very willing to share liquidity among themselves and are so unworried about each other in fact (and the FOMC had pumped in so much money), that billions of dollars traded over many different days between US banks at very low rates. While these low rates are partially caused by US banks moving money among themselves to ensure reserve requirements are in synch, they also reflect a distinct lack of concern among banks operating within the US (very different from overseas markets). For comparison, the FF Effective rate is usually within just a few basis points of the Target Rate on any given day, so when the FF Target is at 1.50% and money is trading at 0%, it shows there is a tremendous amount of liquidity in the US system.

To continue our exploration of the dynamics of short-term rates, we also need to introduce the "TED Spread." The TED Spread is calculated by subtracting the 3M Treasury yield from 3M Libor. The TED Spread is important because it captures the difference between where banks can borrow short-term and where the US Treasury (risk-free rate) can borrow short-term. The TED Spread is also a great way to measure market stress. In a "normal" situation, the TED Spread is about 45bp to 50b. When the spread widens out, it indicates banks are not willing to lend to one another and are seeking safety (flight-to-quality). Since this is exactly what has been happening as of late, it is no wonder the TED

Spread has also been wide. After the actions this weekend by governments around the world, perhaps there is a silver lining, however. Doing the math this morning, the TED Spread has compressed to 445bp, down from 463bp last week. While that is still wide historically, it is going in the right direction and is much better than recent levels.

We provide this information in an effort to help community bankers track the impact of global events and market gyrations on their own bank. Libor is critical to the banking industry and it will eventually normalize, as banks once again lend to each other around the world. Tomorrow, we will report on the latest Rescue Plan and its impact on community banks, including direct capital injections, guaranteeing business accounts and other aspects of this broadened rescue effort.

BANK NEWS

Rescue Plan

The US Gov't will invest $125B into 9 of the largest financial institutions. The list includes Citi, JP, BofA, Wells, Bank of NY, State Street, Morgan, Goldman & Merrill.

Bank Failure

Main Street Bank ($98mm, MI) & Meridian Bank ($40mm, IL) were closed Friday due to insufficient capital.

Bank Tax Relief

The recent tax law change that effectively removes the limit for net unrealized operating losses for banks that undergo a change of control will be a HUGE stimulus for bank acquisitions. Since the ruling does not apply to asset purchases, the ruling will incentivize banks destine for acquisition not to sell into the TARP facility.

SOV Bank

Banco Santander SA, Spain's biggest bank, will buy the remaining equity in Sovereign Bancorp (the nation's largest S&L), for $1.9B or approximately 0.29x book.