

Observation Deck

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LIBOR vs. TAF Demystified

Ninh Chung, *Portfolio Manager*

The credibility of the London Interbank Offered Rate, otherwise known as LIBOR, as key benchmark rate for the financial system has been under scrutiny of late and may have gone unnoticed if it wasn't for the Federal Reserve. The British Banker's Association (BBA) who governs key rates, is dependent on member banks around the world for their daily submission of hypothetical lending rates to each other ranging from overnight to one-year maturities in determining these LIBOR rates. Coincidentally, many of these member banks happen to be the same banks experiencing asset write-downs that could naturally skew their lending appetite. Perhaps because of this, the Federal Reserve's Term Auction Facility (TAF) program has become, in some circles, a more trusted benchmark for "true" lending rates.

Our study of results from the Federal Reserve's Term Auction Facility program versus the 30-day LIBOR rate yielded some interesting discrepancies between the two rates. Recall, the Federal Reserve along with other central banks established the TAF as a temporary loan program for depository institutions which may use a variety of collateral at the discount window. In its simplistic form, one would expect TAF rates to be lower than the equivalent LIBOR, otherwise, depository institutions in temporary need of capital would simply borrow from their peers.

Reading from the adjacent table revealed the largest spreads (LIBOR minus TAF rate) occurred at the first two auctions as the 30-day LIBOR just failed reaching 5.00 percent. However, as the

TAF and LIBOR Yields

	TAF Amount \$(billions)	TAF Term (days)	TAF Rate	30-Day LIBOR	Spread
12/17/07	20.00	28	4.65000	4.965000	0.32
12/20/07	20.00	30	4.67000	4.896250	0.23
1/14/08	30.00	28	3.95000	4.081250	0.13
1/28/08	30.00	28	3.12300	3.281250	0.16
2/11/08	30.00	28	3.01000	3.138750	0.13
2/25/08	30.00	28	3.08000	3.127500	0.05
3/10/08	50.00	28	2.80000	2.935000	0.14
3/24/08	50.00	28	2.61250	2.606250	(0.01)
4/7/08	50.00	28	2.82000	2.724380	(0.10)
4/21/08	50.00	28	2.87000	2.897500	0.03

Source: Federal Reserve, British Banker's Association, SVB Asset Management

size of the TAF facility was increasing (an indication of increased demand), we were surprised that the spread narrowed – by as much as 42 bps. As the Fed was aggressively cutting the overnight federal funds rate, we can definitely understand the decline in overall yields; however, credit risk was still very elevated. Wasn't the reason for the Fed to cut rates in the first place to ease credit concerns and boost the staggering economy? If so, why did the two yields converge and subsequently cross in the March 24 auction? Is this a technical anomaly or is there something more to it?

The suspicion that banks have been submitting lower rates during the LIBOR setting process in fear of signaling to market participants that they are in more need of capital than reported is not new to traders and banks. The reliability of LIBOR came into question as early as last November at a meeting of the Bank of England's Sterling Money Markets Liaison Group when several members said they believed that LIBOR fixings had been lower than actual traded interbank rates through the period of stress. After studying results of the TAF, we can understand and appreciate the speculations raised.

Developed in the 1980s, the lending community's dependency on LIBOR has grown over time and now approximately \$150 trillion worth of financial products are tied to these indices, according to the BBA. Until the speculation is lifted or more reliable indices are created, investors may want to brace themselves for higher borrowing costs in the future. Due to the heavy reliance on LIBOR, we are encouraged that the TAF auction has signaled one of the flaws in the financial pricing system. As we've mentioned in our April SAM Observation Deck, the TAF tool may be here to stay, especially if LIBOR does not get its act together.

Markets	
Treasury Rates	
3-Month	1.38%
6-Month	1.62%
2-Year	2.25%
5-Year	3.01%
10-Year	3.73%
April Total Returns	
ML 3-Month Treasury	0.11%
ML 6-Month Treasury	0.12%
ML 12-Month Treasury	-0.20%
S&P 500	4.87%
Nasdaq	5.90%

Source: Bloomberg, as of 04/30/08

Economic Vista

Minh Trang, *CFA, Portfolio Manager*

The outlook for the economy remains weak. The labor market has experienced three consecutive months of job losses, with March non-farm payrolls coming in at -80,000. This is quite a reversal given that job growth in 2007 averaged 95,000 per month. Continuing unemployment claims has also climbed steadily and is now at 2,940 thousand, pushing the unemployment rate to 5.1 percent. Further weakness remains in the housing market, which has yet to bottom. Existing home sales dropped 2.0 percent in March and inventory of homes available for sale is currently at a 9.9 months supply level.

Given these weak numbers, the Fed eased rates by 25 basis points on April 30. The Fed Funds target rate is now 2.0 percent. After an aggressive easing policy over the last seven months, the FOMC's latest comments suggest that a pause in this rate cycle may be upon us.

With each successive cut, however, the Fed's options become more limited because inflationary pressures have not abated. March headline PPI increased 6.9 percent and CPI 4.0 percent from the previous year. Core (excluding food & energy) PPI and CPI have been more benign, increasing 2.7 and 2.4 percent respectively. Oil prices soared throughout April, nearing \$120/barrel. In addition, futures prices for grain have increased 12.4 percent for the year. In recent weeks, these price gains have not just added to global inflation, but have caused instability within several developing nations. At some point, the Fed will need to turn some attention to these developments.

Credit Vista

Melina Hadiwono, *CFA, Manager of Credit Research*

The Financial Stability Forum has recently presented to the G7 finance ministers and Central Bank governors a report making recommendations for enhancing the resilience of markets and financial institutions. The recommended actions are in five areas:

1. Strengthened oversight of capital, liquidity and risk management
2. Enhancing transparency and valuation
3. Changes in the role and uses of credit ratings
4. Strengthening the authorities' responsiveness to risks
5. Robust arrangements for dealing with stress in the financial system

These initiatives are intended to improve the new capital adequacy framework over the medium term which should help to prevent a repetition of the 2007/2008 crisis in the future. To restore

confidence in the soundness of markets and institutions, it is essential that steps are taken immediately to enhance the resilience of the global system. At the same time, the FSF recognizes the strains under which the financial system is currently operating and will pursue implementation in a way that avoids exacerbating stress in the short term. Nonetheless, it is clear that banking regulators, under pressure from G7 ministers and Central Bank governors, are now starting to address some of the weaknesses highlighted by the current crisis in financial markets.

As we move through first quarter 2008 bank-earnings releases, continued negative trends in earnings and credit quality are expected. Broadening economic weakness has caused an increased number of non-performing loans in home equity, commercial real estate and commercial lending — beyond the specific consumer-related weakness and the subprime assets which have been the key driver so far. In recent months, the financial sectors have been going through major recapitalization efforts including cutting dividends, receiving capital injections from third parties or issuing hybrid securities — albeit at a cost. Capitalization efforts have been well-received by investors — a significant positive sign. We expect to see more of these important recapitalization efforts going forward as they are critical in bolstering financial institutions' capital and increasing their financial flexibility.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

After the volatility in the markets in March, April seemed relatively quiet as we saw the spreads on money market instruments stabilize. The main story in this sector was the rise of LIBOR rates which increased about 20 bps across the curve mid-month. The three-month index yield rose from 2.71 percent on April 14 to 2.92 percent by the April 21. Many have speculated that this jump was due to European banks understating their true borrowing costs. Yields on corporate bonds also rose as spreads to LIBOR did not tighten. The two-year Treasury yield rose by 46 bps by month end yielding 2.25 percent after peaking on April 25 at 2.42 percent as corporate earnings reports for the most part beat estimates and the Fed flooded the market with new Treasury bonds. Commercial paper has been trading in line with LIBOR with the three-month yielding 2.78 by month-end, while agency spreads widened a bit and were yielding plus 60 to plus 65 against Treasuries.

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