

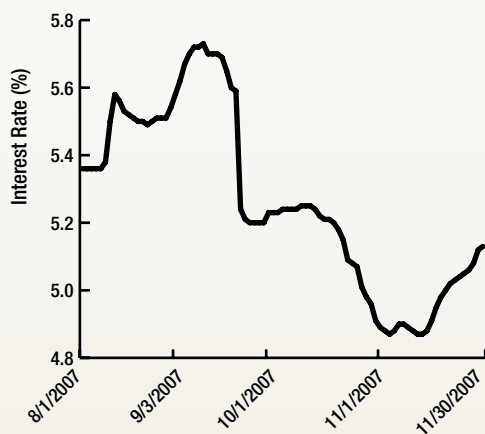
U.S. Banking – 3rd/4th Quarter Interest Review

December 17, 2007

Sector

Banking

Three-Month Libor Rates For Dollar Loans



Source: British Bankers' Association.

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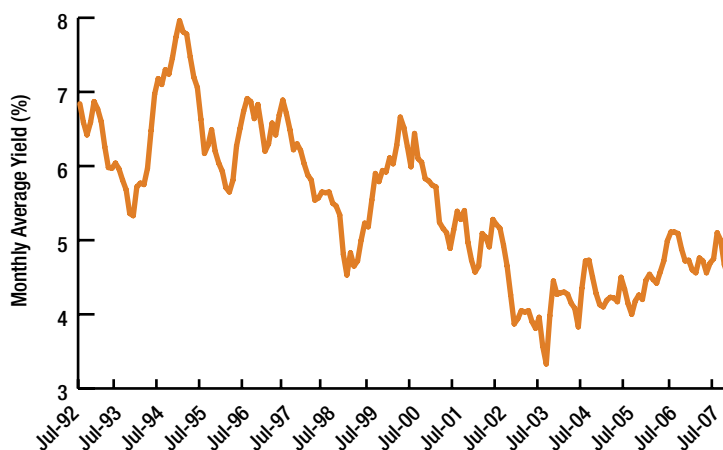
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Risk Aversion Leads To a Steeper Yield Curve

Credit market sentiment shifted in the second half of 2007 to an overall aversion to risk, driven by the subprime mortgage crisis and concerns over liquidity within the banking system. This led to a flight-to-quality to Treasury securities, driving down yields, particularly for Treasury bills and two-year Treasury notes. The result was a steeper yield curve compared with the second quarter.

- Implied yields on Treasury bills fell sharply in November as money market investors shunned asset-backed commercial paper (ABCP), the outstanding amount of which has fallen by 30.2% since the end of July.
- The spread between two- and 10-year Treasury notes has widened considerably since the second quarter, an indicator of market expectations for slower economic growth.
- Other interest rate benchmarks such as the London interbank offered rate (Libor) remain high as banks face year-end funding pressures and their own liquidity needs.
- One-month Libor eclipsed three-month Libor at the end of November, a sign of the significant cash needs that banks had for year-end.
- With financing conditions extremely tight, the Federal Reserve and other central banks around the globe consistently injected extra cash into the financial system in November to keep lending rates near their benchmark targets.
- To help ease liquidity constraints, the Federal Reserve plans four special term funding auctions in December and January.

10-Year Treasury Note Constant-Maturity Yield



Source: Federal Reserve Board.



Credit Woes Push Treasury Yields Lower

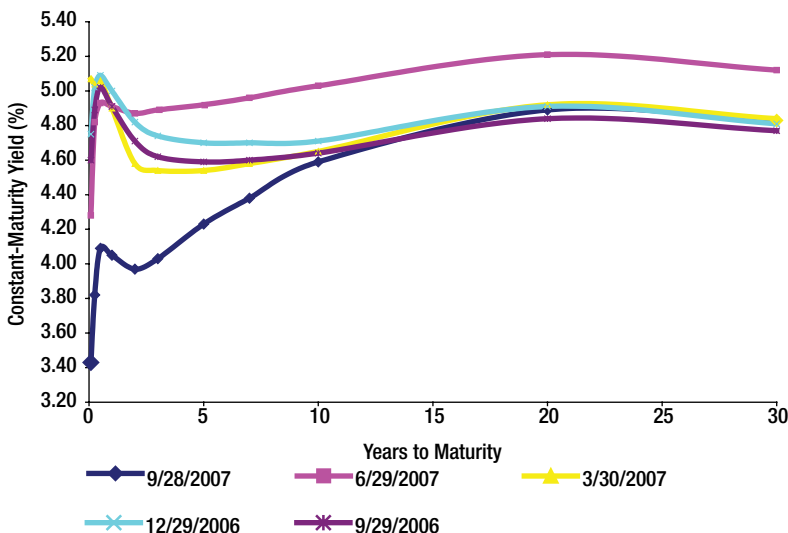
The simmering credit crunch and subprime mortgage crisis that kicked into full gear in August has had a pronounced effect on the Treasury yield curve. The yield curve's gyrations have been volatile since June, when market participants began to change their expectations of tighter interest-rate policy by the Federal Reserve to possible Fed easing. And, as banks have become increasingly wary of lending to each other as 2007 rolls to a close, the steepening pattern the yield curve assumed during the second quarter has accelerated (See Exhibit 1).

Although worries over inflation remain, mostly due to a weak U.S. dollar and higher energy and food prices, credit-market sentiment has shifted toward an overall aversion to risk. After a calm, of sorts, following August's credit market turbulence, the escalating crisis in the market for securities backed by subprime mortgages and a contraction in credit led in November to a significant rush to buy Treasury securities as investors sought a safe haven in highly-rated liquid government debt. Money market investors, in particular, have had a pronounced impact on shaping the front-end of the

yield curve by pouring funds into one- and three-month Treasury bills.

In August, these investors shunned asset-backed commercial paper (ABCP) – debt issued with maturities typically less than 270 days – fearing that the collateral backing the paper was tied to risky subprime mort-

Exhibit 1
Treasury Yield Curve, Quarters –
Ended September 2006 to September 2007



Source: U.S. Department of the Treasury.

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gages. Rather than purchase newly-issued ABCP, they opted for Treasury bills, pushing yields down on one-month bills to as low as 2.47% on Aug. 20. In turn, inflows into money market funds have remained strong through November, prompting further buying of one- and three-month Treasury bills. Total money market mutual fund assets rose to nearly \$3.1 trillion as of Nov. 28, up from more than \$2.5 trillion in June, according to the Investment Company Institute.

As of Nov. 29, implied yields on one- and three-month Treasury bills were 3.38% and 2.99%, respectively. That compares with implied yields of 4.28% for the one-month bill and 4.82% for the three-month bill at the end of the second quarter.

Other investors, too, have sought some relief from credit market woes by purchasing two-year Treasury notes – a maturity on the yield curve that would benefit should the Fed cut interest rates further – along with benchmark 10-year Treasury notes. The 10-year note, for example, was yielding 3.94% as of Nov. 29, well below the 4.50% federal funds target rate for overnight loans between banks set by the Fed. (On Dec. 11, the Fed lowered the federal funds rate by a quarter percentage point to 4.25%. The Fed also cut the discount rate – the rate at which the Fed lends directly to banks – by a quarter percentage point to 4.75%.)

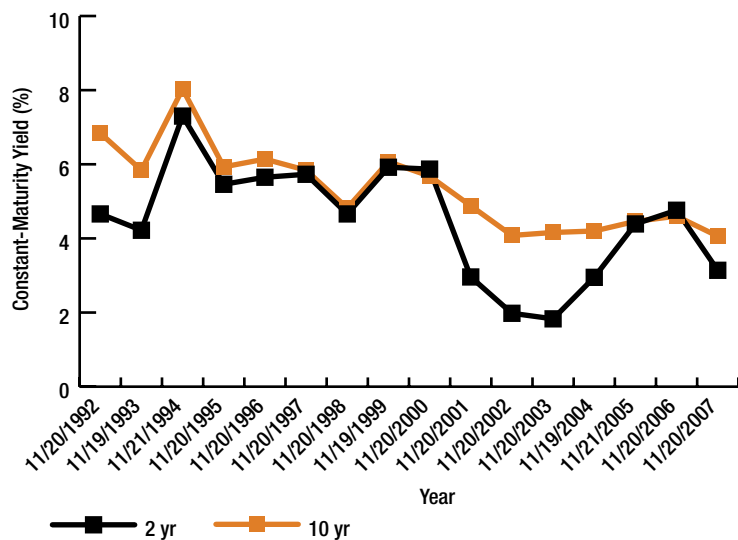
Further steepening in the yield curve since the second quarter is evident in the difference in yields between two- and 10-year Treasury notes. The spread between these two maturities along the yield curve had widened to 88 basis points as of Nov. 29, compared with 16 basis points as of the end of the second quarter. The widening gap between the two- and 10-year Treasuries indicates market expectations for slower economic growth and more Fed interest rate cuts (See Exhibit 2).

Meanwhile, other interest rate benchmarks are signaling concerns in the banking sector. This is evident in London interbank offered rates (Libor) for one- and three-month dollar loans. Libor represents a short-term floating rate that banks charge each other for loans and serves as a benchmark for pricing floating rate bonds, mortgages and a host of other financial instruments. As of Nov. 29, one-month Libor was set at 5.22%, above the

5.12% fixing for three-month Libor, signaling the significant cash needs that banks have for the final month of the year. Both Libor rates were well above three-month Treasury bill yields, an indication of stress within the banking system. (See Exhibit 3).

Similar to last August, when Libor rates first began to spike, banks are again wary of lending to each other because of their own funding needs. Global banks need to hold on to cash now because loan agreements known as liquidity facilities they have provided to ABCP conduits and even commercial paper

Exhibit 2
10-Year and Two-Year Treasury Yields by Year as of Nov. 20



Source: U.S. Department of the Treasury.

Exhibit 3
Three-Month Treasury Bill Yield



Source: U.S. Department of the Treasury.

programs used to fund collateralized debt obligations (CDOs) may be tapped. In recent months, several banks also have had to step in and buy back maturing debt issued by structured investment vehicles (SIVs) – off-balance sheet vehicles that borrow short-term and then buy higher yielding assets with longer-dated maturities.

Funding pressures in global money markets have been so tight that the Fed, the European Central Bank and other central banks around the globe have had to inject extra cash into the financial system during November to keep their lending rates near benchmark targets. In the final week of November, the Fed offered loans of up to six weeks to the Wall Street dealers with which it conducts daily borrowing and lending operations.

Those actions were followed on Dec. 12 by an announcement from the Fed that it would offer 28- and 35-day term funds to banks through two, \$20 billion auctions later

in December. Another two auctions were scheduled for January, with the amount to be determined. The Fed also said it had established temporary reciprocal currency arrangements of up to \$20 billion with the European Central Bank and \$4 billion with the Swiss National Bank.

Now that the Fed again has lowered the federal funds rate, the shape of the Treasury yield curve may flatten over the near term. Yields on the two- and 10-year Treasury notes tend to climb following the third rate cut in an interest-rate cycle. Concerns over the health of the U.S. economy and weaker consumer confidence also may lead to higher yields for shorter-term Treasuries and contribute to a flatter yield curve. For longer-term Treasuries, inflation concerns would tend to lead to higher yields, though buying from foreign central banks and overseas investors may keep longer-term yields in check.



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