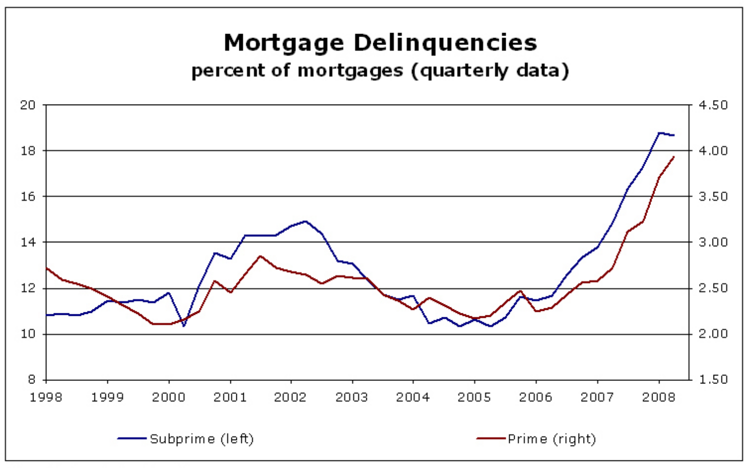
September 16, 2008

The left and right of it all

What a wild day it was on Monday in U.S. and global financial markets. We heard it quipped that the problem with financial institution balance sheets is that "on the left hand side nothing is right and on the right hand side nothing is left." This is clearly an exaggeration, but it does raise the question: What do people look at when gauging the rightness or leftness of balance sheets?

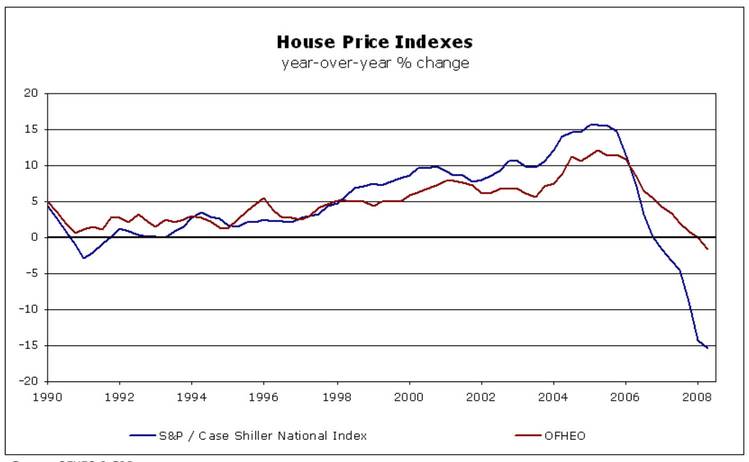
A lot of the discussion about asset quality has focused on mortgage backed securities (MBS). The size of the MBS market has experienced phenomenal growth over the last decade or so—MBS issuance grew from around $500 billion in 1997 to over $2 trillion in 2007. As the name suggests, an MBS is a bond that is backed by the collateral of mortgages—either by mortgages guaranteed by Freddie Mac or similar institutions or other pools of mortgages. The MBS, or pieces of it, are then sold to investors, with the principal and interest payments on the individual mortgages used to pay investors.

Underlying the performance of MBS is the performance of mortgages themselves. Mortgage delinquency has been rising for some time, and especially for subprime mortgages.



Source: Mortgage Bankers Association

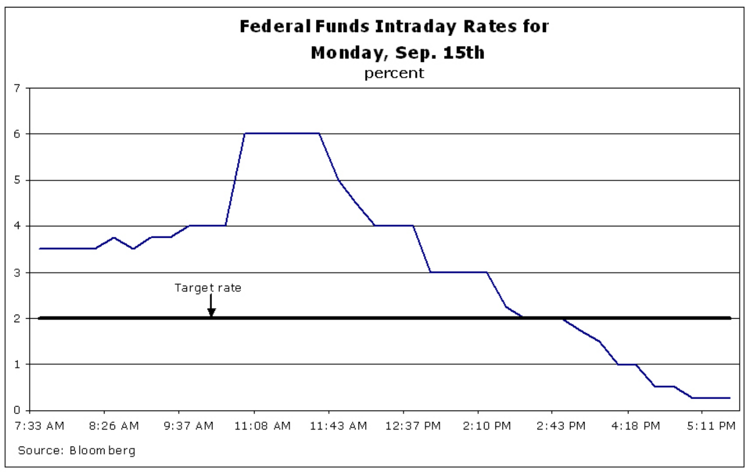
At the same time, the value of the mortgages, as indicated by home prices have been falling.



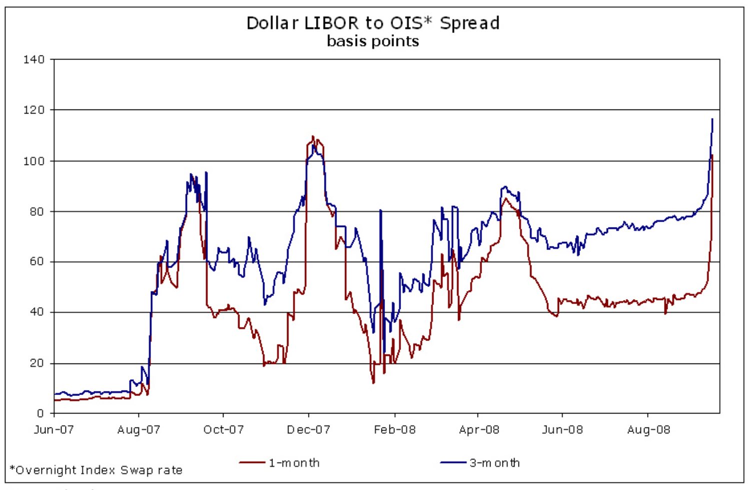
Source: OFHEO & S&P

One of the features of the U.S. financial system is that the debt of financial institutions tends to be weighted toward long-term obligations while the financing has been predominately from short-term borrowing. As the performance of the assets has deteriorated the need for liquidity has risen sharply.

The demand for cash was especially acute on Monday, as can be seen in the large intra-day variability in the federal funds market. Federal funds are the reserve balances of depository institutions held at the Federal Reserve. At times on Monday the federal funds rate traded well above the target of 2 percent before the New York desk intervened with an additional $50 billion injection of reserves. This Bloomberg news story describes Monday's large movements in the federal funds market.



The demand for liquidity at 1 and 3 month horizons also surged, as indicated by the dollar LIBOR spread over OIS at 1 and 3 month horizons. LIBOR (the London Inter-Bank Offered Rate) is the interest rate at which banks in London are prepared to lend unsecured funds to first-class banks. As such it is a guide world-wide for the rate banks use to lend to each other. In the U.S., it is usually not far off from the fed funds rate. But after the emergence of the financial turmoil last fall the LIBOR has risen relative to the fed funds rate. The OIS (Overnight Index Swap) rate is a measure of the expected overnight fed funds rate for a specified term (1 or 3 months, for example). The LIBOR/OIS spread can be used as measure of the amount of liquidity or stress in short-term unsecured cash markets.



Source: Bloomberg

LIBOR spreads edged higher last week amid uncertainty about financial firms, and both spreads jumped higher on Monday and Tuesday, with both at or close to new highs.

Tuesday is another day, but some things will remain the same, including the focus of attention on the left and right of financial institution balance sheets, and the debate about the appropriate role of government in all this.

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