Right, said TED

One relatively straightforward measure of how much the banks trust each other has received surprisingly little attention, writes Professor Robert Marks*.

In its leader of Monday, 13 October, the Financial Times characterises the western world's banking system as suffering "the equivalent of a cardiac arrest." The collapse of confidence in the system means that "it is now virtually impossible for any institution to finance itself in the markets longer than overnight."

In practical terms, this crisis in inter-bank lending is reflected in the difference between the (very low) three-month rate on U.S. Treasury bills (as risk-free as any instruments can be) and the return on Eurodollar lending to other banks, usually measured by the London Inter Bank Offered Rate, or LIBOR. The greater the risk to lending, the larger the TED spread, so-called, since the risk of the borrower defaulting (the counter-party risk) is greater, which means that lenders demand a higher return on their (more risky) investments.

The long-term average of the TED spread has been about 30 basis points, but it has been growing since the sub-prime mortgage crisis emerged in mid-2007, and on 10 October it reached a record high of 465 basis points, which explains the FT's claims.

This precipitous rise in counter-party risk - sometimes not even the borrower is fully aware of its own default risk - is a direct result of the securitisation and on-selling of US sub-prime mortgages. With the bursting of the US housing bubble, returns on these bundles of securitised debt are much riskier, as mortgagees default. If that were all, then borrowers could demand higher returns (as insurance against default and hence bad debts), and still lend.

Crucially, the lack of transparency of would-be borrowing banks' loan portfolios, of institutions around the world, especially after the Lehman Brothers bankruptcy - and particularly in the US and Europe - has resulted in the inter-bank credit market virtually seizing up, as reflected in the historically high TED spread.

TED Spread & Componets - 2008

Source: Wikipedia

To instill confidence in the credit markets, governments have at least two kinds of action. They can offer to buy the so-called "toxic loans" associated with the securitised sub-prime mortgages. The issue of valuation remains, however: too low and the banks are still at risk; too high and tax-payers' money is wasted. This is the proposed US plan, using the $US700 billion "bail-out" fund.

An alternative is the British plan to recapitalise shaky banks by injecting capital into them in return for preferred stock. As a result the UK government is already a dominant shareholder of the Royal Bank of Scotland (60 per cent) and others. If the government goes guarantor for bank borrowings, as the Australian government has done, so much the safer.

These allocations of tax-payers' dollars to revive confidence and trust in the inter-bank credit market, in order to lubricate inter-bank lending, are necessary, I believe. We will only know that they have been sufficient when the TED spread falls to something like its historical levels of less than 60 basis points, say. Time will tell.

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TED Spread 101

The TED spread is the difference between the three-month US Treasury bill interest rate and three-month LIBOR. The TED was once based on futures contracts, and is an acronym formed from T-Bill and ED, the ticker symbol for Eurodollar futures contracts. It is usually denominated in basis points. A widening spread indicates lenders believe the risk of default on interbank loans (also known as counterparty risk) is increasing.

Source: Wikipedia