14 August 2007

Subprime and Central Banks

In recent days I have received a forest of phone calls asking me to explain what is meant by injections of liquidity by Central Banks. How does this relate to Subprime mortgages?

Let us take the example of a US or European bank. This bank owns a subsidiary which invests in Subprime mortgages on behalf of clients. This is a reasonable practice for banks because owning such a subsidiary allows you to on-sell some of the Subprime mortgages that you have originated.

The Cause of the Problem

It has been a common practice for subsidiaries like this to gear up their investment in Subprime mortgages by ten times. This means they were borrowing 90% of the value of the Subprime mortgages they were investing in. The theory was that this was ok as long as you matched your short-term liabilities with your short-term investments and your long term liabilities with your long term investments. This isolated you from shifts up and down in the yield curve. What nobody thought of was the risk of default.

Now, suddenly, the risk of default of Subprime mortgages is say, 3.5% (this is fairly close to the current number). This means that you are receiving no income from these loans. Should you have geared up these loans by ten times, this means that the level of your income has now fallen by 35%. Funds offering investment in these products have seen the value of their units decline by this amount or more. Because of this decline in the value of their investment, clients of these funds have been asking for their money back. This is what is called redemptions.

Normally, what the fund would do would be to then sell their investment in Subprime loans and then refund the money to the investor. The problem is that right now, no-one will buy the Subprime loans from this fund or any other fund. Faced with this situation, the bank owning this fund subsidiary has two choices. The first is that it may close the funds to redemptions. If it does this, the bank may suffer reputational risk. The second alternative is to itself buy the loans from the subsidiary.

To do this, it must sell something that it is sure of getting full value for. What banks have been doing last week, both in the US and Europe, is to sell very short-dated treasury bills.

Why Central Banks Intervened

The pace of the redemptions has been so great as to generate a dramatic pace of sales of these treasury bills by commercial banks. The result of this last week was to increase the interest rate on overnight funds both in the US and in Europe to a little more than half a percent over the target rate that the Central Bank had set in each market. The target rate in the US as everyone knows is the Fed Funds rate, and in Europe it is the Repo rate (repurchasing operations bid rate).

As short-dated Treasury Bill yields rose above these rates, Central Banks intervened to repurchase those treasury bills. They continued to purchase those treasury bills until such time as the interest rate in the overnight market fell back to the target rate of the Central Bank. The money they paid for these treasury bills is referred to in the newspapers as “a cash injection”.

The amount of money that was put in by the Central Banks exactly matches the amount of treasury bills that commercial banks needed to sell. I have been asked “is there an end to the amount of Treasury Bills that the Central Banks can buy?” The answer is no. In theory and in practice, the Central Banks could buy all of the Treasury Bills in their own currency that exists in the world and then buy some that don’t. The ones that don’t exist at the

ABN AMRO Morgans Limited (A.B.N. 49 010 669 726) AFSL235410 A Participant of ASX Group
Level 29, Riverside Centre, 123 Eagle Street, Brisbane QLD 4000, Australia
Phone: 1800 777 946

Analyst
Michael J Knox
ABN AMRO Morgans Limited
+61 7 3334 4876
knox@abnamromorgans.com.au
www.abnamromorgans.com.au

moment would be purchased from their own governments. A couple of years ago when he was a Governor of the Federal Reserve, Ben Bernanke referred to this process as "the printing press". Of course we do not expect that the process will continue this far on this occasion.

The current process of Central Bank intervention is neither inflationary nor deflationary. What the Central Banks are attempting to do is merely keep short term interest rates at exactly the same level they were before this crisis occurred. If for some reason the commercial banks return to a position of excess liquidity, then the Central Banks would be selling treasury bills in order to take that liquidity out of the system. The purpose of the process is to stabilize the system. There are no inflationary consequences which result.

Conclusion

In recent days, Central Banks both in Europe and in the United States have been aggressively purchasing short-dated treasury securities in order to bring overnight interest rates back down to their pre-announced targets. The press refers to this process as "a cash injection".

It is important to understand that the Central Banks are only purchasing securities that the commercial banks need to sell. The purpose is to stabilize official interest rates at their current levels. The result is not inflationary. The purpose is merely to stabilize the system.

RESEARCH TEAM

ROGER LEANING	-	Head of Research	JOSEPHINE LITTLE	-	Analyst
ROBERT BITOMSKY	-	Analyst	ROSS MACLEOD CAREY	-	Analyst
CHRIS BROWN	-	Senior Analyst	BELINDA MOORE	-	Senior Analyst
FIONA BUCHANAN	-	Senior Analyst	SCOTT POWER	-	Senior Analyst
NICK HARRIS	-	Analyst	TOM SARTOR	-	Analyst
LINDSAY HURST	-	Retail Strategy Analyst	TAMARA STRETCH	-	Analyst
MICHAEL KNOX	-	Director of Strategy & Chief Economist	TANYA SOLOMON	-	Analyst
JAMES LAWRENCE	-	Fixed Interest Analyst	REBECCA SULLIVAN	-	Retail Strategy

ABN AMRO MORGANS OFFICES

BRISBANE	(07) 3334 4888	CHATSWOOD	(02) 9411 8988
BUNDABERG	(07) 4153 1050	COFFS HARBOUR	(02) 6651 5700
BURLEIGH HEADS	(07) 5520 8788	GOSFORD	(02) 4325 0884
CAIRNS	(07) 4052 9222	HURSTVILLE	(02) 9570 5755
CALOUNDRA	(07) 5491 5422	MERIMBULA	(02) 6495 2869
CAPALABA	(07) 3245 5466	NEUTRAL BAY	(02) 8969 7500
CHERMSIDE	(07) 3350 9000	NEWCASTLE	(02) 4926 4044
EMERALD	(07) 4988 2777	NEWPORT	(02) 9997 3232
GLADSTONE	(07) 4972 8000	ORANGE	(02) 6361 9166
GOLD COAST	(07) 5592 5777	PARRAMATTA	(02) 9615 4500
IPSWICH	(07) 3202 3995	PORT MACQUARIE	(02) 6583 1735
MACKAY	(07) 4957 3033	SCONE	(02) 6545 9811
MILTON	(07) 3114 8600	WOLLONGONG	(02) 4227 3022
MISSION BEACH	(07) 4088 6188	**MELBOURNE**	(03) 9947 4111
NOOSA	(07) 5449 9511	BERWICK	(03) 9796 2676
REDCLIFFE	(07) 3897 3999	BRIGHTON	(03) 9592 4555
ROCKHAMPTON	(07) 4922 5855	CAMBERWELL	(03) 9813 2945
SPRINGWOOD	(07) 3808 7588	GEELONG	(03) 5222 5128
SUNSHINE COAST	(07) 5479 2757	TRARALGON	(03) 5176 6055
TOOWOOMBA	(07) 4639 1277	WARRNAMBOOL	(03) 5559 1500
TOWNSVILLE	(07) 4771 4577	**CANBERRA**	(02) 6232 4999
YEPPOON	(07) 4939 3021	**ADELAIDE**	(08) 8464 5000
SYDNEY	(02) 8259 6400	**PERTH**	(08) 9261 0888
ARMIDALE	(02) 6772 1288	BUNBURY	(08) 9791 9188
BALLINA	(02) 6686 4144	**DARWIN**	(08) 8981 9555
BALMAIN	(02) 8755 3333	**HOBART**	(03) 6236 9000

DISCLOSURE OF INTEREST

ABN AMRO Morgans and/or its affiliated companies may make markets in the securities discussed. Further, ABN AMRO Morgans and/or its affiliated companies and/or their employees from time to time may hold shares, options, rights and/or warrants on any issue included in this report and may, as principal or agent, sell such securities. ABN AMRO Morgans affiliates may have acted as manager or co-manager of a public offering of any such securities in the past three years. ABN AMRO Morgans affiliates may provide or have provided banking services or corporate finance to the companies referred to in the report. The knowledge of affiliates concerning such services may not be reflected in this report.

The Directors of ABN AMRO Morgans advise that they and persons associated with them may have an interest in the above securities and that they may earn brokerage, commissions, fees and other benefits and advantages, whether pecuniary or not and whether direct or indirect, in connection with the making of a recommendation or a dealing by a client in these securities, and which may reasonably be expected to be capable of having an influence in the making of any recommendation, and that some or all of our Proper Authority holders may be remunerated wholly or partly by way of commission.

RECOMMENDATION STRUCTURE

Absolute performance, long-term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. The target price is the level the stock should currently trade at if the market accepted the analyst's view of the stock, provided the necessary catalysts are in place to effect the change in perception. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value the target price will differ from 'fair' value. Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

For listed property trusts (LPTs) the recommendation is based upon the target price plus the dividend yield, ie total return. A Buy implies a total return of 10% or more; a Hold 5-10%; and a Sell less than 5%.

Absolute performance, short-term (trading) recommendation: The Trading Buy/Sell recommendation implies upside/downside of 3% or more. The trading recommendation time horizon is 0-60 days.

Each stock has been assigned a Volatility Rating to assist in assessing the risk of the security. The rating measures the volatility of the security's daily closing price data over the previous year relative to other stocks included in either the S&P/ASX200 Index (large caps) or the Small Ordinaries Index (small caps) of which it is a member. This rating is a quantitative (objective) measure provided as an additional resource and is independent of the qualitative research process undertaken by our research analysts.

A rating of Low indicates very little movement in price over the previous year (Coefficient of Variation < 4 for small caps or < 5 for large caps). A Moderate rating implies average price movement over the previous year (Coefficient of Variation of 9 - 21 for small caps or 7.25 - 15 for large caps). A High rating implies significant price movement over the past year (Coefficient of Variation greater than 25 for small caps or 35 for large caps).