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THIRD EDITION

BRUCE TUCKMAN ANGEL SERRAT

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Fixed Income Securities

Tools for Today's Markets

Third Edition

BRUCE TUCKMAN ANGEL SERRAT



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Preface to the Third Edition

The goal of this book is to present conceptual frameworks for pricing and hedging a broad range of fixed income securities in an intuitive, mathematically simple, and applied manner. Conceptual frameworks are necessary so as to connect ideas across products and to learn new material more easily. An intuitive and mathematically simple approach is certainly useful to students and practitioners without very advanced mathematical training, but it is also really a good way for everyone to learn new material. Finally, an applied approach is crucial for several reasons. First, examples go a long way in solidifying conceptual understanding. The introduction of practically every concept in this book is followed by an example taken from the markets or, at the very least, by an appropriately calibrated example. Second, important details emerge from applications. Third, only by working through real or realistic examples can orders of magnitude be learned and appreciated. For example, a study of DV01 is not complete without having absorbed that the sensitivity of a 10-year bond is about 8 cents per 100 face amount per basis point, as opposed to 0.8 cents, 80 cents, or 8 dollars.

The book begins with an Overview of global fixed income markets. This section provides institutional descriptions of securities and market participants along with data designed to illustrate absolute and relative sizes of markets and players. A well-informed fixed income market professional has some idea about how central banks around the world have reacted to the financial crisis of 2007–2009 and can say whether the size of the mortgage market in the United States is one-tenth the size of GDP, about equal to GDP, or 10 times GDP.

For securities with fixed cash flows, Part One of the book presents the relationships across prices, spot rates, forward rates, returns, and yields. The fundamental notion of arbitrage pricing is introduced and is central to the analysis. Part Two describes how to measure and hedge interest rate risk, covering one-factor metrics, namely, *DV*01, duration, and convexity (in both their general and yield-based forms); two-factor metrics like key-rate '01s, partial *PV*01s, and forward bucket '01s; and empirical methods like regression and principal component analysis.

Part Three turns to the arbitrage pricing of contingent claims, i.e., of securities with cash flows that depend on interest rates, like options. The science of arbitrage pricing in this context is followed by a framework in which to think about the shape of the term structure of interest rates in terms of expectations, risk premium, and convexity. One-factor term structure models are then described, to be used both in their own right, when appropriate, and as building blocks toward more sophisticated models. Chapter 11, the last chapter in Part Three, has two parts. First, it presents a multi-factor model for use in relative value applications, along with suggestions for estimating its parameters empirically. Second, it introduces the *LIBOR* Market Model, an extremely popular model for pricing exotic derivatives, in a particularly accessible manner.

Finally, Part Four applies the knowledge gained in the previous three parts to present and analyze a broad and extensive range of fixed income topics and products including repo, bond and note futures, rate futures, swaps, options, corporate bonds and credit default swaps (CDS), and mortgagebacked securities.

This edition substantially revises and expands the second. The only parts of the book that have remained essentially unchanged are Chapters 7 through 10 on pricing contingent claims with one-factor term structure models. The rest of the material that was in the second edition has been updated and, with the exception of a couple of particularly interesting case studies, the numerical illustrations, examples, and applications are all new. In addition, several chapters in this third edition are completely new and others significantly expanded. New chapters include the Overview, Chapter 17 on how the realities of financing have changed the practice of discounting cash flows, and Chapter 19 on corporate bond and CDS markets. Significantly expanded chapters include Chapter 6 on empirical hedging, which now includes principal component analysis; Chapter 11, which was discussed above; Chapter 18 on volatility and fixed income options, which now covers a very broad range of products, Black-Scholes pricing, and a mathematically simple introduction to martingale pricing; and Chapter 20, on mortgages and mortgage-backed securities, which takes a much more market-oriented approach and adds material on pool characteristics, TBAs, and dollar rolls.

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An Overview of Global Fixed Income Markets

This overview begins with a snapshot of fixed income markets across the globe and continues with concise reviews of fixed income markets in the United States, Europe, and Japan. These reviews have three goals: one, to describe how households and institutions achieve their borrowing and investing objectives through fixed income markets; two, to highlight the magnitude of the amounts of securities outstanding and of the balance sheets of market participants; and three, to emphasize the themes that are particularly relevant and significant for understanding today's markets.

A SNAPSHOT OF GLOBAL FIXED INCOME MARKETS

While fixed income markets are truly global, the vast majority of securities originate in the United States, Europe, and Japan. Figure O.1 shows the notional amounts outstanding of debt securities by residence of issuer, arranged in order of decreasing size. The largest markets by far are in the United States, the *Eurozone*, Japan, and the United Kingdom. (The Eurozone includes countries that are part of the European Union and also use the Euro as their currency.) The amounts outstanding for many Eurozone countries are shown individually in the graph, and indicated with asterisks, because several of these markets rank among the largest in the world on their own.

Derivative securities do not have an issuer in the same sense as do debt securities, but the distribution of the notional amounts of over-thecounter (OTC) interest rate derivatives across currencies tells a story similar to that of Figure O.1. According to Figure O.2, which shows amounts outstanding of single-currency, OTC interest rate derivatives, markets are dominated by contracts denominated in EUR (Euro), USD (United States dollar), JPY (Japanese Yen), and GPB (British Pound).¹ And with respect

¹The other currencies appearing in the graph are CHF (Swiss Franc), SEK (Swedish krone), CAD (Canadian dollar), AUD (Australian dollar), NOK (Norwegian krone), HKD (Hong Kong dollar), DKK (Danish krone), and NZD (New Zealand dollar).



FIGURE 0.1 Debt Securities by Residence of Issuer as of March 2010 *Source:* Bank for International Settlements.

to exchange-traded derivatives, Table O.1 shows that Europe and North America comprise almost all of the outstanding notional amount.

It is worthwhile noting that Figures O.1, O.2, and Table O.1 report the place of origination of fixed income securities rather than the place of residence of the ultimate owners or counterparties. So, to take one of the more significant examples, China's ownership of nearly \$850 billion of U.S.





Region	Notional
Europe	27,807
North America	22,604
Asia and Pacific	10
Other	934

TABLE 0.1 Exchange-Traded Interest RateDerivatives as of March 2010, in Billions ofU.S. Dollars

Source: Bank for International Settlements.

Treasury securities does not appear anywhere in Figure O.1. Nevertheless, even accounting for such instances, the data presented here justify this book's focus on fixed income securities and markets in the United States, Europe, and Japan.

As a final note before turning to the three overviews, Figure O.3 gives a coarse breakdown of the composition of debt securities in the United States, the Eurozone, Japan, and the United Kingdom. (The totals are the same as those reported in Figure O.1.) While the proportions of debt issued by governments, financial institutions, and corporations are similar in the United States and the Eurozone, debt markets in Japan are dominated by governments while those in the United Kingdom are dominated by the issues of financial institutions.



FIGURE 0.3 Debt Securities by Residence of Issuer and Sector as of March 2010 *Source:* Bank for International Settlements.



FIGURE 0.4 Credit Market Debt in the United States as of March 2010 *Source:* Flow of Funds Accounts of the United States.

FIXED INCOME MARKETS IN THE UNITED STATES

Securities and Other Assets

Figure O.4 shows the major categories of credit market debt in the United States, along with the size of the market for each, as of March 31, 2010.² Due to the definition of credit market debt in this cut of the data, several assets are not explicitly mentioned here (e.g., deposits, money-market fund shares, security repurchase agreements, insurance and pension reserves, equities), but will be included in the discussions of households and institutions later in this section.

Mortgages The largest single category of debt in the United States is *mortgages*, at a size of \$14.2 trillion. A mortgage is a loan *secured* by property, so that if a borrower fails to make the payments required by a mortgage, the lender has a claim on the property itself. Exercising this claim, the lender could keep proceeds from the sale of the property up to the amount still owed; or the lender could seize or *foreclose* on the property, sell it, and recover the outstanding loan amount that way. In practice there might be

²The data for this figure and for much of this section come from the Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States," June 10, 2010. See also the accompanying "Guide to the Flow of Funds Accounts."

restrictions on the immediate or full exercise of this claim, like bankruptcy and other borrower protections or any tax liens on the same property. Finally, depending on the laws of the relevant state, the lender might or might not have *recourse* to the borrower's other assets to collect any remaining amount owed after the sale of the property.

Of the \$14.2 trillion outstanding, \$11.6 trillion is home or other residential mortgages, \$2.5 trillion is commercial mortgages, and \$138 billion is farm mortgages. To put the size of this market into context, two comparative statistics are useful. First, the annual gross domestic product (GDP) of the United States as of the first quarter of 2010 was \$14.6 trillion.³ Hence, it would take almost the entire output of the economy for one year to pay off all mortgage debt. Second, as of March 31, 2010, the public debt of the United States, at a historical high of \$12.8 trillion, was \$1.4 trillion less than the amount of mortgage debt outstanding.

Mortgages and mortgage-backed securities are the subject of Chapter 20.

Corporate and Foreign Bonds The second largest category of debt in Figure O.4 consists of corporate and foreign bonds. Corporate bonds are sold by businesses to finance investment, like the building of a new plant, the purchase of other businesses, or the purchase of investment securities. Bonds are also sold to *refinance* outstanding debt issues, that is, to retire existing debt not with corporate cash, which might have better uses, but with the proceeds raised by selling new debt. Motivations for retiring existing debt include redeeming maturing debt, repurchasing an issue to be rid of bond covenants that have become overly onerous, or exercising an embedded option to repurchase bonds at some prespecified and currently attractive call price.

As of the end of March 2010, \$11.4 trillion of corporate and foreign bonds were outstanding, \$5.6 trillion of which were sold by corporations in the financial sector. Proceeds raised by the financial sector, as will be discussed shortly, are used for the most part to purchase other securities.

Corporate bonds and derivatives on corporate bonds, namely, *credit default swaps*, or CDS, are the subject of Chapter 19.

Treasury Securities The next category is *Treasury securities*, obligations of the U.S. government incurred to finance its spending. U.S. Treasuries are among the most liquid securities in the world, meaning that investors can almost always buy and sell large amounts of Treasuries at prices close to relatively transparent market levels. In addition, while the finances of the U.S. government have deteriorated by historical standards, its debt is still

³Source: Bureau of Economic Analysis, U.S. Department of Commerce.

perceived as one of the safest investments in the world; when world events scare investors and trigger a "flight to quality," demand for U.S. Treasuries increases and their prices rise. As shown in Figure O.4, at the end of March 2010, there were \$8.3 trillion of such securities outstanding, \$7.7 trillion of which were *marketable*, i.e., traded in markets.

With respect to the credit quality of Treasury securities, it is important to note that Treasuries do not constitute the entire public debt of the United States, which, as mentioned in the discussion of mortgages, is \$12.8 trillion or about 88% of GDP. The public debt includes intragovernmental holdings, i.e., debt that one part of the government owes to another in support of third-party claimants (e.g., holdings of government debt in the Medicare and Social Security trust funds). There is a statutory ceiling on the amount of public debt, which, of course, limits the issuance of Treasury securities as well, although this limit has been increased many times. An increase on February 12, 2010, the latest as of the time of this writing, raised the limit to \$14.294 trillion. In any case, the ratio of public debt to GDP is used as an indicator of the credit quality of government debt, although it is widely recognized that certain economies can sustain higher ratios than others. With this caveat, the ratio of 88% in the United States is low compared with Japan but high compared with several, although certainly not all, European countries. Furthermore, 88% is very high relative to recent U.S. history: at the end of 2006, the public debt was \$8.7 trillion and GDP \$13.4 trillion, for a ratio of only 65%.

With the increasing global scrutiny of government financing, the maturity structure of government debt has taken on new importance. Since shorter-term rates are usually lower than longer-term rates, there is always an incentive to reduce borrowing costs by concentrating borrowing at shorter maturities. But this strategy can be dangerous; the more debt with shorter maturities, the greater a government's difficulties should investors suddenly become reluctant to purchase its new bond issues. While the United States has not had any trouble selling its debt, as Greece and Ireland recently

Maturity Years	Outstanding \$Billions	Percent %
< 2	3,482	45
2-5	1,953	25
5-10	1,528	20
> 10	782	10

TABLE 0.2	Maturity Structure of U.S. Treasu	ıry
Marketable	Securities as of March 31, 2010	

Source: Monthly Statement of the Public Debt of the United States, March 31, 2010, and authors' calculations.

have, in the spirit of this new scrutiny Table O.2 presents the maturity structure of marketable U.S. Treasury securities. In comparison with the maturity structures in Europe and Japan (see Tables O.12 and O.18, respectively), government borrowing in the United States is relatively heavy at the shorter maturities.

Turning now to taxonomy, the U.S. Treasury issues securities in several different forms. Treasury *bills*, or *T-bills*, mature in one year or less and are *discount* securities, meaning that they make no payments until the promised payment at maturity and, consequently, sell for less than, i.e., at a discount from, that promised payment. Treasury *notes* are *couponbearing* securities, issued with 10 or fewer years to maturity, that make semiannual interest payments at a fixed rate and then return principal at maturity. Treasury *bonds* are also coupon-bearing securities, but with original maturities greater than 10 years. This separate classification of notes and bonds continues today, but is a historical artifact: bonds used to be subject to a maximum, statutory rate of interest, but this limit was eliminated in 1988.⁴ In any case, this book uses the term "bond" loosely to refer to notes or bonds.

The U.S. Treasury also issues *TIPS*, or *Treasury Inflation Protected Securities*. The principal of TIPS adjusts to reflect changes in the consumer price index so that the coupon, together with the return of indexed principal, preserves a real return, i.e., a return above inflation. The maturing principal of a TIPS, however, will never be set below the original principal, no matter how much deflation might take place. As of March 31, 2010, the amount of TIPS outstanding was a relatively small \$573 billion, less than 7% of the \$8.3 trillion of Treasury issues. Nevertheless, TIPS have a significance beyond their size as their prices reveal market expectations about future inflation.

The last category of U.S. Treasury securities to be mentioned here, simply because they are well known, are U.S. savings bonds, which are nonmarketable, discount securities sold mostly to retail investors. As of March 31, 2010, the amount of savings bonds outstanding was a relatively tiny \$190 billion.

In a largely successful effort to foster the liquidity of Treasury securities, the U.S. Treasury auctions them to the public at preannounced auction dates and quantities. The schedule of which maturities are offered and at what frequencies changes slowly over time with the financing needs of the Treasury. Currently, bills with maturities of 4, 13, and 26 weeks are sold weekly, while bills maturing in 52 weeks are sold every four weeks. Notes with 2-, 3-, 5-, and 7-year maturities are sold monthly. There are quarterly issues of 10-year notes and 30-year bonds, although individual issues are

⁴ Marcia Stigum, The Money Market, 3rd Edition, (Dow Jones-Irwin, 1990) p. 37.

reopened, i.e., sold through subsequent auctions.⁵ Finally, 5- and 30-year TIPS are issued annually and reopened twice per year while 10-year TIPS are issued semiannually and reopened four times per year.

Agency- and GSE-Backed Securities Agency- and GSE-backed securities are obligations of agencies of the U.S. government and of GSEs or government-sponsored entities. This category consists of three subcategories:

- Debt issues of U.S. agencies, which comprise only \$24 billion of the \$8.1 trillion total.⁶
- Debt issues of such GSEs as FHLMC (Federal Home Loan Mortgage Corporation or "Freddie Mac"), FNMA (Federal National Mortgage Association or "Fannie Mae"), and FHLB (Federal Home Loan Banks), which comprise \$2.7 trillion of the total. These debt issues are used to finance a portfolio of mortgage-related investments, mostly portfolios of mortgages in the case of FHLMC and FNMA and mostly secured loans to banks making mortgage loans in the case of FHLB.
- Issues of mortgage-backed securities by FHLMC, FNMA, and of the wholly-owned government corporation GNMA (Government National Mortgage Association or "Ginnie Mae"), which comprise \$5.4 trillion of the total. Aside from the *portfolio business* described in the previous bullet point, FHLMC and FNMA have a *guarantee business*, as does GNMA. This business consists of guaranteeing the performance of *conforming* mortgages (i.e., mortgages that meet specified criteria) in exchange for a fee. These mortgages are then bundled into mortgage-backed securities, which, in turn, are sold to investors.

The historical justification for GSEs has been that they serve a public purpose in addition to making profits for their shareholders. In the case of the mortgage-related GSEs, this public purpose has been to facilitate home ownership. As a result of this mix of public and private objectives, there

⁵As an example, consider the issuance and two scheduled reopenings of the 2.625% notes maturing on August 15, 2020. A face amount of \$24 billion of these notes was initially sold to the public on August 11, 2010. Subsequently, in the first reopening auction, on September 8, 2010, another \$21 billion of this issue was sold. Then, in the second and final scheduled reopening, on October 13, 2010, yet another \$21 billion was sold.

⁶This discussion of agency- and GSE-backed securities uses Flow of Funds data as of December 2009 instead of March 2010, as in Figure O.4. As of 2010, mortgage pools were consolidated into the balance sheets of FNMA and FHLMC, blurring the distinction between GSE debt securities and mortgage-backed securities.

has always been furor about the extent to which the U.S. government is responsible for agency or GSE debt that it has not explicitly guaranteed, particularly in the cases of FNMA and FHLMC. These GSEs have been able to borrow at advantageous terms⁷ because the global investment community has believed there is an implicit U.S. government guarantee, despite occasional statements by officials denying that to be the case. And in fact, after September 2008, when FNMA and FHLMC were failing and placed into government conservatorship, the U.S. government did exert considerable effort to protect and calm bondholders.⁸

Municipal Securities Municipal securities or *munis* are for the most part issued by state and local governments. The variation across issues is particularly large in this market, with over 55,000 different issuers⁹ and a staggering number of distinct issues. Shorter-term issues are typically used for cash management purposes, e.g., to manage time gaps between tax collections and expenditures, while longer-term debt issues are often used to finance infrastructure projects. General obligation (GO) bonds are backed by the full faith and credit of the issuing municipality while revenue bonds are backed by the cash flows from a particular project. Municipal bonds as an investment class have historically had very low rates of default, but perceived creditworthiness does vary dramatically across issues. At the safest extreme are GO bonds of the most creditworthy states while at the other extreme are *revenue* bonds dependent on particularly risky projects. At the time of this writing the credit quality of municipals is under increased scrutiny because spending commitments made in better economic environments are now straining municipal budgets.

An extremely important feature of the municipal bond market is that the interest on the vast majority of issues is exempt from U.S. federal income tax. As a result, municipalities are able to pay much lower rates of interest than would otherwise be the case. Nevertheless, investors subject to the highest marginal federal tax rate earn a higher rate on municipal bonds, particularly those of longer term, than they earn, on an after-tax basis, on otherwise comparable taxable bonds.

Muni investors often enjoy advantages with respect to state income taxes as well, although the exact treatment varies by state. Most commonly,

⁷The Congressional Budget Office has estimated that the implicit government guarantee enables the GSE to raise funds at a rate savings of 0.41% through their debt issues and 0.30% through their mortgage-backed security issues. See "Updated Estimates of the Subsidies to the Housing GSEs," Congressional Budget Office, April 8, 2004.

⁸See, for example, Federal Housing Finance Agency, "U.S. Treasury Support for Fannie Mae and Freddie Mac," Mortgage Market Note 10-1, January 20, 2010. ⁹See the Municipal Securities Rulemaking Board website, www.msrb.org.

a state exempts interest on bonds it has issued while taxing interest on bonds sold by other states.

The much-heralded Build America Bond (BAB) program, created in February 2009, expired at year-end 2010 and, as of the time of this writing, has not been renewed by Congress. Bonds under this program were typically sold as taxable to the investor, with the U.S. government rebating 35% of the interest to the issuing municipality. As of the end of October 2010, only about \$150 billion of BABs had been sold, compared with approximately \$3 trillion of municipal bonds outstanding,¹⁰ but the program was very popular with municipalities. BABs opened the municipal market to investors in low or zero tax brackets who typically buy taxable bonds. On the other hand, the program is costly for the U.S. government to maintain.¹¹

Other Categories Loans and advances of \$4.1 trillion in Figure O.4 include loans made by banks and others (e.g., government, GSEs, finance companies) that are not included in any other category. Almost all of consumer credit of \$2.4 trillion consists of credit card balances and automobile loans. Finally, open market paper of \$1.1 trillion consists almost exclusively of *commercial paper*. Commercial paper issuers borrow money from investors on an unsecured and short-term basis, with maturities extending up to 270 days¹² but averaging about 30 days.

Households and Institutions

Figures O.5 and O.6 show the largest sectors that borrow and that lend funds through credit markets, respectively. These sectors are now discussed in turn, leaving out those that were already described in the securities subsection. (Note that, as in Figure O.4, only securities defined as credit market debt are included in Figures O.5 and O.6. Other assets, however, are included in the balance sheets to follow.)

Households Table O.3 shows the balance sheet for households and nonprofit organizations as of March 2010. Note that the percentage of liabilities is exactly that, and not the percentage of liabilities plus net worth. Hence, there is no percentage associated with net worth.

¹⁰ Source: U.S. Build America Bond Issuance, Securities Industry and Financial Markets Association (SIFMA), and Flow of Funds Accounts of the United States.

¹¹ The argument that the program is costly is that since BABs, like all heavily taxed assets, are bought primarily by investors in low or zero tax brackets, the tax paid on BABs is very much below the 35% subsidy. It has been argued by some, however, that the relevant tax rate is higher so that a larger portion of the subsidy is recouped. ¹² Longer maturities would trigger Securities and Exchange Commission (SEC) registration requirements.



FIGURE 0.5 Credit Market Debt Owed as of March 2010 *Source:* Flow of Funds Accounts of the United States.

The largest asset of households is real estate followed by pension fund savings. Holdings of other assets are spread relatively evenly, with a significant percentage in equity of noncorporate business, e.g., relatively small, family-run businesses. The liabilities of households are predominantly mortgages and consumer credit, the latter consisting mostly of credit card debt and automobile loans. In short then, households own their homes and durable goods and invest in a wide range of financial assets, a significant portion of which are held through pension funds. Households borrow mostly



FIGURE 0.6 Credit Market Assets Held as of March 2010 *Source:* Flow of Funds Accounts of the United States.

Assets	68.5	100%
Real Estate	18.1	26.5%
Consumer Durables	4.6	6.8%
Deposits and Money Market Funds	7.7	11.2%
Credit Market Instruments	4.2	6.1%
Corporate Equities	7.8	11.4%
Mutual Funds	4.3	6.3%
Pension Fund Reserves	12.3	18.0%
Equity in Noncorporate Business	6.5	9.5%
Life Insurance Reserves	1.3	1.8%
Miscellaneous	1.7	2.5%
Liabilities	14.0	100%
Home Mortgages	10.2	73.3%
Consumer Credit	2.4	17.3%
Miscellaneous	1.3	9.4%
Net Worth	54.6	

TABLE 0.3 Balance Sheet of Households and Nonprofit Organizations as of March 2010, in Trillions of Dollars

to finance their housing and durable purchases, but also to manage their short-term cash requirements. The European market overview, by the way, will discuss pension funds in more detail.

Since the financial crisis of 2007–2009 has had a significant impact on the balance sheets of households and institutions, it is noted here and in subsequent discussions how balance sheets have changed since the end of 2006. With respect to households, net worth has fallen from \$64.4 to \$54.6 trillion, or by more than 15%. And of this \$9.8 trillion drop, \$7.1 trillion or 11% was from a fall in the value of real estate assets and most of the rest from falling values of stocks and noncorporate equity.

Nonfinancial, Nonfarm Businesses Table O.4 gives the balance sheet of corporate and noncorporate businesses, excluding the financial and farm sectors. Businesses in the financial sector will be covered in later subsections and the farm sector is relatively small.

Nonfinancial business assets consist of real estate and equipment, along with a large portion classified as miscellaneous. There is a reasonable amount of trade financing, amounting to 7.2% of assets and 10.8% of liabilities. As for longer-term liabilities, businesses finance property with mortgages while financing other assets with loans and corporate bonds.

Table O.4 is not a snapshot of an individual business but an average across the sector, which obscures the life-cycle of financing a business. Initial capital comes from "friends and family" and bank loans. Then, as a

Assets	36.4	100%
Real Estate	12.1	33.1%
Equipment and Software	5.0	13.6%
Inventories	1.8	4.9%
Deposits and Credit Market Instruments	2.7	7.3%
Trade Receivables	2.6	7.2%
Miscellaneous	12.4	33.9%
Liabilities	18.9	100%
Corporate Bonds	4.2	22.5%
Mortgages	3.4	18.1%
Trade Payables	2.0	10.8%
Loans and Miscellaneous	9.2	48.7%
Net Worth	17.5	

TABLE 0.4Balance Sheet of Nonfinancial Nonfarm Businessesas of March 2010, in Trillions of Dollars

business grows, it may obtain loans from investor groups and from *private placements* of debt (e.g., negotiating the terms of a loan with one or several insurance companies). Finally, a larger business, with a track record and name recognition, can tap public bond markets.

From year-end 2006 to the end of the first quarter of 2010, the balance sheet of nonfinancial businesses deteriorated along with those of households: liabilities rose and assets fell, the latter predominantly because of real estates' values falling. As a result, net worth fell by about \$5 trillion, or 23%, from \$22.6 to \$17.5 trillion. Or, taking a different perspective, the ratio of liabilities to assets increased from 42% to 52%.

Commercial Banking Table O.5 gives the financial assets and liabilities of the commercial banking sector as of March 31, 2010. Note that unlike the previous balance sheets, this one lists only financial assets and liabilities. This is a reasonable view for financial intermediaries whose nonfinancial assets are relatively insignificant.

The sources of funds for the commercial banking sector as a whole are deposits, *federal funds* (overnight loans between banks in the federal reserve system; see Chapter 15), and *repurchase agreements* or *repo* (usually very short-term loans secured by relatively high-quality collateral; see Chapter 12), bonds, and other sources. These funds are invested in a broad range of assets, although a significant percentage of these are mortgages (26%) or mortgage-related (i.e., agency- and GSE-backed securities at 8.8%). Banks make money by earning spreads between the rates they pay on their sources of funds and the rates of return they earn on their assets. But to earn spreads, banks have to take certain risks. In particular, banks typically take on three types of risk. First, banks take *credit risk* by lending to homeowners and to

Financial Assets	14.4	100%
Reserves at Federal Reserve	1.0	6.7%
Agency- and GSE-backed Securities	1.3	8.8%
Corporate and Foreign Bonds	.8	5.4%
Loans	1.8	12.2%
Mortgages	3.8	26.0%
Consumer Credit	1.2	8.1%
Other and Miscellaneous	4.7	32.7%
Financial Liabilities	12.8	100%
Deposits	7.6	59.6%
Federal Funds and Repo (net)	.9	6.7%
Open Market Paper	.2	1.6%
Corporate Bonds	1.4	10.7%
Other Loans and Advances	.4	2.8%
Other and Miscellaneous	2.4	18.6%

TABLE 0.5 Financial Assets and Liabilities of Commercial Banks as of March 2010, in Trillions of Dollars

businesses that may not repay their borrowings as promised. This source of risk is not a main focus of this book, but will be discussed in Chapter 19. Second, banks may take *interest rate risk* by borrowing with shorter-term securities but investing in longer-term assets. Shorter-term funds can usually be borrowed at relatively low rates of interest but, as these borrowings come due, banks run the risk of having to pay higher rates of interest on new borrowing. At the same time, longer-term lending is usually initiated at relatively high rates of interest, but these rates are fixed for years. Hence, should a bank's shorter-term borrowing costs rise relative to its fixed lending rates, its profit margin or spread will narrow or even turn negative. Interest rate risk is the subject of Part Two of this book.

The third source of risk for banks is *financing risk*. Deposits are regarded as relatively stable sources of funds because of deposit insurance: because the FDIC (Federal Deposit Insurance Corporation) insures deposits, at least up to a limit, depositors do not need to pull deposits at the first breath of rumor about a bank's financial health. Corporate bonds, with their relatively long maturities, also constitute a stable source of funds in the sense that a bank has time between the surfacing of any financial problems and the maturity of its bonds to sort out its difficulties.¹³ Federal funds and repo, however, along with open market paper, are shorter-term sources of funds and are less stable: at the first sign that a bank is in financial difficulties, its ability to finance itself with federal (fed) funds and repo can erode in days, to be

¹³ Of course, corporations typically stagger the maturities of their longer-term debt to ensure that only manageable amounts come due at any one time.