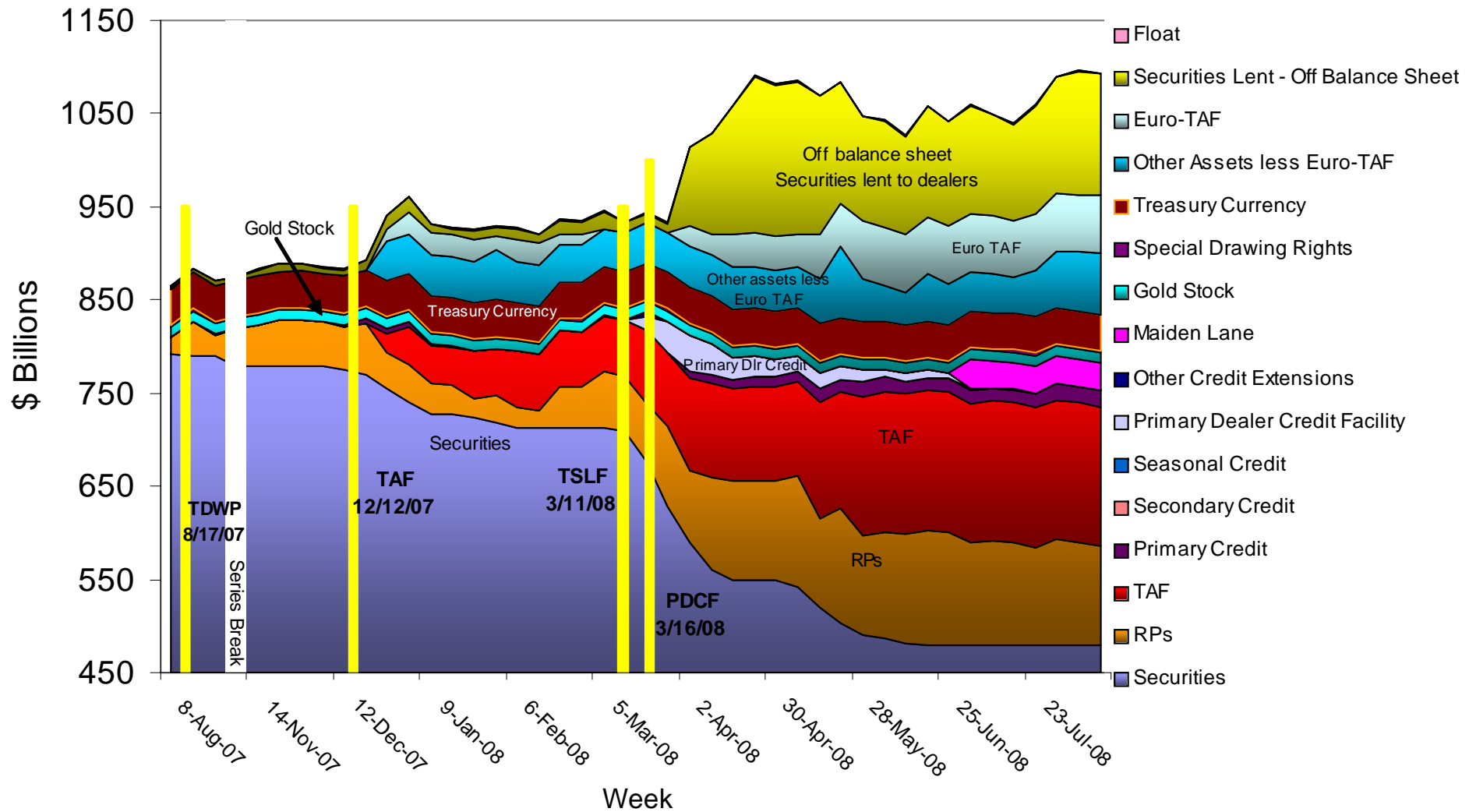


Factors Adding to Reserves and Off Balance Sheet Securities Lending Program



Source: Federal Reserve Board of Governors Statistical Release H.4.1. Data through 8/13/08.

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Explanation of Factors Adding to Reserves Chart

The Federal Reserve Board has posted on its website information on how its balance sheet was allocated across the different asset classes, as well as the composition of its liabilities. For many years prior to the most recent turmoil that has occurred in financial markets, the bulk of the Federal Reserve's assets were in the form of its holdings of US Treasury securities. Nearly 90% on average of its assets were of this type. Other major asset categories included Treasury currency and the gold stock. Normal daily open-market operations which add to and subtract from the Federal Reserve's balance sheet take place mainly through repurchase and reverse repurchase agreements.

The composition of the Federal Reserve's portfolio has, however, changed dramatically during the recent period of financial turmoil, as the Board of Governors has modified the terms under which access to the discount window is available to banks, and now to investment banks, and the FOMC has modified its securities lending program from the System Open Market Account (SOMA).

Specifically, four new programs have been created:

Term Discount Window Program (TDWP) – announced August 17, 2007

Under the TDWP banks were permitted to borrow on the full range of eligible discount window collateral for a term of up to 90 days.

Term Auction Facility (TAF) – announced December 12, 2007

Under the TAF banks were permitted to bid for term federal funds with maturities up to 28 days, backed by the full range of eligible discount window collateral.

Term Securities Lending Facility (TSLF) – announced March 11, 2008

Under the TSLF primary dealers (both banks and investment banks) were permitted to borrow US Treasuries from the SOMA portfolio overnight for a term of up to 28 days, using Treasuries, agency securities, agency mortgage-backed securities, AAA/Aaa-rated private-label real estate MBS, collateralized MVS, agency-collateralized mortgage obligations, and other asset-backed securities (these latter securities were added to the list on May 2, 2008). The Treasury securities so borrowed could then be repo-ed overnight and used as a way of liquefying what might otherwise be illiquid assets in this period of market turmoil. The TSLF-related securities lent show up on the System's balance sheet as off-balance-sheet items.

While the Federal Reserve has attempted to sterilize the impact of its lending programs so as to avoid undue expansion of the money supply, we do not believe that this adequately represents the total expansionary impact of the Federal Reserve's efforts to deal with the problems in certain segments of financial markets. The System has also initiated, in addition to its regular securities lending program, the Term Securities Lending Facility.

This Facility permits prime dealers to borrow securities from the Federal Reserve's portfolio for a term of up to 28 days. In a series of rolling overnight loans of securities, prime dealers are permitted to pledge a wide range of eligible collateral (Treasuries, agencies, agency MBS, AAA/Aaa-rated private-label RMBS, CMBS, agency CO and other ABS) in return for US Treasuries which they can then RP out overnight. The effect is to enable them to liquefy otherwise illiquid securities on their balance sheets and replace them with dollar assets which can then be deployed in other ways. While these assets represent a reallocation of reserves within the US banking system, they also represent a way for prime dealers to tap into dollar reserve assets from the rest of the world. To the extent that prime dealer assets are freed up, these institutions can engage in lending that would otherwise not occur. Securities lent under the TSLF are off the Federal Reserve's balance sheet since the transaction is unwound each morning. During the day, the funds that had been RPed by the prime dealers is likely replaced by daylight overdrafts from the Federal Reserve. Thus, there is effectively an off balance sheet creation of additional reserves to the banking system. To reflect the potential expansionary impact of the TSLF, we have created Chart 2, which attempts to reflect the potential impact that the TSLF may be having on the banking and financial system by adding the TSLF memorandum item to the Federal Reserve's balance sheet.

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Primary Dealer Credit Facility (PDCF) – announced March 16, 2008

Under the PDCF primary dealers (both banks and investment banks) were permitted to borrow at the discount window using US Treasuries, agency securities, agency mortgage-backed securities, and investment-grade debt facilities.

The documentation for these programs and weekly balance sheet effects can be gleaned from the Federal Reserve's H.4.1 data release and are the basis for the information contained in the chart shown on Cumberland's website. We have followed the unusual procedure of adding the Memo Item Securities Lent to Dealers to the factors adding to reserves, despite the fact that these are off-balance-sheet items and technically don't inject reserves into the banking system. However, because the securities lent to the primary dealers can be used to temporarily generate funds for these institutions that are pivotal in the monetary transmission mechanism and that have been at the core of the recent financial turmoil, the reallocation of funds within the banking system to these institutions is intended to be captured by recognition of these off-balance-sheet items. The Federal Reserve could have simply increased its balance sheet by the amount of the reserves lent, but this would not deal with the funding problems experienced by the primary dealers who were weighed down by holdings of high-grade but illiquid assets that brought the intermediation process to a standstill. So in this respect, the securities lending program was a targeted way to enable the primary dealers to resume activities that they might not have otherwise been able to do.

Definitions of Items Shown in Cumberland Table on Factors Adding to Reserves

The following are the definitions of the items shown on the chart:

Reserve bank credit

Securities held outright include US Treasury bills, notes and bonds, inflation-indexed compensation, and federal agency securities (these securities are not presently in the portfolio).

Repurchase agreements – securities sold under agreements to repurchase them at a latter time

Term auction credit – loans of term federal funds to banks under the TAF

Primary credit – discount window credit available to generally sound depository institutions on a very short-term basis as a backup rather than a regular source of funding. Depository institutions are not required to seek alternative sources of funds before requesting advances of primary credit.

Secondary credit – discount window credit that is extended on a very short-term basis to depository institutions not eligible for primary credit. It is available to meet backup liquidity needs when its use is consistent with a timely return to market sources of funding or the orderly resolution of a troubled institution.

Seasonal credit – discount window credit that is available to relatively small depository institutions to meet regular seasonal funding needs. Historically, the credits were related to agriculture.

Primary dealer credit – discount window credit that has been extended to the primary dealers (institutions eligible to deal directly with the Open Market Desk at the Federal Reserve Bank of NY)

Other credit extensions – emergency credit extended by a Federal Reserve Bank under exigent circumstances to an individual, partnership, or corporation that has been approved by the Board of Governors

Float – temporary funds that reflect the difference between checks that been credited against the sending bank's reserve account but have not been cleared against the receiving bank's account

Other Federal Reserve Assets

Gold – gold bullion held by the System primarily in the Federal Reserve Bank of NY's vaults

Special drawing rights certificate accounts – an asset reflecting an allocation of funds to the US from the IMF and any accumulation of such assets by the Federal Reserve that had been allocated to other countries

Treasury currency – US Treasury currency (mainly silver certificates that are being held by the Federal Reserve system but not in circulation)

Memo Items:

Securities Lent to Dealers

Overnight Facility – Treasury securities lent under the Desk's normal securities lending program

Term Facility – Treasury securities lent under the TSLF

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Chart 3

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