DCFC
DEVELOPMENT COMPANY FUNDING CORPORATION

Date: December 26, 2009

To: Certified Development Companies

From: Steve Van Order, DCFC Fiscal Agent

Subject: Dec. 2009 SBA 504 Debenture Offering (2009-20L)

On December 16, 2009, 595 twenty-year debentures totaling $352,985,000 were funded through the sale of certificates guaranteed by SBA. Below are debenture pricing details:

Sale/Sale Comparison	Treasury	Swap Spread	Spread	Rate	T plus
2009-20L (12/08/09)	3.368%	13.50 BP	54.70 BP	4.05%	68.2 BP
2009-20K (11/03/09)	3.406%	18.25 BP	50.15 BP	4.09%	68.4 BP
Change	-3.8 BP	-4.75 BP	+4.55 BP	-4 BP	-0.2 BP

- The January offering will consist of *10*- and *20-year debentures.*
- The ***cutoff date*** to submit loans to Colson for this offering is Tuesday **December 21**.
- A ***request to remove a submitted loan*** from a pool must be made through Colson Services by close of business Thursday, **December 31**.
- ***Pricing date*** is Tuesday **January 5**, on which the debenture interest rates will be set.
- The debentures will be funded on Thursday, January 13.

The Fed in 2010. The final FOMC statement of 2009 was released Wednesday, December 16 with the following highlights:

- Economy and labor and housing markets were upgraded.
- Inflation outlook unchanged (will be low for a long time).
- Target Fed funds unchanged and will remain low for a long ime.
- Expiration dates for liquidity and credit support facilities and programs remain on track – almost all liquidity facilities by February 1, all government bond purchases (LSAPs) and TALF for ABS (includes SBAs) by April 1, TALF for CMBS by July 1.
- There were no dissenters among voters on the policy action.

In 2009 Fed monetary and credit polices drove huge drops in long-term interest rate once it became clear collapse was averted. Investors were forced to chase yield in a Fed-created environment that featured near-zero money market rates and near-record or record low government bond yields. SBA interest rates plunged and additionally benefited from the TALF eligibility that brought back leveraged investors last seen in early 2007. The 20-year 504 debenture rate fell from 6.22% to 4.05% in December year-over-year. There were all time lows for 10-year (2.98% in November) and 20-year (3.92% in October) debenture rates. These are likely to be cycle lows for debenture rates unless the economy falls into a deflationary malaise in coming years.

Assuming the consensus is correct and growth remains steady but subdued and inflation expectations stable and low, below are major Fed policy actions I expect in 2010, in the order expected:

Fed balance sheet growth will slow, then stop (first half 2010). We will start 2010 with money and credit markets in better working order so the Fed will want to stop expanding the balance sheet and withdraw the crutches, some of which have been in place since 2007. In 2010 (as in 2009, 2008 and 2007), central bank policy actions will be a primary driver of returns in bonds. The FOMC statement signaled the Fed does not want to commit any more balance sheet and wants to wind things down. There is some potential conflict with Treasury as the Secretary recently suggested more TARP money could be targeted at the TALF. But that is looking more political statement than potential action. At $50 billion outstanding, TALF is only one-quarter of the original $200 billion size originally announced so hardly looks to need more TARP capital if the Fed will close it as scheduled.

Excess bank reserves fenced-in (starting 1Q or 2Q). Before the Fed hikes official policy interest rates it will look to fence-in some of the $1 trillion in excess reserves so they eventually don't flood the money supply. This will be accomplished by tying up excess bank reserves in reverse repo and term deposit transactions. Now, before we get carried away, remember banks will remain staggered and in repair mode with commercial real estate loans the current menace to capital. Many small banks may fail in 2010 therefore we are doubtful banks soon will decide to start lending strongly against those excess reserves. Banks will continue to buy government bonds to capture the Fed-engineered steep yield curve carry that will boost retained earnings therefore rebuild capital.[1] Fully-guaranteed government bonds on a bank balance sheet require no capital set aside (i.e. 0% risk weighting) versus a full capital set aside for private loans. Banks probably will be content to sit with a lot of excess reserves, perhaps as a psyche salve.[2]

So the Fed will not have to rush this fencing-in of excess reserves but will want to get the process going in orderly fashion. Primary dealers do not have enough balance sheet capacity to facilitate a fencing-in of massive excess bank reserves with the Fed. Tests of third party reverse repos are complete and the Fed is working on a method do term deposits directly with banks. Money markets are starved for supply so there will be a ready market for repos at low rates. Subdued inflation expectations would keep pressure off of the Fed to fence-in reserves on a large scale over a short timeframe (which would drive up money market rates).

Interest rate hikes will start (perhaps 2Q or 3Q). If the Fed can fence in a large amount of reserves without requiring notably higher reverse repo and term deposit rates[3] the Fed will have more time before hiking its most publicly-recognized policy interest rate – the Fed funds rate. Banks would be able to earn the government bond yield curve carry for longer, helping replenish decimated capital accounts. The FOMC again stated an "exceptionally low Fed funds rate" remains likely for an "extended period." Now, the Fed could move the funds rate up to 1% and that would only take it back to 2003 lows. At that time 1% qualified as exceptionally low and was justified to fight deflationary risk (like today's rationale).

---

[1] The Fed-engineered a protracted steep yield curve in the early 1990s to help US banks recover from the excesses of the 1980s such as the LDC and S&L crises.

[2] Chairman Bernanke will not forget the mistake of 1938 when the Fed withdrew excess reserves which resulted in a credit crunch recession.

[3] Recent small-sized tests of short-maturity third party reverse repos stopped out within the Fed funds target range of 0% to 0.25%. But we emphasize they were small-sized tests.

The Fed lost control of the Fed funds rate for much of 2008. In response, in October 2008 the Fed received legislated authority to pay interest on bank reserves as a way to control the money supply in an era of expanded Fed balance sheet and in December the FOMC set the bank reserves interest rate at 0.25%. The Fed funds target was announced as a 0% to 0.25% range. Since then the Fed funds effective rate has been pretty stable, averaging 10-13 BP below the bank reserves rate. A sign of how times have changed in monetary policy is the collapse in volume of interbank Fed funds trading, now near the September 2000 level and down 66% from the summer 2008 peak. With the banking system flooded with $1 trillion in excess reserves banks do not need to trade much in the Fed funds market. So the Fed probably will start with a desired bank reserves rate and back into a Fed funds target rate about 15 BP below it. The bank discount rate (currently 0.50%) still will be set by the FOMC in response to requests from regional Federal Reserve Banks.