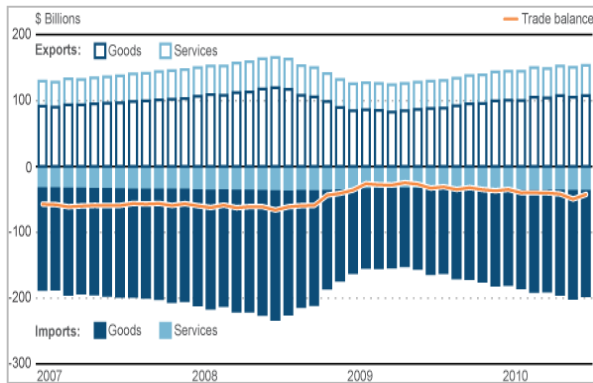


CHART OF THE DAY

U.S. trade balance



Trade gap shrank 14 percent to \$42.8 billion in July reflecting a 1.8 percent increase in exports to \$153.3 billion, while imports fell 2.1 percent to \$196.1 billion.

TODAY'S TOP NEWS

- U.S. data shows economic recovery still on track
- Obama firm against tax cuts for rich; no veto threat
- OECD says recovery slowing, urges policy caution
- U.S. 30-year bond auction meets with soft demand
- FDIC's Bair warns of government "exposure" in mortgages
- BoE holds rates at 0.5 pct, makes no change to QE
- Japan's Noda: may contact China over bond buying

ECON WATCH

FOR FRIDAY SEPTEMBER 10

ET	Indicators	Unit	Reuters	Prior
02:45	FR Industrial output	%	0.7	-1.7
04:00	IT Industrial output mm sa	%	0.5	0.6
04:30	GB PPI Input mm	%	0.1	-1.0
04:30	GB PPI Input yy	%	8.9	10.8
04:30	GB PPI output mm	%	0.1	0.1
04:30	GB PPI output yy	%	4.8	5.0
04:30	GB PPI Core Output mm	%	0.1	0.2
04:30	GB PPI Core Output yy	%	4.6	4.7
05:00	IT GDP final qq	%	0.4	0.4
07:00	CA Employment change	k	30.0	-9.3
07:00	CA Unemployment rate	%	8.0	8.0
10:00	US Wholesale inventories	%	0.4	0.1
10:00	US Wholesale sales	%	0.3	-0.7

Thomson Reuters LPC Loan Conference

Wednesday, September 22, 2010
Marriott Marquis, New York City
For more please [click here](#)

MARKETS TODAY

TODAY'S TOP STORY: New U.S. claims for unemployment benefits fell more than expected last week to a two-month low, while the trade deficit narrowed sharply in July, hopeful signs for the stuttering economic recovery. **For more please [click here](#)**

TREASURIES: U.S. Treasuries fell after jobs and trade data suggested the economy wasn't as weak as feared, boosting riskier assets such as stocks and hurting demand at the government's long-bond auction.

- Auction of \$13 billion of reopened 30-yr bonds met with comparatively soft demand. The bid-to-cover ratio in the 30-yr auction was 2.73, right on the average from the eight 30-yr reopenings over the past year. 30-yr bond yield was last at 3.84 pct.
- 10-yr notes were yielding 2.75 pct. 5-yr notes fell 16/32 to yield 1.56 pct. [Click here to watch related Reuters Insider video](#)

FOREX: The yen hovered near a 15-year high against the dollar as conflicting messages from policymakers led investors to bet Japanese authorities were not ready to intervene to weaken their currency.

- Dollar was down 0.06 pct at 83.8 yen. It earlier hit a session low of 83.49, within sight of the 15-year low of 83.35 yen hit on Wednesday.
- The euro fell 0.13 pct at \$1.2707. It fell 0.19 pct to 106.49 yen, after earlier hitting a session low of 105.98 yen, moving closer to a nine-year low of 105.41 yen hit in late August.
- The Australian dollar extended gains as a barrier was taken out at \$0.9250, hitting a four-month high. The Aussie dollar was up 0.5 pct at 0.9233. Sterling shed 0.23 pct to \$1.5435 after earlier falling to \$1.5376.

CORPORATES: U.S. corporate bond spreads were unchanged to tighter after the market successfully digested about \$32 billion in new bond issuance this week, the most priced in any week this year.

- The CDX.IG-14 index tightened by 1 bps to 105 bps.
- The previous high issuance volume this year was \$31.85 bln in the week ended Aug. 6. The corporate bond market has been able to absorb about \$100 bln in new supply since the beginning of August.
- City National sold \$300 mln and Linn Energy sold \$1 bln of senior unsecured notes on Wednesday.

STOCKS: U.S. stocks rose as better-than-expected jobs and trade data helped lift optimism about the economic recovery, although sentiment was fragile as investors fretted over European banks.

- Dow rose 0.27 pct to 10,414.86, S&P climbed 0.49 pct to 1,104.25 and Nasdaq added 0.33 pct to 2,233.20.
- U.S. listed shares of Deutsche Bank fell 3.18 pct to \$59.99, BofA added 0.97 pct to \$13.50 and McDonald's dropped 2.25 pct to \$74.37.
- KBW bank index rose 1.59 pct. S&P healthcare index was up 1.16 pct.

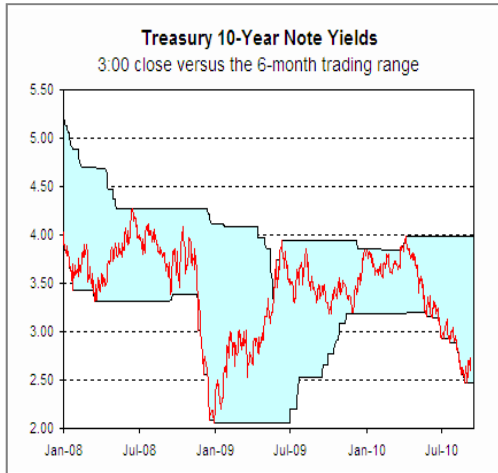
C & E: U.S. crude oil futures prices fell back after seesaw trading as investors shrugged off a government oil inventory report that showed crude stocks unexpectedly fell last week.

- U.S. crude oil fell 0.78 pct to \$74.09 per barrel.
- Gold fell 0.84 pct to \$1,243.9 an ounce.
- Reuters-Jefferies index lost 0.39 pct to 273.21.

- For MARKET SNAPSHOT [click here](#)
- For NEXT UP [click here](#)
- For DEEP DIVE [click here](#)



MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.110	0.075	0.112	0.001
3-Mo Bill	0.140	0.130	0.142	0.007
6-Mo Bill	0.185	0.180	0.188	0.009
1-Year	0.245	0.220	0.249	0.012
2-Year	99.617	99.648	0.571	-0.086
3-Year	99.609	99.641	0.883	-0.211
5-Year	98.500	98.547	1.565	-0.492
7-Year	97.938	97.984	2.196	-0.648
10-Year	98.828	98.891	2.761	-0.875
30-Year	100.578	100.641	3.842	-2.000

EQUITIES

	INDEX	CHANGE
DJIA	10426.17	38.86
NASDAQ	2237.79	8.85
S&P 500	1105.39	6.47

OIL

	PRICE	CHANGE
NYMEX	74.3	-0.4
BRENT	77.4	-0.7

EURODOLLAR FUTURES

	CLOSE	CHANGE
Sep-10	99.700	0.000
Dec-10	99.545	0.000
Mar-11	99.465	0.005
Jun-11	99.360	0.000

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.280	O/N	0.290
2-Week	0.280	2-Week	0.300
1-Month	0.280	1-Month	0.300
3-Month	0.290	3-Month	0.310
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.280	10:00 AM	0.210
2-Week	0.290	3:00 PM	0.205
1-Month	0.290		
3-Month	0.300		

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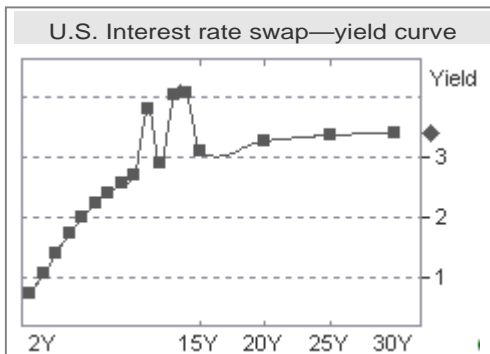
	SPREAD		RATE	
2-Year	17.75	21.75	0.74	0.77
3-Year	18.75	22.75	1.06	1.09
5-Year	16.50	20.50	1.72	1.74
7-Year	4.75	8.75	2.24	2.25
10-Year	-4.50	-0.50	2.71	2.71
30-Year	-39.75	-35.75	3.44	3.43

FUTURES

	PRICE	CHANGE
CBOT 5 yr	120.09	-0.48
CBOT 10 yr	124.69	-0.73
CBOT 30 yr	131.97	-1.66

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.200	0.230	-	-
1-Month	0.250	0.360	0.182	0.192
3-Month	0.330	0.450	0.186	0.196
6-Month	0.500	0.650	0.186	0.196
12-Month	0.800	1.100	0.230	0.240



CURRENCIES

	BID	ASK
Euro	1.2704	1.2706
Sterling	1.5429	1.5434
JP Yen	83.87	83.90
Swiss Franc	1.0150	1.0154
Can Dollar	1.0331	1.0336
Mexico	12.9869	12.9970

FED FUNDS NYFRSM - 10AM

Open	0.2100	1m	0.2481
High	0.2500	3m	0.3125
Low	0.1400		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.625	24/09/2012	17	16.5	0.73
3-Year	1	23/09/2013	19.5	19	1.07
5-Year	2.375	28/07/2015	24	23.5	1.8
7-Year	3.75	27/03/2019	8	7	2.84
10-Year	6.625	15/11/2030	25	-	4.09
30-Year	6.25	15/07/2032	25	20	4.09

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	27/07/2012	13	12	0.69
3-Year	0.875	28/10/2013	21	20.5	1.09
5-Year	2.875	09/02/2015	9.5	9	1.65
7-Year	5.125	18/10/2016	6	-	2.25
10-Year	-	-	-	-	-
30-Year	-	-	-	-	-

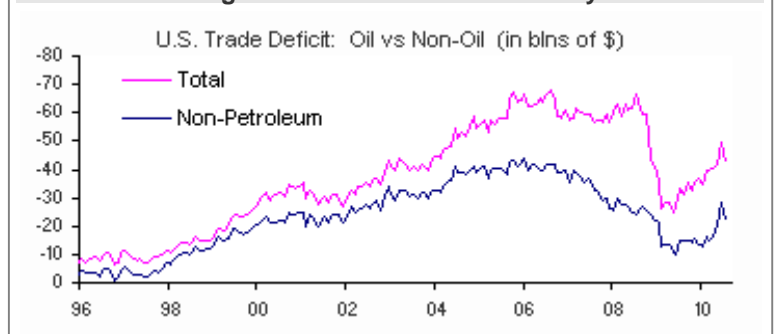
Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	4.0	104.1400	104.1400	2.530
FHLMC	4.0	104.1410	104.1450	2.544

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	4.5	104.0800	104.0800	2.861
FHLMC	4.5	104.0520	104.0560	2.783
GNMA	4.5	105.0900	105.1000	3.027

Wrightson ICAPSM Chart of the Day



TODAY'S TOP NEWS

U.S. data shows economic recovery still on track

New U.S. claims for unemployment benefits fell more than expected last week to a two-month low, while the trade deficit narrowed sharply in July, hopeful signs for the stuttering economic recovery.

Initial claims for state unemployment benefits dropped 27,000 to 451,000, the lowest since the week ended July 10, the Labor Department said. That was well below financial market expectations for 470,000.

Separately, the trade deficit shrank 14 percent to \$42.8 billion in July, smaller than the \$47.3 billion gap that markets had expected. Analysts said that suggested the pace of economic growth would quicken in the third quarter. The U.S. economy braked sharply in the second quarter, expanding at just a 1.6 percent annualized rate.

The shrinking of the trade deficit was welcome news after a widening trade gap sliced nearly 3.4 percentage points off U.S. economic growth in the second quarter. The smaller trade gap reflected a 1.8 percent increase in exports to \$153.3 billion, the highest since August 2008. Imports fell 2.1 percent to \$196.1 billion. However imports from both China and Germany were the highest since October 2008. The closely watched trade deficit with China fell almost 1 percent in July at \$145.4 billion.

OECD says recovery slowing, urges policy caution

Global recovery looks to be slowing more than expected as growth weakens in rich economies, and stimulus should be extended or stepped up if the slowdown endures, the OECD said.

The OECD forecast growth across the G7 group of major economies to average an annualized 1.4 percent in the third quarter and 1.0 percent in the fourth, down from 3.2 and 2.5 percent in the first and second quarters respectively.

The OECD forecast annualized U.S. growth rates of 2.0 and 1.2 percent in the third and fourth quarters, after 1.6 percent in the second quarter and 3.7 percent in the first.

For Germany, France and Italy combined, the OECD forecast expansion to plunge to an annualized 0.4 and 0.6 percent respectively in the third and fourth quarters of the year, from 5.1 percent in the second quarter.

For Japan, the OECD forecast 0.6 and 0.7 percent annualized GDP rises in the third and fourth quarters respectively. For Britain, the OECD predicted 2.7 and 1.5 percent annualized growth in Q3 and Q4 after a second-quarter rise of 4.9 percent annualized versus the previous quarter.

[Click here to watch related Reuters Insider video](#)

FDIC's Bair warns of government "exposure" in mortgages

A key U.S. banking regulator raised concern about the risk of "exposure" the government is taking on in the mortgage market and urged more stringent standards for underwriting mortgages. "We should all be concerned about the type of exposure that the government is taking on through guaranteeing so many mortgages right now and make sure that we do have some prudent underwriting standards," FDIC Chairman Sheila Bair suggested in an interview on CNBC.

Fannie Mae and Freddie Mac and the FHA, currently back some 90 percent of new U.S. mortgages. In the interview, Bair said the Fed's rules were more focused on higher-cost loans and that the sweeping regulatory reforms President Barack Obama signed into law incorporated some good standards.

Meanwhile, the average 30-year fixed mortgage rate rose to 4.35 percent. Fifteen-year mortgage rates held steady at 3.83 percent, the lowest on Freddie Mac's records.

Obama firm against tax cuts for rich; no veto threat

U.S. President Barack Obama stood firm in opposition to a Republican push to extend Bush-era tax cuts for the rich but stopped short of threatening to veto such a measure if passed by Congress.

"There are a whole bunch of better ways to spend the money," Obama said when pressed twice whether he would use his veto power to block such a move.

Obama, fighting to keep Democrats in charge of Congress, reiterated his view that the United States could not afford to extend tax cuts for wealthy Americans enacted under former President George W. Bush and set to expire at the end of this year. The issue has become a hot-button issue in a congressional election year.

John Boehner, the Republican leader in the House of Representatives, called on Wednesday for a two-year freeze on all current U.S. tax rates, which would cover the middle-class as well as the rich. Obama has made clear that he would not support such a blanket freeze but says his administration is ready to extend tax cuts for families making less than \$250,000 a year.

[Click here to watch related Reuters Insider video](#)

U.S. 30-year bond auction meets with soft demand

An auction of \$13 billion of reopened 30-year bonds met with comparatively soft demand, rounding out this week's sales of \$67 billion of U.S. government coupon-bearing securities.

The auction "tailed," with a high yield of 3.82 percent -- above where the comparable securities were trading on the open market and indicating bidders moved aggressively to cheapen the bonds going into the sale.

Primary dealers, the large banks and investment firms that do business directly with the Federal Reserve, also had to take home about 56 percent of the paper, which is the highest share since October 2009. Direct bidders took 8.3 percent, which was the lowest since January.

The bid-to-cover ratio in the auction was 2.73, right on the average from the eight 30-year reopenings over the past year.

The two previous auctions this week were met with much more enthusiastic demand.

BoE holds rates at 0.5 pct, makes no change to QE

The Bank of England kept interest rates at 0.5 percent for the 18th month in a row and announced no new quantitative easing purchases, in a widely expected decision.

British inflation was 3.1 percent in July, well above the central bank's 2 percent target, but the BoE said last month this was mostly due to temporary factors while future growth was likely to weaken, making rate rises inappropriate for now.

None of the 60 economists had forecast a change in policy and most do not see interest rates rising until the second quarter of next year at the earliest.

As usual, the central bank issued no statement alongside the policy announcement made after the nine-man Monetary Policy Committee's Sept. 8-9 meeting. Financial markets were unmoved. The BoE cut rates to a record low of 0.5 percent in March 2009 and started buying financial market assets -- mostly gilts -- with newly-created money, a scheme which topped out at 200 billion pounds (\$309 billion) at the end of January.

When minutes to this month's meeting are published on Sept. 22, many economists expect it to show a repeat of August's discussion, in which Andrew Sentance was the sole policy-maker to vote for a rise in rates, as he has been since June.



TODAY'S TOP NEWS

Japan's Noda: may contact China over bond buying

Japanese Finance Minister Yoshihiko Noda said the government may contact China about allowing Japanese purchases of Chinese bonds, which could help to curb the yen's surge, and is looking into a recent jump in Chinese buying of Japanese debt. But Noda also said Japan's foreign reserves, totaling \$1.07 trillion, are held chiefly in dollars because they are designed for use in currency market intervention, suggesting Tokyo sees little need to diversify away from the dollar. He said it was not known why China was increasing its buying of short-term Japanese government securities but Tokyo was keeping in contact with Chinese authorities to confirm what was behind the move. China bought a net 640.8 billion yen (\$7.65 billion) in short-term Japanese bills in July. The recent surge in Japanese bond investment by Chinese investors has stirred talk that China may be diversifying its foreign reserves into the yen and away from the euro and the dollar.

Bank capital shake-up seen moderate, shares up

A growing confidence that new bank capital rules are unlikely to be as stringent as many feared, and will allow years to implement change, buoyed European bank stocks.

New capital rules -- dubbed Basel III -- to make banks resilient enough to cope with another financial crisis are due to be laid out on Sunday after international regulators worked out a compromise deal to put to central banks.

Banks will need to have a minimum core Tier 1 capital ratio of 7 to 9 percent, including a capital conservation buffer, officials and regulatory sources have said.

That would include a minimum base core Tier 1 capital ratio of 4.5 to 6 percent and an additional capital conservation buffer of 2 to 3 percent. Any bank that fails to keep above the buffer would have to curb payouts such as bonuses and dividends.

Separately, the euro zone is on the brink of a sustainable recovery and the ECB is likely to discuss removing some support measures at its December meeting, Yves Mersch said.

[Click here for an interactive graphic on European banks capital raising](#)

Canada trade deficit hits record, housing slows

Canada had a record high monthly trade deficit in July and the housing market stalled, data released showed, signaling sputtering economic growth as the third quarter got under way.

Canada's trade deficit rose more than three times expected to C\$2.74 billion (\$2.66 billion) in July as exports to the U.S. sank because of anemic demand, while overall imports surged to their highest level since November 2008, Statistics Canada data showed. Statscan also revised its estimate of the June trade deficit to C\$1.81 billion from C\$1.13 billion.

Exports fell 0.7 percent to C\$32.80 billion in July but imports were up 2 percent to C\$35.54 billion.

Canada's trade surplus with the United States narrowed to C\$1.2 billion in July from C\$2.4 billion in June as the stumbling U.S. economic recovery reduced demand for Canadian goods.

Housing starts slipped a greater-than-expected 3 percent in August to a seasonally adjusted rate of 183,300 units from a downwardly revised 188,900 units in July, Canada Mortgage and Housing Corp said. The new housing price index slipped 0.1 percent in July. Home prices rose 0.1 percent in June.

UK July goods trade gap hits record as imports surge

Britain's goods trade deficit with the rest of the world unexpectedly widened to a record high in July after imports of chemicals and oil surged and exports fell, data showed.

Britain's total trade deficit, which includes services, also widened sharply to its highest in almost five years, denting hopes that exporters will be able to pick up the slack in the economy as consumer and government spending slows.

The Office for National Statistics said Britain's goods trade gap widened to 8.667 billion pounds in July from 7.532 billion in June, wrong-footing analysts who had expected a broadly unchanged reading.

July's deficit was the biggest since the series started in January 1998 and has not been exceeded in earlier but non-comparable records that date back to 1697.

Imports rose 3.1 percent on the month in value terms. Exports, by contrast, fell 0.9 percent.

NEXT UP

Economists cut U.S. growth forecast again

Projected U.S. economic growth for the rest of this year and next was revised down for a third month in a row by a panel of about 50 economists.

The latest Blue Chip Economic Indicators report on Thursday said the weaker outlook for second-half 2010 growth stemmed from lower expectations for consumer spending, business investment and private construction.

"Growth in the current quarter now is expected to be little better than the disappointingly soft advance registered last quarter," the survey said. Gross domestic product grew at a meager 1.6 percent annual rate in the second quarter, less than half the first quarter's 3.7 percent rate. But the economists' group said that, after the mid-year soft patch, it saw a gradual improving trend setting in with growth slightly surpassing trend rate in the second half of 2011. Blue Chip defines GDP trend growth at about 2-3/4 percent a year.

"For all of 2010, real GDP now is forecast to increase 2.7 percent on a year-to-year basis, 0.2 of a percentage point less than a month ago and 0.6 of a point less than predicted in June," the survey said.

U.S. health reforms cause bump in spending - report

U.S. reforms will slightly accelerate the rise in healthcare spending, according to a survey released, handing Republicans more ammunition as they attack the Obama administration's legislative victory.

The survey said the spending bump is modest, and the more dramatic change is in how money is spent as roughly 32 million Americans gain coverage.

Government researchers said U.S. healthcare spending will rise at an average annual rate of 6.3 percent over the next decade, reaching almost \$4.6 trillion by 2019.

But the CMS said they expect the sharp changes to come in the type of spending -- not only curbing Medicare costs but also pumping more money toward the private sector -- as the bulk of the recently passed law starts taking effect in 2014.

The study is just one of a slew being pumped out ahead of the November mid-term elections as Democrats hail healthcare reform as a legislative victory and Republicans decry "ObamaCare" as a taxpayer burden that destroys jobs. Another study showed having more primary care doctors available does not necessarily translate to healthier patients.



DEEP DIVE Commentary and Analysis

China's yuan - the only way is up

By Jeremy Boulton

China may be slowing but, despite talk of bubbles, remains the engine of world growth. The yuan is tightly controlled against the dollar but yields in excess of 200 basis points more than the greenback over 12 months.

What more reason does a trader need to run long yuan?

There are plenty more reasons and yuan non-deliverable forwards (NDFs) clearly indicate the Chinese currency will head higher in time.

That would be music to the ears of U.S. politicians who are clamouring for change in China's currency policy.

Since China abandoned the dollar peg in June, the yuan has barely gained 1 percent versus the greenback. That is certain to have U.S. senators pressing for greater action to force China's hand ahead of November congressional elections.

They have good reason to push for a more level playing field with China, and could get the backing of President Barack Obama, whose declared aim is to double export growth in five years.

The U.S. trade deficit with China has ballooned to \$145 billion so far this year, compared with \$123 billion in the same period in 2009. China's exchange rate advantage is clear.

Given this scenario U.S. political pressure will remain high for a move to force China to adopt stronger yuan. The threat of trade sanctions is sure to see China willing to play the game.

That, after all, was behind its move back to a managed float in June, the timing of which worked to calm the last rush of blood in congress.

What can China offer as an olive branch to the U.S this time?

The answer may be as simple as letting the yuan head higher within its trading band, but in tiny steps measured in tenths of a percent on a daily/weekly basis. That would almost certainly placate the Senate.

As for more significant changes, the Chinese authorities have allowed foreign companies to issue yuan bonds. They are making inroads to open up yuan trade, especially within BRIC countries.

Small steps, but moves towards the much vaunted free float.

After all, the float is widely seen as helping China although external risks, especially related to the euro zone or United States, will stop any near-term leap to a full float.

Further tweaks to pave the way to flexibility are assured.

Greater currency flexibility will suit China in time as the authorities there have a clear concern over the gargantuan FX reserve which is dominated by U.S. assets.

That is leading to increasing diversification towards Japanese and European assets, but also an inclination to buy into energy/commodity producers.

DIVERSIFICATION

However, whilst the sums involved in this diversification are large, they are only really balancing the reserve at its record. i.e. diversifying a fresh build up.

An even larger reserve or even greater diversification looks assured given the path of the surplus and the lack of yuan flexibility.

That would be unwelcome as there are simply not enough alternatives to U.S. assets to offset the huge amounts involved.

Increased flexibility would at the very least alleviate this build-up in reserves that is forcing China to expand its search to offset its excessive reliance on U.S. assets.

Clearly a lower dollar would exacerbate losses on the reserve, and the U.S. economic outlook and trade deficit would argue for the U.S. currency to weaken further.

If that were not enough to guide a stronger yuan, its rise also has the handy monetary policy effect of offsetting the unwelcome rise in domestic inflation, which is expected to head further above the 3 percent target.

A higher yuan suits all parties, it seems, and for those who can buy it, sitting long offers modest returns, but returns insulated against the risks linked to currency trades elsewhere.

-- Jeremy Boulton is an FX market analyst for Reuters. The opinions expressed are his own --

Fed and banks wrangle over scope of pay oversight

By Kristina Cooke and Steve Eder

A year after wading into the politically charged issue of banker bonuses, the U.S. Federal Reserve is still wrangling with banks about how broad its purview over pay should be.

Last fall, amid public anger over exorbitant pay packages at bailed-out firms, the Fed said it would police Wall Street pay to ensure it didn't affect banks' safety and soundness.

But after months of back and forth with about 25 large banks, a critical issue is still unclear: How many bankers, traders and salespeople are subject to the Fed's guidelines?

Skewed incentives are blamed for helping fuel the boom in risk-taking that laid the groundwork for the global financial crisis of 2007-2009, and regulators are trying to better align pay with banks' long-term health.

While efforts in Europe have focused mainly on senior management, the Fed is delving deeper into the bowels of banks, including major U.S. firms such as Goldman Sachs Group Inc, Morgan Stanley and Citigroup Inc, as well as the operations of foreign banks in the United States.

Banks have been pushing back on Fed reviews of how they pay lower-level staff, with some arguing the scrutiny is unnecessarily intrusive and time-consuming.

When the Fed asked banks to identify employees who were material risk-takers who would be covered by its guidance, at least one firm submitted just over a dozen names, according to a source familiar with the discussion.

The Fed "came back and said, 'No, you are off by a couple orders of magnitude here,'" the source said.

If mortgage originators as a group, for example, can influence the risk of a portfolio by controlling the flow of information or coaching borrowers on what to say on their applications, banks would have to ensure their incentives are adjusted for the risks they are taking.

"While no single person might seem important enough in their own right, what incentives are for the entire group would be important," said Joseph Haubrich, head of the banking and financial institutions group in the Cleveland Federal Reserve Bank's research department.

"It's more exciting to talk about the big executives, who get paid in millions, or the rogue trader who blew up a bank, but there are a lot of bread-and-butter issues we have also had to look at."

The disagreements as the Fed ventures into uncharted supervisory territory foreshadow further tensions as the central bank fleshes out a broad new role as systemic risk regulator.

"If you think our sales people are managing risk, you have a problem," one person who took part in the discussions said. "Sales people don't manage risk. That's the kind of head-butting that you get between banks and the Fed."

The Fed has told banks' senior management that it is open to good explanations for why certain trading desks or mortgage originators should not be subject to Fed review.

DEEP DIVE Commentary and Analysis

LETTERS TO BANKS

The Fed sent letters earlier this year suggesting areas where firms could improve, after which the banks submitted revised pay plans.

Within weeks, the Fed is expected to issue a second round of letters outlining where more work has to be done, a source familiar with the process said.

The Fed's broad guidelines on pay, issued in June, aim to align the financial incentives of employees with the longer-term performance of their firms. That often means more stock-based compensation with longer vesting periods, tying employees to the performance of the firm.

The guidelines were a joint effort with the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation.

The regulators are building from scratch a framework for supervising pay, and industry sources say this, coupled with a less prescriptive approach than that of European regulators, has fueled a frustrating back and forth.

Industry sources say the Fed is relying on banks to explain their pay plans, which can vary widely from a complex firm like Citigroup to a more straightforward regional bank.

Rose Marie Orens of Compensation Advisory Partners said the

Fed isn't starting with a sophisticated basis for the pay reviews, and different banks are getting different messages from their Fed supervisors.

"They are learning as they are going," she said.

The Fed has drawn on its existing lineup of supervisors and economists, rather than hiring a team with specific expertise in compensation, say people familiar with the discussions.

At the beginning of 2010, as the effort was being launched, about 150 Fed staff were working on pay.

"It's an interesting tension they are struggling with. Most compensation research is focused on maximizing shareholder value," while regulators want to minimize the risk of default, said David Yermack, a professor of finance at New York University's Stern School of Business and a visiting scholar at the New York Fed.

But pay experts wonder if the Fed's eye on pay will make a difference in preventing another crisis.

Less than a year in, it may be too early to tell.

"The real operative question would be whether any of these things would prevent the financial panic," said Ira Kay, an consultant with Pay Governance LLC.

"In some future crisis, will these things make a difference?"

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