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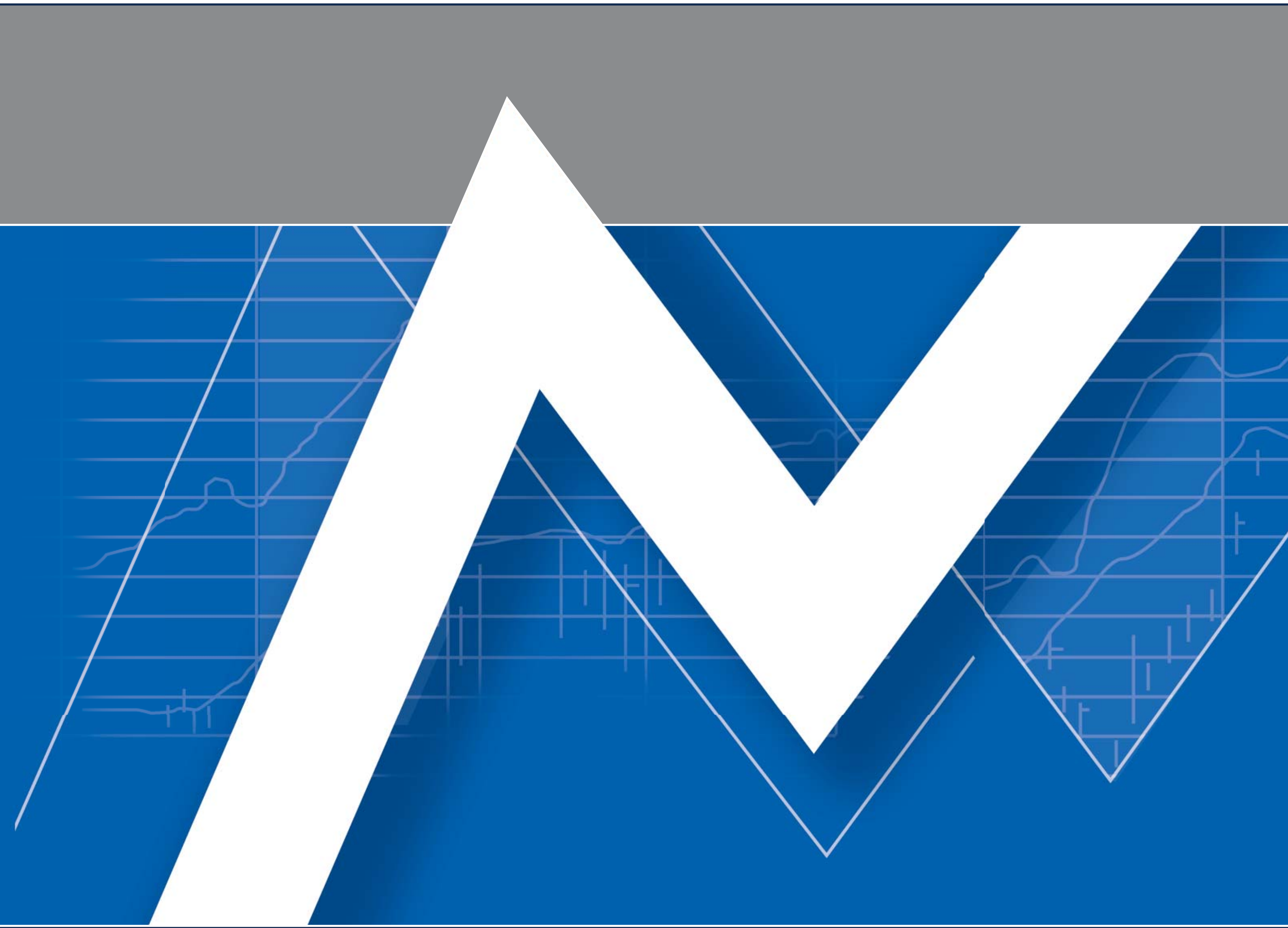

- **BASEL II: AN UPDATE ON U.S. IMPLEMENTATION**
  By: Kyle L Brandon

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BASEL II: AN UPDATE ON U.S. IMPLEMENTATION

Introduction

The new Basel Capital Accord (Basel II or the Accord),[1] the capital adequacy framework released by the Basel Committee on Banking Supervision (BCBS)[2] in 2004, is a comprehensive measurement and regulatory minimum standard for capital adequacy that national supervisory authorities are now implementing through domestic rule-making and adoption procedures throughout the world. The Accord "seeks to improve on the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face."[3] In the US, Basel II implementation is being undertaken by the four national bank regulators[4] and has recently been the subject of two congressional hearings.[5] The US Securities and Exchange Commission (SEC) is also utilizing the Basel standards in its Consolidated Supervisory Entity regime (CSE).[6] This article will briefly review the essentials of the Basel II Accord and the status of implementation in the US.

Summary of the Basel II Accord

The Basel II Accord is comprised of three pillars: Pillar 1 – Minimum Capital Requirements; Pillar 2 – Supervisory Review Process; and Pillar 3 – Market Discipline.

Pillar 1

Minimum regulatory capital requirements are calculated under Basel II to reflect a bank's exposure to market, credit and operational risks. Pillar 1 is comprised of six sections, namely: (1) Calculation of Minimum Capital Requirements; (1a) Constituents of Capital; (2) Credit Risk – Standardized Approach; (3) Credit Risk – Internal Ratings-Based Approach; (4) Credit Risk – Securitization Framework; (5) Operational Risk; and (6) Market Risk. Market risk calculations have been used since the 1996 Market Risk Amendment to Basel I,[7] the current accord. The risk-sensitive credit and operational risk calculations described in Basel II are new and not part of the current accord. The Basel II Accord itself describes three approaches to credit risk measurement: the Standardized Approach, which relies heavily on external credit assessments by credit rating agencies; and the Internal Ratings-Based Approaches (IRB), which rely on internal credit assessments, and are further broken into Foundation (F-IRB) and Advanced (A-IRB). Operational risk measurement, a risk discipline that is very much a work in progress, also has three approaches: Basic Indicator, Standardized and Advanced Measurement (AMA).

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1 See www.bis.org/publ/bcbsca.htm.

2 The Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the UK, and the US. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

3 Op. cit. 1.

4 Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury, "Risk-Based Capital Standards: Advanced Capital Adequacy Framework," September 25, 2006 (www.federalreserve.gov/GeneralInfo/Basel2/NPR_20060905/).

5 US House of Representatives, Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, "A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate," September 14, 2006 (http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=507); and US Senate, Committee on Banking, Housing, and Urban Affairs, "An Update on the New Basel Capital Accord," September 26, 2006 (http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=241).

6 US Securities and Exchange Commission, "Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities," June 8, 2004 (http://www.sec.gov/rules/final/34-49830.htm). See also www.sec.gov/divisions/marketreg/consupervision.htm.

7 See www.bis.org/dcms/fl.jsp?aid=7&pmdid=3&smdid=14&tmdid=0&fmdid=0&tid=21.

Pillar 2

The Accord attempts to do much more than merely set down new rules for the calculation of minimum regulatory capital requirements. Through Pillar 2, the Accord sets out to encourage the development of enhanced risk management techniques to monitor and manage risks. The Pillar 2 section of the Accord includes "guidance relating to, among other things, the treatment of interest rate risk in the banking book, credit risk (stress testing, definition of default, residual risk, and credit concentration risk), operational risk, enhanced cross-border communication and cooperation, and securitization."[8] Assessment of compliance with the more advanced Pillar 1 measurement methods is also described as appropriate under Pillar 2.

The Accord specifically recognizes that "increased capital should not be viewed as the only option for addressing increased risks…other means…such as strengthening risk management, applying internal limits, strengthening the level of provisions and reserves, and improving internal controls, must also be considered. Further, capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management processes."[9] The interaction between supervisors and banks is meant to encourage an active dialogue so that when problems arise, quick action may be taken – whether to increase capital and/or reduce risk.

Pillar 2 describes four key principles of supervisory review[10]:

> **Principle 1**: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.
>
> **Principle 2**: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, and their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of the process.
>
> **Principle 3**: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.
>
> **Principle 4**: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Pillar 3

Pillar 3 is designed to complement the minimum capital requirements of Pillar 1 and supervisory review process of Pillar 2 through disclosure requirements that will encourage market discipline. The disclosures should be consistent with how the bank's management and board of directors assess and manage risk, while based on a common framework, thereby providing consistent and comparable disclosures. The disclosure framework was also designed to avoid conflict with other disclosure requirements such as those required under accounting standards, and the Committee has built in flexibility for modifications as future developments may warrant. An additional consideration is the materiality of the disclosures. Consistent with accounting standards, information is considered "material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions."[11]

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8 BCBS, "Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version," June 2006 (http://www.bis.org/publ/bcbs128.htm), p. 204, paragraph 719.

9 Ibid, paragraph 723.

10 Ibid, pp. 205-212.

11 Ibid, p. 227, paragraph 817. The Accord sets out the disclosures in tabular format on pages 228-242.

Implementation of the Accord

As the Accord must be made into legally binding regulations in each national jurisdiction through domestic rule-making and adoption procedures, Basel II implementation is currently among the most important topics for banks globally. Of particular interest have been some of the differences in proposed implementation in the US through the Notice of Proposed Rulemaking (NPR)[12] and the EU, through the Capital Requirement Directive (CRD).[13] Some of the most obvious differences involve their very different implementation schedules and floors.

Implementation Timetable and Transitional Floors

	2006	2007	2008	2009	2010	2011
Accord[14]	Parallel for Foundation Approach only	95% floor for Foundation Approach (or parallel for A-IRB)	90%	80%	N/A	N/A
CRD	N/A	95% floor for Foundation Approach	90%	80%	N/A	N/A
NPR	N/A	N/A	Parallel	95%*	90%*	85%*

* Period may last longer than one year.

The Accord imposes transitional floors below which a bank's risk-based capital may not fall. In the US, that transition begins later and lasts longer, and the floors are more restrictive. The US transitional floors are calculated in a more restrictive manner than those outside the US, and each will last at least one year. The removal of the floors or graduation to the next floor will require the approval of a bank's primary supervisor.

The NPR also imposes a material capital reduction trigger for US banks in aggregate. If the minimum required risk-based capital in aggregate declines 10% or more from the minimum capital required under existing rules, the US supervisors may modify the regime. Under the EU's CRD there is no numerical trigger, but there is the suggestion that supervisors may modify the requirements as they see fit. The Accord itself includes no numerical triggers, but states that "[s]hould problems emerge during [the transition period], the Committee will seek to take appropriate measures to address them, and, in particular, will be prepared to keep the floors in place beyond 2009 if necessary."[15] An additional non-risk-based limitation imposed by the NPR is the maintenance of the current leverage ratio.

Another area of differences involves the allowed computational approaches. As described above, the Accord provides several degrees of computational sophistication for credit risk and operational risk measurement. The following table highlights the differences in measurement approaches contained in the NPR and the CRD / Accord.[16]

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[12] According to the terms of the Notice of Proposed Rulemaking (NPR), the US's Basel II implementation document.

[13] According to the terms of the Capital Requirements Directive (CRD), the EU's Basel II implantation document.

[14] According to the terms of the Basel Capital Accord (op. cit. 1).

[15] Op. cit. 8, p. 13, paragraph 48.

[16] On June 30, 2006, four US banks wrote to the four national bank supervisors requesting that the US implementation allow all the computational alternatives allowed in the Basel II framework, rather than mandatory use of only the advanced approaches as contained in the NPR. In testimony before the House (September 14, 2006) and Senate (September 29, 2006), Jim Garnett, Head of Risk Architecture for Citigroup, speaking on behalf of the Financial Services Roundtable and American Bankers Association, respectively, discussed the differences and the implications of the differences between the NPR and the Accord. For written testimony see http://financialservices.house.gov/media/pdf/091406jg.pdf and http://banking.senate.gov/_files/garnett.pdf.

Measurement Approaches

	Credit Risk			Operational Risk		
	Standardized	F-IRB	A-IRB	Basic Indicator	Standardized	AMA
NPR			x			x
CRD/Accord	x	x	x	x	x	x

Not all implementation issues have to do with the particular implementation documents of a specific jurisdiction. There are many issues that are of interest to all implementing countries, and they may be on the agenda of the BCBS's Accord Implementation Group (AIG), which was founded to promote consistency in implementation of the Accord. The AIG is a forum for discussing different approaches to implementing Basel II and currently has three subgroups: (1) the Validation Subgroup, which explores issues related to the validation of the systems used to generate the ratings and parameters that serve as inputs to the internal ratings-based approach to credit risk; (2) the Operational Subgroup, which addresses issues related primarily to the implementation of an Advanced Measurement Approach for operational risk; and (3) the Trading Book Subgroup, which addresses issues regarding the implementation of the recommendations in the Committee's July 2005 paper, "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects."[17]

Another BCBS subcommittee relevant to implementation and interpretation of the Basel II framework is the Capital Task Force (CTF), which assists the BCBS by considering options for and providing suggested interpretations of the Accord. The CTF houses the Working Group on Overall Capital and Quantitative Impact Studies and the Risk Management and Modeling Group. The Core Principle Liaison Group (CPLG) is another relevant BCBS subcommittee that is made up of senior representatives from eight Committee member countries and 16 non-G10 supervisory authorities as well as the European Commission, the IMF, the World Bank and Financial Stability Institute (FSI). While originally designed to serve as a technical group to discuss and oversee the application of the Basel Core Principles,[18] it has further developed into a high-level forum for the BCBS to liaise with senior non-G10 supervisors, the IMF and the World Bank.

Basel II for Investment Banks – The CSE Framework[19]

Evolution of Framework

In response to global competition and customer demand for new products and services over the last several decades, the number and size of large financial conglomerates has grown significantly. These financial intermediaries – banks, brokers, and insurers – no longer engage solely in activities that have traditionally been regulated on a purely functional basis. As a result, both regulators and market participants recognized the need to obtain a comprehensive view of all of a firm's activities, as distinct from an individual line of business. The risk of

[17] Double default refers to the additional benefit obtained from the presence of credit protection, under which both the underlying exposure and the protection provider must default for a loss to be incurred. The risk of both a borrower and guarantor defaulting on the same obligation may be substantially lower than the risk of only one of the parties defaulting. See www.bis.org/publ/bcbs116.htm.

[18] BCBS, "Core Principles for Effective Banking Supervision," October 2006 (www.bis.org/publ/bcbs129.htm). Some of the documents issued by the Committee, such as "Home-host Information Sharing for Effective Basel II Implementation," June 2006, have been developed in association with the CPLG (www.bis.org/publ/bcbs125.htm).

[19] This section of the paper is drawn from the testimony of Marc E. Lackritz, President, Securities Industry Association, before the House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, US House of Representatives, "A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate," September 14, 2006 (http://financialservices.house.gov/media/pdf/091406mel.pdf).

potential systemic problems in the capital markets led to the conclusion that a form of consolidated supervision of such conglomerates was necessary.

In early 1996, the Joint Forum on Financial Conglomerates (Joint Forum) was established under the sponsorship of the BCBS, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors to deal with issues common to the banking, securities, and insurance sectors, focusing especially upon oversight of financial conglomerates. In early 1999, the Joint Forum published a collection of papers on this subject under the title "Supervision of Financial Conglomerates."[20] That document proved to be very influential in Europe, particularly in the context of the EU's Financial Services Action Plan (FSAP)[21] that was developed to create a single market in financial services throughout the EU.

One of the top FSAP priorities was the development of legislation for the prudential supervision of financial conglomerates, which ultimately resulted in a document entitled the Financial Conglomerates Directive (FCD).[22] The FCD mandates that any financial firm with significant operations in the EU demonstrate that it is subject to and in compliance with a regime of consolidated supervision. Under the terms of the FCD, any non-EU firm must prove that it is subject to consolidated supervision by its home regulator that is "equivalent" to that required of EU firms. A failure to demonstrate equivalency would require that the firm's EU operations be "ring fenced" from the remainder of its global activities and that it have an EU regulator undertake supervision of its EU-based operations. Although London is the most significant location for the EU-based transactions of US securities firms, the UK's lead financial regulator, the Financial Services Authority (FSA), expressed doubts about its ability to adequately supervise a non-EU-based financial conglomerate.[23]

Similarly, EU representatives – after discussions with the SEC in 2001 and 2002 – expressed doubt that the SEC's existing supervisory regime applicable to the material affiliates of broker-dealers would be judged "equivalent" to the EU requirements. Consequently, the SEC crafted a new regulatory framework for consolidated supervision of major independent investment banks not otherwise subject to consolidated supervision. The agency published the initial CSE proposal in October 2003[24] and received more than 20 responses from private and public commentators, both foreign and domestic. The SEC then made a number of amendments to the proposal and finalized the CSE framework in June 2004.[25]

[20] "Supervision of Financial Conglomerates," papers prepared by the Joint Forum on Financial Conglomerates, February 1999 (www.bis.org/publ/bcbs47.htm).

[21] The FSAP is a set of 42 separate legislative and non-legislative measures in banking, insurance and securities, which collectively provides a plan for European financial services market integration. It groups the various proposals into three broad categories: 1) the development of a single EU institutional market; 2) open and secure retail markets; and 3) developing state-of-the-art prudential rules and supervision (http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm).

[22] The FCD was finalized in December 2002 and made applicable to firms with financial years beginning on or after January 1, 2005. Directive 2002/87/EC of the European Parliament and of the Council, 16 December 2002 (http://europa.eu/scadplus/leg/en/lvb/l24038c.htm).

[23] "We do not believe that it will generally be feasible for the EU coordinator to achieve the oversight of major third country [i.e., non-EU] banking and investment groups and conglomerates necessary to assess whether they have adequate capital and adequate systems and controls and management at the top of the financial group. ... It is not likely, therefore, that we will apply worldwide group supervision to [such] banking and investment or financial conglomerate groups." FSA and HM Treasury, "Financial groups," Consultation Paper 204, October 2003 (www.fsa.gov.uk/pubs/cp/cp204.pdf) p. 45.

[24] See Release No. 34-48690 (Oct. 24, 2003) (www.sec.gov/rules/proposed/34-48690.htm), 68 Fed. Reg. 62872 (Nov. 6, 2003) (http://www.sec.gov/rules/proposed/34-48690.pdf), and comments (www.sec.gov/rules/proposed/s72103.shtml).

[25] See Release No. 34-49830 (June 8, 2004) (www.sec.gov/rules/final/34-49830.htm) and 69 Fed. Reg. 34428 (June 21, 2004) (www.sec.gov/rules/final/34-49830.pdf).

Operation of Framework

Overview – Under the CSE framework, the SEC supervises certain broker-dealers, their holding companies, and affiliates on a consolidated basis, focusing on the financial and operational status of the entity as a whole. The goal is two-fold: first, to reduce the possibility that some problem within the holding company and / or an unregulated affiliate could endanger regulated entities; and second, to reduce any potential systemic threat to the capital markets as a whole.

Parallel with the requirements of other global consolidated supervisors, the CSE framework incorporates significant elements of Basel II.[26] Although Basel II was not yet in effect when the first CSE applications were approved, it is an element of the new framework. Partly this was due to its status as an internationally agreed upon capital standard and partly based upon practical considerations. Otherwise, the CSE applicants would have had to bear the cost of implementing Basel I on a firm-wide basis only to replace it with Basel II shortly thereafter. The CSE framework permits the broker-dealer of a CSE registrant that is judged as having strong internal risk management practices to utilize their own mathematical modeling methods, such as value-at-risk models and scenario analysis, to compute their capital requirements. The SEC must be notified if the broker-dealer's capital falls below $5 billion.

Application process – In reviewing a CSE application, the SEC staff assesses the firm's financial position, the adequacy of the firm's internal risk management controls, and the mathematical models the firm will use for internal risk management and regulatory capital purposes. The staff also conducts on-site reviews to verify the accuracy of the information included in the application and to assess the adequacy of the implementation of the firm's internal risk management policies and procedures.

Additionally, a firm's ultimate holding company must consent to group-wide consolidated supervision by the SEC. Among other things, the firm's holding company must agree to:

– Maintain and document an internal risk management control system for the affiliate group;

– Calculate a group-wide capital adequacy measure consistent with Basel Standards;

– Agree to SEC examination of the books and records of itself and its affiliates, where those affiliates do not have a principal regulator;

– Regularly report its financial and operational condition and make available to the SEC information about itself or any of its material affiliates; and

– For those affiliates that are not subject to SEC examination, make available examination reports of their principal regulators.

Continuing oversight – Following approval, the SEC staff reviews monthly, quarterly, and annual filings containing financial, risk management, and operations data on the CSE registrant. These reports include consolidating financial statements (which show inter-company transactions not included in the presentation of consolidated financial statements) and risk reports substantially similar to those provided to the firm's senior managers. At least monthly, the holding company files a capital calculation made on a consolidated, group-wide basis consistent with Basel standards.

Additionally, the SEC staff meets at least monthly with senior risk managers and financial controllers at the holding company level to review the packages of risk analytics prepared at the ultimate holding company level for the firm's senior management. The focus is on the performance of the risk measurement infrastructure, including: statistical models; risk

[26] Facing severe time constraints, the first SEC-approved CSE applicant utilized Basel I, but subsequent applicants implemented Basel II. The first CSE applicant will switch to Basel II in due course.

governance issues, including modifications to and violations of risk limits; and the management of outsized risk exposures. There are also quarterly meetings to review financial results, the management of the firm's balance sheet, and, in particular, balance sheet liquidity. Also on a quarterly basis, SEC staff meets with the internal audit department to discuss audit findings and reports that may have a bearing on financial, operational, and risk controls. These regular discussions are augmented with focused work on risk management, regulatory capital, and financial reporting issues.

In conjunction with the staff of relevant self-regulatory organizations, SEC staff also conducts examinations of the books and records of the registered broker-dealer and material affiliates that are not subject to supervision by a principal regulator. The examinations focus on the capital calculation and on the adequacy of implementation of the firm's documented internal risk management controls.

Perception of the Framework

The first CSE applicant was approved on December 23, 2004, with four additional applicants gaining approval between March and November 2005.[27] Shortly after publication of the final CSE framework by the SEC in July 2004, the EU provided general guidance indicating that the framework is "equivalent" to the form of consolidated supervision required under the FCD. And with the UK's FSA acting on behalf of the EU, that finding has been subsequently affirmed by its equivalency determinations for each of the individual CSE registrants.

There are at least two dimensions to these equivalency determinations. The CSE framework itself had to demonstrate that it established a high standard for a registrant's internal controls, risk management infrastructure, and capital resources, and that it would be applied in a rigorous fashion by regulators. But it was also necessary to show that cooperation of supervisors across borders would be a central feature of the framework. Each of the CSE firms has large and important affiliates that are functionally regulated in other jurisdictions, in particular by the FSA in London. While the SEC – as the home regulator – must take the lead in overseeing these firms, foreign regulators have a legitimate interest in knowing the overall financial condition of the holding company and obtaining some comfort that the local entity will not be imperiled by events elsewhere in the group. A structure had to be created that facilitates a high level of cooperation between US and foreign regulators.

Future Basel II Issues

With implementation of Basel II just underway, there will no doubt be many issues to deal with in the future. In the US, the comment period for the NPR extends into January 2007 and therefore affords many months for comments, objections and doubts to surface. Some of them will involve competitiveness issues raised by the differences between the NPR and the rest of the world's implementation, while others will concern the differences between the 20 or so major globally-active US banks that may have to implement advanced approaches, and the vast majority of US banks that will be implementing a modified Basel I approach.[28]

[27] On August 11, 2006, the SEC approved an application that will permit the broker-dealer of a bank holding company already subject to consolidated supervision to utilize the alternative method of computing net capital set forth in CSE. But as the SEC does not purport to provide consolidated supervision of the entity as a whole, strictly speaking it is not a CSE firm *per se.*

[28] The modified version of Basel I is known as Basel IA, and a proposal is expected soon so that its comment period will overlap with that of the Basel II NPR.

Of course, not all Basel II-related issues will concern competitiveness – many will concern all banks and require industry-supervisor cooperation to craft good and usable implementation. An example of such an issue is the AIG's Trading Book Subgroup's current project. The Subgroup's member global supervisors, with input from the industry worldwide, released the 2005 paper, "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects"[29] and have together worked on the subsequent implementation issues as they have arisen. While many jurisdictions have differing experiences with trading book issues, there is no doubt that by working together and meeting with industry representatives over a period of years, all participants are coming to a better understanding of each other's concerns. Consequently, the Subgroup has a better chance of an outcome that achieves its supervisory goals, while allowing the varying market participants to use appropriate risk-based approaches for capital calculations.

The recent congressional hearings have sparked a more public debate among bank regulators, even prompting Federal Reserve Chairman Ben Bernanke to comment on some of the more contentious issues. In recent remarks, Chairman Bernanke discussed some of the competitiveness questions raised by the industry, in particular, mentioning that the Fed would consider the suggestion that Basel IA might be a burden to some smaller banks, which should be allowed to remain with Basel I. Further, in addition to generally reducing unnecessary burdens on banks that might be imposed by the proposed rules, Mr. Bernanke acknowledged that "some significant differences do exist between the US and other countries in the proposed implementation of Basel II's advanced approaches, beyond the transitional safeguards. Early comments on the Basel II NPR suggest that, whatever the merits of these international differences in rules, they are likely to add to implementation costs and home-host issues, particularly for globally active banks operating in multiple jurisdictions…we intend to review all international differences to assess whether the benefits of rules specific to the US outweigh the costs. In particular, we will look carefully at differences in the implementation of Basel II that may adversely affect the international competitiveness of US banks."[30]

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[29] Op. cit. 17.

[30] Remarks by Federal Reserve Chairman Ben S. Bernanke, "Bank Regulation and Supervision: Balancing Benefits and Costs," before the Annual Convention of the American Bankers Association, Phoenix, Arizona, and the Annual Convention of America's Community Bankers, San Diego, California (via satellite), October 16, 2006 (www.federalreserve.gov/boarddocs/speeches/2006/20061016/default.htm).

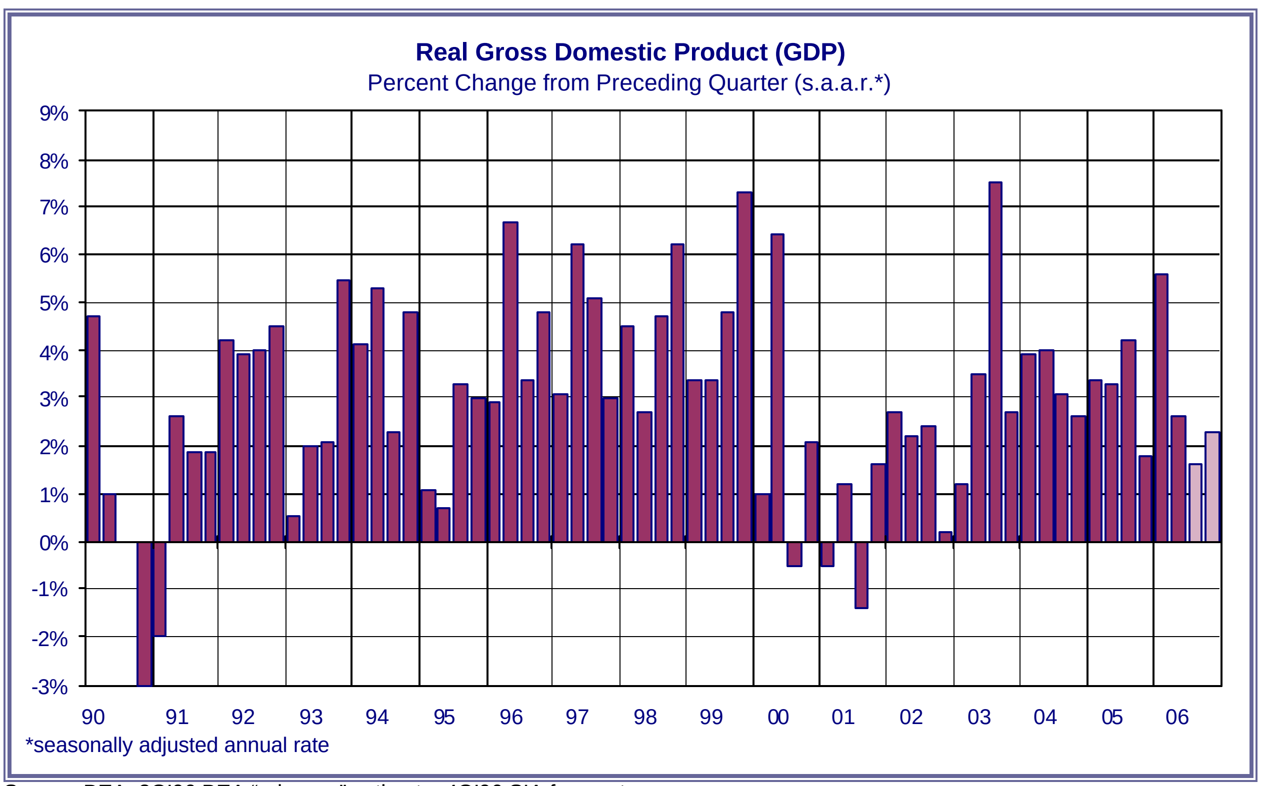
ECONOMIC AND INDUSTRY UPDATE

Introduction

Real economic growth slowed in 3Q'06. September results, however, proved stronger than expected, and the US economy (excluding the housing sector) entered 4Q'06 with substantial momentum, with growth accelerating modestly as we approach year-end. Similarly, activity in both primary and secondary securities markets jumped in September after weak summer results, prices of stocks and bonds moved higher, and the securities industry and financial markets continued to post solid results. This favorable performance appears to have brought retail investors off the sidelines, and building momentum boosted institutional investor activity early in 4Q'06. This surprisingly strong finish, along with a continuation of outsized trading gains in September, has prompted us to raise our estimates for securities industry revenues and profits for 3Q'06 and for 2006 as a whole.

Economic Growth

Real gross domestic product (GDP) growth slowed in 3Q'06 largely due to a plunge in residential fixed investment (housing) and a strong pickup in import growth. Inventory drawdowns and slower growth of spending on services and by state and local governments also contributed to the slowdown, which were partially offset by stronger growth in durable goods consumption, equipment and software purchases, and federal government spending. ***Real GDP increased 1.6% in 3Q'06, which followed growth of 2.6% in 2Q'06 and 5.6% in 1Q'06.*** This estimate, the first and generally least accurate of three estimates of 3Q'06 economic growth that will emerge from the US Department of Commerce's Bureau of Economic Analysis (BEA) before year-end, was released on October 27 and was below the consensus expectation of 2.0%. Modest upward revisions are expected in later releases.

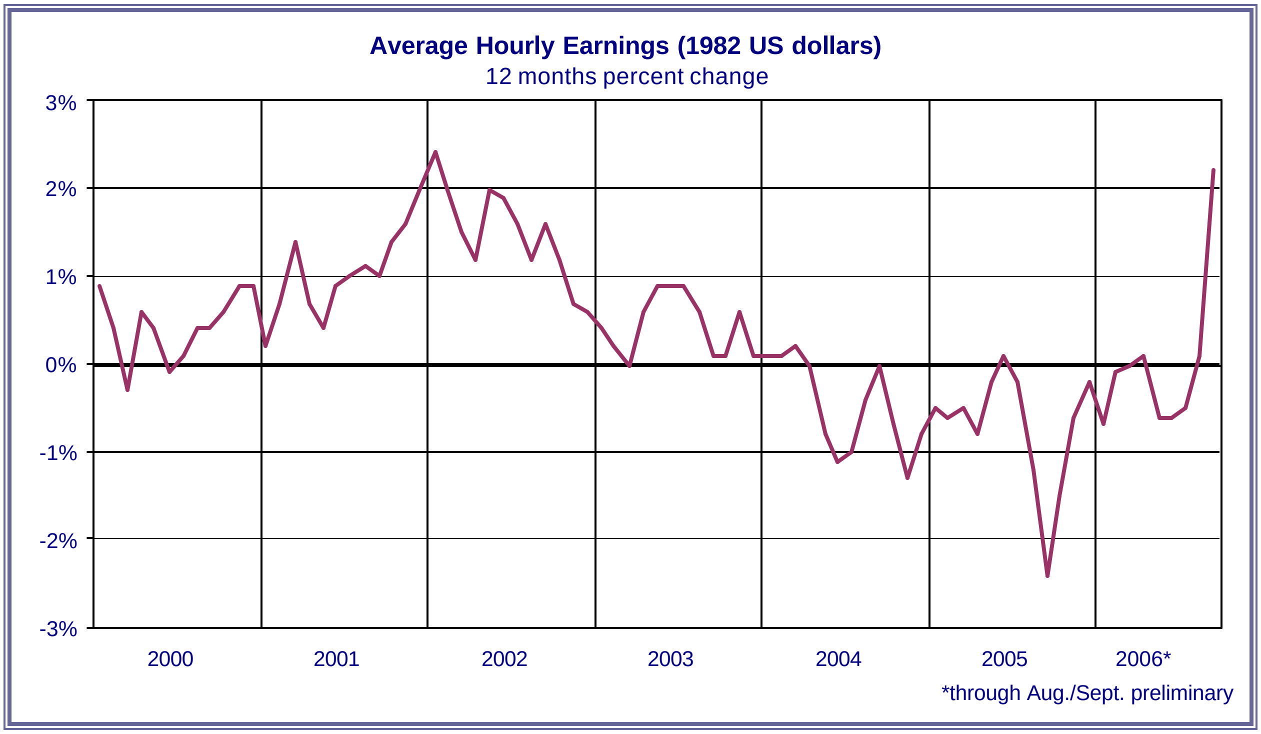


Source: BEA; 3Q'06 BEA "advance" estimate; 4Q'06 SIA forecast

Housing decreased 17.4% at seasonally adjusted annual rates (s.a.a.r.) in 3Q'06 after an 11.1% decline in 2Q'06. This weakness in housing shaved more than a full point (1.12 percentage points) from overall growth in 3Q'06, after paring 0.72 percentage point from growth in the preceding quarter. Excluding housing, the economy grew 2.7% in 3Q'06 and 3.5% in 2Q'06. Imports increased 7.8% in 3Q'06 after growth of only 1.4% in the prior quarter. The jump in import growth more than offset a slight improvement in export growth and cut overall GDP growth by 1.31 percentage points in 3Q'06.

Real personal consumption expenditure (PCE) increased 3.1% in 3Q'06, up from 2.6% growth in 2Q'06, thanks to an acceleration in durable goods spending, which was up 8.4% after a decrease of 0.1% in the prior quarter. This rebound more than offset weaker growth of services expenditures, which slowed to 2.8% compared to 3.7% in 2Q'06.

However, growth showed an uneven pattern across the third quarter. After an unusually weak August, ***September proved stronger than expected, and the US economy, outside the housing sector, entered 4Q'06 with substantial momentum.*** In fact, overall growth may be rising modestly at year-end, rather than slowing as it had been since early spring. Real personal income growth has been accelerating in recent months, and job markets remain strong. Oil prices have fallen 22% from their August peaks, and consumers have seen substantial declines in prices at the gas pumps, which has both lifted consumer sentiment and freed up household purchasing power as 4Q'06 opened.

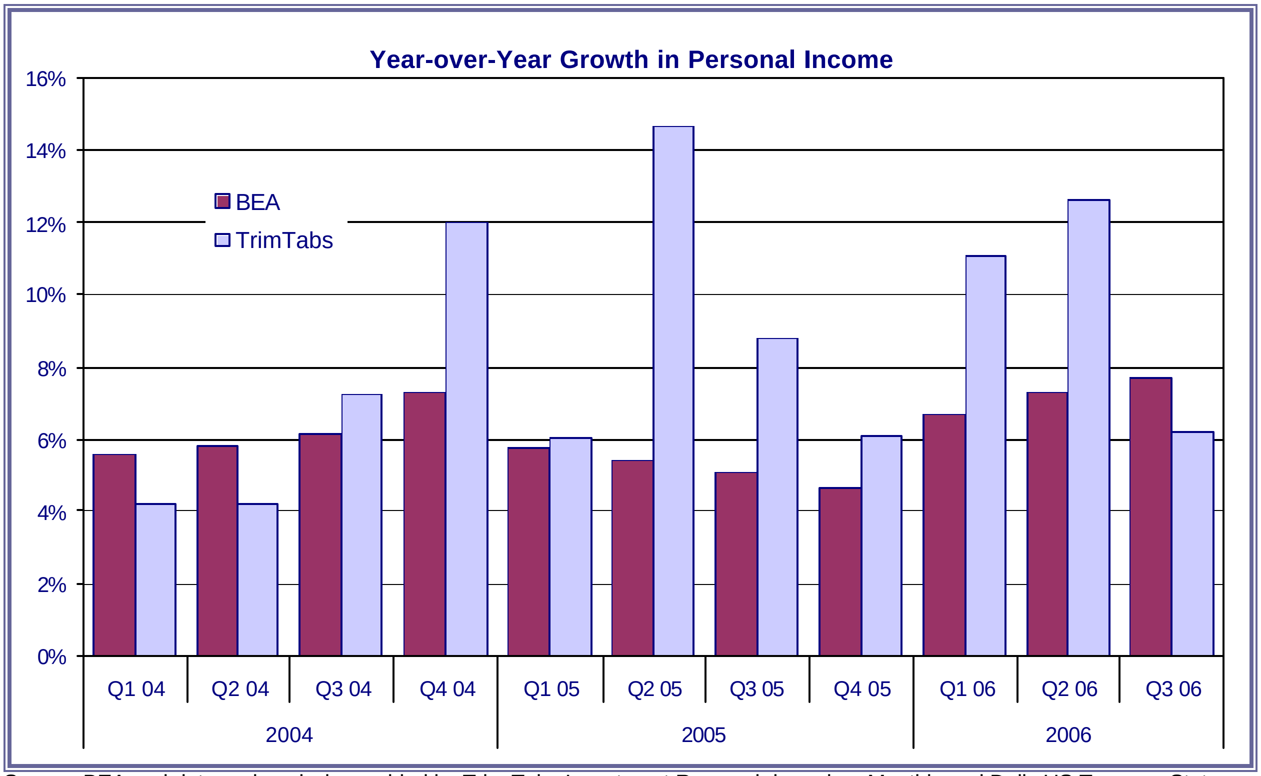


Source: US Department of Labor, Bureau of Labor Statistics

Personal income growth has been accelerating and may be growing more quickly than official BEA estimates suggest. Real disposable personal income increased 3.7% in 3Q'06, following an increase of 1.7% in 2Q'06. Real average weekly earnings rose 1.0% in September from August levels and were 2.2% above year-earlier levels. Another source of data on personal income is US Department of the Treasury data on income tax withholdings (which can be used to estimate growth in wages of salaried employees)[1] and "Other Income Tax Not Withheld,"[2] which are

[1] Estimates provided by Trim Tabs Research.

collections from various sources. This aggregate data for the whole population may provide a much more accurate picture of the growth in jobs and personal income (and a basis for estimates and forecasts) than the data produced by the BEA, which are frequently revised estimates drawn from a relatively small sample. Estimates based on US Treasury tax collection data show personal income growth slowed in July and August before rebounding in September, and that there are as many as 2.08 million more self-employed individuals paying taxes than there were two years ago – income earners who are not captured in the official personal income statistics.



Source: BEA and data and analysis provided by Trim Tabs Investment Research based on Monthly and Daily US Treasury Statements (http://www.fms.treas.gov/dts/)

Monthly BEA data for September,[3] which was released after the advance estimate for 3Q'06 GDP, supports the view that future estimates of growth will be higher than the advance estimate and that personal income growth accelerated at end-3Q'06. Personal income in September was up 0.5% from August levels, after 0.4% monthly increases in July and August. Personal disposable income[4] also showed a nominal monthly increase of 0.5% in September. Perhaps more importantly, real personal disposable income[5] increased 0.8% in September, up from monthly increases of 0.2% in both July and August. Largely as a result of this strong September rise, real disposable personal income was up 3.7% (s.a.a.r.) for 3Q'06 as a whole, a sharp increase over the 1.7% gain registered in 2Q'06. In addition, preliminary indications for October suggest that real personal income growth continued to accelerate into 4Q'06.

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[2] Includes tax collections from a variety of sources, including interest income, dividend income, capital gains on stock purchases, capital gains on real estate transactions, earned income from sales commissions, and 1099 income earned by self-employed individuals.

[3] BEA, "Personal Income and Outlays: September 2006," October 30, 2006.

[4] Personal income minus personal current taxes.

[5] Personal disposable income expressed in constant (chained 2000) dollar measures.

Lower mortgage rates could provide a brake to the precipitous decline in the housing sector, and, if so, the steepest declines in construction and sales of homes may have already occurred in 3Q'06, followed by a more gradual slide in the months ahead. While there is a significant overhang of unsold new homes, which will pressure activity and prices, some recent signs suggestive of a "soft landing" have appeared. Existing home sales fell 1.9% in September from August levels, the sixth consecutive monthly decline, and are now down 14.2% from year-earlier levels. Meanwhile, the median sale price fell 2.2% from year-earlier levels, matching a drop in August that was the first monthly decline in over 11 years. However, new homes sales, which make up about 15% of the market, while still down 14% from year-earlier levels, increased for the second month in a row, rising 5.3% in September. Builder incentives, lower mortgage interest rates, and discounts reportedly contributed to last month's uptick. In addition, housing starts rose a surprising 5.9% in September,[6] returning to June levels, in part reflecting a 44 basis point decline in mortgage rates over the past three months.[7] However, "the continued downward plunge in building permits suggests that the stabilization in the housing market is temporary,"[8] and a significant buildup of home inventory implies that permits and starts may continue to fall, albeit in a more gradual fashion.

The job market remains strong. Weekly unemployment claims dropped by 10,000 claims to 299,000 claims during the week ending October 13, 2006 from an adjusted 309,000 claims during the previous week. The four-week moving average fell by 5,750 to 307,750 claims. Further evidence of the strength of labor markets came from the US Department of Labor's Bureau of Labor Statistics (BLS) preliminary estimate of the upcoming annual benchmark revision to establishment survey employment, which added 810,000 jobs to employment totals for the 12-month period ending March 2006.

Business investment remains robust, strengthening in the third quarter. Business investment (real nonresidential fixed investment) increased 8.6% in 3Q'06, after an increase of 4.4% in 2Q'06. Investment in equipment and software rose 6.4% in contrast to a decline of 1.4% in 2Q'06. Nonresidential construction spending has surged, increasing nearly 24% over the past year and in real terms (s.a.a.r.) was up 14% in 3Q'06 following an increase of 20.3% in the immediately preceding quarter. Business investment should continue to strengthen in the final quarter of 2006, as corporate profits continue to expand at double-digit annual rates and corporate cash remains near record levels. Corporate profits, which grew 18.5% in 2Q'06, were up an estimated 14% in 3Q'06, and borrowing costs are relatively low. Growth of new orders for nondefense capital goods excluding aircraft increased steadily across the course of 3Q'06 and by September were 9.0% above levels in September 2005, while for the first nine months of the year they were 9.7% higher than during the same year-earlier period.

Inflation and Interest Rates

Inflation appears to be stabilizing. The Federal Reserve, which had correctly anticipated the increase in headline and core inflation that occurred earlier this year, forecast that these inflationary pressures would subside as we approach year-end. That appears to be the case, and core rates and headline rates are expected to converge in the months ahead. The principal factor helping stabilize inflationary pressures is the current period of below-average growth, as

[6] Month-over-month decline to an annualized rate of 1.772 million units.

[7] According to Freddie Mac's weekly primary mortgage market survey, the average 30-year fixed rate mortgage was 6.36% for the week ending October 19, compared to 6.80% for the week ending July 20.

[8] Merrill Lynch, *The Market Economist: Weekly Guidebook for the Global Investor*, October 20, 2006, p.12. Permits fell 6.3% m/m in September and are now down for eight consecutive months — a losing streak last seen in 1961. The year-on-year rate is at -27.7% — the worst pace since February 1991. Since 2003, we have only seen six times when permits fell and starts rose, and in five of those occasions, starts always fell the next month by an average of 8.0%.

the effects of past interest rate hikes curb demand with appropriate lags. The recent fall in oil prices should help contain the rise in core inflation, while the amount of "pass-through" onto general prices produced by increases in energy prices is substantially lower than it has been in the past. What may be working against the Fed is that inflationary expectations, which normally are very persistent and, until recently, remained reasonably well anchored, have now begun to increase, albeit modestly, in part due to recent real wage gains.

Consumer prices increased 0.8% (s.a.a.r.) in the third quarter of 2006, following increases in the first and second quarters at annual rates of 4.3% and 5.1%, respectively. This brings the year-to-date annual rate to 3.4%, the same as for all of 2005. Meanwhile, core consumer prices (all items other than food and fuel) rose 2.7% at a compound annual rate in the third quarter, a bit lower than the 2.9% pace for the 12 months ending September. An inflation measure that is even more closely watched by the Fed is the core PCE (the price index for PCE, excluding food and energy). Core PCE during 3Q'06 increased 2.7% from the same quarter one year ago. However, the annualized rate of increase for core PCE fell to 2.3% in 3Q'06, from 2.7% in 2Q'06.

With inflation stabilizing, the Fed's decision to halt the two-year string of 17 consecutive quarter-point increases in the Federal Funds rate looks increasingly prescient and appears to represent a halt to that tightening cycle rather than merely a "pause." Financial markets appear to have adopted this view, with long-term rates, including mortgage rates, falling in recent weeks. ***This has led many analysts to look for the Fed to begin cutting rates next year***, perhaps as early as March.

Securities Industry Performance

At end-September we noted[9] that industry results remained strong in 3Q'06, though down from near record first-half levels. It was already apparent at that time that secondary market volume had jumped markedly in September after weak results in July and August. This, combined with gains in both stock and bond prices,[10] had boosted both commissions and asset management fees, while strong flows into funds in both August and September had lifted mutual fund sales revenue. The jump in volume and prices reflected improving investor sentiment bolstered by receding oil prices, still strong corporate profit growth, and growing confidence that the Fed's "pause" could actually prove to be a halt after two years of interest rate increases. Retail investors moved off the sidelines, while building momentum lifted algorithmic/program trading volumes into October.

However, better-than-expected results in investment banking and proprietary trading were not evident until securities firms released their quarterly results in October. Underwriting totals in September jumped nearly 31% from August levels, salvaging what otherwise would have been a disappointing quarter even by seasonably weak summer standards. Even so, US underwriting activity in 3Q'06 was only 0.8% above levels seen in the same year-earlier period. Similarly, mergers and acquisition activity improved in September, both in terms of the dollar value and the number of deals announced.

But the biggest positive surprise came in an even more unpredictable revenue line item: trading gains. Trading gains, which surged in 1Q'06, nearly doubling to $11.6 billion from $5.9 billion in 4Q'06, remained well above average at $8.3 billion in 2Q'06. We had assumed that trading gains would fall back to more normal levels, in part owing to a decline in market volatility in

[9] See *SIA Research Reports*, Vol. VII, No. 10, September 26, 2006, pp. 3-11.

[10] See our "Monthly Statistical Review and Third Quarter Wrap-Up" that follows this report, pp. 18-33.

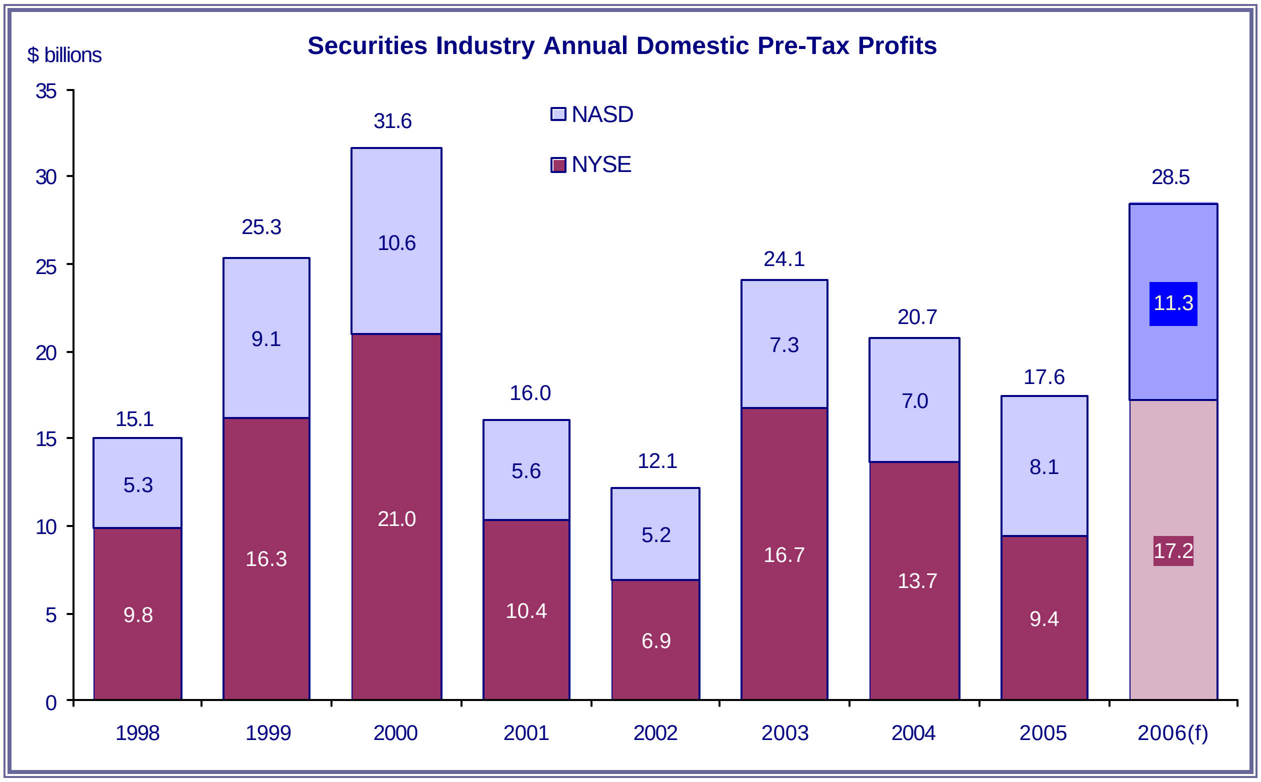
3Q'06. Judging from a sample of individual firms' releases, our judgment may have been too pessimistic, as proprietary trading gains for some were boosted as the quarter came to a close.

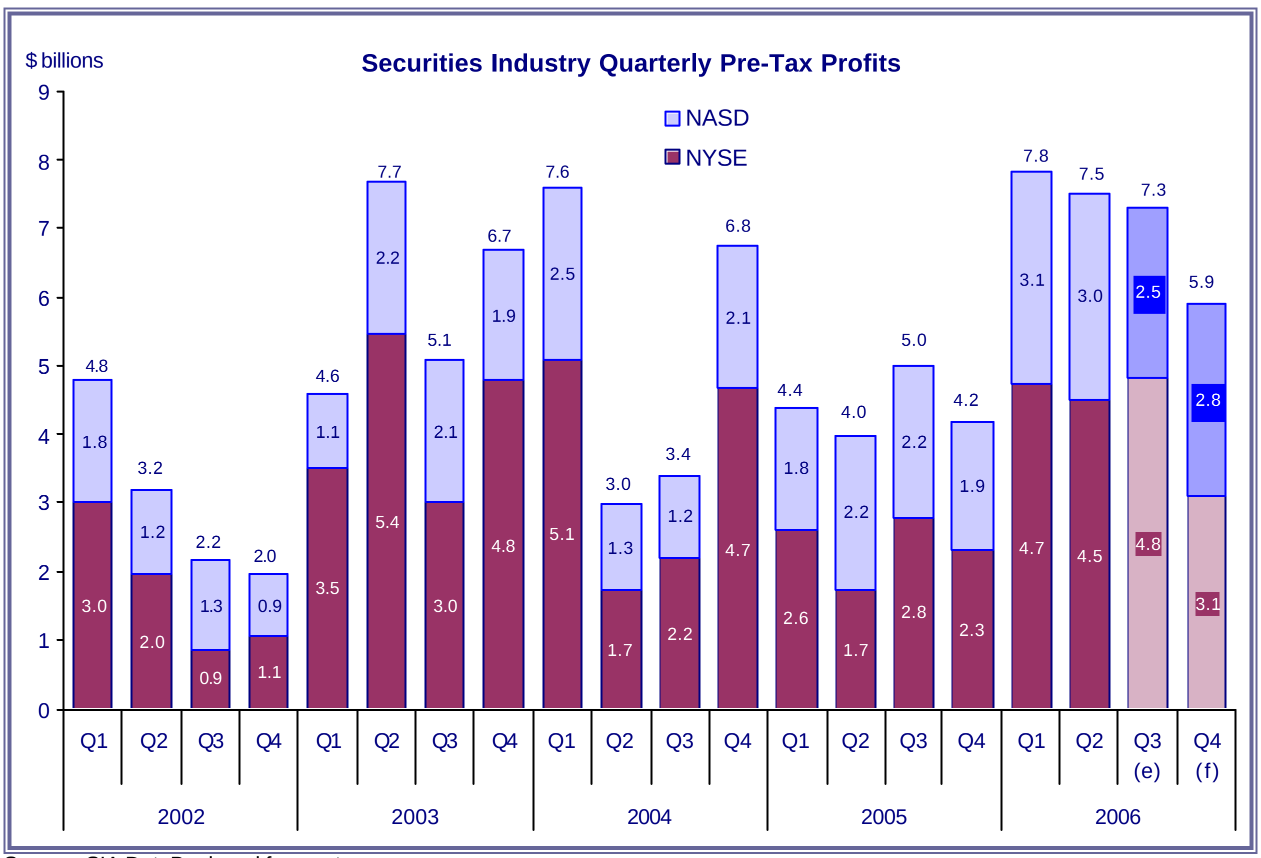
While third quarter results for the entire industry won't be available for some time, based on a representative sample of firms reporting for the quarter ending September 30, it appears that gross revenues, net revenues and profits for 3Q'06 might well have been higher than we forecast just prior to the quarter's end. Overall, for those securities firms that have publicly reported, 3Q'06 earnings exceed analysts' expectations by roughly 20%. Accordingly, we are raising our estimates for revenues and profits for the industry for 3Q'06 and for 2006 as a whole.

We now estimate that US securities industry pre-tax net income (profits) reached $7.25 billion in 3Q'06, down only slightly from the $7.5 billion earned in 2Q'06 and $7.82 billion reported in 1Q'06. Indications are that growth in October remained strong, led by increases in commission and fee income and in mutual fund sales revenues and asset management fees. Accordingly, we are raising our forecast for 4Q'06 results.

For the year 2006 as a whole, we expect profits to top $28.5 billion, $10.9 billion higher than in 2005 and easily surpassing the industry's second best annual performance of $25.3 billion set in 1999, but still short of the record $31.6 billion earned in 2000. Total revenues in 2006 are expected to top $414.8 billion, an increase of 28.9% from 2005 results. More importantly, net revenues (total revenues net of interest expense) are forecast to reach $211.5 billion, up 13.9% from last year's levels.

Frank A. Fernandez
Senior Vice President, Chief Economist and Director of Research





Source: SIA DataBank and forecasts

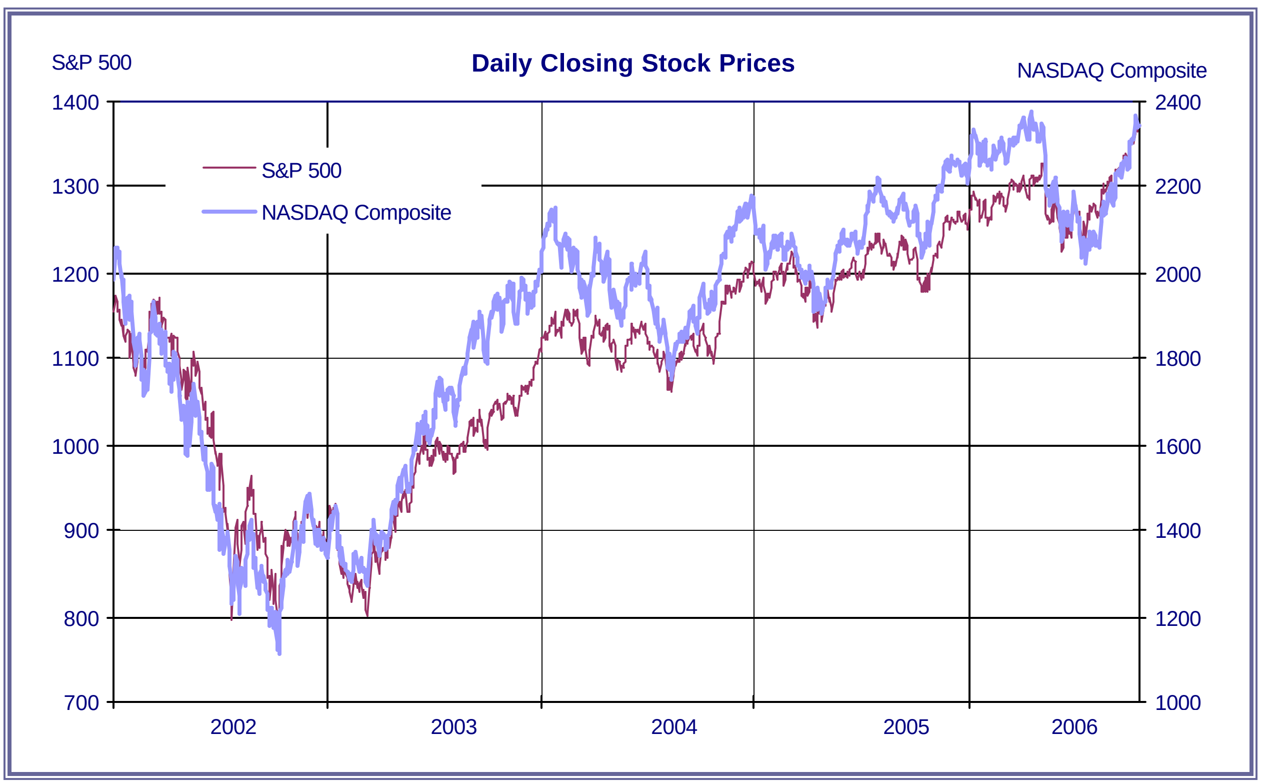
U.S. Equity Market Activity

Stock Prices – The major equity indices stayed near their year-to-date highs in September on strong volume, as investor sentiment was bolstered by receding oil prices, still strong corporate profit growth and the end of a two-year escalation of short-term interest rates. The Fed's pause encouraged more retail investors to move off the sidelines, while building momentum lifted programmed trading volumes into October.

Stock prices rebounded towards the end of the month and quarter after an early dip. For the month overall, the Dow Jones Industrial Average was up 2.6%, closing at 11,679.07. The S&P 500 index advanced 2.5% to 1,335.85, and the NASDAQ Composite Index experienced the greatest increase, rising 3.4% to 2,258.43.

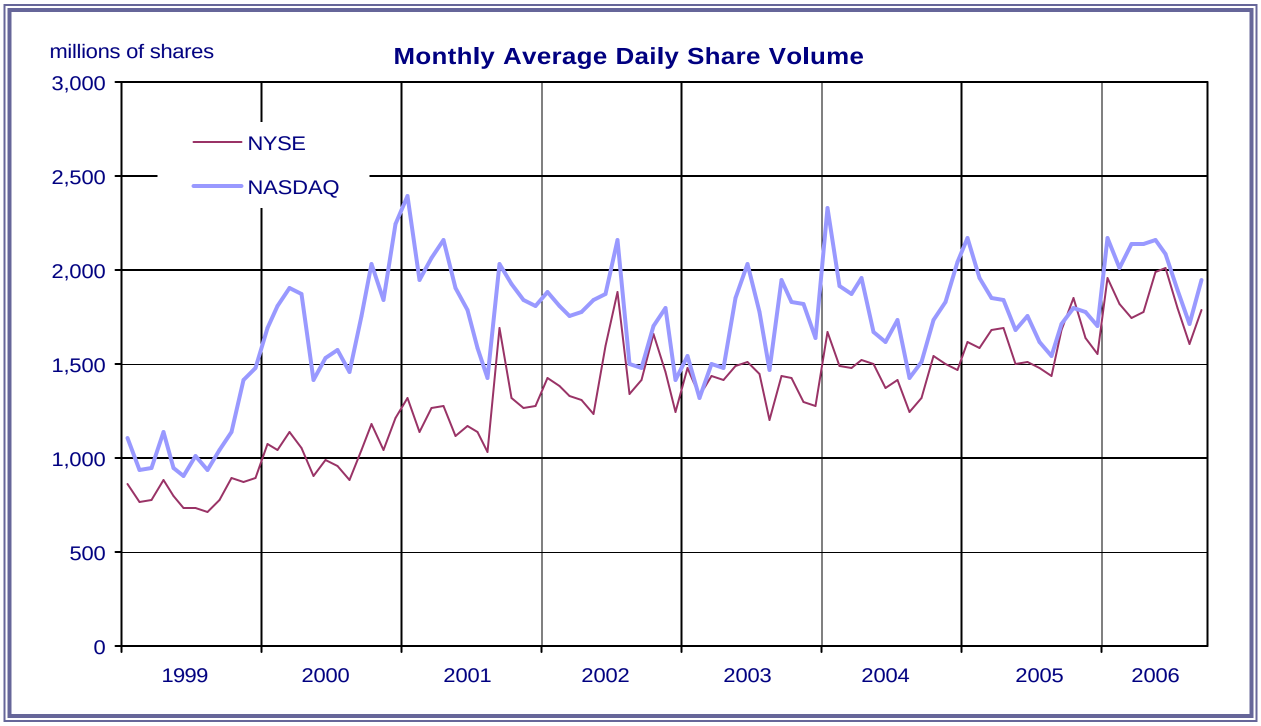
During 3Q'06 as a whole, all three major equity market gauges registered positive results for the second consecutive quarter. These gains were the largest quarterly increases in percentage terms since the end of 2004 for the DJIA and S&P 500, which were up 4.7% and 5.2%, respectively. The NASDAQ Composite rose 4.0%. Stock prices in the UK and Europe rose 3.3% and 6.1%, respectively, and a stock price index for the World excluding the US rose 3.2% during the third quarter.[1]

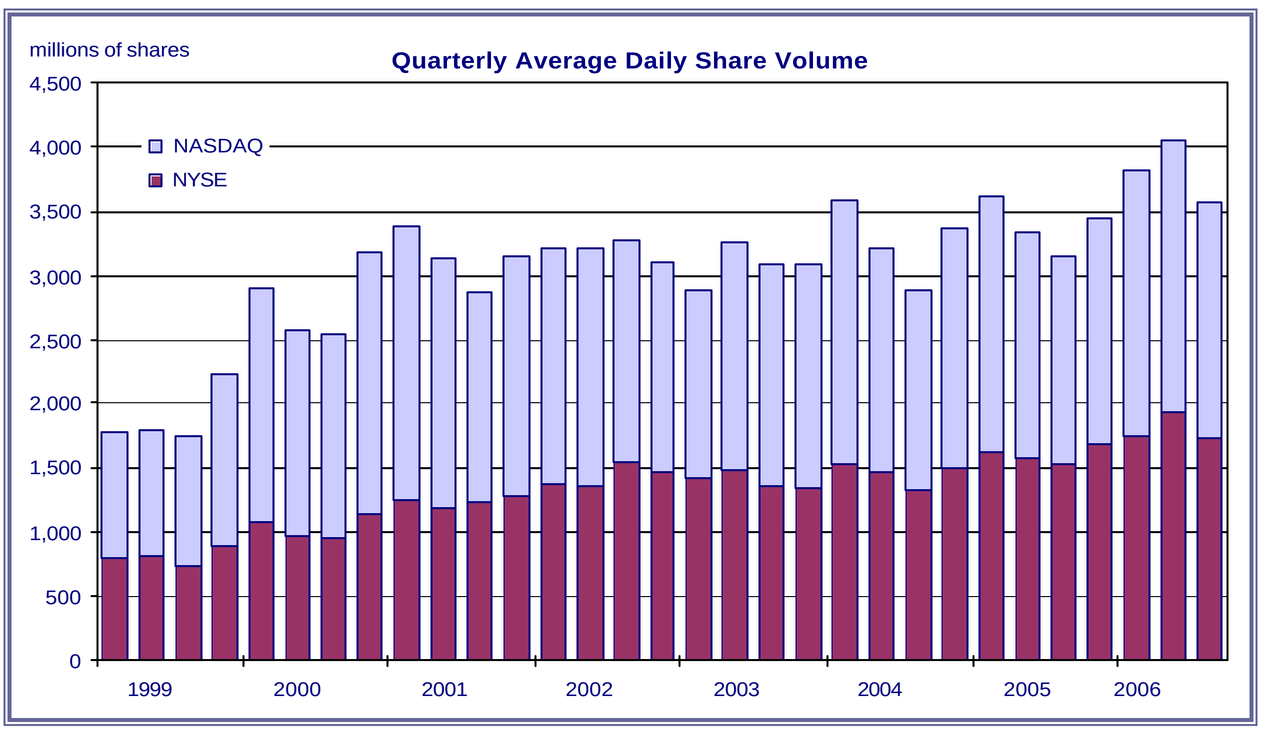
Through the first nine months of 2006, the DJIA increased 10.5%, the S&P rose 8.7%, and the NASDAQ Composite rose 5.0%, propelled by strong corporate earnings and a more benign economic environment.



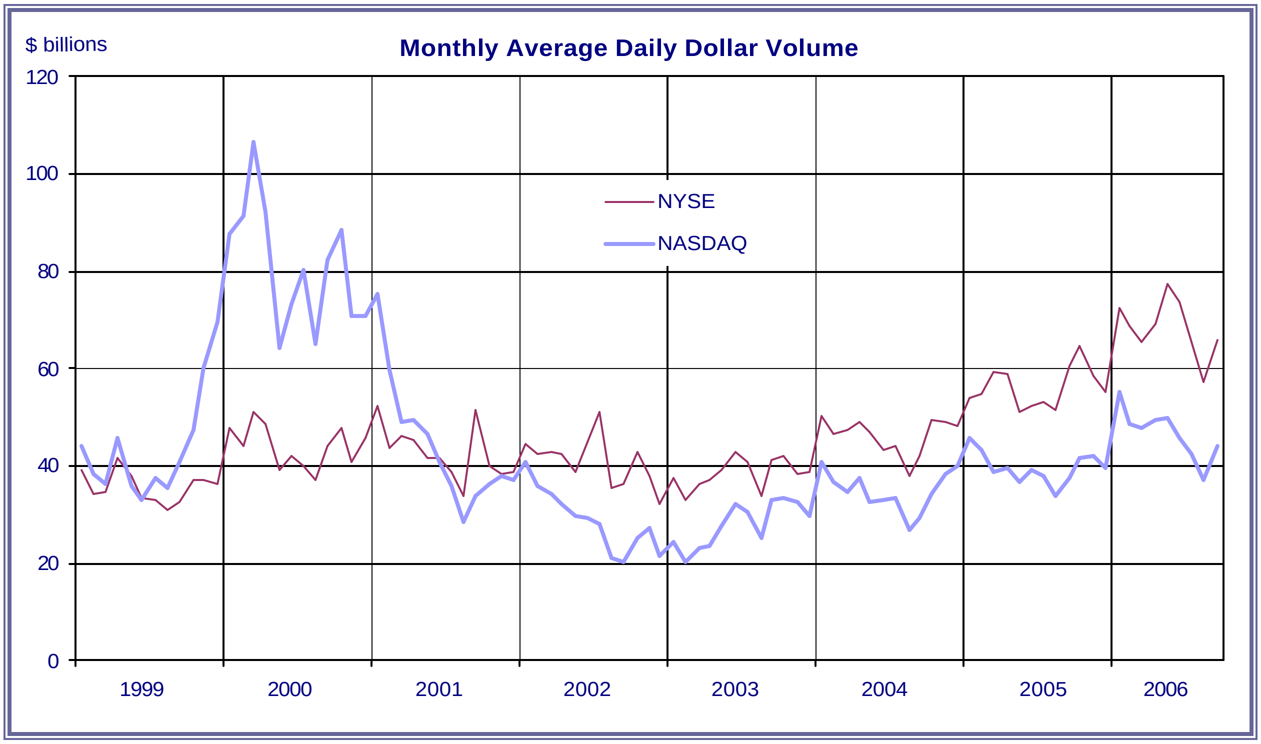
[1] Morgan Stanley Capital International Inc. (MSCI) Indices for the UK, Europe excluding the UK, and the World excluding the US.

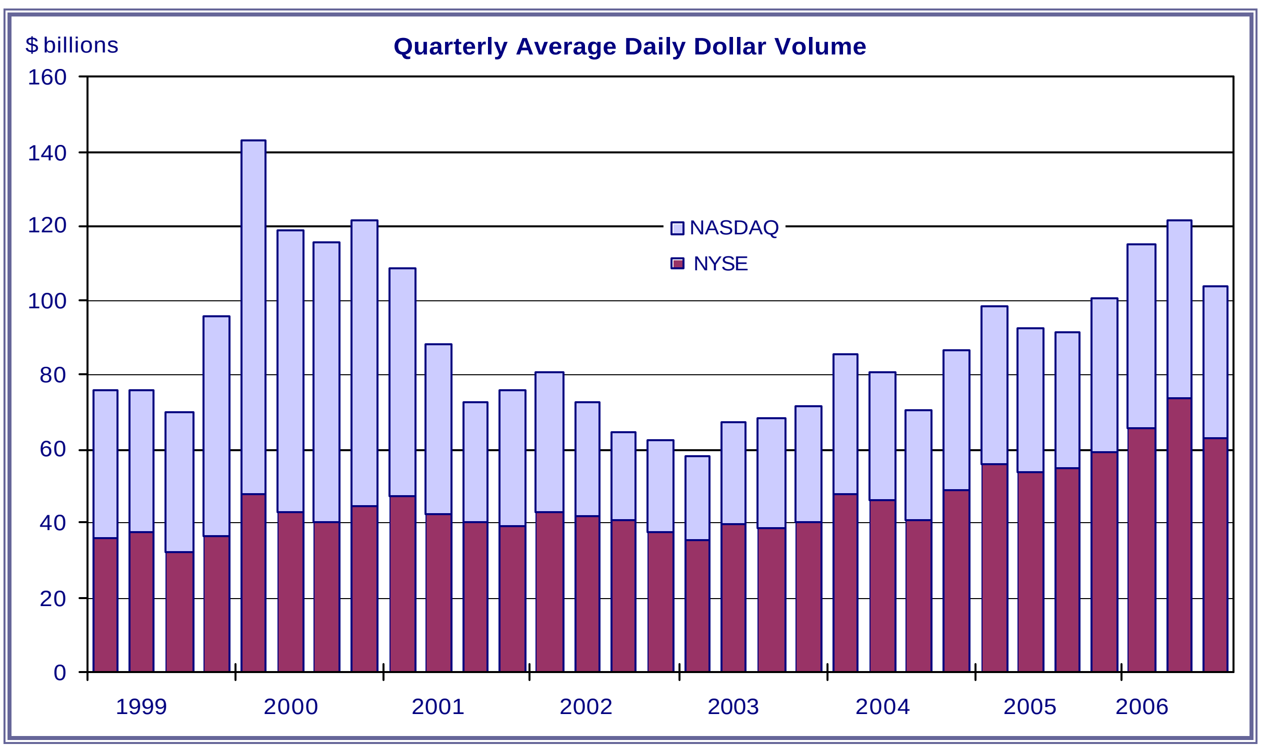
Share Volume – Volume on both the New York Stock Exchange and NASDAQ picked up markedly in September after falling for two and three consecutive months, respectively, to fresh 2006 lows in August. Average daily volume on the NYSE jumped 10.7% to 1.79 billion shares in September. That was not sufficient, however, to offset weak July and August volume, resulting in a decrease of 10.5% from 2Q'06 levels. Nevertheless, due to a strong first quarter, NYSE average daily share volume through the first nine months of 2006, at 1.83 billion shares, was 16.1% above the same year-earlier period. A 13.5% increase to 1.94 billion shares in NASDAQ daily volume in September wasn't enough to offset declines in July and August. As a result, 3Q'06 average daily share volume was 13.5% below the 2Q'06 level. The year-to-date average of nearly 2.03 billion shares, however, was 13.5% above that in the same year-earlier period.



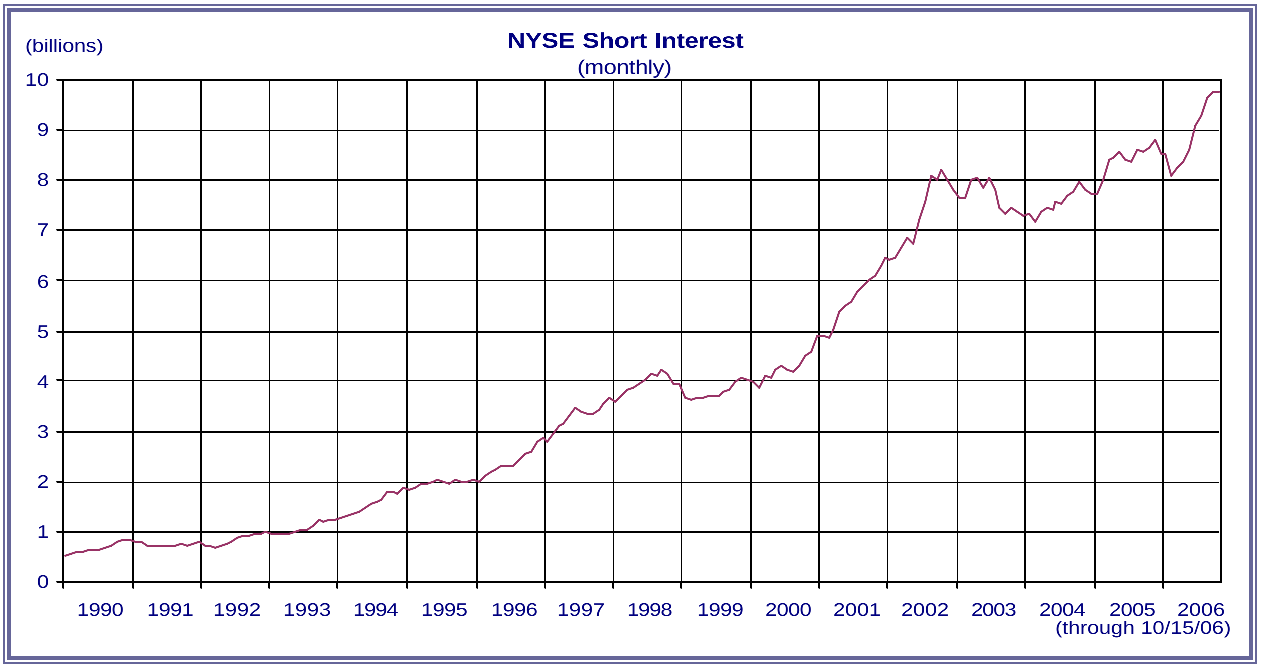


Dollar Volume – Increased trading activity led to significant gains in average daily dollar volume on both the NYSE and NASDAQ in September. Although average daily dollar volume on the NYSE jumped 14.6% to $65.8 billion in September, the 3Q'06 average was 14.8% below that reached in 2Q'06. Through the first nine months of 2006, NYSE daily dollar volume averaged $68.2 billion, 24.1% above last year's same nine-month period. The average daily dollar volume on NASDAQ increased 19.9% in September to $44.3 billion. Despite September's gain, daily dollar volume in 3Q'06 was weaker than in the previous quarter. Nonetheless, year-to-date NASDAQ average daily dollar volume of $46.4 was 18.9% higher than that recorded in the same year-earlier period.

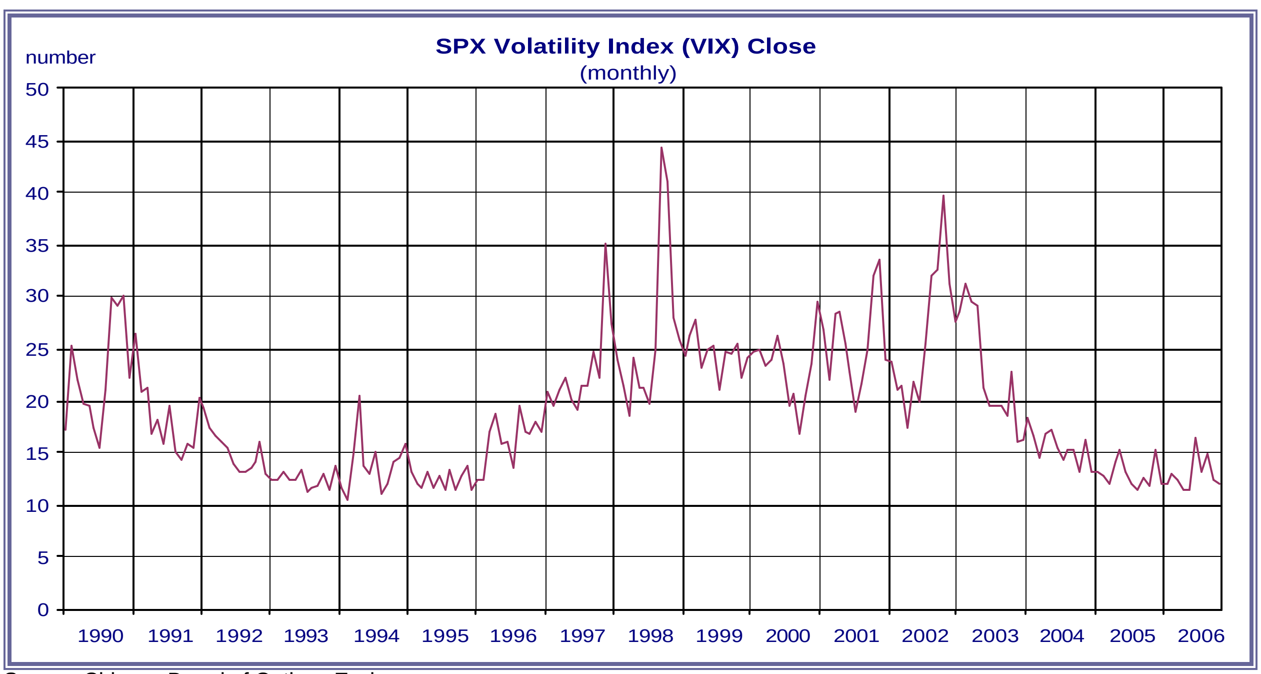




Short Interest – NYSE short interest remained above the nine trillion-share level for the fifth consecutive month, with October 15's short interest at 9.744 trillion shares, or 2.6**%** of the total shares outstanding on the NYSE. The short ratio, or the number of days' average volume represented by the outstanding short positions at the exchange, rose to 7.0 in September, only to decline to 6.2 in October. Nevertheless, NYSE short interest has increased by 14.7%, or 1.25 trillion shares, since January.



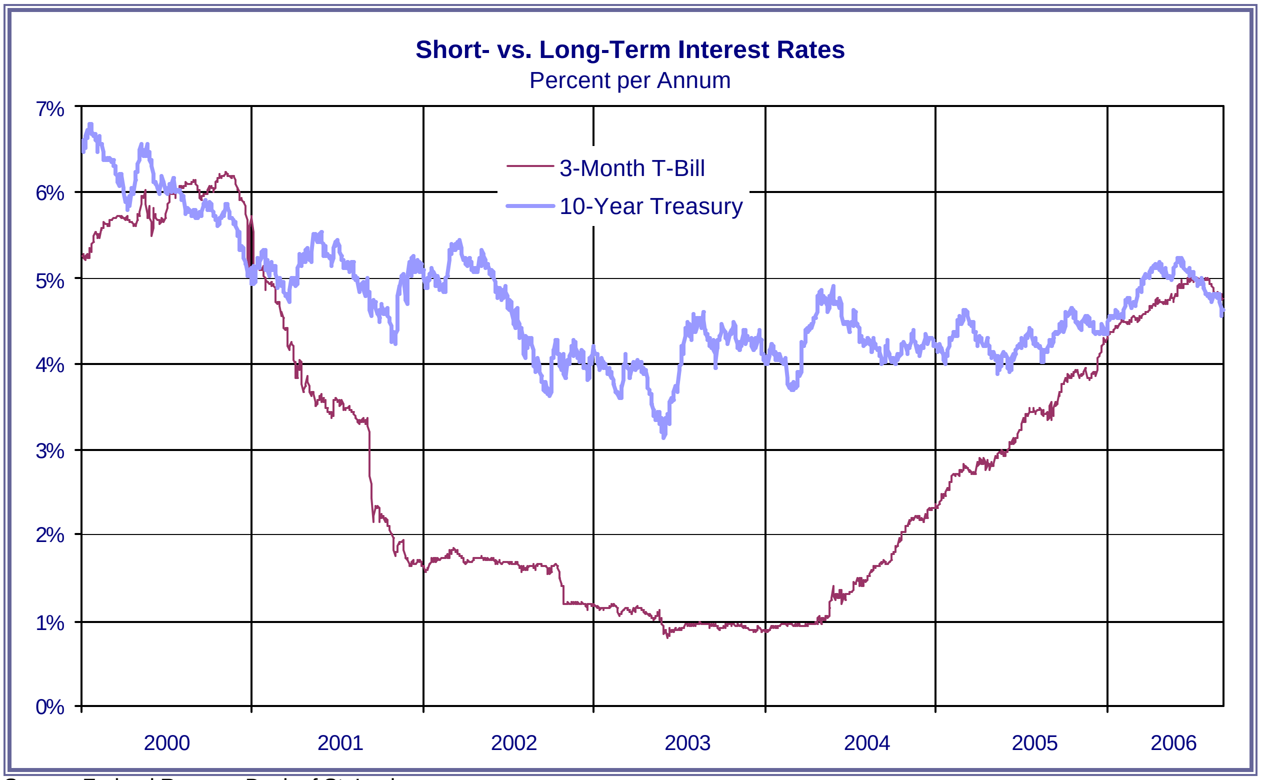
CBOE Volatility Index (***VIX***)[2] – The Chicago Board of Options Exchange Volatility Index, or VIX, is a forward-looking measure of the expected volatility of the S&P 500. The VIX closed the month of September at 11.98, down 2.7% from August's close of 12.31 and slightly above (0.5%) September 2005's level. For 3Q'06 the VIX declined 8.4%, reaching a high of 18.64 on July 17th, only to be down 35.8% by quarter-end from that July high.



Source: Chicago Board of Options Exchange

[2] The VIX is an indicator of the degree to which options traders expect the value of the S&P 500 to fluctuate over the next 30 days.

Interest Rates – The US Treasury yield curve remained inverted[3] for the second consecutive month in September. The last such inversion occurred in 2000, when the 3-month yield remained below the 10-year bond yield for five months. The average 3-month Treasury bill yield was 4.81% in September, down from 4.96% in August, while the 10-year bond yield averaged 4.72%, down from 4.88%. For the third quarter as a whole, the monthly average 3-month bill yield rose to 4.91% from 4.7% in 2Q'06. The 10-year bond yield average in 3Q'06 fell to 4.9% from 5.07% in 2Q'06. Year-to-date, the monthly average 3-month yield rose to 4.67% from 2.92% in the same year-earlier period, while the 10-year yield's monthly average rose to 4.85% from 4.22%. The spread between the 3-month and 10-year yields collapsed to a monthly average 18 basis points (bps) in the first nine months of this year, from 131 bps during the same period in 2005.

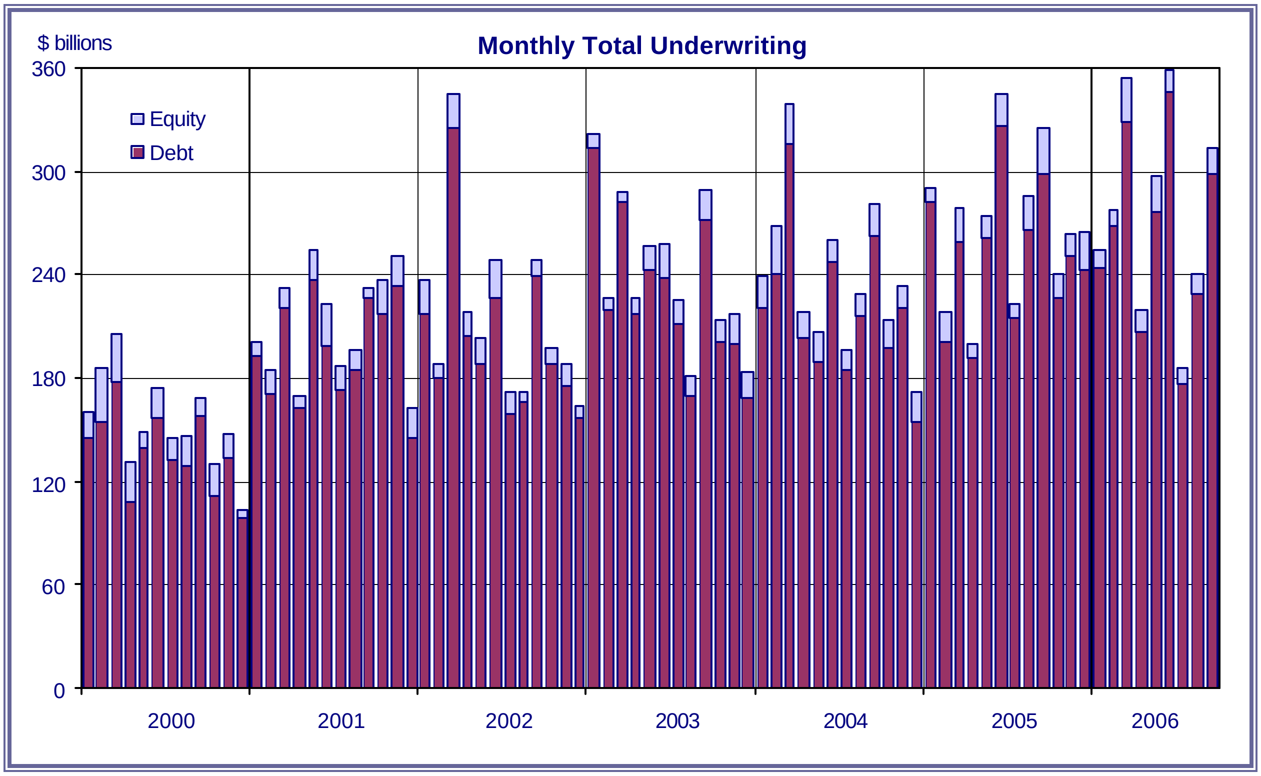


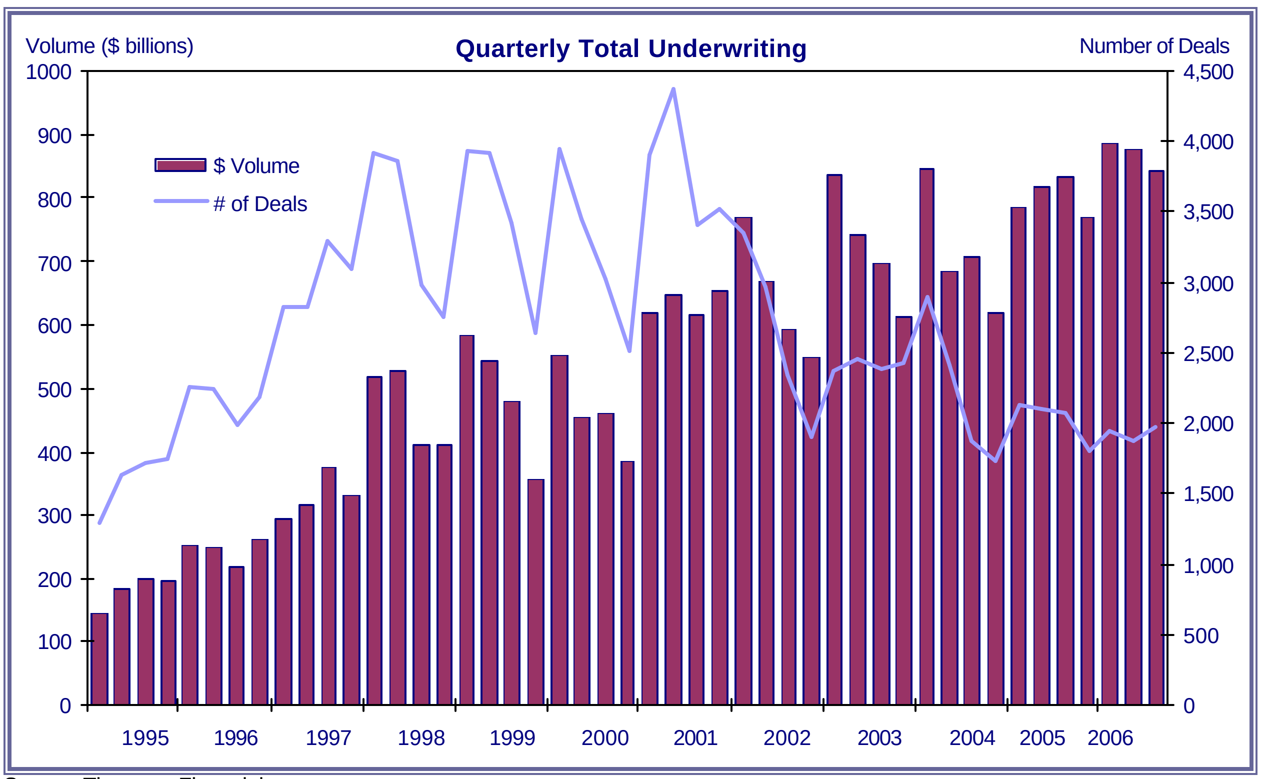
Source: Federal Reserve Bank of St. Louis
Note: Daily closing yields

3 Here we note by "inverted" that the 3-month T-bill yield was below the 10-year Treasury bond yield.

U.S. Underwriting Activity

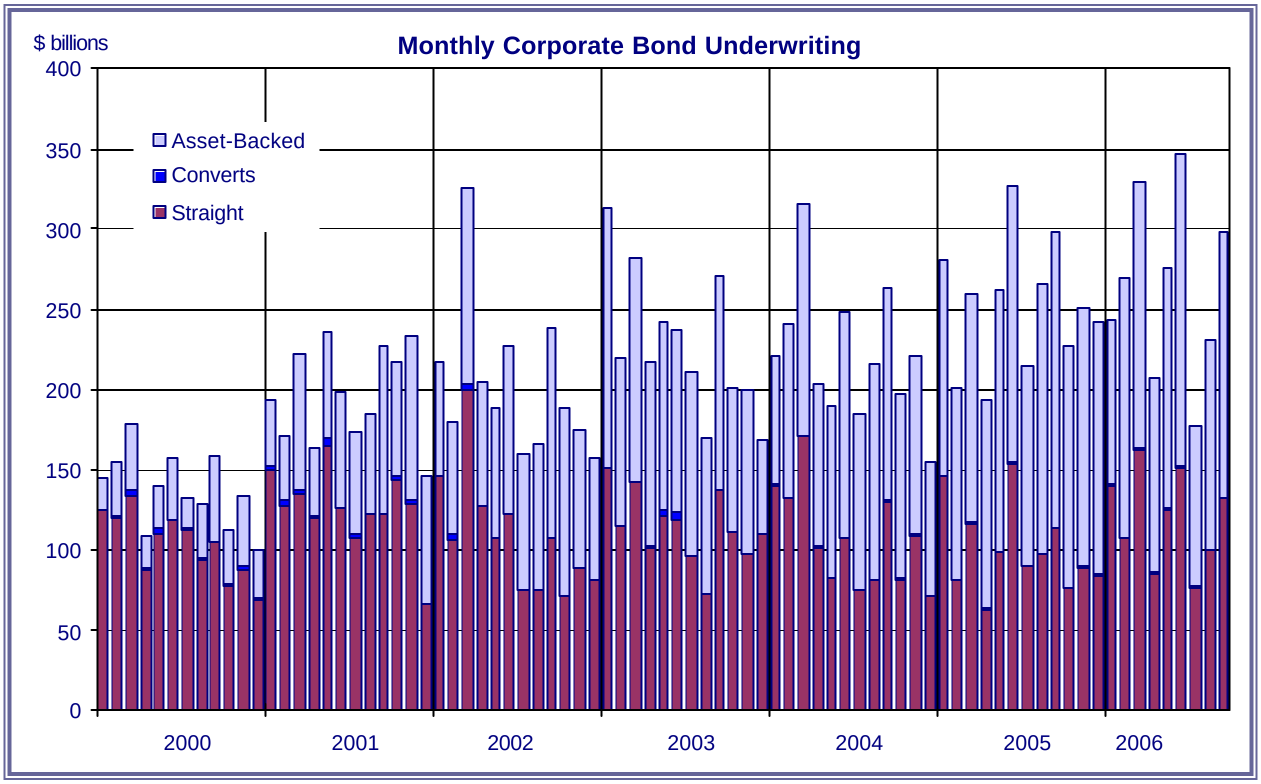
US underwriting totaled $842.2 billion in 3Q'06, 3.9% below Q2'06's level, but 0.8% above that of 3Q'05, thanks to a 30.9% rebound in September from weak August levels. Total issuance of stocks and bonds is running 2.5% ahead of last year's pace for the first nine months of the year, with $2.5 trillion raised in the first nine months of 2006 compared with $2.44 trillion in 2005's same period.

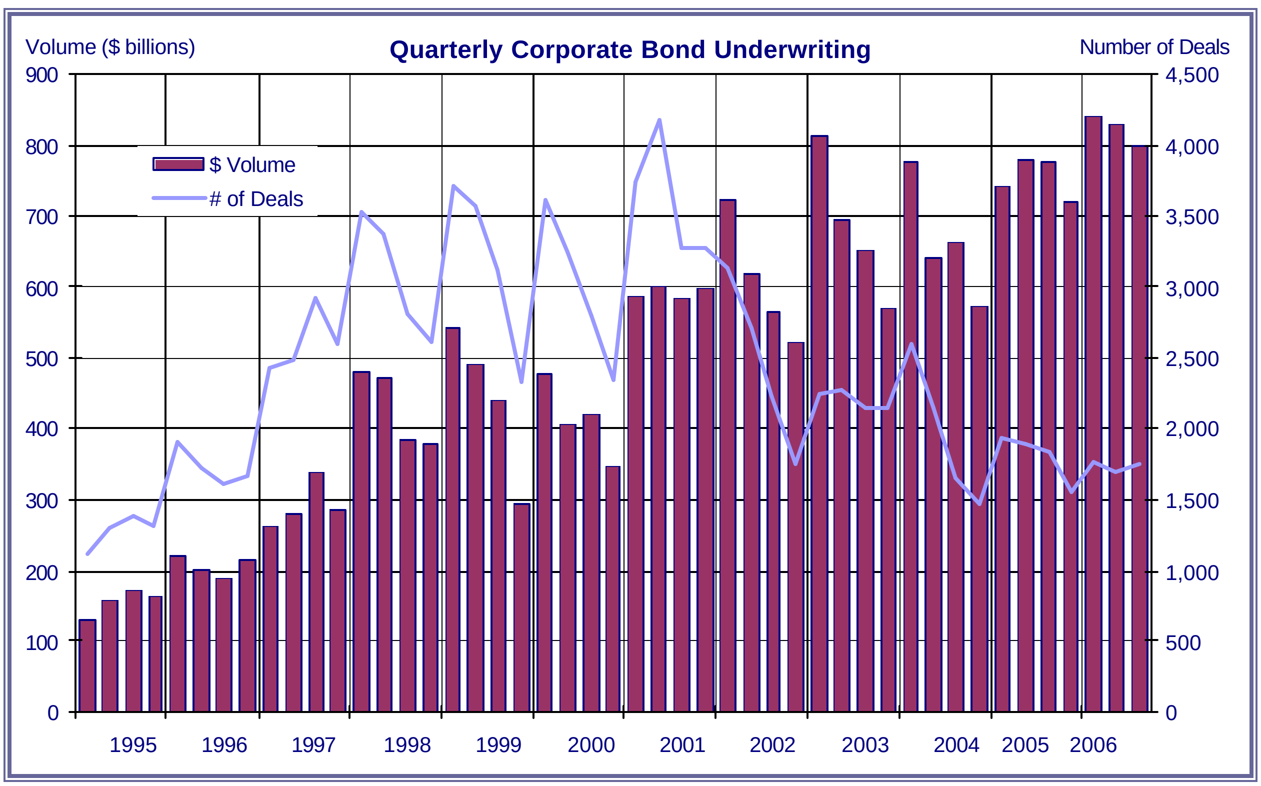




Source: Thomson Financial

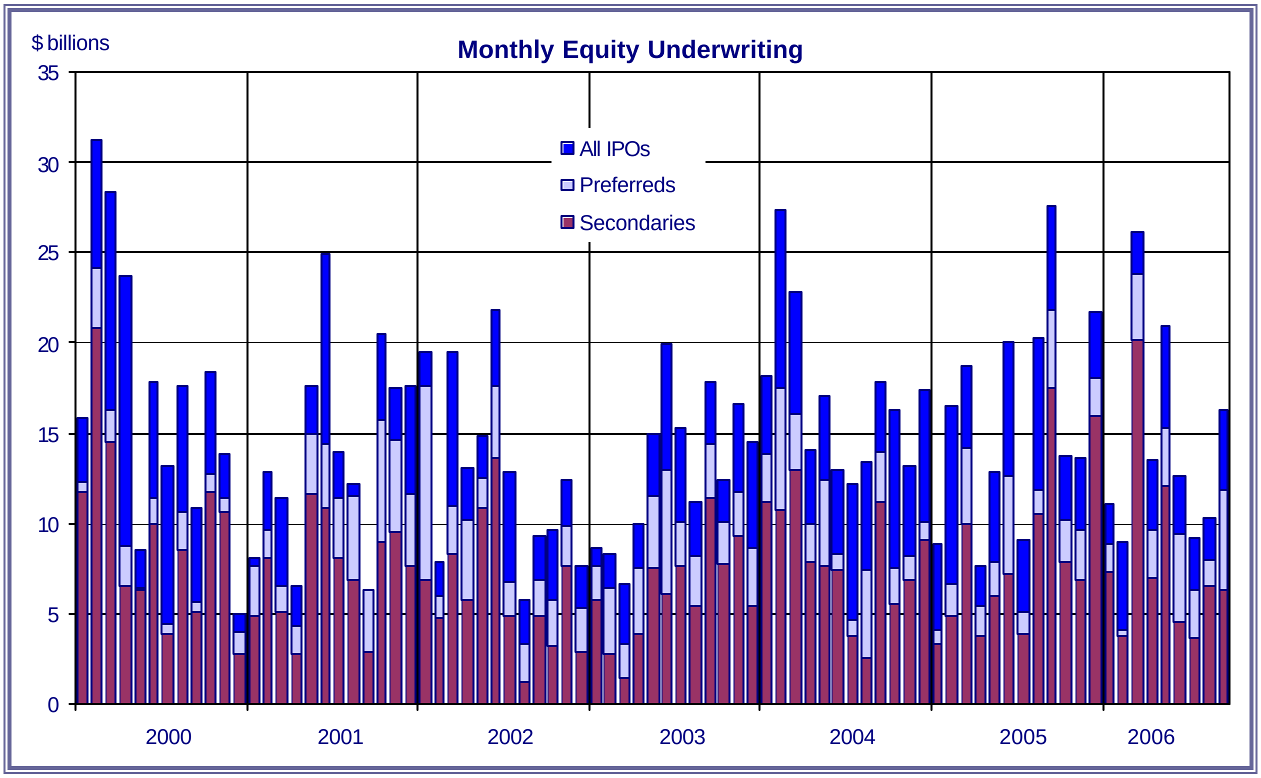
Corporate Bond Underwriting – Total corporate bond issuance rose in September by 29.7% to $298.0 billion, with straight corporate debt issuance leading the way, up 32.9%. For the quarter, straight debt issuance declined by 2.3%, while asset-backed offerings dropped 4.7% from the last quarter. Despite the recent slowdown, the $2.37 trillion of debt raised in this year's first nine months represented a 3.2% increase over the amount raised during the same period last year. In fact, this is the third consecutive year that this ninth-month period has recorded an increase in corporate bond issuance.

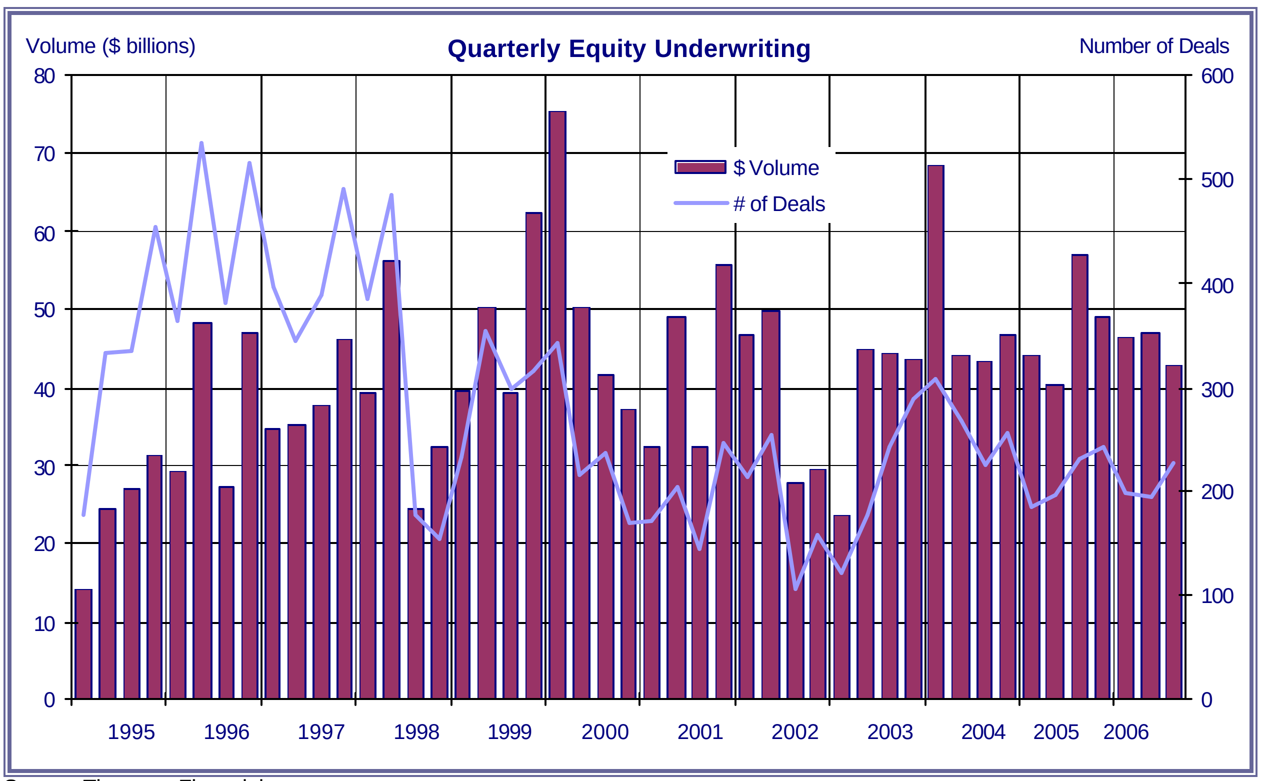




Source: Thomson Financial

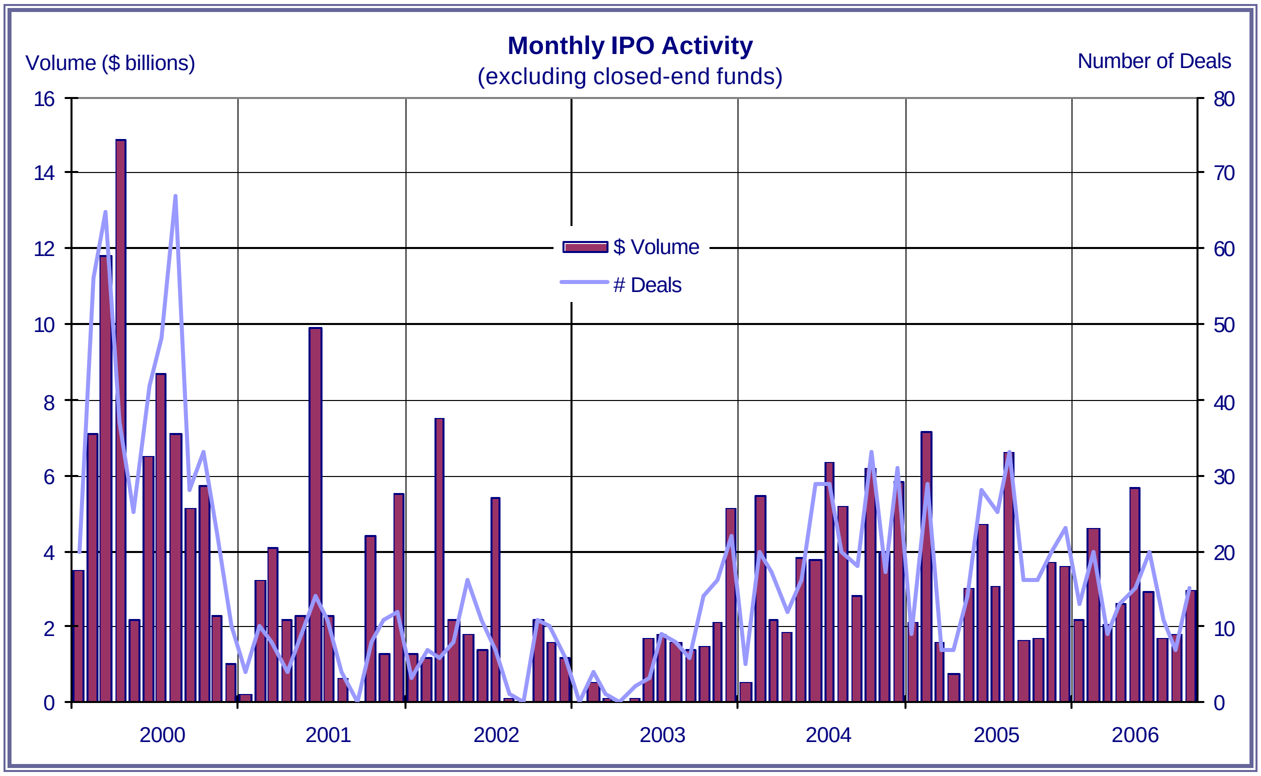
Equity Underwriting – Overall issuance volume of common and preferred stock rose by 57.5% in September to $16.2 billion from August's $10.3 billion, the second consecutive monthly rise. In the third quarter, dollar proceeds from equity offerings totaled $42.8 billion, 9.3% below 2Q'06 levels and 24.8% below 3Q'05. Year-to-date equity issuance is down 8.6% to $129.1 billion compared with $141.4 billion recorded in the same year-earlier period.

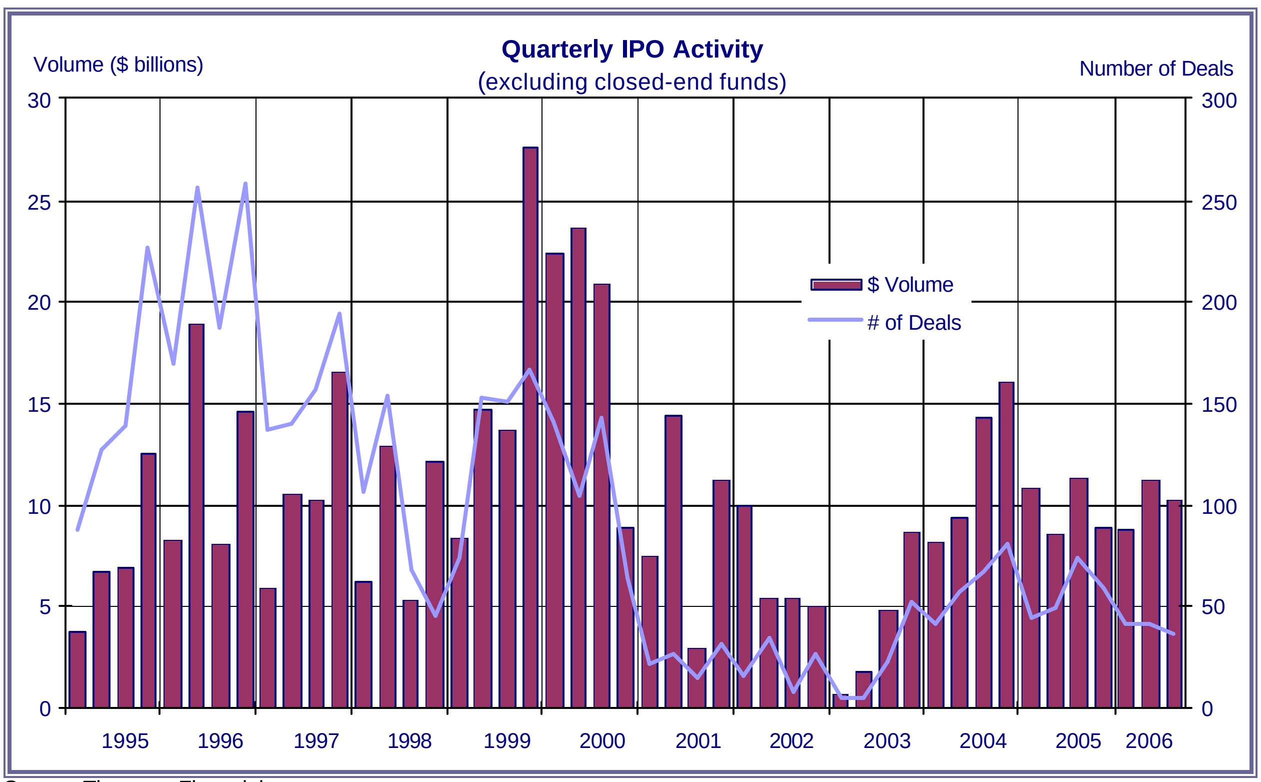




Source: Thomson Financial

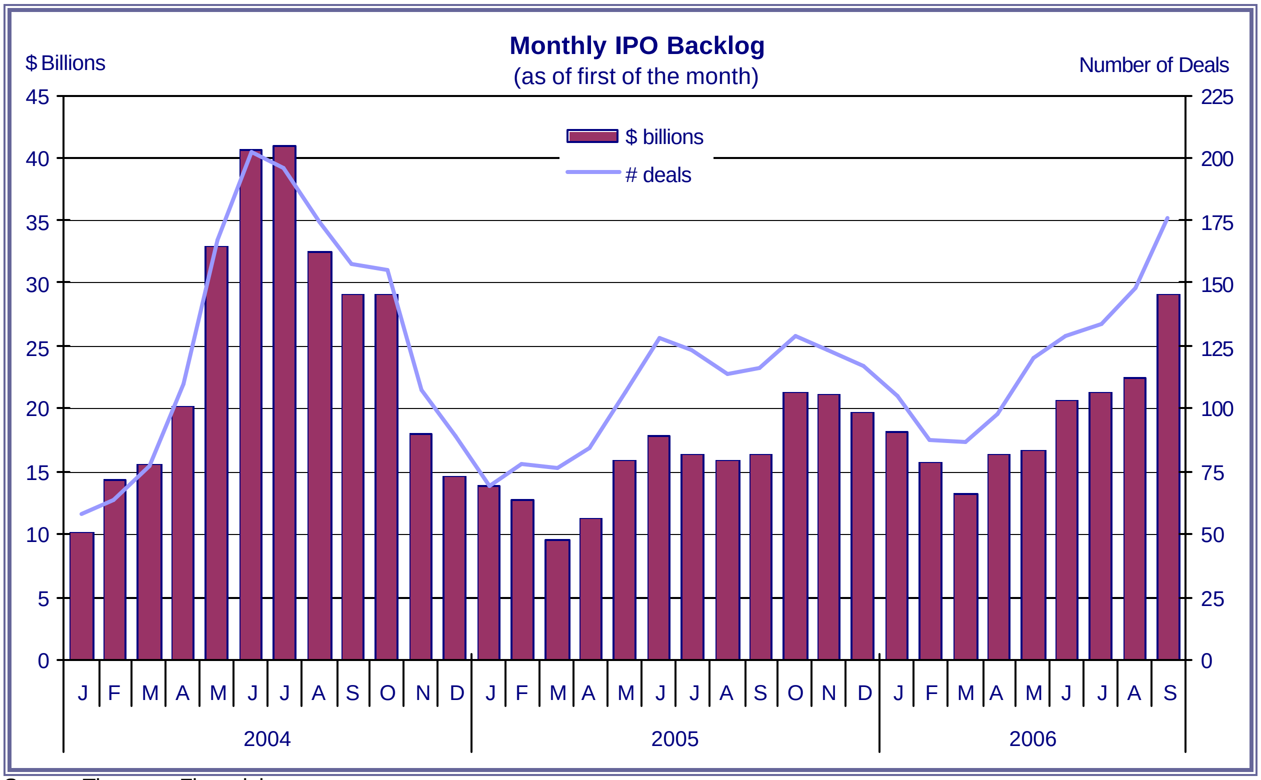
Initial Public Offerings (***IPOs***) – US total IPO activity increased in September, rising 90.4% to $4.3 billion, with 'true IPOs' up 68.9% to $3.0 billion. For the third quarter as a whole, true IPO volume totaled $10.3 billion, down 7.9% from the second quarter and down 9.1% compared to 3Q'05. During the first nine months of 2006, IPO volume reached $26.4 billion, 13.8% below the same year-earlier period.





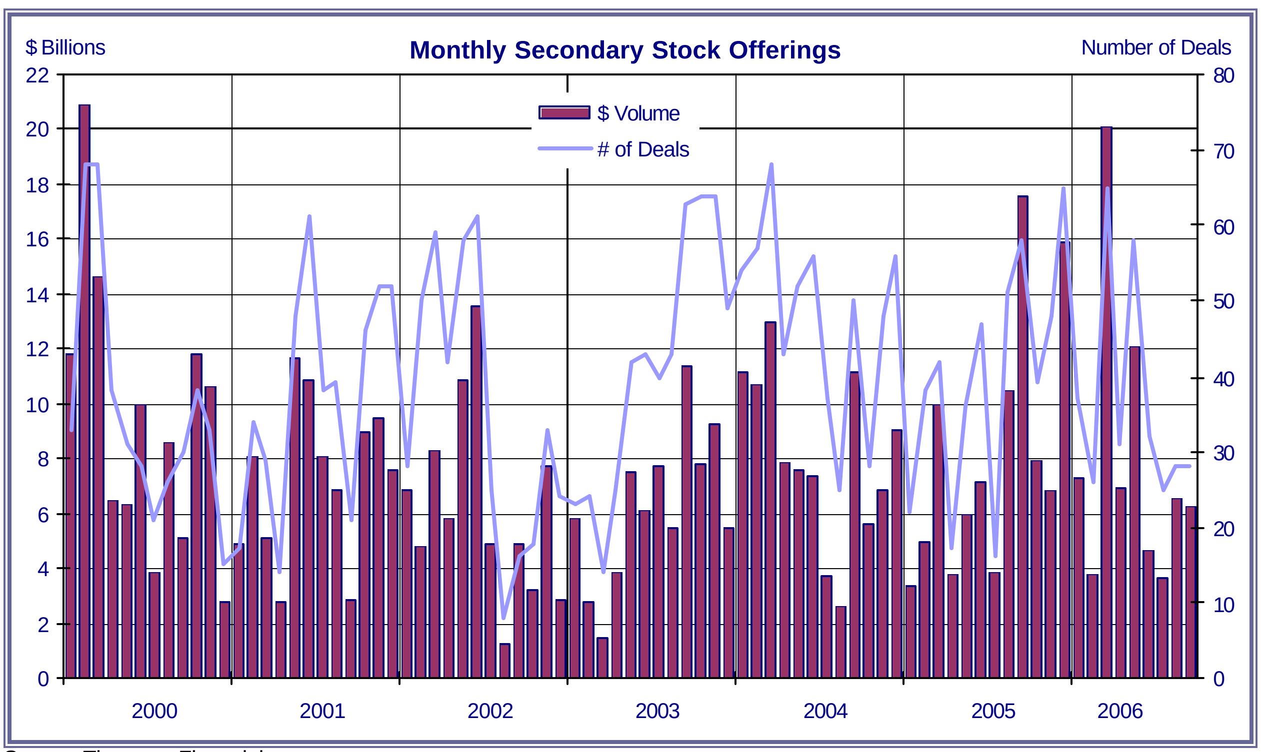
Source: Thomson Financial

IPO Backlog — The backlog of filed US IPOs grew for the sixth consecutive month, reaching $29.2 billion at end-September, up 29.5% from August, on 176 deals.



Source: Thomson Financial

Secondary Offerings of Common Stock – US secondary issuance volume dropped in September to $6.3 billion, down 3.4% from August. Total volume for the third quarter of $20.3 billion was 14.2% below 2Q'06, and down 36.4% from 3Q'05. Year-to-date, secondary offerings totaled $71.3 billion, up 6.1% above the same year-earlier period.



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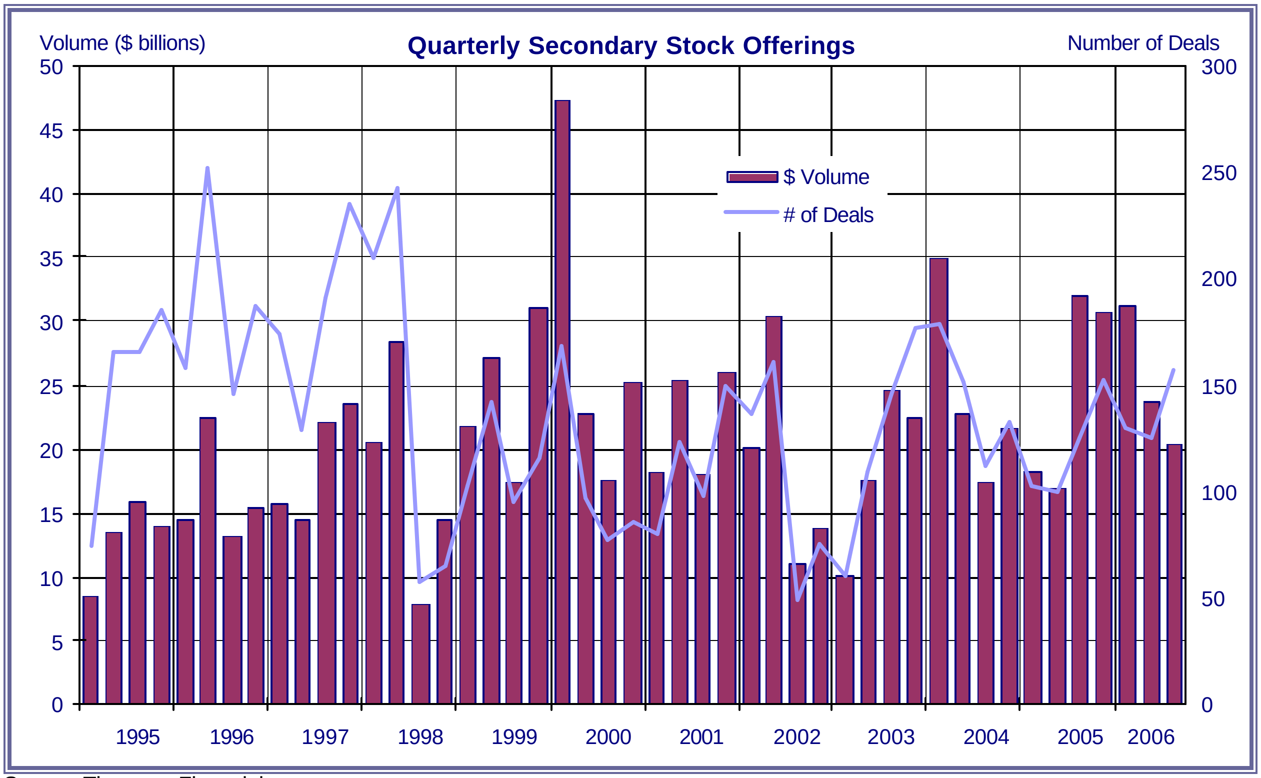
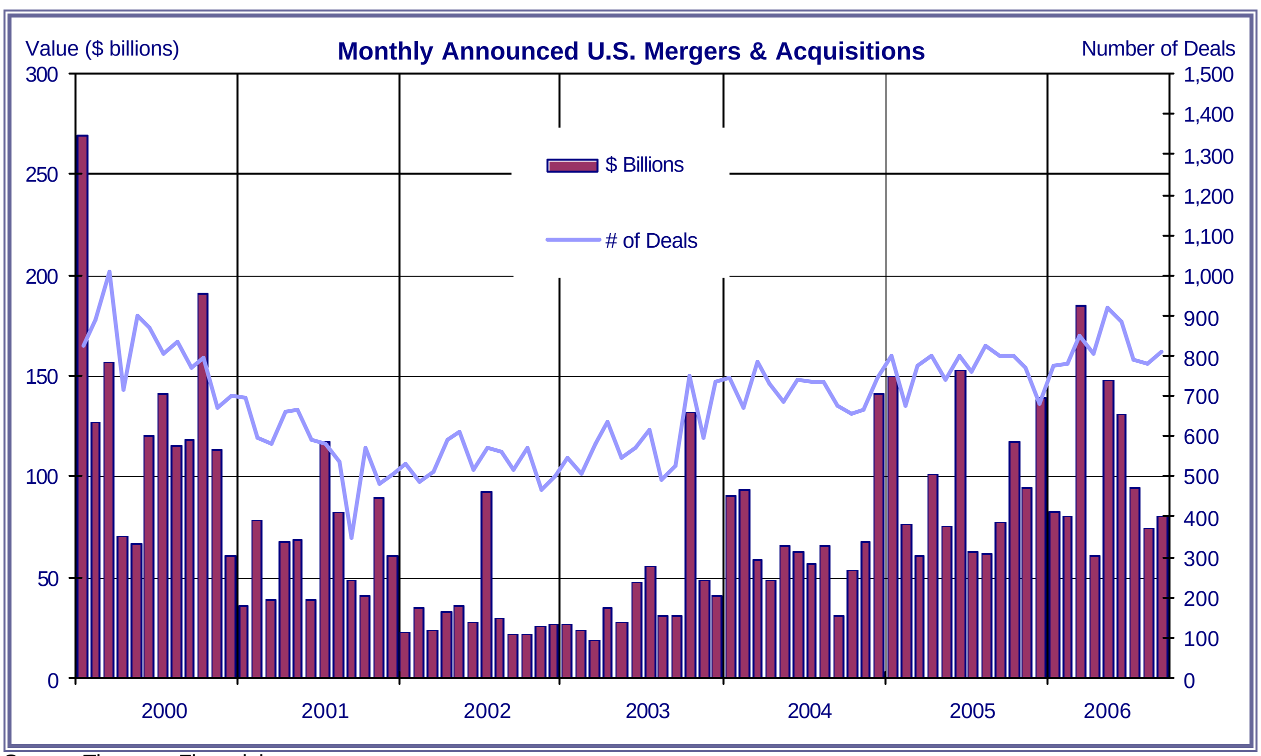
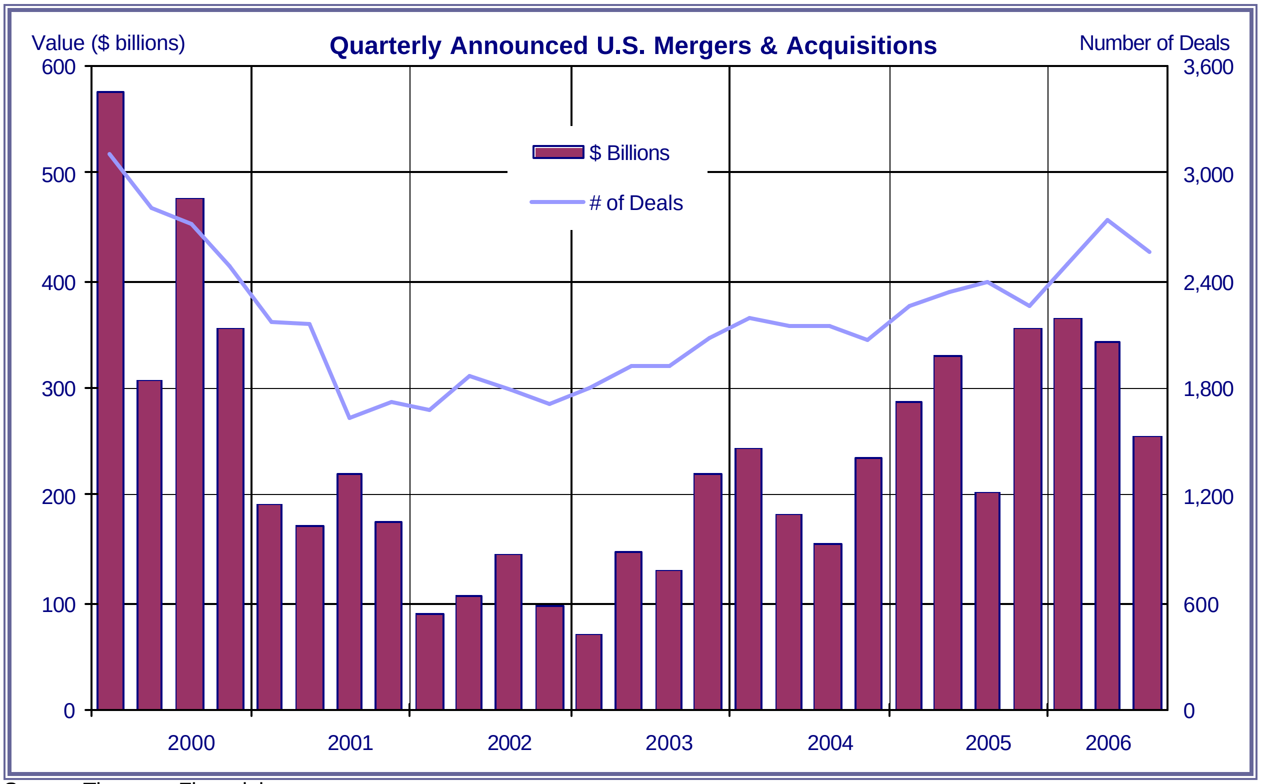


Source: Thomson Financial

Mergers & Acquisition (***M&A***) – US M&A activity increased in terms of deal size in September but declined in the number of deals announced. For the month, 811 deals were announced, which was down 4.2% from August, but September dollar volume was $80.4 billion, up 7.4% from August. Nevertheless, for the third quarter as a whole, announced deal volume fell 25.8% to $254.7 billion. Year-to-date announced deals were up 17.5% above the same year-earlier period, on pace for an excellent full-year result.

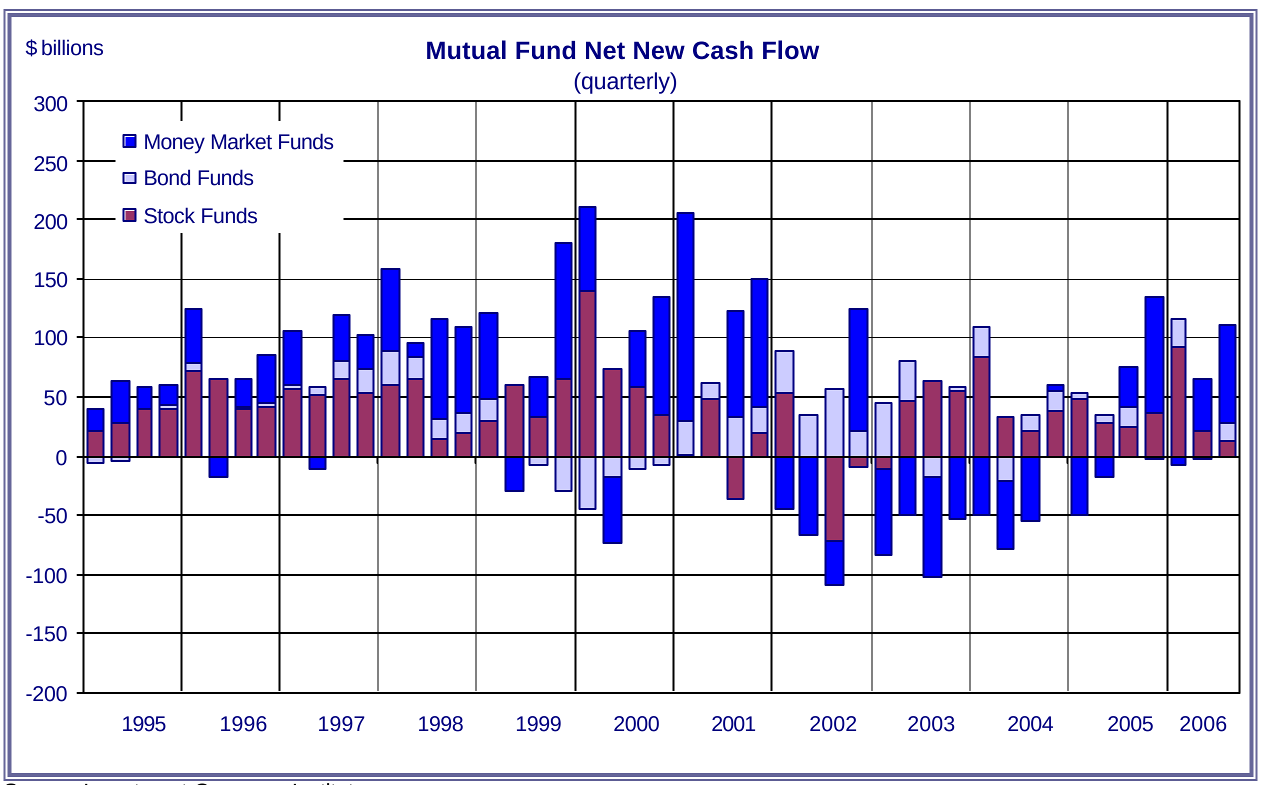


Source: Thomson Financial



Source: Thomson Financial

Mutual Funds – Total mutual fund assets were $9.7 trillion at the end of 3Q'06, up 4.1% from 2Q'06 and 13.2% above the 3Q'05 level. Net new cash flows into mutual funds were strong overall, with only equity funds experiencing an increase less than that of 2Q'06. For the year through September, total net new flows were $283.3 billion, over 130% greater than in the same year-earlier period.



Source: Investment Company Institute

Charles M. Bartlett, Jr.
Vice President and Director, Statistics

U.S. CORPORATE UNDERWRITING ACTIVITY

(In $ Billions)

	Straight Corporate Debt	Con-vertible Debt	Asset-Backed Debt	**TOTAL DEBT**	Common Stock	Preferred Stock	**TOTAL EQUITY**	All IPOs	"True" IPOs	Secondaries	**TOTAL UNDER-WRITINGS**
1985	76.4	7.5	20.8	104.7	24.7	8.6	33.3	8.5	8.4	16.2	138.0
1986	149.8	10.1	67.8	227.7	43.2	13.9	57.1	22.3	18.1	20.9	284.8
1987	117.8	9.9	91.7	219.4	41.5	11.4	52.9	24.0	14.3	17.5	272.3
1988	120.3	3.1	113.8	237.2	29.7	7.6	37.3	23.6	5.7	6.1	274.5
1989	134.1	5.5	135.3	274.9	22.9	7.7	30.6	13.7	6.1	9.2	305.5
1990	107.7	4.7	176.1	288.4	19.2	4.7	23.9	10.1	4.5	9.0	312.3
1991	203.6	7.8	300.0	511.5	56.0	19.9	75.9	25.1	16.4	30.9	587.4
1992	319.8	7.1	427.0	753.8	72.5	29.3	101.8	39.6	24.1	32.9	855.7
1993	448.4	9.3	474.8	932.5	102.4	28.4	130.8	57.4	41.3	45.0	1,063.4
1994	381.2	4.8	253.5	639.5	61.4	15.5	76.9	33.7	28.3	27.7	716.4
1995	466.0	6.9	152.4	625.3	82.0	15.1	97.1	30.2	30.0	51.8	722.4
1996	564.8	9.3	252.9	827.0	115.5	36.5	151.9	50.0	49.9	65.5	979.0
1997	769.8	8.5	385.6	1,163.9	120.2	33.3	153.4	44.2	43.2	75.9	1,317.3
1998	1,142.5	6.3	566.8	1,715.6	115.0	37.8	152.7	43.7	36.6	71.2	1,868.3
1999	1,264.8	16.1	487.1	1,768.0	164.3	27.5	191.7	66.8	64.3	97.5	1,959.8
2000	1,236.2	17.0	393.4	1,646.6	189.1	15.4	204.5	76.1	75.8	112.9	1,851.0
2001	1,511.2	21.6	832.5	2,365.4	128.4	41.3	169.7	40.8	36.0	87.6	2,535.1
2002	1,303.2	8.6	1,115.4	2,427.2	116.4	37.6	154.0	41.2	25.8	75.2	2,581.1
2003	1,370.7	10.6	1,352.3	2,733.6	118.5	37.8	156.3	43.7	15.9	74.8	2,889.9
2004	1,278.4	5.5	1,372.3	2,656.2	169.6	33.2	202.7	72.8	47.9	96.7	2,859.0
2005	1,205.4	6.3	1,808.6	3,020.3	160.5	29.9	190.4	62.6	39.6	97.8	3,210.7
<u>2005</u>											
Jan	145.6	0.2	135.5	281.3	8.2	0.7	8.9	4.9	2.1	3.3	290.2
Feb	80.5	0.0	121.2	201.7	14.8	1.7	16.4	9.8	7.1	5.0	218.2
Mar	116.0	0.5	142.8	259.3	14.4	4.3	18.7	4.4	1.6	10.0	278.0
Apr	62.5	0.8	129.3	192.5	6.0	1.6	7.6	2.2	0.8	3.8	200.2
May	98.9	0.0	162.5	261.4	10.8	2.0	12.8	4.9	3.0	6.0	274.2
June	152.5	2.0	171.4	325.9	14.5	5.5	20.0	7.3	4.7	7.1	345.9
July	90.9	0.0	123.8	214.7	7.8	1.3	9.1	3.9	3.1	3.9	223.8
Aug	97.3	0.0	168.3	265.6	18.8	1.4	20.2	8.3	6.6	10.5	285.8
Sept	112.8	0.0	185.2	298.0	23.4	4.2	27.6	5.8	1.6	17.6	325.7
Oct	75.9	0.0	150.8	226.7	11.4	2.2	13.7	3.5	1.7	7.9	240.4
Nov	88.9	1.6	159.7	250.3	10.8	2.8	13.6	4.0	3.7	6.8	263.9
Dec	83.5	1.2	158.0	242.8	19.5	2.2	21.7	3.6	3.6	15.9	264.5
<u>2006</u>											
Jan	139.8	1.6	101.8	243.3	9.6	1.6	11.2	2.3	2.2	7.3	254.5
Feb	107.4	0.0	161.0	268.3	8.8	0.2	9.0	5.0	4.6	3.8	277.4
Mar	163.0	1.0	164.8	328.7	22.4	3.7	26.1	2.3	2.0	20.1	354.8
Apr	84.6	0.4	121.7	206.7	10.9	2.6	13.5	4.0	2.6	7.0	220.2
May	124.2	1.7	150.0	275.9	17.7	3.3	21.0	5.7	5.7	12.1	296.9
June	150.8	1.1	194.8	346.6	7.9	4.8	12.6	3.3	2.9	4.6	359.3
July	76.3	0.9	99.7	176.9	6.4	2.7	9.2	2.8	1.7	3.6	186.1
Aug	99.6	0.9	129.1	229.7	8.8	1.5	10.3	2.3	1.8	6.5	240.0
Sept	132.5	0.1	165.4	298.0	10.6	5.6	16.2	4.3	3.0	6.3	314.2
Oct											
Nov											
Dec											
YTD '05	957.0	3.5	1,340.1	2,300.6	118.8	22.6	141.4	51.6	30.7	67.2	2,441.9
YTD '06	1,078.3	7.7	1,288.3	2,374.2	103.1	26.1	129.1	31.8	26.4	71.3	2,503.3
% Change	12.7%	119.1%	-3.9%	3.2%	-13.2%	15.3%	-8.6%	-38.4%	-13.8%	6.1%	2.5%

Note: IPOs and secondaries are subsets of common stock. “True” IPOs exclude closed-end funds.
Source: Thomson Financial

MUNICIPAL BOND UNDERWRITINGS

(In $ Billions)

INTEREST RATES

(Averages)

	Compet. Rev. Bonds	Nego. Rev. Bonds	**TOTAL REVENUE BONDS**	Compet. G.O.s	Nego. G.O.s	**TOTAL G.O.s**	**TOTAL MUNICIPAL BONDS**	3-Mo. T-Bills	10-Year Treasuries	SPREAD
1985	10.2	150.8	161.0	17.6	22.8	40.4	201.4	7.47	10.62	3.15
1986	10.0	92.6	102.6	23.1	22.6	45.7	148.3	5.97	7.68	1.71
1987	7.1	64.4	71.5	16.3	14.2	30.5	102.0	5.78	8.39	2.61
1988	7.6	78.1	85.7	19.2	12.7	31.9	117.6	6.67	8.85	2.18
1989	9.2	75.8	85.0	20.7	17.2	37.9	122.9	8.11	8.49	0.38
1990	7.6	78.4	86.0	22.7	17.5	40.2	126.2	7.50	8.55	1.05
1991	11.0	102.1	113.1	29.8	28.1	57.9	171.0	5.38	7.86	2.48
1992	12.5	139.0	151.6	32.5	49.0	81.5	233.1	3.43	7.01	3.58
1993	20.0	175.6	195.6	35.6	56.7	92.4	287.9	3.00	5.87	2.87
1994	15.0	89.2	104.2	34.5	23.2	57.7	161.9	4.25	7.09	2.84
1995	13.5	81.7	95.2	27.6	32.2	59.8	155.0	5.49	6.57	1.08
1996	15.6	100.1	115.7	31.3	33.2	64.5	180.2	5.01	6.44	1.43
1997	12.3	130.2	142.6	35.5	36.5	72.0	214.6	5.06	6.35	1.29
1998	21.4	165.6	187.0	43.7	49.0	92.8	279.8	4.78	5.26	0.48
1999	14.3	134.9	149.2	38.5	31.3	69.8	219.0	4.64	5.65	1.01
2000	13.6	116.2	129.7	35.0	29.3	64.3	194.0	5.82	6.03	0.21
2001	17.6	164.2	181.8	45.5	56.3	101.8	283.5	3.39	5.02	1.63
2002	19.5	210.5	230.0	52.3	73.1	125.4	355.4	1.60	4.61	3.01
2003	21.1	215.8	236.9	54.7	87.7	142.4	379.3	1.01	4.02	3.00
2004	17.2	209.8	227.1	51.5	77.7	129.2	356.3	1.37	4.27	2.90
2005	20.5	240.9	261.4	55.9	89.1	145.0	406.4	3.15	4.29	1.15
<u>2005</u>										
Jan	1.0	11.7	12.7	3.6	6.6	10.2	22.8	2.33	4.22	1.89
Feb	1.5	15.6	17.1	4.5	9.2	13.6	30.7	2.54	4.17	1.63
Mar	1.2	24.1	25.3	7.2	12.5	19.7	45.0	2.74	4.50	1.76
Apr	1.9	16.4	18.2	5.1	7.9	13.0	31.3	2.76	4.34	1.58
May	1.3	20.8	22.1	4.1	9.5	13.6	35.7	2.84	4.14	1.30
June	2.4	25.2	27.6	7.1	9.4	16.5	44.1	2.97	4.00	1.03
July	1.5	21.8	23.3	3.8	6.8	10.5	33.8	3.22	4.18	0.96
Aug	1.3	21.7	23.0	4.3	6.8	11.1	34.1	3.44	4.26	0.82
Sept	2.5	17.2	19.7	4.9	6.7	11.7	31.4	3.42	4.20	0.78
Oct	2.9	18.8	21.7	2.4	3.4	5.8	27.4	3.71	4.46	0.75
Nov	2.3	26.1	28.4	5.1	5.1	10.3	38.7	3.88	4.54	0.66
Dec	0.8	21.5	22.3	3.8	5.2	9.0	31.3	3.89	4.47	0.58
<u>2006</u>										
Jan	0.7	10.6	11.3	3.4	3.9	7.4	18.7	4.24	4.42	0.18
Feb	1.6	12.2	13.8	3.2	5.9	9.1	22.9	4.43	4.57	0.14
Mar	1.1	16.2	17.3	4.2	5.4	9.6	26.9	4.51	4.72	0.21
Apr	2.2	19.9	22.0	2.8	4.2	6.9	29.0	4.60	4.99	0.39
May	2.6	22.2	24.7	3.9	5.6	9.5	34.3	4.72	5.11	0.39
June	2.8	30.1	32.8	4.7	7.4	12.1	44.9	4.79	5.11	0.32
July	1.1	19.7	20.8	4.0	2.9	6.8	27.6	4.95	5.09	0.14
Aug	1.2	19.3	20.5	3.2	7.7	10.9	31.4	4.96	4.88	-0.08
Sept	1.9	15.5	17.5	5.2	4.2	9.4	26.9	4.81	4.72	-0.09
Oct										
Nov										
Dec										
YTD '05	14.5	174.6	189.1	44.6	75.4	120.0	309.0	2.92	4.22	1.31
YTD '06	15.2	165.6	180.8	34.7	47.2	81.8	262.7	4.67	4.85	0.18
% Change	4.9%	-5.1%	-4.4%	-22.3%	-37.4%	-31.8%	-15.0%	60.0%	14.7%	-86.4%

Sources: Thomson Financial; Federal Reserve

	STOCK MARKET PERFORMANCE INDICES (End of Period)				STOCK MARKET VOLUME (Daily Avg., Mils. of Shs.)			VALUE TRADED (Daily Avg., $ Bils.)	
	Dow Jones Industrial Average	S&P 500	NYSE Composite	NASDAQ Composite	NYSE	AMEX	NASDAQ	NYSE	NASDAQ
1985	1,546.67	211.28	1,285.66	324.93	109.2	8.3	82.1	3.9	0.9
1986	1,895.95	242.17	1,465.31	348.83	141.0	11.8	113.6	5.4	1.5
1987	1,938.83	247.08	1,461.61	330.47	188.9	13.9	149.8	7.4	2.0
1988	2,168.57	277.72	1,652.25	381.38	161.5	9.9	122.8	5.4	1.4
1989	2,753.20	353.40	2,062.30	454.82	165.5	12.4	133.1	6.1	1.7
1990	2,633.66	330.22	1,908.45	373.84	156.8	13.2	131.9	5.2	1.8
1991	3,168.83	417.09	2,426.04	586.34	178.9	13.3	163.3	6.0	2.7
1992	3,301.11	435.71	2,539.92	676.95	202.3	14.2	190.8	6.9	3.5
1993	3,754.09	466.45	2,739.44	776.80	264.5	18.1	263.0	9.0	5.3
1994	3,834.44	459.27	2,653.37	751.96	291.4	17.9	295.1	9.7	5.8
1995	5,117.12	615.93	3,484.15	1,052.13	346.1	20.1	401.4	12.2	9.5
1996	6,448.27	740.74	4,148.07	1,291.03	412.0	22.1	543.7	16.0	13.0
1997	7,908.25	970.43	5,405.19	1,570.35	526.9	24.4	647.8	22.8	17.7
1998	9,181.43	1,229.23	6,299.93	2,192.69	673.6	28.9	801.7	29.0	22.9
1999	11,497.12	1,469.25	6,876.10	4,069.31	808.9	32.7	1,081.8	35.5	43.7
2000	10,786.85	1,320.28	6,945.57	2,470.52	1,041.6	52.9	1,757.0	43.9	80.9
2001	10,021.50	1,148.08	6,236.39	1,950.40	1,240.0	65.8	1,900.1	42.3	44.1
2002	8,341.63	879.82	5,000.00	1,335.51	1,441.0	63.7	1,752.8	40.9	28.8
2003	10,453.92	1,111.92	6,440.30	2,003.37	1,398.4	67.1	1,685.5	38.5	28.0
2004	10,783.01	1,211.92	7,250.06	2,175.44	1,456.7	66.0	1,801.3	46.1	34.6
2005	10,717.50	1,248.29	7,753.95	2,205.32	1,602.2	63.5	1,778.5	56.1	39.5
<u>2005</u>									
Jan	10,489.94	1,181.27	7,089.83	2,062.41	1,618.4	62.5	2,172.3	54.1	45.5
Feb	10,766.23	1,203.60	7,321.23	2,051.72	1,578.2	62.7	1,950.2	54.5	43.2
Mar	10,503.76	1,180.59	7,167.53	1,999.23	1,682.6	66.7	1,849.0	59.1	38.8
Apr	10,192.51	1,156.85	7,008.32	1,921.65	1,692.8	61.7	1,839.2	58.8	39.6
May	10,467.48	1,191.50	7,134.33	2,068.22	1,502.1	52.9	1,685.6	50.8	36.6
June	10,274.97	1,191.33	7,217.78	2,056.96	1,515.8	58.0	1,747.9	52.5	39.4
July	10,640.91	1,234.18	7,476.66	2,184.83	1,478.9	58.8	1,621.8	53.1	37.8
Aug	10,481.60	1,220.33	7,496.09	2,152.09	1,441.4	61.9	1,538.9	51.3	34.1
Sept	10,568.70	1,228.81	7,632.98	2,151.69	1,683.0	70.5	1,716.5	60.6	37.5
Oct	10,440.07	1,207.01	7,433.12	2,120.30	1,846.7	72.7	1,796.3	64.6	41.7
Nov	10,805.87	1,249.48	7,645.28	2,232.82	1,641.7	64.6	1,768.3	58.3	41.9
Dec	10,717.50	1,248.29	7,753.95	2,205.32	1,553.5	69.6	1,704.4	55.2	39.6
<u>2006</u>									
Jan	10,864.86	1,280.08	8,106.55	2,305.82	1,956.9	81.4	2,170.7	72.4	55.0
Feb	10,993.41	1,280.66	8,060.61	2,281.39	1,815.2	77.4	2,014.0	68.8	48.8
Mar	11,109.32	1,294.83	8,233.20	2,339.79	1,740.3	75.0	2,135.2	65.2	47.6
Apr	11,367.14	1,310.61	8,471.43	2,322.57	1,775.5	92.0	2,138.7	69.0	49.3
May	11,168.31	1,270.09	8,189.11	2,178.88	1,986.9	92.5	2,163.6	77.3	49.6
June	11,150.22	1,270.20	8,169.07	2,172.09	2,006.2	82.3	2,087.4	73.5	45.6
July	11,185.68	1,276.66	8,242.12	2,091.47	1,797.6	60.1	1,894.6	65.3	42.2
Aug	11,381.15	1,303.82	8,388.56	2,183.75	1,614.2	50.9	1,710.3	57.4	36.9
Sept	11,679.07	1,335.85	8,469.65	2,258.43	1,787.3	55.2	1,942.0	65.8	44.3
Oct									
Nov									
Dec									
YTD '05	10,568.70	1,228.81	7,632.98	2,151.69	1,576.1	61.7	1,785.9	55.0	39.1
YTD '06	11,679.07	1,335.85	8,469.65	2,258.43	1,830.1	73.9	2,026.6	68.2	46.4
% Change	10.5%	8.7%	11.0%	5.0%	16.1%	19.7%	13.5%	24.1%	18.9%

	MUTUAL FUND ASSETS ($ Billions)					MUTUAL FUND NET NEW CASH FLOW* ($ Billions)					
	Equity	Hybrid	Bond	Money Market	**TOTAL ASSETS**	Equity	Hybrid	Bond	Money Market	**TOTAL**	Total Long-Term Funds
1985	116.9	12.0	122.6	243.8	495.4	8.5	1.9	63.2	-5.4	68.2	73.6
1986	161.4	18.8	243.3	292.2	715.7	21.7	5.6	102.6	33.9	163.8	129.9
1987	180.5	24.2	248.4	316.1	769.2	19.0	4.0	6.8	10.2	40.0	29.8
1988	194.7	21.1	255.7	338.0	809.4	-16.1	-2.5	-4.5	0.1	-23.0	-23.1
1989	248.8	31.8	271.9	428.1	980.7	5.8	4.2	-1.2	64.1	72.8	8.8
1990	239.5	36.1	291.3	498.3	1,065.2	12.8	2.2	6.2	23.2	44.4	21.2
1991	404.7	52.2	393.8	542.5	1,393.2	39.4	8.0	58.9	5.5	111.8	106.3
1992	514.1	78.0	504.2	546.2	1,642.5	78.9	21.8	71.0	-16.3	155.4	171.7
1993	740.7	144.5	619.5	565.3	2,070.0	129.4	39.4	73.3	-14.1	228.0	242.1
1994	852.8	164.5	527.1	611.0	2,155.4	118.9	20.9	-64.6	8.8	84.1	75.2
1995	1,249.1	210.5	598.9	753.0	2,811.5	127.6	5.3	-10.5	89.4	211.8	122.4
1996	1,726.1	252.9	645.4	901.8	3,526.3	216.9	12.3	2.8	89.4	321.3	232.0
1997	2,368.0	317.1	724.2	1,058.9	4,468.2	227.1	16.5	28.4	102.1	374.1	272.0
1998	2,978.2	364.7	830.6	1,351.7	5,525.2	157.0	10.2	74.6	235.3	477.1	241.8
1999	4,041.9	383.2	808.1	1,613.1	6,846.3	187.7	-12.4	-5.5	193.6	363.4	169.8
2000	3,962.0	346.3	811.1	1,845.2	6,964.7	309.4	-30.7	-49.8	159.6	388.6	228.9
2001	3,418.2	346.3	925.1	2,285.3	6,975.0	31.9	9.5	87.7	375.6	504.8	129.2
2002	2,667.0	327.4	1,124.9	2,272.0	6,391.3	-27.7	8.6	140.3	-46.7	74.5	121.2
2003	3,684.8	436.7	1,240.9	2,051.7	7,414.1	152.3	32.6	31.0	-258.5	-42.6	215.8
2004	4,384.0	519.3	1,290.4	1,913.2	8,106.9	177.9	42.7	-10.8	-156.6	53.2	209.8
2005	4,940.0	567.3	1,357.4	2,040.5	8,905.2	135.5	25.2	31.3	63.1	255.2	192.0
2005											
Jan	4,288.7	515.7	1,302.6	1,892.5	7,999.5	10.1	5.0	4.7	-27.5	-7.8	19.7
Feb	4,416.3	528.9	1,305.3	1,875.4	8,125.8	22.1	4.4	2.6	-19.3	9.8	29.1
Mar	4,349.6	525.4	1,295.7	1,875.7	8,046.4	15.3	3.9	-1.3	-2.2	15.7	17.9
Apr	4,246.8	522.6	1,306.8	1,841.3	7,917.6	8.5	2.6	1.2	-36.7	-24.4	12.3
May	4,407.3	534.7	1,323.4	1,858.4	8,123.7	11.8	2.2	4.0	14.5	32.5	18.0
June	4,472.1	543.9	1,336.4	1,865.4	8,217.7	6.3	2.0	4.1	3.0	15.4	12.4
July	4,670.3	554.6	1,339.4	1,883.9	8,448.3	9.9	1.4	7.4	13.9	32.5	18.6
Aug	4,678.6	557.5	1,360.6	1,922.9	8,519.7	6.4	1.8	7.4	32.5	48.0	15.5
Sept	4,759.5	560.8	1,356.3	1,912.6	8,589.2	7.8	1.3	3.8	-13.4	-0.4	13.0
Oct	4,664.3	552.0	1,344.7	1,936.5	8,497.5	6.5	0.9	0.6	21.2	29.2	8.0
Nov	4,863.6	562.7	1,349.2	1,991.1	8,766.6	21.0	0.5	-0.3	30.3	51.5	21.2
Dec	4,940.0	567.3	1,357.4	2,040.5	8,905.2	9.8	-0.8	-2.8	47.0	53.2	6.2
2006											
Jan	5,196.4	581.1	1,375.4	2,040.4	9,193.3	31.6	-0.1	8.3	-4.4	35.3	39.7
Feb	5,198.1	582.5	1,389.3	2,051.0	9,220.9	27.3	0.8	8.7	5.5	42.3	36.8
Mar	5,340.5	588.1	1,384.6	2,048.5	9,361.7	34.4	0.6	5.3	-8.3	32.0	40.2
Apr	5,473.9	596.5	1,389.6	2,027.2	9,487.2	26.3	0.3	0.9	-27.1	0.5	27.6
May	5,262.3	586.1	1,386.3	2,081.9	9,316.6	3.2	-0.2	-2.6	50.8	51.3	0.5
June	5,255.4	585.5	1,387.1	2,108.4	9,336.4	-8.6	-0.5	-0.4	19.8	10.3	-9.5
July	5,237.1	591.5	1,406.5	2,141.8	9,376.9	0.7	-0.1	3.2	25.8	29.7	3.9
Aug	5,361.5	602.8	1,430.9	2,189.5	9,584.7	5.1	0.2	6.6	42.9	54.8	11.9
Sept	5,455.5	613.0	1,443.4	2,210.3	9,722.2	6.5	0.6	4.6	15.5	27.2	11.7
Oct											
Nov											
Dec											
YTD '05	4,759.5	560.8	1,356.3	1,912.6	8,589.2	98.2	24.5	33.8	-35.3	121.3	156.6
YTD '06	5,455.5	613.0	1,443.4	2,210.3	9,722.2	126.4	1.7	34.7	120.4	283.3	162.9
% Change	14.6%	9.3%	6.4%	15.6%	13.2%	28.7%	-92.9%	2.7%	441.5%	133.6%	4.1%

* New sales (excluding reinvested dividends) minus redemptions, combined with net exchanges
Source: Investment Company Institute

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