Risk of Financial Runs – Implications for Financial Stability

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Financial Runs and Financial Stability

- Traditional focus on commercial banks
  - Deposit insurance
  - Additional post-crisis actions – higher capital, stress tests, liquidity rules, resolution plans
- Non-depository institutions also were run on during the crisis
  - MMMFs – Take credit risk with no capital and promise a fixed net asset value
  - SIVs – short-run financing for long-run assets

Broker-Dealers

- Despite broker-dealers’ collateralized borrowing, runs were a significant problem
- Play a critical role in our financial infrastructure
  - Brokers – effect transactions in securities for the account of others
  - Dealers – engage in the business of buying and selling securities for their own account
- Market-makers – ensure markets remain highly liquid and securities transactions can occur effectively and efficiently

Re-examine Capital for Large Broker-Dealers

- Central role in crisis
  - Bear Stearns – Significant disruption
  - Lehman Brothers – Arguably the most disruptive failure of crisis
  - Many other broker-dealers experienced financial difficulties
- Extensive liquidity support
- Too little has changed to avoid a repetition of broker-dealer problems

Broker-Dealers Continued…

- Many large broker-dealers are counterparties to the Federal Reserve when the Fed conducts monetary policy
- Critical to providing market in U.S. Treasury securities – Fed open market operations
- Important market makers in many other securities markets, facilitate well-functioning credit markets more generally

Figure 1
Assets of Large Broker-Dealers

As of December 31, 2006

Broker-Dealer Name	Home Country	Assets Millions of Dollars	Crisis Context
Morgan Stanley & Co. Incorporated	United States	583,405 *	Converted to Bank Holding Company
UBS Securities LLC	Switzerland	575,359	Parent Received Support
Goldman, Sachs & Co. and Subsidiaires	United States	509,251 *	Converted to Bank Holding Company
Lehman Brothers Inc. and Subsidiaries	United States	404,854 *	Filed for Bankruptcy
Citigroup Global Markets Inc. and Subsidiaries	United States	377,951	Parent Received Support
Deutsche Bank Securities Inc.	Germany	317,871	
Credit Suisse Securities (USA) LLC and Subsidiaries	Switzerland	269,834	
Banc of America Securities LLC	United States	251,442	Parent Received Support
Bear, Stearns & Co. Inc. and Subsidiaries	United States	236,191 *	Assisted Merger
Barclays Capital Inc. and Subsidiaries	United Kingdom	236,023	
Total		3,762,181	

*as of November 2006

Source: SEC Focus Report Form X-17A-5 Part III

Primary Dealer Credit Facility

- Established to help stem the financial crisis by providing overnight loans to primary dealers
- Loans were fully collateralized, with “haircuts”
- Interest rate was at the primary credit rate
- Dealer was responsible for the loan beyond the collateral pledged
- Designed to ensure adequate functioning of tri-party repo market
- All loans were paid in full and returns were remitted to the U.S. Treasury

Term Securities Lending Facility

- Allowed primary dealers to lend less-liquid securities to the Fed for one month, for a fee, in return for highly liquid Treasury securities
- Provided liquidity in market when trading was impaired
- Like PDCF, started in March 2008 and ended in February 2010
- No losses, and revenue generated was returned to the U.S. Treasury

Figure 2
Primary Dealer Credit Facility and Term Securities Lending Facility Summary Statistics

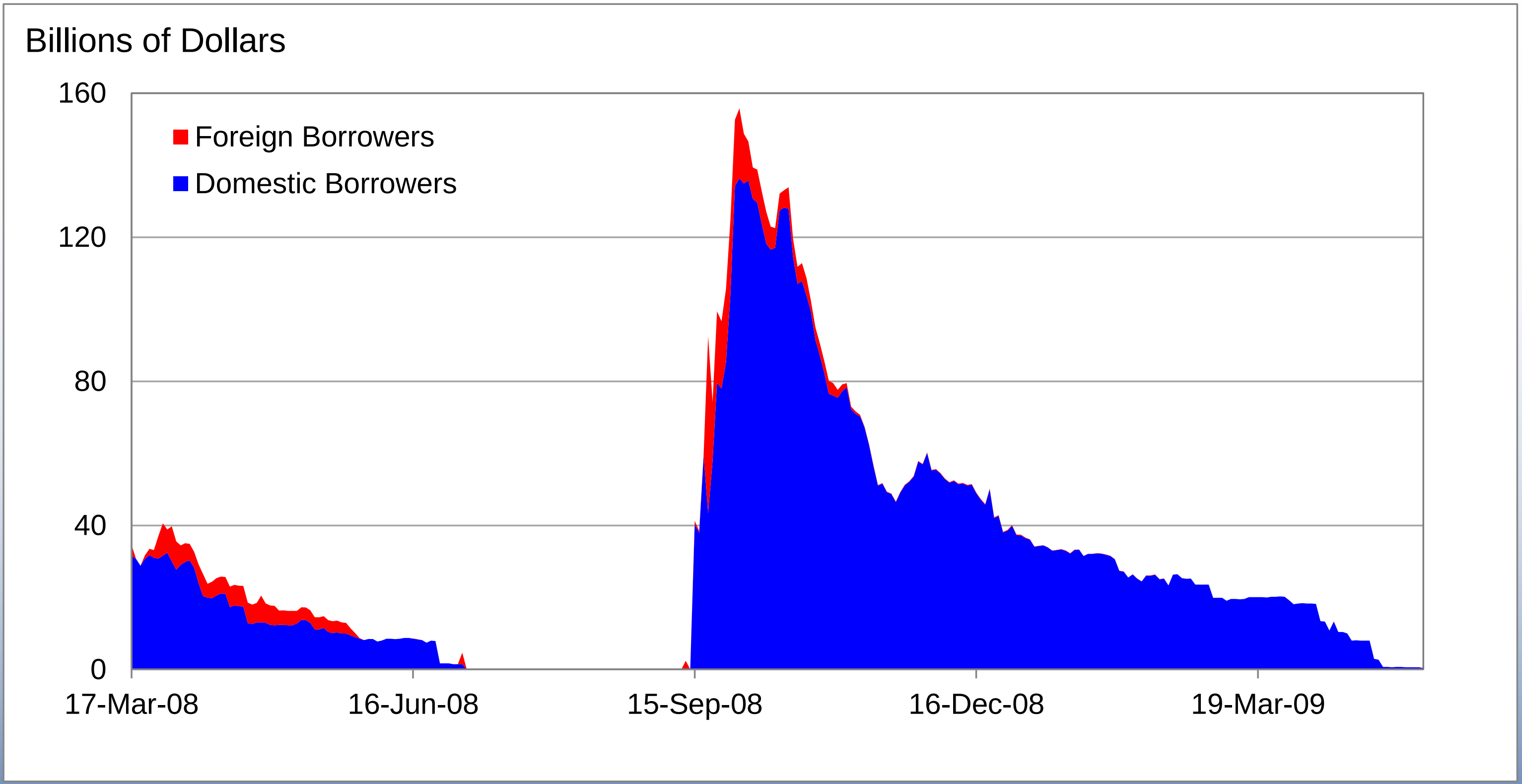
Peak Outstanding Balances (in Millions)						
Facility	Peak	Peak Outstanding Balance	Outstanding Balance of Domestic Borrowers on Peak Date	Share	Outstanding Balance of Foreign Borrowers on Peak Date	Share
Primary Dealer Credit Facility	September 29, 2008	$155,768	$136,325	87.5%	$19,443	12.5%
Term Securities Lending Facility	September 26, 2008	$245,567	$123,507	50.3%	$122,060	49.7%
Totals		$401,335	$259,832	64.7%	$141,503	35.3%

Originations (in Millions)					
Facility	Total Originations	Originations by Domestic Borrowers	Share	Originations by Foreign Borrowers	Share
Primary Dealer Credit Facility	$8,950,992	$8,393,935	93.8%	$557,057	6.2%
Term Securities Lending Facility	$2,005,697	$984,152	49.1%	$1,021,545	50.9%
Totals	$10,956,689	$9,378,087	85.6%	$1,578,602	14.4%

Source: Federal Reserve Board

Figure 3
Primary Dealer Credit Facility Loans Outstanding

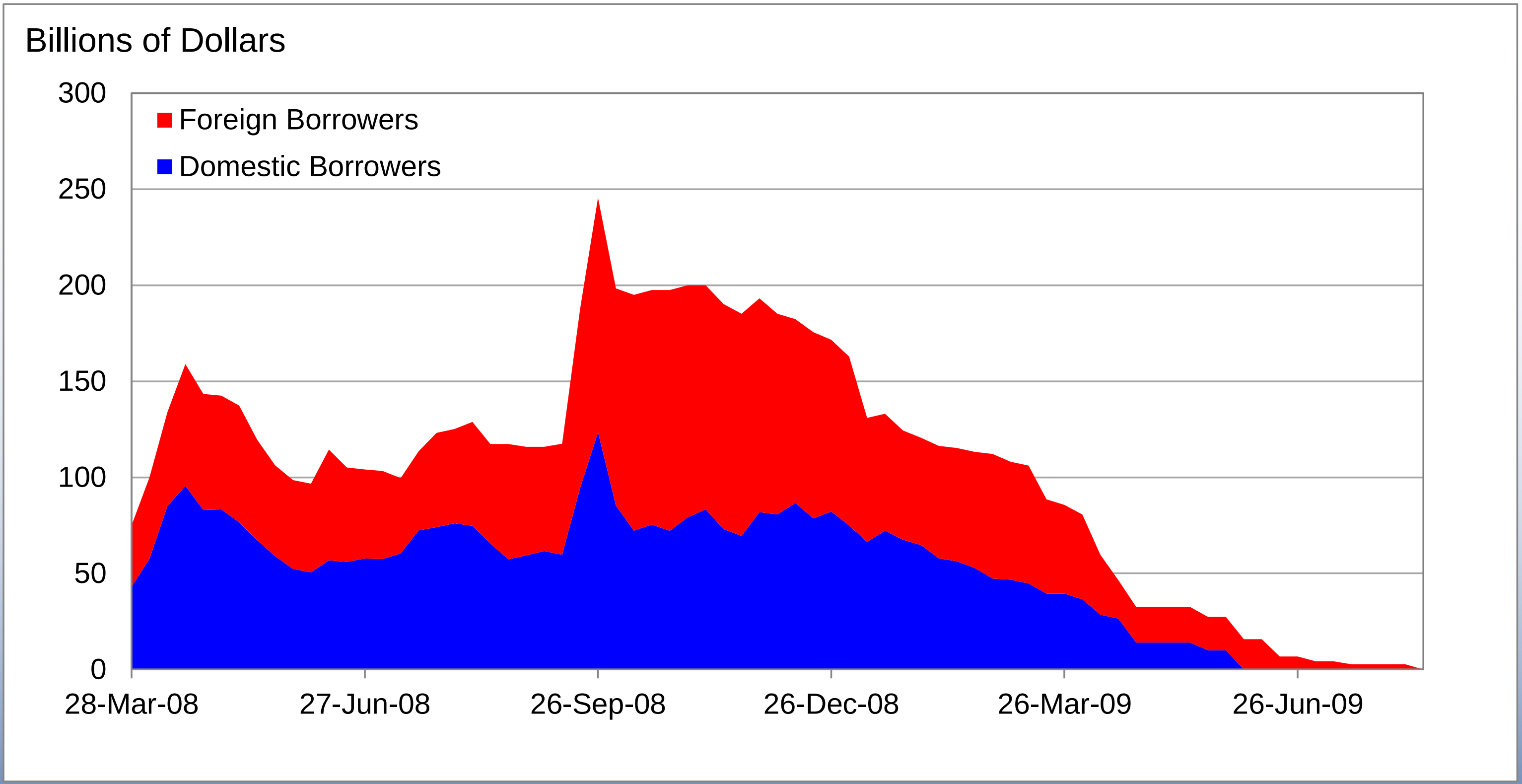
Daily, March 17, 2008 - May 12, 2009



Source: Federal Reserve Board

Figure 4
Term Securities Lending Facility Loans Outstanding

Weekly, March 28, 2008 - August 14, 2009



Source: Federal Reserve Board

Broker-Dealer Regulation by SEC Remains Largely Unchanged

- BHCs with large broker-dealer operations are more sensitive to market volatility
  - Stock price movement
  - Credit default swap (CDS) spreads
- Government liquidity facilities, while critical, created moral hazard
- Actions needed to reduce the need for a government backstop

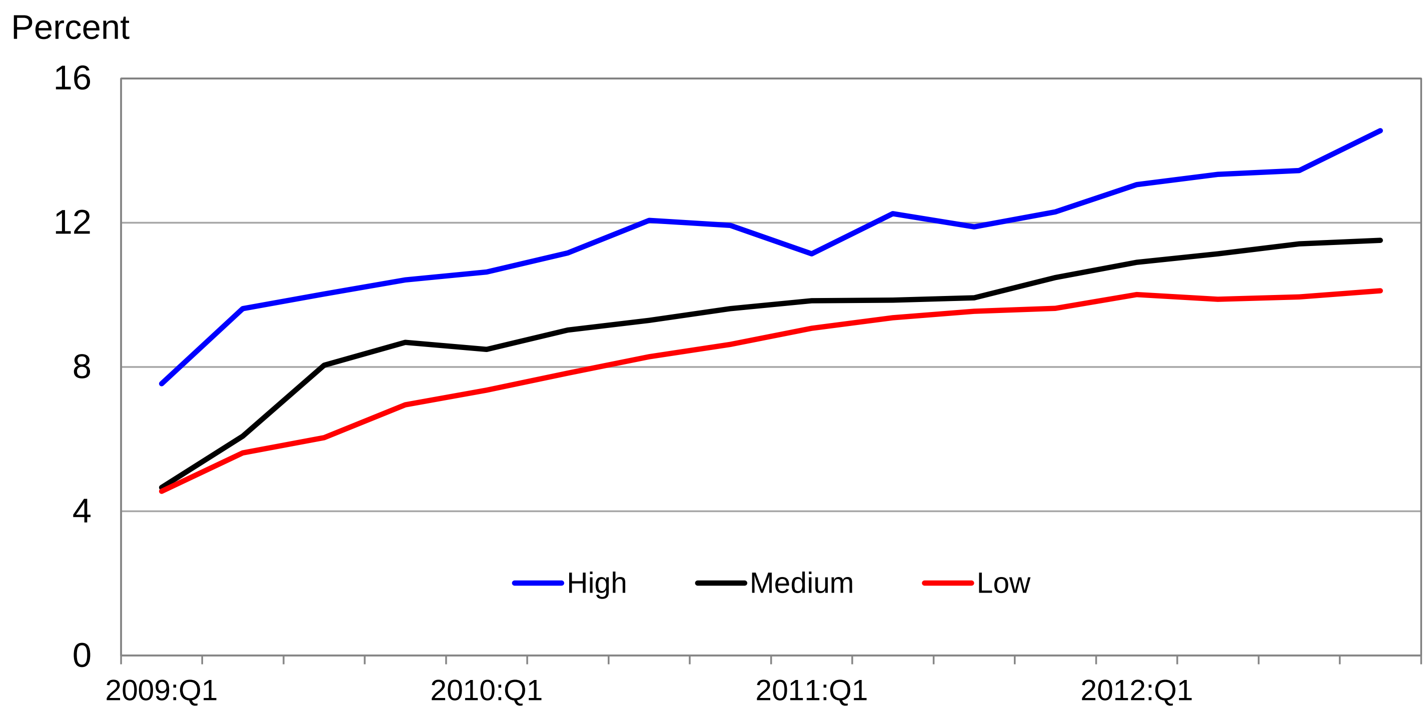
BHCs and Broker-Dealers

- Many large broker-dealers are now in bank holding companies (BHCs)
- Limitations on funding, to protect insured depositories
- Capital should reflect liability structure as well as risks in assets – deposits with FDIC insurance have lower run risk than other liabilities
- BHCs with large broker-dealer should need more, not less, capital

Figure 5

Tier 1 Common Equity Capital Ratio of Large Bank Holding Companies by Broker-Dealer Activity Concentration

2009:Q1 - 2012:Q4

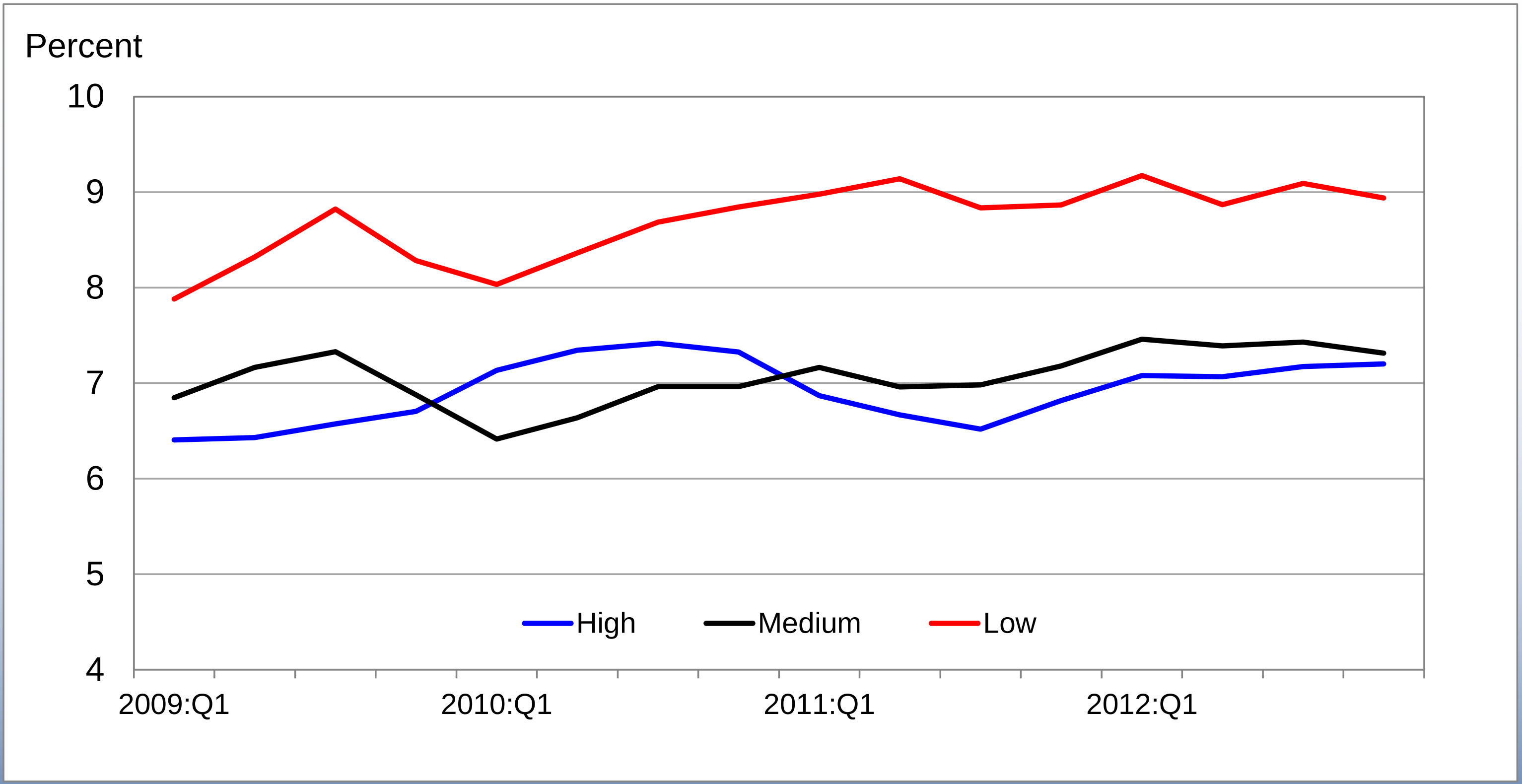


Note: Tier 1 Common Equity Capital Relative to Basel II Risk-Weighted Assets

Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C)

Figure 6
Leverage Ratio of Large Bank Holding Companies by Broker-Dealer Activity Concentration

2009:Q1 - 2012:Q4



Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C)

Concluding Observations

- Broker-dealers did not perform well in the crisis
- Significant government intervention was necessary to maintain market functioning and liquidity
- Little has changed regarding solvency requirements of broker-dealers
- The status quo represents a significant financial stability risk