FEDERAL RESERVE BANK OF BOSTON™

# 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<br>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

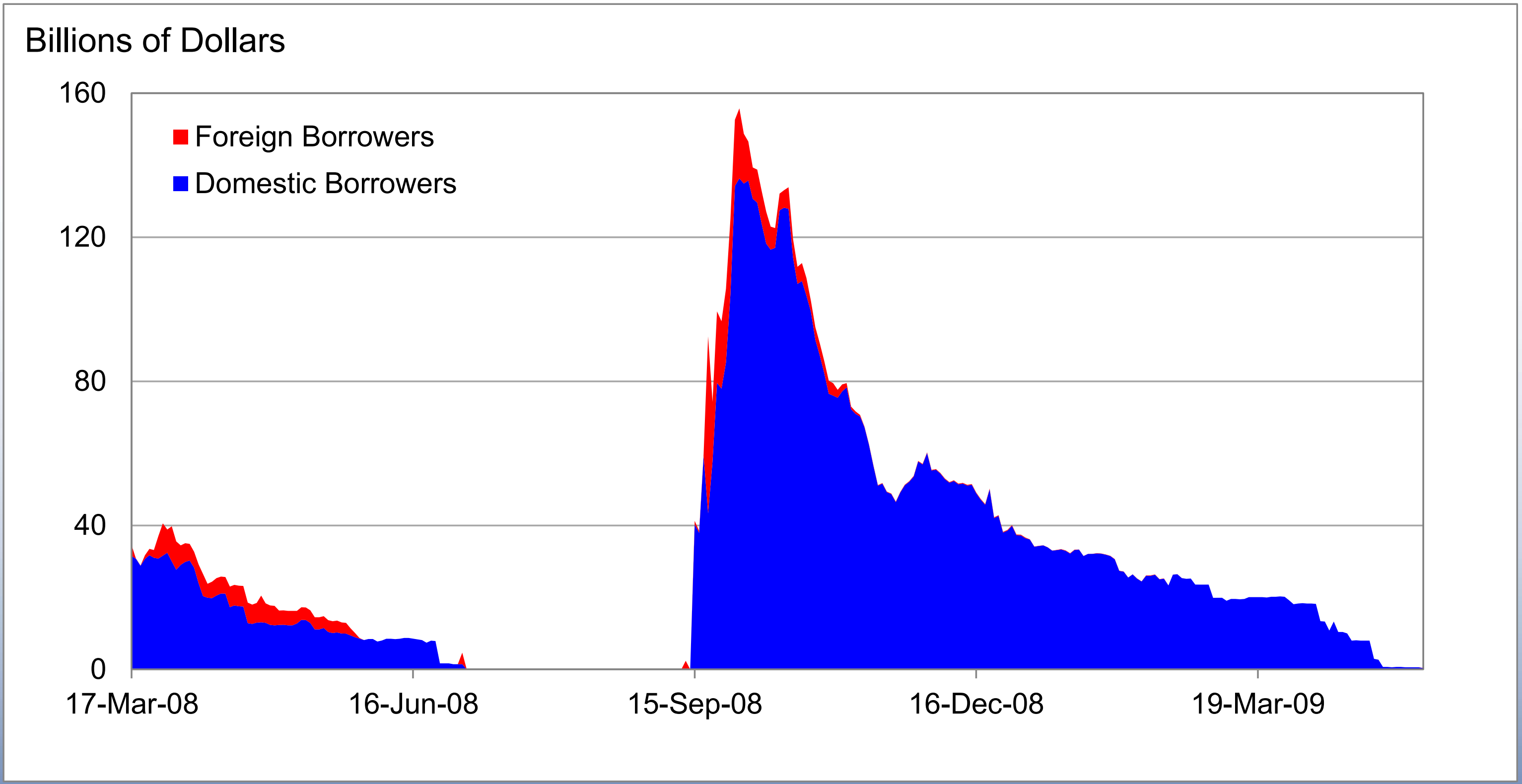
| Peak Outstanding Balances (in Millions) | | | | | | |
|---|---|---|---|---|---|---|
| Facility | Peak | Peak Outstanding Balance | Outstanding Balance of Domestic Borrowers on Peak Date | Share | Outstanding Balance of Foreign Borrowers on Peak Date | Share |
| Primary Dealer Credit Facility | September 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

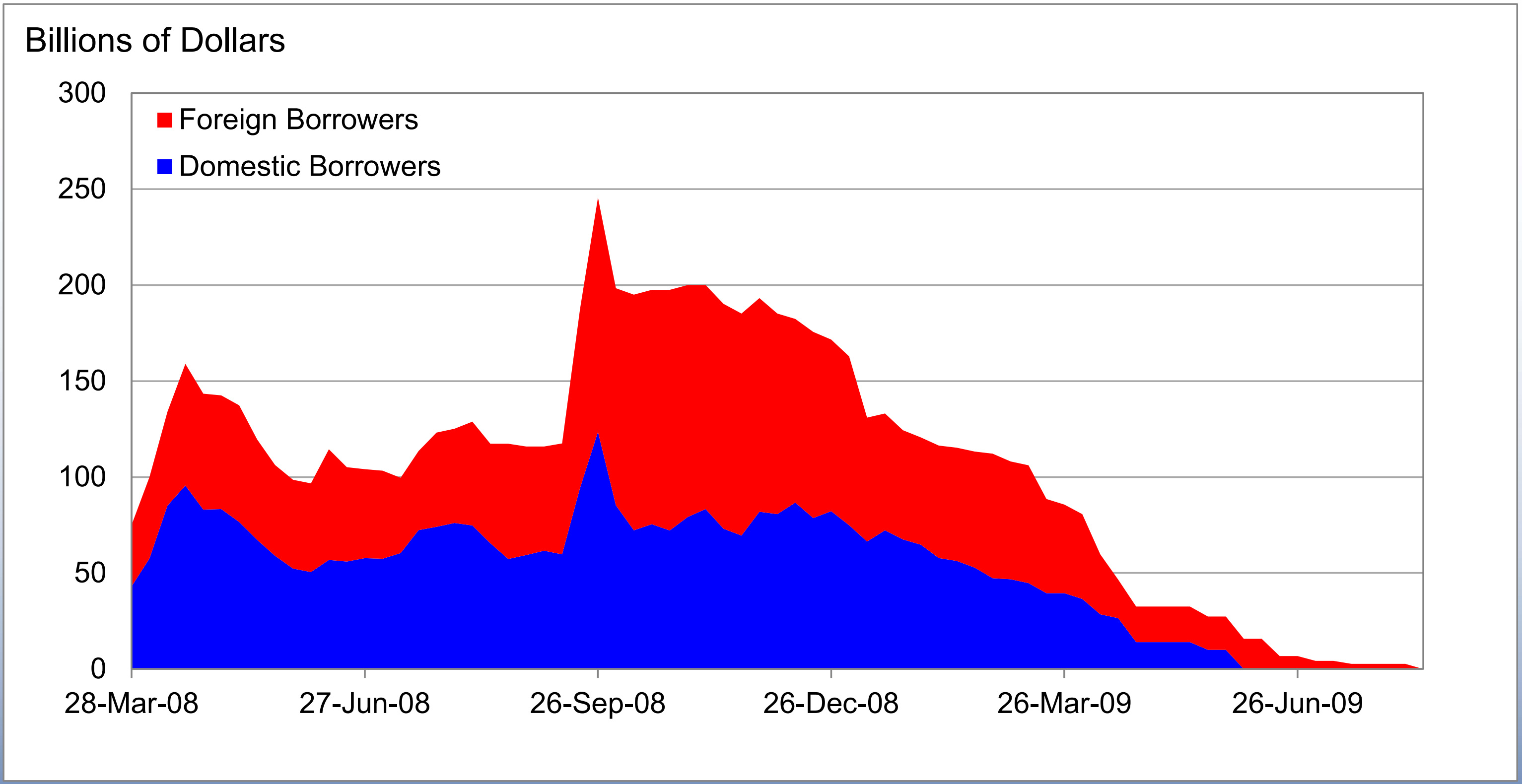
Daily, March 17, 2008 - May 12, 2009




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

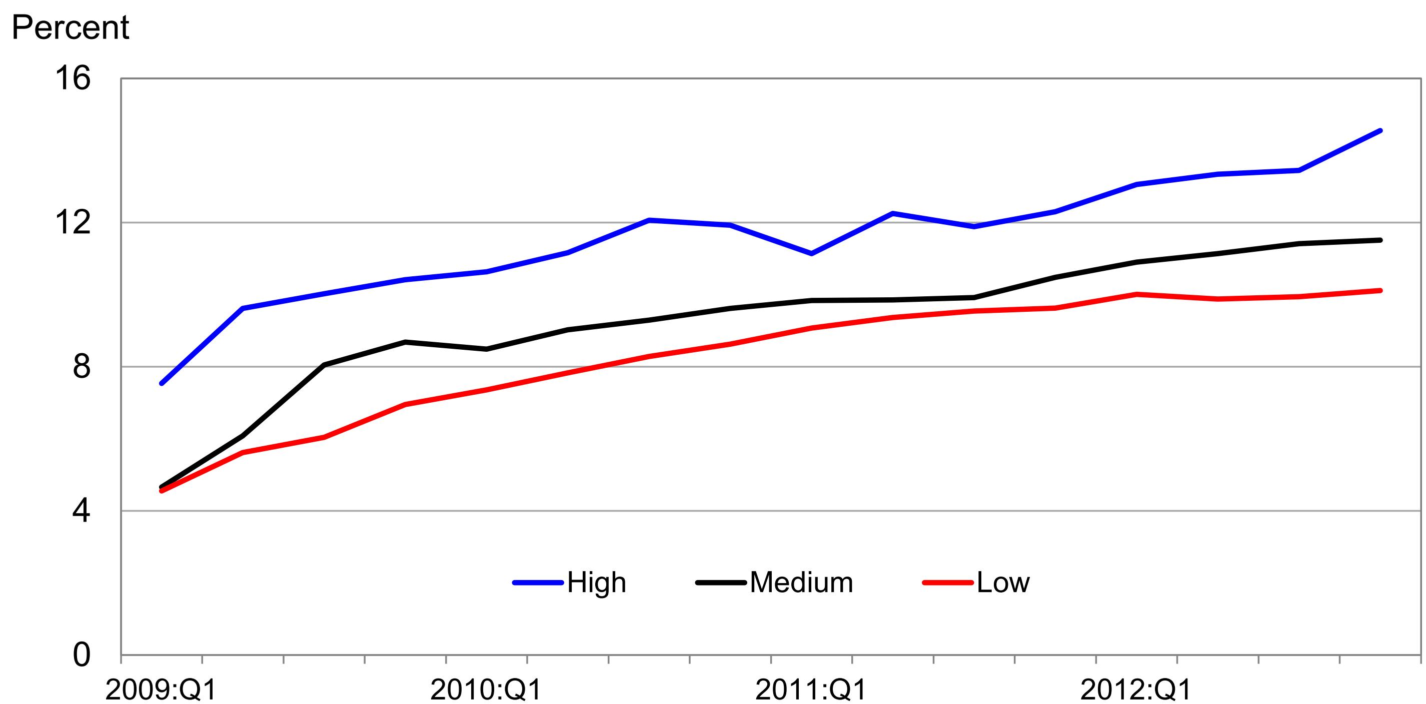
- BHCs with large broker-dealer operations are more sensitive to market volatility
  - Stock price movement
  - Credit default swap (CDS) spreads
- Government liquidity facilities, while critical, created moral hazard
- Actions needed to reduce the need for a government backstop

# 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

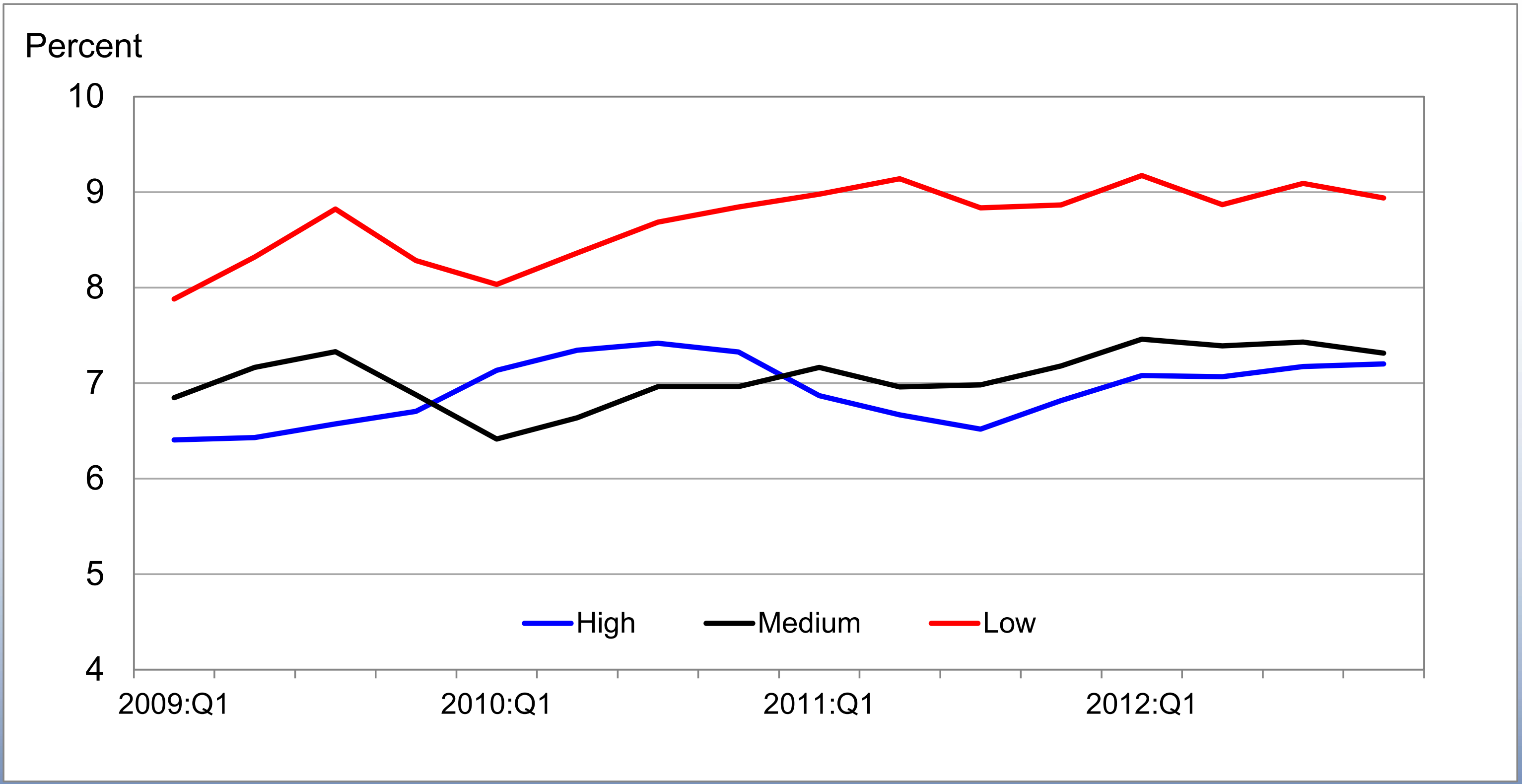



Note: Tier 1 Common Equity Capital Relative to Basel II Risk-Weighted Assets

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