C.F. WHITTELSEY HOLDINGS

Weekly Market Review

August 11, 2014 — August 15, 2014

"Broker-dealers can experience significant funding problems during times of financial stress. Unfortunately that potential for problems has not been fully addressed since the crisis" "I am certainly on record as questioning whether the imposition of withdrawal restrictions and fees will help to stabilize money market mutual funds in crisis situations" - Eric Rosengren—CEO Fed Reserve Bank of Boston

What People are Saying About Broker-Dealers

As you may have heard on the tri-weekly treasury market calls, there has been some discussion around renewed concerns involving broker dealers and their reliance on short term funding facilities. Eric Rosengren and William Dudley of the Boston and NY Federal Reserve spoke last week on the topic.

Broker Dealers are intermediaries that are critical to the financial infrastructure by buying and selling securities. They fund their holdings, often times long duration and potentially risky assets, in the uninsured short term credit markets (specifically Repo agreements which are short term collateralized loans). Repo funding during times of stress is historically fickle which lead the broker-dealers to experience significant funding problems whenever there is a financial crisis or some perception of instability around liquidity or the quality of the underlying asset. They are governed by the SEC and the Fed members point out little has been done to improve the soundness of the funding model of these firms.

In his speech, Rosengren outlined a few ways that broker dealer risks can be mitigated. However, one topic that wasn't touched on was the NY Fed's Full Allotment Reverse Repurchase Facility and the role that could play for the Fed to monitor financial stability risks. While the Fed doesn't have regulatory control over these firms, they can use this facility to lend out securities in exchange for cash collateral. This may give the broker dealer and money market funds the ability to hold cash at the fed directly which may simplify the financial system (see the flowchart). This would also allow the fed to crowd out broker-dealers and force them to fund their portfolios with better funding sources (no doubt this will have earnings consequences as the cost to borrow rises).

Function of the Broker-Dealer as an Intermediary

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- Transform short-term deposits into long term loans
- Transform safe money market holdings into risky investments by money managers
- Transform collateral and risky borrowing into safe holdings by MMFs
- Transform less liquid assets and capital into liquid an readily tradable capital/assets
- Transform market assets into tranches of assets per credit/liquidity risk characteristics

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The graph to the right and quote above is from The Office of Financial Research's white paper "A Map of Funding Durability and Risk". The Below graph is from Rosengren's speech "Broker-Dealer Finance and Financial Stability. "