SPEECH

Introductory Remarks at Workshop on "Fire Sales" as a Driver of Systemic Risk in Tri-Party Repo and Other Secured Funding Markets

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As prepared for delivery

Good morning. I am pleased to have the opportunity to open this workshop and discuss key developments in the tri-party repo market. In my remarks, I would like to give a brief overview of some of the problems that surfaced in this market during the financial crisis of 2008, recognize the improvements that have occurred since then, and most importantly, highlight significant vulnerabilities that still persist despite the progress we have made. While we can feel proud of the enhancements that are currently underway in the tri-party repo market, today I want to underscore the fact that significant work remains to be done.

The tri-party repo market constitutes a vital component of the U.S. financial system. It plays an important role in providing financing for broker-dealers that make markets in Treasury and agency securities, and is an important mechanism that supports dealer intermediation of credit. The market also provides a secure investment vehicle for those that manage large amounts of liquidity and need an investment vehicle to park these monies. We care about the health and stability of the tri-party repo market both because of our interest in promoting stable and liquid financial markets and because we use it to implement monetary policy.

The recent financial crisis showed us that the tri-party repo market was inherently unstable due to deficiencies in the settlement infrastructure.   Prior to 2008, there was limited recognition of the ways in which adverse developments in this market could quickly transmit risk to other parts of the financial system with unforeseen consequences. We now know, with the benefit of hindsight, that the market was overly reliant on massive extensions of intraday credit by the clearing banks to the broker-dealers, that market participants did not adequately appreciate the magnitude of the risk embedded in the role played by the clearing banks, and, as a result, market participants underpriced risk in ways that undermined the market's resiliency during periods of stress.

These vulnerabilities were made apparent in the spring of 2008 when the events surrounding Bear Stearns demonstrated the run risk that existed more broadly in the tri-party repo market, prompting the Federal Reserve to intervene in order to restore confidence and market functioning. This intervention took the form of the creation of a Primary Dealer Credit Facility in March 2008, and a subsequent expansion of the facility in September 2008. The scope and scale of the market disruption were clearly very troublesome.

As many of you are aware, the Federal Reserve Bank of New York published a white paper in May 2010 that highlighted three critical sources of instability associated with practices in the tri-party repo market: (1) the market's excessive reliance on intraday credit from the clearing banks; (2) weaknesses in the liquidity and credit risk management practices of cash lenders and clearing banks that left them vulnerable to stress environments; and (3) the lack of a mechanism or process for liquidating collateral during periods of stress in a manner that did not destabilize other segments of the financial system.

After the crisis, we asked the industry to help develop a plan to reengineer the tri-party repo settlement infrastructure to mitigate these risks. The industry responded by identifying key changes that could be made to the platform to eliminate market reliance on intraday credit, thereby removing a key source of fragility observed in 2008.   This process was challenging at times, and ultimately required our intervention as a supervisor to move forward. But the industry successfully developed a roadmap for reform that is the basis for the changes now being implemented. The clearing banks are making substantial investments to reengineer their tri-party repo settlement processes, while lenders and borrowers are making adjustments to their business practices and technologies to ensure they are ready for changes that are occurring in the market. When completed at the end of next year, we expect that these changes will substantially improve the stability of the market. Indeed, the work completed to date has already reduced the amount of activity being financed on an intraday basis from 100 percent to about 70 percent, and we project that intraday credit usage will decline to no more than 10 percent by the end of next year. By removing the clearing bank from the role of substantial intraday lender, and making tri-party repurchase exposures truly bilateral, we expect that market participants will have better incentives to manage their liquidity and credit risks more prudently.

While these changes represent positive developments that will enhance the stability of the tri-party repo market, an important challenge remains. Current reforms do not address the risk that a dealer's loss of access to tri-party repo funding could precipitate destabilizing asset fire sales, whether by the dealer itself, or by the dealer's creditors following a default. Industry participants have yet to fully embrace the role they must play in finding a solution to this problem. As a result, I would urge industry participants to begin work on this issue without further delay. In fact, this is one of the motivations for convening today's workshop—to start the dialogue.

As several of the speakers will discuss in greater detail today, when fire sales occur they can undermine the stability of other markets beyond the tri-party repo market. The transmission of instability typically occurs as a consequence of increased margin calls and mark-to-market losses that strain firms' liquidity and capital positions and put additional pressure on firms to further deleverage. Such scenarios can have material adverse repercussions on other market segments and market participants.

It is vital that we take steps to address this risk now, during a period when markets are functioning without stress, in order to improve the resiliency of this market before the next crisis occurs. This is especially important in light of the heightened threshold established by the Dodd-Frank Act for future central bank interventions in the event of a market disruption. Even if this constraint did not exist, the experience of the recent financial crisis has served to strengthen our resolve to ensure that the market is structured in a way where risk is accurately priced and resilient to stress on a day-to-day basis, without the need for official sector intervention as a first resort.

As many of you know, the Federal Reserve has been calling for action on this issue over the past two years, and all three Financial Stability Oversight Council annual reports have highlighted this as a significant issue worthy of our attention. However, the diversity of participants in the tri-party repo market has made it difficult to move forward quickly with a market solution that addresses the risk I have outlined. Industry leadership is absolutely critical to overcoming these challenges. If industry is unable to play its role in achieving a holistic solution, regulators may find themselves forced to employ the specific policy tools at their disposal in their respective purviews to address the fire sale risk. While such an approach may indeed enhance the overall stability of this market, it could also lead to unintended consequences that include reducing the efficacy of the critical role played by this market in supporting the broader financial system.

I am glad that you are all here today to work with us to begin to identify the best solutions to the problem of fire sale risk in the context of the tri-party repo market. I urge you to participate actively and express your ideas candidly. I am confident that we will come up with the best solution to this problem by working together.