Report Pursuant to Section 129 of the Emergency Economic Stabilization Act of 2008: Primary Dealer Credit Facility and Other Credit for Broker-Dealers

Overview

On March 16, 2008, the Board of Governors of the Federal Reserve System (Board) by the unanimous vote of its five members approved under section 13(3) of the Federal Reserve Act (12 U.S.C. § 343) the establishment of the Primary Dealer Credit Facility (PDCF) and authorized the Federal Reserve Bank of New York (the Reserve Bank) to lend under that program. The PDCF is an overnight loan facility that provides funding to primary dealers in exchange for collateral eligible for tri-party repurchase agreements with the Reserve Bank and is intended to foster the functioning of financial markets more generally.

On September 21, 2008, the Board by the unanimous vote of its five members authorized the Federal Reserve Bank of New York to extend credit under section 13(3) of the Federal Reserve Act (12 U.S.C. § 343) to the U.S. broker-dealer subsidiaries of Merrill Lynch & Co., Inc. (Merrill Lynch), The Goldman Sachs Group, Inc. (Goldman Sachs), and Morgan Stanley against types of collateral that may be pledged by depository institutions at the Federal Reserve's primary credit facility.

Background and Details on the PDCF

The primary dealers are designated banks and securities broker-dealers with which the Reserve Bank trades U.S. government and select other securities, and are the trading counterparties for the Federal Reserve in its execution of open market operations to carry out U.S. monetary policy.[1] In addition, the primary dealers have a key role in providing liquidity in the market for government securities, which is in turn critical to the implementation of monetary policy.

In early March 2008, strains in financial markets escalated sharply, resulting in the near-failure of Bear Stearns and the acquisition of that company (with Federal Reserve assistance) by JPMorgan Chase & Co. This and other developments demonstrated that there had been impairment of a broad range of financial markets in which primary dealers financed themselves. This impairment

[1] A list of primary dealers can be found at http://www.newyorkfed.org/markets/pridealers_current.html

in turn significantly degraded the ability of the primary dealers to provide financing to participants in securitization markets. The available evidence also indicated that the dealers had difficulty obtaining necessary financing for their operations from alternative sources.

In these circumstances, conditions indicated that lending to the primary dealers by the Federal Reserve was necessary to maintain the orderly function of financial markets. As a result, the Board determined that unusual and exigent circumstances existed and approved the establishment of the PDCF.

In September, financial market strains worsened following the bankruptcy of Lehman Brothers Holdings, Inc., further impairing the ability of broker-dealers to obtain financing. On September 21, the PDCF was expanded to include the London-based broker-dealer subsidiaries of Merrill Lynch, Goldman Sachs, and Morgan Stanley. Separately, the Board approved applications by Goldman Sachs and Morgan Stanley to become bank holding companies. To provide increased liquidity support to these firms as they transitioned to managing their funding within a bank holding company structure, the Board authorized the Reserve Bank to extend credit to the U.S. broker-dealer subsidiaries of these firms against types of collateral that may be pledged by depository institutions at the Federal Reserve's primary credit facility; the Federal Reserve also made this collateral arrangement available to the U.S. broker-dealer subsidiary of Merrill Lynch.

Structure and Basic Terms

Under the PDCF, the Federal Reserve provides collateralized overnight credit to primary dealers (credit is extended to primary dealers through their clearing banks). The PDCF is authorized under section 13(3) of the Federal Reserve Act, which permits the Board, in unusual and exigent circumstances, to authorize Reserve Banks to extend credit to individuals, partnerships, and corporations that are unable to obtain adequate credit accommodations from other banking institutions. PDCF lending commenced on March 17, 2008, and will remain available until January 30, 2009, or longer if conditions warrant.

The following provides an overview of the terms and conditions that govern the PDCF and other lending to broker-dealers. The Board and Reserve Bank continue to monitor the affected financial markets and to consult with market participants and, accordingly, the terms and conditions governing the facility may be modified in the future if appropriate.

Advances. The PDCF and other related loans to broker-dealers are overnight only. The lending rate is equal to the discount window primary credit rate in effect at the Reserve Bank. For the PDCF, dealers communicate their requests for funding to their clearing banks. The clearing bank verifies that a sufficient amount of eligible collateral has been pledged by each borrower and notifies the Reserve Bank accordingly. Once the Reserve Bank receives notice that a sufficient amount of margin-adjusted eligible collateral has been assigned to the Reserve Bank's account, the Reserve Bank transfers the amount of the loan to the clearing bank for credit to the primary dealer.

Frequency-based Fee. Fees are assessed to borrowers who access the PDCF on more than 30 business days out of 120 business days. Additional fees are assessed beginning on the 31st business day.

Collateral Eligibility and Valuation. Primary dealers may secure loans under the PDCF with all collateral eligible for pledge in tri-party funding arrangements through the major clearing banks.[2] The pledged collateral is valued by the clearing banks based on a range of pricing services. Margin requirements are determined by the Reserve Bank.

U.S. broker-dealer subsidiaries of Merrill Lynch, Goldman Sachs, and Morgan Stanley may also borrow against types of collateral that may be pledged by depository institutions at the discount window. This collateral is valued and margined by the Reserve Bank according to the standards used for the discount window.[3]

Amount Outstanding. As of October 29, 2008, the value of PDCF and related credit to broker-dealers was $79.5 billion. The value of the collateral pledged under the PDCF was $85.8 billion.

Expected Costs. The Board does not expect that lending to broker-dealers, including under the PDCF, will result in any losses to the Federal Reserve or the taxpayer. Such loans are made with recourse beyond the pledged collateral to the broker-dealer entity itself. While losses could occur in the event of a broker-dealer

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[2] The range of eligible collateral for the PDCF was expanded to encompass these types of collateral on September 15, 2008. Previously, collateral eligible for pledge included all collateral eligible for pledge in open market operations (Treasury securities, agency securities, and mortgage-backed securities issued or fully guaranteed by federal agencies); plus investment grade corporate securities, municipal securities, mortgage-backed securities and asset-backed securities that were priced by the clearing banks.

[3] Collateral margins for the discount window can be found at http://www.frbdiscountwindow.org/discountmargins.cfm?hdrID=21&dtlID=83

bankruptcy, the risk of loss is mitigated by haircuts on collateral value and daily revaluation of the collateral.