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Introduction

The financial crisis of 2007-09 highlighted the fragility of many financial intermediaries and markets. As asset values declined and funding sources dried up, a significant number of commercial banks, investment banks, and money market mutual funds experienced distress, as did some market-based intermediation arrangements such as asset-backed commercial paper. Borrowing rates and haircuts reached record-high levels and some funding markets completely froze. These difficulties were severe enough to cause several institutions to fail and others to require extraordinary public support.

This special issue of the *Economic Policy Review* examines the stability of different "funding models," or arrangements for financial intermediation. The first of the three featured papers is a review of the economics literature on the stability of financial intermediaries, with a focus on intermediaries' funding models. The paper discusses the standard framework used in the literature to analyze the fragility associated with financial institutions that perform maturity and liquidity transformation and the potential factors that amplify or mitigate such fragility. Furthermore, it reviews developments in the financial sector that may have affected the stability of funding models.

The second paper presents case studies of several major financial markets and intermediaries that experienced significant distress during the crisis. For each case, we provide a discussion of the size and the evolution of the market, the sources of the disruptions, and the policy responses that were implemented to mitigate distress and make markets and intermediaries more liquid. We analyze the markets for auction rate securities, commercial paper, asset-backed commercial paper, and bilateral and tri-party repo, as well as credit commitments by banks, dollar funding of non-U.S. banks, and money market mutual funds. We also consider the fragility associated with wholesale funding, using the run on Northern Rock as our case study.

In reviewing recent events, we find that some markets and intermediaries appear to have been more fragile—that is, less able to withstand shocks to their asset values and funding sources—than others. The third paper develops a simple analytical framework to analyze the factors that affect markets' and intermediaries' ability to survive stress events. A financial intermediary faces two types of risk: the value of its assets may decline, and/or its short-term creditors may decide not to roll over their debt. We measure the stability of the intermediary by looking at what stress events it can survive, that is, what combinations of shocks to the value of its assets and to its funding it can absorb and still remain solvent. We also study how the intermediary's stability depends on balance sheet characteristics such as leverage, the maturity structure of its debt, and the liquidity and riskiness of its asset portfolio. Finally, we employ our framework to analyze current policy issues and recently proposed regulatory changes.

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