The US Tri-party Repo Market Reforms

Susan McLaughlin

Federal Reserve Bank of New York

October 7, 2011

The views expressed here are those of the author, and should not be Interpreted as expressing the views of the Federal Reserve Bank of New York or the Federal Reserve System

The crisis experience

- The tri-party repo market was a locus of stress and a channel of risk transmission during the crisis
- In response, the Federal Reserve intervened to stabilize the market, establishing the primary dealer credit facility (PDCF) as a liquidity backstop to promote investor confidence and mitigate run risk
  - March 16, 2008 – backstop established for all investment grade fixed income assets financed in tri-party
  - September 14, 2008 – expanded to all assets funded in tri-party, including equities and noninvestment grade fixed income
  - September 21, 2008 – expanded to the tri-party repo operations of London broker-dealer subs of Morgan Stanley, Goldman Sachs and Merrill Lynch ("transitional credit")
    - Included non-USD securities and discount window pledges of loans
  - November 23, 2008 –expanded to the tri-party repo operations of London broker-dealer sub of Citigroup ("transitional credit")

Reforms

A NY Fed white paper on the tri-party repo market identified three weaknesses:

- Excessive reliance by market participants on massive extensions of intraday credit by the clearing banks
  - 8:30 am - all repos were unwound by clearing banks (including nonmaturing trades) – funds returned to lenders
  - 6:30 pm – all new and continuing trades were “rewound” with lenders’ funds credited to borrowers, and collateral pledged to lenders
  - Clearing banks funded borrowers during this time gap every day – and market participants assumed they would always do so
- Inadequacy, and pro-cyclicality, of market participants’ risk management practices
- Lack of plans or mechanisms to facilitate the orderly liquidation of a large dealer’s tri-party repo collateral and avoid fire sales of assets

Market dependence on intraday credit

- The transfer of risk between lenders and clearing bank each day introduced instability – each has incentives to run first from a troubled dealer
- Failure of a large dealer could destabilize a clearing bank, if exposure to that dealer is large relative to capital level
- Destabilization of a clearing bank could cause broader pullback by lenders – impeding surviving dealers’ access to funding
- Destabilization of a clearing bank could impair its conduct of securities and payment clearing activities that are critical to broader fixed-income market liquidity and functioning

Inadequacy of risk management practices

- Some lenders accept assets as collateral that they may not hold in their investment portfolios
  - Creates strong incentive to withdraw funding if a borrower is troubled
  - Intensifies run risk – many lenders are themselves subject to runs
  - Disincents prudent collateral risk management measures – lender acts like an unsecured lender, doesn't look to collateral
- Dealers' reliance on short-term funding creates high rollover risk, and heightens their vulnerability to runs
  - Dealers relied too heavily on the clearing bank's uninterrupted provision of intraday credit

Dealer default as a systemic risk event

- A default of a large dealer could spark a number of problems as lenders try to liquidate its collateral
  - Fire sales of assets
  - Run on one or more investors (headline risk) which accelerates withdrawals of funding from surviving dealers
  - Destabilization of clearing bank if capital is insufficient to absorb losses
- During the recent crisis, the need to liquidate a large dealer’s tri-party repo collateral was averted
  - JPMC’s purchase of Bear Stearns, with the help of a Fed loan
  - PDCF funding was provided to bridge Lehman’s U.S. broker-dealer subsidiary to acquisition by Barclay’s

Tri-party Repo Task Force

- Established September 2009, with diverse membership
  - All large dealers
  - Both clearing banks
  - Representatives of large investors: Money market funds, securities lending operations
  - Fed and SEC staff serve as technical advisors, observers

- Formed to identify one or more paths to reduce sources of systemic risk inherent in this market's processes and practices

May 2010 Task Force Recommendations

- Eliminate reliance on intraday credit
  - Reduce demand by
    - Ceasing daily unwind for non-maturing repos
    - Implementing automated collateral substitution to allow dealer access to collateral for other market making activities while keeping investor fully collateralized
    - Eliminating the time period between maturity of old repos and settlement of new repos
  - Reduce supply by requiring clearing banks to provide credit only on a capped and pre-committed basis
- Strengthen risk management practices
  - Reduce dealer reliance on overnight funding
  - Improve investor margining practices
  - Improve investors' planning and readiness to liquidate collateral in an orderly manner, in event of dealer default
- Disclose aggregate market data to public (began in fall 2010)

Foundation for future risk reduction is being built…

- Auto-substitution of collateral within repo shells began 6/27
  - Needed to allow dealers access to securities in their box for market making activities once the daily unwind process ceases
- Move to 3:30 pm settlement time began 8/22 for all but interbank GCF repo trades
  - Technology to support later unwind for interbank GCF under development
  - Move is precursor for a shorter, more streamlined end-of-day settlement process that ensures timely return of cash to lenders
- 3-way deal confirmation between borrower, lender and tri-party agent began to be phased in on 10/3
  - Will ensure trade maturities are accurately reflected
  - Critical prerequisite to identifying which trades remained locked up on a given day

…but risk reduction has not yet been achieved

- Reforms will not be completed by October 2011, as planned
- Several key goals still need to be achieved, as pointed out in the Task Force progress report:
  - Practical elimination of intraday credit by the clearing banks (reduces demand for intraday credit). Requires:
    - Not unwinding non-maturing trades
    - Simultaneous settlement of new and maturing trades
  - Better integration of interaction of the tri-party repo market with the GCF platform (reduces demand for intraday credit)
  - Clearing banks to provide intraday credit only on a capped and pre-committed basis (reduces supply of intraday credit)

What is needed to achieve the goals

- Some major infrastructure builds are required from the clearing banks and FICC
  - They must communicate in real time with each other to allow collateral substitution
  - The clearing banks must integrate, streamline and automate the allocation of collateral for both GCF and tri-party
  - The clearing banks must provide better collateral management tools to dealers so that manual intervention is no longer necessary to optimize collateral usage
- Business practices will need to change for dealers and investors
  - Dealers may see an increase in price of funding
  - Dealers cannot rely just on clearing bank credit to support settlement
  - Some investors may find a more robust tri-party market less attractive and withdraw some or all of their funds
  - Reforms should strengthen incentives for investors and dealers to appropriately assess and price risk in tri-party repo transactions

Conclusion

- Successful reforms will require a fundamental reengineering of the end-of-day settlement process
  - More standardized, centralized, straight-through-processing for collateral management
  - Better integration of GCF repo settlement with triparty settlement
  - Implementation of a “simultaneous” unwind and rewind for repos
- All market participants will bear some of the costs of reform
  - Clearing banks need to invest in infrastructure improvements
  - Dealers must rely more on term funding, and will need to upgrade their trade execution and settlement systems
  - Investors no longer get access to their cash early, and will need to upgrade their processes for trade execution and settlement
- Reforms could lead to a smaller and more conservatively collateralized market