Infrastructure Weaknesses in the US Tri-party Repo Market

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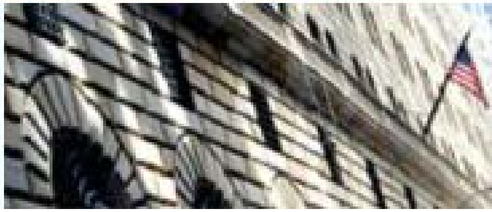

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Outline

- Overview of U.S. repo market
- Infrastructure weaknesses revealed by the crisis
- What have we learned from the reform effort?

Repo and tri-party repo

- A repo is the sale of a security with a promise to repurchase the security at a specific future date
- In a tri-party repo, a clearing bank provides collateral management and settlement services
- Two clearing banks in the US market:
  - JP Morgan Chase (JPMC)
  - Bank of New York Mellon (BNYM)
- Provide intraday credit to dealers
  - Until 2010, uncapped and uncommitted intraday credit from about 8:30 AM to 6 PM against all collateral

Europe vs. U.S. repo markets

- In Europe, the repo market is mainly interbank
  - Size of the repo market has increases as the unsecured interbank market has decreased
- In the U.S., the repo market is a key funding market for securities dealers
  - Dealers fund their inventories
  - They also intermediate between their clients (hedge funds) and cash investors (MMFs and securities lenders)

Infrastructure weaknesses

- The unwind: CBs extend intraday credit to all dealers against all collateral
  - Uncapped credit: Huge exposure for the clearing banks
  - Uncommitted credit: Potential conflict of interest between what is good for the CB and what is good for the market

- Fire sale risk: Particularly important in TPR market
  - Large size of portfolios financed
  - Some investors, such as MMFs and securities lenders, face liquidity pressures of their own

Reforms: The unwind

- Industry led reform effort (2009 – 2011)
- Market participants agreed that CBs would extend only capped and committed credit for at most 10% of a dealer's book (from about 3:30 to 5:15 PM)
- Current timeline: End of 2014
- Why is it taking so long?
  - Requires large investments by both clearing banks
  - Settlement requires information to be shared between the two clearing banks and FICC, who plays the role of CCP for an interdealer repo market

Reforms: Fire sales

- No industry progress on fire sales, despite continuing risk
  - Issue mentioned in the three FSOC annual reports
- Solving the issue requires industry participants to bear more of the costs they impose on the system
- Fire sales are due, in part, to a coordination problem

Crisis and reforms: Key policy questions

- Utility vs. competing providers
  - The US TPR market evolved with competing providers
  - Economies of scale decreasing number of providers
  - Multiple providers create considerable complexity
  - Should clearing banks be more interoperable?
  - Did competition lead to much innovation?
- Fire sale risk
  - Not enough infrastructure?
  - Clear rules determining who will liquidate the collateral of a failed dealer, who provides liquidity, and how potential loses are shared would be desirable