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APRIL 11, 2011

Everything You Wanted to Know about the Tri-Party Repo Market, but Didn't Know to Ask

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The tri-party repo market is a large and important market where securities dealers find short-term funding for a substantial portion of their own and their clients' assets. The Task Force on Tri-Party Repo Infrastructure (Task Force) noted in its report that "(a)t several points during the financial crisis of 2007-2009, the tri-party repo market took on particular importance in relation to the failures and near-failures of Countrywide Securities, Bear Stearns, and Lehman Brothers." In this post, we provide an overview of this market and discuss several reforms currently under way designed to improve functioning of the market. A recent New York Fed staff report provides an in-depth description of the market.

What Is the Tri-Party Repo Market?

The tri-party repo market is one where securities dealers fund their portfolio of securities through repurchase agreements, or repos. A repo is a financial transaction in which one party sells an asset to another party with a promise to repurchase the asset at a pre-specified later date. A repo resembles a collateralized loan but its treatment under bankruptcy laws is more beneficial to cash investors: in the event of bankruptcy, repo investors can typically sell their collateral, rather than be subject to an automatic stay, as would be the case for a collateralized loan. In the tri-party repo market, a third party called a clearing bank acts as an intermediary and alleviates the administrative burden between two parties engaging in a repo.

Why Should We Care about the Tri-Party Repo Market?

The importance of this market was highlighted by the recent financial crisis. As noted above, the tri-party repo market took on particular importance in relation to the failures and near-failures of Countrywide Securities, Bear Stearns, and Lehman Brothers. "The potential for the tri-party repo market to cease functioning, with impacts to securities firms, money market mutual funds, major banks involved in payment and settlements globally, and even to the liquidity of the U.S. Treasury and Agency securities, has been cited by policy makers as a key concern behind aggressive interventions to contain the financial crisis," according to the Task Force Report.

The tri-party repo market is very large. At its peak in 2008, about $2.8 trillion of securities were funded by tri-party repos. Volumes shrank to $1.6 trillion in the second half of the financial crisis, and have been steady around that level since. The size of

individual portfolios being financed in this market is also very large. At the peak, some dealers were financing portfolios of $450 billion in the tri-party repo market, mostly overnight.

While a large fraction of the assets financed in the tri-party repo market is liquid and of high quality, available tri-party repo data show that some less liquid assets are also financed in this market. The share of less liquid assets has decreased since the market peaked in 2008.

Who Are the Participants?

The tri-party repo market is made up of three types of participants: securities dealers, cash investors, and clearing banks that function as intermediaries between dealers and investors.

Dealers

The dealers sell securities with a promise to repurchase these securities at a later date. Alternatively, this transaction can be viewed as borrowing cash using securities as collateral. The largest dealers in the tri-party repo market are primary dealers. Primary dealers are banks or securities broker-dealers that are authorized to trade directly with the New York Fed. This side of the market is concentrated, with the top five collateral providers accounting for over 50 percent of borrowing and the top ten accounting for almost 80 percent.

Cash Investors

The cash investors buy securities that they will sell back at a later date. Alternatively, this can be thought of as lending cash and taking securities as collateral. The set of cash investors in the tri-party repo market is larger and more diverse than the set of dealers. There are over 4,000 individual firms active as cash investors. Money market mutual funds and securities lenders are the two largest groups of cash investors, each representing about a quarter of the cash invested in that market. The agent banks of the securities lenders use the tri-party repo market to re-invest the cash collateral they receive when they loan securities. The largest ten investors account for about 60 percent of the lending. To diversify their risks, large investors typically seek to lend to a number of different collateral providers.

Clearing Banks

The two tri-party repo clearing banks in the United States are JPMorgan Chase and Bank of New York Mellon. These clearing banks play a number of important roles as intermediaries. They take custody of the securities involved in the repo, value the securities and make sure that the specified margin is applied, settle the transaction on their books, and offer services to help dealers optimize the use of their collateral. The clearing banks do not, however, match dealers with cash investors, nor do they play the role of broker in that market.

To give dealers access to their securities during the day, the clearing banks settle all

repos early each day, returning cash to cash investors and collateral to dealers. Because of the delay in settlement, the clearing banks wind up extending hundreds of billions of intraday credit to the dealers until new repos are settled in the evening.

How Are Reforms Improving the Market?

The financial crisis highlighted some problems with the tri-party repo market. A white paper prepared by the New York Fed describes how this market may contribute to systemic risk. The white paper mentions three key areas of concern: 1) the tri-party repo market's dependence on intraday credit provided by the clearing banks, 2) risk management practices that may increase stress in bad times, and 3) the lack of effective and transparent plans to support orderly liquidation of a defaulted dealer's collateral.

A considerable amount of work is under way to address concerns about intraday credit. The Task Force on Tri-Party Repo Infrastructure is currently working on implementing the plan described in its report. In early December, the Task Force issued a proposal describing a new operational arrangement that will eliminate the need for the clearing banks to extend such large volumes of intraday credit to dealers.

The publication of more tri-party repo market data, including the level of haircut or margin (the extent to which the value of the securities used as collateral exceeds the value of the cash received in the repo) and the share of the top three dealers in each asset class may help improve risk management practices.

By contrast, little progress has been made to address the problem associated with the liquidation of a large dealer's portfolio. The Task Force report contains some recommendations to improve the preparedness of cash investors and the tri-party repo market to cope with a dealer default. Nevertheless, because some dealers fund such large portfolios of securities financed in the tri-party repo market, the failure of such a large dealer could lead to a fire sale, as investors try to sell their collateral in an uncoordinated fashion. In addition, many financial institutions have to mark their assets to market, so fire sales of securities financed in the tri-party repo market could spill over to other markets.

Looking Ahead

In the next few months, the tri-party repo market will change in important ways as the recommendations of the Task Force are implemented. It will be interesting to see how the market adapts to new ways of doing things and what reforms are enacted to increase the stability of the tri-party repo market regarding dealer defaults. While the Task Force has accomplished quite a bit, more needs to be done to address the risk associated with the default of a large dealer.

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Posted by Blog Author at 10:00:00 AM in Fed Funds, Financial Markets

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