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Flash: Tri-Party Repo Infrastructure Reform

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The Tri-Party Repo Infrastructure Reform Task Force released its final report yesterday. While the task force accomplished a great deal, it made clear that the ultimate goal of the “practical elimination” of intra-day credit extension by the clearing banks is years away. As a result, the Fed decided to work directly with the clearing banks and the FICC to “intensify oversight” of infrastructure changes. Furthermore, the Fed will explore additional policy options, including limitations on eligible collateral and a “facility to foster the orderly liquidation of collateral in the event of a dealer’s default.”

This note makes the following observations with respect to these latest developments:¹

- 1) Based on the significant accomplishments of the task force, a substantial reduction in intra-day credit is feasible now and should be encouraged by authorities, either by persuasion or by requiring that the clearing banks set aside capital against intra-day risk.
- 2) Tri-party repo should be managed by an industry utility, not by businesses inside two large banks. The opportunity to create such a utility is better now than it has ever been, given the broad agreement as to the woeful inadequacies of the system’s infrastructure, the complexities of coordinating technology across two clearing banks and the FICC, and the conflicts of interest—made apparent during the crisis and the MF Global episode—of each tri-party repo agent also being a large commercial bank.
- 3) Collateral eligibility in tri-party repo is indeed too broad, including hard-to-price and illiquid securities. Creating rules to limit eligibility, however, will prove very challenging for regulators. A better approach might be for the industry utility that would clear repo to take on the task.
- 4) A facility created to liquidate the collateral of a defaulting dealer would, almost by definition, be too-big-to-fail. Policy should obviate the need for Fed interventions in a crisis, not enshrine such actions.

Reduce Intra-Day Credit Now

The accomplishments of the tri-party repo task force include implementing a three-way trade confirmation process, auto-substitution functionality, and delaying the daily unwind to 3:30pm. This means that dealers can substantially reduce the amount of intra-day credit they need from the clearing banks in the following ways. First, remove non-maturing or term trades from the daily unwind. For any term borrowing with rights of substitution, the dealer can use the auto-substitution facility to effect any desired substitution of collateral without requiring an unwind. Second, remove open trades that have not been terminated from the daily unwind. Once again, the auto-substitution facility can be used to move collateral across trades as needed. Third, manage rolls of maturing trades so that the clearing banks do not extend intra-day credit. More specifically, use the three-way confirmation process and the fact that the unwind has been pushed off until 3:30pm so that the clearing bank does not have to return cash to repo lenders that are rolling maturing trades.

¹ Readers are assumed to be familiar with tri-party repo, the daily unwind, and the problem of intra-day credit. See “Systemic Risk and the Tri-Party Repo Clearing Banks” by Bruce Tuckman, CFS Policy Paper, February 2, 2010.



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Reducing the extension of credit as described in the previous paragraph requires a lot of work on the part of dealers. Furthermore, their profitability will most likely fall as they will not be able to optimize the placement of collateral across lenders as well as the algorithms of the clearing banks after a daily unwind. But, given the systemic risks involved, the Fed should probably force the point. One way this can be accomplished is by regulatory prodding. Another way is to provide a strong incentive, such as requiring the clearing banks to set aside capital against their extension of intra-day credit. The costs of their doing so will be immediately passed through to dealers who, in turn, will use the tools now available to optimize—and almost certainly reduce—their use of intra-day credit.

Replace the Clearing Banks as Tri-Party Repo Agents with an Industry Utility

There are several reasons why the role of the clearing banks in the tri-party repo system should be replaced by a single industry utility.

First, the infrastructure the clearing banks created over the years is woefully inadequate: systemic problems created by the daily unwind and the extension of intra-day credit existed for years, although these problems failed to attract serious attention until the onset of the financial crisis.

Second, part of the technological complexity of eliminating intra-day credit is that three clearing systems have to be coordinated: one at each of the two clearing banks and one at the FICC.

Third, there are significant conflicts of interest when a commercial bank acts as a dealer's tri-party repo agent at the same time as it conducts bilateral business with that dealer. A dealer experiencing financial difficulties can easily expose its repo counterparties and its commercial bank to losses. But, as a dealer's tri-party repo agent, the commercial bank has both knowledge and opportunity to protect itself first and foremost. During the financial crisis, for example, it was alleged that Lehman Brothers' clearing bank used its repo-agent powers to grab enough collateral to insulate itself from all losses, including those having nothing to do with tri-party, like exposures arising from derivatives trades. Whether these allegations are true or not, the conflict of interest and power to act are realities. Another example surfaced in the MF Global episode. Losses existed that had to be borne by someone. But given the clearing bank's role in moving cash and securities, it may legitimately have been able to ensure that it was protected at all times, leaving customers to bear losses. Once again, this pattern of events has not been established as the explanation of customer losses at MF Global, but an independent utility would not have any incentive to favor one claimant over another.

Restricting Tri-Party Repo Eligible Collateral

Borrowing against hard-to-price and illiquid assets creates systemic risk. Funding for these assets can disappear quickly in a crisis, threatening the viability of systemically important financial institutions that depend on such funding. Furthermore, even if only non-systemically important institutions fail initially, the distressed sales of illiquid assets that can no longer be funded can weaken the viability of more important institutions carrying inventory in those assets. Finally, despite the systemic dangers of borrowing against illiquid assets, "safe harbor" rules allow repo lenders to jump to the front of the queue of creditors. Hence repo lending—even on very illiquid assets—is overly encouraged by current bankruptcy laws.



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Because of these considerations, the Fed's desire to restrict tri-party repo borrowing to more liquid securities is perfectly reasonable. Creating a detailed list of eligible securities, however, is quite a difficult undertaking for a regulator. One might have thought that the clearing banks, particularly since they were extending such large amounts of intra-day credit, would have insisted that collateral be relatively easy to price and margin. For some reason, however, this did not prove to be the case: during the crisis clearing banks were holding seriously problematic collateral.² Ideally, an industry utility with no unrelated businesses or sources of capital would be more careful with the painstaking job of monitoring collateral quality and margin.

Beware the Creation of Too-Big-to-Fail Facilities

Even if tri-party repo infrastructure is improved so that clearing banks (or an industry utility) no longer have to extend intra-day credit, the repo market can still be a source of systemic risk in a crisis. The default of a dealer could result in losses for repo lenders who simultaneously rush to liquidate collateral. Or these lenders might fear the possibility of such losses. In either case, repo lenders might pull lending from other dealers and, in the process, break those dealers as well.

The potential fragility of repo funding has inspired several policy recommendations, including the creation of a liquidation facility. In the event of a dealer default, such a facility would—at least in theory—manage the liquidation of the collateral of a failing dealer in an “orderly” manner, i.e., in a way that avoids fire sales and that maximizes recovery values for repo lenders. If repo lenders believe in the success of such a facility, they would be much less likely to run in the event of a dealer default.

The problem with the proposal, however, is in the far from impossible scenario that the liquidation facility cannot recover enough value for repo lenders to prevent a run on other dealers. In that case, given the stated purpose of the facility to stabilize markets, authorities would be severely tempted to bail out the facility or, equivalently, to bail out repo lenders. For this reason, any such liquidation facility is, almost by definition, too-big-to-fail.

For a policy proposal that can contain runs on repo without creating another too-big-to-fail entity, see the recent CFS policy paper on the subject.³

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² See, for example, the testimony of Barry Zubrow of JPMorgan Chase on September 1, 2010, before the Financial Crisis Inquiry Commission with respect to the tri-party repo collateral posted by Lehman Brothers.

³ “Federal Liquidity Options: Containing Runs on Deposit-Like Assets without Moral Hazard and Bailouts” by Bruce Tuckman, CFS Policy Paper, January 24, 2012.