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Statement of the Investment Company Institute

Hearing on "The Tri-Party Repo Market: Remaining Challenges"

Subcommittee on Securities, Insurance, and Investment,
Committee on Banking, Housing, and Urban Affairs

United States Senate
August 2, 2012

The Investment Company Institute[1] is pleased to provide this written statement in connection with the Subcommittee's hearing on the tri-party repo market.

Registered investment companies—including mutual funds, ETFs, closed-end funds, and UITs (collectively, "registered funds")—have a significant interest in the subject of this hearing. Tri-party repo is a key source of short-term financing for a wide range of borrowers such as banks and brokerage firms.[2] The Federal Reserve Bank of New York (the "FRBNY") reports that as of June 2012, borrowers financed $1.8 trillion through this market.[3] Likewise, cash investors such as corporations, state and local governments, financial institutions, and registered funds use this market to invest short-term cash. Among registered funds, money market funds have the largest presence in this market with $519 billion invested in repos in June 2012, while stock and bond funds invested an additional $96 billion. Most of these repos are tri-party repo.

The ICI and several representatives from ICI member firms participated on a special Task Force on Tri-Party Repo Infrastructure (the "Task Force"), which was formed in September 2009 under the auspices of the Payments Risk Committee, a private sector body sponsored by the FRBNY. The Task Force recently concluded its work, highlighting a number of areas in which significant

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.1 trillion and serve over 90 million shareholders.

[2] The Federal Reserve Bank of New York's white paper on tri-party repo provides a comprehensive description of the repo market. *See* Tri-Party Repo Infrastructure Reform (May 17, 2010), available at http://www.newyorkfed.org/banking/nyfrb_triparty_whitepaper.pdf.

[3] *See* Tri-Party Repo Statistics as of 06/11/2012, available at http://www.newyorkfed.org/tripartyrepo/pdf/jun12_tpr_stats.pdf.

progress was made to meaningfully reduce both the potential for systemic risk and the magnitude of the risk associated with the tri-party repo infrastructure.[4]

These reforms include increased transparency, significant reduction in the extension of intraday credit by the clearing banks, improved collateral substitution and management practices, and best practices for cash investors for disposing of securities in the event of a failure of a tri-party repo counterparty. Each of these reforms is described briefly below.

Increasing Market Data for Repos. Beginning in May 2010, the FRBNY began publishing market data on the tri-party repo market on its web site.[5] This data highlights the overall size of the market, collateral, concentrations, and margin requirements that exist within the market. This reporting has provided greater transparency into the broader market, giving all market participants and regulators the ability to monitor repo exposures and highlight repo market trends.

In addition, in response to a Task Force recommendation, dealers, cash investors, and tri-party repo clearing banks are now fully implementing three-way trade confirmations. These added operational enhancements allow the tri-party clearing banks and regulators to monitor "real-time" credit exposures. It also provides the tri-party repo clearing banks an additional level of transparency within the repo market and reduces the risk of the occurrence of failed or intraday defaulted repo trades for all market participants.[6]

Delaying the "Unwind." Changes have recently been implemented to cause the daily "unwind" of most tri-party repo transactions to move from early morning to mid-afternoon, greatly reducing the duration of intraday credit extensions by the tri-party repo clearing banks to the dealers. The delay in the unwind has been very significant, in that the tri-party banks now have much greater clarity into the ability of borrowers to finance their repo book. The situation was much more opaque with a morning unwind. Work on this front continues, with the ultimate goal of reducing credit extensions by the tri-party repo clearing banks to the dealers to no more than 10% of a dealer's notional tri-party book.

Improving Collateral Substitution/Collateral Management. Both tri-party repo clearing banks have recently implemented automated collateral substitution capabilities as a result of

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[4] See Task Force on Tri-Party Repo Infrastructure Payments Risk Committee, Final Report (February 15, 2012), available at http://www.newyorkfed.org/tripartyrepo/pdf/report_120215.pdf.

[5] *See* http://www.newyorkfed.org/banking/tpr_infr_reform.html.

[6] In addition to the increased transparency in the tri-party repo market, registered funds are required to provide additional disclosure about their repo activities. This disclosure appears in the fund's prospectus and statement of additional information, both of which are available to investors, regulators, and the public. Twice a year, registered funds also prepare financial statements that are filed with the Securities and Exchange Commission (SEC) and sent to shareholders. In addition to the semi-annual financials in these shareholder reports, registered funds also file Form N-Q after the first and third quarters, which include a detailed listing of the fund's portfolio.

Money market funds have additional disclosure requirements. They are required to post their portfolio holdings on their websites each month within five business days after month end. Money market funds also are required to file Form N-MFP with the SEC on a monthly basis. This provides details on the fund and its portfolio holdings (including detail on each security held as collateral), and has given regulators and the public significantly enhanced transparency with respect to money market funds' role in tri-party repos.

recommendations from the Task Force. The introduction of such automated systems has allowed cash investors and other industry participants to monitor and manage their intraday collateral positions and ensure that their repo exposures are adequately collateralized on a "real-time" basis. Industry participants continue to actively work with the tri-party repo clearing banks to build out the capabilities of this technology and improve the transparency and the efficiency of this important monitoring system. The ability to efficiently substitute collateral helps to prevent disruptions to regular market activity as dealers have full access to their positions throughout the day.

SEC guidelines require that registered funds involved in a repo transaction receive at least 100 percent of the value of the cash invested. In practice, virtually all investors over-collateralize repos at levels ranging from 102 to 110 percent, demonstrated by the collateral haircut data published monthly by the FRBNY. The tri-party clearing banks price the collateral on at least a daily basis using various independent pricing sources, which ensures centralized and consistent valuation across all market participants. The clearing banks continually review the pricing sources to ensure that the repo transactions are marked-to-market daily and are adjusted so that the obligations remain fully collateralized at all times.

Dealing with the Potential for Counterparty Defaults. Money market funds are distinct from other lenders in the repo market in that they are required to determine that counterparties present "minimal credit risk," assuring that the funds are only dealing with the highest quality counterparties. Nevertheless, money market funds and other registered funds share the common goal of minimizing counterparty risk in tri-party repo, and have strongly supported the Task Force's efforts in this regard.

And as a result of the recommendations from the Task Force, the repo markets are better prepared to deal with potential dealer defaults. The tri-party clearing banks are working toward adopting "waterfall" recommendations of the Task Force that will mandate the priority of payments or distribution of assets in the event of a default. In addition, various industry groups continue to work with the tri-party repo clearing banks and industry participants to develop a process for the orderly liquidation of collateral. For example, in consultation with its members, the ICI published a checklist for cash investors in the event of the insolvency of a tri-party repo borrower.[7] This checklist includes preliminary steps that registered funds investing in tri-party repo should have in place as well as actions that would need to be taken in the event of a default, including guidelines on collateral valuation, board notification, and regulatory filings.

With the ongoing implementation of these and other Task Force recommendations, the tri-party repo markets are better prepared to deal with potential defaults. As the Task Force's final report noted, additional work is needed to put in place the infrastructure to meet the Task Force's goal of "the practical elimination of intraday credit associated with the settlement of tri-party repo transactions." ICI and its members continue to support that important goal.

In any event, market participants and regulators have become much more attuned to the risks of overreliance on short-term financing. Cash investors and borrowers regularly engage in discussions

[7] *See* Investment Company Institute, Checklist for Fund Investors of Repurchase Agreement in the Event of Dealer Insolvency, available at http://www.ici.org/policy/current_issues/11_mmf_repo_checklist.

about the degree to which borrowers are relying on the repo markets, and regulators are encouraging banks and other borrowers to extend the terms of their borrowing to reduce their reliance on short-term financing.[8] These efforts have reduced the chances that a firm's inability to access the short-term markets would lead to its immediate collapse, as was the case with Bear Stearns and Lehman Brothers.

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We appreciate the opportunity to share our views with the Subcommittee on the tri-party repo market, and we look forward to working with Congress in addressing these important issues in a manner that benefits the millions of American investors who rely on registered funds to achieve their investing goals.

[8] *See*, *e.g.*, FRBNY Update on Tri-Party Repo Infrastructure Reform (July 18, 2012) ("Broker-dealers are expected to reduce their reliance on short-term tri-party repo financing, particularly for less liquid assets, to achieve the necessary reductions in the usage of intraday clearing bank credit."), available at http://www.newyorkfed.org/newsevents/statements/2012/0718_2012.html.