

The tri-party repo task force deserves great commendation for its work, particularly for its detailed and actionable plan for the “practical elimination” of intraday credit extension by the clearing banks through the daily unwind. The industry’s progress on this front will substantially reduce systemic risk although, as I have written elsewhere,¹ an explicit capital charge on clearing banks’ intraday risk would efficiently internalize incentives.

The industrial organization of the tri-party repo market was undoubtedly outside the scope of the task force’s work. But the Federal Reserve Bank of New York should be asking whether it makes sense for the operations of the tri-party repo market to reside in two large, systemically important clearing banks.

There are several reasons to believe that the current industrial structure does not make sense:

1. Threats to the solvency of the clearing banks will be transmitted to the tri-party repo system and *vice versa*. Furthermore, any efforts to wall-off tri-party repo from the rest of a clearing bank are unlikely to succeed completely. Consider two recent examples: the great difficulties in separating the remains of Lehman Brothers’ defunct entities from one another; and errors at one of the clearing banks that resulted in the failure to segregate significant amounts of customer cash.
2. With numerous financial interests in the businesses of repo customers apart from repo, the clearing banks are not disinterested parties in the management of the tri-party repo system. The claims in the Lehman Brothers’ bankruptcy examiner’s report and a lawsuit by Lehman Brothers Holdings’ estate against one of the clearing banks, whether with or without merit, at the very least highlight the potential for such opportunistic behavior.
3. Given the too-big-to-fail perception of the clearing banks and, by extension, of the tri-party repo system (which perception was reinforced during the crisis), lenders of cash through tri-party repo are unlikely to exercise as much prudence as would otherwise be optimal. In fact, the weakness of collateral valuation procedures highlighted in the task force report may very well be a symptom of this implicit guarantee.

These reasons probably go far in explaining why all other significant clearing houses are stand-alone, regulated entities, or, put another way, why the industrial structure of the tri-party repo system is such a prominent outlier in the financial system. No doubt there are historical antecedents for the current structure, including innovation and leadership from the clearing banks but also, most likely, the significant competitive advantage that the risks of the “daily unwind” were never explicitly incorporated into the banks’ regulatory framework and capital requirements. But at the present time, with so much discussion of financial reform, the Federal Reserve Bank of New York should consider encouraging or requiring the complete separation of tri-party repo operations from other banking activities.

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¹ “Systemic Risk and the Tri-Party Repo Clearing Banks,” <http://www.centerforfinancialstability.org/research/Tri-Party-Repo20100203.pdf>