



**Regulatory Analysis:
Does the US Need a Third Tri-party Collateral Manager?**

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The US Federal Reserve has openly discussed wanting a new central facility for managing tri-party collateral. This has significant implications for government control over financial markets and capital deployment at large banks. It also affects the fortunes of the two major players in the space, Bank of New York Mellon and JPMorgan Chase.

“In a tri-party collateral management transaction, the Bank acts as an intermediary between a buyer and seller, or lender and borrower of securities to ensure proper collateralization throughout the term of the transaction. The Bank maintains cash and securities accounts for both parties, verifies collateral eligibility, marks to market securities pledged as collateral, processes income and provides daily reporting to both parties.” – Bank of New York Mellon press release

From this innocuous sounding description of a mundane task springs one of the more fundamental issues to reach US financial markets in 2009. Unlike Europe, which has five substantial tri-party collateral managers, the US only has two, Bank of New York Mellon (BNYM) and JPMorgan Chase (JPMC), and both are private banks. This concentration of credit risk in the \$2 trillion tri-party collateral management market was never a concern prior to the failures of Lehman Brothers and Bear Stearns, but has since become a major consideration for regulators and other market participants.

Recently the Federal Reserve has voiced its interest in a non-bank tri-party collateral manager. The first call came in March 2009 with a speech from Chairman Ben Bernanke, and The Financial Times had a brief article on the topic this June. It appears that momentum is gathering for the Fed to make an effort to establish a new tri-party facility.

Any new tri-party collateral manager would be a non-bank entity backed with a central credit counterparty guarantee. This means that the new manager would function much like an options or futures clearinghouse; all risk would be supported by an organization with the backing of the entire financial markets industry instead of relying on the credit of one individual bank.

With two large, well respected firms managing the business today, it is a legitimate question to ask why this matters. There are several reasons, each of which has multiple variations and fine points to argue; this article can attempt only a very brief summary. First and foremost is the risk that BNYM or JPMC could fail, disrupting the flow of billions if not trillions of dollars in repo and collateral assets. These assets belong to major money managers, institutional investors, and anyone with a simple money market

account. If BNYM or JPMC were to fail, they would take with them a very large cross-section of the investing public.

The US government is now a major asset holder in firms with tremendous exposure to collateral; a key factor in AIG's failure was their need to repay collateral lost on securities lending transactions. If any future market failure were to occur, the government and taxpayers would need to make up the difference. The government cannot allow this happen.

While the government may not care, other banks have a reason to be interested in who manages tri-party collateral. Under today's rules, firms that use BNYM or JPMC as their tri-party clearing agent must allocate a portion of their balance sheet corresponding to the concentration of their credit risk with these banks. The more business they do, the greater percentage of their balance sheet they must allocate.

There are different rules for balance sheet allocation to banks than to non-bank clearing firms such as Euroclear or Cleartream. By using a non-bank central credit counterparty, firms like Goldman Sachs, Morgan Stanley or Citigroup would be able to allocate more capital elsewhere. This may or may not be central to the Federal Reserve's thinking but it certainly will help the banks.

Skeptics may ask why another single bank shouldn't enter the market and why the government should be involved at all. In our research, we have identified that while several other banks would like to enter the space, they are unlikely to gain the critical traction necessary given that they face the same credit quality concerns as BNYM and JPMC. Rather, we think it makes better business sense for these firms to join a government initiative. Banks could pursue a consortium of their own, but the government has an organizational lead at this point.

BNYM and JPMC may also stand to gain from a new entrant. It has been noted that JPMC would like to leave the tri-party collateral business as it entails too much risk for their size; a new manager could absorb the JPMC business as its initial infrastructure. BNYM could appreciate a competitor as deflecting attention away from itself with no harm to its revenues; with tri-party balances expected to grow substantially from centrally cleared repo as well as other asset-backed securities, there should be plenty of business to go around.

We expect that before long, there will be a third tri-party collateral manager in the US; the economics make sense and with the Federal Reserve involved, the financial markets industry should listen. The mechanics are not overly difficult but will require substantial coordination between the government, banks and investors. The impact of a new tri-party collateral manager will have substantial ramifications for the financial services industry as a whole.