

**MEMORANDUM FOR THE RECORD**

Event: Teleconference with a cross-divisional Bank of NY Mellon team about the Repo market

Type of Event: Conference Call

Date of Event: March 11, 2010

Participants - Non-Commission:

Brian Coad – Assistant General Counsel, Legal; Aielleen Fajardo – Managing Director and Senior Counsel, Legal; Art Certosimo – Senior Vice President, Head of Broker-Dealer Services; and Jim Malgieri – Executive Vice President, Broker-Dealer Services

Participants - Commission:

Tom Krebs, Mina Simhai, Jay Lerner, Ron Borzekowski, and Desi Duncker

MFR Prepared by: Desi Duncker

Date of MFR: March 11, 2010

Summary of the Interview or Submission:

*This is not a transcript of the meeting and should not be quoted as such*

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On Thursday, March 11, 2010 Tom Krebs, Mina Simhai, Jay Lerner, Ron Borzekowski, and I had a conference call with Scott Goebel, Kevin Mahar, Norm Lind and Nancy Fryer of Bank of NY Mellon to discuss their perspective of the repurchase agreement (repo) market. *Note that the following is merely a synopsis of the comments of the Bank of NY Mellon team and is not necessarily a statement of fact or of the opinions of the FCIC team.*

Repo Market and BNYM's Perspective

Current BNYM tri-party repo balances are approximately \$1.5 trillion. As the end of last year, they were \$1.3 trillion, and when the market peaked they were \$2 trillion. Their best guess is that the overall repo market is \$4 trillion, \$1.5 of which is tri-party. The overall repo market consists of delivery repo—otherwise known as bilateral repo—and tri-party repo. The only difference between the two is in the operational structure. The BNYM team stated that their past belief is that the market was 50/50. Generally, there are the same repo counterparties in bilateral repo as there are in tri-party repo.

They estimated that the total U.S. repo market was \$6 trillion in early 2007, when they were doing \$2 trillion. We saw short-term spikes after the Lehman situation. The market data on the SIFMA website is the most reliable—there may be other data from the Fed and Treasury, but BNYM said it's kind of sketchy.

As for European repo, there is cash lending from European players to U.S. broker-dealers, but that was a small piece of the market and would be included in the U.S. totals. There are foreign subs of U.S. broker-dealers, but that was a small percentage of the market, maybe 10%.

In the Mar'08 – Sep'08 timeframe, the period between Bear Stearns (BSC) and Freddie/Fannie was stable. The Primary Dealer Credit Facility (PDCF) implementation after BSC really hit the mark.

From Jul'07 – Aug'07, there was a difference in behavior regarding certain collateral that could not get priced. There was a drop in value of less liquid collateral—mainly private-label MBS—and if we couldn't price it, we had to price at zero. The private-label CMO is currently 8% of the market. Given that they were being priced at near zero, these securities were still being used to generate cash, but much less. If the security's cash flow is disrupted and it is not being traded, BNYM would have to work with the dealer community to come up with a value. There is a natural tension here, as the dealer wants to use anything that has value as collateral, whereas the investor, as the security drops in value, may require more collateral or not want to take that collateral. (BNYM noted that they were talking about CMO, CDO and asset-backed private label securities.)

Before the crisis, BNYM cleared for 10 of the 19 primary dealers. Now they clear for 13 of the 18 primary dealers. Besides the primary dealers, the other broker-dealers in the tri-party market are pretty good-sized institutions—they make up less than 10% of the tri-party market. \$1.2 – \$1.3 trillion of BNYM's tri-party business is from primary dealers.

On the cash lending side, the market consists of agent securities lenders (the largest pool), money market funds (2a-7), other asset managers, and state treasury funds (who usually go through an advisor). A securities lender like State Street will ask for cash in the market, take that cash and invest it in the repo lender. Securities then get delivered for some kind of obligation, *i.e.*, short sales. (SEC regulations require shares to be borrowed for short-sales.)

In Response to FCIC Question about Securities Being Rehypothecated in the Repo Market

BNYM said “We’re not sure—maybe sometimes.” They don’t follow securities on a CUSIP by CUSIP basis, so it’s fungible for them. BNYM suggested that we speak with the dealer community. The team said that their gut feel was that once collateral is used, that’s it. As for the question on double-counting, they said that double-counting could be defined in several ways. Reverse repo in, and delivering out against the repo for cash would be a rehypothecation. But BNYM can only see them as cash collateral volumes, and they can’t see the difference between purchase and rehypothecation.

#### In Response to FCIC Question about the Bear Stearns Situation

BNYM team said they were kind of relieved that they weren’t the clearing bank. They were involved that weekend in helping design the PDCF, as they felt that this was critical. The Term Securities Lending Facility (TSLF) was also critical, and it was a great program. We had some comfort coming out of that weekend.

The market was backing up from certain kinds of collateral, increasing haircuts by lenders on certain collateral types. They noted that the buyer and seller do the negotiating, as BNYM is not involved in this, as they’re only the custodian. Generally, Treasuries were king—other than that, it varied by dealers. Money market funds worry about counterparties first, then collateral second. Other investors, such as corporate treasurers, backed away from certain asset classes. PDCF was critical to take other kinds of collateral. Hedge funds do repo trades through prime brokers. BNYM has a handful of the highest quality hedge funds, and they leave the rest to the prime brokers.

#### In Response to FCIC Questions about Trading Protocols

When BNYM unwinds tri-party arrangement, they are leaning on the security. They reserve the right to adjust their margin. BNYM charges dealers only a basis-point fee on outstanding balances. There is also a transaction fee for movements in and out of the account.

To trade, all it takes is a phone call. The dealer is usually calling the investors, saying they need funding and what the collateral is, and then asking how much it costs. The dealer’s system is governed by electronic feeds.

As a collateral agent, it’s BNYM’s job to make sure that only eligible collateral is used. The counterparties can get as specific as down to the CUSIP. As for cash, it is in the bank already and just transferred between accounts or transferred from outside the bank. There are usually accounts specific to these types of trades.

BNYM stated that if we want to know how the market works, we should go to the dealers, and that they will tell us why they use these markets to fund, chapter and verse. The main matter in the crisis was the loss of confidence by repo investors. There was panic in the market, as evidenced by the amount of short-selling and the widening of CDS spreads.

During the week before Lehman went bankrupt, the BNYM team remembers that they had to expand the PDCF program to include the 'kitchen sink'. There were tremors in the market, as Lehman stock dropped significantly and their CDS spread widened. However, Bank of NY Mellon didn't clear Lehman or Merrill Lynch, so they didn't directly see the turmoil. Goldman Sachs and Morgan Stanley were stable that week, although they had to rely on PDCF.

#### In Response to FCIC Questions about Repo Maturities

One of BNYM's difficulties is that the maturity field is not required to be filled in, so they don't have visibility there. If this field were filled in, that would reduce the risk involved, as both parties would know the terms and wouldn't have to roll it over every day. In that case, the counterparties would only have to adjust the collateral, as there would be no change in the obligation to finance.

The tri-party task force has made this one of their key recommendations. (Another recommendation is to have a standard margin.) BNYM expects implementation this year. The amount of term repo has increased to 40% of the repo market—with the balance being open repo (*i.e.*, renewed overnight). Previously, term repo was 10% of the market. The goal of the tri-party task force was to reduce the amount of intra-day credit (or to shift the concentration of intra-day credit from the custodian to the market), and to come up with an orderly wind-down (which they are still working on, given the operational changes).

***BNYM stated that they put out a white paper on this, which they'll send to the FCIC team.***

At this point, all repo is unwound on a daily basis. But BNYM is in the process of shifting to a system of netting out and adjusting as needed. BNYM usually gains confidence that the transaction will roll by 11am. Repo starts at 6:30/7am, is done by 9am, and BNYM knows by 10:30/11am.

Two emotions that govern Wall Street: fear and greed. Repo markets didn't flinch for 20 years, but firms that were relying on it have learned their lesson. It's an extreme amount of poor risk

management to fund illiquid assets with overnight repo. The shock to the system has woken everyone up.

Up until four or five years ago, the repo market was taken for granted. But BNYM has invested \$10 million annually in their system, which is getting more sophisticated. The first tri-party transaction was in '84-'85. In the early 90s, tri-party took off with mostly agency pools. Then DTCC collateral started to trickle into this system. About ten years ago, other collateral, such as CDO/CMOs, were introduced.

Keep in mind that the dealer is in the middle of the capital markets, often buying and then financing. Asset expansion was enabled by expansion of the repo markets.

We do not see uninformed investors in these markets. They are all professional investors.

*The lesson to America is to be sensitive and tread lightly when it comes to the repo market, and to work with us to put through productive change. A lot of institutions rely on this market. For example, if corporate America can't issue debt, there are problems for employment. There is not enough capacity in the banking system to support the amount of credit required. [Emphasis added by author.]*