

# TESTIMONY OF KAREN B. PEETZ

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## **Before the Subcommittee on Securities, Insurance and Investment Committee on Banking, Housing and Urban Affairs United States Senate August 2, 2012**

Chairman Reed, Ranking Member Crapo, and members of the subcommittee, my name is Karen Peetz, and I am Vice Chairman of The Bank of New York Mellon and CEO of the company's Financial Markets and Treasury Services businesses. I appreciate the opportunity to appear before you today to discuss the tri-party repurchase – or “repo” – market in the United States.

I would like to begin by briefly describing the history and operations of BNY Mellon, as our business model is very distinct from traditional retail or investment banks. BNY Mellon was formed in 2007 as a result of the merger between The Bank of New York and Mellon Financial Corporation. The company has a rich and distinguished history that is inextricably woven into the broader history of the United States. The Bank of New York was founded in 1784 by Alexander Hamilton, and with its predecessors, BNY Mellon has been in business for 228 years, making it one of the oldest continuously operating financial institutions in the world.

In contrast to most global banking organizations, our business model does not focus on the broad retail market – we do not offer credit cards, traditional mortgages, auto loans or similar products to retail consumers. Rather, we are a provider of services that help major financial institutions access funding and support the operational infrastructure of the global capital markets. BNY Mellon operates two primary businesses: investment servicing and traditional asset management. Through our various clearance, advisory, global markets, treasury services and asset management platforms, we facilitate the trading, settlement and distribution of client assets around the world.

Before I address the topic of today's hearing, let me begin by stressing BNY Mellon's support for recent U.S. and international regulatory reforms that have strengthened our financial system, including the Dodd-Frank Wall Street Reform and Consumer Protection Act. BNY Mellon has a long history of working with the government to help steady financial markets, often providing the benefit of the expertise we have developed from our unique role in the markets to the government regarding the structure of support facilities.



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In addition, the nature of our business allowed us to see first-hand how insufficient capital and liquidity at some institutions contributed to the financial crisis. Since the Dodd-Frank Act was enacted, we have worked with our global and domestic prudential supervisors to provide meaningful feedback on regulatory proposals and explain how proposed rules may affect critical aspects of the financial system. We have heartily endorsed meaningful reforms – including enhancing the quality and quantity of bank capital – that will strengthen the banking sector, guard against future systemic shocks, and encourage economic expansion.

For the purposes of my testimony today, I will focus on three issues:

1. How the tri-party repo market operates;
2. BNY Mellon’s role supporting the tri-party repo market; and
3. The performance of the tri-party repo market during the financial crisis and ongoing reform efforts.

Before addressing the intricacies of the tri-party repo market, I would like to start with a general explanation of the repurchase market and why it exists. A “repo” is a sale of securities by a dealer to an investor, accompanied by a contract to repurchase the securities for an agreed upon price at a later date. These arrangements are entered into by dealers who have liquidity needs and investors looking to put cash holdings to good use (often investment managers for endowments, pension funds, and municipalities, money market mutual funds, custodial banks investing cash collateral on behalf of their securities lending clients, and other asset managers).

The repo market is a major source of funding for the financial institutions that drive business and finance globally and is an integral part of ensuring that the financial system is able to work for downstream customers.

Functionally and economically, repos operate like secured loans. On any given day, a cash investor (the lender) extends funds to a dealer (the borrower) at an agreed rate – the “repo rate” – and the dealer provides the investor with securities as collateral. As the Federal Reserve Bank of New York (the “FRBNY”) has explained, “[t]he proceeds of the initial securities sale can be thought of as the principal amount of the loan, and the excess paid by the cash borrower to repurchase the securities corresponds to the interest paid on the loan, also known as the repo rate.”<sup>1</sup>

### **Tri-Party Repo and BNY Mellon Operations**

Tri-party repo transactions are a type of repurchase agreement involving a third party, the tri-party agent – the function BNY Mellon serves – who facilitates settlement between dealers (cash borrowers) and investors (cash lenders). The tri-party agent maintains custody of the collateral securities, processes payment and delivery between the dealer and the investor and provides other services, including settlement of cash and securities, valuation of collateral, and optimization tools to allocate collateral.

The tri-party repo market has grown and evolved over the years, in response to market and economic factors that made the structure a more attractive mechanism for meeting the market's funding needs. The use of a tri-party agent has enabled the market to operate more efficiently by reducing settlement risk and related costs, allowing for collateral recall, providing independent collateral verification and monitoring and standardizing transaction agreements. According to the Financial Stability Oversight Council's (the "FSOC") 2012 Annual Report the current value of the tri-party repo market is \$1.8 trillion.

BNY Mellon is a substantial tri-party agent, with an approximately 80 percent market share. Our involvement in a transaction commences after a broker-dealer and a cash investor agree to a tri-party repo trade and send instructions to BNY Mellon. These instructions represent the parties' agreement concerning the tenor of the transaction, the amount of cash lent, the value and type of collateral returned, and the repo rate.

To facilitate the tri-party repo market we extend secured intraday credit to dealers to repay their investors from the prior day's trades. If a dealer becomes distressed we could refuse to extend such credit and investors could withdraw from the market. Both of these actions could lead to destabilizations in the economy. Once a tri-party trade settles, BNY Mellon is no longer exposed to direct risk of the dealer or the underlying securities. Thereafter, the ultimate risks associated with a defaulting dealer who has pledged collateral are with its cash investors.

### **Tri-Party Repo Reform and the Financial Crisis**

Few parts of the United States financial system were untouched by the global financial meltdown from 2007-2009; therefore, it is unsurprising that the tri-party repo market experienced strain. The crisis revealed that the market could experience systemic problems: dealer defaults could leave investor counterparties or the tri-party agent holding collateral that was increasingly illiquid, leading to a seizing up of the financial markets.

In light of our role as tri-party agent, we are uniquely positioned to work with the Federal Reserve to identify ways to take risk out of the way this market operates. We have been in continual discussions with supervisors and clients regarding measures to reduce and eventually eliminate our exposure to intraday credit risk, as well as to help address broader structural concerns with the tri-party repo market.

After the financial crisis, the Federal Reserve asked clearing banks, primary dealers and investors to consider policy options to address problems with tri-party repo infrastructure that were revealed during the financial crisis, which led to the creation of the Tri-Party Repo Infrastructure Reform Task Force<sup>2</sup> – in which BNY Mellon participated. The Task Force published its final report in February 2012 summarizing the current state of reform efforts. In addition to identifying the measures I describe below as important steps, the Task Force noted other achievements that increased transparency, enhanced data reporting and strengthened cash investor stress testing practices. The report recognized that additional measures to further reduce intraday credit to broker-dealers would be necessary.

In addition to our work on the Task Force, BNY Mellon has been working with our regulators and our clients to address practices within the market that require strengthening. We have focused our own internal reform efforts on reducing the provision of intraday credit and influencing collateral standards.

With respect to reducing intraday credit provided by BNY Mellon to facilitate the triparty repo market, we are implementing recommendations made by the Task Force. We have moved to a later day unwind for most maturing tri-party repos, reducing the intraday risk exposure window from ten to approximately three hours. We have instituted an “auto substitution” process to allow dealers to replace needed, pledged collateral by first overcollateralizing with cash. Additionally, BNY Mellon introduced a three-way trade confirmation process known as automated deal matching for dealers, agents and investors. The trade matching enhancements allow BNY Mellon, as the clearing bank, to receive both the dealer and cash investor’s trade instructions separately and match the required information fields systematically. This automated matching process provides dealers and investors with an efficient and consolidated view of trade instructions, terms and modifications to ensure accuracy and transparency.

BNY Mellon is also identifying asset classes eligible for intraday credit associated with tri-party repo transactions and we are working with our clients to eliminate intraday credit associated with less liquid forms of collateral. We expect these measures to reduce intraday exposures by \$230 billion by early next year. Moreover, we are developing the technology for a systematic approach to reforming the entire unwind process that will practically eliminate exposures by the end of 2014. As we develop and implement these measures, we are working closely with our clients and the Federal Reserve to ensure that these changes are adopted in a manner and on a timetable that does not unduly disrupt the market.

Last, I would note that on July 18, The Federal Reserve Bank of New York released a statement acknowledging its efforts to use the supervisory process to effect reductions in intraday credit and implement other risk management reforms detailed in the Task Force’s recommendations. A day earlier, the FSOC issued its annual report, which sounded similar themes. The report raised the intraday credit concern I have described and stated that reforms should proceed expeditiously. I can assure you that we are partnering with the Federal Reserve on these efforts and are committed to enhancing tri-party operations to reduce systemic risk. Specific to the pace of reforms, I would note that the measures we have already implemented are materially reducing intraday credit exposures.

## **Conclusion**

BNY Mellon strongly believes that the tri-party repo market is a crucial component of the global financial system’s infrastructure. We are committed to continuing to develop meaningful reforms that limit systemic risk and enable market participants to efficiently and effectively fund their operations.

Again, I thank you for the opportunity to testify before you today and look forward to any questions you may have.

1 *Tri-Party Repo Infrastructure Reform*, The Federal Reserve Bank of New York, p. 5 (2010).

2 The Task Force on Tri-Party Repo Infrastructure Reform was formed by the Payments Risk Committee, a private sector body sponsored by the FRBNY. The Task Force included representatives from a diverse group of market participants. Federal Reserve and SEC staff participated in meetings of the Task Force as observers and technical advisors. *Task Force on Tri-Party Repo Infrastructure*, Payments Risk Committee, p. 1 (2010).