FCIC memo of staff interview with Sandy O'Connor, JPMorgan Chase

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MEMORANDUM FOR THE RECORD - MFR

Event: Telephone Interview with Sandy O’Connor, JPMorgan and Paul Weiss

Type of Event: Conference Call

Date of Event: March 04, 2010

Participants - Non-Commission:
Sandy O’Connor, JPMorgan

Participants - Commission:
Tom Krebs, Mina Simhai, Greg Feldberg, Landon Stroebel, Desi Duncker, Troy Burrus and Jay Lerner, and Hilary Allen

MFR Prepared by: Hilary Allen

Date of MFR: March 04, 2010

Summary of the Interview or Submission:

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted except where clearly indicated as such.

On Thursday, March 4, 2010, I, together with Tom Krebs, Mina Simhai, Greg Feldberg, Landon Stroebel, Desi Duncker, Troy Burrus and Jay Lerner, participated in a phone call with personnel from JPMorgan and Paul Weiss. The purpose of the phone call was to discuss the repo market, with an emphasis on the functioning of the tri-party repo market and the effect on the repo market of the events of March 2008 and September 2008.

Description of Repo Generally
- Repo is the sale of securities with a simultaneous agreement to buy them back at a later date.
- In layman's terms, it is just a secured loan. The securities are collateral, the cash paid for the securities is the loan and the repo rate paid by the borrower is the equivalent of interest.
- The bilateral repo market grew up during the 70s, 80s and 90s, because of the growth in (i) the issuance of Treasury securities and (ii) money market funds, which increased demand for safe, short-term securities.
- The repo market developed first to finance treasuries, then it expanded to agency bonds, then to DTC securities (i.e. securities that are cleared through the DTC, which clears securities not eligible for Fed clearing).
- At the peak of the market, 70% of repo was done using treasury or agency bonds, and 30% DTC. Now the split is 80% treasuries/agencies and 20% DTC.
- The bilateral repo market is costly and inefficient for some counterparties. Tri-party repo is typically used by MMFs, custodial institutions (for securities lending) and by asset managers.
- The bilateral market (primarily used interbank, and between banks and broker-dealers) is currently larger than the tri-party market, in dollar terms. The tri-party market is currently $1.7 trillion (down from its peak of $2.5-3 trillion in late 2007-early 2008).
- Tri-party repo has become the centralized global funding marketplace. At the end of the term of the repo agreement, the cash and securities go back to the original parties.
- The bulk of the tri-party repo market is made up of overnight repo agreements: investors want regular access to their cash in the morning (i.e. the end of the term).
- Each counterparty determines what type of collateral is eligible to them (they take on the risk of that credit during the term of the repo – usually overnight).
- The collateral is fully locked up for the term of the repo trade (e.g. overnight for overnight repo) and cannot be changed. For overnight repo, the collateral can be changed during the day after the daily unwind if the parties agree to revise the collateral eligibility schedule to the master repo agreement.
- Investors typically expect to get their cash back in the morning, rather than to take the collateral.

**Role of Tri-party Agent**
- With tri-party repo, there is a third party independent agent who administers the transaction. The agent verifies the deal between the two parties, and verifies the accuracy and value of, and the margin on, the collateral.
- A counterparty uses the same agent (either BONY or JPM) as both their clearing agent and their tri-party repo agent.
- The main clients of the tri-party agent are the primary government dealers.
- The tri-party agent provides daily reporting, marks collateral to market and materially reduces operational/settlement risk (when the collateral resides with an agent, there is no need to move securities across the Fed wires). The use of a tri-party agent also reduces cost.
- The agent provides secured intra-day credit to brokers as part of its settlement services, and as such bears the risk of intra-day security exposure. The agent requires a margin on the collateral in case of volatility on the securities during the day (this margin is separate from the margin that the counterparty requires on the collateral overnight).
- Separate from the margin, the agent charges fees for its clearance activity. These fees are calculated as a percentage of the collateral value.
- The agent also has the contractual right to withdraw its credit during the day.

**Effects of the Crisis**
- From 2007 until Lehman's failure, the tri-party repo market functioned fairly well because it was a collateralized lending market (the problems were more in the unsecured markets, although loss of faith in these did not lead to an increased use of the tri-party repo market).
- The volume of the tri-party market decreased a little in March 08, but there were no significant changes in margins or general behavior as a result of Bear's failure. However, people became more selective about the counterparties they would deal with.
- Lehman was the first major broker/dealer default.
- During the Lehman failure, the Fed asked JPM not to withdraw its credit during the day, and to
instead step in as principal and assume the collateral. JPM did so (it wasn't happy about it, but realized the importance of doing so to the financial system). The fear was that MMFs didn't have a credible way of taking/holding the collateral (generally, MMF documentation was not clear on whether they could hold collateral), and if they were forced to take the collateral, they would sell it in a fire sale, leading to a reduction in the price of the underlying collateral and runs on the MMFs.

- During the crisis, it was discovered that DTC securities were less liquid than everyone thought. Even the highly rated, readily available DTC securities were difficult to move.

- JPM's market share of the tri-party repo market is now 20-25%, down from 50% in late 2007-early 2008. JPM's clients typically have 90% of their collateral as either treasury or agency securities, and 10% as other collateral.

- Since the peak of the market in late 2007-early 2008, there has been an unwillingness to accept mortgage backed securities and CDOs as collateral for repos, and also fewer MBSs/CDOs are being created. This is led to the shrinking of the repo market overall.

- Margins between repo counterparties have not increased significantly post-Lehman (although there has been a shift in the types of collateral that are readily accepted), but JPM has increased its margin to reflect the potential volatility in the value of the collateral and the intra-day risk that JPM bears with respect to that collateral.

- JPM's margins are significantly higher (often around 3%) than the margins required by repo counterparties. JPM’s margins are calculated with reference to the liquidation value of the collateral, but do also take into account the counterparty risk.

- Investors are now more cognizant of the risks inherent in repo transactions, including the risk of actually having to take the collateral instead of being repaid cash. Previously, investors tended to focus only on the risks posed by the counterparty and didn't properly evaluate the collateral.

- Financial reform is likely to require more transparency regarding the margins required by repo counterparties - this is likely to result in a slight increase of margins across the board.