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VIA FEDERAL EXPRESS AND FACSIMILE

March 14, 2000

Peter R. Fisher
Executive Vice President
Markets Group
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045

RE: Continuation of FRBNY's Ability to Engage in Triparty Repo

Dear Mr. Fisher:

The Bond Market Association (the "Association") appreciates the opportunity to provide the Federal Reserve Bank of New York ("FRBNY") with its views in connection with consideration by the Federal Reserve Board of Governor's ("Board") of whether to allow the FRBNY to engage in triparty repo on a permanent basis for purposes of conducting open market operations. We welcome the possibility that the Board may extend the current authorization to engage in triparty repo beyond the April 2000 sunset date. Indeed, the recent experience of our members entering into triparty repo transactions with the FRBNY (in conjunction with the Millennium changeover period and related liquidity concerns) has proven to be very positive.

Specifically, the Association would like to provide the FRBNY with its thoughts and substantive suggestions regarding: (i) the advantages to both the broker/dealer community and the FRBNY of the ability to engage in triparty repo transactions with each other; (ii) the merits of broadening the collateral types acceptable for open market operations on a triparty basis; and (iii) useful operational changes and other enhancements to the triparty process as discussed by the Association's Funding Division Executive Committee during its February 4th meeting with your colleagues Sandra Krieger and Deborah Perelmuter.

Advantages of Triparty Repo between the FRBNY and the Broker/Dealer Community

- The industry is increasingly moving toward triparty repo as the preferred settlement method for its funding operations. This move is largely driven by the cost savings benefits inherent in triparty repo (as opposed to Delivery versus Payment ("DVP") repo), the increased ease of execution of repo trades done on a triparty basis, as well as the possession and control of collateral in a separate custodial account. Therefore, given this growing trend toward triparty repo, if the FRBNY is unable to engage in triparty repo transactions with dealers, it may experience decreased effectiveness in achieving its desired objectives with respect to open market operations.

- Specifically, as you know, triparty repo does away with most of the operational demands associated with DVP repo by involving a custodian bank to perform the operational and settlement functions. As a result, triparty repo arrangements virtually eliminate fails and allow substitutions to be done automatically with the custodian bank delivering only collateral that is acceptable to the investor. Additionally, principal and interest distributions received on the collateral are automatically remitted, margin is automatically maintained on a daily basis, and the collateral is priced and marked to market by the custodian bank.
- Because triparty repo arrangements allow for the allocation of collateral late in the day, dealers have enhanced flexibility to deliver securities out on other transactions with customers, thereby reducing congestion in the securities settlement system and improving system liquidity. Additionally, the investment rate for triparty repos tends to be higher than the rate available on repos involving DVP settlement.
- The triparty settlement mechanism--due to the features described above--makes firms' funding operations as well as the FRBNY's open market operations smoother and more efficient. This increased efficiency will likely result in increased operational flexibility for the FRBNY in the conduct of its open market operations for the Federal Open Market Committee ("FOMC"), and may lead to a higher investment rate on average.
- As an additional benefit, the Association believes that it would be realistic to expect greater market participation (hence a deeper market) from the dealer community in FRBNY open market operations should the Board continue to permit the use of a triparty settlement mechanism in the execution of its monetary policy objectives. Furthermore, as a result of the improved money flows in the overnight repo market that a FRBNY triparty facility would affect, tangible benefits would also accrue to dealers' clients.
- Finally, dealers would strongly encourage the Board to allow the FRBNY to engage in both triparty and DVP repo transactions when carrying out open market operations. Such a combination is attractive to the dealer community because it is accommodative toward customers--thereby allowing for more participation and enhanced overall liquidity--and it retains the option of DVP should technical problems arise at one or both of the clearing banks on a given occasion.
- In sum, the Association believes that permanent authorization of the FRBNY to engage in triparty repo with the dealer community would result in tangible benefits to both sides.

Comments Regarding the Expansion of Collateral Accepted in FRBNY Repo Trades

- As you are aware, the Association strongly supported the FOMC's vote last year temporarily to expand the securities eligible as collateral in the repurchase transactions undertaken by the FRBNY in the management of banking system reserves. In particular, the expansion of eligible collateral to encompass structured agency securities and adjustable rate mortgage pass-through securities was viewed by the dealer community as an extremely positive development.

- In addition to continuing to accept structured agency securities as well as both fixed and adjustable rate mortgage pass-through securities as eligible collateral for FOMC purposes, we would encourage the Board to consider expanding the list of eligible repo collateral to encompass all the security classes currently accepted at the Discount Window. By doing away with distinctions between the collateral eligible to be pledged for FOMC operations and Discount Window lending, we believe that overall liquidity would be substantially enhanced. Specifically, we would suggest that the Board consider permanently adding investment grade securities of each of the following security classes to the list of acceptable collateral for open market operations: (i) agency securities; (ii) pass-through mortgage securities; (iii) commercial and multifamily mortgage-backed securities; (iv) REMICS; (v) corporate securities; and (vi) asset-backed securities.
- The Association is, however, aware of the FRBNY's concern regarding pledges of collateral that have gone "special" as well as collateral pledges comprising small pieces of mortgage-backed securities. The dealer community wishes to accommodate these concerns, and therefore proposes that: (i) dealers will--to the extent possible--avoid using "specials" in their collateral pledges and will encourage the clearing banks to cooperate with the FRBNY in developing a CUSIP filter for those particular securities (and issues of securities) that the FRBNY prefers not to receive as collateral; and (ii) dealers avoid making collateral pledges (of mortgage-backed or other non-Treasury collateral) with pieces below a $500,000 minimum value in conjunction with transactions with the FRBNY (other than simply to fill out a trade).
- In sum, as the Board reviews its experience with the broader range of eligible collateral and triparty arrangements in the context of its millennial open market operations, we would like to reaffirm our strong support for continuing to make the ability to engage in triparty repo transactions as well as to use further expanded collateral classes, permanent features in future FOMC operations.

Enhancements to Triparty Process

- The Association would ask that the return of cash in a repo transaction with the FRBNY occur later in the day, or in any case, after allowing for the netting/paring-off of new transactions to achieve a net amount, thereby reducing potential daylight overdraft charges. It is important to note that agreeing to this change would not expose the FRBNY to any additional counterparty risk, as the cash would be in the FRBNY's triparty account at the clearing bank and would be fully collateralized by either securities or cash until it is returned.
- The Association supports the FRBNY's proposal to consider automating the triparty settlement process.
- Dealers would appreciate receiving additional information from the FRBNY on system reserve requirements as a tool for improving their own firms' planning abilities.

Conclusion

The Association appreciates the opportunity to offer these comments as the Board prepares to consider extending the ability of the FRBNY to engage in triparty repo transactions for open market purposes. As you are aware, the Association was strongly supportive of the initial decision taken by the Board last year to temporarily permit--for the first time--the FRBNY to implement the monetary policy decisions in the repo markets through triparty as well as DVP repo. The Association is hopeful that the many tangible benefits of triparty repo--to both the FRBNY as well as the dealer community--will be favorably considered by the Board as part of its overall decision-making process on this issue. Should you have any questions concerning the letter, please do not hesitate to contact me at 212.440.9436.

Sincerely,

Scott C. Rankin
Vice President and
Assistant General Counsel

cc: Sandra C. Krieger, Senior Vice President, Federal Reserve Bank of New York
Deborah Perelmuter, Vice President, Federal Reserve Bank of New York
Members of the Funding Division Executive Committee
Members of the Funding Division Trading Practices Committee
Members of the Funding Division Legal Advisory Committee
Members of the Funding Division Treasurer's Committee
Members of the Primary Dealers Committee
Members of the Federal Agency Committee
Members of the Government Operations Committee
Members of the Mortgage Operations Committee
Micah Green, Chief Operating Officer, The Bond Market Association
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