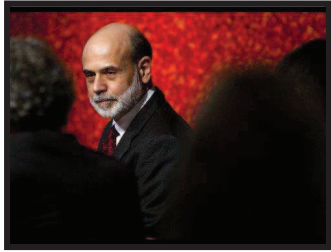


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Fed Said to Consider Clearing Bank, Facility to Drain (Update1)

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By Liz Capo McCormick and Craig Torres



Oct. 9 (Bloomberg) -- The Federal Reserve is considering accessing money market funds through clearing banks or creating a facility to drain the record amount of **cash** added to the financial system, according to people familiar with the plans.

Those methods may help conserve the capital of the 18 primary dealers that act as counterparties for open market transactions as the Fed removes some of the more than

\$1 trillion the central bank pumped the economy, said the people, who declined to be identified because no decision has been made.

Dealers would face constraints on capital if they were the sole counterparties on all the so-called reverse repurchase transactions while they're still repairing balance sheets after booking losses and writedowns in the aftermath of the worst financial crisis since the Great Depression. In a reverse repo, the Fed sells securities for a set period, temporarily decreasing the amount of money available in the banking system.

"One of the goals could be that the Fed is trying to distribute paper without encumbering dealers' balance sheets while utilizing existing distribution channels" to expand the transactions to money markets, said **George Goncalves**, chief fixed-income rates strategist in New York at primary dealer Cantor Fitzgerald LP.

Discussions on how to access a broader array of counterparties other than primary dealers are still developing, said one of the people with knowledge of the situation. **Deborah Kilroe**, a spokeswoman for the New York Fed, declined to comment.

'Down The Road'

Fed Chairman **Ben S. Bernanke** said yesterday that the central bank will be prepared to tighten monetary policy when the outlook for the economy "has improved sufficiently."

"My colleagues at the Federal Reserve and I believe that accommodative policies will likely be warranted for an extended period," Bernanke said at a Board of Governors conference yesterday in Washington, echoing language from last month's meeting of the Federal Open Market Committee. "At some point, however, as economic recovery takes hold, we will need to tighten monetary policy to prevent the emergence of an inflation problem down the road."

The Fed, after purchasing about \$1.33 trillion in mortgage, government-housing agency and Treasury debt, would also be supplying short-term assets to the money markets at a time when corporate issuance has declined and following the expiration last month of a federal guarantee on money funds.

Tri-Party Market

Bernanke and fellow policy makers face the challenge of decreasing the cash without stunting the economy's recovery and before it sparks inflation. The central bank's balance sheet surged by \$1.16 trillion in the 12 month period ending August, according to Fed data.

Central bank officials have started talks with bond dealers about withdrawing the unprecedented amount of cash injected into the financial system through the use of reverse repos agreements, people familiar with the discussions said last month. At maturity, the securities, usually Treasury, mortgage-backed and agency debt, are returned to the Fed, and the cash to the dealers.

The value of the transaction is listed as an asset on the dealer's balance sheet, and stays there even if a dealer uses the so-called tri-party market to enter into an agreement with another firm for the security, reducing the amount of capital that can be allocated for other investments.

In a tri-party arrangement, a third party known as a clearing bank functions as the agent for the transaction and holds the security as collateral. **JPMorgan Chase & Co.** and **Bank of New York Mellon Corp.**, both based in New York, are the only banks that serve in a trade-clearing capacity in the tri-party repo market. When dealers use repos to borrow money from institutional investors, it is through tri-party repo.

'Range' of Counterparties

"The Fed has used reverse repos with dealers in the past but it has never been on the scale that is being talked about here," said **Alex Roever**, head of short-term debt strategy at primary dealer JPMorgan in New York. "Operationally, it would be much easier to use the primary dealers to arrange reverse repo with money funds, but capital considerations interfere here."

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