Repurchase Agreements (Repos)

The repo involves one party buying an asset (usually treasuries and agency bonds) from another, who promises to buy it back at a higher price, often the next day; the markup is equivalent to the interest rate on the loan. Central banks around the globe have used their own repo markets to extend credit in tight markets, stabilize financing costs and guide interest rates (in the US, the Federal Open Market Committee/FOMC can use repos to keep the Fed Funds rate in the target range). ***(see more)***

Repo transactions let investors earn on cash that might otherwise sit idle and enable banks and broker dealers to draw liquidity from securities they own without needing to necessarily sell them. This 'shadow ownership' of collateral makes markets generally more liquid, as the bonds that are swapped around in repo deals can then be used to facilitate other transactions.

Repos involve some of the safest and low-credit risk securities in the market. They are a large underpinning of money market funds which target capital preservation, because every transaction is backed by security collateral. However, repos are *not immune* to liquidity issues. In the Global Financial Crisis, Lehman Brothers failed as repo market participants stopped rolling over its loans because they were worried about the insolvency of the firm. Liquidity evaporated and led to the firm's failure.

What happened in the REPO market in September?

Due to a convergence of several factors including corporate tax payments and a treasury auction settlement, primary repo participants backed away from the market, raising the repo rate to 10%, a 4x multiple of the Fed Funds target rate at the time. The FOMC had to step in to stabilize the rate by offering $75 billion of overnight funding and has continued for several subsequent days to maintain the stability of rates. ***(see more)***

REPO Rates Spiked Overnight to 10%, settled just below 7% on 9/17
Source: Federal Reserve, TradingEconomics.com

Historically, the Fed was a regular participant in the day-to-day liquidity of the REPO market pre-crisis. However, after QE and newer regulations focused on maintaining excess bank reserves, they have not been an active participant in repos until this month. In addition to overnight loans, they have added several (oversubscribed) 14-day term loan programs to lock in capital for end of month expenditure needs. There is still demand for funding for the end of the month that's not being met.

This leads to many questions about the true state of liquidity in markets, and if the actual plumbing of repo markets is still stable and not a broader sign of hidden systemic (market-wide) risk. Chances are that we have not seen the last of this type of liquidity event. The Fed may have staved off short-term risks with its injection of liquidity, but a different regulatory environment since the crisis has solved some problems and created others.

We feel that this uncertainty around liquidity among market participants is not a signal of a recession or a market "air pocket." However, it does show that the mechanics of the money markets are less liquid, and the Fed may have to work on a long-term solution (aside from one-off overnight actions). Whether that is an ongoing full allocation repo facility, another QE, or something else, only time will tell.

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