BETTER MARKETS

- FACT SHEET -

Repo Market: Reality vs. Wall Street Claims

FEDERAL AGENCIES:
Federal Reserve, Federal Deposit Insurance Corp.

DESCRIPTION:
A detailed explanation of recent issues affecting the Treasury repo market, why the market matters, and the facts and assertions concerning the contributing factors.

BACKGROUND

Repo market madness September 17, 2019 — The Treasury repurchase agreement (repo) market experienced a brief period of unexpectedly high volatility as short-term borrowers faced a decline in the supply of cash being provided to fund Treasury repos. As a result, interest rates in U.S. Treasury overnight repo markets jumped as high as 10% for some transactions, a fourfold increase from recent average rates in the market. The Fed felt compelled to provide liquidity to reduce this market volatility and bring rates back in line with market expectations and monetary policy targets.

While the reason(s) for the spike in volatility were not immediately clear, some Wall Street banks and their allies were quick to point to Dodd-Frank financial protection rules as a cause of this disruption; some observers even suggested a crisis might occur if rules were not weakened (which those very same banks had been lobbying for since they were enacted), with many pointing to year-end as the most likely time for increased volatility.

Repo market stability year-end 2019 — There was no crisis. In fact, there was virtually no volatility at all; year-end was pretty quiet. That's because, since September, the Fed has continued to provide substantial liquidity to the Treasury repo market and has also been growing its balance sheet through purchases of Treasury bills, increasing cash in the banking system. Those large Fed liquidity programs offered enough funding for the year-end Treasury repo market that they were not even fully utilized by dealer banks. This indicates banks may have had more cash to provide other borrowers in repo markets than had been expected.

Thus, the Fed's provision of liquidity appears to have been effective: less volatility than many had anticipated and no repo market crisis. However, the September volatility and the Fed's actions raise a number of serious questions about the repo markets, the dealer banks and the Fed's short, medium and longer-term plans.

Why should anyone care about what's happening in the Treasury repo market?

The Treasury repo market is an important part of how the financial system functions, helping to facilitate the funding of government debt and providing short-term cash or securities for financial institutions that may need them for a variety of purposes. This market also plays a key role in the Federal Reserve's monetary policy execution. Should disruptions in the Treasury repo market occur over an extended time period, it could weaken the Fed's ability to control the interest rate targets it sets to achieve monetary policy goals and support economic growth.

What is the Treasury Repo (repurchase agreement) market?

In the Treasury repo market, banks, money market funds, hedge funds, and others lend and borrow money collateralized by U.S. Treasury Securities (Treasuries), regularly on an overnight basis. Financial institutions swap short-term cash for securities with amounts changing hands totaling up to trillions of dollars each day. It is a big part of how money and securities move through the financial system between financial institutions that have them to those that need or want them. This market provides a significant source of funding for the purchase of government securities, and also serves as a major source of funding for financial institutions, such as hedge funds, when taking leveraged positions in these securities.

What happened in the Treasury Repo Markets that caused so much controversy?

In September 2019, demand for overnight cash to fund Treasury positions at some financial institutions was greater than the cash that was being offered by the Wall Street banks and money market funds that generally serve as key sources of cash in this market. This drove up the interest rate required to access cash through the overnight Treasury repo market. Periodic increases in rates happen with regularity on dates when cash needs for other purposes are high, though not to the degree it happened in September.

In this case, the larger than expected price increase was seen as particularly important because it caused the Fed Funds rate to rise above the target the Fed uses in its monetary policy operations. To stabilize the market and bring rates within the Fed's target range the central bank injected billions of dollars in cash into the system via the Treasury repo markets and has continued to offer liquidity through repos over the past several months.

The September event was also viewed as unusual because of the substantial cash holdings some of the largest banks had on deposit at the Fed (at that time) relative to the cash demand in the market. This has led to questions about why the small number of huge banks that normally provide cash in this market did not step in to take advantage of the unusually high repo rates they could have earned?   Put differently, given that there was some quick and easy money to make due to the higher overnight rates, why didn't they deploy their available cash? This question remains unanswered, though it seems unlikely bank regulatory requirements were a material contributing factor as some have asserted. (See below for a discussion of specific regulations that have been pointed to as possible causes).

Widespread predictions of further and perhaps even greater repo market volatility at year-end 2019 did not come to pass, likely because of Federal Reserve efforts to increase cash in the system and to offer substantial direct liquidity by funding Treasury repos at dealer banks. The Fed has committed to increasing cash in the system by growing its balance sheet and to providing liquidity for repo markets through at least the first quarter of 2020. These actions by the Fed have raised questions about Fed policy and its increased role in repo markets.

- Many market observers think the Fed will now have to remain actively engaged in Treasury repo markets for the foreseeable future, and some have even called for the creation of a permanent so-called 'standing repo facility', through which the Fed would commit to providing a broad set of banks with cash via repo funding of government securities on an as-needed basis. The Fed board has reportedly been considering such a facility but no final decision has been made. Such a move would increase the Fed's role in money markets and would not be without complications. Key questions include – which and how many firms would get to access the facility, what types of government securities would it be willing to fund and where to set the price to ensure the facility functions more as a backstop and not banks' first stop for daily funding needs?

Why was the supply of cash inadequate to meet demand at normal prices in September?

A combination of reasons has been offered to explain the supply/demand imbalance for cash in repo markets in the middle of September 2019. First, corporate demand for cash was high due to their need to make quarterly tax payments, which happens every quarter. To make these tax payments, corporations withdrew the cash they have on deposit at money market funds (MMFs). This, in turn, limited the ability of MMFs, which are typically a large net supplier of cash in the overnight Treasury repo market, to provide as much short-term cash as was customary.

At the same time, there was a large issuance of government securities and cash was needed by so-called 'dealer banks' and others to purchase these securities. This also reduced available cash in the system and financial institutions that needed to fund preexisting or new US Treasury positions in the repo markets, the argument goes, were forced to pay very high rates to access cash.

There is a fairly broad consensus that the growing supply of government debt, driven by the rapid increase in the federal deficit, combined with the shrinking of the Fed's balance sheet associated with the winding down of its quantitative easing program, and the related decline in the cash banks held in their Fed accounts, were important drivers of this event.

Additional factors some have cited include: (1) Banks having reportedly grown increasingly hesitant to borrow from the Fed's discount window, pointing to the increased post-crisis stigma associated with using the Fed discount window and (2) a possible reduction in the Fed's provision of intraday loans to banks through daylight overdrafts in their Fed accounts.

Wall Street banks and their advocates have also pointed to stronger post-2008 crisis financial protection rules, which require banks to have more liquidity and capital to make them financially stronger and thus less likely to precipitate another crisis.

- They appear to be using these events as an opportunity to further criticize and hopefully weaken key aspects of the post-crisis regulatory regime that they have long tried to get rolled back. At various times, some have cited as the alleged culprit -- either individually or in combination -- liquidity regulations, capital regulations, resolution planning (so-called 'living will') requirements and supervisors' guidance to and expectations for banks.

Is there evidence that Wall Street banks' decisions to not provide more funding in the Treasury repo market in September 2019 were a direct result of the post-crisis bank regulatory regime?

No hard evidence has been provided that banking supervision and regulations were a material contributor. While it is the case that the post-crisis financial protection rules can constrain banks' activities and risk-taking more than those in place pre-crisis, that is by design and to protect taxpayers, the financial system and the economy. Put differently, those rules are meant to prevent another catastrophic financial crash like 2008, which threw tens of millions of hardworking Americans out of their jobs and homes and inflicted significant other injuries (Read Better Markets' *Cost of the Crisis Report*).

The Federal Reserve is still analyzing the repo market events, including the impact of regulations and supervision. It said in November 2019 that post-crisis regulatory increases in banks' required liquidity and capital did not appear to be driving the unusual activity in the repo markets. Fed officials more recently stated that one part of post-crisis bank supervision for liquidity at the largest banks – the Comprehensive Liquidity Analysis and Review (CLAR) – may have played a contributing role. Importantly though, they have not yet said whether this was a material contributor, if it is something that they think needs to be changed, or if making changes in CLAR would in any meaningful way address the issues that arose in repo markets.

Specific post-crisis regulatory enhancements some claim have been contributing factors:

The Liquidity Coverage Ratio (LCR)

The LCR subjects the largest banks to a fairly stringent quantitative liquidity standard requiring them to hold enough high-quality liquid assets (HQLA) to withstand a 30-day stressed level of net liquidity outflows. Cash, including reserves held at the Fed, and Treasury securities, are treated the same in the LCR calculation, so using cash to fund Treasuries in a repo transaction would have no impact at all. Conceding this point, some have said there is a bank examiner 'preference' for cash reserves held at the Fed relative to Treasury securities in HQLA portfolios.

- While some have said that this 'examiner preference' may have led banks to hold a greater share of excess cash reserves at the Fed relative to US Treasury debt in their HQLA, the range of reserves as a share of HQLA at U.S. GSIBs is quite wide, indicating there is no specific required share of excess reserves supervisors are telling all banks to hold. In addition, for some banks this share has fallen significantly in recent years.

- As a matter of good risk management, it is to be expected that a bank's own liquidity risk management practices would include some consideration of the dollar amount of Treasuries a bank assumes it can turn into cash quickly without taking a pricing hit. In other words, banks' own practices may lead to some internal 'preference' for cash in the shape of a possible haircut on Treasuries as a source of rapidly available liquidity in a period of stress.

• Banks' internal business decisions are the primary drivers of how much cash they need to hold and what they do with it. It is easy to assert a supervisory preference is driving behavior, but banks make such decisions on their own for either risk management or business reasons and an 'examiner preference' is not a binding requirement.

Liquidity Stress Testing

This refers to the Fed's Comprehensive Liquidity Analysis and Review (CLAR), which is its liquidity risk management supervision program for the very largest banks. It is important to note that the Federal Reserve does not itself run a liquidity stress test. Banks are required to run their own internal liquidity stress tests and are expected to use the results in decisions.

• CLAR includes no binding quantitative minimum requirements, though it can lead the Fed to criticize bank practices in ways that may get the bank to take action to enhance its liquidity pool. CLAR assesses the quality of the banks' liquidity risk management broadly. It assesses the comprehensiveness and suitability of the largest banks' internal measures of liquidity risk, including the internal liquidity stress tests that banks run. It also looks at practices such as banks' management of concentrations of funding sources and types. CLAR is largely designed to look for liquidity risk management weaknesses that may not be addressed by the LCR regulation since such a one-size-fits-all approach cannot effectively capture all material sources of liquidity risk at every large bank.

Guidance from the Fed and FDIC on Resolution Plans (aka – Living Wills)

Guidance about liquidity needs for resolution planning may increase liquidity needs at banks by asking banks to assume flows between certain legal entities may be restricted in a period of severe stress. This can lead to greater liquidity needs across a large bank relative to what would be considered needed if one assumed all sources of liquidity across all bank affiliates were completely fungible and available for use anywhere, and at any time. If regulators are serious about increasing the likelihood a large bank could be resolved, assuming some possible constraints on intra-group liquidity flows in a time of severe stress is reasonable. Indeed, ignoring such a possibility would be to ignore actual experience from past periods of stress.

• Regulators have told banks they should have liquidity in place or ready to be put in place quickly at all material legal entities such that frictions, including possible foreign supervisor 'ring-fencing' of liquid assets in foreign subsidiaries and branches, would not lead to liquidity being stuck in places where it cannot be accessed when needed elsewhere. Such 'ring-fencing' is not uncommon during a period of stress and occurred in the financial crisis.

Leverage Ratio-based Capital Requirements in Fed Stress Tests

Providing repo funding of Treasuries to other financial institutions could lower a bank's leverage ratio if the bank were to borrow the money used to fund the repos, expanding their total assets and liabilities. Importantly, however, leverage ratios are based on banks' average asset balances over a period of time and even a very large short-term increase in assets such as would result from funding overnight repos at, for example, a $2 trillion bank, would have a minimal effect.

- Moreover, even if a bank borrowed money and funded Treasury repos over a more extended period of time and this were to have a meaningful impact on its leverage ratios, there appears to have been capital capacity above even the post-stress leverage threshold at a number of the largest banks, based on the Fed's most recent stress tests.

    - Since this capital could be leveraged in Treasury repos at 25 and 33 times, under post-stress tier 1 leverage and supplemental leverage ratios, respectively, it's hard to imagine some of the largest banks could not have significantly increased their treasury repo market participation and maintained capital above this threshold. This seems especially the case given that these repos are meant to be short-term transactions and the leverage ratio calculation uses average assets, as noted above.

The Capital Surcharge for Globally Systemically Important Banks (the "GSIB Surcharge")

The GSIB surcharge places progressively higher capital requirements on the largest banks, depending on a variety of factors included in the calculation of their systemic importance. Each of the U.S. GSIBs' capital surcharge is determined annually based on five main factors. A GSIBs' required capital ratio could potentially increase if a bank becomes more 'systemically important' as defined by the factors used in the calculation of the GSIB surcharge. This regulation may encourage banks to shrink their balance sheets or otherwise scale back certain activities in advance of year-end reporting dates, and some claimed this may deprive repo markets of cash/liquidity at year end and lead to another bout of volatility.

- There are five main categories used in determining the level of a GSIB's specific surcharge. Three are determined based on year-end point in time considerations and two are based on averages over a period of time.

- Total assets and the extent of a banks' use of short-term wholesale funding, such as would commonly be used to borrow in the interbank market to fund treasury positions through repos, are calculated using averages, so a year-end reduction in either of these would not be likely to have a meaningful impact on the GSIB surcharge.

- While it seems unlikely the GSIB surcharge played a material role in repo market events, elements that are captured using year-end positions can and do vary over time. Allowing banks to measure such positions only at year end can mask a significant increase in those positions within the period, and obscure the true risks they may present to the system. This could lead to under-measuring these banks' systemic importance. Measurement of such factors using daily averages over the period would be a welcome enhancement.

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Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity and prosperity of the American people by working to enact financial reform to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth and broad-based prosperity Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.

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