ADVISOR PERSPECTIVES

Salve for a Constrained Repo Market, or Potential Funding Destabilizer?

December 10, 2019

by Jerome Schneider, Kate Lehrkind, William Martinez, Jerry Woytash of PIMCO

A series of imbalances have arisen in money markets in the decade since the financial crisis, including September's dramatic spike in overnight repo rates. We believe market participants' increased reliance on overnight funding and banks' reduced ability to intermediate money markets under post-crisis regulations were key drivers of this spike – and continue to leave repo markets vulnerable.

The recent repo squall also shined a spotlight on "sponsored repo" transactions, a growing segment of the U.S. overnight funding market that has helped boost participation and liquidity since its origination two years ago. But is sponsored repo a salve for constrained repo markets, which have grown increasingly sensitive to dealers' balance sheet allocations? Or is it a potential Trojan horse of financial instability, contributing to an overreliance on overnight funding that could lead to future liquidity imbalances and volatility in term repo rates?

Behind the growing dependence on overnight funding

As a refresher, a repurchase agreement (repo) is a financing trade in which the lender of cash receives securities as collateral. Before the financial crisis, banks and broker-dealers were very willing to intermediate these trades given their negligible costs, which helped ensure money markets remained fairly priced (e.g., with no arbitrage). However, post-crisis leverage and liquidity rules have significantly increased these costs, limiting dealers' appetite for repos.

For many dealers, one solution has been to engage in more trades that "net" assets versus liabilities and therefore have reduced capital costs. In this example, netting involves offsetting a collateralized financing trade with a collateralized lending trade. But the challenge for dealers is that the same counterparty must be on both the cash investing and borrowing side of a netting trade. This presents an obvious problem: There are only a few limited circumstances in which an account would look to raise cash by financing a U.S. Treasury bond and simultaneously lend the cash that was raised in the repo market.

Enter 'sponsored repo'

To solve this problem, the Fixed Income Clearing Corporation (FICC) introduced its sponsored repo program, which provides the ability to "net" trades through a centrally cleared counterparty. Through the FICC, dealers have long been able to net trades with other dealers in the interdealer market; sponsored repo extends the potential benefit of interdealer netting to non-broker-dealers by allowing eligible FICC members to sponsor their clients.[1] A sponsored client's trade contract is then novated (replaced with a new contract) to face the FICC, reducing the balance sheet impact of the trade. This allows dealers to provide more attractive pricing and to intermediate more trades.

Over the past year, repo financing demand has increased as the U.S. deficit expanded and the Federal Reserve reduced its balance sheet. These developments have increased the amount of collateral that the repo market is required to fund. Money market funds are an important funding source, providing funding for over $1.25 trillion in overnight repos as of the end of September 2019, up $150 billion from September 2017.[2] The evolution of sponsored repo has contributed to this upward trend, and its growing significance and utilization bear watching for the subtle structural changes that may result.

Investor takeaways: benefits and risks of sponsored repo

Sponsored repo has been a key reason that money market funds have been able to increase their investments in repos. However, these transactions currently have a critical limitation: They can only be executed on an overnight basis. *This exposes the counterparties relying on sponsored repo for funding to increased rollover risk.* One way to reduce this risk and improve sponsored repo would be to create a mechanism to provide term financing.

Over the past year, investors have increased allocations to short-term strategies and money market funds as they seek to

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de-risk their portfolios amid growing global economic uncertainty. Investing in overnight repos has potential benefits, including over-collateralized investment of cash (which helps protect against a decline in the value of the bond) and daily liquidity. However, imbalances can emerge if vast segments of the financial markets use overnight funding as a method of maturity transformation (i.e., borrowing money on shorter horizons than they lend out). September's volatility showed what can happen when a shock hits a fragile market. While discussions of the reliance on overnight funding will evolve into 2020 as the market awaits SEC approval to engage in term FICC-sponsored repo trades, recent developments remain noteworthy given sponsored repo's clear benefits to market liquidity along with potential for destabilizing risk as its acceptance grows.

PIMCO believes it is critical to continuously monitor market indicators to gauge the health of funding markets and to be mindful of portfolio liquidity needs in order to proactively avoid funding stress. And an active, nimble approach can allow investors to take advantage of opportunities that arise due to breakdowns in money markets. While our near-term outlook is that funding markets will remain orderly, we are prepared to act if pricing dislocations occur.

Visit our short-term page for more on PIMCO's approach to investing in short-term markets.

Jerome Schneider is PIMCO's head of short-term portfolio management. Kate Lehrkind, William Martinez, and Jerry Woytash are portfolio managers on the short-term desk.

[1] See the Depository Trust & Clearing Corp. (DTCC) page for more information: http://www.dtcc.com/clearing-services/ficc-gov/sponsored-membership
[2] According to the U.S. Money Market Fund Monitor, published by the U.S. Treasury Department's Office of Financial Research, as of 31 October 2019.

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