

MONETARY POLICY RESEARCH**November 13, 2024****Quick Primer on the Repo Market****KEY TAKEAWAYS**

A repo transaction is a collateralized loan where the collateral is a security, typically a treasury or agency security. The cash lenders in the repo market are money market funds and GSEs such as federal home loan banks. The cash borrowers are hedge funds and foreign banks. The market is intermediated by primary dealers.

Repo transactions may be 'general' collateral where collateral is managed by a third-party service and the transaction is executed without the designation of a specific security. Rather, at settlement time, collateral is selected from an eligible pool by the collateral manager. These are called 'tri-party' transactions as opposed to 'bilateral' transactions where there is no third-party collateral manager.

Client-to-dealer transactions (e.g., where a money fund lends to a dealer) and inter-dealer transactions tend to be tri-party; dealer-to-client transactions (e.g., where a dealer lends to a hedge fund) tend to be bilateral. The rate on repo transactions, whether tri-party or bilateral, is also affected by whether the transaction is uncleared, where counterparties face each other, or centrally-cleared where a central counterparty guarantees the trade.

The Standing Repo Facility allows dealers and large banks to borrow in the tri-party *uncleared* segment at a rate equal to the upper bound of the funds' policy range. This SRF rate places a ceiling on trading in the tri-party uncleared segment for which SRF is an effective substitute. The ceiling is soft in that there can be volume traded above the SRF rate particularly at reporting periods such as quarter-end.

More meaningful volumes can trade above the SRF rate, even on SRF-eligible collateral, in other segments of the repo market. For example hedge funds, that do not have access to SRF, will pay mark-ups to dealers that do. And even SRF-eligible counterparties may prefer to borrow in the *cleared* tri-party market, at rates higher than that on SRF, since rate is not the only cost in a repo transaction.

For example, cleared transactions allow netting and so reduce balance sheet costs. Further, unlike uncleared tri-party transactions including SRF that settle early afternoon, cleared repo settles in the morning and so can reduce the need for daylight overdrafts at the Fed.

Ratings

Industry View: Neutral

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Quick Primer on the Repo Market

Given the [discussion](#) by Robert Perli, who manages the System Open Market Account (SOMA) at the Fed that holds the securities balances running off through quantitative tightening, we thought a brief primer on the repo market timely.

The smooth functioning of the repo markets, and money markets more generally, is essential to interest rate control and hence the implementation of monetary policy. Setting a *policy* range for the fed funds rate is not useful if the NY Fed is not able to ensure the *effective* fed funds rate is maintained within the policy range.

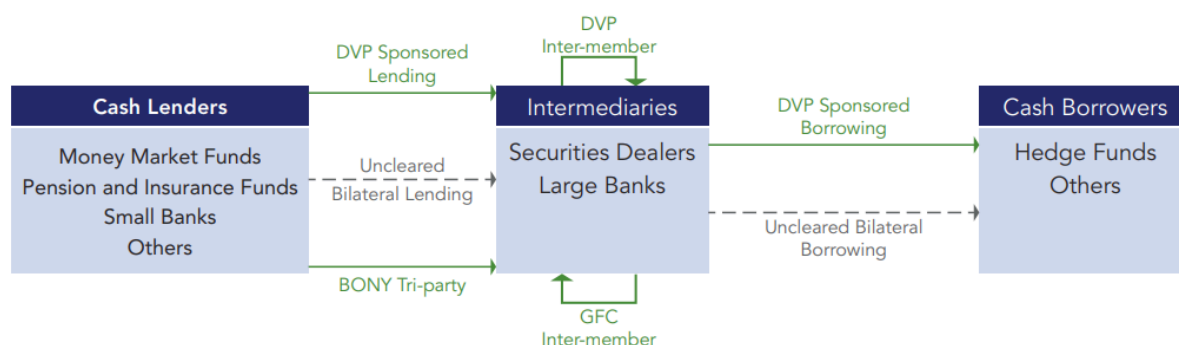
As Mr. Perli comments ‘that makes the smooth functioning of money markets [including the repo market] more than an esoteric, acronym-riddled island populated by highly specialized market participants and the occasional central banker ... it is at the heart of what the Fed does.’

Participants in the Repo Market

A repo transaction is a collateralized loan where the collateral is a security, typically a treasury or agency security such as those issued by the government-sponsored enterprises (GSEs). The cash lenders in the repo market include money market funds and GSEs such as the federal home loan banks (FHLBs); the cash borrowers include hedge funds and foreign banks.

The repo market is intermediated by primary dealers (i.e., the counterparties to the NY Fed in the treasury market). Domestic banks tend not to be end-lenders in the repo market since, unlike money funds and FHLBs, they can earn interest on reserve balances [IORB] at the Fed; they may be end-borrowers but typically prefer to fund in the deposit markets since, unlike foreign banks, they can offer FDIC insurance. Ex 1 presents a stylized view of the repo market.

Ex 1: Stylized view of the Repo Market



Source: [Office of Financial Research](#)

Collateral Management and Clearing Services

In a repo transaction, there may be a third-party custodian to manage collateral on behalf of the borrower. If there is, we have a ‘tri-party’ repo transaction (with the collateral custodian being the third party); and, if there is not, we have a bilateral repo transaction. In tri-party transactions the counterparties agree on a bundle of securities that are eligible as collateral, but the borrower does not know specifically what security has been pledged.

Bilateral transactions do not use this *general* collateral approach; rather collateral is *specific*. The advantage of specific collateral is that it is easier to re-hypothecate (i.e., to pledge again in another repo transaction) and rates can be collateral-specific. Further, a bilateral transaction is necessary if the motivation of the cash lender is not so much to earn interest on an excess cash balance but to borrow a specific security as a means, for example, of establishing a short position. (If there is a high demand for a specific security, the repo rate can be below that on general collateral; the security is said to be ‘on special.’)

Finally, regardless of whether a repo transaction is tri-party or bilateral, it may be uncleared where the counterparties face each other directly or centrally-cleared where a central counterparty guarantees the trade. Central clearing is handled by the Fixed Income Clearing Corporation ([FICC](#)). FICC has a GCF Repo Service that offers both collateral management and central clearing services to support cleared tri-party transactions, and a Delivery-versus-Payment or DVP Repo Service to support cleared bilateral transactions.

In the DVP service, clearing members of FICC can transact directly (in an ‘unbrokered’ market), via interdealer-brokers (to mask the identity of the counterparties in a ‘brokered’ market), and they can sponsor counterparties that are not clearing members.

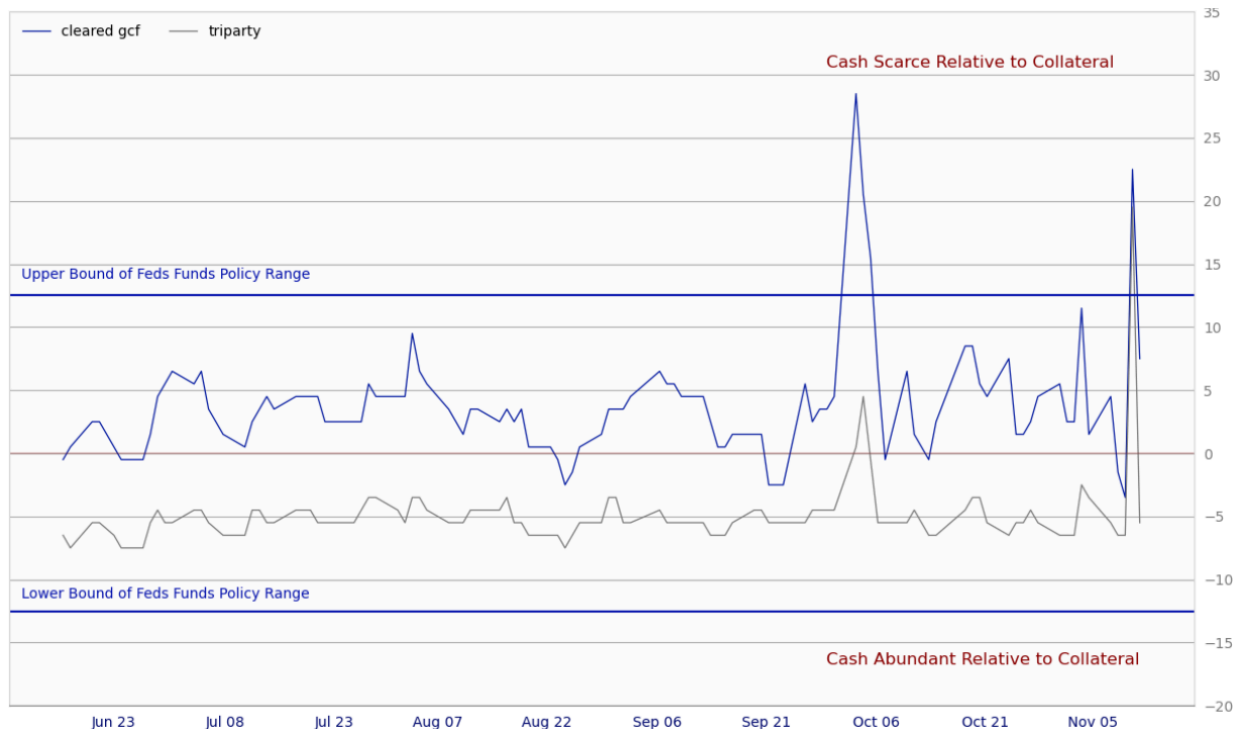
Repo Market Pricing and the Standing Repo Facility

The Standing Repo Facility (SRF) is administered by the NY Fed to support interest rate control, and hence the implementation of monetary policy, by putting a ceiling on the effective funds rate.

As Roberto Perli comments, it is designed to achieve this ‘by dampening upward pressure on repo rates that can spill over into the federal funds market by offering liquidity to eligible counterparties, including primary dealers and certain banks, subject to a minimum bid rate [currently set by the FOMC at the top of the policy range for the fed funds rate].’ He adds that SRF can dampen upward pressure on rates ‘even with little or no usage as long as it is a credible outside option for our counterparties.’

However, the SRF does not establish a hard ceiling on repo rates even in the uncleared tri-party market in which it operates. One reason is that eligible counterparties may borrow from SRF and on-lend, with a mark-up to compensate for their intermediation role, in the segment to counterparties that are not SRF-eligible. That said, Mr. Perli notes ‘activity for which the SRF is an effective substitute – i.e., uncleared triparty trading – has occurred almost exclusively below the SRF offering rate ... outside of the most recent quarter-end, we have seen little volume trading above the SRF rate.’ The gray line in Ex 2 illustrates this.

Ex 2: Repo Pricing for Cleared GCF Transactions (Blue) and General Tri-Party Transactions (Gray)



The blue line of Ex 2 illustrates that cleared GCF repo transactions may trade above the SRF rate more frequently than uncleared tri-party transactions for which SRF is a more effective substitute. This is because SRF-eligible counterparties may choose to borrow uncleared even at rates higher than that on SRF. The reason is that rate is not the only cost in a repo transaction. For example, cleared transactions offer netting and so lower balance sheet costs. Further, cleared transactions settle in the morning while SRF, like other uncleared tri-party transactions, settle in the afternoon and so may require the use of daylight overdrafts.

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