VANDERBILT Ave.
ASSET MANAGEMENT

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The Quarter End Tumult in Money Market Funds

Follow-up to:
REPO or Reverse-REPO? ... Buying or Selling? … Depends Who's Asking

REPOS in the news again…technical difficulties

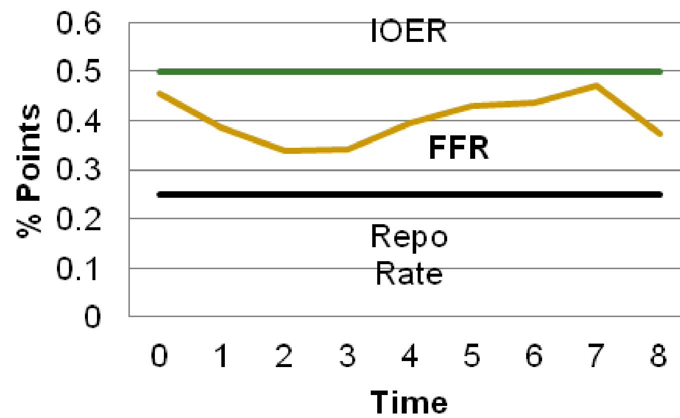
Most quarter ends are turbulent time for banks. Banks typically increase their balance sheets while decreasing their REPO activity. This is partly due to the liquidity coverage ratio ("LCR"), an important part of the Basel Accords. The LCR requires banks to hold enough high grade securities, such as treasuries, which can be sold during a crisis and provide funding for the bank for 30 days. As a result banks are less able to lend out short-term debt via REPO during these times.

At the end of the third quarter in particular, with banks unwilling to lend their securities in the REPO market, REPO activity was down and rates briefly soared. This put money market funds, looking to invest cash, into a difficult position. Not only were they in need of investment vehicles in general, but they were also facing the October 14 deadline to their rule changes. The new rule would require certain funds to abandon their stable $1/share value and allow their prices to fluctuate daily based on the current market value of their holdings, rather than maintaining a fixed net asset value ("NAV"). The floating NAV rule excludes government securities, however, which still offer a stable NAV, so money funds preferred government-only securities. Therefore, as an alternative to lending money to banks, money funds invested in government securities made available by the Fed's Reverse Repo.

In anticipation of fourth quarter and year end, the market is again anticipating a significant increase in the REPO rate. With year-end on the horizon, lenders pull back from making loans in order to dress their balance sheets for regulatory reporting. With more money expected to flow into the Fed repo facility at year end, we can expect a rise in the repo rate even greater than that at the end of the third quarter.

Some background on the Fed's Reverse Repo Facility…

From the Federal Reserve's perspective, it uses its Reverse Repo facility and Interest on Excess Reserves (IOER) as a method to control short term interest rates and keep the Fed Funds rate within a target range. See chart below.



During the financial crisis, the volume of reserves greatly exceeded the volume of required reserves because the Fed created reserves to implement emergency easing measures. Previously, the volume of reserves and the volume of required reserves were nearly identical, so there was little excess. Post crisis, there was significant excess. Therefore, the traditional way of controlling interest rates by varying money supply became impractical. Instead, the Fed began to pay interest on excess reserves (IOER).

The issue became that not everyone who transacts in the Fed Funds market is eligible for IOER because they don't have an account with the Fed (such as money funds, GSEs), so the Fed Funds rate (rate banks charge each other) was falling lower than IOER (rate they lend to Fed). This is counterintuitive since the risk to lending to other banks should be greater, and therefore garner a higher rate, than the rate of lending to the Fed. Rates should have equalized but didn't, because not the same participants were active in the two markets. Therefore, the Fed needed to establish a floor for interest rates. So they created a Reverse Repo facility, which allows other participants to lend money and earn interest on deposits.

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