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ASSET MANAGEMENT

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REPOS in the news again…technical difficulties

Follow-up to our April 2015 article

The most recent deterrent to the repo market is not more pressure from government regulation, but a more 21st century problem: technical difficulties. Dealers who enter into repo trades clear through either Bank of New York Mellon ("BNY") or through J.P. Morgan Chase ("JPM"). These repos are then processed by Depository Trust and Clearing Corp ("DTCC"). Currently, an agreement allows dealers processing their repos through BNY to trade with dealers processing with JPM. However, DTCC is proposing a change, which if approved by the Securities and Exchange Commission ("SEC"), will not permit DTCC to mediate trades between JPM and BNY beginning on July 15th. Dealers will have to trade with firms who clear through the same bank (i.e., either through BNY or through JPM).

The impetus for this decision by DTCC to discontinue mediating came about as a response to a failed attempt by itself, BNY and JPM to actually improve communications between each other. Currently, about $45 billion, representing 15% of the $300 billion daily interdealer repo trading resides in general collateral financing ("GCF"). GCF includes repos of Treasuries, MBS, and Agency securities. The Federal Reserve, in its attempt to regulate the repo market, criticized that the inter-dealer GCF repos across clearing banks were out of sync with other repos and demanded that they be realigned. In response, DTCC began to work on building a new technology which would have allowed for more information exchange between clients in order to resolve the misalignment. While JPM and DTCC enhanced their systems, BNY decided to pass on the project, as it would drain too many of its resources. In addition to this disagreement, BNY asked DTCC to accept new credit limits, resulting in DTCC deciding to suspend its interbank GCF repo services.

BNY currently clears 85% of the repo market, while JPM only clears 15%. When DTCC stops facilitating inter-clearing-bank repos, clients of both banks will suffer, but particularly those of JPM as their trading partners will be limited. Additionally, repo rates for the two banks are likely to vary. While prior to adoption, DTCC's changes would have to be approved by the SEC, their effects are already being felt in the marketplace. Some dealers have entered into long dated repos with expiry dates just short of the July 15th cutoff. If approved, this change will only underscore the already tepid market liquidity banks have been facing.

While technical difficulties are creating a less liquid repo environment for dealer banks, it could also trickle down to smaller investors such as money managers. The repo market has already been shrinking over the last several years in response to increased regulation. Splitting the market for clearing could serve to complicate it further, resulting in investors choosing to put their money in other short term investments.

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