by Viral V. Acharya and T. Sabri Öncü

Although one of the main concerns of the Dodd-Frank Wall Street Reform and Consumer Protection Act was soon to be signed by President Obama to law is systemic risk, it is disconcerting that the Act is completely silent about how to reform one of the systemically most important corners of Wall Street: the repo market, whose size based on daily amount outstanding now surpasses the total GDP of China and Germany combined. The financial crisis of 2007-2009 to which the Dodd-Frank Act is a response was a crisis not of the traditional banks, but also of the shadow banks, those non-banks that have the institutions that buy and sell securities in the repo market to lend investment grade paper and short-term debt. Unlike traditional banks, shadow banks did not have access to the safety net designed to prevent wholesale runs on banks - namely, deposit insurance and the central bank as the lender of last resort - until 2008. Although there was no wholesale run on the traditional banking system during the crisis of 2007-2009, we effectively observed a run on shadow banks that led to the demise of a significant part of the shadow banking system. Since repo financing was the basis of most of the leveraged positions of the shadow banks, a large fraction of the run occurred in the repo market. In the repo market of 2007-2009 was triggered by a shadow bank run on two Bear Stearns hedge funds speculating in the potentially illiquid subprime mortgages by borrowing short-term in the repo market.

A sale and repurchase agreement as executed in the U.S. is a short-term transaction between two parties in which one party borrows cash from the other by selling a financial security as collateral. From the point of view of the party that lent cash, this transaction is called a repo, whereas from the point of view of the lender of cash, it is called a reverse repo. Although loans secured by some collateral have been traced back at least 3000 years to ancient China, repos as we know them were introduced to the U.S. financial market by the Federal Reserve in 1917 to extend credit to its member banks after a war time tax on interest payments on interest-bearing government bonds had made it difficult for banks to raise funds in the commercial paper market. Later in the 1920s, the New York Fed used repos secured with bankers’ acceptances to extend credit to dealers to encourage the development of a liquid secondary market for acceptances. Repos fell from grace during the Great Depression after massive bank failures and suppressed interest rates, only to make a comeback after the Treasury-Federal Reserve Accord of 1951 that renewed emphasis on controlling inflation rather than keeping interest rates low.

During the period of high inflation in the 1970s and early 1980s, rising short-term interest rates made repos a highly attractive short-term investment to holders of large amounts of idle cash. Increasing numbers of local and state governments, and, at the encouragement of securities dealers, even school districts and other small creditors started depositing their idle cash in “repo banks” to earn interest rather than depositing money in commercial banks which did not pay interest on demand deposits. Furthermore, the U.S. Treasury started borrowing heavily after 1974, eventually changing the status of the U.S. from a creditor to a debtor nation and increasing the volume of marketable Treasury debt by a large amount. This led to a parallel growth in government securities dealers’ positions and financing, and the repo market grew by leaps and bounds.

Two big changes in the 1980s further solidified the use of repos in the U.S. financial market. The first was the extension introduced by the Federal Reserve in 1917 to extend credit to its member banks, much of the early contracting conventions had not changed until 1982. The first big change came in 1982 in the treatment of accrued interest on repo securities; accrued interest which had been excluded from the invoice price of the repo securities now became a part of the invoice price. This change to repo contracts was brought about after the spectacular collapse of Drysdale Government Securities Inc. in 1982. Despite its limited equity, Drysdale had been acquiring substantial amounts of debt securities through reverse repos and at prices that excluded the accrued interest. Drysdale then short sold these debt securities to third parties at prices that included the accrued interest. Drysdale used the surplus thus generated to raise more capital and to make interest payments to its reverse repo counterparties. However, when interest rates moved against Drysdale in May 1982, the cumulative losses on Drysdale’s interest rate bets depleted its capital and on May 17, 1982, Drysdale failed to pay the interest on securities it had borrowed. When the news about Drysdale’s failure to pay interest hit the repo market, it came to a near halt, and forced the Fed to intervene as the lender of last resort to calm fears and prevent a collapse. This near collapse exposed the systemic risk associated with the exclusion of accrued interest and therefore, largely at the encouragement of the Federal Reserve Bank of New York, inclusion of accrued interest in the invoice price of repo securities became standard market practice.

The second and more important change came in 1984 via the extension of Federal Bankruptcy laws to repos not only on Treasury and federal agency securities, but also to repos on bank certificates and bankers’ acceptances. Until this change, repo securities

The Dodd-Frank Wall Street Reform and Consumer Protection Act and a Little Known Corner of Wall Street: the Repo Market

About Restoring Financial Stability

Previously, many of these faculty developed 18 independent policy papers offering market-focused solutions to the financial crisis, which were published in a book, Restoring Financial Stability: How to Repair a Failed System (Wiley, March 2009).

About the Authors

- Viral V. Acharya
- Barry Adler
- Edward T. Altmann
- John Birge
- Benjamin Bengen
- Stephen J. Brown
- Jennifer H. Carpenter
- Thomas P. Cooley
- Robert F. Engle
- Farhang Farzanegan
- Xavier Gabaix
- Harish Goyal
- Niurupam Kulkarni
- Hans Le
- Samuel Lee
- Anthony W. Lynch
- Thomas Mertens
- Wee Ming Ng
- T. Sabri Öncü
- Lasse Pedersen
- Armita Payghe
- Thomas Philippon
- Matthew P. Richardson
- Joshua Ronen
- Stephen G. Rozen
- Helise Santana
- Anjolein Schmeits
- Philipp Schmidt
- Kermit Reinthal Schoenholtz
- Dr Shachar
- George Smith
- Roy C. Smith
- Ratti G. Subrahmanyam
- Richard Sulla
- Sri Van Nesenwether
- Paul A. Wachtel
- Zeo Waiteur
- Lawrence J. White
- Robert Whiteaw

Categories

General Analysis of Bill
Financial Architecture
- The Architecture of Financial Regulation
- Central Bank Independence and the Role of the Fed
- Systemic Risk
- Measuring Systemic Risk
- Taxing Systemic Risk
- Capital and Liquidity Requirements
- Glass-Steagall 2.0 - Volcker Rule
- Contingent Capital
- Resolution Authorities
- Shadow Banking
- Money Market Funds
- Hedge Funds, Mutual Funds and ETFs
- Regulating OTC Derivatives
- Repo Market
- Credit Markets
- Towards a New Architecture for US Mortgage Markets
- Regulation of Rating Agencies
- Securitization Reform
- Consumer Finance Protection Agency
- Compensation
- The Insurance Industry
- Accounting Topics
- Other Finance Regulatory Topics
- Media Coverage
- Published Opeds on Financial Reform

Monthly Archives

November 2010 (2)
October 2010 (2)
September 2010 (2)
July 2010 (9)
June 2010 (3)
May 2010 (10)
April 2010 (19)
March 2010 (5)
February 2010 (1)

Search

About this Entry

This page contains a single entry by Sabri Öncü published on July 16, 2010 6:22 PM.

Consumer Finance Protection Regulation: The Winners and Losers was the previous entry in this blog.
Dodd-Frank and the Fed is the next entry in this blog.

Find recent content on the main index or look in the archives to find all content.
on bank certificates and bankers' acceptances were subject to automatic stay, an
injunction issued automatically upon bankruptcy filing that prohibited collection against
either the debtor or the debtor's property. However, after the change repo securities on
bank certificates and bankers' acceptances became exempt from automatic stay. The
underpinnings of this change were laid when another government securities dealer,
Lombard-Wall, with $2 billion in assets and comparable liabilities, collapsed three
months later in August, 1982. Prior to Lombard-Wall's bankruptcy filing on August 12,
1982 with the Federal Bankruptcy Court of New York, there had been no precedent
case in which the question of "whether repos were secured loans or independent
sale and repurchase agreements" was directly addressed. If repos were classified as sale
and repurchase agreements, then creditors could take immediate possession of the repo
securities; if they were classified as secured loans, then repo securities would have
been subject to automatic stay. On August 17, 1982, the Federal Bankruptcy Court of
New York announced that Lombard-Wall's repos were secured loans and imposed a
restraining order prohibiting the sale of these repo securities. Although submissions by
the Federal Reserve Bank of New York and several others argued that the decision would
undermine the liquidity of the repo market, the court reaffirmed its decision a month
later. This removed the vagueness associated with whether repos were secured loans or
independent sale and repurchase agreements. Despite this ruling, investment banks,
mutual funds and other large financial institutions favored the exception of repo
securities from the application of automatic stay, although they seemed unwilling to
write contracts that clearly stated that a repo was a pair of outright sale and repurchase
transactions.

Debates continued until another securities dealer, Lion Capital Group, collapsed in May
1984 and a bankruptcy court placed an automatic stay on Lion's repo securities. Shortly
thereafter, Congress ended the debates about the classification of repos by enacting the
Bankruptcy Amendments and Federal Judgeship Act of 1984 exempting repos on
Treasury and federal agency securities, as well as on bank certificates of deposit and
bankers' acceptances, from the application of automatic stay. Since then and to this
day, repos on these securities have been exempt from automatic stay.

Dealer delivery failures in the 1980s also gave rise to the emergence of "tri-party repos,"
in which the counterparties used a third agent, called the tri-party agent, to manage
the collateral. The tri-party agent ensured that the collateral pledged was sufficient
and met eligibility requirements, and all parties agreed to use the collateral prices
supplied by the tri-party agent. Today, there are only two tri-party agents in the U.S.,
called the 'tri-party clearing banks,' namely, Bank of New York Mellon and J. P. Morgan.
Because these two clearing banks have a huge amount of exposure on an intra-day basis,
regulators expressed concerns that fears of the financial health of a major dealer or
clearing bank could quickly spread contagion throughout the market. Indeed, the Fed's
decision to extend its lender of last resort support to the systemically important primary
dealers during the current financial crisis through the so-called 'Primary Dealer Credit
Facility' was partly a result of these concerns. Recently, on May 17, 2010, the Federal
Reserve Bank of New York Task Force on Tri-Party Infrastructure published a white
paper addressing these concerns that proposed potential solutions that may prevent a
bank run on tri-party repo.

Although the repo market grew by leaps and bounds after the Bankruptcy Amendments
and Federal Judgeship Act of 1984, until the mid-1990s it remained confined mostly to
U.S. government debt, federal agency debt, corporate debt and federal agency
mortgage-backed securities. However, since the mid-1990s, it has grown to include a
broad range of debt instruments as collateral, including all types of private-label
mortgage-back securities such as residential mortgage-back securities and commercial
mortgage-backed securities, all types of asset backed securities such as auto loans,
credit cards and student loans, as well as tranches of structured products such as
collateralized mortgage obligations, collateralized loan obligations, collateralized debt
obligations and the like. In 2005, the exemption from automatic stay was further
extended to mortgage loans, mortgage-related securities, and interest from mortgages
or mortgage-related securities.

Then the financial crisis of 2007-2009 came at the end of July 2007, following the
collapse of two highly levered Bear Stearns hedge funds on June 20, 2007; these funds
invested in subprime mortgages. The collapse of these two Bear Stearns hedge funds
was indeed a run on a shadow bank in the repo market. These two funds, one of which
at its peak was levered 10 times its equity, speculated mostly in collateralized debt
obligations (CDOs) on subprime mortgages, borrowed funds in the repo market and
pledged their CDOs as collateral. When the housing market changed course in the first
quarter of 2006, the subprime mortgage market began to deteriorate. With the
deterioration of the subprime market in the first half of 2007, creditors began asking
the two Bear Stearns funds to post more collateral to back the repos by mid-June 2007.
When the funds failed to meet these margins, creditors led by Merrill Lynch
threatened to declare the funds in default of repo agreements and seize the
investments. In fact, on June 19, 2007, Merrill did seize $850 million of the CDOs and
tried to auction them. When Merrill was able to sell only about $100 million worth of
CDOs, the illiquid nature and the declining value of subprime assets became
evident. This shadow bank run and the systemic crisis which followed provide a feel for
the significance of repo securities from the application of automatic stay;
the repo securities been subject to automatic stay, or other alternatives such
as those we proposed elsewhere, the Bear Stearns funds could have filed for bankruptcy
and the forced fire sale of their assets could have been avoided.

The run on the shadow banking system in the repo market came in two phases. After
Bear Stearns collapsed in March 2008, the Fed introduced its most radical change in
monetary policy since the Great Depression by extending its lender of last resort support
to the systemically important primary dealers through the new 'Primary Dealer Credit
Facility'. However, even this extension of the lender of last resort facility did not
prevent the run on Lehman Brothers, as investors realized that this support was not
unconditional and unlimited. With the Lehman bankruptcy on September 15, 2008, the
repo market on even U.S. government debt, federal agency debt, corporate debt and
federal agency mortgage-backed securities came to a near halt and settlement fails of primary dealers skyrocketed. When the Fed and the U.S. government let Lehman collapse, the next in line for a run, Merrill Lynch, had to merge with Bank of America. Shortly thereafter, the two remaining independent broker-dealers, Morgan Stanley and Goldman Sachs, were forced to convert to bank holding companies and were formally put under supervision and regulation of the Federal Reserve. In fact, the entire Wall Street system of independent broker-dealers collapsed in a matter of seven months.

The Dodd-Frank Act is completely silent on how to reform the repo market. This is a mistake given the systemic nature of the repo market and its structural weaknesses discussed above. Unlike the liquidity risk that unsecured financing may become unavailable to a firm, the liquidity risk that secured repo financing may become unavailable to a firm is inherently a systemic risk; the markets for the repo securities held predominantly by the financial sector may become illiquid. Unless this systemic liquidity risk of repo market is resolved, the risk of a run on the repo market will remain. At any rate, leaving the repo market as it currently functions is not an alternative; if this market is not reformed and their participants not made to internalize the liquidity risk, runs on the repo will occur in future, potentially leading to systemic crises.

Categories: Repo Market

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