There has been continued fallout today (and plenty of questions from clients) from yesterday's WSJ article that spoke about the risk that a downgrade of the US credit rating would cause haircuts in the $4 trillion US repo market to rise and, consequently, funding costs to rise. We are in a unique position on the AVM Financing Desk to actually see and speak to all three sides of the repo market: collateral providers, cash providers, and broker/dealers. We have not seen any sudden increase in haircuts, as described in the WSJ article. But, the problem with an article like this is that while there has been no raising of haircuts, the article itself being from the WSJ (who rarely stoops to speak about repo) gives it undo credibility and creates more questions and fear around a subject that people were perhaps not focused on. It reminds me of Y2K and all the articles, fear, and committees to combat the speculated problems for Y2K (that never occurred) which themselves caused some illiquidity and changes in client behavior. An article like this can become a self-fulfilling prophecy: if you say that people are concerned or fearful of something happening, even if they weren't thinking about that happening before, they suddenly are concerned and fearful because you said it. Today, we saw an unusual move lower in the stock prices of almost all REITs. Is it a coincidence that the WSJ article yesterday mentioned that REITs would probably be the most affected by rising haircuts in the repo market because many of them rely so heavily on leverage? If you asked me, I think that Agency MBS pools are king of 'money good' because while carrying an implied guarantee from the US government, they don't rely on the US government to pay the coupon, amortization, and final maturing principal. As long as the underlying mortgages continue to be paid by consumers, then owners of the securities will be paid. A US Treasury and an Agency debenture, in contrast, rely on the Treasury or the US Government entity to pay the coupon or the maturing principal, not that I think there is much of a risk that that won't happen.

As I said yesterday in this Repo Commentary, I don't agree that a downgrade of US credit rating would necessarily cause repo haircuts to increase in the short-term. The process to increase haircuts in repo triparty agreements, which is how the majority of repo cash providers access the market, is a laborious documentation process and would likely not happen overnight. Furthermore, most 2A-7 money market funds define their Tier 1 eligible collateral as any US government security or a security rated in the highest short-term category. So, US Treasuries, Agency debentures, and Agency MBS, even if downgraded, would still qualify. In my almost 29 years of experience in the repo market, I don't believe I've seen a direct link between the haircuts on US Treasuries/government securities and the underlying rating or implied rating. Haircuts are more directly correlated with counterparty credit worthiness, the first line of defense in a repo, and the price volatility of the underlying securities, the second line of defense. Unless US Treasury/government securities increase in price volatility for an extended period of time, we probably won't see much of an impact on short-term repo haircuts.

That being said, uncertainty, fear, and articles such as the one in the WSJ can have an impact on perception of risk and client behavior. It probably hasn't helped that the Federal Reserve has refused to meet with the broker/dealers to discuss contingency planning in the event of a default or a US credit rating downgrade. Rather than allaying fears, as that type of contingency planning did in Y2K, not broaching the subject seems to create more fears. We have seen the behavior of clients in the repo market over the last week or so cause repo rates to increase dramatically, as perceived liquidity has decreased. Money market funds have been reducing their short-term repo positions and going into cash, due to the uncertainty in the market and to provide for any investor redemptions or reallocations into stocks. I have heard that actual money market fund redemptions were $67 billion last month and $37 billion last week alone. This has removed a significant amount of cash from the repo market that broker/dealers used to fund the US Treasury, Agency Debenture, and Agency MBS portfolios of the broker/dealers and the collateral they reversed in from collateral providers in the repo market. Consequently, those broker/dealers have been forced to reduce their balance sheets, particularly of collateral they reversed in from collateral providers in the repo market and to raise their bidside repo rates for that collateral dramatically. Agency MBS pools, which may have been bid at 0.16% overnight last week, were bid at 0.35% today. Those broker/dealers who have not been able to reduce their balance sheets (including some primary dealers who had to take down the latest 5-day Cash Management Bill from the US Treasury) have had to raise their offerside repo rates to attract dwindling cash in the repo market to finance themselves. Agency debentures, which may have been offered at 0.05% overnight last week, were offered at 0.20% today. This has been exacerbated and could be exacerbated further by clients who change their restrictions on the repo investment collateral they take, based on the uncertainty in the market and articles like the one in the WSJ. Some clients are now excluding US Treasuries for a short period of time, until the market becomes 'normal', while other clients are moving their repo from Agency MBS pools to US Treasuries for a short period of time. Other clients are making a distinction between the maturities of US Treasury securities they will take for this short period of time, avoiding those securities that pay a coupon (perceiving that they may be at some risk of the government not making good on that coupon) in August or avoiding securities that mature in August (perceiving that they may be at some risk of the government not paying the principal at maturity). I personally think these concerns are overblown, but that doesn't actually matter. What matters is what the market behavior becomes. Even if the fears are unwarranted, if enough clients behave in a manner to reduce liquidity or change liquidity for one type of security over another, it will have an impact on the repo market.

Jeffrey Kidwell

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