

Direct Repo™ – a money market paradigm shift

Ever since the Lehman event, repo markets have struggled unsuccessfully to regain their status as one of the broadest and deepest pockets of liquidity in the world. What's changed and what's the alternative?

In the aftermath of the credit and liquidity crisis, Dodd Frank, Basel III, the Fed's zero interest rate policy, and a host of other market and regulatory reforms have combined to create a perfect storm of adverse conditions for the traditional operation of the repo markets. This new environment has caused a number of key structural changes, a few of which are:

- Dealer leverage ratios are a lot lower than pre-Lehman
- Dealer balance sheets are smaller and more expensive
- Dealer risk profiles are lower

The natural result of these three related changes is a reduced appetite for repo among most dealers, as evidenced by higher haircuts, wider spreads and smaller matched books. While these changes have helped to make dealer repo books relatively more profitable than in their pre-Lehman days (when they were an inefficient allocation of balance sheet for bank-owned dealers), they have not been sufficient to make them major contributors to dealers' bottom lines. And, of course, today's wider spreads and higher haircuts are done at the expense of the very clients who supply them with cash and collateral.

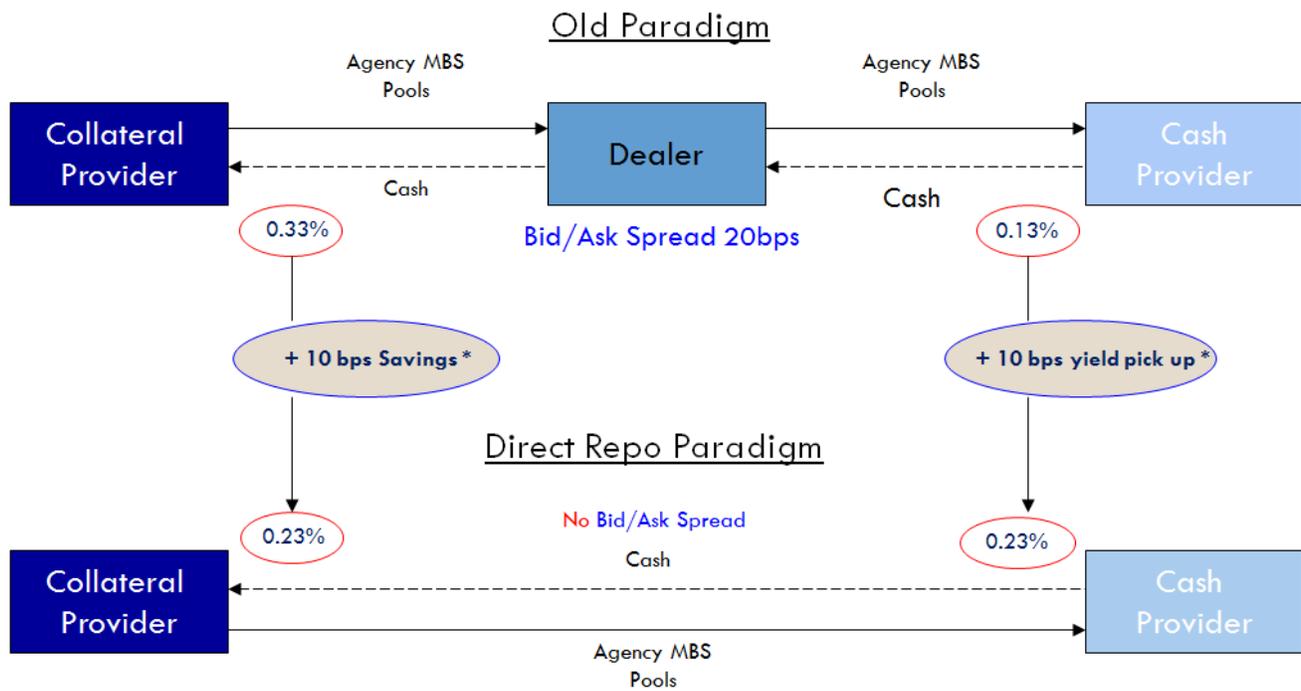
Today, whether you're a traditional cash provider to dealer repo desks, like a money market fund, or a traditional collateral provider, like a mortgage REIT, you're now facing dealers who either don't really want your business or can't take your business due to reduced balance sheets, and they're demonstrating this by charging too much for their repo products.

Is there an alternative to this bottleneck at the dealers? We believe so – Direct Repo™

Direct Repo™ is a pairing of cash providers with collateral providers, both of whom have a strong financial incentive to do business directly with each other. Typically, the trades are done pursuant to tri-party repo agreements, where the custodian (BNY Mellon or JPM Chase) maintains the collateral, generates independent pricing for margin management, and provides a layer of protections from the counterparty.

This financing away from dealer balance sheets actually helps dealers to focus more on their higher margin businesses, such as market making.

Even in today's extremely low-rate environment there may be significant savings for those willing to adopt the new Direct Repo™ paradigm. The graphic below, clearly shows the rate advantage to be enjoyed by both cash and collateral providers in today's market:



- All rates and spreads presented are approximations based upon market indications from 11/22/11 and are used for illustrative purposes only and before any transaction fees. Actual market rates may vary materially.

Besides this rate advantage, the **counterparty diversification inherent in Direct Repo™ transactions is becoming much more important** as the dealer banks credit continues to deteriorate in today's challenging global environment.

Whether the repo markets ever return to the good old days or not, it behooves major market players in the repo markets to seek alternatives now, and Direct Repo™ is an idea whose time has come.

Bill McCauley

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