GLOBAL MARKETS ANALYSIS
Monetary and Capital Markets

SRF: A new Fed facility

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SRF: A NEW FED FACILITY AS A FINANCIAL STABILITY AND MONETARY POLICY TOOL

On July 29 2021, the Fed announced the establishment of a domestic standing repurchase agreement (repo) facility (SRF) and a repo facility for foreign and international monetary authorities (FIMA repo facility).[1] The facilities formalize previous domestic and foreign repo arrangements with a view to serve as a backstop in money markets to support the effective implementation of monetary policy and smooth market functioning. This special feature focuses on the domestic SRF. It reviews the main features of the recently introduced SRF by the Fed and discusses potential impact on the functioning of the US money markets. It also summarizes the market reception of the facility and market expectations on its use.

BACKGROUND AND OPERATIONAL DESIGN

The precursors to the SRF were the repo operations following the Treasury market stress in September 2019 and the pandemic-related Treasury market dysfunction in March 2020.

- The September 2019 events unfolded following the Fed's "balance-sheet normalization". The gradual decline of the Fed's reserve balances came to a sudden halt, as a series otherwise expected events (including Treasury market issuance and tax collection) combined with structural changes in the money market regulation following the Global Financial Crisis (GFC) revealing insufficient reserve balances. Dealer banks stepped back from lending and hoarded liquidity, disrupting the functioning of the Treasury repo markets. The Fed re-started daily repo operations with primary dealers to provide additional reserves to the system, reversed its balance-sheet normalization, and expanded the pool of reserves to normalize market functioning (Figure 1, Panel 1).

- In March 2020, the pandemic market turmoil and the ensuing "dash-for-cash" led to vast selling pressures for Treasuries with longer maturities, leading to temporary but sharp increases in their yields. The volatility in the Treasury market shot up, while liquidity drained from the market (Figure 1, Panel 2). The developments forced the Fed to markedly increase the size of its Treasury repo operations, especially term repo, expand asset purchases and add significantly to the quantity of additional reserves.

Since, the SRF has been a subject of discussion at recent FOMC meetings, while garnering increasing support from academics and practitioners. As evident from the FOMC minutes since April the concept of the facility had garnered broad support among Committee members early on, while cautioning on the calibration of the design parameters (including the pricing structure, the counterparty range, and the collateral pool) and their implications in the functioning and the role of the facility. A standing repo facility was also favored by the Group of Thirty (G30), and featured as one of the suggested recommendations to improve the functioning of the Treasury market. The Group of Thirty proposal, albeit vague in certain key operational aspects (such as the appropriate interest rate), suggested a broader reach (address the facility to a broader set of counterparties) with a narrow focus on Treasuries (Treasuries only as eligible collateral). Market participants also broadly welcomed the Group of Thirty proposals.

The design of the overnight SRF, as announced by the Fed in July 2021, allows for competitive auctions of limited size and is open to further modifications in the future. The SRF has a competitive auction design with the minimum bid rate at the top of the IOER and a fixed allotment size. Under the SRF, the Federal Reserve will conduct daily overnight repo operations against Treasury securities, agency debt securities, and agency mortgage-backed securities, with a maximum operation size of $500 billion. The minimum bid rate for repos under the facility will be set

[1] According to the Fed, the FIMA Repo Facility provides, at a backstop rate, an alternative temporary source of U.S. dollars for foreign official holders of Treasury securities other than sales of the securities in the open market. FIMA account holders consist of central banks and other international monetary authorities with accounts at the Federal Reserve Bank of New York.

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initially at 25 basis points, at the top of the Fed policy range. Counterparties for this facility will include primary dealers and will be expanded over time to include additional depository institutions (see statement). In line with the July FOMC minutes, the design parameters may be further adjusted on the basis of experience gained from the operation of the facility. The facility aims to serve as a backstop in money markets, to support both monetary policy and financial stability purposes, as explained below

IMPACT ON MONEY MARKETS

The Treasuries market and the repo market are inextricably linked with policy and money market rates. For example, Treasury issuances are heavily funded in the repo market, while also affecting reserve balances and subsequently money market rates (the September 2019 event is a good illustration of the latter channel). At the same time, policy rates aim to control the range of outcomes in the Treasury repo market rates and link Treasury repo market rates to policy rates through arbitrage.

In this context, the SRF could significantly impact US money markets in a range of functions.

- **Backstop tool for smooth market functioning***:* The SRF practically formalizes temporary repo interventions of the Fed in September 2019 and March 2020 (Figure 2, Panel 1). The facility (together with FIMA) provides an alternative to selling Treasuries for market participants who are short of cash. This can prevent the strong selling pressures which destabilized the Treasury market during the pandemic period. It can also help to provide liquidity to cash-constrained counterparties likely avoiding the stigma problems that make the discount window an ineffective tool in these circumstances.

- **Monetary policy implementation tool to control short-term interest rates**: The SRF could create a ceiling for the federal funds rate and complement the existing overnight reverse repo facility (ONRRP), which sets an effective lower bound to the federal funds rate. Together, these two facilities would create the standard deposit and lending tools used in typical floor-operating regimes (Figure 2, Panel 2).

- **Facilitate tapering decisions of the Fed:** The facility is designed to automatically dispense reserves to the system when more reserves are needed. This can become handy as reserves start draining out of the system, because the facility would allow to replenish reserves if they are considered scarce. Recourse to the SRF should also prevent associated rate spikes in the Treasury repo market as seen in the September 2019 incident (as seen in Figure 1, Panel 1), helping the Fed to maintain control over rates during the tapering. Potentially this feature could render Fed balances and Treasuries closer substitutes, leading to a decline in the demand for Fed balances and lower reserves in the system.

MARKET RECEPTION AND ANALYSIS

Markets welcomed, albeit tepidly, the introduction of the SRF as a first step to the right direction, but with more way to go. They saw the SRF as an important element to improve Treasury repo market resiliency, and the proposed version as a first step towards this goal. They anticipated, however, that it would require some time for the Fed to learn how to best set its parameters to influence money market rates, not least because the ideal SRF (an unlimited, market-wide liquidity backstop at a fixed rate) may be unattainable. More than in the content, the surprise for some was the timing of the adoption, which was considered rather fast, given the discussions in preceding FOMC meetings.

Market analysis considered the impact on the money market to be important in cases of future market impairments and when excess liquidity starts to normalize.

- In the current conditions of ample liquidity, the facility is unlikely to be needed. However, it is a prudent step to safeguard against future market impairment and regular bouts of volatility (such as quarter-ends), and a useful tool during monetary policy normalization. As such, it could dampen the volatility in treasury repo markets and flatten term premia in the repo market curve. In this context, some analysts suggested that the SRF may support repo rates ahead of the debt ceiling deadline, by absorbing Treasuries with coupons or maturities around the debt ceiling dates.

- When excess liquidity normalizes, the impact will depend on changes to the design parameters of the facility. In an environment of lower reserves, the current design with the minimum bid rate at the top of the federal funds range could lead to significantly more usage, shifting the nature of the facility from a money-market backstop to a monetary policy implementation tool. To prevent or enhance this outcome, the minimum bid rate may be adjusted, with respect to the discount window rate and the IOER.

At the same time, market analysts considered that the facility does not address other aspects that could avert or ease potential market dislocations. For example,

- The announced (current and intended) counterparty range of the facility is too narrow to safeguard effective intermediation of liquidity in times of stress. Analysts pointed to the G30 proposal for a facility with access to a broad range of market participants for possible direction. However, they recognize that formulating a pragmatic approach is challenging, also because the Fed would be unwilling to provide a liquidity backstop to entities it does not supervise[2]. Therefore, it would come, at a minimum, with increased regulatory oversight.

- In addition, the competitive auction design of the SRF may fall short from alleviating market pressures and from creating a solid ceiling on secured money market rates. The SRF is not a fixed-rate / full allotment facility. Instead, the minimum bid rate could end up higher as it is a function of the demand for the facility and the fixed auction amount. They recognize, however that the current ceiling is large, mitigating the upward pressure to the SRF rate. In addition, they expect that the Fed may adjust flexibly the ceiling in case of crises.

- The facility is not designed to overcome completely the distribution blockages created by the leverage ratio. Counterparties may still have less capacity to intermediate and provide funding to a broader array of institutions unless the supplementary leverage ratio rules (SLR) are relaxed when reserves are concerned. If not, counterparties may be reluctant to use the facility, because it would expand their balance sheets and render the SLR rules binding. Analysts consider that relaxing the SLR rules as unlikely, and therefore question whether the facility per se can render Fed balances and Treasuries closer substitutes.

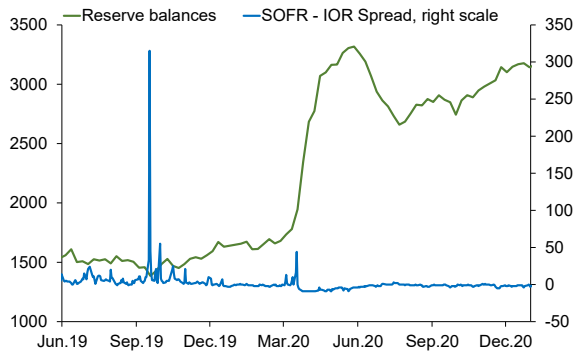
- Additional practical considerations in the repo market can limit the role of the facility as a liquidity backstop. The limited window in which the facility is open (1:30 PM – 1:45 PM) could mean borrowers still encounter difficulty accessing liquidity early in the morning (collateral seeking financing would be delayed). The one-off late operation could also impact the ability to obtain intra-day liquidity and intra-day funding.

[2] For example, market analysts considered the relevant G30 proposal not practically feasible. The proposal was for the Fed to clear its repos through the Fixed Income Clearing Corporation (FICC), the central clearing platform for repo. In order to do so, the G30 suggested that the FICC exempt Fed from its member requirements in cases of default by its other members. Other concerns related to the systemic relevance of the FICC, its transparency and governance would also need to be addressed.

Figure 1. Treasury Markets were destabilized in September 2019 and March 2020

Overnight Treasury repo rates spiked following a decline in reserve balances in September 2019

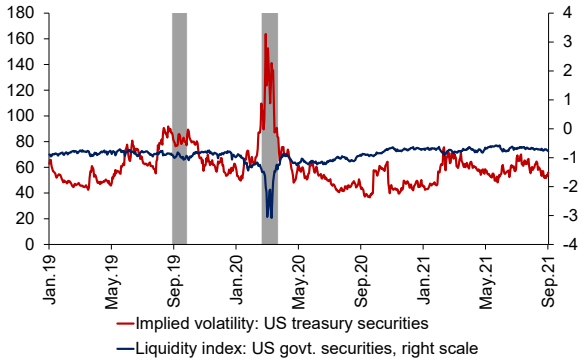
1. Overnight repo rates and reserve balances
(Billion US dollar, left scale; basis points, right scale)



- In September 2019 reserve balances reached the lowest level since 2011
- The SOFR rate volatility that ensued was unprecedented

In March 2020 volatility in Treasury yields spiked while liquidity plunged

2. US Treasury market volatility and liquidity
(Percent, left scale; inverse in percent, right scale)



- During the "dash for cash" episode in March 2020 Treasuries sold-off
- This lead to increased volatility as liquidity evaporated from the market

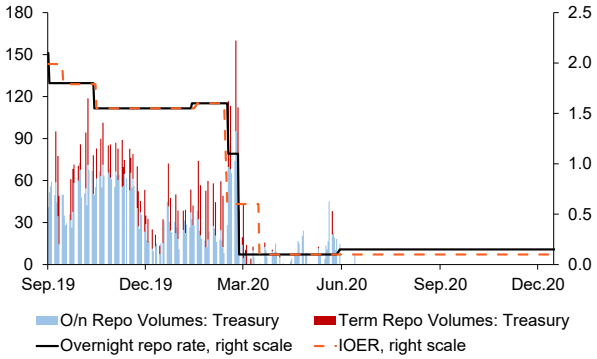
Sources: Federal Reserve Economic Data, Bloomberg and IMF Staff calculations
Note: The Liquidity Index is a Bloomberg measure of prevailing liquidity conditions in the US Treasury market. This Index displays the average yield error across the universe of US Treasury notes and bonds with remaining maturity 1-year or greater, based off the intra-day Bloomberg relative value curve fitter. The index is inverted. The implied volatility is the so called MOVE index. It is a yield curve weighted index of the normalised implied volatility on 1-month Treasury options.

Figure 2. Fed repo tools used for effective monetary policy implementation and smooth market functioning

The Fed had used repo operations on an ad-hoc basis to thaw recent Treasury market freezes

1. Repo volumes and rates

(Bn. US dollar, right scale; percent, left scale)

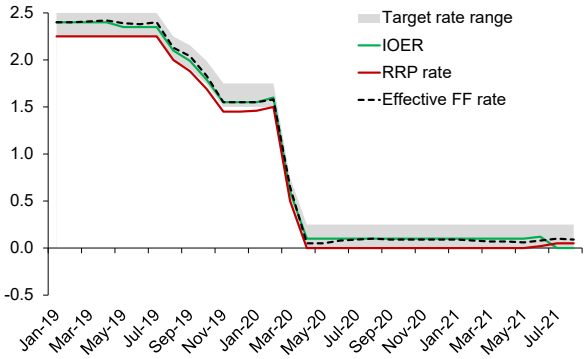


- Repo operations were conducted from September 2019 to June 2020
- In June 2020, when the rate on ON repo was raised relative to the IOER, take up stopped

The new facility can help with financial stability and monetary policy considerations

2. Monetary policy implementation "corridor"

(Percent)



- The SRF and the ON RRP rates effectively create a corridor for the FFER
- Positioned above the IOER, the SRF rate ensures the use of the SRF as a backstop

Sources: Bloomberg, Haver Analytics and IMF Staff calculations