Cash Academy

BlackRock

Understanding repo: A cash building block

The repurchase agreement market is one of the largest and most actively traded sectors in the short-term credit markets and is an important source of liquidity for many money market funds (MMFs). As a core building block of the cash industry, it's important for investors to understand the asset class and the role it plays in certain cash portfolios.

$3.7 trillion

The daily volume of the tri-party repo market according to the Federal Reserve Bank of NY.
Source: Federal Reserve Bank of Newy York. As of April 9, 2024.

Background: what is a repurchase agreement?

A repurchase agreement (repo) is a contractual arrangement between two parties, where one party agrees to sell securities to another party at a specified price with a commitment to buy the securities back at a later date for another (usually higher) specified price.

Essentially, this makes repo economically similar to a short-term interest-bearing loan against specific collateral. Both parties, the seller (the collateral provider) and buyer (the cash lender), are able to meet their investment goals of secured funding and liquidity.

Repo is available with many different tenors. While repo typically matures the next day (overnight repo), some mature at a specified later date (term repo). Other repo with no specified maturity date are considered "open." Open repo typically rolls over every night, though it can be terminated by either party at any time, whereas evergreen repo contracts include an agreed-upon notice period before either party can end the agreement.

How do cash investors use repo?

Repo is used in certain MMFs as a way to invest surplus cash on a short-term basis and by financial institutions to both manage their liquidity and finance their inventories. While repo is commonly held within MMFs as short-term, overnight investments, a cash investor might look to utilize term repo to invest cash for a more customized period of time to fulfill a specific investment need.

How are repo rates determined?

Since repo is generally short-term in nature and considered less risky due to being the economic equivalent of a collateralized transaction, rates for repo are typically competitive with the market rate for other lower-risk securities. While there are multiple factors that impact market rates for repo, we believe the two most important are:

- **the terms of the agreement; and**
- **the type of securities being sold and repurchased.**

Traditional securities offered in repo – and referred to as general collateral (GC) – are U.S. government securities including U.S. Treasuries, agency debt, and agency mortgage-backed securities. Non-traditional repo agreements may include non-government forms of collateral such as corporate investment grade and non-investment grade debt, and even equity securities.

Returns from repo may also fluctuate depending on market conditions and other factors such as outstanding supply and demand for certain forms of collateral. Due to these risks, a discounted price for the collateral (i.e. a haircut) is negotiated between the two parties. This "overcollateralization" is commonplace in the repo markets and may vary between repo transactions depending on the credit quality of the underlying collateral type. Importantly, this practice provides an additional measure of protection for investors in the event of a default by a counterparty.

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What is tri-party repo?

Tri-party repo is the most widely used form of repo across MMFs. What distinguishes tri-party repo is the use of a third party — a custodian bank or clearing organization known as the "tri-party agent" — to serve as an intermediary between the counterparties to the deal. The role of this collateral agent is critical: it acts on behalf of both the buyer and seller, thereby minimizing the operational burden of receiving and delivering the collateral and cash.

The collateral agent also prices the securities under the transaction. Notably, the use of this agent provides the benefit of additional protection to investors in the event of a dealer's bankruptcy; because the agent holds the collateral, it is separate from the dealer's assets.

See the illustration below for more detail on the mechanics behind a tri-party repo transaction.

What is cleared repo?

Cleared repo, also known as sponsored repo, is a form of repo in which an approved member (e.g. a Bank or Broker-Dealer) of the Fixed Income Clearing Corporation (FICC) sponsors a non-dealer counterparty to transact on FICC's cleared repo platform. This platform currently settles trades through the Delivery Versus Payment settlement process, a method which permits the transfer of securities only after payment is made. By doing so, FICC is able to efficiently match, net, and settle repo trades in U.S. government debt. In September 2021, the FICC added functionality to settle FICC cleared repo trades on BNY Mellon's a tri-party platform through its General Collateral (GC) Service[1].

Because of these features, both counterparties reap certain benefits, including expedited settlement. The non-dealer counterparty also gains access to highly rated central trading partners, which increases its capacity to engage in other financing opportunities via this broader counterparty set. Meanwhile, by transferring the risk and collateral requirements of the specific repo over to FICC, the approved member is no longer restricted from a balance sheet perspective.

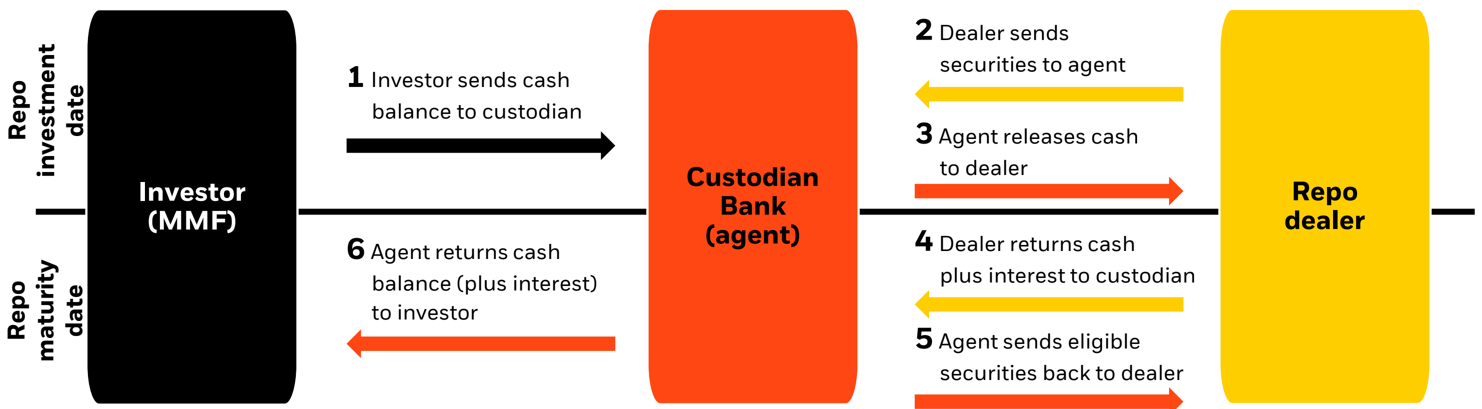
Although the idea of cleared repo is not a new phenomenon (FICC's sponsored repo platform began in 2005), the recent market-wide adoption of the program was born out of the coexistence of the exponential growth of assets in the money market sector and increased balance sheet constraints imposed on financial institutions.

How does the Fed use repo?

The Federal Reserve (Fed) plays a key role in the repo market. By engaging in open market operations, the Fed is able to regulate the money supply and bank reserves, helping keep the federal funds rate within the target range, as set forth by the Federal Open Market Committee.

When the Fed conducts a repo transaction, it purchases securities and temporarily increases available cash within the banking system. Conversely, in a reverse repo, the opposite occurs- the Fed sells securities, which in turn temporarily reduces cash available within the system. Repo operations are conducted to support effective policy implementation and ensure the smooth functioning of short-term U.S. funding markets.

Tri-party repo transaction



For illustrative purposes only

1 Source: Depository Trust and Clearing Corporation.

How does BlackRock use repo?

As a provider of MMFs with 50 years[2] of cash management expertise, BlackRock deploys a significant allocation of assets to repo in an effort to both strengthen the liquidity characteristics of those MMFs permitted to use repo and to potentially generate positive returns on excess cash balances. We look to execute those repos primarily through large, well-capitalized financial institutions and "look through" to the underlying collateral pool of high-quality securities to seek to improve liquidity levels within our funds. Any potential repo transaction under consideration for a portfolio would initially be vetted through our robust three-tiered credit review process to determine any associated risks, including a careful analysis of each and every counterparty with whom we engage to help ensure that the portfolios meet the high credit standards of BlackRock.

Our core objectives remain preservation of capital, liquidity, and yield – in that order. Following years of experience managing our funds through volatile markets, we have maintained our commitment to this philosophy, backed by the breadth and scale of our global platform. Our Risk & Quantitative Analysis (RQA) team leverages our proprietary Aladdin® technology[3] to thoroughly understand a multitude of risks in the repo market. One of the tools they utilize is DECO, an application within Aladdin® that monitors the eligibility of securities, overcollateralization rates for repo collateral, and valuations on a daily basis. We believe that by harnessing technology like DECO, we increase our ability to invest in only the most secure repo with only the strongest counterparties while limiting downside exposure to those we deem most vulnerable.

Have a conversation with your BlackRock relationship manager to hear more about repo and how this important asset class can play a key role in your portfolio.

2. **Source**: BlackRock. As of 31 March 2024. Cash management expertise includes history from predecessor entities.

3. While proprietary technology platforms may help manage risk, investment risk cannot be fully eliminated. BlackRock's Aladdin® platform is a financial technology platform designed for institutional use only and is not intended for end investor use.

Want to know more?

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As always, we are here to help. Please contact your relationship manager or visit www.blackrock.com/cash for more information.

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