BANK POLICY INSTITUTE

How the Overnight Reverse Repurchase Agreement Facility Could Derail the Fed's Path to Getting Smaller

Bill Nelson and Tara Payne | Sept. 15, 2022

BPI hosted an open Zoom panel discussion on Sep. 9, 2022, on the overnight reverse repurchase agreement facility, reserve balances and the end of quantitative tightening. Discussion has been brewing among market participants and Fed watchers about whether the large and growing ON RRP facility will siphon reserves out of the banking system and force an early end to the Fed's QT process since the possibility was discussed at a BPI symposium on money markets and the Fed's balance sheet back in February (see summary here).

Friday's panel, led by BPI Chief Economist Bill Nelson, included Joe Abate of Barclays, Mark Cabana of BofA Securities, Teresa Ho of JPMorgan and Mike Cloherty of UBS. Below are some key takeaways from the discussion.

Setting the Stage: Nelson laid out the current state of play at the opening of the panel. Between March 2020-March 2022, the Federal Reserve purchased $4.6 trillion in Treasuries and agency MBS, financing its purchases initially with an expansion of reserve balances – deposits of banks at the Fed. But after the Fed's temporary modification to the supplementary leverage ratio expired in March 2021, the purchases were also financed by overnight repurchase agreements of predominantly money market mutual funds at the ON RRP facility (for additional discussion go here.) The facility currently holds $2.2 trillion.

During the pandemic, bank deposits ballooned by $4.5 trillion, in part because deposits were an attractive place to keep cash – deposit rates and money market rates were all zero. If funds flow out of deposits and into money funds as the fed funds rate rises, money funds could invest in the ON RRP facility, which is a liability of the Fed. Holding the rest of the balance sheet constant, if the ON RRP rises, reserve balances would fall. Such a scenario could force the Fed to end the quantitative tightening process early because the central bank plans to end the process at any sign of reserve balance scarcity. The key question: will the ON RRP facility fall to near zero before reserve balances become scarce?

So far, the picture is mixed. Deposits started to decline in May as interest rates rose, but the ON RRP facility has not risen, it has held steady since the beginning of June. QT is just now getting underway. Several things remain unclear: Will the ON RRP facility remain high or get even higher as extra deposits continue to leave the banking system, forcing an early end to QT? Or will the facility decline as money market rates edge up relative to the ON RRP rate (the interest rate the Fed pays on ON RRPs)? Will the Fed widen the spread between the interest on reserve balances (IORB) rate and the ON RRP rate? A lower spread puts money market rates closer to the ON RRP rate, so that it isn't acting as the backstop it was intended to be.

The ON RRP facility was never meant to be huge or permanent, and its level and trajectory are now important inputs for understanding the overall market (for a primer on the ON RRP facility, go here). Movements in the facility could change the path forward for the Fed and the banking system at a pivotal moment for the central bank. The ON RRP facility's massive growth could cement money market funds' strange new role as funding sources for the Fed's large balance sheet. It could also undermine financial stability during times of stress by attracting lending from money funds that would otherwise support businesses, or by drawing cash into money funds that would have gone as deposits to banks. The facility has fascinated professional investors, banking analysts and even Reddit stock traders. The facility was intended to be a backstop to the IORB rate for achieving the FOMC's fed funds rate objective. However, with the IORB – ON RRP rate spread so much narrower than previously, the facility has become the marginal price setter for collateral rather than an escape valve for extra liquidity.

Participants in the panel had different views on where reserves, the ON RRP facility and the quantitative tightening process will go.

Will Reserves Stay 'Ample'? Bank reserves will fall to a "minimally ample" level by the first quarter of next year, as RRP balances approach $3 trillion, predicted Joe Abate, a managing director at Barclays. The "ample reserves" framework sets a level of bank reserves large enough that the Fed does not need to intervene in the market. The Fed will likely taper QT early next year, particularly if pressure emerges in unsecured funding markets or deposit rates rise abruptly, Abate predicted.

Increasing flows into money funds could boost RRP balances and drain bank reserves to $2.1 trillion by the first quarter of 2023, Abate said.

Abate noted signs suggesting that RRP balances will rise – government money market fund balances usually increase during a tightening cycle, but government-only money market fund balances have been flat since the spring, he said. In an environment with 2% money fund yields and banks having been "over-deposited" for the better part of two years, that implies a slow exit of surplus cash from the system, he said.

Pressure would likely be confined to unsecured funding markets, he said.

Competition Driven: Mark Cabana, head of U.S. rates strategy at BofA Securities, has a different outlook for the ON RRP/QT path forward. ON RRP will fall, driven by bank funding competition. Money market funds are currently wary of being "out-hawked" by the Fed, Cabana noted, leading them to shorten up the maturity of their portfolios. Money funds face the risk that the Fed will deliver more rate hikes than expected – resulting in a money fund underperforming its competitors and experiencing outflows. When investors gain clarity on the Fed rate path, money funds will have the confidence to extend the weighted average maturity of their portfolios, he said.

Institutional investor funds will likely leave banks in favor of higher-yielding securities or money funds, he said, but "we don't expect banks to sit idly by and let that happen." Banks want funds in order to make loans, he said.

Banks can compete by offering higher deposit rates or issuing more certificates of deposit or commercial paper, he said.

The ON RRP facility will show the first material signs of drain in the first quarter of 2023, Cabana has predicted. At that time, Fed hikes will have stopped or slowed, giving money market funds the confidence to extend, and banks will have likely shed excess deposits.

Cabana predicted that the Fed will not lower ON RRP use caps or widening the interest on excess reserves/ON RRP spread.

Getting Close to the Floor: The banking system is likely only $500 billion away from the reserve minimum necessary to avoid repo market stress, according to Mike Cloherty, UBS head of U.S. rates strategy. Reserves falling below $2.75 trillion would cause problems, in his view.

The existence of a huge reverse repurchase agreement facility changes the way banks model their reserve needs. In 2019, when repo markets experienced turmoil, the ON RRP facility was small and stable – now, it is at $2.25 trillion and vulnerable to large swings. Banks will need to model a flight-to-quality scenario where investors flock to Treasuries, cash flows into government money market funds and money market funds invest in the RRP facility. Those actions would cause an equivalent drop in bank reserves. To cover the risk of being on the high end of a system-wide reserve exodus, banks may need something like an additional $650 billion in reserves.

Repo rates may not move immediately if reserves fall below the floor, Cloherty said. There may be a situation where the Fed has gone too far but we don't know for a long time. The Fed might continue QT as reserves fall too far below the floor. A red flag for that scenario: afternoon pressure in the repo market, which could signal that the repo market is relying on stabilization by money market funds, and the money market fund arbitrage disappears mid-day when the RRP investment takes place.

Confluence of Factors: Teresa Ho, a managing director on JPMorgan's U.S. fixed income strategy team, predicted that the ON RRP facility would eventually decline, perhaps with a push from a wider spread between IORB/ON RRP, but it will take time. As a result, reserve scarcity could coincide with an elevated ON RRP.

The hurdle for the Fed to abandon QT early because of reserve scarcity is high, but not without its challenges, according to Ho. Market structure and conditions make the process of draining ON RRP more difficult in practice, she said. In particular, she expects government MMF balances to remain elevated over the near-term, and in the absence of sufficient assets, the demand for RRP will remain high.

Even with Fed intervention, such as widening the RRP/IORB spread and lowering the RRP counterparty cap, it's unclear if the central bank can fully drain RRP. The standing repo facility could be used to deal with liquidity shortfalls, she said.

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