Investing Ideas

Institutional Insights

Understanding Repurchase Agreements

How the money market industry utilizes the product to add value to their portfolios

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KEY TAKEAWAYS

- Repurchase (repo) agreement transactions are commonly used by money market funds as short-term investments.
- Repo agreements are contracts for the sale and subsequent repurchase of securities and functionally represent a short-term loan that is (over) collateralized by the securities sold.
- Collateral in repo agreements typically includes U.S. Treasuries and other government securities, as well as a range of "nontraditional" collateral including, but not limited to, corporate bonds, asset backed fixed income securities, and equity securities.
- Fidelity's money market mutual funds enter into repos only with counterparties that Fidelity's research team determines to represent minimal credit risk. Fidelity money market funds also participate in repo agreements with the Federal Reserve (Fed) utilizing the Overnight Reverse Repo Facility (ON/RRP), in which the Fed acts as the repo counterparty.
- Several industry-standard methods utilized to settle and clear repurchase agreement transactions ensure the delivery of adequate and eligible securities against the required cash payments by the parties.
- The repo "market" is in fact comprised of several markets with differing settlement and clearing mechanisms. In December 2023, the SEC adopted a final rule that will require the central clearing of virtually all treasury repo activity by June of 2026, representing an important change in market structure.

Fidelity INVESTMENTS

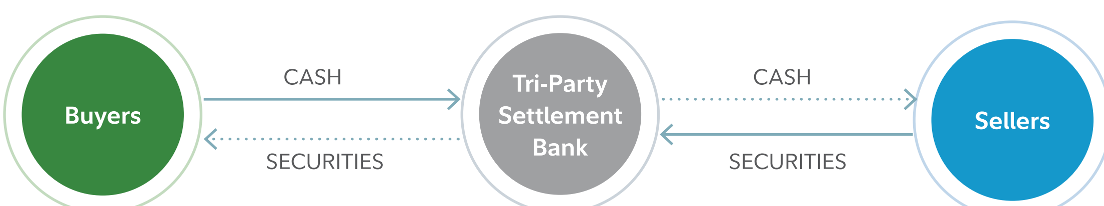
A liquid and collateralized short-term investment

Money market funds have regularly participated in repurchase agreements for decades. Repo agreements are contracts between a buyer and a seller for the sale and future repurchase of securities. On the termination (repurchase) date, the original seller repurchases the securities from the original buyer at a contractually agreed upon price that is typically higher than the original sale price, with the difference of the two akin to accrued interest. Repos functionally represent a short-term collateralized loan, but the sale-and-repurchase structure offers favorable legal protections to cash lenders.

Fidelity's money market mutual funds enter into repo agreements acting as buyers (sometimes referred to as resale agreements) and cash providers primarily using tri-party repos. Tri-party repo agreements consist of a buyer, a seller, and a tri-party bank that processes the settlement of the repos and acts as a custodian of the securities and cash involved in the transactions (Exhibit 1). The securities are held by a fund or, in the case of a tri-party repo, in a separate account at a tri-party bank, which acts as a repo custodian for the fund. The tri-party bank is responsible for processing the settlement of the repo agreement and ensuring the eligibility and sufficiency of the securities and cash required to settle the trade. As the securities are delivered to the buyer's account at the tri-party bank, simultaneous payment is forwarded to the seller's account at the tri-party bank. The securities are priced daily (marked to market) to maintain a market value at least equal to the repurchase price (which includes accrued interest) plus a positive margin that varies based on the type of collateral and its potential price volatility.

The seller is required to deliver additional securities (collateral) or cash when the value of the securities falls below the agreed-upon level of overcollateralization, known as the haircut or margin. At maturity, the tri-party bank returns the securities to the seller while simultaneously crediting the buyer's account with the original principal amount plus the transaction's accrued interest (or premium). Fidelity monitors the settlement practices of the tri-party bank to ensure that the industry-agreed operating procedures are being followed.

EXHIBIT 1: Tri-party repos consist of a buyer, a seller, and a tri-party bank that processes the settlement and acts as a custodian for the securities and cash.



Source: Fidelity Investments. For illustrative purposes only. The dotted line represents ownership while the solid line represent actual transfer and delivery of assets. Note the tri-party bank does not act as principal to either the buyer or seller.

Term vs. overnight repos

The majority of the repos executed across the industry comprise of overnight investments, in which the securities are repurchased by the seller on the next business day. Fidelity's money market funds utilize overnight repos to help manage the liquidity requirements set forth by the Security and Exchange Commission's (SEC) Rule 2a-7 requirement to hold a 25% minimum of total assets in daily liquid assets. Fidelity's money market funds also invest in term repo agreements. The principle behind overnight repos and term repos is the same, but a term repo's tenor is defined as greater than one business day.

Repurchase agreements are contracts between a buyer and a seller for the sale and future repurchase of securities. They have been utilized by the money market industry for decades to add value to portfolios. The Fed's ON/RRP program provides money market funds an opportunity to invest cash on a collateralized basis at a rate set by the Fed.

Over the term period, the eligible securities (collateral) delivered in connection with the repo are valued and marked to market daily. Additional securities in these cases may be required from the seller if necessary to maintain the market value of all collateral for the repo at the level of overcollateralization represented in the original terms of the contract. Some of the term repo transactions that Fidelity's money market funds enter into include seven-day put options, which allows for the holding to qualify as a weekly liquid asset in the fund's holdings. Rule 2a-7 also requires that a minimum of 50% of a fund's total assets be considered weekly liquid assets.

Eligible securities (collateral) for repos

Treasury repos, government repos, and nontraditional repos are distinguished by the type of eligible securities (collateral) subject to the repo agreement. Collateral for Treasury repos is limited to securities issued by the U.S. Treasury, whereas collateral for government repos can include Treasury securities as well as securities issued or guaranteed by government agencies, including, among others, Fannie Mae, Freddie Mac, and the Federal Home Loan Bank.

Non-traditional repos involve a wider range of collateral, including, without limitation, investment-grade and non-investment-grade fixed income securities, equities, and money market securities. Provisions of repo contracts, such as the required percentage of overcollateralization (haircut or margin) and the types of eligible collateral, are negotiated between the buyer and seller. Fidelity negotiates the haircut for each type of eligible collateral based on a variety of factors, including market conditions and a security's historical volatility during periods of stress.

Growth in repo through the Fixed Income Clearing Corporation (FICC)

FICC is an SEC-registered clearing agency that provides central clearing services for U.S. Treasury and government agency securities in both the cash and repurchase markets. As part of their clearing services, FICC allows well-capitalized netting members[1] ("sponsoring members") to "sponsor" certain eligible buy- and sell-side market participants for membership in the clearinghouse. Through the program, repo agreements between a sponsored and sponsoring member are "novated" to FICC, at which point FICC interposes themselves in the transaction and becomes the legal counterparty to the sponsored members. Sponsoring members guarantee the settlement obligations of each of their sponsored member to FICC and must meet FICC's admission standards to become sponsoring members. Fidelity's money market funds enter into sponsored repurchase transactions and face FICC principally as a result. In late 2023 the SEC adopted a final rule that will mandate the central clearing of nearly all repurchase and reverse repurchase agreements collateralized by U.S. Treasury securities by June 2026.

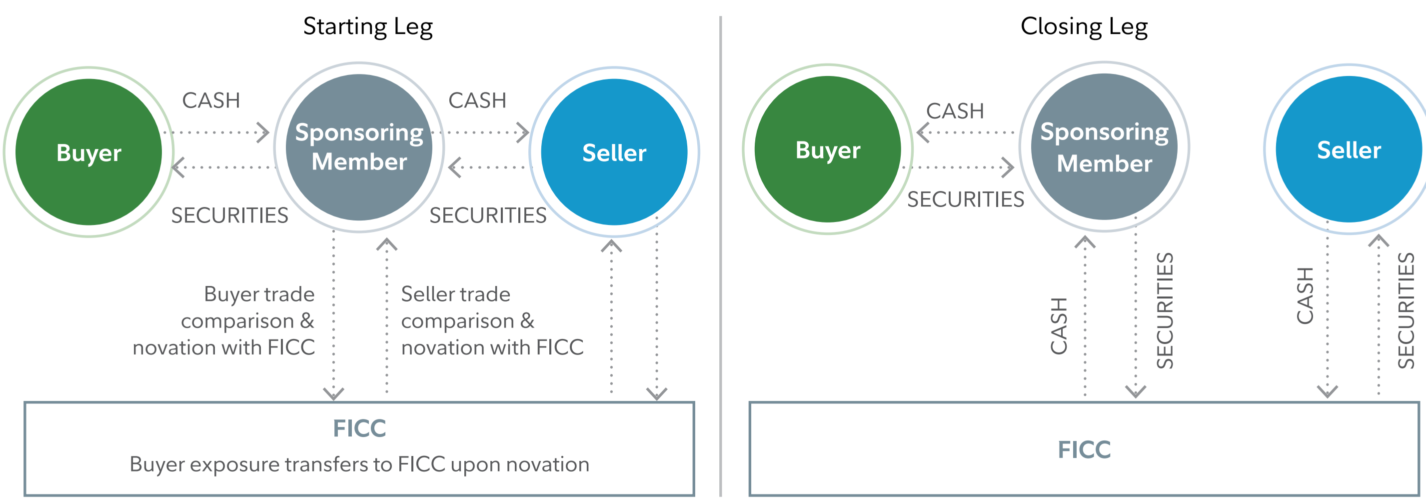
FICC's Sponsored Service includes two offerings, the Sponsored DVP service and the Sponsored General Collateral (GC) service. In the sponsored DVP service the repo seller and buyer execute and settle transactions on a fully bilateral, delivery-versus-payment (DVP) basis in specific treasury CUSIPs.

The Sponsored GC service enables sponsoring and sponsored members to execute repo transactions in a number of generic CUSIPs, including Treasuries as well as agency- and agency-mortgage backed securities, that settle via the tri-party repo platform at BNY Mellon. In both services, exposure is ultimately novated to, and risk managed by, FICC.

Exhibit 2 illustrates the process for Sponsored DVP repurchase transactions.

Financial regulators have endorsed the use of central clearing as a method to reduce systemic risk in the financial system, as the clearinghouse may effect a more orderly liquidation of collateral in the event a netting member fails, helping avoid fire sales. Novated transactions can also be more capital efficient for netting members, which can result in more investment opportunities for the funds and for yield advantages relative to uncleared repo. It is important to note that Fidelity's money market funds, as sponsored members, are not required to contribute to FICC's clearing fund and are not subject to loss mutualization in the event of a member default.

EXHIBIT 2: FICC-sponsored repo transactions allow for counterparty exposure between buyer and seller to novate to FICC.



Note that after novation, the repo buyer faces FICC as principal, but the sponsoring member continues to serve as processing agent for the closing leg. Source: Fidelity Investments. For illustrative purposes only.

Industry standard repo settlement and clearing methods

The industry has several different clearing and settlement methods. All of the methods seek to ensure the delivery of adequate and eligible securities against the required cash payments by the parties.

Clearing Mechanism	Settlement Mechanism: **BILATERAL** Direct exchange of cash and collateral between buyer and seller; typically in "specific" securities	Settlement Mechanism: **TRIPARTY** Exchange of cash and collateral is managed by BNY Mellon as a third-party triparty agent; typically in "general collateral" shells that can be filled with a broader range of individual securities
CLEARED Exposure between initial buyer and seller novates to FICC, who subsequently serves as principal counter-party to both buyer and seller	FICC's delivery-vs-payment (DVP) service for activity between netting members and Sponsoring Members Exposure has typically accounted for a quarter of primary dealer repo activity	Accessed via FICC's interdealer GCF service, "sponsored" GC service and CCIT service Typically accounts for a small share of primary dealer repo activity
UNCLEARED Repo buyer and seller retain counterparty exposure to one another through the life of the trade	Primary market through which dealers borrow from, and lend to, non-MMF counterparties Has historically represented the largest share of primary dealer repo volume	Primary market through which MMFs lend into the repo market, including the Fed's RRP program. Exposure has typically accounted for a quarter of primary dealer repo activity

Source: Federal Reserve

The Fed as another Repo Counterparty

The Fed's Overnight Reverse Repo Facility (O/N RRP) enables approved participants to enter into overnight repo transactions with the New York Fed. The facility is a supplemental policy tool that is used to help control and maintain the federal funds rate within the target range set by Federal Open Market Committee (FOMC). The O/N RRP has been a key tool of the Fed's since 2020 to help absorb excess liquidity as a result of the Fed's quantitative easing program and set a floor on money market rates.

Registered money market funds are generally eligible to participate in the program if they have either more than $2 billion in net assets, or have an average outstanding amount of repo of more than $500 million. A single fund can invest up to $160 billion per day. Many money market funds, including Fidelity's, use the O/N RRP facility as a high-quality and reliable source for overnight Treasury repo collateral. One notable difference with the Fed's program, as compared to repo executed with securities dealers and banks, is that it is highly structured, with a short 30-minute window of operations (Exhibit 3).

EXHIBIT 3: Operational parameters of the Fed's O/N Reverse Repo Program.

Schedule	Every business day from 12:45 to 1:15 p.m. ET, unless otherwise stated
Aggregate operation limit	Limited by the value of Treasury securities held outright in the system Open Market Account (SOMA)
Counterparty limit	$160 billion
Offering rate	Currently 5.30%
Eligible counterparties	Primary dealers and RRP counterparties, which include 2a-7 money market funds, banks, and government-sponsored enterprises
Eligible securities	U.S. Treasuries

Source: Federal Reserve Bank of New York. As of March 31, 2024.

Conclusion

Repo agreements are collateralized, short-term investments that are widely used across money market funds to help manage liquidity and satisfy regulatory requirements while also achieving an appropriate level of return. Fidelity's dedicated team of credit analysts conducts fundamental research to determine the credit quality of its counterparties and ensure they meet high credit quality standards and present as minimal credit risk to our funds. Fidelity's participation in the repo market supports the management of our money market portfolios and helps add value for our investors.

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You could lose money by investing in a money market fund. An investment in a money market fund is not a bank account and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Before investing, always read a money market fund's prospectus for policies specific to that fund.

Endnotes

1. The term "Netting Member" is defined in FICC's GSD Rule 1 as a Member of FICC's Comparison System (i.e., the system of reporting, validating, and matching the long and short sides of securities trades to ensure that the details of such trades are in agreement between the parties) and FICC's Netting System. Source: Securities and Exchange Commission. https://www. sec.gov/rules/sro/ficc/2019/34-85470.pdf.

For more information about the repo market or Fidelity's money market funds, please contact your Fidelity representative.

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