Product Strategy

Fidelity Institutional Insights

Understanding Repurchase Agreements

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

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KEY TAKEAWAYS

- Repurchase agreement transactions (repos) are used by money market funds as short-term investments.
- Repos are backed by collateral including Treasury and other government securities, as well as a range of nontraditional repo collateral including, but not limited to, fixed income 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 the repo market through a structured Federal Reserve (Fed) program, the Overnight Reverse Repo Facility (ON/RRP), in which the Fed acts essentially as another repo counterparty.
- Several industry-standard methods utilized to settle repurchase agreement transactions ensure the delivery of adequate and eligible securities against the required cash payments by the parties.

A liquid and collateralized short-term investment

Money market funds have regularly participated in repurchase agreements for decades. Repos are contracts between a buyer and a seller for the sale and future repurchase of securities. On the termination (repurchase) date, the seller repurchases the securities from the buyer, along with a premium that is akin to accrued interest.

Fidelity's money market mutual funds primarily use tri-party repos, consisting of a buyer, a seller, and a tri-party bank that processes the settlement of the repos and also acts as a custodian of the securities and cash involved in the transactions (Exhibit 1). Fidelity's money market funds enter into repos acting as buyers and cash providers. 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 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 delivers the securities to a preapproved and specified tri-party bank that acts as the repo custodian for the buyer's account and the seller's account, each maintained with the tri-party bank. The tri-party bank is responsible for processing the settlement of the repos and ensuring the eligibility and sufficiency of the securities and cash required to settle the repo on the start and maturity date. As the securities are delivered to the buyer's account, simultaneously payment is forwarded to the seller's account. 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 and processing of the tri-party banks to ensure that their 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.

Term vs. overnight repos

A majority of the repos executed across the industry comprise overnight investments, in which the securities are repurchased by the seller on the next business day. Fidelity's money market funds invest in overnight repos to enhance liquidity and help satisfy the Security and Exchange Commission's (SEC) Rule 2a-7 requirement to hold a 10% minimum of total assets in daily liquid assets. Fidelity's money market funds also enter into term repos. 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 and help satisfy another Rule 2a-7 requirement to hold a 30% minimum of total assets in one-week liquid assets. Although seven-day put options are rarely exercised, this feature can be used to provide the funds with additional liquidity and credit protection.

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 and regulated market utility that provides central clearing in the government repo market. The FICC-sponsored program has grown rapidly due to the balance sheet-friendly flexibility the program offers to absorb the funding needs of sell-side participants such as banks and broker-dealers, given that the repos move onto the FICC balance sheet. As part of the service, FICC allows well-capitalized netting members[1] of FICC ("sponsoring" members) to sponsor FICC clearing by certain eligible buy- and sell-side repo market participants (the "sponsored" members).

The sponsoring members guarantee the settlement obligations of their sponsored members and must meet FICC's admission standards to become sponsoring members. Fidelity's money market funds, as buy-side sponsored members, can execute overnight Treasury repos that utilize FICC's sponsored member clearing services and have the obligation to FICC to deliver and return the securities that collateralize the repo on the maturity date.

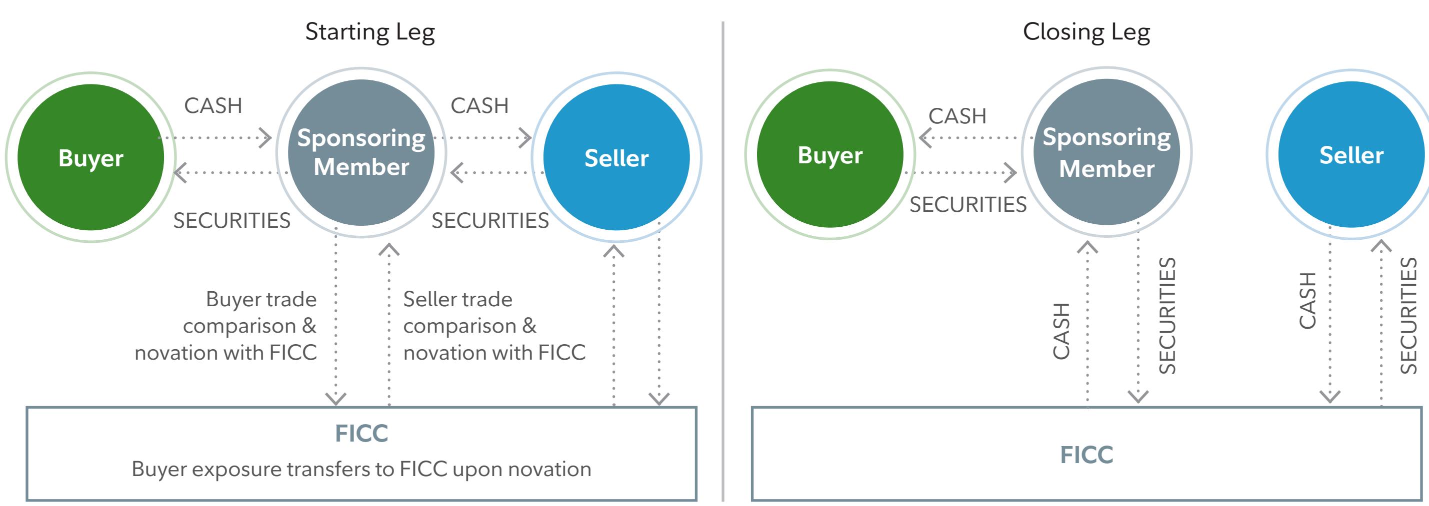
In sponsored repo transactions, the seller and fund execute, on a bilateral delivery versus payment (DVP) basis, the settlement and exchange of the purchase price and collateral (including the haircut) on the start date of the repo. (See page 5 for more on settlement methods). The seller, who is also likely the sponsoring member of the fund, then submits the trade details relating to the relevant DVP repo to FICC. If the DVP repo satisfies FICC's criteria for acceptance, then the seller's obligation to pay the repurchase price (which includes interest) for the securities on the maturity date against the return of the securities is legally transferred (novated) to FICC. FICC is then the fund's counterparty to the cleared repo transaction and the fund receives the benefit of a guaranteed completion of settlement by FICC in the event of a default by a sell-side netting member.

Exhibit 2 illustrates the process that enables select FICC clearinghouse members the ability to sponsor eligible buyers and sellers into membership to facilitate clearinghouse services that include the comparison and novation of repurchase agreement transactions that establishes FICC as the legal counterparty.

FICC's Sponsored General Collateral Service (Sponsored GC Service) enables centrally cleared tri-party repos between a sponsored member and its sponsoring member. The Sponsored GC Service accepts collateral in a number of generic CUSIPS, including Treasuries as well as agency- and mortgage-backed securities.

Financial regulators have endorsed the use of central clearing as a method of reducing systemic risk in the financial markets, as the clearinghouse may engage in the centralized liquidation of the relevant assets of any failed netting member. Novated transactions are capital efficient for the netting members that are typically the sellers in repos with Fidelity's money market funds, resulting in more investment opportunities for the funds and potential for yield advantages. It is important to note that Fidelity's money market funds, as sponsored members, are not required to contribute to FICC clearing funds and are not subject to its loss allocation regulations in connection with counterparty failures.

EXHIBIT 2: In a FICC-sponsored repo, the structured process enables buyers and sellers to compare and novate the repo agreements to FICC and allows cash and securities to move back to the buyers and sellers.



Source: Fidelity Investments. For illustrative purposes only.

Industry standard repo settlement methods

Fidelity utilizes three industry standard methods—tri-party, delivery versus payment, and FICC-sponsored repurchase agreements. All of the methods seek to ensure the delivery of adequate and eligible securities against the required cash payments by the parties.

TRI-PARTY	DVP	FICC SPONSORED
Tri-party bank is responsible for processing the settlement of the repos	Federal Reserve settlement system (Bilateral)	FICC provides central clearing (Bilateral or tri-party)
At maturity, tri-party bank returns securities to seller while simultaneously crediting the buyer's account with the original principal amount plus the transaction's accrued interest (or premium). Fed's O/N RRP facility utilizes tri-party settlement.	Collateral is delivered to the fund's custodian. (Buyer is never without either collateral or cash.) At maturity, the buyer returns the securities to the seller versus a payment that includes the original principal amount plus the transaction's accrued interest amount (or premium).	Sponsoring members guarantee the settlement obligations of their sponsored members and must meet FICC's admission standards. For Sponsored GC Service, a clearing bank facilitates settlement.

The Fed as another Repo Counterparty

The Fed's Overnight Reverse Repo Facility (O/N RRP), a monetary policy tool designed to help control short-term rates, enables approved participants (based on eligibility requirements) to enter into overnight repo transactions with the New York Fed. The facility helps the Fed by establishing a "floor" under overnight interest rates. The O/N RRP has been a key tool of the Fed's since 2013, and has been heavily used in recent years to absorb excess liquidity in the markets.

Registered money market funds that are active in tri-party repo and either have more than $2 billion in assets or have an average outstanding amount of repo of no less than $500 million are eligible to participate in the program. 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 pm–1:15 pm 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 4.80%
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 22, 2023.

Conclusion

Repo rates have remained attractive despite periods of volatility and increased government participation. Fidelity, as one of the largest asset management companies in the industry, has the scale and experience to navigate shifting environments and identify opportunities. Fidelity also has a dedicated team of credit analysts that 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.

Author

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Kerry Pope is an institutional portfolio manager in the Fixed Income division at Fidelity Investments. In this role he is responsible for communicating portfolio strategy and positioning, designing customized liquidity-management solutions for institutional clients, and providing portfolio reviews.

Fidelity Thought Leadership Vice President Martine Costello Duffy provided editorial direction for this article.

You could lose money by investing in a money market fund. An investment in a money market fund 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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