J.P.Morgan

US Fixed Income Strategy
Short-Term Fixed Income Markets Research Note
J.P. Morgan Securities LLC
July 1, 2014

# Fed RRP: Why the Surge?

- **Yesterday (June 30, 2014), the Fed's overnight reverse repo facility (RRP) program allotted a record $340bn to 97 approved program counterparties.** There is a history of quarter-end surges in use of the RRP program, although this is by far the largest (Exhibit 1).

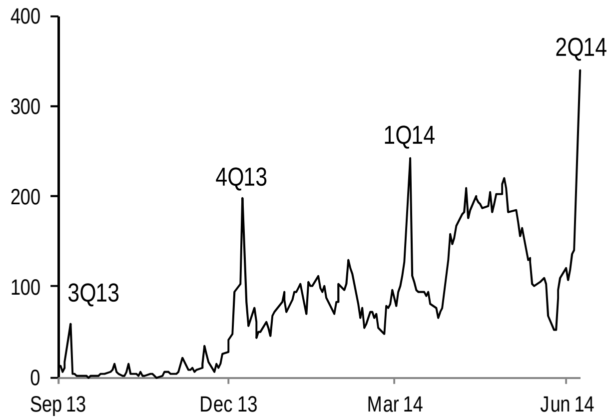
- **All else equal, an increase in overnight RRP balances reduces reserves on the Fed's balance sheet by an equal amount**. The converse holds true for decreases in overnight RRP balances. These effects net, and in aggregate, should have no impact on the size of the Fed's balance sheet.

- **Drop in bank reserves means banks are leaving fewer deposits at the Fed.** Reserves are assets, so a decline in assets implies an offsetting drop in liabilities.

- **Across the financial system, demand for very liquid overnight assets surges around quarter-ends.** This is a well established phenomenon that predates the financial crisis. Historically, this practice increases demand for bank deposits and close substitutes including money market instruments.

- **Recent changes in bank capital and liquidity rules (Basel III) make banks' use of wholesale funding sources like repo and overnight time deposits more costly.** These added costs limit banks' ability to scale balance sheets to meet quarter-end surges in demand. While most US banks' balance sheet costs are measured against a daily average, some foreign banks are managing their costs against a quarterly average calculated using month-end balances. This latter practice depresses the availability of repo and time deposit outstandings at month- and quarter-ends.

**Exhibit 1: There is a history of quarter-end surges in use of the RRP program, although this past quarter-end is by far the largest**
Federal Reserve RRP daily usage ($bn)




Source: Federal Reserve

Short Duration Strategy

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- **Since the advent of the Fed's overnight RRP facility in September 2013, excess demand can flow through money market funds (MMFs) and other approved counterparties to the Fed.** As a result of banks' desire to limit balance sheet size around quarter-end, more money is finding its way into the RRP facility as an alternative. Counterparties are substituting RRP for their overnight repo and time deposit holdings at quarter-end.

- **This pattern of increased RRP usage at quarter-ends should continue for the foreseeable future.** As bank regulations continue to be implemented, banks' use of balance sheets will continue to be more limited. In the future, to limit these quarter-end surges, the Fed may impose a cap on overall facility usage. We think this is a controversial solution, because it doesn't address the root issue of there being very high demand for short-term liquid assets at quarter-ends, and it actually aggravates the issue by limiting supply relative to demand. A possible result of imposing a cap could be to push overnight rates below the RRP at quarter-ends.

- Next week, we will know more about MMFs' participation in the RRP facility as we take a closer look at MMFs' month-end portfolio holdings. However, there is currently no transparency into other approved counterparties' use of the RRP facility. Those other counterparties include GSEs, banks and primary dealers[1].

[1] http://www.newyorkfed.org/markets/expanded_counterparties.html

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