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Reforming Repo Rules

By Mark Roe

Sometimes, we just don't learn.

After the financial crisis, the United States enacted the Dodd-Frank Act to overhaul American financial regulation, with the aim of reducing the risk of another financial meltdown. But it did nothing to reform "repo" lending – arguably the weakest link in the financial chain. And we have just seen another major financial firm collapse as a result.

A repo, or repurchase agreement, is a sale of a security (often a US Treasury obligation) that the seller promises to buy back later – often the day following the original sale – at a slightly higher price. The repo buyer thus lends to the seller, with the difference between the immediate "spot" price of the obligation and the "forward" repurchase price representing the interest on the loan. These repo loans give firms – typically financial firms – access to vast pools of cheap financing (often emanating from US money-market funds). It is a market measured in the trillions of dollars.

MF Global, the global financial firm that filed for bankruptcy in October, is just the most recent noteworthy example of how repo lending can go wrong. Like Bear Stearns and Lehman Brothers before they failed, MF Global had huge short-term, repo-based debt. Bear failed in 2008 as its mounting real-estate losses prevented it from quickly rolling over its repo debt, which made up fully one-quarter of its balance sheet. Then, a year later, Lehman failed with one-third of its balance sheet in repo. Repo debt seems to have made up an astounding one-half of MF Global's balance sheet.

The rules of the financial game privilege repo financing over other kinds, and Dodd-Frank did nothing to fix this. First, normal bankruptcy rules don't apply to repos. Second, much repo financing flows into large risk-taking financial firms like MF Global, Lehman, and Bear Stearns through money-market funds, which must invest very short-term, because their depositors want immediate liquidity.

In the US, the usual bankruptcy rules allow regulators and courts to hold a bankrupt company's operations together long enough to determine if the firm is worth more dead than alive. The law stops creditors from grabbing assets after the company enters bankruptcy, and it recalls many payments made to favored creditors in the 90 days before bankruptcy was declared, so that all creditors facilitate the firm's survival.

Repo creditors' exemption from these rules privileges them over the failed firm's other creditors. The original rationale was that allowing repo creditors to cash out fast would reduce runs, contagion, and credit freezes. But the opposite seems to be the case: if the regular rules applied, repo players would be more careful. They would be wary of firms like MF Global with massive short-term liabilities and only a thin equity buffer to absorb losses. They would charge more, curtail some short-term lending, or both, and they would insist that firms like MF Global maintain a larger equity cushion. If they charged more, other capital sources – long-term debt and equity – would become more attractive.

The result is that the economy gets too much overnight repo, and the rest of us pay a price for it, because favoring such short-term debt means that more financial firms like Bear, Lehman, and MF Global fail. True, failed firms' creditors, owners, and managers bear the brunt of the losses initially. But when systemically vital firms overdose on repo, we all pay, first as taxpayers when the government bails them out, and then as we suffer from the resulting economic disruption and downturn.

The second financial rule that privileges repos is that money-market funds must keep their portfolios extremely liquid, because their customers draw checks on their deposits. The cash therefore goes into short-term investments – often via repos to financial firms with risky investments.

We cannot do without this short-term financing channel, but it need not be as big as it is. When shocks hit a fragile financial system, as in 2007 and 2008, the government has reason to guarantee the money market funds, as US authorities did. These implicit government guarantees attract more money into these financial channels from nonguaranteed channels, and more "hot money" flows into firms like MF Global, Lehman, and Bear via repo.

There is no easy way out of this problem, but we must try to find one.

One improvement would be to reform the bankruptcy rules that favor repos. Another would be to increase financial institutions' capital requirements. But these steps must be taken in tandem, because firms and creditors will try to circumvent capital requirements if they see attractive alternative sources of funds – like rule-exempt repo financing.

There is another solution as well: repo users could be made to pay for their privileges and the costs that they impose on the rest of the economy. They could be charged a few basis points per annum in government fees in order to align repos' private price with their social cost. Doing so could bring more market discipline to this part of the financial market without extensive regulation.

The collapse of Bear Stearns and Lehman Brothers exacerbated the US and global recession. MF Global's failure stands as a warning that only three years later, and even after the major Dodd-Frank financial reforms, the US still has not fixed key problems that brought them down.

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