Collateral Demand in Wholesale Funding Markets

Jamie Coen, Patrick Coen, & Anne-Caroline Hüser

Discussion by Sriya Anbil
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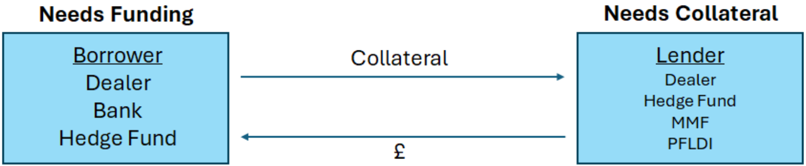
Research Question

How are p's and q's in the repo market affected by funding versus collateral demand?

- Rich transaction data of Sterling gilt repo market.
- A lot of dense findings.
- Structural model that allows us to turn on and off funding demand versus collateral demand and understand their impacts on repo market functioning.

Funding vs. Collateral Demand



Transaction No.	Collateral in Demand?	Repo Rate
1	Yes	↓ General Collateral Rate
2	No	↑ General Collateral Rate

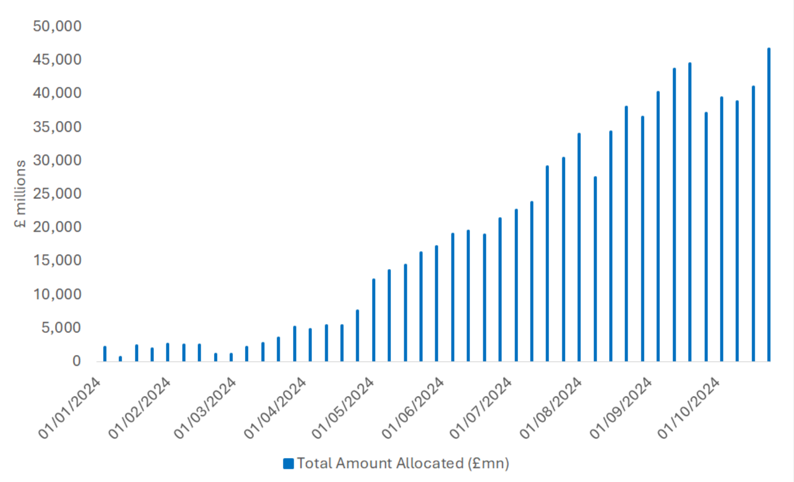
Findings

- Funding demand follows UK's monetary policy stance. Collateral demand follows gilt secondary market, and can affect prices in that market.
- Collateral demand varies significantly across repo lenders.
- Higher collateral demand negatively affects repo market functioning. Counterfactual of rich structural model shows that repo trading declines.

Comment 1: Use the model to assess the UK's updated monetary policy framework

- The Bank of England has committed to using its Operational Standing Facility and Short-Term Repo Facility as its ceiling tools to assess bank reserve demand as it undergoes QT.
- Short-Term Repo Facility lends for 7-days against gilts at the Bank Rate (more ITM than the OSF).
- Will these facilities meet funding demand when collateral demand is sufficiently high?

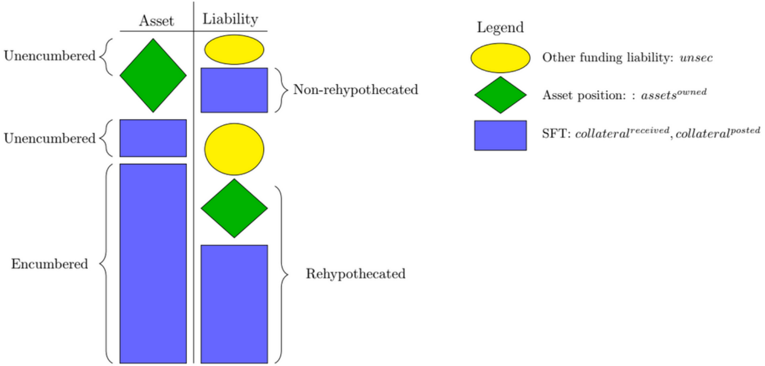
Amount Borrowed from Short-Term Repo Facility



Source: Bank of England website

Comment 2: Why don't dealers rehypothecate?

- Infante (2020) and Infante & Saravay (2023) find that when collateral demand (in the U.S.) increases, dealers re-use that collateral to meet funding demand.
- Dealers will re-use the same Treasury cusip up to 5x per day.



Source: Figure 2 from Infante & Saravay (2023)

Comment 2: Why don't dealers rehypothecate?

Why does this not occur in Sterling gilt markets?

- Dealers supposedly only demand collateral to hedge interest rate risk. In the model, they demand collateral because of "speculation" or "hedging". Never re-use.
- In the U.S., dealers borrow collateral from investors that seek interest rate exposure and then lend to those investors seeking safe asset properties.
- How many dealer repo transactions use the same cusip as their reverse repo transactions?
- When collateral demand is high, does re-use drop? This could be a novel result (and opposite to U.S. markets). Because of safe asset scarcity?

Conclusion

- Fascinating paper that brings two important concepts of repo market functioning together.
- Excellent application of a structural model that allows us to run counterfactual scenarios.
- Could use the model to assess how the UK's new monetary policy framework might assist with repo market functioning.