US Rates Watch

Funding spike: drivers & implications

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Funding spike: the facts

US funding rates spiked on Sept quarter end. We address funding drivers, implications for year end, and Fed balance sheet policy considerations below.

On Sept 30, SOFR rose 12bps in the largest single day increase since COVID (Exhibit 1). The move coincided with a $450b increase in SOFR volumes, largely driven by bilateral trades (Exhibit 2). Sponsored repo volumes also saw a sizeable increase of $158b (Exhibit 3). MBS repo also jumped (Exhibit 4). The sharp increase in funding rates occurred with a divergence in Fed repo facility use. The Fed's liquidity adding SRF saw the largest use at $2.6b since '20. The Fed's liquidity draining ON RRP facility increased $29b to $465b (Exhibit 5). The Fed was simultaneously adding & draining repo liquidity to the largest extent since Mar / Apr '20.

Funding drivers: large settlements & dealer constraints

The funding spike was driven by large UST settlements & dealer constraints, details below. Fed QT drain of $20b on Sept 30 was a more marginal contributor to the move.

UST settlements: UST month end coupon settlements totaled $118b (Exhibit 6, Exhibit 7). Additional coupon settlements on Sept 27 = $28b. Total = $146b in last two days of quarter.

Dealer constraints: dealer B/S constraints likely factored heavily into the moves. Recall, dealers have been running very high in their UST & MBS holdings (Exhibit 8). US GSIBs have also recently run high in their GSIB surcharge scores, which likely limits balance sheet capital flexibility (Exhibit 9). Contacts suggest RWA pressures at end Q3 may have pushed dealers to shed collateral contributing to the repo jump (especially in MBS).

Dealer constraints likely supported diverging use of Fed repo tools. **ON RRP use** typically rises at Q/E as dealers reduce repo activity for reporting. MMF are then pushed into ON RRP & unable to shift into FICC due to their own internal counterparty constraints (detail in: Sticky ON RRP). **Fed SRF use** rose because dealers could not easily access MMF cash or obtain attractive funding through FICC. In essence, dealer balance sheet constraints & MMF FICC limits are pushing the Fed to be the repo intermediary of last resort.

Year-end implications: risks of tighter funding

The repo dynamics at end Q3 raise risks of tighter funding conditions into year end. We expect dealers to better prepare for year-end vs Q3 quarter end but can't rule out a similar set of RWA or other capital constraints at end '24. It doesn't help that there will be a marginally larger $147b of month end coupon settlements expected at end Dec '24. Consistent with this, Dec '24 SOFR/FF basis now implies the tightest levels seen YTD. Cross-currency basis does not imply a similar degree of expected funding pressure as SOFR/FF. We see risks that all funding markets may tighten into end '24. … *See page 2 for more detail on Fed & funding pressures including QT risks & dashboard omission…*

SOFR: secured overnight financing rate

SRF: standing repo facility

ON RRP: overnight reverse repo facility

UST: US Treasury

QT: quantitative tightening

B/S: balance sheet

GSIB: Global systemically important bank

RWA: risk weighted assets

MMF: money market funds

Q/E: quarter-end

FICC: Fixed Income Clearing Corporation

QT: quantitative tightening

SOMA: Secured Open Market Account

Fed & funding pressure: QT risk & dashboard omission

The Fed has undoubtedly taken notice of the funding spike and is internalizing the moves. The Fed is likely in no rush to adjust their balance sheet policy or liquidity tools, first wanting to see where funding rates settle after quarter end. We see three takeaways for the Fed: (1) repo intermediation risk, (2) SRF stigma, (3) QT risks.

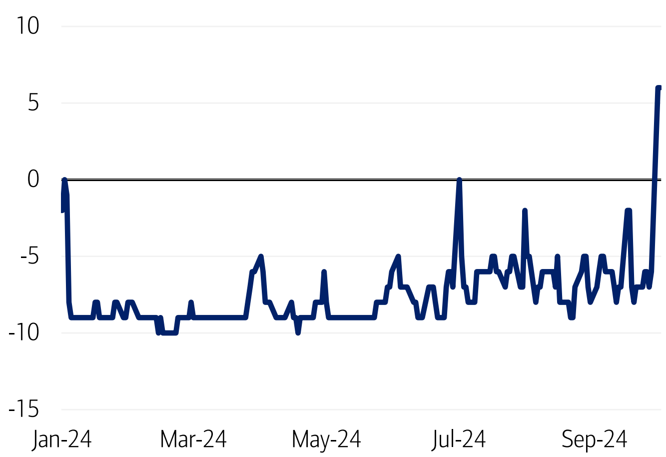
Repo intermediation risk: higher Fed ON RRP & SRF use essentially makes the Fed the repo intermediary of last resort. We doubt the Fed wants this role. To address this concern, the Fed & other official sector actors could: (a) encourage MMF to reduce their FICC internal counterparty constraint, which would push cash out of ON RRP & into sponsored repo, (b) work to reduce the capital impact UST & MBS repo has on dealer balance sheets. If the Fed envisions a more active cash lending repo market role, it may consider becoming a FICC member to allow for repo netting.

SRF stigma: the SRF may be stigmatized. At least $630b in UST repo cleared above the SRF rate on Sept 30 (as implied by SOFR percentiles). Yet only $2.6b was drawn from the Fed facility. Timing of UST repo trades may contribute to some of this dynamic but we think dealers may not be using the facility due to stigma concerns. Market contacts have suggested a reluctance to use SRF since it is a "facility" and not a more standard "open market operation". We initially dismissed these considerations as semantics, but it appears some are choosing to avoid any funding through a Fed facility.

QT risks: the Fed is unlikely to over-react to a repo jump on quarter-end. Persistent upward pressure in funding would increase risk of an earlier QT end. The Fed funding dashboard is not flashing signs of concern outside of recent repo dynamics (peak daylight overdraft activity did pick up towards in the most recent publicly available data as of end June '24 (Exhibit 10); see: Reserve "ampleness"). Last week, NY Fed SOMA manager Roberto Perli said "there is plenty of room to continue shrinking the SOMA portfolio". Persistently elevated repo rates might change that view. Note: we pushed our QT stop date to end March '25 after the Sept FOMC but before recent funding pressure.

Bottom line: recent repo pressure suggests there are broader shifts in cash, collateral, and dealer balance sheet dynamics. UST collateral continues to grow and dealer balance sheet flexibility is limited by capital considerations. Dealer balance sheet constraints are not a part of the Fed's funding dashboard but drive spikes in repo. The Fed may consider adding dealer balance sheet limits to their funding dashboard or risk becoming a more permanent repo intermediary. Recent funding dynamics also highlight SRF stigma and raise risks of an early QT end if repo pressure persists.

Exhibit 1: SOFR spread to IORB (bps)
SOFR jumped 12bp on quarter-end



Source: Bloomberg

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Exhibit 2: SOFR volume ($bn)
SOFR volumes climbed nearly $450b on quarter-end

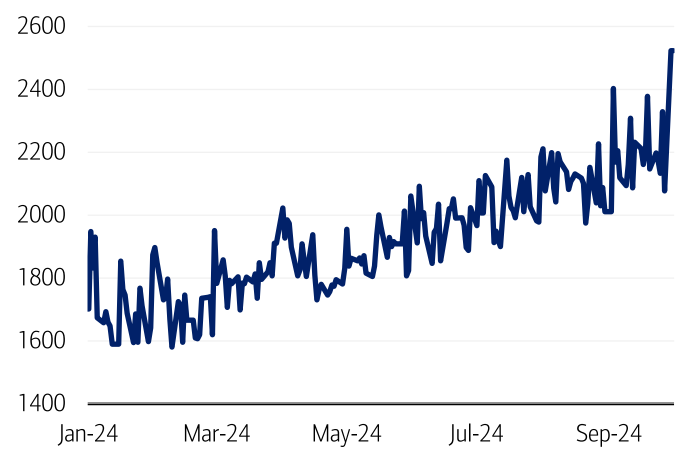

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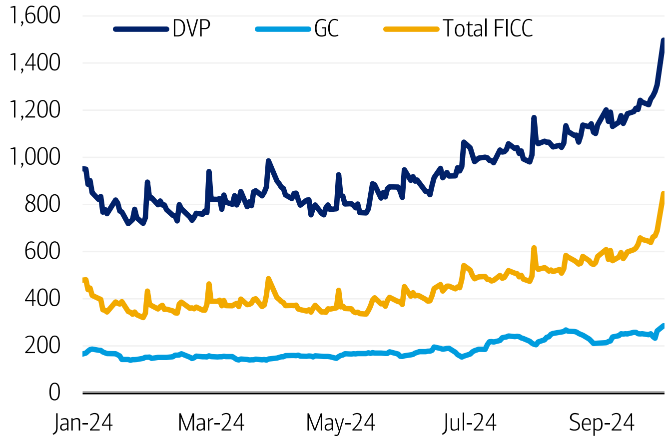
Exhibit 3: FICC sponsored repo volumes ($bn)

FICC sponsored repo increased $158b on quarter-end, largely in DVP



Source: DTCC FICC

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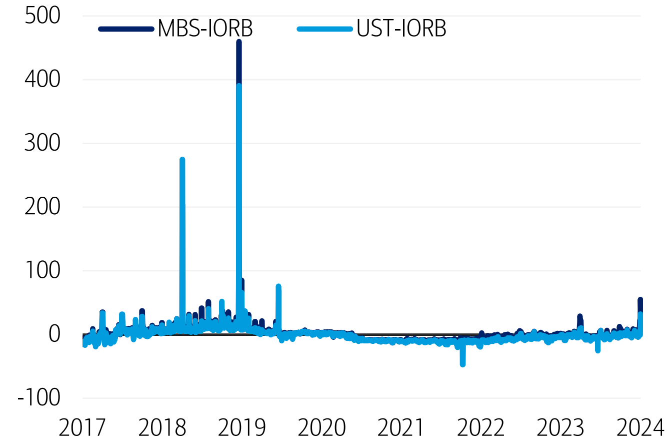
Exhibit 4: UST & MBS GCF repo spread to IORB (bps)

MBS repo saw significant upward pressure on quarter-end



Source: DTCC, Bloomberg

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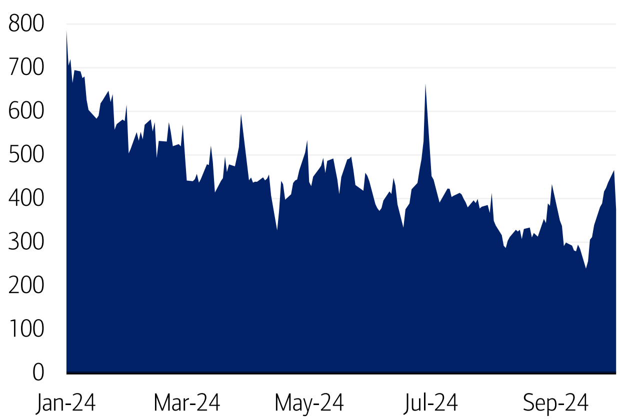
Exhibit 5: ON RRP take-up ($bn)

ON RRP take-up increased $29b on quarter-end



Source: Bloomberg

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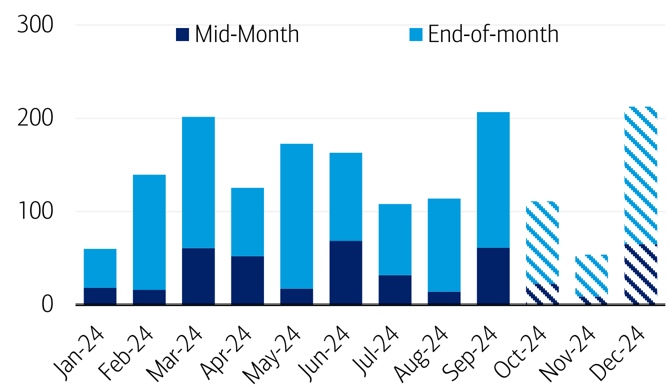
Exhibit 6: UST coupon settlements by mid-month and end-of-month dates ($bn)

Oct & Nov will be smaller settlement months but Dec end will be $148b



Source: BofA Global Research, US Treasury

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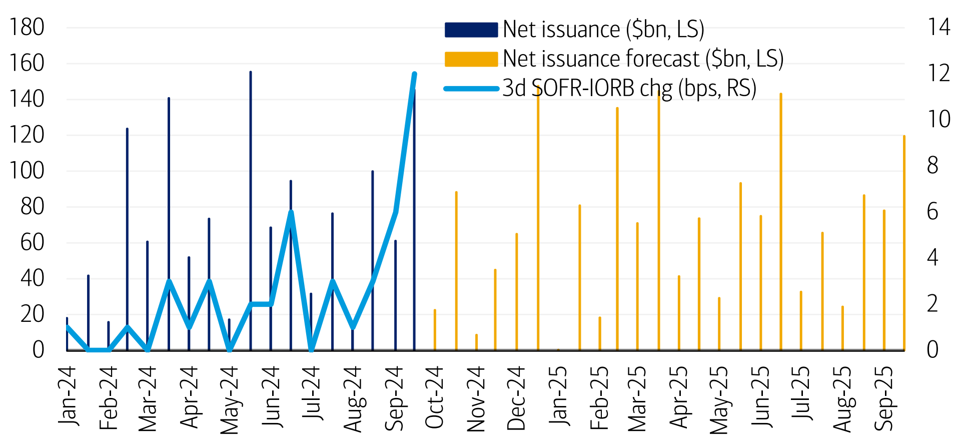
Exhibit 7: UST coupon settlement vs 3-day change in SOFR-IORB spread

Larger UST settlements have had a larger impact on SOFR in recent months



Source: BofA Global Research, US Treasury, Bloomberg

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Exhibit 8: Primary dealer securities holdings ($bn)
Dealer UST and MBS holdings are elevated

	Total	US Treasuries	Bills	Coupons	FRNs	TIPS	Agency ex MBS	MBS	Corporates	Commercial Paper	State & Munis	ABS	Variable Rate Notes
9/18/2024	483,536	320,076	77,527	217,089	2,778	23,673	11,874	116,769	11,452	6,696	12,732	8,199	2,434
Chg YTD	84,061	63,687	12,200	56,519	-10,169	6,128	-143	19,539	88	2,705	348	700	-158

Source: BofA Global Research, Bloomberg

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Exhibit 9: GSIB surcharge changes over recent reporting dates
Large banks have generally shifted higher across GSIB surcharge ranges

Low End	GSIB Score	High End	Surcharge
930	JPM 1024	1029	5.0%
830	JPM 857	929	4.5%
730	C 734	829	4.0%
630	BAC 663; C 697; GS 711	729	3.5%
530	MS 580; BAC 598; GS 599; MS 614	629	3.0%
330		429	2.0%
230	BK 267; BK 277; WFC 288; WFC 313	329	1.5%
130	STT 214	229	1.0%

GSIB score based on 2Q24 data (JPM 1024, C 734, BAC 663, GS 711, MS 614, BK 267, WFC 313)
Score determining current G-SIB surcharge (JPM 857, C 697, MS 580, BAC 598, GS 599, BK 277, WFC 288, STT 214)

Source: FR Y-15, BofA Global Research

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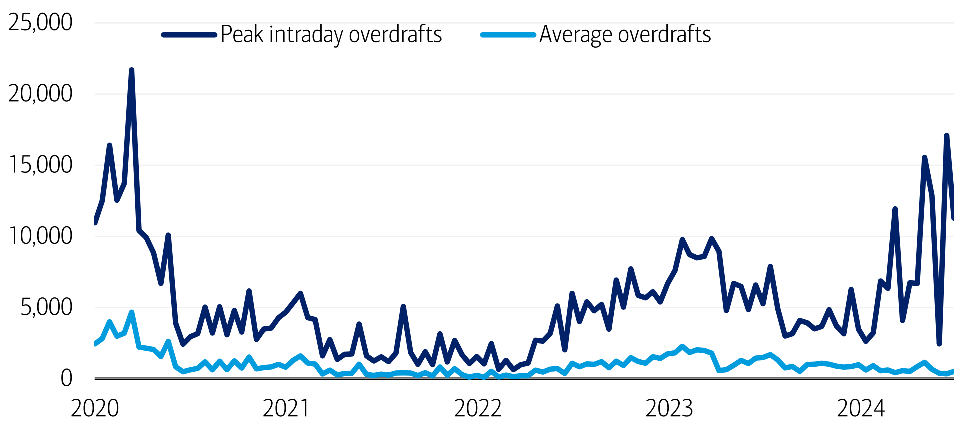
Exhibit 10: Peak and average overdraft activity ($mn)
Peak daylight overdraft activity has been rising as of late



Source: Federal Reserve

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