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Discussion of *(In)efficient repo markets* by Tobias Dieler, Loriano Mancini and Norman Schürhoff

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(In)efficient repo markets

- Model repo market very parsimoniously
  - Repo borrowers use safe collateral endowment to borrow on repo and invest in a risky technology. Must roll over the repo to realize the project.
  - Exogenous funding shock may restrict roll overs – particularly for those with a 'low' realization of technology.
- Contrast OTC and CCP mechanisms and find
  - OTC: direct funding to 'high' type, but run on 'low'
CCP: inefficiently limit funding to 'high' type
- Proposals for CCPs:
  - shifting to non-anonymous trading when funding tight
  - 2-tier guarantee fund: not just a default fund, but also a liquidity fund that transfers collateral to 'low' type when illiquid

A nicely focused problem

- *(In)efficient repo markets* does an excellent job of focusing narrowly on the decision to roll over a secured financing transaction
  - All dynamic repo market effects are neutralized:
    3 period model with a debt rollover problem in the middle period, t=1
    Exogenous shock to funding liquidity, f
    Collateral's market liquidity at date 1 is exogenous, κ_1
  - Very useful for thinking through and characterizing the nature of the roll-over problem and when it can freeze the market
  - But …

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A nicely focused problem, but …

- Claims about implications for financial stability regulation are hard to follow
  - precisely because the model explicitly neutralizes the dynamic effects that play a well established role in repo-driven financial market instability (e.g. Brunnermeier and Pedersen 2009)
  - 'Financial stability' redefined
    - Instead of asking how to avoid episodes with funding shocks and asset price illiquidity
    - Ask how to make the market mechanism resilient to funding shocks and asset price illiquidity, where funding shocks are not 'too' big, $f < f^{FB}$
  - No effort to justify why we should focus on the latter
- Liquidity black holes are a very 21st century problem. Why didn't we have them in the past? And why do we have them now?

A nicely focused problem, but …

Two additional notes

- Borrower participation constraint requires *negative* repo haircut
  → the model is **a model of securities lending, not repo**
  - Cf. AIG and Maiden Lane II
- Evaluation of market resilience biased in favor of OTC
  - OTC markets are favored by treating them as having full information on types
  - CCPs are disfavored by analysis of an equilibrium (pooling) that has built in inefficiencies when an alternative (separating equilibrium) does not.

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Why no liquidity black holes in the past? Regulation

- Repo markets: money market financing of long-term assets
- Traditional Anglo-American financial regulation puts firewalls up to strictly circumscribe precisely this type of finance. Examples:
  - 19th century: real bills doctrine
  - 20th century: Glass-Steagall Act – one of the laws the 'repurchase' structure arbitrages

  These policies were consciously adopted in pursuit of financial stability (Sissoko 2016, Sissoko 2017)
- From the 1980s, these protections were steadily eroded with a complete rewriting of the laws governing financial market collateral, culminating in …

Why do we have liquidity black holes today? 'Modernized' regulation

- In 2005 'reforms' culminate in legislation that integrates the derivatives collateral, securities lending, and repo markets (Sissoko 2010)
  - Part of a broader process of lawyers actively 'coding' capital (Pistor 2019)
- Today stress on any one of these markets will show up in the 'repo' market
  - March 2020:
    margins calls in derivatives markets cause
    pension and insurance funds to draw down money market fund holdings
    reducing repo market funding (Schnabel 2020)

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Solving the repo market problem: It needs to shrink

- The problem: Modern repo markets generate financial instability
- They cannot be allowed to continue to operate as they do now. They must be regulated with a view to shrinking them. For example:
  - Raise minimum initial margin requirements on risky assets. Raise minimum initial margin requirements on any sovereign debt of more than 5 years maturity. Goal: the markets become tiny.
  - Alternatively, bring repo markets ‘in the bank’ by replacing repo borrowing with bank credit lines – and strictly regulating banks ability to sell underlying collateral into an illiquid market.
  - Many other possibilities …