Capital markets

Hedge funds key in exacerbating repo market turmoil, says BIS

Bank for International Settlements point to firms' thirst for borrowed cash to fire up returns

Investors and policymakers were stunned when the cost of borrowing cash overnight in exchange for high-quality collateral shot higher in September © JUSTIN LANE/EPA-EFE/Shutterstock

Tommy Stubbington and Joe Rennison in London YESTERDAY

Hedge funds exacerbated the recent turmoil in the repo market with their thirst for borrowing cash to juice up returns on their trades, according to the Bank for International Settlements.

Investors, bankers and policymakers were left stunned in September when the cost of borrowing cash overnight in exchange for high-quality collateral such as US government debt shot higher, eventually forcing action from the Federal Reserve to keep the market functioning smoothly.

In the aftermath, attention focused on the role played by banks, which had become reluctant to lend cash into the market despite the higher interest rates on offer.

While the BIS acknowledged in its quarterly assessment of the health of global markets, released on Sunday, that the pullback by banks was a significant factor in the shake-up, it also said that cash-hungry hedge funds had amplified the dislocation.

"High demand for secured (repo) funding from non-financial institutions, such as hedge funds heavily engaged in leveraging up relative value trades," was a key factor behind the chaos, said Claudio Borio, head of the monetary and economic department at the BIS.

The findings from the BIS — often referred to as the central bank for central banks — highlight the growing clout of hedge funds in the repo market. Millennium Partners and Capula are among the large hedge funds active in the market, according to people familiar with the funds. Both declined to comment.

One increasingly popular hedge fund strategy involves buying US Treasuries while selling equivalent derivatives contracts, such as interest rate futures, and pocketing the difference in price between the two.

On its own this is not very profitable, given the close relationship in price between the two sides of the trade. But people active in the short-term borrowing markets say that to fire up returns, some hedge funds take the Treasury security they have just bought and use it to secure cash loans in the repo market. They then use this fresh cash to increase the size of the trade, repeating the process over and over and ratcheting up the potential returns.

The strategy was once popular among banks, but higher capital charges since the financial crisis have led to their displacement by hedge funds, which have more ability to take on risk.

As banks have pulled back from the market, hedge funds have also sought cash from new sources, such as non-bank dealers or through a platform run by the Fixed Income Clearing Corporation that gives them access to cash from money market funds and other lenders.

The growing significance of these new cash sources "can result in unfamiliar market dynamics", said Mr Borio.

He added that September's dislocation suggests that repo markets "may again find themselves in the eye of the storm should financial stress arise at some point".

Despite the Fed's efforts to calm the repo market, the cost of borrowing cash overnight on the last day of the year surged last week, raising concern for fresh volatility ahead.