

Repo Counterparty Risk and On-/Off-the-Run Treasury Spreads

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We propose a dynamic asset pricing model in which two assets with identical cash flows can trade at different prices not only because of differences in liquidity but counterparty risk. Counterparty risk reduces lenders or borrowers' willingness to supply funds and collateral, incentives to shortsell and lend, and the likelihood for new bonds to be on special, thereby narrowing on-/off-the-run spreads and affecting asset prices in spot markets. Consistent with this prediction, we find that on-/off-the-run spreads are low when counterparty risk is high and this relationship is much stronger during the financial crisis.

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