THIS MONTH

GOOD HOUSEKEEPING

July and August are typically, but not always, two of the quieter months in the year. So they can be a good period to gather one's thoughts and prepare for the busy months ahead (while also taking some well-deserved annual leave). They can also be an excellent time to revisit treasury policies, bank mandates and all those other tasks we keep putting off. On these pages, we bring you a few important topics and developments to reflect on over the summer.

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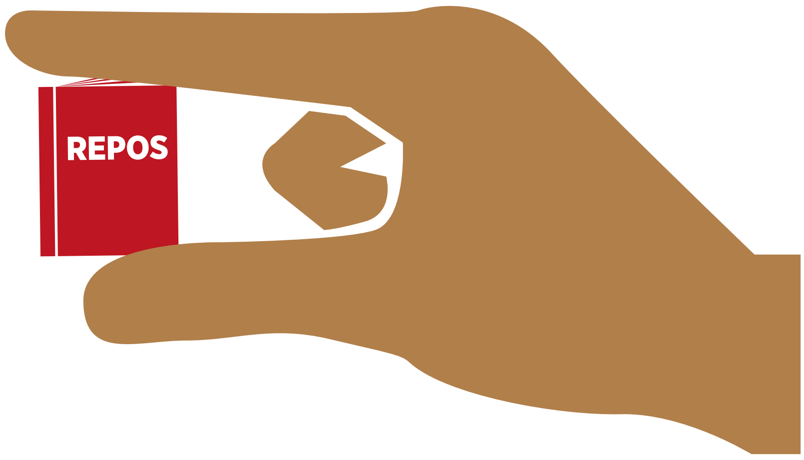
{ IN DEPTH }

REPOs IN A NUTSHELL



Is a repo riskless? The short answer is no, but a treasurer can use a repo to achieve a substantial reduction in credit risk when investing their company's excess cash. The degree to which credit risk is reduced depends on a number of factors. These include the counterparty bank selected, the quality of the collateral chosen, the size of the haircut, and the legal and operational ability to liquidate the collateral in response to a default event.

A 'repo' is the generic term for a repurchase agreement. These are agreements to sell securities (usually bonds, gilts, treasuries or other government or tradeable securities) and then buy them back at a specified later date and price. Repos are secured investments whereby, if the bank counterparty defaults, the corporate investor can sell the collateralised security. Unsecured investment products, such as money market funds and bank deposits, do not provide this additional protection.

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Repos can be used for a very short-term investment, such as an overnight deposit, or for a longer-term investment stretching up to many years. Rolling overnight repos can be used to allow same-day access to the cash deposited.

When investing in repos, the corporate's primary credit risk exposure is the counterparty bank with which they have transacted the repo. The preferred outcome is that the repo counterparty bank repays in full and on time. While counterparty credit risk is the corporate's primary exposure in a repo, choice of collateral is still very important. The credit risk on the collateral should have a minimal correlation with the credit risk on the counterparty to the repo.

If a counterparty to a repo were to default, there still exists 'gap' risk, ie the movement in the value of the securities from the time the counterparty defaulted to the time when the corporate sells the securities. The haircut that is added onto the collateral value is there to cover a couple of days of market volatility. Accordingly, it is low for government bonds (say 2%), higher for equities and corporate debt, etc. The non-defaulting party can sell the collateral immediately in a default scenario, provided the requisite default notices are served correctly.

Many counterparty banks are active traders of securities and obtain from the corporate investor the right to substitute collateral at any time during the repo with an alternative asset that is acceptable to the corporate investor. A repo with a right of substitution typically pays a higher repo rate than one without.

As 'owner' of the collateral during the term of the repo, interest or dividends may be paid on those collateral securities. Contractually, this income must be paid back to the counterparty bank.

The global master repurchase agreement is a framework agreement containing standard terms that the parties involved wish to apply to all the repo trades that take place between them. This, therefore, saves the need to agree these provisions each time a trade is transacted. Corporates that invest in repos also need to have a plan in place to liquidate collateral rapidly in case a counterparty defaults. As described, the management of collateral can become quite complicated and administratively burdensome. For this reason, corporates typically use a tri-party repo instrument, which has a tri-party agent responsible for the administration and valuation of the collateral.

Further details on repos can be found in the ACT's briefing note: *Practical Steps to Investing in Repos*. This briefing note was updated in May 2014 (more than 500 copies have been downloaded since it was originally published in November 2012). A copy can be found at www.treasurers.org/repos

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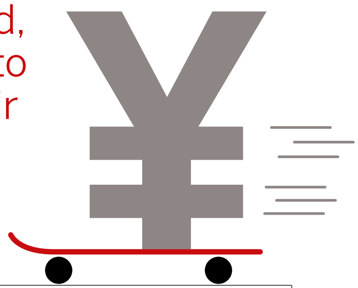

{ INTERNATIONAL }

RENMINBI LIBERALISATION GATHERS SPEED

China's State Administration of Foreign Exchange, the body that regulates dealings in the renminbi, has issued important new guidance on cross-border renminbi settlement. This guidance, entitled *Pilot Rules on Foreign Currency Cash Pooling of Multinational Companies*, applies to the Shanghai free-trade zone. It allows banks in Shanghai to provide cross-border renminbi settlement services to their clients without upfront review of the contract and invoice documentation.

International groups with enterprises established in the free-trade zone can now also conduct cross-border renminbi cash pooling with affiliated companies. There is no restriction on where the funds can be used, which will allow companies to make use of idle cash in their Chinese entities.

The People's Bank of China has also signed memoranda of understanding with Germany's Bundesbank and the Bank of England to establish renminbi clearing and settlement arrangements in Frankfurt and London.

Once clearing banks have been selected and the clearing solution launched, renminbi-denominated transactions will settle in Frankfurt and London, rather than via agent banks in Hong Kong, Singapore or Taiwan. European corporate treasurers will therefore expect the cost of renminbi payments to fall, since they can be processed closer to home.

The City of London initiative on London as a centre for renminbi business is currently updating its corporate resource pack: *Accessing London RMB products and services*. Copies can be found at www.cityoflondon.gov.uk/renminbi or www.cityoflondon.gov.uk/rmb

NEW ON THE WEB

EACT comment letter on the European Commission proposal for Payment Services Directive II

EACT monthly report on European regulatory initiatives and the issues relevant to corporate treasurers

ACT past webinar: Effective credit risk pricing – the applications for treasurers

ACT past webinar: The impact of market structural reform

{ WATCH THIS SPACE }

UPDATE ON PSD II

The European Parliament's work on the new Payment Services Directive II (PSD II), proposed last year, will pause for a while following the elections. A new rapporteur will also be needed to steer the legislation through the parliament's Economic and Monetary Affairs Committee.

The European Association of Corporate Treasurers (EACT) has seized the moment to brief the new MEPs with a position paper (available at www.treasurers.org). The paper feeds back the combined views of treasury associations across Europe. In particular, it expresses concern that the attempts to widen the sorts of institutions that are regulated, by introducing the concept of a third-party payment services provider, inadvertently go too far. Corporate in-house banks or payment factories could be caught, whereas the intention was to regulate genuine external payment intermediaries. There is an exclusion from regulation for intragroup payments, but this would not cover third-party payments 'on behalf of'.

The EACT welcomed the PSD's extension of scope to non-EU currencies and 'one-leg-in-EU' transactions, the general inclusion of a third-party payment services provider and the further limiting of surcharges on payment cards imposed by some merchants, such as purchases of airline tickets. But companies were concerned by the idea of limiting the right of refund on direct debits where "the payee has fulfilled its contractual obligations and the goods have been consumed by the payer or services have been rendered".

{ TECHNICAL ROUND-UP }

SANCTIONS, PAYMENT SYSTEMS AND NEW SENTENCING GUIDELINES

The impact of sterner Russian sanctions on the derivatives market is not yet understood. The International Swaps and Derivatives Association (ISDA) master agreement allows for a trade to be terminated under a *force majeure* clause or if it becomes unlawful for one of the parties to continue honouring the contract. While the ISDA master agreement allows for a swap to be terminated, doubt has been cast on the ability to settle derivative trades with a Russian counterparty without breaching the sanctions.

The Financial Conduct Authority has published a new payment systems web page in preparation for the Payment Systems Regulator becoming fully operational when regulation commences in April 2015. This follows on from the creation of a new regulator for payment systems on 1 April 2014. For more, see www.fca.org.uk/firms/firm-types/payment-systems

In May, the UK Sentencing Council published sentencing guidelines for offenders who have committed acts of bribery, fraud and money laundering. The *Fraud, Bribery and Money Laundering Offences: Definitive Guideline* will apply to offending individuals and organisations that are sentenced from 1 October 2014. Fraud now carries a maximum sentence of 10 years' imprisonment, false accounting seven years, money laundering 14 years and, for corporates, an unlimited fine. See http://tinyurl.com/lxhah4d

A taskforce led by the European Banking Authority is seeking to define virtual currencies and assess whether they can, and should, be regulated. While the Bitcoin is one of these virtual currencies, it is, in fact, more akin to a system for verifying payments without the need for a third party, rather than being a currency in its own right. Further details on the Bitcoin network can be found in an article by investment management firm Payden & Rygel at http://payden.com/library/pov/POVQ413.pdf

The International Organization of Securities Commissions (IOSCO) has published a consultation on good practices for reducing reliance on credit rating agencies. While the majority of questions are directed at investment managers, IOSCO is also seeking the individual investor's view, for example, what is the reliance on credit ratings when investing in money market funds? A copy of the consultation can be found at www.iosco.org/library/pubdocs/pdf/IOSCOPD442.pdf