The power of three

TRI-PARTY REPOS ARE BECOMING INCREASINGLY POPULAR AS TREASURERS SEE THE MANY ADVANTAGES OF THIS CONVENIENT INVESTMENT PRODUCT, SAYS STEVE LETHABY

There was a time when the repo market was the preserve of banks and central banks, which used it for interbank securitised borrowing and lending. But since the global financial crisis struck, repos have entered the mainstream and today they are increasingly used by corporates as an investment product. Their appeal is simple: they deliver yields that are as good as – if not better than – unsecured bank deposits, while offering the additional benefits of security, flexibility and control.

What is a repo?

A repurchase agreement or 'repo' is a sale of a security by a bank together with an agreement for the bank to buy the security back at a later, predetermined date – perhaps as soon as the following day. The repurchase price will be greater than the original sale price, with the difference between the two effectively representing interest – usually referred to as the 'repo rate'.

The counterparty that buys the security (the corporate) is the cash provider, while the seller (the bank) is the cash taker. Among the types of security that can be used as collateral are all types of fixed-income securities, including government and corporate bonds, commercial papers and certificates of deposit, as well as equities and money market or mutual funds.

With a tri-party repo, there is a third party involved in the trade. This is a collateral management agent, which is an independent intermediary that is appointed to handle the administrative tasks associated with the repo. The two trading parties will agree the details of the repo, including the currency, principal amount, interest rate, term and collateral set (or 'basket'), and pass these on to the tri-party agent for matching and confirmation. Once these terms have matched, the trade will be presented for clearing (or opening) on the value date. The cash will move through the segregated tri-party collateral account of the cash provider and be paid to the cash taker, while the securities will simultaneously move into the tri-party collateral account of the cash provider. Put in simple terms, a tri-party repo is essentially a bank deposit that is backed by assets that are independently held and managed.

The collateral management agent will then monitor the trade on an ongoing basis, focusing on issues such as margin calls (if the value of the collateral moves up or down, securities may need to be brought out of or into the account), credit ratings and substitution of securities. When the trade closes, the tri-party agent will ensure that the cash and collateral are duly returned to their rightful owners, with the cash provider receiving its accrued interest as appropriate.

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WHAT IS A HAIRCUT?

A haircut is the amount of over-collateralisation that a treasurer will demand with a repo in order to get a buffer should they ever need to liquidate the collateral at market value. If the collateral is a top-quality asset such as sovereign debt, then the haircut is likely to be minimal, but it will be greater for a more volatile asset that may drop in value or become less liquid just at the time it needs to be sold. Some treasurers will look at the likely five-day volatility of an asset and base their haircut on that.

Benefits of repos

As an investment product, tri-party repos offer many benefits to corporates:

1. Security

Repos are a relatively low-risk investment product for corporates, since their exposure to their banking counterparty is reduced through holding collateral. If the banking counterparty should default, the corporate won't lose its cash in the way it would if it had an unsecured deposit. Instead, it can liquidate the collateral (which should have sufficient margin to allow for a 'haircut' – see box above: What is a haircut?) to get its cash back. With repos, corporates don't need to worry that their cash might become subject to a bank 'bail-in' of the kind seen in Cyprus.

2. Diversification

Repos also enable corporates to follow a strategy of diversification for their cash investments, rather than tie up their money exclusively in bank deposits and money market funds (MMFs). This is particularly significant given that European regulators are looking to regulate the MMF industry and require funds with a constant net asset value to switch to a variable net asset value, or else hold a 3% capital buffer. They may also potentially be stripped of their triple-A credit ratings.

3. Support of a collateral management agent

A collateral management agent will ensure that the tri-party repo process runs smoothly. It will also continue to monitor the value of the collateral that the corporate has acquired for the duration of the trade and report this on a daily basis, saving time for the treasury team.

4. Control

Corporates have control over the type of collateral they wish to receive. Inevitably, there is a correlation between risk and reward, ie the riskier the collateral the corporate will accept, the higher the yield it is likely to get on its investment. The corporate can also determine the currency, the collateral amount and the length of the trade.

5. Reuse of collateral*

With a tri-party repo agreement, corporates have the opportunity to reuse the collateral that they receive from the cash taker as collateral for OTC-derivative exposures that they have with other counterparties instead of using their cash. This is an important benefit since the European Market Infrastructure Regulation has specific collateral-exchange requirements for OTC derivatives that are not cleared by a central counterparty. Corporates could also reuse the collateral to undertake a repo to get cash financing or to support liquidity or treasury lines.

GETTING STARTED WITH TRI-PARTY REPOS

1. **Appoint a collateral management agent. This will involve going through the know-your-customer process in order to set up an account with the agent.**
2. **Sign the tri-party legal agreement (collateral management service agreement (CMSA) or equivalent).**
3. **Agree the bilateral terms and conditions with your counterparty using either a global master repurchase agreement (GMRA) or Clearstream's master repurchase agreement, an annex to its CMSA, which negates the need for individual GMRAs with each counterparty.**
4. **Set up the collateral eligibility schedule. This schedule is the collateral 'basket', ie the collateral that you are willing to accept from your cash taker. When weighing up collateral options, it is important to consider factors such as currency risk and exposures to individual countries.**
5. **Confirm operational requirements such as the platform that you wish to trade on – for example, 360T, Bloomberg or the collateral management agent's own instruction interface or web portal. You also need to agree standard settlement instructions.**
6. **Agree terms with your counterparty and start trading. The minimum amount that a corporate can invest in a repo can be as little as £1m. Trading is straightforward and cost-effective when undertaken on an electronic trading platform.**

Win-win

Thanks to the Basel III banking standard on capital adequacy and market liquidity risk, banks increasingly want to take cash from their corporate clients on a secured, rather than an unsecured, basis, especially in the long term. That's because they see it as a way to get balance-sheet liquidity. The capital and liquidity coverage ratios set by Basel III also mean that banks are trying to squeeze as much economic value as possible out of the collateral that they hold – in other words, they want to make sure they have the right collateral, in the right place, at the right time.

Meanwhile, corporates like being able to ring-fence their cash against collateral and have it managed by a third-party administrator rather than entrust it to their bank on an unsecured basis. So it is not surprising that the tri-party repo market is continuing to grow in popularity. Without doubt, repos are here to stay and they will be used more and more in the years to come.

*** Reuse of collateral is only possible within the tri-party system itself, since the tri-party agent always needs to guarantee the right of substitution for the original collateral giver.**

Steve Lethaby is vice president, global securities financing for the UK, Ireland and South Africa, at Clearstream. For more on investing in repos, see www.clearstream.com and the ACT webinar at www.treasurers.org/investinginrepos

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