A CHEAPER WAY TO BORROW

SAHEED AWAN OF CLEARSTREAM BANKING LOOKS AT THE ADVANTAGES OF TRI-PARTITE REPURCHASE AGREEMENTS AS AN EFFECTIVE WAY TO RAISE SHORT-TERM FUNDING.

Treasurers in the UK are waking up to the benefits of commercial paper (CP) and even repurchase agreements (repos) as an alternative to traditional bank credit lines. But in the current market context of aversion to corporate risk, CFOs might do well to give serious consideration to tri-partite repo as a durable and cost-effective source of short-term funding. The City of London plays a major role in the euro-denominated repo market and can open up further opportunities for those treasurers in search of cheap funds.

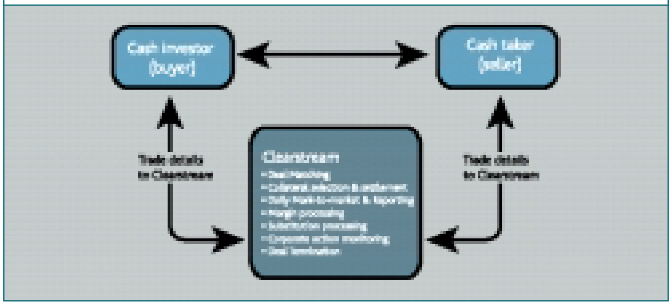
These opportunities result from the expansion of the euro-denominated repo market over the past three years. The conventional money market has developed fast across the euro area, but along the way banks with surplus cash have realised the drawbacks of unsecured loans. They favour repos because, as a secured alternative, they do not carry risk-related capital ratios. Therefore, a significant source of cash has become available in the euro area, especially for corporate borrowers because they enable banks to diversify beyond the narrow circle of financial institutions.

Developments in the euro money market have also been favourable to the growth of CP, although it lags way behind the US market. CP offers lower interest rates than a standard credit line and can handle very large needs. But for borrowers, repayment terms are more rigid than for credit lines. Lack of a secondary market results in two further drawbacks for CP: investors keep purchases until maturity and there is no reliable benchmark for new issue pricing. Moreover, the minimum maturity on the European CP market is three months, compared with two days in the US.

LOW FINANCING RATES. As noted above, repos work in much the same way as secured money market instruments – a cash loan backed by securities which may not be denominated in the same currency (cross-currency repo). Cheaper margins are a big attraction. The repo rate is typically lower than unsecured bank deposit, CP and even Treasury bill rates.

Repos are less expensive because they enhance credit in two distinct ways. If the cash borrower defaults, the lender keeps the securities. Moreover, the quality of the securities (for example, government bonds) is often higher than the credit standing of the cash borrower,

FIGURE 1
LIFECYCLE. TRIPARTITE REPO SERVICE.



making it easier for the cash provider to sell them. As a result, repo has become a proxy for very short-term risk-free interest rates in the financial markets.

Corporate treasurers looking to enhance returns or lower borrowing costs must remain alert to the opportunities their assets can open up for them on the repo market. Take the case of a German government bond. If it is in short supply on the market (say, ahead of the quarterly settlement of the Bund future contract), it can be repoed as 'special' collateral, potentially lowering the cost of funds by up to several percentage points.

Although they are tied to the money market rather than to bond yields, repo rates are affected by overall bond market conditions. When the fixed income market trend is down, repo rates decrease because bond dealers need to borrow securities to cover short positions. Conversely, when the fixed income market is on the way up, so are repo rates, as dealers look to borrow cash to finance fresh bond positions.

Repos also leave treasurers free to borrow or productively park cash for the particular maturity that best suits their needs. Whatever the duration of the contract, the rate on a term repo – that is, one with a pre-agreed maturity – remains fixed. By contrast, the rate on an open repo changes every day because counterparties can terminate it at any time. However, an open repo, where the rate is re-set daily, should be cheaper than an overnight repo, which carries the cost of cash and securities transfers.

LEGAL AND OPERATIONAL RISK. For all their benefits, most types of repo face two different sets of problems. Some are of a legal nature. A country's legislation may not provide the watertight ownership rights to the security that are required. For this reason, Spain and Italy have a preference for the sell/buy-back alternative. This structure involves two distinct contracts instead of just one, but in practice the buy-back leg tends to be left behind.

Other countries favour the 'hold in custody' alternative, where the seller holds on to the collateral on the buyer's behalf. This simplifies administration tasks for the seller but prevents the buyer from on-lending the collateral. The buyer also faces a double risk: bankruptcy risk, which must be reflected in the repo rate; and the risk of 'double dipping', when the seller uses the collateral for another repo.

Classic bilateral repos are legally safer but pose a logistic challenge. Temporary transfer of securities is a cumbersome procedure. This makes cash providers reluctant to allow asset substitutions and therefore removes some of the flexibility inherent to the instrument. More importantly, treasury operations are not usually prepared or equipped to handle the administrative and operational functions, costs and risks involved in the securities leg of a repo.

In Europe, multi-currency or cross-border deals can enhance liquidity. But higher repo rates reflect the foreign exchange (FX) and interest rate risks involved, at least for the time being. Back office tasks are also more complex. European securities clearing systems remain fragmented along national and market barriers. The resulting operational and settlement risks combine to make asset substitutions impractical, reducing both flexibility and returns.

TABLE 1
TRI-PARTITE REPO: COMPARATIVE BENEFITS

	TRI-PARTITE REPO	CP	BANK CREDIT
INTEREST RATE	8-10bp below CP	50-100bp below bank credit	Spread over Libor/Euribor
DEAL SIZE	EUR50m to EUR 1,000m+	EUR500m to EUR5bn	May take several banks for similar size
MATURITY	Overnight to one year	One week to a year	One year or less
FREQUENCY	Flexible	Some preparation + market conditions	May be restricted by credit limits
REPAYMENT	Pre-determined but flexible	Fixed and rigid	Fixed but negotiable
SET-UP COST	Fee for third party	Fee for programme Dealer fee	Compensating balance at the bank

REPO WITHOUT THE RUB. The benefits of repo without the paperwork nor the risk: this is the ideal mix tri-partite repo provides to corporate treasurers. In this area as well, the euro-denominated market has expanded dramatically of late, with major institutions reporting volume increases of 100% or more in two years. On the Continent, tri-partite repo has become a favourite short-term placement for cash-long banks. And here, again, as Europe's largest financial centre, London is well placed to open up these cross-Channel opportunities to British corporate treasurers.

This popularity stems from the two key features of tri-partite repo. The third-party agent keeps the security on behalf of the cash provider, giving the borrower better protection in case the counterparty defaults. It also takes over the administrative and operational tasks involved in securities settlement and management.

As providers of world-class clearing, settlement and custody services to listed and unlisted markets, key international central securities depositories (ICSDs) are able to handle the transfers of cash and securities involved in repos. They can do so across borders, thereby expanding the scope for opportunities and liquidity in tri-partite repos.

A tri-partite repo leaves users free to borrow or lend cash against securities with the counterparties that best suit their credit policies. Users can even leave the tasks of selecting and, when required, substituting assets to an automated facility from the start and throughout the life of a transaction. The automated facility eliminates the need for manual intervention by the cash borrower, but conforms to the cash borrower's specific criteria.

As third-party agent, the ICSD handles all the operational tasks. These include matching instructions and checking the quality and quantity of collateral against customers' criteria, including eligibility in terms of credit rating, liquidity and currency. The next step is to safeguard the securities in segregated accounts, transfer cash and securities and, finally, settle transactions at both ends of the repo. Highly automated systems perform these tasks to world-class standards (delivery versus payment) and report back to customers on the spot.

Repos also require daily administrative tasks. The third-party agent marks securities loans to market every day, calls for and collects margin and reports to customers. Further tasks include withdrawals, top-ups, re-pricing and simultaneous substitutions. Custody functions involve monitoring income events and notifying customers as and when required.

BENEFITS OF A THIRD PARTY. With a leading ICSD acting as third-party agent, clients enjoy economies of scale because they use systems which already serve the largest banks and securities companies as well as their networks across the world. Complex tasks such as asset substitution become much easier, which mitigates the higher repo rates they usually entail. In terms of cost, tri-partite repos typically fall in between the riskier hold-in-custody alternative and the cumbersome bilateral contract.

Acting as a neutral intermediary between the two parties to a repo transaction, an ICSD can add to liquidity in a number of ways. Using its international market contacts, it can put potential counterparties in touch with each other. This helps repo participants diversify credit risk without infringing their respective credit guidelines. It can also, as suggested above, open up high-quality sources of liquidity to treasurers.

An ICSD such as Clearstream Banking also acts as central depository for Germany, at the heart of the euro area. It is well equipped to overcome the barriers that fragment settlement systems, especially in the euro area. It can accept more than 200,000 securities (including those from a number of emerging markets) denominated in 40 different currencies (with same-day settlement in sterling, the euro and US and Canadian dollars, among others).

Tri-partite repo is the short-term funding alternative of choice, as it leaves treasurers free to take advantage of the opportunities domestic and foreign markets throw at them. World-class back-office systems put them in a better position to secure their optimal risk-return tradeoff.

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