Know your repo

MARK STOCKLEY LOOKS AT THE IMPORTANT MARKET OF REPURCHASE AGREEMENTS, WHO USES IT AND HOW IT WORKS.

The repurchase agreement market is one of the largest and most actively traded sectors in the short-term credit markets and represents an important source of liquidity for money market funds and institutional investors. Repurchase agreements (commonly referred to as repo agreements) are short-term secured loans frequently obtained by dealers (borrowers) to fund their securities portfolios, and by institutional investors (lenders) such as money market funds and securities lending firms as sources of collateralised investment.

WHAT IS A REPURCHASE AGREEMENT? In its simplest form, a repurchase agreement is a collateralised loan, involving a contractual arrangement between two parties, with one party agreeing to sell a security at a specified price and committing to buy it back at a later date for another specified price. In essence, this makes a repurchase agreement much like a short-term interest-bearing loan against specific collateral. It enables both parties – the borrower and lender – to meet their investment goals of secured funding and liquidity.

> AS THESE TRANSACTIONS ARE SHORT TERM AND CONSIDERED RELATIVELY SAFE DUE TO THE SECURED COLLATERAL, MARKET LIQUIDITY AND RATES REMAIN COMPETITIVE FOR ALL INVESTORS.

There are three types of repurchase agreement used in the markets: deliverable, tri-party and held in custody. Held-in-custody repos are relatively rare, and tri-party agreements are most commonly utilised by money market funds.

Repurchase agreements are typically done on an overnight basis; a small percentage of deals are set to mature longer and are referred to as term repos. Additionally, some deals are referred to as open – they have no end maturity date and allow the lender or borrower to mature the repo at any time. In a deliverable repurchase agreement, a direct exchange of cash and securities takes place between the borrower and lender.

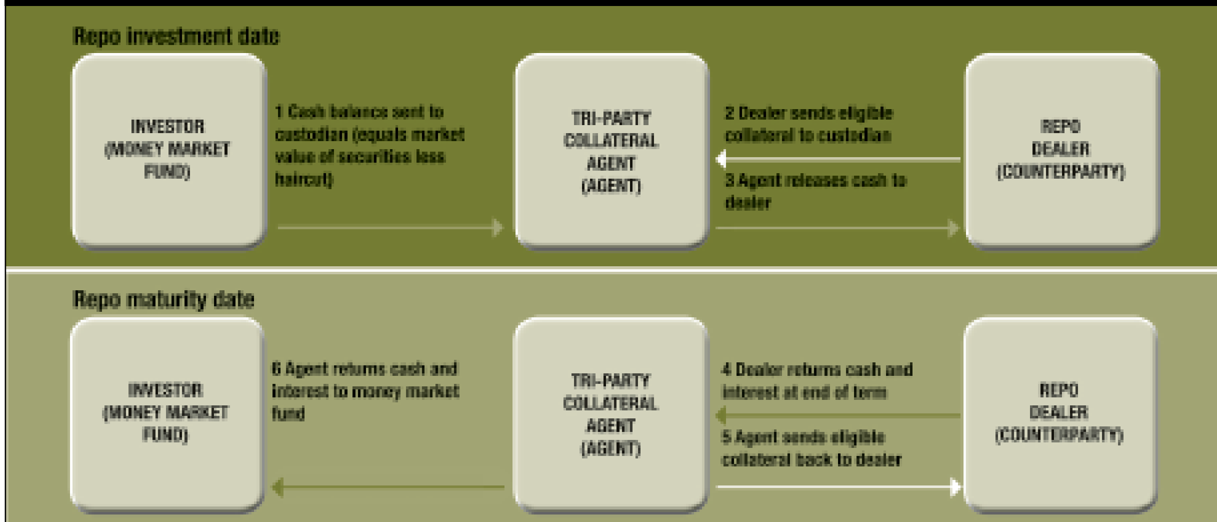
As mentioned, the most widely used form of repurchase agreements by money market funds is the tri-party – the tri-party market recently stood at approximately $1.7 trn[1]. Tri-party repos use a third party – a custodian bank or a clearing organisation known as the collateral agent – to act as an intermediary between the counterparties. The collateral agent's role is critical: it acts on behalf of both the borrower and lender, minimising the operational burden and receiving and delivering out securities and cash for the counterparties. The collateral agent also serves to protect investors in the event of a dealer's bankruptcy, by ensuring the securities held as collateral are held separately from the dealer's assets. Figure 1 illustrates how a tri-party repurchase agreement is structured and how it serves to protect lenders and borrowers in a transaction.

HOW INVESTORS USE REPOS Repurchase agreements are used by money market funds to invest surplus funds on a short-term basis and by dealers as a key source of secured funding. Securities dealers use repos to manage their liquidity and finance their inventories. While repurchase agreements are commonly found within money market funds as short-term, mostly overnight investments, the cash investor might look to invest cash for a more customised period of time to fulfil a specific investment need.

As these transactions are short term and considered relatively safe due to the secured collateral, market liquidity and rates remain competitive for all investors.

Of the several factors that impact market rates two of the most important are the type of collateral behind a contract and the terms of a deal. Traditional or general collateral (often referred to as GC) consists of government securities including treasuries, agencies and agency mortgage securities. As of Q2 2011, traditional collateral comprises

Figure 1: The mechanics of a tri-party repo transaction



approximately 80%[2] of the outstandings in the tri-party market. Non-traditional/corporate or alternative repurchase agreements may include as collateral a range of non-government securities, including corporate investment-grade and non-investment grade debt and even equity securities.

The use of traditional collateral, coupled with a shorter term, will typically result in a lower yield, whereas use of non-traditional collateral, together with a longer term, will generally result in higher yields. The level of returns offered by dealers will also vary greatly, depending on market conditions and factors such as outstanding supply, demand for certain types of collateral (ie. treasuries), and the specific credit risk of the counterparty.

As the events of the past few years have shown, preparation for unforeseen market conditions is vital. As such, overcollateralisation or haircuts are commonplace in the repo markets. They provide a level of increased security in the event of a default by a counterparty.

Typical overcollateralisation percentages based on collateral type are as follows:

- traditional: 102–103%; and
- non-traditional: 105–107%.

Under Rule 2a-7 of the Investment Company Act of 1940, money market funds are subject to a 5% maximum exposure to any single issuer. Due to the importance of liquidity within money market funds, as well as the secured nature of repurchase agreements, those that utilise traditional collateral are permitted to "look through" to the high-quality collateral and utilise less restrictive exposure criteria. However, transactions that utilise non-traditional collateral are still subject to these exposure limits.

WHY IS THE TRI-PARTY REPO MARKET IMPORTANT? The recent financial crisis highlighted the significant role that repurchase agreements have come to play in the short-term liquidity markets. In 2008 at the high-water mark for the sector, an estimated $2.8 trn[3] of securities was funded through repurchase agreements. Major investment banks such as Bear Stearns and Lehman Brothers relied heavily on these deals to fund their operations. As their financial difficulties became more apparent, other institutions reduced their credit lines, including repurchase agreements, or declined to lend to them altogether.

As a result, they ran into financial difficulties, and regulators and investors alike became acutely aware of the extent to which these transactions were employed by investment banks' dealers to fund their operations. Regulators concluded that banks' overreliance on repurchase agreements for short-term funding was a major contributing factor toward instability in the financial markets.

As a result, domestic and international regulation in both the banking and securities markets has been amended in recent years to reduce the potential for repurchase agreements to freeze the credit markets. While this market remains a highly significant sector for lenders and borrowers alike, the overall size has been reduced from its 2008 peak to its current position of around $1.7 trn[4]. Recent industry reforms, such as changes to custodial bank intraday credit, settlement processes and a widespread reduction in banks' leverage have strengthened the sector and it remains important for money market funds and other institutional investors, in particular as a source of overnight liquidity.

References

[1] Federal Reserve Bank of New York, October 2011.
[2] Federal Reserve Bank of New York.
[3] Federal Reserve Bank of New York, May 2010,
[4] Federal Reserve Bank of New York, October 2011.

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