SEARCH FOR SECURITY

WHICH PRACTICAL CONSIDERATIONS COME WITH USING REPOS? MATT SHELLEY EXPLAINS

In 2012, international investment manager 3i changed its business and financial strategy following a change of leadership. Among other things, this involved the group reducing gross debt and cash investments, and operating with a much smaller treasury team.

3i's treasury team had previously invested in money market funds (MMFs) alongside a longer-term book of deposits and certificates of deposit (CDs). But, in 2012, it moved to investing primarily in MMFs, attracted by counterparty diversity, same-day liquidity, reasonable yields and low operational impact. Furthermore, the consolidated 'X-ray' reporting made available by money market portals in recent years made it easier to assess counterparty exposure across several fund investments.

But where are we now? Looking ahead, developing regulation of the banking and shadow banking sectors means that existing day-to-day investment products are, or are likely to become, less attractive either due to reduced availability or falling yields for corporates and non-bank financial institutions, such as 3i. These regulatory developments include:

- Basel III's liquidity ratio means that banks have little desire for term funding of less than one month. Marginally longer-dated deposits are also unattractive, since they will eventually have less than a month to maturity.
- Operational cash balances have become more attractive to banks than investment cash.
- Deposits from corporates are now more attractive for banks than deposits from bank and non-bank financial institutions.
- Proposed European MMF regulations have included moving from constant net asset values to variable net asset values, introducing liquidity gates and fees, and capital buffers that would reduce overall attractiveness to investors.

Investigating the options

As it started to prepare for the future and looked to diversify away from MMFs generally, 3i considered using deposits, commercial paper and CDs either through a self-managed portfolio or through outsourcing to a third party, via a segregated mandate.

As a segregated mandate would present many of the same issues as the proposed regulatory changes to MMFs, and because a self-managed portfolio would likely increase 3i's individual bank exposures, we investigated repos as a low-risk investment with reasonable yields.

The legal form of a repo, or repurchase agreement, involves the purchase of an asset with a simultaneous agreement to sell back the asset at a pre-agreed price. Economically, the repo is similar to a secured deposit, with the difference between the purchase and sale price being analogous to an investment yield, and where the asset can be sold if the counterparty defaults.

During the life of a repo, various operational activities relating to the asset take place. These include related income being paid to the asset seller, and changes in the value of the assets requiring further assets or cash to be posted or received by the seller. A repo can take a bilateral form (where the asset buyer and seller undertake all the operational activity) or be tri-party (where an agent such as Euroclear or Clearstream performs the operational activity). 3i chose the tri-party form, as we wanted to outsource all operational activities to a third party while benefiting from the asset seller paying the tri-party custody fees.

3i set up relationships with both Euroclear and Clearstream, as some banks choose to deal with only one tri-party agent.

Counterparty credit risk and asset risk

3i chose well-rated relationship banks to transact with because the primary repo counterparty risk was its key consideration, regardless of the quality of the assets involved in the transaction. When considering different asset types, the group's main considerations were:

- **Price transparency.** Using the tri-party form, the agent normally values the assets once per day. Some assets are simple to price, whereas other more esoteric, or illiquid, assets are harder to price.
- **Liquidity.** If a repo counterparty defaults, market liquidity is likely to be lower for many asset types, increasing the period of time taken to sell the assets and widening spreads significantly.
- **Price/currency volatility.** Historic data can give a guide as to how volatile the asset price and/or currency rate will be during the period from default to selling the assets. This data can be used to sense-check proposed 'haircuts' on asset values in comparison with cash invested.
- **Wrong-way risk.** This risk arises as many asset-value movements will be correlated with a bank default. This can be a general risk arising from geography or industry factors, or it can be a specific risk where the asset value and liquidity is linked to the repo counterparty's credit, for example, the counterparty's bonds or other securities with direct exposure to the counterparty credit.

Robust processes have been established to notify the tri-party agent of a default under a global master repurchase agreement (GMRA), move the assets to an operational custody account, and then sell the assets, in the event of a counterparty defaulting.

Set-up process

Historically, repo legal contracts have been documented using a GMRA, although Clearstream offers the Clearstream Repurchase Conditions (CRC), which should be a simpler document with less negotiation required. The GMRA can be thought of in a similar way to an International Swaps and Derivatives Association master agreement, in that it covers how a default can occur and what happens as a result. The key risk for the asset purchaser is that, if the asset seller defaults, the administrator may try to challenge the contract, arguing that a true sale and purchase has not occurred. 3i chose to negotiate GMRAs with repo counterparties, since they are tried and tested, and have proven robust, under real default situations. Both GMRAs and CRCs have legal opinions available, supporting the view that a true sale and purchase has occurred. This provides a high degree of legal certainty to repo market participants.

The GMRA covers all bilateral repos, with certain terms being overridden by tri-party agency contracts where tri-party repo arrangements are used. 3i obtained GMRA proposals from various banks, taking legal advice to negotiate a broadly consistent standard: this process took about three months. Typically, any new GMRAs negotiated now take less than a month to negotiate, with the removal of proposed cross-default and set-off clauses usually being the most contentious points. Certain law firms provide useful guides to the 2000 and 2011 GMRA forms, and Euroclear is now providing standard GMRA formats that are likely to be suitable for new tri-party repo participants.

LEARNINGS FROM IMPLEMENTATION

- Don't be put off going down the GMRA route by concerns over either complexity or the time required to negotiate each agreement.
- Do a test trade for each new bank and asset agreement, to ensure that communication channels, payment details and asset transfers work correctly.
- Banks were unaccustomed to using Bloomberg for confirming tri-party trades; this created some problems on the first trade with each bank.
- A significant number of banks are unwilling to repo gilts under tri-party arrangements, preferring bilateral arrangements through CREST.
- Invest time in establishing robust processes for selling the assets involved in the repo transaction. Ensure that you can move them into a custody account through which you can access and confirm trades.
- Maintain relationships with banks and brokers through whom you can sell the assets.

During the life of a repo, various operational activities relating to the asset take place

The onboarding process with Euroclear and Clearstream typically takes six to eight weeks to complete and tends to happen in stages, with new documentation being provided at each point.

The asset seller, purchaser and tri-party agent must document which asset types are authorised for repo, including any restrictions and haircuts, with each agreement typically taking a week to implement.

A new repo participant needs to decide how to communicate with the tri-party agent and how to receive information on asset positions. This tends to be through SWIFT, the tri-party agent's proprietary system or a third-party route. In order to minimise changes to existing systems and avoid taking on new systems, 3i chose to use Bloomberg to trade repos and to confirm them with both Euroclear and Clearstream. Euroclear and Clearstream email regular asset reports to 3i.

Current position

3i has chosen only to repo gilts for short-term, fixed-term sterling repos, although we are investigating evergreen repos and other asset types for the future. Yields are generally better than those offered by unsecured deposits and they are comparable to MMF net yields.

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