Wanted: new approaches to cash

CHANGES IN THE REGULATORY LANDSCAPE ARE MAKING TRADITIONAL MONEY MARKET FUNDS LESS VIABLE AND TREASURERS WILL BE SEEKING NEW OPTIONS, SUGGESTS MARK ASHLEY

SHUTTERSTOCK

Since the credit crisis, prudent financial management by corporates has led many to accumulate substantial cash reserves. Historically, these reserves have been placed with banks or in money market funds (MMFs). However, with bank credit ratings having deteriorated and potential regulatory developments putting pressure on traditional MMFs, many cash investors are seeking alternative solutions.

This has brought attention to the repo market, which can potentially offer greater security for cash investors. The repo market itself faces challenges, but new approaches are being developed to offer attractive cash-investment alternatives that are secure and liquid, and offer the potential for yield.

Challenges facing banks

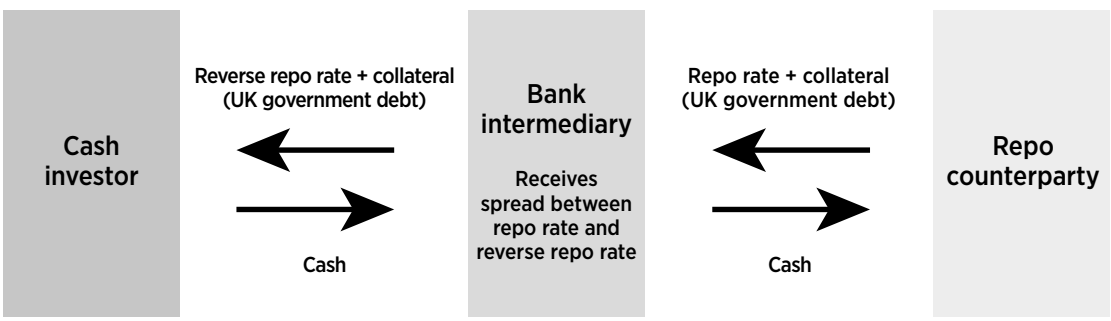
Basel III, developed by the Basel Committee on Banking Supervision, is a package of standards that aims to reform how banks approach capital and liquidity. It is set for full implementation in 2019, but some regulations have already taken effect, and many banks are already following the rules sooner than required. This is having a significant impact on how banks consider investors wishing to place cash with them.

Under the regulations, there are several parameters that define how much capital a bank sets aside to cover its liabilities. Core or strategic cash incurs a higher charge than operating cash, as it is deemed more likely that institutions will withdraw it during times of market stress.

As a result of Basel III, banks are less willing to take on cash investments with maturities of less than three months as they incur higher capital charges, preferring instead to offer three-month maturities or longer. Where banks are accepting short-term cash investments, in some instances, these banks are offering less yield to cover the cost of these new capital charges.

On top of regulatory pressure, many bank credit ratings have deteriorated in recent years. This has put pressure on the ability of corporates to diversify counterparty risk given limits based on credit ratings

FIGURE 1: HOW REPO/REVERSE REPO USING GILTS WORKS



For illustrative purposes only.

contained within many treasury policies.

Challenges facing MMFs

The challenges facing banks have led many larger cash investors to consider MMFs, but these are also facing some headwinds.

Historically, MMFs have offered a stable net asset value (NAV) with daily liquidity, meaning they were appealing to cash investors seeking both security and liquidity. But during the financial crisis in 2008, some US MMFs saw the value of their holdings fall significantly, resulting in them requiring financial support to maintain their constant NAV. One fund, the Reserve Primary Fund, 'broke the buck' and could no longer maintain its constant NAV.

In the US, regulations due to be implemented later this year will lead prime MMFs to adopt variable NAV status, apply liquidity triggers that limit investor withdrawals if short-dated assets drop below a certain proportion of the portfolio assets, and redemption fees. The exception is funds that invest only in treasuries, which will be allowed to maintain constant NAV status.

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These changes have prompted an outflow of cash from US prime MMFs.

European regulators are following the lead of their US counterparts, and it is widely expected that regulations for MMFs, currently being drafted and set to be proposed soon, will follow a similar model. It is clear that if MMFs are required to apply liquidity triggers, redemption fees or convert to variable NAVs, corporate investors may have to reassess whether they are suitable vehicles for their cash holdings.

Cash investment and the repo market

Given these conditions, cash investors have been looking for alternative solutions to meet their requirements, and their focus has turned to the gilt repo market.

A repo is typically a bilateral trade. One party sells an asset to another party and agrees to buy the asset back in the future with interest. For the party buying the asset and selling it back on a future date, the transaction is known as a reverse repo. The interest rate they receive is known as the reverse repo rate (see Figure 1, on page 42). Historically, a bank has typically intermediated between both sides of the transaction, taking a spread as the cost of its involvement.

In effect, reverse repos are a form of short-term lending to a counterparty that provides collateral (such as gilts) as security. If the counterparty defaults, the investor holds the gilts: this compares well with other investments, which typically do not offer comparable security.

The repo market, however, faces its own challenges. The introduction of Basel III regulations has adversely affected banks with regard to repo transactions, as it requires them to hold capital against their gross repo book even if there are offsetting exposures. This has led to repo transactions becoming more costly for banks, and this increased cost has been passed on to counterparties through a widening of the bid-offer spread on repo. As can be seen in Figure 2 (left), at maturities of one month and beyond, this spread widening has been considerable.

In addition, while investors would typically prefer gilts as security, transactions are often arranged with collateral that is less secure than gilts, such as low-quality bonds or even equities.

It has become clear that if transactions can be arranged without bank involvement, it should be possible for counterparties on both sides of a repo transaction to enjoy better terms.

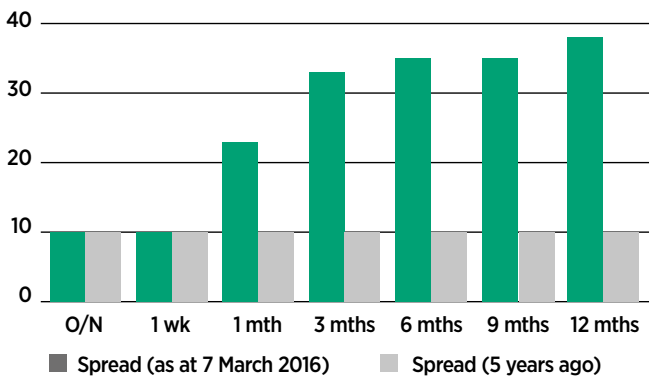
In light of this, some cash investors have opted for cutting out the intermediary by trading directly with a counterparty, and repos/reverse repos are being traded directly at superior rates as a result. However, this approach is typically limited to larger, well-resourced investors, which are able to analyse the credit quality of a counterparty and to manage the legal infrastructure that lies at the heart of repo transactions.

Another approach is the creation of peer-to-peer platforms, which aim to match cash investors and cash borrowers. These are still largely in development.

A new approach

In our view, treasurers looking to meet the standards of security and liquidity, with yield following some way behind, should be prepared to consider new approaches to the repo market. Ideally, these would potentially offer the security of gilts as collateral (via an MMF vehicle) as against traditional unsecured cash investments or those offering low-quality assets as collateral. At Insight, we have been helping treasurers enhance their cash-investment options without compromising on appropriate investment standards.

FIGURE 2: SPREAD BETWEEN THE REPO RATE AND REVERSE REPO RATE HAS WIDENED



Source: Insight Investment. Current spreads provided by one bank counterparty, which Insight deems to be representative of spreads available across the market

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