IMAGE SOURCE

Investing a surplus

CORPORATE TREASURERS ARE DISCOVERING THE BENEFITS OF REPOS FOR INVESTING THEIR CASH, WRITES OLIVIER DE SCHAETZEN

Repos are an increasingly popular choice for corporate investors looking for a safe, liquid and relatively high-yield haven for their surplus cash. The repo market is particularly well developed in Europe and the US, and in recent years corporate treasurers have taken a keener interest in it.

Typically, companies have parked their short-term cash with banks or money market funds (MMFs). But we now live in atypical times. Banks have become a higher credit risk, and money deposited with them is paying very low rates of interest. As for MMFs, new regulations have made them less attractive than they used to be.

Consequently, repos, in particular tri-party repos, have become more in vogue for corporate treasurers. Even so, they are still used far less by corporates than bank deposits and MMFs.

Repos defined

A repo is an agreement for the sale and repurchase (repo) of securities. The seller of the securities (the collateral giver) agrees to repurchase them from the buyer (the collateral taker) at a later date for a set price. The repurchase price is higher than the original sale price, and the difference is known as the repo rate.

Sellers are usually investment banks, broker-dealers and prime brokers looking for funding. Buyers are usually cash-rich, risk-averse investors – such as commercial banks, central banks, MMFs, insurance companies and, to a small, but growing extent, corporate treasuries – looking for short- to medium-term, highly liquid investments.

The securities are often high-quality government bonds, but they can be lower-rated corporate bonds, equities or other securities. If the seller defaults, the buyer can sell the securities to recoup the cash invested.

Striking a balance between risk and return

The main objective of corporate treasurers when investing surplus cash is to strike the right balance between investment risk (credit, liquidity and market risk) on the one hand, and the investment yield on the other. Several years ago, before the global financial crisis, the

balance was generally skewed more towards yield. Today, the balance is more in favour of risk mitigation, with yield taking second seat.

In other words, the priority for corporate treasurers has generally become 'return *of* capital' rather than 'return *on* capital', and they are looking for new ways to protect their capital. Repo is one of these ways.

The main benefit of repo is that it provides double indemnity for the cash invested, reducing the risk: first, there is the indemnity provided by the credit quality of the bank borrowing the cash; and second, there is the indemnity provided by the name and standing of the securities used as collateral. The treasurer, therefore, mitigates the company's exposure to the credit quality of the bank by holding the securities as collateral, as they will be able to sell the collateral received in the event of default of its counterparty to recoup their investment.

Another benefit of repo is that the treasurer can design a collateral basket to meet the company's yield and risk objectives. The yield from a repo can be higher, and the risk lower, than that provided by short-term, unsecured bank deposits.

Before the financial crisis, unsecured bank deposits based on the Euro Interbank Offered Rate, for example, paid reasonable interest rates that increased the longer they were held, and the credit risk profile of banks was generally high. However, in today's low-interest-rate environment, returns on deposits are much lower, even when held for one, two or three months, and banks are perceived to be riskier places to put cash. Corporate treasurers are therefore reluctant to leave money on deposit with banks for more than a week because of the lower yield and higher risk.

A repo, however, allows the corporate treasurer to make an investment that is backed by the securities held as collateral, *and* which generates a yield based on the creditworthiness of its counterparty and the underlying performance of those securities.

Tri-party repo

Despite their attractions, repos are still relatively underused by company treasurers. This is because some feel that the documentation is complicated, managing the collateral can be arduous and time-consuming, and repo transactions are often too large for corporates to contemplate. There is, however, a solution to these obstacles – tri-party repo.

Most repos are transactions with only two parties – the collateral giver on one side, and the collateral taker on the other. A tri-party repo involves a third party – a tri-party agent (TPA), such as a central securities depositary like Euroclear – to stand in the middle.

With tri-party repos, the corporate treasurer, as the collateral taker, outsources the administrative and operational burden to the TPA, thus reducing the work involved, as well as a large amount of the operational risk.

For example, Euroclear has recently launched its RepoAccess service, designed to alleviate the administrative burden and risk associated with completing the required legal documentation. Removing these tasks from the equation means that the treasurer can focus on the economics of the trade, while the TPA handles the collateral and other functions throughout the life of the transaction. The icing on the cake is that the TPA's fees are paid by the collateral giver, not the corporate treasurer.

Advice from the ACT

A few months ago, the ACT ran a webinar on repos, entitled 'Repos – too good to be true?', which can still be viewed on the association's website (see www.treasurers.org/repos2014). "When we published our first briefing note on investing in repos, back in November 2012, very few corporates used repos to invest their excess cash," said Michelle Price, the ACT's associate policy and technical director, on the webinar.

Interest in the original briefing note was high, so a revised version was published last year, and nearly 400 people registered for the webinar. "However, while repos are popular, the take-up among corporates is still slow," said Price.

The revised briefing note, *Practical Steps to Investing in Repos*, states that bank deposits and MMFs continue to be the favoured vehicles for investing surplus cash. But "the focus on banks' credit risk, together with the proposed regulatory changes of MMFs, has caused many treasurers to look further afield", and that includes examining the potential of repos.

"While the majority of short-term investment products used by corporates are unsecured, a repo is a secured money market instrument where the investor receives extra protection through the ownership of collateral," states the note.

> "The repo market isn't as broadly used in the corporate world as much as it might be, predominantly because corporates are wary of the counterparty risk"

Reality check

There are plenty of corporate treasurers who still have unanswered questions related to repos. "The repo market, generally speaking, isn't as broadly used in the corporate world as much as it might be, predominantly because, traditionally, banks have done them on a bilateral basis and corporates are wary of the counterparty risk," says one treasurer.

"The tri-party route can be document-heavy and not always easy to use," he adds. "Pricing is still rather difficult for us. When treasurers talk to their boards about repos, the boards still have some suspicions of any product coming from the financial services industry, which isn't relatively straightforward and easy to manage."

Popular appeal

Nevertheless, there is no denying that the repo markets in Europe and the US are large and liquid. The latest survey of the European repo market carried out by the International Capital Market Association in December 2014, and published in February 2015, showed that the institutions in the survey had a total repo value on their books of €5,500bn and €5,499bn the previous year, which represents a huge sum.

Repos are, slowly, but surely, becoming a more popular way of investing short-term cash. And for corporate treasurers who have neither the time nor the expertise to negotiate bilateral repo agreements with prospective counterparties, tri-party repos are a way forward.

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