Tri-Party Repos: Minimising Risk, Maximising Efficiency

by Steve Lethaby, Senior Sales Manager, Global Securities Financing Sales and Relationship Management – UK, Ireland and South Africa, Clearstream

In my most recent article in TMI (edition 235. www.treasury-management.com, 'A Value Added Approach to Corporate Cash Investment') I outlined some of the reasons why treasurers are expanding their investment horizons into tri-party repos, and the characteristics of these instruments that make them attractive. This article looks at how treasurers can use tri-party repos to be very precise in meeting their risk and liquidity objectives, whilst achieving a high level of straight-through processing.

The investment context

Corporate treasury is typically characterised by conservative cash investment mandates, prioritising security and liquidity over yield. These priorities are starting to level up, with a greater focus on yield given the extended period of low interest rates, but security and

Treasurers can use tri-party repos to be very precise in meeting their risk and liquidity objectives.

liquidity remain as important as ever. As a result, cash and cash equivalent instruments, particularly deposits and to some extent money market funds (MMFs), have dominated corporate cash investment portfolios, together with instruments such as certificates of deposit (CDs) and commercial paper (CP) amongst those with larger cash balances.

With a range of market, regulatory and internal factors now prompting treasurers to rethink their choice of investment solutions, as discussed in my previous article, investing in tri-party repurchase agreements or repos can be a highly effective means of meeting investment objectives. Banks too will be increasingly motivated to offer tri-party repos given the changing market and regulatory environment, while Target T2-Securities (T2S), the new European securities settlement engine, is harmonising market processes across major European markets, providing both the buy side and the sell side with a more consistent experience.

Tri-party repos in brief

A tri-party repo (or reverse repo from the perspective of the corporate investor) is a secured form of money market instrument in which one counterparty sells securities or other assets to another with the agreement to sell them back on a pre-agreed date. These securities or assets act as collateral in the event of counterparty failure, providing far greater risk protection than most investment instruments, which are typically unsecured. As most assets are subject to changes in pricing, the value of this collateral can be affected, so the use of 'haircuts' (margins) adds additional protection against changes in asset prices, usually assessed in percentage terms. For example, a haircut of 2% may be added to the market value of an asset, but this can differ according to asset class.

The maturity of a repo is variable, usually up to 90 days, with the interest rate (or repo) rate calculated based on the yield of the underlying security between the sale and repurchase date. From an accounting perspective, short-term tri-party repos are considered as cash equivalent instruments, and therefore there are no additional back-office complications to consider.

Tri-party repos offer considerable flexibility for investors, and often far more than other instruments.

Flexibility and versatility

Tri-party repos offer considerable flexibility for investors, and often far more than other instruments. From a liquidity perspective, treasurers can select a maturity date, as they would a deposit. From a security point of view, they can choose an asset profile that meets their credit policy, whilst taking advantage of higher returns that may be available on longer-term securities compared with deposits and MMFs. Many treasurers have focused on higher grade government bonds as repo collateral, which has the advantage of simplicity. However, demand is very high for these assets, notably from banks to meet their liquidity coverage ratio and as collateral for over-the-counter (OTC) derivatives with clearing houses. With a lot of demand for these instruments, the return is inevitably depressed, and availability is reduced. Consequently, other types of asset are becoming more attractive, such as investment grade corporate debt, emerging market assets and some types of fund.

The ability to tailor credit criteria according to a company's risk appetite, which gives the ability to attract a higher yield, is becoming a compelling proposition for corporate treasurers. As with any secured investment, the collateral itself is only important if the counterparty defaults, so treasurers perform the same due diligence on repo counterparties as they would for any other investment product. Given the nature of the instrument, however, they may be in a position to connect with a wider range of counterparties, again providing greater flexibility.

Clearstream

Clearstream is a wholly-owned subsidiary of Deutsche Börse and a leading European supplier of post-trading services, ensuring that cash and securities are promptly and effectively delivered between trading parties. It also manages, administers and holds in safekeeping securities on behalf of its customers. Over 300,000 domestic and internationally traded bonds, equities and investment funds are currently deposited with Clearstream, with relationships with around 2,500 customers in over 110 countries. Its global network extends across 54 domestic markets. Backed by flexible securities lending and collateral management services, Clearstream offers one of the most comprehensive international securities services available, settling more than 250,000 transactions daily.

Overcoming objections

Collateral value

One concern that some corporate investors have expressed is the potential for a fall in value of the underlying collateral. Small changes in value, typically 2% depending on the asset, can be managed by building haircuts into the collateral value. More significant changes, such as a ratings downgrade, can be anticipated by programming the collateral schedule in advance, including substituting assets if required.

Legal processes

Although tri-party repos, as opposed to bilateral repos, avoid the need to contract separate legal agreements with each asset owner, treasurers still need to appoint a third party collateral agent and sign a master repurchase agreement with each trading counterparty, which sets out the rules and duties of the various parties under a repo transaction. This is no longer an onerous process, however, with Clearstream's new legal master agreement for tri-party repo transactions called the Clearstream Repurchase Conditions (CRC). This new agreement allows market participants to sign just one contract which then provides access to a wide range of counterparties that have also signed the same agreement.

A collateral agent also fulfils a crucial role in supporting treasurers' security and liquidity concerns by selecting and screening collateral for the tri-party repo, effectively matching buyers and sellers and reducing the risk for both parties. It also manages key processes such as margin calls. As the agent holds collateral in segregated accounts, neither party has an exposure to the agent.

Operational efficiency

Technology plays a vital role in differentiating between collateral agents to ensure that they are able to perform their various roles with a high degree of efficiency, integrity and transparency. The collateral agent needs sophisticated technology in place to support granular eligibility screening, substitution processes in the event that an asset becomes ineligible, regular valuations and automatic trigger of market calls.

Just as importantly, however, investors in tri-party repos need to be able to connect with their collateral agent seamlessly and securely, and pass transaction details through to their treasury management system or ERP without the need to re-key information.

Clearstream addresses a treasurer's need for connectivity, accessibility and integration in two ways. Firstly, its online Global Liquidity Hub provides treasurers with access to a full range of transaction management and monitoring tools, with the ability to take control of collateral in the event of counterparty default, and liquidate or refinance assets through their own bank or broker. These capabilities are available without cost to the corporate investor. Secondly, treasurers can transact repos directly through industry-standard online dealing platforms, such as Bloomberg, 360T etc. using standard SWIFT-based messaging. This enables full end-to-end integration, consistent processes and controls, and better operational risk management

Early corporate investors in tri-party repos were often the largest corporations with significant cash holdings and treasury personnel with specific investment expertise.

This is no longer the case, with companies of all sizes, including those with small treasury functions, recognising the value of tri-party repos as part of a balanced portfolio in meeting both investment and operational objectives. With increasing publicity about tri-party repos in the treasury media from organisations such as Clearstream and banks, and more guidance from national treasury associations, this trend is likely to continue strongly. ■

Steve Lethaby
Senior Sales Manager, Global Securities Financing Sales and Relationship Management – UK, Ireland and South Africa, Clearstream

Steve Lethaby is a senior sales manager within the Global Securities Financing (GSF) Sales and Relationship Management department at Clearstream Banking. Based in London, he is responsible for day-to-day triparty sales and relationship management and client implementation (repo, securities lending and collateral management) looking after clients and prospects based in the UK, Ireland, the Americas and South Africa. He joined Clearstream in 2008 working in the Origination and Global Securities Financing Sales team as a sales and relationship manager for triparty collateral management clients.

Steve has held previous roles as Regional Sales Manager for SunGard Data Management solutions and as Vice President at Pershing Securities working in a sales and relationship role. He holds a BA (Hons) in Economics and Law from the University of Wolverhampton.