

Your liquidity ally – the Repurchase Agreement

How do you find the balance of keeping as much of your money invested in the best possible way but have the ability to meet expenses or other payment on time? This question has plagued many treasury and portfolio managers for years. Sure it sounds simple enough when you're dealing with a very small portfolio but it definitely becomes trickier as that book grows and becomes more complex.

Many managers find themselves being driven by the ultimate desire to have all cash invested in the highest yielding securities, but neglect the need for cash to pay expenses and liabilities which may come due.

A manager may also be unwilling to sell his/her securities just to make a payment especially if that security was purchased as part of a long term strategy. A useful tool to aid in this situation is a repurchase agreement or repo. To put it simply, a repurchase agreement is an agreement made between the owner of a security to sell that security to another party now and buy it back or repurchase it at a later date.

The manager is able to sell the security temporarily, obtain the cash to make the required payment and repurchase the security at a later time thereby obtaining the required liquidity without losing ultimate title to the security. This tool may also assist in a situation where the timing of interest payments on invested assets is not matched exactly to the liabilities to be paid. The repurchase agreement will give the manager the ability to meet those payments bridging the time gap between them and receiving interest on instrument.

Further benefits to repos are the ease of execution versus obtaining a short term loan and the possibility of paying lower interest rates than a loan. These benefits are possible as lenders favour this type of instrument because of the reduced risk involved since the security is being transferred into their name over the duration of the agreement. They therefore have the ability to sell the security to recover their funds if the borrower fails to repurchase the security at the appointed time. This leads to lower rates to be paid since the risk of default is ultimately that of the underlying security.

Repurchase agreements can be classified according to their maturity characteristics where one day repos are termed 'overnight repos', repos with specific maturity dates are referred to as 'term repos' and those with no specified end date termed 'open repos'. Open repos however are not usually conducted in Trinidad and Tobago where investors are more comfortable with all details being specified beforehand.

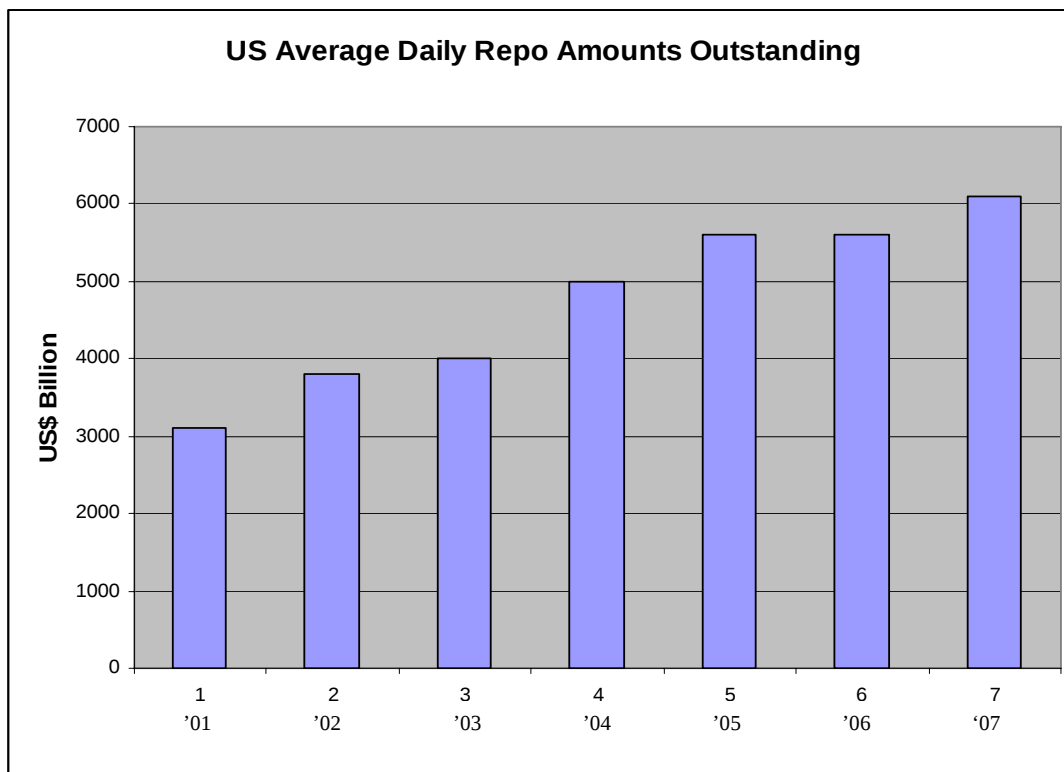
The way in which a repo is administered however brings another dimension to its classification where three main forms exist namely the 'held in custody repo', the tri-party repo' and specified delivery. The first form -held in custody- is actually the most risky of the three, as the issuer of the repo maintains title of the security throughout the duration of the agreement. Here the asset is placed in an account for the lender however there is the risk that the borrower sells that security out of that account before the agreement comes to a close. The lender would have therefore been totally unprotected during that time. There is also the risk that the same security is used to enter into more than one repo unknowing to all other counterparties.

The second form of repo- the tri-party repo- is currently the fastest growing class. This repo involves the use of an agent who acts impartially between the borrower and the lender. The agent takes on all administrative activities and locates and matches the

relevant parties based on their requirements. The use of an agent grants the benefit of reduced costs to the borrower in setting up the repo itself. The borrower is now also released from the costs and burden of tracking the repos issued and any mark to market, allocation or substitution of assets. Borrowers also gain access to lenders who they would not normally approach because of their type of business. Lenders benefit here as the agent accepts part of the responsibility for further assessing the quality of assets being offered and the risks associated with the borrower of the funds. Settlement and reporting costs are also now borne by the agent.

The third type- specified delivery- involves the security being transferred to the lender where they are responsible for ensuring the transfer is made to them and back to the borrower at the end of the agreement. This means that the responsibility for the administration (and transaction costs) of the deal is shared between the borrower and the lender.

Globally, familiarity and use of repurchase agreements has been steadily increasing. The Securities Industry and Financial Markets Association (SIFMA) has reported that over the last six years the average value of repo trades in force per day for the US market has increased US\$3000Bn (from US\$3,100Bn to US\$6,100Bn) by third quarter 2007. The third quarter of 2007 also showed that over US\$378 Trillion of repurchase trades were conducted.



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While repurchase agreements are currently used in Trinidad and Tobago, there are no statistics publicly available for volumes outstanding and issued. The Central Bank of Trinidad and Tobago however does have a Master Repurchase Agreement in force to govern these types of transactions.

In conclusion, corporate investors have been familiar with investing in this product; however they may not have been aware of the benefits that they may obtain themselves if they utilize their assets by issuing repos. Recently, this situation has begun to change as treasury and portfolio managers in the Caribbean have begun to look more closely at their own books and maximizing their returns. The onus is now on them to continue to take that next step forward.

Information sourced from:

Tri-Party Solution – Fred Francis

Securities Industry and Financial Markets Association quarterly research (Nov 2007)

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