

WILLING TO TRI ?

Is the tri-party repo merely a flash in the pan? Or is it an investment solution that offers safety to Canadian institutional investors? **By Fred Francis**

We are stuck in the deepest bear market since the Second World War and the confidence of investors is suffering. Events such as the meltdown in the technology and communications industries, the terror attacks of 9/11 and the dramatic implosions of Enron and WorldCom have heightened investor malaise.

Given this scenario, the market is ripe for tools that facilitate safe, secure and prudent transactions, particularly for large institutions such as pension funds, mutual funds and insurance companies. Enter the tri-party repurchase, otherwise known as tri-party repo, which has a 20-year history in the United States but is just beginning to make inroads into Canada.

A tri-party repo is a short-term money market investment, an evolution of the bi-party or two-party repo concept. Simply put, a repo behaves like a secured loan, although the mechanics are more complex in order to add extra protection for investors. As an investment vehicle, tri-party repo offers institutional investors a range of benefits, including:

1. Extremely low risk.
2. A secure investment vehicle that isn't subject to the volatility of equity-based markets.
3. A solution for the perpetual dilemma of where to allocate short-term cash.
4. A way to optimize large influxes of cash without a long-term commitment.
5. No cost. For the party doing the investing, such as a pension fund, there is no need for any special infrastructure or transactional costs.

As the name implies, a tri-party repo investment involves the sale and subsequent repurchase of a security.

In a typical transaction, a borrower—a brokerage firm or other financial institution—sells the security to an investor (e.g. the pension fund) and agrees to buy it back at a slightly higher price at the end of the transaction. The difference in the two prices is known as the repo rate, which can be thought of as the interest rate the investor earns.

By legally structuring the transaction as a sale and buy-back rather than a loan, the investor technically owns the securities over the life of the repo, which can be as short as 24 hours or as long as several months.

In traditional two-party repos, securities are either

Before You Leap

While tri-party repos are an appropriate vehicle for pension funds, it's important to consider the following points before taking the plunge:

- How large are your cash flows?
- How long do they stay idle (the shorter the period, the more tri-party repo makes sense)?
- What is your appetite for operational risk (the lower it is, the more tri-party repo makes sense)?
- Are you investing any cash in unsecured investments?
- What's the cost of the custodian's services versus the cost of doing everything in-house?
- What's the custodian's track record in tri-party repo and how does it fit in with other products and services offered?

delivered by the dealer to the investor (incurring transaction costs for the dealer) or held in custody by the dealer for the investor's account. In tri-party repos, the third party (e.g. a custodian or other highly rated financial institution) acts as an agent and intermediary between the investor and cash borrower (seller) to ensure that all the safeguards and mechanics are in place, such as transactional flow, avoidance of fails, proper collateral and appropriate legal documentation.

The third party performs all the duties that fall to the investor in a bi-party repo, including marking the collateral to market, checking the securities to ensure they meet the investor's eligibility, meeting margin requirements and, most important, making sure the investor isn't exposed.

While there are variations on the levels of services custodians provide—some are beginning to offer fully automated processes, accommodating both current and future market trends—it's the fundamentals that are most appealing to the two other parties. These include:

1. Providing an inexpensive source of funding for brokers/dealers while enhancing yield over other money market instruments for investors.

2. The alternative of a new money market investment vehicle.

3. Handling mid-office and risk management procedures, while providing pre-trade compliance.

4. Minimizing the risk of fail upon repo maturity.

5. Reducing back-office processing.

While it's certainly possible for pension funds to get into the repo market on their own, this approach requires a hefty financial investment, as well as the potential for a lot of operational headaches. These include pre-trade compliance monitoring to ensure adherence to policy, operational duties, high volume turnover, collateral substitutions, credit risk management, margin calls, etc.

An article that appeared in a December 2002 issue of *The Economist* notes that "the biggest lesson from Enron is investors must look after themselves." While there are obviously no clear-cut guarantees when it comes to investing, the prudent use of a few valuable tools can go a long way toward minimizing investor risk. Vehicles such as the tri-party repo are emerging instruments for pension funds. They provide the benefits of the markets without full exposure to the Enrons of the world. **BC**

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