

REPOS, RISK AND GLOBAL PORTFOLIOS

Securities lending and repurchase agreements are one route to enhancing cash performance.

FRED FRANCIS

Vice-president, securities finance and global products, RBC Global Services.

The global portfolio is already a reality for many Canadian pension plans, yet the importance of short-term investments is too often overlooked. Effective use of money market products involves both yield enhancement and control of operational and credit risks.

Cash and near-cash holdings have become increasingly significant due to prolonged underperformance of equities and increased use of synthetic assets to gain access to foreign markets. Over the four years through 2003, 30-day T-bills returned 15.6%, while U.S. and Canadian broad market indices generated only 4% and MSCI EAFE lost more than 29%. The average level of cash and near-cash assets in Canadian pension funds also doubled.

As equity returns fell, money market yields declined and forced the collapse of credit spreads at a time when credit quality was a concern. From 2000 through 2003, 75% of Canadian credit rating actions by Standard and Poor's were downgrades. Credit risk in Canadian pension plans has risen due to the search for yield, retirement of Canadian government debt, and domestic concentration of short-term assets as foreign content limits are exhausted in core debt and equity classes.

The dramatic collapses of trusted 'big names' such as Enron, WorldCom, Tyco, Global Crossing and Parmalat have prompted regulators to increase the focus on credit and operational risk controls. The Basel II Accord, from the Bank for International Settlements (BIS), recognizes the need to assess operational risk, as well as market and credit risk, in establishing adequate capital. Canada's Office of the Superintendent of Financial Institutions supports the BIS initiatives for the private pension plans it supervises. Whether directly regulated or not, Canadian pension plans are faced with higher standards for best practices in managing risk and ensuring adequate security.

One money market product offering such security, as well as flexibility of term and amount, is the repo. In a repo transaction, the buyer earns a predetermined return on cash by purchasing securities, taking full title and possession of them, and then reversing the purchase at the

end of the repo term. The holding of security to mitigate credit risk and the fixed return make the transaction comparable to a collateralized loan. In the U.S., the average daily repo volume in 2003 totaled \$4.04 trillion, a 59.5% increase since the year 2000. In Europe, the total repo volume is approximately 4 trillion euros, up 23% from 2002 and 69% from the level measured in 2001.

The repo provides yield enhancement as well as increased security. In the last four years, overnight repo rates provided almost a 1/4% yield enhancement over T-bills. Over a longer horizon, repos have provided as much as a 1.5% advantage.

In September 2002, the Bank of Canada changed its procedures for the Receiver General cash balances auction to require full collateralization though repo investments—a significant move to increase security in the lending process. Further, they elected to use a tri-party facility to reduce the costs and operational risks of associated middle- and back-office functions.

In a tri-party repo, an agent administers the transaction and monitors compliance with its terms. The agent screens the seller's available pool of securities to meet the buyer's risk tolerances; coordinates the simultaneous flows of cash and securities; revalues the securities daily; monitors risk exposures; ensures that the daily margins maintain the level of securitization; and reports on the status of the transaction.

Acting as a middle office, the tri-party agent guides the repo buyer in establishing restrictions on collateral through a multi-tiered set of exposure limits and exclusions which control eligible securities, margin ratios, and exposures to currency, credit and market risks. The task of dynamically matching buyer risk preferences and seller inventory throughout the term of a repo is a complex optimization problem that is solved only by significant investment in expertise and technology.

The repo market offers opportunity for significant yield enhancement with security, and the tri-party repo structure provides a cost-effective and comprehensive solution. ■