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What is a Tri-Party Repo ?

A Repurchase agreement (also known as a "Repo" or "Sale and Repurchase Agreement") allows a borrower to use a financial security as collateral for a cash loan at a fixed rate of interest. In a repo, the borrower agrees to sell immediately a security to a lender and also agrees to buy the same security from the lender at a fixed price at a specified future date. A repo is equivalent to a cash transaction combined with a forward contract. The cash transaction results in transfer of money to the borrower in exchange for legal transfer of the security(ies) to the lender, while the forward contract ensures repayment of the loan to the lender and return of the collateral of the borrower. The difference between the forward price and the spot price is the interest on the loan while the settlement date of the forward contract is the maturity date of the loan.

A repo is economically similar to a secured loan, with the Buyer (effectively the lender or investor) receiving securities as collateral to protect against default of the seller (effectively the borrower). Almost any security may be employed in a repo, though practically speaking highly liquid securities are preferred because they are easier to dispose of in the event of a default and, equally importantly, they can be easily secured in the open market where the buyer has created a short position in the repo security through a reverse repo and market sale. Treasury or Government bills/ bonds, Corporate bonds and equities may all be posted as "collateral" in a repo transaction. Unlike a secured loan, however, legal title to the securities passes from the Seller to the Buyer. Coupon payments that are payable to the owner of the securities which are paid while the Repo Buyer has legal title to the securities are usually passed directly onto the Repo Seller. This might seem counterintuitive, as ownership of collateral technically rests with the Buyer during the term of the repo. It is possible to instead pass on the coupon by altering the cash paid at the end of the agreement, though this is more typical of Sell/Buy Backs.

Structure and terminology

Although the underlying nature of the transaction is that of a loan, the terminology differs from that used when talking of loans because the seller does actually repurchase the securities back from the Buyer at the end of the repo. So, although the actual effect of the whole transaction is identical to a cash loan, in using the "repurchase" terminology, the emphasis is placed upon the current legal ownership of the collateral by the respective parties.

Types of repo and related products

There are three types of repo maturities: overnight, term, and open repo. Overnight refers to a one-day maturity transaction. Term refers to a repo with a specified end date. Open has no end date. Although repos are typically short-term, we sometimes see repos with a maturity as long as two years.

Repo transactions occur in three forms: delivery, tri-party, and held-in-custody. The third form is quite rare in developing markets, primarily due to counterparty risk. The first form requires the delivery of a prespecified bond(s) at the onset, and at maturity of the contractual period. Tri-party essentially is a basket form of transaction, and allows for a wider range of instruments in the basket or pool. Tri-party utilizes a third-party clearing/ custodial agent to hold/ monitor the collateral and is the most efficient form of repo transaction.

Hold-in-custody repo

In a "HIC" repo, the collateral pledged by the (cash) borrower is not actually delivered to the cash lender. Rather, it is placed in an internal account ("held in custody") by the borrower, for the lender, throughout the duration of the trade. This has become less common as the repo market has grown, particularly owing to the creation of centralized counterparties. Due to the high risk to the cash lender, these are generally only transacted with large, financially stable institutions.

Tri-party repo

The main distinguishing feature of a tri-party repo is that a custodian bank or international clearing organization, "the tri-party agent", acts as an intermediary between the two Principal counterparties to the repo. The tri-party agent is responsible for the administration of the transaction including collateral allocation, marking to market, and substitution of collateral. Tri-party agents each administer US$ trillions of collateral. They therefore have the scale to subscribe to multiple data feeds to maximise the universe of coverage. As part of a tri-party agreement the three parties to the agreement, the tri-party agent, the repo buyer and the repo seller agree to a collateral management service agreement which includes an "eligible collateral profile". It is this "eligible collateral profile" that enables the repo buyer to define its risk appetite in respect of the collateral that it is prepared to hold to mitigate its counterparty credit exposure. For example, a more risk averse repo buyer may wish to only hold only AAA-rated government bonds or non-financial, primary market equities as collateral. In the event of a credit event affecting the Repo Seller (eg filing for bankruptcy) these forms of collateral are likely to remain highly liquid thus enabling the Repo Buyer to sell the collateral quickly and therefore retrieve its on-loan cash. A less risk averse repo buyer might be prepared to take (eg) non-investment grade corporate bonds as collateral, which may be less liquid and suffer a greater price volatility in the event of a Repo Seller's default, making it more difficult for the repo buyer to sell the collateral and recover its cash. The tri-party agents are able to offer sophisticated collateral eligibility filters which allow the repo buyer to create more complex, bespoke "collateral profiles" which can systemically generate collateral pools which more precisely reflect the buyer's risk appetite. Collateral eligibility filters could include asset type (eg bonds or equities), issuer type (SIC code), named issuers, currency, domicile, credit rating, bond maturity, index component, issue size, average daily traded volume, etc. Both the lender (repo buyer) and borrower (repo seller) enter into tri-party repo transactions

to avoid the administrative burden of bilateral repos. In addition, because the collateral is being held by an agent, counterparty risk is reduced because collateral is held by an independent third party.