

## **Repo - A Financing Instrument for Banks**

by Victor Füglistler, Deputy Chief Executive Officer of the  
Swiss Bankers' Association

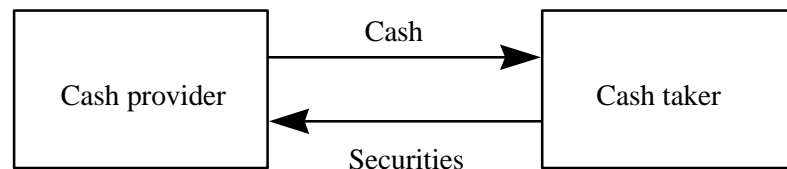
Ladies and Gentlemen

Repo business is neither new nor is it a Swiss invention. Repurchase Agreements were launched in the USA very soon after the foundation of the Federal Reserve System, i.e. around 1913, when the Federal Reserve Bank started to accept banker's acceptances as guarantees in exchange for liquidity made available to its member banks. The US repo market began to gain momentum at the end of the 70s in line with the soaring US budget deficits. With the dematerialization of the international financial markets and the growing significance of securitization, the repo market was gradually accepted by international market players in the 80s. This development did not come as a surprise. Free movement of capital, together with the need to invest globally, led on one side to liquidity squeezes and on the other to an excess of liquidity. The Bank of England formally launched its repo market for gilts in January 1996. Eight months after the launch the outstanding volume already ran to 80 billion pounds. The current volume in the USA is estimated to total 2 trillion US dollars, representing approximately 70% of worldwide repo business. The Swiss big banks have their share too. Repo transactions are not really a novelty for them. However, a standardized market for repo transactions in Swiss francs as it will be officially launched next week thanks to the joint efforts made by the Swiss National Bank and SEGA is new.

I shall now briefly describe a repo transaction: the cash taker who wishes to overcome a liquidity squeeze tries to find a cash provider in the market. From the cash taker's point of view, this transaction is a Repurchase Agreement. The cash provider on the other hand carries out a spot transaction (purchase) linked with a forward transaction (sale), a so-called reverse repo. To facilitate the transaction

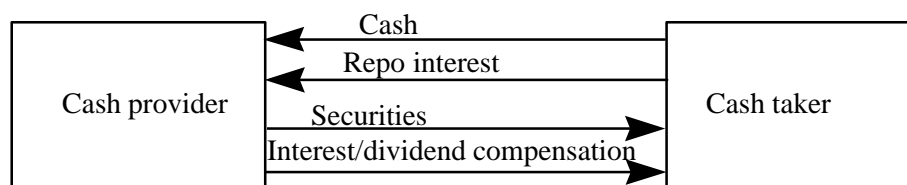
and reduce its costs the cash taker has to transfer collateral in the form of securities to the cash provider.

*Graph 1: Opening of a repo transaction*



The transaction is closed as soon as the repurchase date fixed in advance is reached. The cash provider returns the collateral to the cash taker in exchange for the lent capital plus interest. The securities will pass into the ownership of the cash provider until the transaction is closed. Any income earned on the securities is for this reason distributed to the cash provider. Since the cash taker wishes to remain the beneficial owner of the collateralized securities, the cash provider must forward to him any income earned.

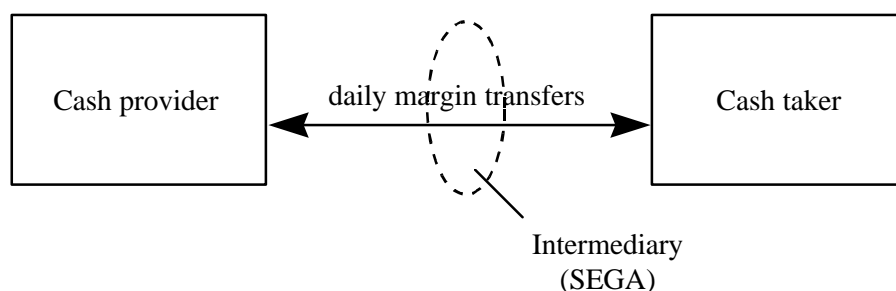
*Graph 2: Closing of a repo transaction*



A repo transaction can best be compared with a swap operation (e. g. a swap involving money market debt register claims) or a buy/sell back arrangement. An essential difference between these types of transaction is shown during the life of the agreement when the price of the collateralized securities fluctuate either because of market trends or because of issuer-specific factors. An account may therefore be insufficiently covered or covered in excess of 100%. There are a number of options available to eliminate this risk. The parties may agree that the loan must be covered in excess of 100% all the time. This system involving a so-called haircut takes into account the interests of the cash provider but not those of

the cash taker and thus necessarily leads to a clash of interests. The Swiss system has a different approach, which avoids this sort of conflict. Securities are transferred at their market value; they are also priced daily to their market value, and deviations are compensated by margin transfers. SEGA plays an important role in this respect. It not only manages the securities of the repo participants, but it is also responsible for initiating the daily margin calls on the basis of the mark-to-market method by means of further securities or cash.

*Graph 3: Margin-maintenance*



A repo is a financial instrument with many similarities, but also dissimilarities, to other instruments. I should like to point out these differences to you:

**Repo versus buy/sell back arrangements:** the combination of a concurrent purchase and sale of securities is also considered to be a repo operation. In contrast to a "genuine" repo operation, the transactions are carried out individually and do not require the conclusion of an agreement between the parties; this may lead to an increased risk, because margin calls do not take place.

**Repo versus Lombard loan:** a Lombard loan is a credit granted against securities as collateral. The securities serving as guarantee are, however, pledged and the ownership is not conveyed. The provisions of the Swiss Banking Law (Art. 17) are an impediment insofar as pledged securities are not easily marketable. Pledged securities cannot be transferred to other parties for use.

**Repo versus securities lending:** although the two types of operations are very similar, they differ considerably as far as their economic motivation is concerned: whereas a repo transaction is used to overcome a liquidity squeeze, a securities lending operation serves the purpose of overcoming shortfalls in the securities settlement process or of covering short positions. This is why securities lending is also considered as a form of loan against payment of a fee in favour of a lender. Usually, securities are lent out against deposit of other securities as collateral. Margin calls do not take place.

**Repo versus FX forward or swaps:** an FX forward operation is a commitment to fulfill a foreign currency obligation on a specified date. Two currencies are exchanged against each other for a limited period. The forward price consists of the spot rate, the term and the interest rate differential. Cash in a foreign currency here replaces the securities as collateral. In contrast to repo transactions, a margin call does not take place even if strong exchange rate fluctuations occur.

**Repo versus deposits:** Traditional money market operations involve considerable counterparty risks, because advances are unsecured. I shall explain this point in a minute.

The advantages of repo business are evident from what has been said until now. The emphasis is on risk. In the event of unsecured advances, banks must cover the weighted counterparty risk, i.e. the risk that a party will completely or partly fail to fulfill its obligations, with adequate capital at a rate of 2 to 8%, depending on the creditworthiness of a debtor. Additional reserves have to be set aside during the term if the credit is in danger. In the event of a repo transaction the counterparty risk is limited to a possible negative difference between the market price of the securities and the lent cash amounts thanks to the collateral. Since this difference is compensated on a daily basis, it is only necessary to balance the maximum fluctuation of a day. This is where repo transactions differ considerably from other covered financial instruments. The replacement cost risk associated with the collateral is practically eliminated or at least reduced to a minimum thanks to daily margin calls. With the use of the SECOM system the settlement risk is de facto

eliminated. SECOM provides for the clearing of securities transactions on a delivery versus payment basis. Mr Haeberli will give you the necessary details later on.

What, you might ask, are the prospects for the Swiss repo market? The Swiss financial community can rely on a completely integrated real-time trading and settlement network which is unique in the world. The same is true of SOFFEX derivatives and trading in the underlying securities, starting with the conclusion of a trade at the stock exchange and ending with the necessary money and securities bookings at SEGA and the SNB. These prerequisites ensure the settlement of standardized and fully automatic repo transactions and meet the most stringent demands in terms of security. Furthermore, it is a step towards linking up the cash market with the securities market. Developments abroad have shown that such a link is important. The results will be extremely beneficial to all banks, not only the big ones. The launch of the Swiss repo market will influence the financial market in several respects:

**First**, repo transactions, as Mr Spörndli explained, will serve the Swiss National Bank as an additional instrument to control the money market. The Swiss National Bank has defined its basket of repo-eligible securities.

**Second**, banks are free to define additional securities categories for repo transactions in the interbank sector. Their choice is not limited to interest-bearing securities. They may also use shares as collateral for interbank loans. Thanks to SECOM, all SEGA-eligible securities and book entry claims can be used for repo operations and processed via the existing systems. Banks will gradually replace the classic money market transactions by repo operations. The following aims can be accomplished with this:

- The counterparty risk is reduced
- Banks can allocate their own resources more efficiently
- The liquidity of the market is increased

**Finally**, a liquid repo market ensures that market players are able to cover short positions at low cost and enhance the performance of their customers' portfolios, either if they are themselves party to a repo transaction or if they make repo-eligible securities available to banks via the securities lending program.

The Swiss repo market is doubtless beneficial to the entire financial community, i.e. to the banks, the Swiss National Bank and their clients, institutional investors in particular.