

Private Repurchase Market^Ψ

I. Overview

➤ Definition and characteristics of repo market

Repo market is a market in which securities are exchanged for cash with an agreement to repurchase the securities at a future date. In the transaction, securities serve as collateral for what is effectively a cash loan. Securities most commonly used as collateral in repo market are sovereign debt instruments. Repo transactions may be of any maturity, but are generally of a short maturity, ranging from overnight to one-year.

Risk in repo market arises mainly from volatility in the value of the collateral, which can open up a credit exposure and risk of counterparty default. To mitigate this risk, cash lenders typically require margin. Accordingly, risk is controlled through margin practices, which involve both setting of initial margins (haircut), and implementation of margin calls based on an ongoing revaluation of collateral.

➤ Economics of repo market

The economic significance of repo transactions derives from the fact that they allow one party to temporarily exchange cash for securities and the other to temporarily exchange securities for cash. From a legal point of view, a key feature that makes the repo contract attractive is that the legal transfer of securities for the duration of the contract provides protection against credit risk.

A useful starting point for analyzing the repo market is to distinguish between participants according to their motivations for engaging in repo transactions either to obtain cash or to obtain securities. Depending on their uses, either securities or cash serve as collateral for any particular transaction. In the case of specific collateral repos, the transaction enables participants to obtain particular securities issues.

In addition to participants supplying cash or securities to repo market borrowers, a third group, repo market intermediaries, plays a key role in addition to that of administering transactions. Their arbitrage and speculative activities are important in facilitating price discovery, especially for those seeking specific securities, and in providing liquidity.

➤ Background and objectives of private repo market

In Thailand, the initiative on developing private repurchase market began in 1998 when the bond market was activated by the massive issuance of government bond for Financial Institutions Development Fund (FIDF) indemnification. In order to achieve this objective with low cost, the government had realized the necessity of putting in place the elements and mechanism to make the bond market a new investment alternative and then an efficient source of funding. If bond prices are transparent and reliable, bonds can be used as collateral in the money market. The link between these two markets was, thus, built through the repurchase market.

Having appreciated the importance of bond market, the Ministry of Finance has set up a working group for bond market development with 8 sub-working groups. One of which is sub-working group on repurchase market, comprising of representatives from the Bank of Thailand (BOT), Securities and Exchange Commission (SEC), Thai Bond Dealing Center (TBDC) and private sector. The group was entrusted to deal with the master agreement and to resolve all tax-related impediments of the transaction. In addition, BOT has shown firm commitment to encourage the repo market by using bilateral repo transactions as a means to adjust market liquidity with its primary dealers.

The main objectives of private repo market development are as follows:

1. To facilitate bond market development by

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- 1.1 Adding liquidity to the bond market as the collateralized bond is transferred to the lender, thus, enabling him to use it for further transaction provided that the security has to be returned before its contract maturity.
- 1.2 Encouraging investment in bonds as investors can use bond as collateral to obtain cash if needed.
- 1.3 Stimulating the financial institutions to be active market makers as short sellers can borrow bonds through repo market for delivery.
- 1.4 Enhancing yield of the bondholders by lending it out.
2. To broaden money market structure and to add on an instrument to the market toward collateralized term loan. Currently, most loans are in the form of interbank or clean loan with overnight period or of call type.
3. To act as a channel for central bank open market operations. The BOT can absorb and inject liquidity to the financial system through primary dealers.
4. To be used as an alternative hedging instrument.

II. Existing BOT-run repo market VS private repo market

At present, the volume of “true” repo transaction in Thailand is still at negligible level. All transactions done in the current BOT-run repo market are for financial institutions’ liquidity adjustment. The current repo market is an alternative source of funding apart from interbank clean loan and foreign exchange swap. Main feature of the repo transactions is that it is a collateralized loan. Most financial institutions park their excess liquidity in this market. In the current repo market, BOT acts as a matchmaker for lenders and borrowers. The market is distorted as credit risks of counterparties are not reflected in the interest rate charged in each tenor. This is because all transactions are done with BOT. Hence, rates reflect central bank risk rather than other participants in the transactions. Having realized this distortion, BOT has tried to encourage the establishment of private repo market so that financial institutions can access short term fund or have an avenue for short term investment in place of the current repo market. This will enable BOT to gradually phase out of the current distorted market and change the role of this window for purely monetary operations to absorb or inject market liquidity.

While allowing the financial institutions to adjust to the new privately run repo market, BOT have started, since the year 2000, to conduct bilateral repo transactions exclusively with primary dealers in parallel with the existing repo market. This new bilateral repo market was established to support the new monetary operations under inflation targeting, with modern concepts of applying the initial margin and mark-to-market concept to the collateral.

Nevertheless, to remove this distortion and to allow the private repo market to fully develop take a certain period of time so we cannot immediately abolish the existing repo market. Differences between the bilateral repo market and the existing repo market can be compared as following:

	BOT-run repo market	Bilateral repo market (between BOT and primary dealers)	Private repo market
1. Participants	Commercial banks, finance companies, FIDF and State Enterprises of which permission from the MOF are granted	Only primary dealers ^Ω	Private sector
2. Role of the BOT	As a matchmaker between lenders and borrowers	BOT actively adjust market liquidity for stability	Not relevant. However, BOT expects primary dealers to bridge the liquidity from bilateral to private repo market

^Ω In the third quarter of this year, BOT will completely separate the list of primary dealers into 2 tiers, outright and bilateral repo transaction. Only the second type of primary dealers can participate in bilateral repo markets. Before then, primary dealers for outright transaction are temporarily allowed.

	BOT-run repo market	Bilateral repo market (between BOT and primary dealers)	Private repo market
3. Maturity	1-, 7-, 14 days 1-, 3- and 6 months	Mainly 14 days as it represents the policy rate of interest	Mutually agreed between counterparties
4. Trading session	Two sessions 1. Morning session: 9.30 am to 10.30 pm 2. Afternoon session: 15.30 pm to 16.30 pm	Only one session in the morning from 9.15 am to 9.45 am (afternoon session might be opened to trade in the future)	All day
5. Collateral • eligible securities • security selector • pricing • registry system • settlement date	T-bill, government bonds, BOT bonds, State Enterprise bonds with MOF guarantee and bonds issued by State Enterprises endorsed by the specific law under BOT's consent BOT Face value (to be changed to market value with haircut practice in the near future) R/P pool system Same day (T)	Same as stated in BOT repo market Cash borrower Market price subject to haircut and margin call Book Entry system (B/E) Same day (T)	Mutually agreed between counterparties Cash borrower Market price subject to haircut and margin call B/E (if delivery-versus-payment (DVP) is used) Mutually agreed between counterparties
6. Agreement	BOT's Regulations	BOT's Regulations	Standard master agreement

III. Recent developments

The existing BOT-run repo market can be abolished only when the transmission mechanism of bilateral repo market functions and the private repo market develops to a certain level. To expedite the development of private repo market, the efforts have been made in the following areas.

1. Taxation

The borrowing in the repo market differs from that in the general money market in the way that the underlying collateral is transferred from the borrower to the lender in the form of purchase contract instead of being maintained with the borrower in the form of pledge. Hence, the transaction is treated as a sale transaction under tax imposition and incurs unfair burden on the participants.

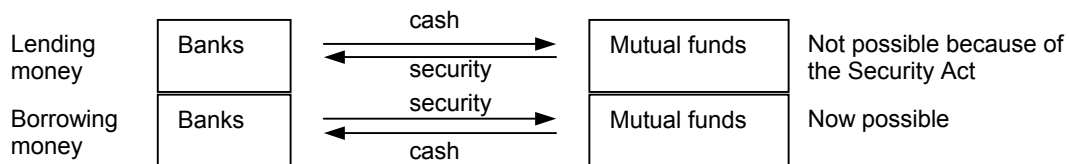
Since the borrower has to deliver bond for cash, this transaction is treated as a sale transaction. When the transfer price of bond is higher than the last marked price in the book, the borrower is subject to capital gain tax even though the securities are merely collateral for borrowing, not a genuine sale transaction, and will be returned to borrower when the loan is settled at the end of contract. However, with the effort of various parties concerned including BOT to eliminate the hindrances of the development of this market, the Revenue Department has finally agreed to exempt the capital gain tax on the repo transactions on 10 April 2000. In addition, special business tax (SBT) on the capital gain of the repo

borrower as well as Stamp Duty for the transfer of security are now exempted. All these exemptions have already been announced in the Royal Gazette.

2. Market participant regulations

To broaden market participants, various laws and regulations have been amended to allow certain entities to engage in this type of transaction. In summary, permitted activities for some types of financial institutions are as follows:

- Currently, mutual funds are permitted to engage in repo transaction only on cash lending side according to the section 126 of Securities Act. However, the SEC has proposed the amendment to allow mutual fund to incur the obligations and therefore be able to borrow cash through repo market. In the workshop on capital market development chaired by Prime Minister on 31 March 2001, it was agreed to speed up the process of the amendment as an urgent issue. This will preclude the adverse effect of the massive sale by mutual funds when market volatiles and unit trust holders rush for redemption.
- Insurance companies will have to wait for the regulations on repo transactions from the Department of Insurance, Ministry of Commerce.
- Commercial banks, according to the Commercial Banks Act, used to be prohibited from borrowing cash from entities other than financial institutions. Hence, at that time, mutual funds are not able to lend in repo form. However, BOT has already lifted this regulation. The flow of collateralized lending between mutual funds and financial institutions can be summarized as following.



3. Clearing and settlement system

Prior to the introduction of Bahtnet II which employs the electronic DVP settlement at the end of last year, the transfer of collateralized security can be cumbersome as the procedure requires filling in forms and endorsement if bonds are in registry system. Most transactions in the repo market are of short term. Hence, it is not convenient at all for both the transferee and transferor to travel to the registrar, taking into account the short term nature of the contract and same day settlement transaction. With the implementation of Bahtnet II, this problem has been alleviated. However, to resolve all clearing and settlement problems, the solution to the lack of access to Bahtnet II for some potential participants is promptly needed.

With this new Bathnet II system, the counterparties can send on-line orders of cash and bond transfer directly from their workstation and check end-of-day transaction summary report from the web. Initially we expected the private repo market would progress and the launch of the Bahtnet II would facilitate the collateral transfer and hence enable primary dealers to effectively pass on BOT operations to the financial system. But quite a few impediments remain unsolved resulting in the delay of private repo establishment.

4. Master Agreement

Through the discussion between the market participants and legal experts, it was agreed that the *TBMA/ISMA Global Master Repurchase Agreement (GMRA)* will be used as the master agreement with the rationale that it has been amended and tested in many courts to suit the practice. Moreover, it provides the convenience for dealing with foreign counterparty. As GMRA is governed by English law, it is agreed that this Master Agreement will have Thai annex to suit Thai Legal environment. The legal consultant of the TBDC has finished reviewing the Agreement and it is now ready for adoption.

IV. Other initiatives for development

While attempting to put all necessary elements in place to give the market “a start”, the BOT and other concerned organizations are also working on other areas to facilitate growth of the bond market as well as to modernize the market. These can be listed as follows:

1. Electronic front office transaction

- The BOT will introduce the Electronic Financial Services (EFS) via BOT web for each BOT counterparty in bilateral transaction such as swap, outright transaction, bilateral repo, electronic bidding, etc. This will reduce time of data re-inputting and checking.
- Among financial institutions: the market is selecting electronic trading platform that enables more transparent price and lays the base for linking to the straight through processing (STP) in the future.

2. New intermediaries

If the existing BOT-run R/P market phases out and is no longer an investment channel, the components of the market will inevitably change

- Primary dealers in money market: BOT’s present set of primary dealers was designated to function in both money and bond markets. To efficiently support the large volume of new bilateral repo transactions, the primary dealers should have sufficient capabilities to absorb both bonds and cash from the central bank and widely distribute the activities through their network distribution. Hence, the new round selection will take into account of these additional elements.
- Money brokers: when the BOT does not service as the central broker of lenders and borrowers, money brokers who specialize in this function will be in demand. Due to the fact that this is a new type of business in Thailand, the study is being carried out about the scope of permissible activities, the regulation and supervision, and example experiences in other countries.

3. Further broaden the scope of market participants and eligible collaterals

After the first phase of expansion mentioned above, the plan to embrace more investors such as companies and other saving corporations is under construction. Groups of institutions to be included in the plan are those who either involve actively in the bond market or those who have a large buy-and-hold inventory of bonds or cash.

On the other dimension, good rating corporate bond or other asset-back security with fair and transparent pricing should also be considered as an eligible collateral for the repo borrowing in the private repo market.

4. Code of conduct

It is essential to have a code of conduct in the new privately-run repo market for orderliness. The code will prove a useful guide to the best conduct and practices for all market participants. The TBDC may act as a coordinator of market participants on drafting this.

V. Concluding Points

There are a number of structural features and market practices that support sound and efficient repo market. Some, such as an adequate legal framework, sufficient settlement system and good margining practices, are essential to limit risks and to ensure efficient and sound operations of the market, while others are probably less crucial. In addition to promoting these features and practices, authorities may want to conduct market surveillance of the repo market to help ensure that such practices are respected and to help detect instances of market manipulation or abuse. A number of features and market practices are especially important for a sound and efficient repo market, i.e.

- An adequate and efficient legal framework. There should be a clear legal definition of the repo contract (including buy/sell-back and securities lending agreements), an essential feature being unambiguous certainty in the event of a default as to legal rights vis-à-vis the counterparty. The legal framework should be complemented by well-structured legal documentation, such as master agreements.
- Secure and efficient settlement systems. Since the securities leg of a repo serves as collateral for the cash leg, the failure to settle simultaneously opens up a credit exposure. This risk can be

contained by using safe settlement procedures based on delivery-versus-payment (DVP) arrangements.

- Appropriate haircuts and margin call practices. While the use of collateral reduces credit risk, market participants remain exposed to credit risk arising from volatility in the value of collateral, counterparty default and liquidity risk. Haircuts and margin call practices limit these risks provided they are set at levels commensurate with risks and adjustments are implemented promptly when appropriate.
- Adequate transparency. To efficiently manage their risks in repo market, creditors need to have sufficient comprehensive and relevant information to assess the risks they face on an ongoing basis. However, provision of such information needs no compromise proprietary information.

VI. Reference

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