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Will Direct Repo save the cash markets?

by [AssetOps](#) on [FEBRUARY 5, 2012](#) in [CASH MANAGEMENT](#), [COUNTERPARTY RISK](#), [REPO](#) [\[EDIT\]](#)

We met recently with a AVM Solutions, a Florida company that offers a new product they call Direct Repo. Direct Repo is an intriguing notion; it solves a pressing problem in the repo and funding markets by matching cash investors and repo providers up directly without using a bank's balance sheet. As banks are pressing down on repo credit lines, the Direct Repo product offers an imperfect but still very attractive way for cash investors to get returns.

The basic idea of Direct Repo is to match up investors with high quality treasury or agency assets with cash investors. Since AVM is not a bank, they act as broker only and match counterparties at the midpoint of the trade. AVM gets paid of course in a commission-kind of format, but according to our analysis both investors and providers do better in the deal financially than by going through a bank acting as principal to both sides of the trade.

The most obvious question here is credit risk, and in fact, Direct Repo means that both parties have direct credit exposure to the other. While clearly state pension plans will not be lending cash to hedge funds, there are a host of other potential repo providers who look pretty credit worthy, at least on the surface. So here we have the first hurdle: conducting credit research and ensuring credit stability of the counterparty.

Second, Direct Repo leaves both parties exposed to the operational risks of transacting without a big bank behind them. While tri-party repo providers may get involved in the future, right now each market participant needs to settle its own accounts and provide a backstop in the case of counterparty failure. As one example, the provider must know how it will liquidate assets if the counterparty fails and all of a sudden is left with a pile of agencies that were left as collateral. These operational issues are the second hurdle.

While some matters still need to be sorted out, we think that Direct Repo can provide meaningful benefits to both repo providers and cash investors. The opportunity to invest in high-quality repo without bothering with a bank's credit line means more stable product and better returns. AVM Solutions is on to something, now they just have to convince market participants to try them out.

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