TOTAL RETURN SWAPS AND REPOS: FINANCING SOLUTIONS FOR CREDIT FUNDS

INTRODUCTION

As credit funds look for creative solutions to finance assets, total return swaps (TRS) and repos have become increasingly popular. These products are often more competitively priced than traditional fund finance options and can be tailored to meet specific needs. For credit funds seeking to provide leveraged returns to their investors, TRS and repo structures provide a way to gain upside exposure to the full principal amount of an asset without needing to fund it in full. They can also be used to syndicate existing assets within a portfolio in return for bank funding which can be redeployed on other higher return investments.

Weil has been involved in a number of these transactions financing a range of assets, including corporate loans, bonds and asset backed securities.

TOTAL RETURN SWAPS V REPOS

A TRS is a derivative contract where one party (the TRS payer, referred to below as the "bank") transfers to a buy-side investor (referred to below as the "fund") the total economic performance (including interest, fees and capital gains/losses) of a reference asset in return for a fee (usually a floating interest rate plus a spread) based on the notional amount of the contract.

Repo is the market term for a 'repurchase transaction', which involves the spot sale of an asset by the seller (the fund) to the buyer (the bank) with a simultaneous agreement (forward transaction) for the seller to repurchase the asset from the buyer on a future date for a specified "repurchase" price. Repos are often discussed alongside TRS, but there are some important differences:

- TRS are synthetic notional derivative contracts, whereas repos involve a true sale of the assets (giving the bank legal title with rights of rehypothecation) with the obligation on the fund to repurchase "equivalent" assets on a future date. As a result, repos are typically more suited to liquid and freely transferable assets. The increased certainty of recovering title to the assets makes repos useful where the fund intends to retain and manage legal ownership once the repo financing matures.
- Repos are therefore primarily a means collateralised lending driven by demand to obtain funding. They do not involve a directional market view on the price of the asset. In contrast, TRS transactions are typically driven by the motivation of the fund to get synthetic exposure to an asset.
- Repos are securities financing transactions generally documented under the Global Master Repurchase Agreement (GMRA), rather derivatives transactions documented under the International Swaps and Derivatives Association (ISDA) framework. This also involves different applicable regulatory regimes (SFTR v EMIR).

Notwithstanding these differences, repo financings are also bilateral and can be customised in much the same way as TRS financings with regard to commitment terms, eligibility criteria and margin mechanics. Which instrument is preferred will depend on the commercial drivers and motivations of the parties. Both TRS and repos are valuable options for credit funds seeking alternative sources of financing. The remainder of this note looks more specifically at the structural features and benefits of TRS.

STRUCTURAL FEATURES OF TRS

TRS facilities have become increasingly popular for private funds, allowing them to gain synthetic leveraged exposure with respect to a range of reference assets on a committed basis (subject to agreed asset and portfolio eligibility criteria). TRS contracts are bespoke, but will generally involve the following cash flows:

- An upfront payment from the fund to the bank, usually in the form of initial margin which will represent only a portion of the reference asset principal amount. The loan to value (LTV) ratio will vary depending on commercial factors. Most TRS structures will include a variation margin mechanic whereby the fund must "top up" the collateral balance to maintain the initial LTV. The bank will finance the remaining purchase price of the asset, often funded via a structured note.
- Interim exchanges will involve two separate "legs":
  - A total return leg, whereby the bank will pay to the fund all interest and fees received by a notional holder of the reference asset. Typically the bank will hold the reference asset (either directly or via an orphan SPV) as a hedge to ensure it can meet its payment obligations under the TRS.
  - A funding leg, pursuant to which the fund will pay a periodic financing rate on the notional amount of the TRS (corresponding with the amount of leverage incurred).
- A "final exchange" following valuation of the reference asset. If the market price has increased since inception of the TRS, the bank will pay the fund this increase; if it has decreased, the bank will net this depreciation against the margin balance.

DOCUMENTATION

TRS transactions are documented using the ISDA documentation architecture - the ISDA Master Agreement, Schedule and a credit support annex. The TRS confirmation itself is usually a bespoke document, which will set out the specific terms of the TRS transaction. Often TRS are provided on a facility basis, with a master confirmation setting out facility terms and a transaction supplement used for each individual TRS transaction.

WEIL STRUCTURED FINANCE TALKING POINTS

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BENEFITS

- **Synthetic exposure** – TRS structures are synthetic in nature, allowing the TRS buyer to benefit from upside exposure to an asset without legal ownership, thereby providing operational efficiency (as costs connected to transfer and settlement are avoided) and potentially bypassing contractual restrictions in the underlying documents.
- **Leverage** – since the TRS buyer will typically only need to deliver an agreed upfront initial margin (rather than source the full capital required to purchase the reference asset), TRS financings offer a form of leverage which can be used to increase the internal rate of return on assets and deploy capital more efficiently.
- **Customisability** - TRS financings are highly customisable. While they are based on ISDA documentation infrastructure, which reduces the amount of documentation to be negotiated, these documents can be tailored with limited amendments to accommodate different contractual terms with respect of the "Key Points of Negotiation" below.

KEY POINTS OF NEGOTIATION

- **Term, size, eligibility criteria and portfolio adjustment:** TRS facilities will generally provide committed financing for an agreed term with respect to a range of reference assets, subject to certain asset eligibility and portfolio concentration criteria. The bank will also generally cap the maximum amount of financing provided and require the fund to pay a commitment fee on the unused portfolio notional amount in order to ensure a minimum return. From the perspective of the fund, it will want to maximise flexibility – for instance, by disapplying the concentration criteria during an agreed "ramp up" period and thereafter being allowed to adjust the portfolio and reinvest proceeds until the facility enters amortisation. These commercial terms will be a key focus of negotiation.
- **Valuation of Reference Asset:** The "initial" price of the reference asset is established at the beginning of the TRS transaction, serving as a benchmark against which any capital appreciation or depreciation will be determined, while the "final price" of the reference asset is established at the end of the TRS transaction (either at scheduled maturity or upon early termination) which will determine the quantum and direction of the "final exchange". Generally the bank will act as calculation and valuation agent during the life of the TRS transaction with discretion to determine the price and value of the reference asset, with some additional objectivity introduced when determining the final price. The detail of the valuation process, including inputs and dispute rights, will be a key source of negotiation, particularly for illiquid assets.
- **Margin and credit support:** Most TRS structures will include credit support provisions requiring the fund to deliver variation margin to cover any decline in the market value of the reference asset. This serves to maintain the agreed LTV and mitigates credit risk for the bank (as upon any default of the fund, the bank will be able to realise the market value of the loan and also the collateral balance posted under the TRS to cover any shortfall). The detail of these margin mechanics is often a source of negotiation, including the potential for margin "holidays" (allowing the LTV do increase by a set amount before a collateral delivery obligation kicks in) or margin "add on" (where additional margin is required upon the occurrence of certain events (e.g. liquidity or ratings based) impacting the reference obligation). If the fund is acting through an asset-holding vehicle, the bank may also request a fund guarantee to give it wider recourse upon default.
- **Information and voting rights:** Whilst the purpose of a TRS is to replicate the economics of owning the reference asset, TRS typically do not pass through voting and control rights completely to the fund. This may be because the bank has a commercial relationship with the underlying obligor it wants to manage and preserve. Providing unfettered control to the fund may also undermine characterization of the TRS as a swap for legal and accounting purposes. However, there will normally be some ability for the fund to "request" voting rights are exercised in a certain way. The underlying reference obligation documents will need to be reviewed to ensure that information received by the lender of record can be passed through under the TRS financing structure.

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