



## **Establishing a Policy for Reverse Repurchase Agreements (2010) (NEW)**

A GFOA *advisory* identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

**Background.** Reverse repurchase agreements (reverse repos) are the mirror image of a repo. In a reverse repo, an investor (governmental entity) owns securities, such as a Treasury note, U.S. government agency bond or other security, that a bank or dealer purchases under an agreement and sells back to an investor on a specified date, at an agreed-upon interest rate.

### **Reverse repos generally have two basic uses:**

- Reverse repos may be one way to avoid liquidating a portfolio to meet unexpected or immediate cash flow requirements. Most public finance officers accept this straightforward use of the instrument as a legitimate cash management practice.
- A potentially more controversial use of the reverse repo is to enhance portfolio returns through the purchase of securities financed through repurchase transactions. The cash obtained can be invested in another higher-yielding instrument.

### **Benefits of Reverse Repos:**

- Provides an alternative to liquidating a portfolio;
- Provides incremental income with use of certain techniques by expert investment officers;

### **Risks Associated with Reverse Repos:**

- The reverse repurchase agreement with an entity's counterparty is not properly established;
- The financial strength of the counterparties and value of the collateral are not properly monitored;
- The governmental entity does not possess proper authority to enter into such a transaction;
- A counterparty may default on its obligations;
- Underlying securities are subject to and may erode due to volatile changes in market conditions; and
- The government entity uses the dollars from the reverse repo to leverage the investments in the portfolio.

### **Mitigating the Risk:**

- Execute a Securities Industry and Financial Markets Association (SIFMA) *Master Repurchase Agreement* including additional provisions specific to the governmental agency that is signed by a duly authorized officer with each counterparty;
- Establish financial strength criteria for counterparties and for reviewing financial statements at the inception of relationship and at least annually. Some entities will limit counterparties to primary dealers;
- Use the proceeds from the reverse repo only to invest in securities whose maturity matches or is no longer than the term of the repo; and
- Settle the transaction on a delivery-versus-payment (DVP) basis at the entity's custodian or trustee for third-party safekeeping.

**Reverse repo agreements require the same essential basic components as a repo.** A Master Repurchase Agreement should be entered into with a bank or counterparty. A form of the agreement may be obtained from the website of the Securities Industry and Financial Markets Association (SIFMA) formerly known as The Bond Market Association (TBMA). The agreement should detail the nature of the deal and conform to suit the specifics of the governmental entity's transaction. Proper securitization practices should be utilized to protect the securities in reverse repo transaction as well as safekeeping duties should be performed by a third-party custodian in accordance with an executed agreement.

The conservative and prudent approach to the use of reverse repos involves short-term contracts in which the term of the reverse repo is matched with the maturity of the reinvestment. Losses of state and local government funds (e.g., losses amounted in the billions in the 1980s and 1990s when governmental entities were borrowing short to lend long in adverse markets) have occurred as the result of unsound investment practices and the inappropriate use of reverse repos in leveraging portfolios to increase investment returns.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that state and local government finance officers develop policies and procedures to ensure the safety of reverse repos. The following actions are recommended:

1. Government entities and investment officers should exercise special caution in selecting and evaluating the creditworthiness of counterparties with whom they will conduct repurchase transactions and be able to identify the parties acting as principals to the transaction.
2. Reverse repo proceeds generally should be invested in securities whose maturity matches or is no longer than the term of the reverse repo. For example, borrowing short to lend long can produce losses in adverse markets. Further, the possibility exists that other factors can go wrong, such as default by the dealer or adverse market changes that erode the value of the underlying securities.
3. Master repurchase agreements for reverse repos should be employed, subject to appropriate legal and technical review. Governments using the prototype agreement developed by SIFMA should include appropriate supplemental provisions regarding the types of securities, delivery, substitution, margin maintenance, margin amounts, seller representations, and governing law as contained in the GFOA-developed *Considerations for Governments in Developing a Master Repurchase Agreement*.
4. Governmental entities should only engage in reverse repos if they possess the necessary expertise and resources required to enter into this type of investment. Government officials should verify whether the use of such financial instrument is legal in their respective jurisdictions. Governmental officials **should not engage in any investment practices for speculative purposes.**

## **References.**

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- *An Introduction to Collateralizing Public Deposits for State and Local Governments*, Second Edition, M. Corinne Larson, GFOA, 2006.
- *Investing Public Funds, Second Edition*, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- GFOA Best Practice, *Frequency of Purchased Securities Valuation in Repurchase Agreements* (1999, 2003, 2006, 2008).
- *Considerations for Governments in Developing a Master Repurchase Agreement*, Third Edition, 2001.
- "Do You Know Your Repurchase Agreements as Well as You Think?" *GFOA's Treasury Management Newsletter*, October 3, 2009, Volume 27, Number 10.
- Sample Custodial Trust Agreement, GFOA.
- The Securities Industry and Financial Markets Association (SIFMA) <http://www.sifma.org>

Approved by the GFOA's Executive Board, October 15, 2010.