



BEST PRACTICE

Adopting Policies for the Frequency of Purchased Securities Valuation in Repurchase Agreements (1999, 2003, 2006, 2008 and 2010) (TIM)

Background. A repurchase agreement (repo) is a transaction between a buyer/investor (e.g. government entity) and a seller/counterparty (e.g. bank or securities dealer) in which the counterparty sells securities to the investor with a simultaneous agreement to buy the securities back from the investor on a future date. The securities are repurchased, or bought back, at the same price plus the interest earned at the repo rate for the period of the repo. U.S. Treasury Securities (Bills, Notes, Bonds) and Government Sponsored Enterprise (GSE) (e.g. Fannie Mae, Freddie Mac) securities are the most common securities sold for repos involving government entities. Terms for repos can be overnight (from one business day to the next business day), for a specified number of days (term repo) or as a continuing open contract (open repo) to be closed at the request of either party.

Public funds have used repos since the 1970s. In September 1996, the Securities Industry and Financial Markets Association (SIFMA) formerly, The Bond Market Association, published a revised version of its *Master Repurchase Agreement*, which previously had been amended in 1987. The revised agreement includes modifications designed to reflect the expansion of the repo market, changes in the law and “market participants’ experience in exercising liquidation and similar closeout rights in the context of counterparty insolvency.” (SIFMA *Guidance Notes and Supplemental Guidance Notes*).

In March of 2003, the Governmental Accounting Standards Board (GASB) published Statement No. 40, *Deposit and Investment Risk Disclosures*, an amendment to GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements* which states that government entities should briefly describe policies regarding securitization and safekeeping for deposits and investments, including repos, that are related to the risks that must be disclosed under this Statement No.40.

An important factor in managing the risk of default in repurchase transactions is the valuation of the purchased securities. For the term of the repo agreement, it is common practice for the counterparty to deliver purchased securities to the investor in a total value amount (market value plus accrued interest) that is equal to the investor’s investment plus a margin percentage. The margin percentage, typically 102% for Treasury and GSE securities, protects the investor from a decline in the price of the purchased securities during the time the repo transaction is in effect. The value of the securities must be monitored frequently to insure the market value remains at least equal to the invested amount plus margin percentage in case of default of the counterparty. If the value of the purchased securities falls below the invested amount plus margin percentage, then the counterparty is required to deliver additional securities to the investor upon their request.

The frequency of the valuation depends on several factors:

- The maturity of the purchased securities, since longer maturities have greater price volatility;
- The security types, since certain securities have greater price volatility;
- Market volatility; and,
- The margin percentage that is required by the investor; the lower the margin percentage, the more frequent the valuation of the purchased securities.

Recommendation. Because the investor may need to liquidate the purchased securities in the secondary market in the event the counterparty defaults on the repurchase agreement transaction, the Government Finance Officers

Association (GFOA) recommends that government entities establish a policy and procedure for monitoring the value of the purchased securities in a repo transaction to insure that it does not drop below the value of the repo investment plus any required margin percentage. For maximum protection, government entities should value the purchased securities in their repo transactions to their current market price **on a daily basis**. At a minimum, the purchased securities should be valued:

- Weekly;
- Whenever there is a major increase in rates or market volatility is high; or,
- Whenever a coupon and/or principal payment on the purchased securities is wired back to the counterparty.

In order to facilitate the determination of market value, government entities should specify the acceptable securities for a repo transaction. Acceptable securities are those that have readily available pricing information from a reputable, independent pricing source. The independent source of pricing **should not be a counterparty** to the repo transaction and could include:

- a broker or other financial institution that was not a counterparty to the transaction,
- the custodial bank if the bank was not a counterparty to the transaction,
- publicly available publications such as the Wall Street Journal, or
- other pricing services for which a separate fee would be paid.

When valuing securities, the purchased securities are valued using their current market price plus accrued interest to compute their total value. The total value is then compared to the repo value multiplied by any margin percentage. If the total value of the purchased securities is less than the repo value plus the margin percentage, then the investor/buyer should request sufficient additional securities on a same-day or next-day basis from the counterparty to bring the total value up to the proper level.

Further discussion of repos and recommended safeguards is provided in the references listed below. Public investors should consult their investment policy as well as state law and local ordinances for any further restrictions or guidance on repurchase agreements and valuation of purchased securities.

References

- GFOA Best Practice, “*Establishing a Policy for Repurchase Agreements*,” (2003, 2006, 2008 and 2010), GFOA Committee on Treasury and Investment Management
- GFOA Advisory, “*Establishing a Policy for Reverse Repurchase Agreements*,” (2003, 2006, 2008 and 2010), GFOA Committee on Treasury and Investment Management
- Do You Know Your Repurchase Agreements as Well as You Think?” *GFOA’s Treasury Management Newsletter*, October 3, 2009, Volume 27, Number 10.
- *Introduction to Broker-Dealers for State and Local Governments, Second Edition*, Sofia Anastopoulos, GFOA, 2008.
- *An Introduction to Collateralizing Public Deposits for State and Local Governments, Second Edition*, M. Corinne Larson, GFOA, 2006.
- *Considerations for Governments in Developing a Master Repurchase Agreement, Second Edition*, GFOA Committee on Cash Management, 2001.
- “*Investing Public Funds*”, *Second Edition*, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- Master Repurchase Agreement, September 1996 The Securities Industry and Financial Markets Association (SIFMA), <http://www.sifma.org>
- Governmental Accounting Standards Board (GASB), <http://www.gasb.org>