



## RECOMMENDED PRACTICE

### Repurchase Agreements and Reverse Repurchase Agreements (2003, 2006, and 2008) (CASH)

**Background.** Where permitted by statute, governmental entities often enter into repurchase agreements (repos) to invest funds on a short-term basis. Repos are financial instruments in which an investor purchases securities from a bank or dealer and at the same time, the selling bank or dealer contractually agrees to repurchase the securities at the same price (plus interest) at some mutually agreed-upon future date. The parties to the agreement (governmental entity and bank/dealer) are commonly referred to as counterparties.

Repos may be used as a way of earning incremental investment income. Governmental entities commonly use repos to secure money market rates of interest on funds. There are three types of repos:

- Overnight Repo: refers to a one-day maturity transaction.
- Term Repo: refers to a repo agreement with a specified maturity, usually no more than a few weeks, although terms of two years or more are available.
- Open Repo: typically, has no maturity date, and renews daily until terminated by one of the counterparties.

In addition, repurchase agreements called “flexible repurchase agreements” (flex repos) are often used for bond reinvestment activity where cash is obtained from a bond issue associated with a capital project. This type of a repurchase agreement can be for multi-year periods associated with a specific capital program. The flexible portion of the agreement permits multiple cash drawdowns to fund the expenditure requirement. Governments should ensure that these investments meet their liquidity requirements.

The Securities Industry and Financial Markets Association (SIFMA) formerly known as The Bond Market Association (TBMA) published an optional substitution/termination provision to its *Master Repurchase Agreement* that allows the repo seller (bank or dealer) to retain effective control over the purchased securities, or the repo seller could elect to terminate the transaction prior to maturity on short notice to the repo buyer (government entity).

Although governmental entities are not bound by the Financial Accounting Standards Board (FASB), FASB Statement No.140 affects the counterparties to repurchase transactions with governments. FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities," generally provides that if the repo buyer (i.e., government entity) has the right to sell or re-pledge the securities, then the repo seller (i.e., bank or dealer) does not have the right to substitute the securities or terminate the contract on short notice. The repo buyer will be obligated to record both the securities, together with any obligation to return the securities. The repo seller will be required to reclassify the securities from a securities inventory or investment account to a securities pledged account on its balance sheet. Accordingly, the nature of the underlying repurchase agreement may change from a buy-sell transaction to a collateralized loan. **This change of treating repurchase agreements as collateralized loans would make them illegal for local governments in many states.**

In a reverse repurchase agreement (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 to sell back to the 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. 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 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 repos and 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. Proper securitization practices are necessary to protect the public funds invested in repurchase agreements. Safekeeping shall be performed by a third-party custodian. Duties of the custodian (either direct or tri-party) should be outlined in a written agreement. The purchased securities (collateral) pledged to collateralize the repurchase agreement should maintain a market value in excess of the value of the repurchase agreement (called margin, "haircut," or over securitization). Regular market valuing of the purchased securities during the term of the repurchase agreement should be a mandatory practice in order to ensure the purchased securities maintain sufficient market value to cover any default. A typical margin requirement for a short-term repo is at least 102%.
3. Master repurchase agreements should be employed, subject to appropriate legal and technical review. Governments using the prototype agreement developed by SIFMA should include appropriate supplemental provisions regarding 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. Legal counsel should review SIFMA's optional substitution/termination provision in its master agreement to assure no loss has incurred. In jurisdictions where substitution of securities is permitted, a loss provision is provided that is intended to place the repo buyer in the same position it would have been had the repo seller not exercised the substitution/termination right. However, in jurisdictions where substitution is restricted, the effect of FASB Statement No.140 may be troublesome depending on the relationship established with the bank or dealer; the jurisdiction's position with respect to the change in accounting treatment of the transaction; and whether the government has the ability to avoid the restriction on substitution of purchased securities.
5. 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.
6. 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.

7. Governmental officials **should not engage in any investment practices for speculative purposes.**

**References:**

- *Considerations for Governments in Developing a Master Repurchase Agreement*, Third Edition, 2001.
- *An Introduction to Broker/Dealer Relations for State and Local Governments*, M. Corinne Larson, GFOA, 1994.
- *An Introduction to Collateralizing Public Deposits for State and Local Governments*, Second Edition, M. Corinne Larson, GFOA,,2006.
- GFOA Sample Custodial Trust Agreement, [www.gfoa.org](http://www.gfoa.org).
- "Investor Alert: Repo Agreements," *Public Investor*, April 3, 1998.
- *Investing Public Funds*, Second Edition, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- GFOA Recommended Practice, *Frequency of Purchased Securities Valuation in Repurchase Agreements* (1999, 2003, 2006, 2008)
- GFOA Recommended Practice, *Securities Lending Programs* (1995, 2002, 2008).
- FASB Statement 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities," <http://www.fasb.org/pdf/fas140.pdf>

Approved by the GFOA's Executive Board, October 17, 2008.