BEST PRACTICE

Establishing a Policy for Repurchase Agreements (2003, 2006, 2008 and 2010) (TIM)

Background. Where permitted by statute and investment policy, governmental entities often enter into Repurchase Agreements (repos) to invest funds on a short-term basis primarily to fund liquidity needs. Repos are contractual financial transactions in which an investor (e.g. governmental entity) purchases securities from a bank or dealer with a simultaneous contractual agreement by both parties to reverse the transaction 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 are an integral part of an investment program of state and local governments and provide an alternative or supplement to local government investment pools, money market mutual funds and other money market instruments. However, like all investments, there are associated risks with repos, one in particular is the counterparty's credit risk. Such risk can be mitigated by the utilizing proper securitization practices.

Common Types of Repos:

- **Overnight Repo**: refers to a repo that goes from one business day to the next business day. These repos have a negotiated fixed interest rate.
- **Term Repo**: refers to a repo agreement with a specified maturity of several days to several weeks. Term repos can be established for up to several years when the investment policy permits. The interest rate for the period is usually fixed.
- **Open Repo**: typically, has no maturity date, and renews daily until terminated by either one of the counterparties. The interest rate adjusts daily to the overnight rate and is averaged for the period of the repo.
- **Flex Repo** (flexible repurchase agreements): are often used for the reinvestment of bond proceeds used for capital projects. These repos are often for multi-year periods associated with a specific capital program. The flexible portion of the agreement permits multiple cash draw-downs to fund the expenditure requirement. Governments should ensure that these investments meet the liquidity requirements of the project and adhere to any bond covenants.
- **Tri-Party Repo**: occurs when a custodian (a.k.a. the tri-party agent) participates as an intermediary between the two parties (investor and lender) of the repo. The custodian administers and ensures the transaction occurs simultaneously and that necessary safeguards are in place to protect the underlying securities during term of the repo.

Benefits of Repos:

- Repos are safe when properly established and monitored;
- At times, provide higher yields than other money market alternatives;
- Provide diversification to other money market investments; and
- Provides flexibility.

Risks Associated with Repos:

- The 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 bank or dealer cannot buy securities back when repo is closed by governmental entity.

- The collateral for the repo is not liquid or easily marketable; and
- The value of the repo is not sufficient to cover the funds invested and interest earned.

Mitigating the Risk:

- Execute a 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 review financial statements at inception of relationship and at least annually. Some entities will limit counterparties to primary dealers;
- Allow only highly marketable, easily priced collateral priced at a minimum of 102% and monitoring their value at least weekly; and
- Have collateral settled delivery-versus-payment (DVP) at the entity's custodian or trustee for third-party safekeeping.

Master Repurchase Agreement. A Master Repurchase Agreement is the contractual agreement a governmental entity enters into with a bank or counterparty. A form of the agreement, also known as a blanket agreement may be obtained from the website of the Securities Industry and Financial Markets Association (SIFMA) formerly known as The Bond Market Association (TBMA). However, governmental entities may wish to amend SIFMA's form of the *Master Repurchase Agreement* to suit the specificities of their respective transactions.

A master repurchase agreement governs the repurchase transaction. An agreement should reflect the following characteristics:

- Defines and provides detail as to the nature of the transaction;
- Identifies the relationship of the parties to the agreement;
- Establishes the parameters concerning the ownership and custody of the collateral securities for the term of the agreement;
- May include right to substitute collateral during the term of the agreement; and
- Provides for remedies in the event of default by either party.

SIFMA has also 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).

Securitization Provisions.

Safekeeping: In order to protect public funds, governmental entities should ensure proper securitization practices when utilizing repurchase agreements for investments. Safekeeping should be performed by an independent or third-party custodian. Duties of the custodian (direct or tri-party) should be outlined in a written safekeeping agreement.

Collateral: The underlying security of a repurchase agreement is collateral. Collateral arrangements for repurchase agreements are short-term and liquid in nature. Typical collateral instruments are U.S. Treasuries (e.g. U.S. Treasury bills) and governmental agency securities (e.g. Farm Credit Banks, Home Loan Banks bonds). Governmental entities should be aware of the risk factors of the underlying collateral instrument for the repo and refer to their respective investment policies to verify if such collateral instruments are permissible to utilize for the repurchase transaction. The purchased securities (collateral) 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).

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 substitute 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 collateral 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.**

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. 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. 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 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.*

3. Government entities' legal department should review SIFMA's optional substitution/termination provision in its master agreement to assure no loss has incurred (e.g. in event of a default). 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.

4. Proper securitization practices are necessary to protect the public funds invested in repurchase agreements. Safekeeping duties should be performed by a third-party custodian in accordance with an executed agreement. The purchased securities (collateral) 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). Routine 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 using US Treasuries or US agency securities as collateral is at least 102% and higher (typically 105%) for other securities.

5. Consideration should be given to restricting the allowable securities that are used for collateral. Entities may prefer to only allow for security maturity and security types that are allowable for direct investment under their policy. If there is a default of the counterparty, the securities held as collateral of the repo will be owned by the entity, supporting the need to restrict the maturity and type of security to what is allowable under policy.

References.

- "Do You Know Your Repurchase Agreements as Well as You Think?" *GFOA's Treasury Management Newsletter*, October 3, 2009, Volume 27, Number 10.
- *An Introduction to Broker-Dealers for State and Local Governments, Second* Edition, Sofia Anastopoulos, GFOA, 2008.
- "GFOA Best Practice, *Securities Lending Programs" (*1995, 2002, 2008).
- *An Introduction to Collateralizing Public Deposits for State and Local Governments, Second Edition,* M. Corinne Larson, GFOA, 2006.
- GFOA Best Practice, *Frequency of Purchased Securities Valuation in Repurchase Agreements* (1999, 2003, 2006, 2008).
- *Investing Public Funds, Second Edition,* Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998.
- "GFOA Best Practice, *Securities Lending Programs" (*1995, 2002, 2008).
- Sample Custodial Trust Agreement, GFOA.
- FASB Statement 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities," http://www.fasb.org/pdf/fas140.pdf.
- The Securities Industry and Financial Markets Association (SIFMA) http://www.sifma.org

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