REPURCHASE AGREEMENTS
A Refresher Course

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Repurchase agreements have long been a safe way to invest short-term or overnight cash. But given the precarious condition of a number of banks and the nervous attitude of many finance officers, now is an opportune time to review the basics as well as recent rulings.

Repurchase agreements, or 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 — the governmental entity and the bank or dealer — are called counterparties. Historically, repos have been used as a way of earning incremental investment income.

A SIMPLE OVERNIGHT REPURCHASE TRANSACTION

The following is a typical scenario. A governmental entity determines the amount of excess liquidity it has on an overnight basis. The government then enters into a repurchase agreement with its bank for that amount, with the goal of earning incremental interest. It invests $1 million.

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The bank identifies a security in its portfolio, free and clear of any encumbrances, and agrees to sell that security to the government with a written agreement to buy it back the following morning at a higher price. In this example, the bank sells the government a U.S. Treasury Bond with a $1.02 million face value, or par. The market price is par value, or 100 percent, and the agreed-upon margin is 102 percent. The agreed-upon repurchase price the next day is $1 million plus $27,000, a 1 percent annual rate.

The bank notifies its safekeeping agent, a non-related third party, to transfer ownership of the security to the governmental entity, and the bank also instructs the agent to transfer the security back the following morning in a way that ensures the governmental entity has ownership and receives its cash back. The bank sends a written confirmation on a daily basis to the government, clearly listing and verifying the issuer, the face value, coupon (the coupon rate of a bond is the amount of interest paid per year, expressed as a percentage of the face value), CUSIP (the identification number the Committee on Uniform Security Information Procedures assigns the security), market value, and amount invested. This information is used by the government entity to update its accounting records.

In reality, this process is almost totally automated. Only rarely would a human become involved in an overnight repurchase agreement. The governmental entity's primary checking account is typically set up to have a threshold or target balance, and anything left over is swept into a repurchase agreement.

The bank's computer aggregates all swept balances from all of its customers to find the total amount of securities it needs to sell, then allocates the securities to each customer and informs the custodian. A daily confirmation is prepared and mailed. A sum total of all daily interest paid is shown on the monthly checking account statement, and the entity books that amount as interest.

POINTS TO CONSIDER

All investment decisions need to be made with caution, even regarding transactions broadly considered to be low risk. Governments that use repurchase agreements still need to play it safe. For example, someone needs to open the daily confirmations and verify that the information is correct. Few entities take the time to do so, and many do not even open the envelope. Similarly, make sure your organization has all the paperwork necessary for controlling securities. Generally, three conditions need to be met. First, the daily written confirmation should clearly identify the security that is subject to the repurchase agreement. The agreement should appoint the bank as the entity's agent in the event of a default and provide the entity with the express authority to instruct the agent to sell the securities. Finally, the agreement should prohibit the bank from substituting securities.

Know how your bank values securities, and how often. There are several methods used to mark securities to market (rather than valuing it at its cost or its book value), including mathematical modeling and getting actual market bids, and

you should feel comfortable with the method employed. It is also a good practice to find out how frequently your counterparty marks the securities to market value. Not all counterparties mark to market daily, and some do so only quarterly. Many organizations require a higher margin (the difference between the actual market value of the security and the value the lender assigns to the security — this is sometimes called the "haircut") for banks that do not mark to market daily. Generally, haircuts are between 102 percent and 112 percent. Factors to take into account in determining the appropriate amount are the issuer, the coupon rate, the maturity date, and the level of volatility.

Review all securities purchased in light of the jurisdiction's investment policy.

THE NEW RULES

New Federal Deposit Insurance Corporation (FDIC) rulings have made taking care of the details more important than ever. The FDIC has noted a potential problem with the variety of master repurchase agreements that exist, given the increased number of failed banks during the current ecnomic troubles (see "Banking Due Diligence in the New Financial World" in this issue for more information about failed banks). Master repurchase agreement refers to the blanket agreement that governs an entity's agreement with its bank or counterparty, and the wording in or structure of some of these agreements could cause the agreement to be deemed a loan to the bank rather than a purchase of securities from the bank. If the bank fails, a jurisdiction with this sort of agreement will fall into a creditor status. In some instances, a sweep customer could find that the amount swept is classified as a bank deposit and subject to FDIC insurance limits, currently $250,000. This does not take into account the FDIC's temporary Transaction Account Guarantee Program, or TAGP, which is currently set to expire at the end of 2009. An extension to June 30, 2010, has been proposed, however, which might temporarily enhance FDIC coverage, providing unlimited coverage to transaction accounts and some negotiable order of withdrawal accounts. However, not all banks elected to participate. It is up to a jurisdiction to confirm if the program is in effect and that its bank has opted to participate. (See www.fdic.gov for more information.)

As of July 1, 2009, banks were required to review their existing agreements and notify all customers how their swept balances would be classified if the bank should fail. It should be noted that this notice was required of all banks, regardless of safety or soundness, so it does not indicate that there are any problems with the bank. FDIC Final Rule 12 C.F.R. S 360.8 (e), officially known as the Final Rule on Processing of Deposit Accounts in the Event of an Insured Depository Institution Failure and popularly known as the Failed Bank Rule, sets out the criteria for all sweep account options. The rule does not single out repurchase agreements for notification but does include all sweep investment options, including those beyond the scope of this article.

Most banks took this opportunity to review their master repurchase agreement and ensure that the language transfers control of sold securities to the buyer. There were some banks that have since modified their agreements and subsequently sent out notices to any clients that were affected.

The new regulations provide further protection to bank customers, so change of terms were often included in monthly statements.

WHAT IS REQUIRED NOW

As the FDIC found, users of repurchase agreements — both counterparties — might have become complacent. While this established product has not had any problems, several steps may be prudent for any governmental entity that uses this option for short-term cash. It is a good idea to:

- Review the master repurchase agreement, and make sure it is still current.
- Review internal procedures for verifying the information on the daily confirmation. If income is reconciled monthly, daily interest rates should be reconciled to the combined amount paid.
- Review the securities purchased in light of the jurisdiction's investment policy to make sure all the securities qualify. Confirm that the jurisdiction's investment policy does not limit the concentration of assets in any one category. An example of such a restriction would be limiting the total investment portfolio to a maximum of 5 percent in Government National Mortgage Association securities. If the investment policy places concentration limits on some issuers, consider eliminating those issuers from your repurchase agreements, thus removing the risk of accidentally violating policy limits.
- Review the added margin (or haircut) compared with how often the securities are marked to market. Longer periods between valuations should have wider margins of safety. For example, if a daily valuation requires a 102 percent margin, a monthly valuation might require a 104 percent margin for the equivalent amount of safety.
- Verify that your bank's required message (which should have been provided between July1, 2009, and August 31, 2009) clearly notes that your repurchase agreement is not a deposit, which would be subject to FDIC limits.
- Ensure that internal or external audit procedures verify CUSIP, issuer, par, coupon, maturity date, and current market values. Clear documentation of such audits is strongly recommended.
- Compare the long-term investment portfolio to the overnight securities under repurchase agreement for any possible excess exposure.
- Revisit your sweep investment alternatives to ensure a competitive return. Alternatives of equal safety but higher returns might be available. The market environment is fluid and has shifted a great deal over the last 18 months.
- Review all agreements for the term "collateral." Ensure that you understand how the term is used to ensure that the transaction is a repurchase agreement and not a loan.

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CONCLUSIONS

Repurchase agreements remain a much-used and safe method for investing excess cash, and recent clarifications and rulings further protect investors. At the same time, given the general atmosphere of economic uncertainty and the increased number of bank failures over the past 18 months, it makes sense to pay attention to details and make sure your organization's repos are managed correctly. Another source of information is the GFOA's best practices, a number of which address the use of repurchase agreements. Readers are encouraged to review *Repurchase Agreements and Reverse Repurchase Agreements* and *Frequency of Purchased Securities Valuation in Repurchase Agreements*, both available on the GFOA's Web site at www.gfoa.org.

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