Repurchase Agreements (Repo):
Guidelines for Public Fund Investors

A **repurchase agreement**, often called a **repo**, is the agreement by a seller (an authorized dealer) to sell to the buyer (a public fund investor) authorized investment securities (referred to as collateral), with the agreement to purchase the securities back on an agreed to date and rate of interest (simple interest on 360-day basis), to be paid to the buyer. The most common maturity is an overnight repo (O/N) that matures the following day. Term repo can be done for any maturity date but the longer the time period, the higher the risk.

Repos are not specifically mentioned in statutes as an eligible investment. The authority for their use is based on the purchase and sale of the securities being traded. Consequently, the securities utilized in the repos must be statutorily eligible for purchase by public fund investors.

Repos are the most common investment vehicle in the marketplace, with trillions of dollars in repo transactions taking place every day. While they can be a safe, straightforward investment, they can also be quite complex and contain a higher level of risk than a cursory glance might reveal. It is important to understand those risks and to take steps necessary to mitigate them.

Repos are governed by Master Repurchase Agreements (MRA), which are agreements entered into by both parties involved in a repo transaction. There is a standard MRA document that has been developed by the Securities Industry and Financial Markets Association (SIFMA). While the main MRA document is an industry standard, most dealers will have an annex that adds to or amends the main document. Investors should pay close attention to the details of any annex that comes with the MRA. An MRA is a written contract and your legal counsel should be involved in the process. Once an MRA is executed with a dealer, it will govern all repo transactions between you and the dealer, i.e., you do not have to execute a separate MRA for each repo transaction.

The key points in a repo transaction are the counterparty to the transaction, the type of security utilized, the repo haircut, the safekeeping arrangement, and (for term repo) the ongoing monitoring of margin levels.

> *Counterparties* - Care should be taken to only conduct repo transactions with well capitalized firms that have a good reputation in the industry. Get a current, audited financial statement and look it over carefully. Also, make inquiries about the firm with people in the business with whom you have dealt and whom you respect.
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> *Purchased securities* - This is commonly referred to as the repo collateral, but keep in mind that a repo is ***not*** a collateralized loan. You are purchasing the securities, with an agreement to sell them back on the repo maturity date. The purchased securities must be statutorily eligible.

Beyond that, they should be sufficiently liquid so that in the event of a counterparty default you can sell the securities to recover the principal amount invested.

Repo haircut - It is standard industry practice to over-collateralize a repo to ensure that in the event of a dealer default you will be able to fully recoup your principal investment. For example, repo utilizing US Treasury and Agency securities commonly has a 2% haircut, meaning that on a $100 million repo the value of securities purchased would be $102 million. For less liquid securities the haircut will be even higher, e.g., 5% or more. The haircut margin will allow for market fluctuations.

Safekeeping - Safekeeping of the purchased securities should be done by an independent third party. You should never have the party you are doing the repo with do the safekeeping of the securities for you. The only exception to this would be if the securities can be kept in the bank's trust safekeeping department, for the account of the investor.

Monitoring the margin maintenance – For term repos, the market price of the purchased securities should be monitored on a regular basis to ensure that the repo remains adequately collateralized (including the haircut). This is especially important when the term of the repo is for more than a few days. Should the repo become under-collateralized you should go to the dealer to have them restore the repo to the proper margin (this is known as a margin call). Similarly, if market prices shift such that the repo becomes over-collateralized, a dealer may request the return of a portion of its collateral prior to the maturity of the repo. In a volatile market there may be several margin calls on a single term repo transaction.

Reverse repurchase agreements, technically called matched sales-purchase agreements, are essentially the mirror image of repos. In this instance, the investor is the initial owner of the securities, and the bank or dealer is the entity with money. All other aspects remain identical.

State of Washington Treasury/Trust Investment Policy:
Guidelines on Repurchase and Reverse Repurchase Agreements

Section VI.2: Repurchase and reverse repurchase agreements will be subject to the following additional restrictions:

- transactions will be conducted only with primary dealers, the state's bank of record, or master custodial bank, and under the terms of a written master repurchase agreements;
- purchased securities utilized in repurchase agreements will be limited to government securities;
- repurchase agreements with any single primary dealer or financial institution will not exceed 20% of the portfolio;
- the maximum term of repurchase agreements will be 180 days;
- the share of the portfolio allocated to repurchase agreements with maturities beyond 30 days will not exceed 30% of the total portfolio;
- the maximum term of reverse repurchase agreements will be 180 days and must be matched to anticipated cash flows adequate to liquidate the transaction; and,
- the maximum portion of the portfolio allocated to reverse repurchase agreements will not exceed 30% of the total portfolio.

Securities accepted for repurchase agreements will be subject to the following additional restrictions:

- Securities utilized in a repurchase agreement with a maturity date longer than seven days will be priced at least weekly;
- all substitutions will be approved by the Office of the State Treasurer (OST) before the existing purchased security is released to the broker/dealer;
- the market value, plus accrued income, of securities utilized in repurchase agreements will be priced at 102% of the value of the repurchase agreement, plus accrued income.

Additional operating guidelines will provide details relating to the frequency of security pricing, substitutions, and margin calls.