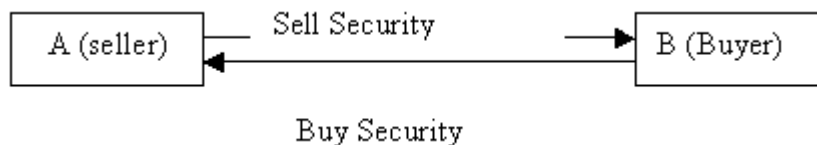


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Repurchase Agreements (Repos)/Ready Forward Transactions

A repo is an agreement in which a participant sells security to acquire immediate funds and then agrees to purchase the same or similar securities after a specified time at a given price. The transaction involved in repos contains elements of both the sale/purchase of securities and the operations involved in money market borrowing and lending. Repo transactions are collateralized short-term lending. The terms of contract are specified as the “repo rate,” representing the money market borrowing/lending rate. As in the case of other instruments, repos help the equilibrium between demand and supply of short-term funds. Internationally, the repurchase agreement (repo) is a versatile and perhaps the most popular money market instrument.



If the above diagram is considered from the buyer's perspective, i.e. from B's perspective, it will be termed a reverse repo. So, a reverse repo is a mirror image of a repo. Hence, whether a transaction is a reverse repo or a repo transaction is determined by who has initiated the transaction.

Purpose

The seller in the transaction can earn immediate cash in the short-term, without liquidating his or her position in the security. The buyer of the firm will have an avenue to deploy his/her surplus funds. Governments use repurchase agreements to exercise control of interest rates and liquidity in the money market. These agreements are used to inject/absorb liquidity in the market by the RBI.

Operational Aspects

Size of the Loan. The size of the loan is decided by the party that initiates the agreement. For example, if a borrower initiates the agreement, he/she will decide the size of the agreement.

Selection of Security. The RBI announces the nature of instruments that will be eligible for repo transaction. Currently, all government securities, treasury bills, public sector and private corporate debt securities that are in the demat form are eligible for repo transactions.

Interest rate. Interest rates on the bonds will be mutually agreed upon by borrowers and lenders, depending upon the term amount and the prevailing call money rate and term money rate.

Settlement. Parties to the agreement have a current account and a SGL account. Once the deal is finalized, it is passed through the SGL account and the same is shown to the RBI.



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Once the RBI is satisfied with the details mentioned in the account, the RBI will make the necessary entries into the book of accounts of the buyer and seller.

Types of Repos

There are four types of repos, namely buy-sell repo, classic repo, bond borrowing and lending repo, and tripartite repo.

- 1. Buy-Sell Repo.** Under a Buy-Sell repo transaction, the lender actually takes possession of the collateral. Here a security is sold immediately and bought back simultaneously for settlement on a later date. In a Buy-Sell repo, the ownership is passed on to the buyer, and therefore, he retains any coupon interest due on the bonds.
- 2. Classic Repo.** A classic repo is an agreement to sell securities along with a simultaneous agreement to repurchase them at a later date. In this type of repo, the start and end prices of securities are the same, and a separate payment of "interest" is made. Here, the coupon income will be accrued to the seller of the security.
- 3. Borrowing and Lending Repo.** In a bond lending / borrowing transaction, the customer lends bonds for an open-ended or fixed period in return for a fee. The fee charged depends on the type of underlying instrument, the size and term of the loan, and the credit rating of the counterparty. The transaction is taken care of by an agreement on securities lending, and cash or other securities of equal value is provided as collateral.
- 4. Tripartite Repo.** Under a tripartite repo, a common custodian / clearing agency arranges for custody, clearing and settlement of repo transactions. They operate under a standard purchase agreement and provide for a DVP system, substitution of securities, automatic marking to market, reporting and daily administration by a single agency that takes care of the risk and does not insist on disclosing the identities of counterparties. The system begins with the signing of agreements by all parties, including the Tripartite Repo Service Agreements. This type of arrangement minimizes credit risk and can be utilized when dealing with clients with low credit ratings.

Repo Period

A repo period is the time at which the agreement between parties matures and ceases to exist. There are overnight, flexible and fixed repo periods. Overnight repo agreements expire within one day. In a fixed repo, the date or period during which the agreement expires is decided in advance. In a term repo, either party can terminate the agreement by giving a few days notice. Generally, the term of the repo is around a week.