UNDERSTANDING REPURCHASE AGREEMENTS (REPOS)

1 The following describes the common underlying risks in repurchase agreements (repos) and some commonly adopted risk management techniques.[1]

2 A repo is a transaction in which two parties agree that one will sell specific securities (repo seller) to the other (repo buyer) and (at the same time and as part of the same transaction) commit to repurchase equivalent securities on a specified future date at a specified price.

LEGAL, MARKET-RELATED AND OPERATIONAL RISKS

Legal

3 *Legal certainty of transactions:* Repos are undertaken on the basis of a title transfer. Under this approach, funds and securities are transferred against an obligation of the transferee to return the funds and equivalent securities on the maturity of the contract. Like any contract, repos may be unenforceable because the counterpart lacks the capacity or authority to enter into repo agreements, or the counterparty may be subjected to certain restrictions imposed on their capacity or authority to engage in repos. The use of repos may run the risk that a court will re-characterise the transaction as a collateralised loan if documents supporting the transactions were not carefully crafted. Standard legal agreements or master agreements have been developed to address the various legal aspects of repos, and clarify the roles and responsibilities of the participants and the legal framework in a particular jurisdiction.

4 *Master agreements:* A master agreement is a legal document that specifies the terms that apply to all transactions between parties, or a defined subset of transactions, including remedies in the event of counterparty default. Subsequent transactions between the same parties are consequently subjected to the master agreement through the

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[1] For a more extensive discussion, please refer to the CPSS-IOSCO publication "Securities Lending Transactions: Market Development and Implications", July 1999.

use of confirmations that supplement the master agreement. The master agreement also reduces the burdens associated with negotiating legal and credit terms on a transaction-by-transaction basis. The PSA/ISMA Global Master Repurchase Agreement (GMRA) is commonly used for repos.

5 The following are normally included in master agreements:

- Capacity of the parties, either as agents or principals
- Authority of the parties to purchase or sell securities
- Absolute transfer of legal title
- Market risk management such as mark to market, margin percentages, substitution or re-pricing
- Arrangements for delivery/receipt of securities
- Treatment of dividends payments and timing of payments
- Default procedures and the consequential rights and obligations of the counterparties, including rights of set-off
- Governing law of the agreement

6 *Set-off of mutual debts:* The legal enforceability of the right of set-off in the event of an insolvency, is essential in a contract under title transfer due to the obligation of the transferee to return the fund or equivalent securities at maturity. In Singapore, mutual set-off in the case of a counterparty default is generally recognised. Repo participants with multiple transactions with each other may seek to enter into a single master agreement that provides for the close-out netting of obligations under all contracts made under the agreement in the event of a default of either counterparty.

7 *Custody:* In the custody and management of securities assets, custody risk may arise when the practices and management of securities under custody and the roles and responsibilities of the agent and the principal are unclear. It is beneficial, both for the principals and agents to avoid ambiguities by specifying the rights and obligations of the agent and the principal in the legal agreements. Some custodian agents grant indemnity to compensate for damages or loss. A fairly standard practice is for agent banks to offer the principal indemnification against losses arising from counterparty default.

Market-related

8 *Credit evaluation:* Participants of repos may be exposed to counterparty risk in the event of a counterparty default. Prior to conducting any repo transactions, participants would conduct formal credit evaluations and impose a credit limit on their counterparties. A formal credit evaluation involves participants acquiring comprehensive financial information about the counterparty in order to understand the financial capacity, risk profile and risk management strategy of the counterparty. Formal credit ratings from rating agencies may be used by participants to ensure their counterparties' creditworthiness. Generally, participants set differing limits based on the credit evaluation of their counterparties.

9 *Marking-to-market (re-pricing):* A decline in the market value of the securities sold in repos creates a credit exposure for the repo buyer, as the value of the securities asset is now lower than the cash value. To mitigate this exposure, marking-to-market is practiced to revalue repos using current market prices. The value of all repos are usually marked-to-market (or re-priced) on a daily basis to reflect changes in market prices and to re-calculate exposures. Without proper re-pricing, exposure arising from price movements may not be immediately recognised. Mark-to-market margining allows repo buyers to call for additional cash or securities assets from the seller. Notification and settlement of margin calls should be timely and damages for non-performances of margin calls should be established in legal agreements.

10 *Liquidity:* Liquidity risk is the risk that the counterparty cannot settle an obligation for the full value when it is due, but would be able to settle on some unspecific date thereafter. The reason for the counterparty's inability to settle is usually temporary, for example, from a demand for large quantities of securities or funds that renders the counterparty unable to meet its obligations when due. Another reason could be the counterparty's inability to unwind its short outright position. One way to manage the overall liquidity is through the use of buffer securities or reserve cash. The size of buffer may be determined partly by the seller's willingness to sell, and partly by the participant's own risk management policy, for example, a higher buffer for less liquid issues. Some sellers manage their overall liquidity by selling not more than three days' worth of the underlying security's turnover.

Operational

11 Trading and settlement procedures in the repo market may give rise to operational risk and lead to the occurrences of settlement fails. The following are some common measures used to mitigate operational risk:

- Maintaining a high degree of separation of duties for trading, operations, accounting, client services, marketing, asset/liability and risk management, legal services and compliance.
- Ensuring trades fall within credit limits for counterparties and overall trading limits.
- Ensuring that details of trade confirmation are complete and properly issued and that transactions are accurately recorded in internal systems.
- Applying appropriate haircuts and margin call practices.
- Emphasising management's role in measuring, monitoring and controlling credit and market risks.
- Setting appropriate fail clauses in legal agreements to ensure that the technical (temporary) inability to deliver securities does not give rise to a formal default.

ACCOUNTING AND TAX TREATMENT OF SGS REPOS

Accounting

12 According to the accounting standards prescribed by the Council on Corporate Disclosure and Governance[2], parties to a repo transaction should recognise the economic benefits rather than the legal nature of the transaction.

13 Since the repo seller is entitled and obligated to buy back the SGS from the repo buyer, and it is entitled to receive all interest and other income

[2] In particular, Financial Reporting Standard (FRS) 39 Financial Instruments: Recognition and Measurement, which states that "an enterprise should recognise a financial asset or financial liability on its balance sheet when, and only when, it becomes a party to the contractual provisions of the instrument" and "derecognise a financial asset or a portion of a financial asset when, and only when, the enterprise loses control of the contractual rights that comprise the financial asset (or a portion of the financial asset)".

payment made by the issuer[3], it has not lost the economic benefits of the SGS. Therefore, the repo seller should not remove the SGS from its balance sheet, and the repo buyer should not recognise the SGS on its balance sheet.

Taxation

14 The Singapore income tax treatment of qualifying repo transactions is detailed in the IRAS Guide on Securities Lending and Repurchase Arrangement published by the Inland Revenue Authority of Singapore on 23 November 2001.

15 In essence, the tax treatment outlined in the guide is based primarily on the principle that, and hence will apply only if, the economic ownership of the transferred securities remains with the repo seller, even though the repo seller does not retain legal title to the transferred securities.

16 On this basis, the transfer of securities under a qualifying repo transaction will not be regarded as a disposal by the repo seller. Likewise, the transfer back of equivalent securities will also not be regarded as a re-acquisition of the securities. Accordingly, for income tax purposes, no gain or loss will be recognised by the repo seller as a result of the transfer of securities. Conversely, the recognition of gains/losses for income tax purposes in the case of the repo buyer is also spelt out in the IRAS Guide.

17 In addition, specified payments[4] under any qualifying repo transactions which specified institutions (listed in the Annex) are liable to pay to any non-resident persons (excluding permanent establishment in Singapore), are exempt from tax. In other cases, specified payments may be subject to tax in Singapore unless specific tax exemption is granted.

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[3] Refer to Section 14 (Obligation to make coupon payment) of the SGS Repo Code of Best Practice

[4] "Specified payments" means any of the following :

(a) borrowing fees;
(b) loan rebate fees;
(c) price differentials;
(d) interest payments derived from moneys held on deposits in a Singapore bank, where the moneys are placed as collateral; and
(e) compensatory payments.

18 For more detailed guidelines on the tax treatment of repos, please read the IRAS guide which is available at: http://www.iras.gov.sg/data/etax/SBL_guide_23Nov01.htm

ANNEX

TAXATION

Specified Institutions whose liabilities to pay arises on or after 23 November 2001 but before 28 October 2003:-

1. The Monetary Authority of Singapore.
2. Any bank licensed under the Banking Act (Cap. 19).
3. Any merchant bank approved as a financial institution under section 28 of the Monetary Authority of Singapore Act (Cap. 186).
4. Any holder of a capital markets services licence licensed to carry on business in the regulated activity of dealing in securities under the Securities and Futures Act (Cap. 289)

Specified Institutions whose liabilities to pay arises on or after 28 October 2003:-

1. The Monetary Authority of Singapore.
2. Any bank licensed under the Banking Act (Cap. 19).
3. Any merchant bank approved as a financial institution under section 28 of the Monetary Authority of Singapore Act (Cap. 186).
4. Any finance company licensed under the Finance Companies Act (Cap. 108).
5. Any holder of a capital markets services licence licensed to carry on business in the following regulated activities under the Securities and Futures Act (cap. 289) or a company exempted under that Act from holding such a licence:
   (*a*) dealing in securities (other than a person licensed under the Financial Advisers Act (Cap. 110));
   (*b*) fund management;
   (*c*) securities financing; or
   (*d*) providing custodial services for securities.
6. Any collective investment scheme or closed-end fund as defined in the Securities and Futures Act that is constituted as a corporation.
7. The Central Depository (Pte) Limited.

8. Any insurer registered or regulated under the Insurance Act (Cap. 142) or exempted under that Act from being registered or regulated.
9. Any trust company registered under the Trust Companies Act (Cap. 336).