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Central Banks, Commercial Banks and Repurchase Agreements

1 Introduction

The management of the monetary base and of the velocity of circulation of money is a major function of central banks (see D.N. Chorafas, *The Money Magnet. Regulating International Finance and Analyzing Money Flows*, Euromoney Books, London, 1997), sometimes assisted through repurchase agreements (repos). An example of the use of repos for monetary policy reasons is provided by the Bundesbank and the ECB whose main monetary instrument is repurchase rate. The ECB asks the national central banks to conduct open-market operations to keep interest rates within its desired range, with:

- the ceiling being the rate which banks can borrow overnight from the central bank; and
- the floor being the rate at which banks with surplus cash deposit overnight funds.

In addition to this, the ECB will impose a minimum reserve requirement: banks must deposit at the central bank the equivalent of 2 per cent of their outstanding loans, as reserve requirements, giving a central bank tighter control over bank lending and helping to smooth out money market interest rates. Unlike other central banks, the ECB will pay a rate of interest on these bank deposits.

Over the years repos have developed into flexible instruments. Central banks use repurchase agreements to help commercial banks in terms of liquidity. This is the issue which will primarily occupy us in the present chapter, with emphasis on the fact that a repurchase agreement is committing one party to sell a security to another and buy it back at a later date.

In principle, banks and other companies enter into asset sale and repurchase agreements both for trading and for treasury management purposes. But outside the realm of central banks this tends to be a speculative transaction because such deals are often done for leveraging reasons. From a
macroeconomic viewpoint, dematerialisation sees to it that the same security might be pledged in a repo several times: by its owner, its custodian and the exchange. Repos have become more common as lending has been increasingly securitised. If the asset in a repo is certain to come back to the selling institution at some predetermined date, then the credit risk on the asset sold remains in full risk with the seller.

However, an additional credit risk arises from the possibility of default of the counterparty to the repo deal. The potential size of this counterparty exposure depends on the type of security involved, the arrangements made, the margin and interest payments, the maturity of the repo movements in market prices, and other reasons. The exposure is the net cost of replacing the particular asset should the counterparty fail.

2 Basic features of sales and repurchase agreements

Sales and repurchase agreements are deals under which assets are sold by one party to another on terms that provide for the seller to repurchase the asset under certain conditions. Many institutions consider securities borrowing and lending and generally repo operations as being strategically important. This is particularly true of those able to capitalise on AAA or AA credentials, and those who have access to substantial custodial holdings of customers’ securities (see section 6).

A variation of a repurchase agreement is an arrangement under which one party holds an asset on behalf of another. Another form of repo is outright forward purchases. They are less common than the more classical repurchase agreements, but the full credit risk remains; therefore it is not considered prudent to offset forward sales against forward purchases in assessing credit risk unless the transactions are with the same party. Even then there may be legal issues to be considered before netting.

Combined with the globality of their operations, the activity in securities borrowing and lending enables financial institutions to deliver more diversified services to customers in different financial markets. This policy capitalises on the fact that a bank or investor holding an inventory of assets (for instance, bonds) can fund his position in the repo market, doing so either on term or overnight.

Since repurchase will take place on a specified day in the future, this effectively means that the seller is borrowing money. The repo operation connects the underlying cash market and the futures market. The sale price may be market value, but it could also be another mutually agreed price. The difference between the buy-back price and the selling price is, for any practical purpose, the interest.

Basically, repurchase agreements are a form of collateralised lending by which one party sells securities and agrees to buy them back in the future at