**POLICY FRAMEWORK FOR REPURCHASE AGREEMENTS "REPOS"**

**TRINIDAD AND TOBAGO SECURITIES AND EXCHANGE COMMISSION**

# *Guidelines on Sale and Repurchase Agreements*

**April 09, 2009**

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# PART I – BACKGROUND AND PURPOSE

## *What is a Repo?*

"*…A Repurchase Agreement or 'repo' is the sale of a security with a commitment by the seller to buy the same security back from the purchaser at a specified price at a designated date in the future…*"[2]. Consequently, the terms "repurchase agreement" and "repo" will be used interchangeably throughout this document. The **repurchase price** is the price at which the seller and the buyer agree that the seller will repurchase the security on a specified date called the **repurchase date**.

Accordingly, a repurchase agreement may be viewed as a secured loan where the seller of the repo is the borrower, and the buyer of the repo is the lender. The difference between the sale price and the repurchase price of the repo may be viewed as the dollar cost of the loan. Based on this dollar cost of the repo, its sales price, and the term of the repurchase agreement an implied interest rate called the **repo rate** can be calculated.

When the term of the repo is one day, the repo is referred to as an **overnight repo**. When the term of the repo is greater than one day, the repo is called a **term repo**.

At the time of issuance of the repo, the seller delivers securities as collateral and receives cash (the sale price of the repo) from the buyer. On maturity the collateral is returned the seller, and the seller in turn pays the buyer the cash that was borrowed plus repo interest (the repurchase price).

"Market practice defines Repos from the perspective of recognized dealers – in other words, if the dealer lends securities (and borrows cash) the trade is a repo, if the dealer borrows securities (and lends cash) it is called a reverse repo[3]".

## Other Important Characteristics of Repurchase Agreements

- **Substitution -** Repurchase Agreements may be entered into with or without the right of substitution. Where a right to substitution is included in a Repo, it means that the seller can replace the original securities which have been pledged as collateral for the loan with similar collateral.

- **Margin –** Margin may be defined as the amount of cash or securities that must be set aside by a party before that party enters into a contract. For the purposes of Repo transactions, margin represents the amount by which the value of the underlying security exceeds the sale price (the amount of cash borrowed) of the repo. Margin in a Repo agreement protects the buyer of the Repo against a fall in

[2] Fabozzi 2004
[3] Burke and Martello – Securities Lending & Repurchase Agreements – Edited by Frank Fabozzi

the value of the collateral. "In practice, margin is always taken and can range from 2% to 50% of the collateral value, depending on the perceived risk of the transaction from the cash lender's point of view"[4].

As a result of Margins being used in Repos, the initial sale price of the repo is less than the market value of the underlying securities. This ensures that in the event of default, the collateral is likely to be valued more than the cash lent in the transaction. Further, this seeks to ensure that there is sufficient collateral in the event of a fall in the market value of the securities that are the subject of the Repo.

- **Mark to Market –** Closely related to the concept of Margin is Margin Maintenance or Marking to Market. In finance, marking to market refers to the process whereby a value is assigned to a financial instrument based on the current market price of that instrument. This is normally done to ensure that the margin requirements for a particular security are being observed.

  With Repurchase Agreements, where the market value of a Repo falls below that required by the Margin Requirements, the Seller will be required to either pledge additional securities, or cash, to ensure that the value of the assets pledged as collateral are sufficient to cover the repurchase price of the Repo or to meet the margin requirements originally agreed to.

- **Settlement Method –** The settlement and custodial arrangements associated with Repos form an essential part of the transaction. The settlement method essentially refers to the manner in which a Buyer's interest in the underlying securities is transferred to him for the duration of the Repo. Some of the more prominent settlement methods include:

  i. Hold in Custody Repos – In this arrangement, the securities being pledged as collateral are held by the seller in its own account for the benefit of the buyer. Generally, the securities are held in a segregated account.

  ii. Tri Party Repos – In these Repos, the securities being pledged as collateral is held by an entity other than the seller or the buyer.

## *Benefits of Repurchase Agreements*

There are a number of benefits of using Repos, which have resulted in their rapid growth locally. Market participants who include financial institutions, brokerage houses, and securities companies have found that Repos are a convenient way of improving their respective cash flow situations or sourcing cheap financing. For institutions facing a cash flow shortage or facing long positions in securities, Repos offer an efficient alternative to liquidation, while institutions who are in cash rich situations such as money market funds

[4] Choudry 2006

find them particularly attractive as they are a relatively secure investment option that offers enhanced returns.

These transactions also lead to greater market liquidity, lower the cost of raising funds for capital market borrowers and generally reduce counterparty risks in money market borrowing and lending since collateral is assigned for the transaction.

## *Inherent Risks associated with Repo – Need for regulation*

All securities transactions are subject to various levels of risk. These risks however, are particularly acute in unregulated environments. Limited or no regulation can lead to lax internal controls and imprudent practices that could ultimately place investors and market actors at risk.

Though the very nature of a Repurchase Agreement is a legal contract, meaning that failure to comply with applicable legal provisions can subject participants to civil and in some cases, criminal sanctions; counterparties are not protected against the most significant transactional risk it faces, namely counterparty insolvency. A well drafted securities lending agreement, the segregation of collateralised securities and appropriate guidelines can however mitigate some of the risks.

These risks can be grouped into the following areas:

- **Credit Risk –** The risk that an issuer of debt will default on its repayment obligations or the risk of a downgrade of the quality of the collateral.
- **Liquidity Risk –** The risk that the market for its assets becomes too thin to enable fair and efficient trading to take place
- **Legal Risk –** The risk to earnings or capital arising from unenforceable contracts, lawsuits, adverse judgments, or non-conformance with laws, rules, and regulations. In instances of default the process of liquidation or administration can be lengthy.
- **Market Risk –** Risk arising from movement in prices in financial markets, i.e. the uncertainty of the assets prices when securities are sold.
- **Operational Risk –** The risk of direct or indirect loss resulting from deficiencies in information systems or internal controls, inadequate or failed internal processes, people and systems or from external events resulting in unexpected loss.
- **Custody Risk –** The risk of loss of securities held with a custodian as a result of insolvency, negligence or fraudulent action by the Custodian.

## *The Position of Repurchase Agreements in Trinidad and Tobago (December 2006)*

The aforementioned study which was conducted in 2006 focused on market actors registered under the SIA. The selected companies were as follows-

a) Caribbean Money Market Brokers Limited (CMMB);
b) First Citizens Securities Trading Limited (FCB);
c) RBTT Merchant Bank Limited (RBTT);
d) Scotiabank Trinidad and Tobago Limited (Scotia);
e) AIC Capital Market Brokers Limited (AIC);
f) Scotia DBG Investments Limited (Formerly Dehring, Bunting & Golding Limited - (DBG));
g) Bourse Securities Limited (Bourse); and
h) Guardian Asset Management Limited (GAM).

The seven market actors that reported engagement in the sale of securities under repurchase agreements conducted business in the total amount of TT$7,983 million. At the time of the study, two companies, CMMB and FCB, were securities companies whose principal business activity included selling securities under repos. The following table illustrates the size and volume of repurchase activity, as at December 2006, in the local repo market.

**SCALE AND SCOPE OF REPURCHASE ACTIVITY**

| Company | Total Volume (TT$m) | Market Share (%) | Counterparties to Repurchase Agreements? | | | | |
|---|---|---|---|---|---|---|---|
| | | | Financial Institutions/ Securities Companies | Large Business/ Government Entities | Medium/ Small Businesses | Credit Unions | Individual Investors |
| CMMB | 6,213 | 77.8 | Yes | Yes | Yes | Yes | Yes |
| FCB | 1,000 | 12.5 | Yes | Yes | | | |
| RBTT | 567 | 7.1 | Yes | | | | |
| Scotia | 94 | 1.1 | Yes | | | | |
| AIC | 80 | 1.0 | Yes | Yes | Yes | | |
| DBG | 15 | 0.2 | Yes | Yes | Yes | Yes | Yes |
| Sagicor | 14 | 0.2 | Yes | | Yes | | Yes |
| Bourse | 0 | 0 | Yes | Yes | | | Yes |
| Total | 7,983 | | | | | | |

The Report included some general observations regarding this industry. These observations included the following-

a) With respect to custody arrangements the Repo securities generally remained in the name and under the control of the seller. Issues related to this practice were that:-
    (i) the selling company could sell or otherwise deal with the security without reference to the collateral status, resulting in erosion of the client's security;
    (ii) the purchasing client could not readily dispose of the security in circumstances in which the seller did not repurchase as agreed under the terms of the transaction; and
    (iii) the purchasing client's interest in the security in the event of insolvency of the seller was ambiguous.

b) There was a general lack of margins. Margins provide a buffer to the purchasing client so that the value of the security can fall to a certain amount without compromising full collateralization of the funds advanced under the repo. The lack or margin could effectively result in the company taking a position in the repo securities, potentially being funded by capital. The general lack of margins means that when securities' values fall, the collateral Repos will be valued less than the repurchase price. In these circumstances, the company will need to have sufficient capital to absorb losses in the portfolio and acquire assets to meet the collateral shortfall. Inadequate capital in this regard can result in insolvency. In addition, the prevalent practice of not applying margins and marking-to-market on a daily basis, introduces the risk of unidentified capital deficiency.

c) There are liquidity risks inherent in Repo activities. Companies that sell Repurchase Agreements as a line of business earn a spread between the yield on the securities and the rate paid on the repo. This usually involves funding longer-term, higher yield securities by a series of short-term Repos at lower rates. The continued funding of the portfolio relies on roll-overs of existing repos and where this is not done, sourcing of new purchasers/investors. Companies face liquidity risks since any disruption in the flow of funds will mean that alternative funding must be sourced quickly. In such cases the funding cost is likely to be higher than the Repo rate and can even result in negative spreads.

d) Clients that purchase securities under Repos are exposed to the credit risk of the seller. This risk is mitigated to a large extent by the assignment of collateral securities and the Repo rate takes this into account. This mitigation is, however, weakened and the credit risk exposure increased when there is no margin on the securities, no legal assignment of the security and no additional assignments for mark-to market losses.

The Study revealed that the level of disclosure and documentation varied with the sophistication of the client. Financial institutions and other financially sophisticated clients received more complete and comprehensive documentation and their interests in the collateral were more likely to be protected and preserved. In addition, such clients were likely to receive more disclosure regarding the details of the terms and conditions.

Further, it appeared that some individuals and non-financial clients may not have fully understood the nature of the transactions in which they engaged, (including the fact that they are repurchase agreements), and may have regarded them as other fixed income investments with all the usual safeguards such as an executed trust deed, a trustee and regulatory oversight.

## *Should Guidelines be Developed for Repurchase Agreements?*

All financial services activities that involve solicitation and receipt of funds from the public should be subject to regulatory oversight to safeguard the interest of those providing funds. Commercial banking and the issue of debt securities fall into the category of financial services and are subject to regulatory oversight. Repurchase Agreements fall into this category and whether regarded as collateralized borrowing or the issue of securities, they are packaged and offered as investments for which funds are solicited from the public.

It is recommended that Repurchase Agreement activities by Securities Companies be subject to regulatory oversight by the Commission. Reasons therefore, include the following-

a) Repos are packaged and marketed by Securities Companies as securities;
b) Repos are sold to the public;
c) Repos are not regulated as deposit taking business under the Financial Institutions Act, 2008;
d) Total activity is material in amount and any significant disruptions or company failures could impact the confidence and order of the securities market;
e) A large number of small and unsophisticated clients now participate in the Repos market and, having regard to the level of disclosure that now attends the distribution of repos, it is likely that most of these clients lack a proper understanding of the nature and the risks of the transactions;
f) unsophisticated clients are not in a position to ensure the maintenance of reliable controls and adequate operational practices; and
g) The Commission is charged under the Act with the responsibility for maintaining surveillance over the securities market and to ensure orderly, fair and equitable dealings in the securities market. Thus unsophisticated investors are likely to rely on the Commission to safeguard their interests by taking appropriate measures to have such companies carry on business in a prudent manner.

As stated above, repurchase activity is not regulated in Trinidad and Tobago, and as a result there are no reporting or operational requirements administered by any regulator. However, the legislative process for the introduction of legislation which is intended to regulate this industry is a protracted process.

Accordingly the Commission, in order to fulfil its broad mandate to protect investors, ensure fairness and efficiency in the market and minimize the potential risks to the

system, has decided, in the interim, to issue these guidelines under **section 6(b)** of the SIA in respect of sale and repurchase agreements. The market should be aware that in fulfilling this mandate, it is the Commission's intention to review these guidelines and enact the same as By-Laws in the near future.

## *What Will Be Regulated?*

It is important to note that Repo transactions in the local market can be considered as being issued to serve either one of two purposes. Namely:

1. To meet short term borrowing/liquidity needs. This will include Repo transactions between the CBTT and financial institutions licensed under the Financial Institutions Act, 2008 ("the FIA"),

2. As an investment product and as part of a Securities Company's normal day to day activities, Securities Companies who stand ready to sell securities pursuant to Repos at any given time as a core business activity for the purpose of making a profit on the difference between the return earned from the security sold pursuant to the Repo and the Repo rate that is paid to the buyer of the Repo.

For the purposes of these Guidelines, Repo Agreements that are issued to meet short term borrowing/liquidity needs between CBTT and institutions licensed under the Financial Institutions Act, 2008 will be exempted from the registration requirements that are being developed in these Guidelines

Repurchase Agreements, that are being issued by Securities Companies and Financial Institutions regulated by the CBTT to either retail investors or sophisticated purchasers as defined under the SIA, must satisfy the full requirements of the Guidelines which include, inter alia:

- Registration of the Master Repurchase Agreements with the Commission together with the concomitant registration of the seller of the Repurchase Agreement as a reporting issuer, if the seller is not already registered;
- Structuring of the Repurchase Agreements in accordance with standards set out in these guidelines;
- Abiding by the fit and proper criteria identified in these guidelines;
- Complying with the continuous reporting requirements set out in these guidelines as well as the applicable requirements of the SIA and its related By-laws.

A distinction will be made between repos that are offered to retail investors and those offered to sophisticated purchasers. Retail investors would be defined as all purchasers other than those defined as "sophisticated purchasers".

## *Policy Issues*

In order to prescribe the appropriate guidelines for Repo transactions various policy decisions are required with regard to the major features and permutations of Repos. The following outlines the staff of the Commission's primary stance on these major issues.

### Eligible Collateral

The following securities eligible to be the subject of repos that are being issued to Retail Investors:

- Bonds Issued or guaranteed by GOTT;
- Bonds issued by other Governments for which a price can be established; and
- Corporate bonds listed on a recognized exchange.

Only those securities for which a secondary market exists should be the subject of a repo that is being sold to retail investors. The secondary market could either be a listed market or an over the counter market but there must be evidence of transactions in the past for that type of security. In addition, the seller and buyer should be able to attach a value to the purchased security within a relatively short time frame and at minimal cost.

Repos being sold to sophisticated purchasers may be based on any security that both parties agree upon. The rationale here is that the retail investor may not possess the skill or resources to make an accurate assessment of the underlying security's risk or value.

### Eligible Parties

Persons wishing to issue Repurchase Agreements must be registered as either a financial institution under the FIA or a Securities Company, Dealer, or Underwriter in accordance with the SIA. These requirements seek to ensure that oversight with regard to capital requirements for lending and securities transactions already exist. These entities should also possess the technical resources and capacity to conduct Repo transactions. Participants should ensure that there are no legal obstacles to their undertaking of Repo transactions and that, where appropriate, they have obtained the necessary permissions from their regulatory authorities.

Repo sellers/issuers should ensure that they have adequate systems and controls for administering Repos including clear and timely record keeping, adequate systems for ensuring valuation of collateral given and received on a timely basis, adequate documentation to cover the types of transactions and acceptable systems to account for tax purposes.

In addition to the above requirements, Repo Issuers will be required to be registered with the Commission as a Reporting Issuer in accordance with Section 64(2) of the SIA prior to issuing repos.

## Segregation of Purchased Securities – Tripartite Agreements

Currently various custody and transfer arrangements are practiced by various market participants according to the Study conducted in 2006. In many instances a tripartite relationship is established where a local trust company performs as a custodian on behalf of the buyer. It is also not uncommon for the seller via its affiliated trust company to act on behalf of the buyer as its custodian.

Of particular concern to the Commission are instances where securities remain in the custody of the seller and are not segregated. In other words securities intended as collateral for the agreement are not maintained in a separate portfolio distinct from other assets not intended for sale and repurchase.

To ensure the orderly growth and development of the market and to safeguard the interest of the buyer in a Repurchase Agreement the Commission proposes that all Repurchase transactions take the form of a tripartite agreement requiring a custodian to hold on to the buyer's securities for the life of the transaction. This ensures that in the event of default by the seller the buyer is protected.

To further minimize legal risk associated with Repo transactions the Commission prescribes that the purchased security be transferred to and held by a third party custodian, like the Trinidad and Tobago Central Depository. This approach ensures that the collateralised assets are completely segregated and free from liens or instances of double collateralisation.

The Trinidad and Tobago Central Depository ("TTCD") is the designated custodian for Repurchase Agreements.

## Master Repurchase Agreement

Repurchase Agreements may for convenience be written in the form of a Master Repurchase Agreements wherein the standard terms and condition are set out in an agreement, which is signed once by the client. Each specified transaction must be evidenced by a transaction confirmation which would include the terms and conditions of the transaction (date, interest rate, amount, etc) as well as a provision incorporating by reference all the provisions of the Master Repurchase Agreement. The terms and conditions in the transaction confirmation cannot vary, alter or modify in anyway the terms and conditions in the transactional agreement and a clause to this effect must be included in the Master Repurchase Agreement.

The Master Repurchase Agreement document should state:

- That from time to time two parties will enter into a transaction where the seller agrees to sell to the buyer for specific periods of time. At the end of this period, the buyer agrees to sell and the seller agrees to repurchase the securities at a specified price; and
- That unless otherwise specified, the contract should apply to all Repurchase transactions between counterparties.

This policy statement provides general guidance on the steps institutions should take to protect their interest in securities repurchase transactions. However, ultimate responsibility for establishing adequate procedures rests with the management of the institution. Counterparties may find it useful to adhere to the Master Repurchase Agreement drafted by the Securities Industry and Financial Markets Association, the international best practice standard for repurchase agreements.

## Margins and Capital Requirements

Repurchase Agreements must be margined at the outset. i.e. under any repurchase agreement a buyer must pay less than the market value of the securities, with the difference representing a predetermined margin. The margins prescribed must give consideration to the term of the Repurchase transaction and the type and the maturity of the underlying securities thereby allowing for the anticipated price volatility of the security for the life of repurchase agreement.

Questions have also arisen with respect to whether Repo issuers should be required to maintain minimum capital for each repurchase transaction that they undertake. This is similar to what is required of Banks under the Basel Accords and what the Commission has prescribed for Underwriters of securities via the Underwriting Guidelines[5].

Essentially, the Basel type accords would require that Securities Firm hold certain levels of capital for each asset they own depending on the risk profile of that asset. The Staff are of the view, however, that this type of requirement should not be applied specifically to repurchase transactions. Rather, all securities companies should be asked to adhere to these requirements. Moreover, the Commission should consider applying Basel Type capital requirements to all securities companies rather than just Underwriters and Issuers of Asset Backed Securities.

In light of the foregoing, the staff of the Commission is of the view that margins must be applied to all repurchase transactions. The actual level quantity of the margin would vary depending on the maturity of the repurchase transaction, the type and maturity of the underlying securities, and the basic creditworthiness of the counterparty thereby allowing for the anticipated price volatility of the security until the maturity of the repurchase agreement.

[5] Guidelines for Underwriters and Issuers of Asset Backed Securities

Additional considerations will have to be taken into account when determining the margin requirements for less marketable and less secure securities to compensate for illiquid and less stable market conditions.

The recommended Margins are contained in Appendix 2. These prescribed margin requirements should be interpreted as minimum standards to be applied to Repo transactions so that repo sellers can opt for more stringent margin requirements should they so desire. In arriving at the Margin Requirements the staff considered the margin requirements prescribed in the Basel Accords and repo specific regulations in other jurisdictions. These requirements generally use credit ratings as one of the criteria to classify the securities upon which repos are issued and the concomitant margin requirement. Given the absence of an established policy or procedure which recognizes and regulates credit rating agencies in Trinidad and Tobago however, the staff are reluctant to use credit ratings as the primary basis upon which margin requirements will be determined.

Instead, the staff intends to categorize the securities based on:

1. Type of Issuer;
2. Tenor of the instrument; and
3. Creditworthiness of the issuer of the underlying security, where available.

The schedule below lists the proposed margin requirements for securities which would be the subject of repurchase agreements in Trinidad and Tobago. The schedule prescribes minimum margin requirements (haircuts) for the repo transactions based on the type of issuer, the credit quality of the issuer and the remaining term or tenor of the collateral underlying the repo transaction. In arriving at this framework, consideration was given to recommendations put forward by the Securities Dealers Association in Trinidad and Tobago (SDATT) as well as existing margin requirements established under the United States regulations and the Basel II framework. The Commission will accept credit ratings from the following:

- Standards and Poor's
- Moodys Investment Services
- Fitch Ratings
- Caribbean Information and Credit Rating Services Ltd (CariCRIS)

## Margin Requirements

| Security | Residual Maturity | Margin | | | | |
|---|---|---|---|---|---|---|
| | | **Securities Dealers Association of Trinidad and Tobago (SDATT)** | **US SEC** | **Basel II** | **Mean** | **Recommended** |
| **Investment Grade** | Up to 1 yr | 2% | 1% | 1% | 1.33% | **1%** |

| | | | | | | |
|---|---|---|---|---|---|---|
| **- Sovereign** | | | | | | |
| | Over 1yr to 3yrs | 2% | 3% | 3% | 2.67% | **3%** |
| | Over 3 yrs to 7 yrs | 3% | 4% | 6% | 4.33% | **4%** |
| | Over 7 yrs to 11 yrs | 4% | 4 ½ % | 6% | 5.00% | **5%** |
| | Over 11 yrs | 6% | 4 ½ % - 6% | 6% | 6.00% | **6%** |
| **Investment Grade - Corporate** | Up to 1 yr | 2% | 2% | 2% | 2.00% | **2%** |
| | Over 1yr to 3yrs | 2% | 5% | 6% | 4.33% | **4%** |
| | Over 3 yrs to 7 yrs | 3% | 7% | 12% | 7.33% | **7%** |
| | Over 7 yrs to 11 yrs | 4% | 7 ½ % | 12% | 8.00% | **8%** |
| | Over 11 yrs | 6% | 7 ½ % - 9% | 12% | 9.00% | **9%** |
| **Non – Investment Grade (rated above C)** | Up to 1 yr | 6% | - | 15% | 10.50% | **15%** |
| | Over 1yr to 3yrs | 7% | - | 15% | 11.00% | **15%** |
| | Over 3 yrs to 7 yrs | 8% | - | 15% | 11.50% | **15%** |
| | Over 7 yrs to 11 yrs | 9% | - | 15% | 12.00% | **15%** |
| | Over 11 yrs | 10% | - | 15% | 12.50% | **15%** |
| **Other Securities** | Flat Rate | 50% | 15% | - | 32.50% | **15%** |
| **Un-rated Securities** | Flat Rate | - | - | - | - | **15%** |

## Margin Maintenance/Mark to Market

The staff is cognizant of the fact that an active secondary market may not exist for the securities that are eligible to be sold via Repurchase Agreements pursuant to these Guidelines. Accordingly, the staff recommends that Repos based on securities for which there is no active secondary market, be marked to market on a weekly basis.

Where possible or reasonably practicable, the seller/issuer of Repos will be required to mark the sold securities to the market not less than daily using a generally recognized source for securities prices.

In the event that the market value of all the outstanding securities loaned, at the close of the trading day when the seller/issuer is marking to market, is less than 100% of the collateral then the seller must provide the additional collateral to the buyer by the close of the next business day as necessary[6]. Conversely if the outstanding securities at the close of trading are more than 100% of the collateral then the custodian must return the extra collateral to the seller by the close of the next business day.

[6] Customer protection rules under the U.S. Securities Exchange Act of 1934, as amended (Exchange Act), and particularly Rule 15c3-3

## Income Payments

In keeping with standard international practice Repo sellers will be entitled to receive all interest and other income ("income") on securities subject to Repurchase transactions to the same extent that it would have been entitled to receive had it not entered into Repurchase transactions on the securities. In the event of an "income" payment made by the security issuer, the buyer must manufacture the "income" and pay to the seller on the same business day it is received.

## Substitution

Repo transactions may cater for the right of substitution i.e. the right for the collateral in the trade, in part or in whole, to be called back and similar collateral supplied to replace it. In such instances, substitution should be allowed only where:

- specified in an agreement between the buyer and the seller; and
- the collateral to be substituted is of equal or greater value than the original asset. Where collateral securities are sold the assigned security must be of equal or greater value than the security that was sold.

## Events of Default

In the event of a default, default procedures should be conducted in accordance with the Master Repurchase Agreement. This agreement should specify in no uncertain terms the events constituting default, the consequential rights and obligations of the counterparties and the full set-off of claims between the counterparties.

Once a decision to declare a default has been taken, it is important and in the interests of both counterparties and the market that the process is carried out carefully. In particular:

a. the non-defaulting party should do everything within its power to ensure that the default market values used in the close-out calculations are and can be shown to be fair and in accordance with the default provisions of the Master Repurchase Agreement.
b. the non-defaulting party decides to buy or sell securities consequent to the close-out; it should make every effort to do so without unnecessarily disrupting the market.
c. the custodian (TTCD) must act in accordance with the Master Repurchase Agreement and transfer the collateral to the non-defaulting counterparty.

## Registration and Disclosure

The prospectus or offering memorandum accompanying an application for registration of the Repurchase Agreements must be prepared, as far as reasonably practicable in accordance with the Commission's Prospectus Guidelines. Notwithstanding this, the

prospectus or offering memorandum must be written in plain English and disclose amongst other things:

1. the identities of the parties to the Master Repurchase Agreement;
2. a description of the product being offered and the risks of investing in the product;
3. a detailed outline of the structure and operations of the repurchase agreement which clearly identifies the terms and conditions of the product; and
4. information on the nature and types of securities underlying the Repos.

The sale price of the Repo will be used as the basis upon which the value of the market access fee will be paid. It will not be necessary to pay this fee at the outset. Rather, the Repo seller must commit to forward the required fee within 90 days of the close of its financial year end.

## Credit Ratings

At this current stage the Commission does not deem it necessary to prescribe Credit Ratings for Securities for the following reasons:

- At the moment given the level of development of the regional Credit Rating Agency ("CRA") industry, CRAs will not be able to downgrade or upgrade security ratings on a timely basis as required for efficient margin and repo rate adjustments.
- The specification of an investment being investment grade according to the Commission's guidelines may suggest that the Commission endorses the investment as a good investment by virtue of their rating classification.
- Regionally there only exists one CRA therefore monopoly pricing could ensue making the cost of conducting credit ratings prohibitive for issuers.

Counterparties, however, are encouraged to incorporate credit ratings as part of their internal credit rating and due diligence process, if the facility is available.

## Confidential Nature of Transactions

The preservation of confidentiality and the maintenance of integrity at all times by a participant are essential for the proper conduct of business in the Repo market. Participants in repo transactions shall at all times treat the names and identities of parties to transactions as confidential to the parties involved. It is incumbent upon all participants to actively ensure that their own behaviour contributes to the confidential nature of the transactions.

# *Conclusion*

All repo participants have a common interest in maintaining stability and promoting the overall stability of the market so that it operates in a sound and orderly manner. To

achieve these aims, it is essential that firms and their staff adopt prudent practices, act at all times with integrity and observe the highest standards of market conduct. These include but are not limited to the following:

a. Treating with the names of counterparties to transactions as confidential to the parties involved;
b. Participants accepting responsibility for the actions of their staff;
c. Participants acting with due skill, care and diligence (to this end, staff should be properly trained); and,
d. Market professionals paying particular attention to ensuring fair treatment for their clients where conflicts of interest occur.

In order for the benefits from the Repo market to accrue generally to participants in the broader financial market, it is essential that Repo activity does not distort the actual Repo market or the securities market itself. To this end, Repo participants must not in any circumstances enter into transactions designed to limit the availability of specific securities with the intention of creating false or distorted markets in the Repo or the underlying securities market.

## PART II – THE GUIDELINES

### *Section I - Interpretation*

1. These Guidelines may be cited as the Repo Guidelines.

2. (1) The following terms explain the meaning of various terms commonly used in the repo market. The same terms are often also used, with the same meaning, in other similar markets such as secured lending. These explanations are only of market usage, and do not purport to be legal definitions

(2) In these Guidelines unless the context otherwise requires -

"**the Act**" means the Securities Industries Act, 1995 as amended from time to time together with its related By-Laws and Fee Schedules;

"Business Day" means (please insert)

**"buyer"** refers to the party who is buying securities under the first leg of a repo;

**"collateral"** refers to securities, financial instruments or deposits of the currency that are delivered by the borrower to the lender to support a loan transaction;

**"coupon"** refers to a fixed interest payment**;**

**"**the **Commission"** means the Trinidad and Tobago Securities and Exchange Commission, a body corporate established under **section 4** of the Act;

**"**the **Exchange"** means the Trinidad and Tobago Stock Exchange Limited;

"**FIA"** means the Financial Institutions Act, 2008 as revised or amended;

**"hair cut"** means initial margin, usually expressed as a percentage of the market price;

**"initial margin"** is the excess of cash over securities or securities over cash in repo transactions;

**"maintenance of margin"** see **"re-pricing";**

**"margin"** is where the market value of collateral is adjusted so that it is greater than the amount of cash being lent; this is to protect the cash lender from a drop in value of the collateral;

**"margin call"** is a request by one counterpart for the initial margin to be reinstated or to restore the original cash/securities ratio to parity;

**"mark-to-market"** means the act or process whereby a value is assigned to a financial instrument based on the current market price of that instrument. This is normally done to ensure that the margin requirements for a particular security are being observed;

"purchaser" see "buyer";

**"repo" or "repurchase agreement" or "sale and repurchase agreement"** is *the sale of a security with a commitment by the seller to buy the same security back from the purchaser at a specified price and at a designated date in the future*…;

**"re-pricing"** occurs when the market value of a security in a repo changes and the parties to the transaction adjust the amount of securities or collateral in the transaction to the correct margin level;
"retail investors" means buyers or purchasers other than sophisticated purchasers defined below;

**"reverse repo"** is the mirror image of a repo, the party that is reversing purchases securities from another party and simultaneously agrees to resell the securities at a future date at a fixed price;

**"seller"** refers to the party who is selling the securities under the first leg of the repo;

"sophisticated purchaser" means the persons defined in section 67(2) of the Act;

**"substitution"** is the ability of a lender of securities to recall them from the borrower and replace them with other securities.

3. (1) These Guidelines are not intended to regulate repos issued between institutions licensed under the Financial Institutions Act, 2008 and the Central Bank of Trinidad and Tobago, but is intended to regulate repos issued by these same licensed institutions to sophisticated purchasers and retail investors.

(2) The requirements set out in these Guidelines apply in addition to any other requirements contained in the Act, By-Laws or any other Guidelines.

## *Section II – Conduct of Business*

4. (1) The purpose of these guidelines is to set out standards of best practice for the Trinidad and Tobago Repurchase Agreement Market ("the repo market") so that the repo market would function in a sound and orderly manner.

(2) Participants in the repo market shall at all times conduct their business in such a manner so as not to bring the repo market into disrepute.

(3) No participant shall under any circumstances enter into repo transactions specifically to limit the availability of any securities with the intention of creating a false or distorted market in that security.

## *Section III – Business Hours*

5. (1) Unless the parties to the trade otherwise agree all trades, except overnight and open trades, done 30 minutes before the close of business on the Exchange are assumed to be cash trades and all trades, except overnight and open trades done after this time are assumed to be next day settlement trades.

(2) Unless the parties to the trade otherwise agree all overnight and open trades are assumed to be cash trades until the relevant cut-off time.

## *Section IV - Collateral Securities*

6. (1) Repos to buyers other than sophisticated purchasers as defined by the SIA should be restricted to the following:

a) Bonds Issued or guaranteed by the Government of the Republic of Trinidad and Tobago;
b) Bonds issued by other Governments for which a price can be established; and
c) Corporate bonds listed on a recognized exchange.

(2) Collateral securities must not be used to cover short sales.

(3) Collateral Securities must not be subject to margin purchases where these are held by other brokers.

(4) Collateral securities must not be otherwise pledged or used as collateral.

## *Section V – Business Day Convention*

7. All market participants shall use the Modified Following Business Day Convention, where if the maturity date of a repo falls on a day that is not a Business Day the maturity date shall be the first following day that is a Business Day, unless that day falls in the next calendar month, in which case the maturity date will be the first preceding day that is a business day. Market participants are encouraged to both inquire and to specify the exact maturity dates for transactions prior to maturity.

## *Section VI – Repo Cost*

8. Unless otherwise agreed by the parties, calculation of repo cost is on the basis of 365 days per year.

## *Section VII – Purchase Price*

9. Unless otherwise agreed between the buyer and the seller, the purchase price shall include the accrued interest. The prevailing market prices shall be used as a guide when determining the purchase price of the securities.

## *Section VIII – Substitutions*

10. (1) Substitution should be allowed only where specified in an agreement between the buyer and the seller, and the agreement will include specification of the securities that may be substituted, records to be kept and requirements for disclosure to the investor.

(2) Collateral securities should not be sold without first assigning another suitable asset in its place and there should be a process in place and controls to ensure assignment.

(3) Substitution of assets will only be permitted where the collateral to be substituted is of equal or greater value than the original asset. Where collateral securities are sold the assigned security must be of equal or greater value than the security that was sold.

## *Section IX – Custody and Custodian*

11. (1) Custody arrangements should provide for all buyers to have a perfected interest in the collateral security.

(2) All securities that are used to collateralize repos sold to buyers shall be held under the custodianship of the Trinidad and Tobago Central Depository ("TTCD").

12. A buyer's interest in collateral securities shall be secured by assignment in the books of the TTCD.

13. (1) The custodian referred to in paragraph 12 above shall maintain adequate separate records in respect of collateral securities including-

(i) movements i.e. sales, purchases and substitutions in the assigned pool of repo securities; and
(ii) physical custody or location.

(2) The TTCD in carrying out its duties concerning the safekeeping of and dealing with the collateral securities, shall exercise-

(i) the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances; and
(ii) at least the same degree of care as it exercises with respect to its own property of a similar kind, if this is a higher degree of care than the degree of care referred to in paragraph 13(2)(i).

(3) A sale and repurchase agreement shall not relieve the custodian from liability to a buyer for losses arising out of the failure of a custodian or to exercise the standard of care or diligence imposed by this Part.

## *Section X – Confidentiality and Integrity*

14. (1) The preservation of confidentiality and the maintenance of integrity at all times by a participant are essential for the proper conduct of business in the repo market.

(2) Participants in the repo market shall at all times treat the names and identities of parties to transactions as confidential to the parties involved. It is incumbent upon all participants to actively ensure that their own behaviour contributes to the confidential nature of the transactions.

(3) Dealers involved in a dealer-to-dealer principal trade shall only disclose certain information regarding the trade, as described in paragraph 14(5) below.

(4) The identity of parties to a transaction shall only be disclosed-

(i) when a broker to the trade has disclosed that it is acting solely as agent (i.e. name give-up or non-blind brokered trades); and
(ii) after the trade is completed (i.e. after the bid is hit or the offer is lifted); and then
(iii) the relevant identities shall only be disclosed to the counterparties to the trade.

This is appropriate to enable member firms to follow sound credit procedures.

(5) When discussing completed trades, brokers and dealers shall only communicate to the parties to the trade the security description, repo rate, size and time of the relevant trade and the number of sellers and buyers involved in the trade.

## *Section XI – Legal Agreement*

15. (1) Repo transactions shall be subject to a Master Repurchase Agreement between the two participants concerned, such as the PSA/ISMA Global Master Repurchase Agreement ('the PSA/ISMA agreement') or other suitable Master Repurchase Agreements agreed by the counterparties. The agreement should enable the participants to comply with any requirements to which they are subject and at a minimum, shall include:-

(i) the principle of plain English;
(ii) a description of the nature of the security and the risk;
(iii) the absolute transfer of title to securities, including any securities transferred through substitution or mark-to-market adjustment of collateral;
(iv) provide for daily marking-to-market of transactions;
(v) provide for appropriate initial margin and for maintenance of margin, or re-pricing, whenever mark-to-market reveals a material change in value;
(vi) specify clearly the events of default and the consequential rights and obligations of the counterparties;
(vii) provide, in the event of default, for full set-off of claims between the parties;
(viii) make provisions clarifying the rights of the parties regarding the substitution of collateral and the treatment of coupon and interest payments including, for example, the timing of any payments.

(2) The Master Repurchase Agreement entered into by the parties shall be void if it contains provisions that conflict with these Guidelines or the Act.

## *Section XII – Margin*

16. (1) A haircut margin shall be applied to all repo transactions that these Guidelines are intended to regulate. The recommended margins are contained in Appendix 2 of these Guidelines.

(2) Unless the parties to the trade otherwise agree, margin calls in all repo transactions shall be met with transfers of collateral or cash, or to re-price the existing transaction. In the event that the party being marked chooses to meet its margin calls with cash, such cash should not be used to change the economic substance of the trade, but it will bear interest at a rate to be determined between the two parties. In the event that the party being marked chooses to meet its margin call with collateral, this will be met with transfers of collateral with characteristics similar to or better than the collateral being "repoed", reasonably acceptable to the counterparty and applied on a reasonable basis.

(3) A party wishing to mark-to-market its counterparties shall do so by 1:00 pm but need not specify which issue is being marked. Such specifications, if agreed to be required by both parties, should be made within one hour of initial notification. Collateral for margin shall be allocated and notified by the counterparty prior to 3:00 pm.

(4) Unless otherwise agreed, it is recommended that all margin obligations be settled on a next day basis. This recommendation is designed to provide flexibility for current settlement agent deadlines however; the goal of the Commission is to recommend that margins be settled in the most timely and efficient manner with the final goal of real time margin.

## *Section XIIV – Confirmation of Deals*

17. (1) Market participants shall ensure that a written or electronic confirmation of both legs of the repo transaction is issued on the day on which the trade takes place. This confirmation shall include -

(i) the nominal amount of the security sold and the price at which the transaction was effected, coupon interest, if any, and the total proceeds of the transaction;
(ii) the type of collateral;
(iii) the value date, the date on which securities are first transferred by the seller to the TTCD;
(iv) the transaction date;
(v) the purchase price, the price at which securities are first transferred by the seller to the TTCD (the purchased securities);

(vi) the repurchase date, the date on which the seller is to repurchase the purchased securities from the buyer; and
(vii) whether there are rights of substitution,

and it is recommended that the counterparties attempt to exchange the maximum information relating to the economically known components of the trade.

(2) The medium of electronic confirmation shall only be used if it is subject to an electronic confirmation of receipt from the buyer for example, confirmation of receipt by e-mail.

(3) Participants shall ensure that any confirmations they receive are checked carefully as soon as possible, normally on the day of receipt, and that any queries on their terms are promptly conveyed back to the issuer.

## *Section XIV – Obligation to Make Coupon Payment*

18. A repo seller is entitled to receive all interest and other income ("Income") on securities subject to repurchase transactions to the same extent it would have been entitled to receive such income had it not entered into repurchase transactions on the securities. Consequently, if an issuer of securities fails to make an Income payment, the repo buyer should not make the corresponding payment to the repo seller.

## *Section XV – Settlement*

19. (1) Unless mutually agreed to between the buyer and seller, settlement shall be on the basis of payment against delivery of the security transacted.

(2) All transactions shall be settled no later than at T=3;

(3) Where the dealer has caused any delay in settlement, the counterparty shall have the right to claim from the dealer the loss of interest, if any, on the net amount of the transactions calculated in accordance with the terms of the Master Repurchase Agreement.

## *Section XVI – Default and Close-Out*

20. In the event of a default, the procedures will have to be done in accordance with the Master Repurchase Agreement. Once a decision to declare a default has been

taken, it is important, in the interests of the participant, the defaulting party and the market, that the process be carried out carefully, in particular -

(i) the non-defaulting party shall do everything within its power to ensure that the default market values used in the close-out calculations are, and can be shown to be fair; and
(ii) if the non-defaulting party decides to buy or sell securities consequent to close-out, it shall make every effort to do so without unnecessarily disrupting the market.

## *Section XVII – Registration*

21. No person shall carry on the business of issuing, proposing to issue, offering or distributing repos to the public unless it is registered with the Commission as a reporting issuer or is registered as a securities company authorized to do business as a dealer pursuant to the Act.

22. No repurchase agreement shall be offered to the public unless it is registered with the Commission.

23. (i) A repurchase agreement may be registered with the Commission by filing a completed registration statement on Form No. 4 of Schedule 2 of the Securities Industry By-Laws, 1997.

(ii) The application must be accompanied by the following documents:

(a) a copy of the proposed prospectus for the distribution of the repos;
(b) the fees set out in the said Securities Industry By-Laws,; and
(c) any other documents the Commission may require.

(iii) A repo issued by an issuer in accordance with the terms of a prospectus for which a receipt has been issued by the Commission, is deemed to be registered with the Commission.

24. The Commission may issue a receipt for a prospectus for issuing repos to a person subject to such conditions as-

(i) it may impose in the public interest; or

(ii) may seem to it necessary, advisable or appropriate to ensure orderly growth and development of the repo market.

## *Section XIIX – Disclosure and Reporting*

25. The issuer shall comply with the provisions for continuous disclosure required by the Act and the Securities Industry By-Laws 1997.

26. (1) The issuer engaged in repo transactions shall -

(i) submit to the Commission the following, including up-dates or revisions as they occur-

(a) the prospectus on the repo products;
(b) policies and procedures for the repo operations;
(c) the Master Repurchase Agreement;
(e) the form of all other transaction documents, e.g. confirmation;
(f) marketing material.

(ii) prepare and submit to the Commission a quarterly report containing-

(a) total investments, total repos and computation of the specific asset and capital ratios;
(b) number of repo clients that are not sophisticated purchasers and the total outstanding obligations to such clients under repos;
(c) a Declaration of Compliance with the Guidelines signed by the Chief Executive Officer and two Directors.

(iii) prepare and submit to the Commission a quarterly report that discloses-

(a) a list of assets sold under the repurchase agreements at current values and the total of such assets;
(b) total 'sales' of each asset and current margin on the asset.

(2) The Financial Statements should be made available to all clients and the Commission for inspection.

(3) The marketing material should –

(i) identify the transactions as repos;
(ii) state that the funds invested are not deposits and not covered by the Deposit Insurance Corporation;
(iii) describe the significant risks, e.g. the residual exposure to the credit risk of the company;
(iv) include a summary of the rights and obligations of both the purchaser and the seller.

## *Section XIX - Operational Requirements*

27. (1) The seller should develop and implement documented policies and procedures for repo operations and monitor compliance.

(2) The seller should ensure that there are-

(i) operational systems for transactional valuation and financial reporting;
(ii) adequate human, financial and operational resources.

(3) The seller shall maintain records of the following –

(i) repo securities and the specific assignment of each to repo transactions;
(ii) substitutions;
(iii) all agreements and communications with clients.

28. The total value of repos outstanding to total assets shall not exceed 60% of the issuers' total assets.

29. The Commission is entitled to inspect and/or request copies of all records, including but not limited to those records kept by the TTCD, the issuer and the seller as stipulated under these Guidelines.

# APPENDIX

## APPENDIX 1

| | Repo | Reverse repo |
|---|---|---|
| **Participant** | Borrower<br>Seller<br>Cash receiver | Lender<br>Buyer<br>Cash provider |
| **Near leg** | Sells securities | Buys securities |
| **Far leg** | Buys securities | Sells securities |

## APPENDIX 2

### Margin Requirements

| Security | Residual Maturity | Recommended |
|---|---|---|
| **Investment Grade - Sovereign** | Up to 1 yr | **1%** |
| | Over 1yr to 3yrs | **3%** |
| | Over 3 yrs to 7 yrs | **4%** |
| | Over 7 yrs to 11 yrs | **5%** |
| | Over 11 yrs | **6%** |
| **Investment Grade - Corporate** | Up to 1 yr | **2%** |
| | Over 1yr to 3yrs | **4%** |
| | Over 3 yrs to 7 yrs | **7%** |
| | Over 7 yrs to 11 yrs | **8%** |
| | Over 11 yrs | **9%** |
| **Non – Investment Grade (rated above C)** | Up to 1 yr | **15%** |
| | Over 1yr to 3yrs | **15%** |
| | Over 3 yrs to 7 yrs | **15%** |
| | Over 7 yrs to 11 yrs | **15%** |
| | Over 11 yrs | **15%** |
| **Other Securities** | Flat Rate | **50%** |
| **Un-rated Securities** | Flat Rate | **50%** |