Repo instruments

Responsible teacher: Anatoliy Malyarenko

August 30, 2004

Abstract

Contents of the lecture.

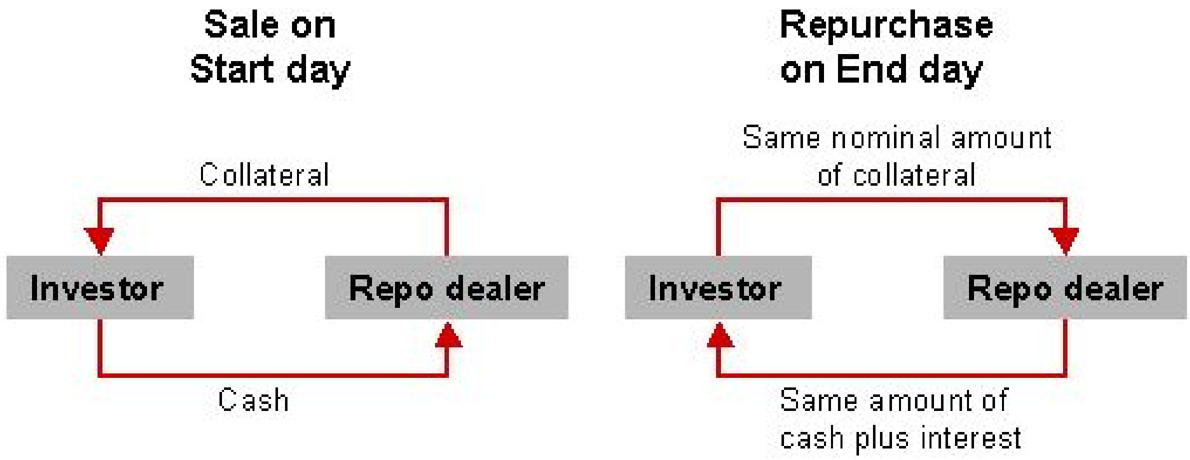
- ☞ Repo/Reverse.
- ☞
- ☞
- ☞

Repo/Reverse: description

A Repo/Reverse involves the sale of assets and a simultaneous agreement to repurchase the same or similar equivalent assets at a future date or on demand for the original value plus a return on the use of the cash. A Repo/Reverse trade is considered a collateralised loan.

☞ A **Repo** involves lending securities with agreement to repurchase at some time in the future.

☞ A **Reverse** involves borrowing securities with an agreement to sell them back at some time in the future.



Other key features of a Repo/Reverse deal:

- ☞ Provides a legal sale of collateral, meaning that the legal title is transferred to the buyer. This provides protection against default for the buyer. Other implications of this characteristic is that the buyer has the right to sell the collateral short, and that the voting rights (on equity collateral) are transferred by the Repo/Reverse deal.

- ☞ Provides an economic loan of cash and collateral, meaning that the risk and return is retained by the seller because sale and repurchase are for same value.

- ☞ Coupons that are paid out during the life of the loan should be transferred to the original owner of the underlying instrument. The present value of a repo trade is the present value of all future cash flows included in the repo transaction. The cash flows are the initial and final payments.

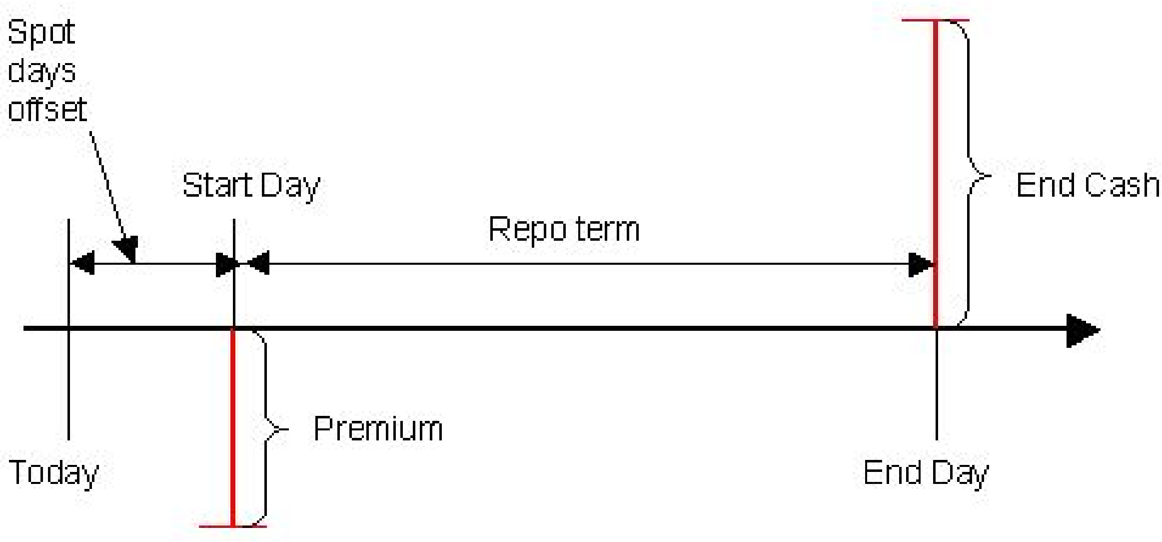
Common cash flow structures

The general cash flow structure of Repo/Reverse instruments depend on the following factors.

☞ Is the deal a Repo or Reverse transaction?

☞ Is the required rate of return fixed, or based on a floating reference rate?

When you are entering into a typical fixed rate "reverse" you face the following cash flow structure:



You pay a premium at start day and receive (borrow) securities as collateral. After the term, you return the securities and receive a cash amount equal to your initial premium plus interest earned during the repo term.