Repo rate and reverse repo rate

Repurchase options or in short repo, is a money market instrument, which enables collateralized short term borrowing and lending through sale/ purchase operations in the debt instruments. RBI uses repo rate to manage their daily or short-term liquidity. Legally, repo means an instrument for borrowing funds by selling securities with an agreement to repurchase securities on a mutually agreed future date at an agreed price which includes interests for the funds that is borrowed. Similarly, the reverse repo means an instrument on a mutually agreed future date which includes interests for the funds lent.

Here is an approach to structure repo and reverse repo rates.

The repo transaction adopted has two legs. In the first leg, the seller sells securities and receives cash, while the reverse happens with the purchaser. Securities are repurchased by the original holder. Repurchasing option happens on a mutually agreed date, under an electronic platform called Negotiated Dealing System or NDS.

The duration between the two legs is called the ‘repo period’. Repos are taken on an overnight basis for a one-day period, or for a maturity of one day known as the term repo.

There are mainly four types of repos based on structuring, known as buy-sell repo transactions, classic repo, hold in custody repo, and tripartite repo. Under the buy-sell repo options, the security is sold outright and bought back under a future date. Classic repo, mostly used in the US, the settlement is the same, while only the interest is paid back. Hold in custody repo allows collateral by the seller to mature until the repo, while eliminating any in-between settlement requirements. Under a tripartite repo, a common custodian arranges for custody, clearing and settlement of repo transactions. Delivery against payment, substitution of securities, automatic market to market, reporting and daily administration takes care of trading entities.

There are a few types of repos operating in India which can be classified into two types- mainly repo on sovereign securities and repos on corporate debt securities. Repo on sovereign securities has three functional segments, namely RBI repo for liquid adjustment facilities, market repo among banks and institutions set by the RBI, and term repo under liquid adjustments. The RBI repo is conducted at a fixed time on a daily basis and on special occasions if liquidity situations want. Market repo rate is determined by the credit worthiness of the borrower, liquidity of the collateral and comparable rates of other money market instruments. As apart to maintain corporate debt market, RBI has permitted select entities- mainly scheduled commercial banks excluding regional rural banks or RRBs, local area banks or LCBs, primary dealers or PDs, non-banking financial companies or NBFCs, mutual funds, housing finance companies and insurance companies to undertake repo in corporate debt securities. Corporate borrowings are used as collaterals for borrowing funds. Listed under AA or AA+ can use these corporate borrowings. Commercial paper, certificate of deposits, non-convertible debentures of original maturity less than one year are not eligible for this purpose.

Repo transactions are used to fund long positions in securities which raise cash through initial repo transactions to buy securities which raise more cash to buy securities determined through a margin known as 'haircut'. Haircut for low-risk banks can be very low, using less volatile collaterals like sovereign bonds, which can be very low. Risking against sovereign bonds can be a tough task, generally used by many countries that are debt laden.

The spread is generally taken under 100 to 150 basis points, starting from a +/ - 100 basis points, with +/ - 50 basis points. The marginal standing facility or MSF will be spread above 50 basis points and below 50 basis points above the repo rate for the buying and selling purpose.

A few norms used internationally are as follows that determine external borrowings and savings.

1. A market for short-term financial instruments
2. Borrowing by pledging a collateral/ asset/ security to the lender of money
3. The percentage by which value of the security is reduced by the buyer of that security for the purpose of calculating the collateral
4. Auctions as 7-day repo rates and 14-day repo rates can be conducted overnight fixed repo and reverse repo
5. Sometimes the central banks will arrest liquidity from the market by sucking out the rupee liquidity
6. The process of selling securities in a market where the price is higher and buying from a market where the price is lower
7. The risk of opposite party not returning the securities lent, or money borrowed
8. Renewal of contracts to another period
9. Commercial paper used as a promissory note can have primary dealers and all India financial conditions
10. Certificate of deposit can be used to issue promissory notes for pay and purchase that can be issued

