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Financial Services Sector Thought Leadership

REPURCHASE AGREEMENTS: A NEW BOOST FOR ACCESSING FINANCE

Author: Okey Nnebedum

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Access to the various financing products in the financial services industry is often limited by the availability of quality collateral assets and the ability of borrowers to meet the generally acceptable levels of compliance and eligibility for financing. In order to develop the capacity of the financial services sector to finance the real sector of the economy, it is important to have flexible financing options and an adequate collateral management system. This will facilitate access to financing for the real sector of the economy and will provide the required comfort to financial institutions and credit providers that their loan assets are satisfactorily secured. The Central Bank of Nigeria's release in April, 2021 of the new Guidelines for the Conduct of Repurchase Transactions is a step in the right direction. The recent development in repurchase transaction regulation provides a new boost for Repurchase transactions in the Nigerian money market and this article seeks to highlight the salient features of repurchase transaction regulation in Nigeria.

A repurchase agreement ("Repo") is a short-term finance instrument that enables money market participants to access alternative source of quick financing. It is the sale of securities with a simultaneous agreement to repurchase those securities at a specified price on a predetermined future date.[1] Repo can also be categorized as securities lending by virtue of Section 318 of the Investment and Securities Act ("ISA") which defines securities lending as the temporary exchange of securities, generally for cash or other securities of at least an equivalent value, with an obligation to redeliver a like quantity of the same securities on a future date and includes securities loans, repurchase agreements (Repo), and self-buy-back agreements.

The Central Bank of Nigeria ("CBN") recently issued new Guidelines for the conduct of Repo transactions in Nigeria essentially replacing the 2012 Guidelines. Repo has been an important financing option for banks and other eligible participants like discount houses. The new CBN Repo Guidelines underscores the importance of repos in the market as the CBN seeks to strengthen the institutional mechanisms for its use.

[1] Repurchase agreement: How it works, https://nairametrics.com/2020/01/30/repurchase-agreement-how-it-works/.

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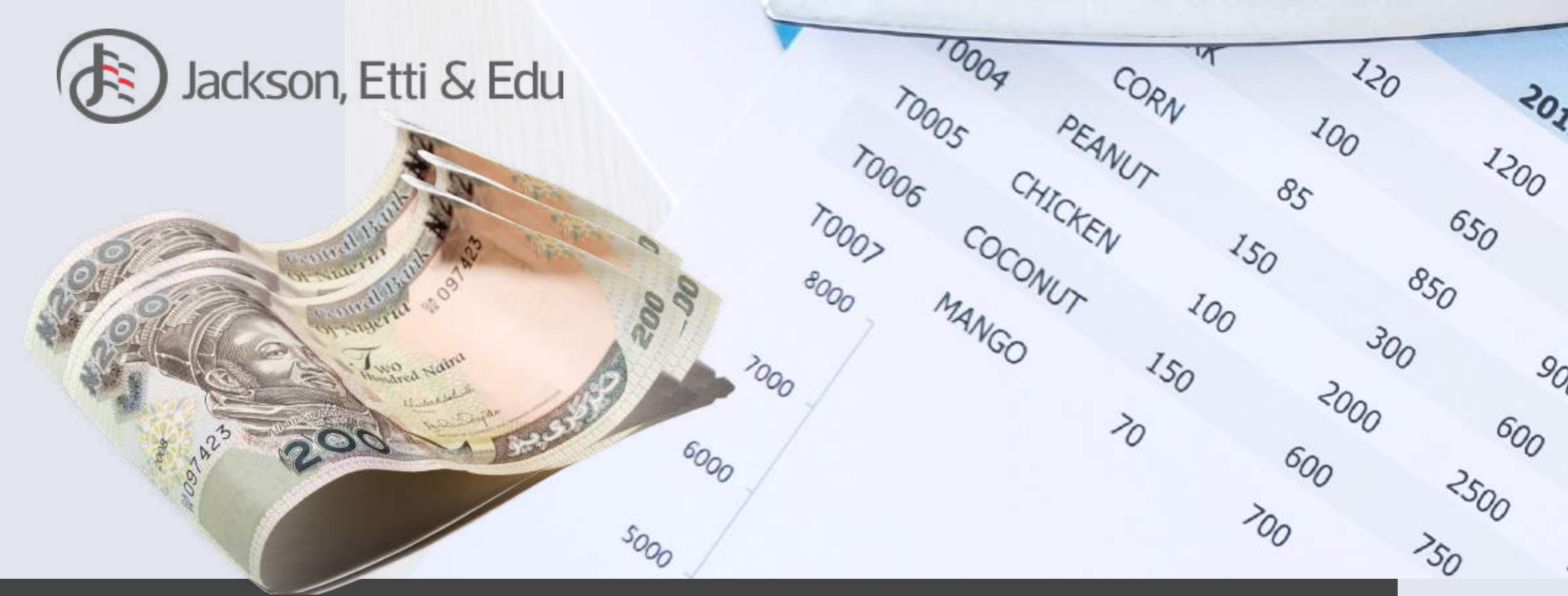

Why are Repos Important?

Repurchase agreements have been described as being instrumental to the efficient functioning of financial markets. Repos have created an avenue for easier, flexible, and short-term funding. Participants are able to quickly access funds by selling the eligible securities and covenanting to buy them back at a slightly higher price.

In addition to this, Repo transactions reduce financial risk as participants who need liquidity in a depressed market are able to exchange their assets into cash through a less risky option. In the Repo market, participants such as banks, broker-dealers and hedge funds who own securities are able to raise short term financing and investors such as investment banks, mutual funds, and high net worth individuals on the other hand, are able to earn return with less risk as the securities serve as collateral.[2]

Furthermore, just like other money market instruments, Repos are essential tools utilized by Central Banks to control money supply. They aid the efficient functioning of financial markets by enabling the redistribution of liquidity between financial institutions[3].

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The Nigerian Regulatory Framework for Repos.

The Nigerian Repo market is to a large extent dominated by the money and interbank markets as the primary liquidity providers[4] and regulators in the financial sector are making significant strides with the continued issuance or regulations, frameworks, and Guidelines to facilitate Repo transactions in the country.

2 Planning for the Development of Repo Market, Report, Reserve Bank of India, 1999 https://www.rbi.org.in/scripts/PublicationReportDetails.aspx?ID=36.

3 *ibid*

4 *FMDQ-Newsletter-Edition-68-June.pdf (fmdqgroup.com)https://fmdqgroup.com/wp-content/uploads/2020/11/FMDQ-Newsletter-Edition-68-June.pdf*

Repo transactions are primarily governed by the provisions of the Nigerian Master Repurchase Agreement ("NMRA") which must be entered by all parties to a Repo transaction. Under the NMRA, Repo is defined as an agreement to sell securities at an agreed price and buy them back at a future date at an agreed price.

The CBN, through its circular FMD/DIR/PUB/GUI/01/001 dated April 12, 2021 released the Guidelines for the Conduct of Repo Transactions under CBN Standing Facilities ("CBN Guidelines"). By virtue of the CBN Guidelines, the CBN will enter Repo transactions under its Standing Lending Facility (SLF) and Term Repurchase Facility (TRF), to provide Naira liquidity to institutions that are unable to access funds on the interbank market.

The SLF is to provide Naira liquidity to eligible institutions who are not able to access funds in the inter-bank market. It has a one day tenor (SLF Repos are overnight Repos) and will be available on all business days between the hours of 5.00 p.m. and 6:30 p.m. or such hours as may be stipulated by CBN from time to time.[5] In addition to this, Repo transactions under the SLF are to be conducted in amounts of a minimum of N100 million and multiples of N1 million or any permissible fractions which shall based on the market value of securities placed for the transaction.[6]

The TRF is a term facility under which Repo transactions can be transacted with the CBN for periods that range from 4 - 90 days.[7] Similarly, it is also available on all business days between 9.00am and 6.30pm and the transactions are also to be conducted in amounts of a minimum of N100 million and multiples of N1 million or any permissible fractions which shall also be based on the market value of securities placed for the transaction.[8] Only Deposit Money Banks (DMBs) and other eligible financial institutions that have executed the NMRA with the Central Bank of Nigeria are eligible to enter Repo transactions with the CBN under the SLF and TRF[9]. The notable difference between 2021 CBN Guidelines and the 2012 CBN's Guidelines[10], is the non-inclusion of discount houses in the 2021 Guidelines. The new Guidelines expressly provides that only DMBs and other eligible financial institution may enter SLF and TRF. The term "other eligible financial institutions" is not defined in the Guidelines.

The eligible securities for Repo transaction include Nigerian Treasury Bills (NTBs), Federal Government of Nigeria Bonds (FGN Bonds), CBN Bills, and any other security that may be approved from time to time.[11] The new Guidelines does not include Asset Management Corporation of Nigeria ("AMCON") bond which was in the 2012 Guidelines. It is imperative to point out that substitution of securities is not permissible.[12]

Under a SLF Repo, if the borrower (the seller) defaults in payment of the repurchase Price on the next business day, securities placed as collateral for the transaction shall revert fully to the CBN (the buyer) position at a rediscounted value.[13] In the case of a TRF, where a borrower (seller) fails to repay the repurchase price on the agreed date, a new Repo transaction will be deemed to have been entered between the parties. The Repurchase Price under the initial transaction becomes the new purchase price and the new pricing rate is set at the applicable rate on the SLF plus five percentage points (or any percentage point as stipulated by CBN). The new transaction is deemed as SLF and the tenor will be overnight. Where the counterparty fails to buy back the new overnight Repo on the next business day, the securities placed for the transaction shall revert fully to the CBN's position at a rediscounted value.[14]

5 Paragraph 5, CBN Guidelines.
6 Paragraph 7, CBN Guidelines.
7 Paragraph 6, CBN Guidelines.
8 Paragraph 8, CBN Guidelines.
9 Paragraph 4, CBN Guidelines.
10 Guidelines for The Conduct of Repurchase Transactions Under CBN Standing Facilities, Dated April 2, 2012, referenced FMD/DIR/GEN/CIR/O3/OO5
11 Paragraph 12, CBN Guidelines.
12 Paragraph 20, CBN Guidelines.
13 Paragraph 23, CBN Guidelines.
14 Paragraph 24, CBN Guidelines.

Settlement Platforms for Repo

Repo transactions are settled under the CBN Real Time Gross Settlement System (RTGS) and the Scripless Securities Settlement System (also known as S4). The S4 portal is the settlement platform administered by the CBN where all government securities such as NTBs are held in dematerialized form and easily traded amongst financial market participants. The movement of trading positions of Repos and inverse Repos between sellers and buyers are conducted under a transparent process enabled by the S4 platform. In the same vein, the RTGS is a settlement platform for credit transfer instructions on participants' accounts with the CBN. It provides a platform for real time processing and settlement of payment and guarantees transaction finality and irrevocability.

Recharacterization of Repos

The question as to whether Nigerian courts can recharacterize a Repo as security for loan other than a sale always arises. This remains a controversial issue because it has not been considered before the Nigerian courts; and due to divergent views expressed in that regard, certain views are to the effect that an underlying intention to return the securities on the repurchase date has the characteristics of secured lending such as mortgage. In jurisdictions like England, the courts have held (in Welsh Development Agency v Export Finance Co (1992) BCC 270 and other cases) that Repos are sale transaction and not secured lending. Although there is no Nigerian case on recharacterization of Repo, the express provisions of the relevant regulations should provide useful guidance. The NMRA has expressly defined Repo as a sale transaction. Similarly, the Fixed Income Securities Investment Clients Service Guidelines issued by the FMDQ OTC Securities Exchange, also define Repo as "a sale of securities with a simultaneous agreement to repurchase those securities at a specified price on a predetermined future date". It is our considered view that Nigerian courts, if presented with an opportunity, would rely on the express provisions of the various regulatory guidelines as well as persuasive judicial authorities in other common law jurisdictions which is to the effect that Repo is a sale transaction.

Conclusion

The CBN's recent Repo Guidelines offers an opportunity for deepening the growth of Repo in the money market. Ultimately, this effort is expected to increase liquidity for the real sector, provide alternative, flexible finance tools and enhance creativity in the financial services sector.

KEY CONTACTS:

ADEKUNLE SOYIBO
Partner, and Co-Sector Head,
Financial Services Sector

OKEY NNEBEDUM
Senior Associate, and Co-Sector Head,
Financial Services Sector