What is a repo?[1]

A repo is a sale and repurchase agreement: Party A sells securities to Party B with a legally binding agreement to purchase equivalent securities from Party B for an agreed price at a specified future date, or at call. Legal ownership to the securities changes – normally via an adjustment in the book-entry depository system - giving Party B full (“unfettered”) title to the securities. Party B may use or dispose of them as it pleases; but it has an obligation to deliver equivalent securities to Party A at the end of the repo. Party A’s spot sale and forward purchase (repo) is matched by Party B’s spot purchase and forward sale (“reverse repo”).

The interest rate implied by the difference between the sale price and “repurchase” price is the repo rate. If Party A is selling securities to Party B in order to raise finance for itself, then the repo rate is, in effect, the cost to Party A of raising secured funds. Party B can “lend” money to Party A for a “repo rate” of interest, and receive government securities. This is a general collateral, or GC, repo (see Figure A), and is normally initiated by the party which wants to borrow money i.e. the cash taker.

Figure A: General Collateral Repo (in non-specific stock)

First leg of the GC repo:

Party A

sells 100 worth of government security[1] ⇒

⇐ pays 100 cash for the government security

Party B

[1] with a nominal value of X; or X/(1-V%) if initial margin is included.

Party A now has 100 of cash, against which it has delivered 100 worth of security to which Party B has full title.

Second leg of the GC repo:

Party A

pays 100 cash plus repo rate ⇒
of, say, 6 1/2%[3]

⇐ sells X nominal of the government security

Party B

Party B has earned 6 1/2% “interest” on its cash and Party A has paid a lower rate of “interest” for the cash than might have been the case if it had raised unsecured finance.

[1] S. Gray: »Repo of Government Securities.« *Handbook in Central Banking*, No. 16, Center for Central Banking Studies, Bank of England, 1998