BOX 12
Standardising the Market Practices for Repurchase and Reverse Repurchase Transactions in Government Securities

Background

Government securities are debt instruments issued by a government to borrow money to fund its expenditure. In the Sri Lankan context, the most common rupee denominated government securities are Treasury Bills and Treasury Bonds. Treasury Bills are issued for a maximum tenor of one year while Treasury Bonds are issued for tenors of over one year and typically up to 30 years. The Central Bank of Sri Lanka (CBSL), as the statutory manager of government debt, is tasked with the issuance and management of Treasury Bills and Treasury Bonds on behalf of the government, in terms of the Local Treasury Bills Ordinance No. 8 of 1923 (LTBO) and the Registered Stock and Securities Ordinance No. 7 of 1937 (RSSO), respectively.

Treasury Bills and Treasury Bonds were issued in paper form, i.e., as printed certificates, until 2004. In 2004, by way of necessary amendments to the legislation, the outstanding Treasury Bills and Treasury Bonds were converted into scripless form and the issuance of new Treasury Bills and Treasury Bonds in scripless form was initiated. A digital depository, namely the Central Depository System (CDS), is maintained by the CBSL to record the ownership of these scripless Treasury Bills and Treasury Bonds.

Efficient functioning of the government securities market is an essential prerequisite in ensuring that funds are sourced for the government at optimal cost. Development of the government securities market by improving and standardising market practices on repurchase and reverse repurchase transactions on Treasury Bills and Treasury Bonds is a critical aspect to this end.

Repurchase and Reverse Repurchase Transactions in Treasury Bills and Treasury Bonds

A repurchase transaction is a transaction where a person who owns a Treasury Bill or a Treasury Bond sells it to another person at a particular price with the agreement to buy back on an agreed future date, at an agreed price. In effect, the person who owns the security is borrowing funds using that security as collateral. The difference between the selling price of the security and the buyback price of the security is the interest cost for borrowing funds. A reverse repurchase transaction, on the other hand, is a lending transaction collateralised by a Treasury Bill or a Treasury Bond, i.e., the inverse of a repurchase transaction.

RSSO and LTBO Direction No. 01 of 2019 on Repurchase and Reverse Repurchase Transactions of Dealer Direct Participants in Scripless Treasury Bonds and Scripless Treasury Bills

The CBSL, on 20.12.2019, in terms of the powers conferred by the RSSO and the LTBO, issued Directions to Dealer Direct Participants (DDPs),[1] prescribing the manner in which repurchase and reverse repurchase transactions on scripless Treasury Bills and scripless Treasury Bonds shall be carried out by such DDPs. These Directions were intended to standardise the basic parameters of repurchase and reverse repurchase transactions while leaving space for effective market-making, enabling parties to enter into repurchase and reverse repurchase transactions in a transparent manner. Directions were also intended to address the shortfalls in the regulatory framework identified during the failure of one of the Primary Dealers and the supervision of other DDPs. These Directions came into operation on 01.01.2020 subject to certain transitional provisions aimed at providing market participants with adequate time to make necessary adjustments to their existing practices.

Salient Features of the New Directions

1. Uniformity in valuing securities

The new Directions recommend that the Treasury Bills and Treasury Bonds used for repurchase and reverse repurchase transactions be priced at market value based on the dirty price, i.e. the price inclusive of accrued interest, corresponding to the average of the bid and offer quotes for the relevant Bill or Bond published daily by the CBSL. However, in recognition of other valuation methods available to DDPs to derive accurate valuations, DDPs have also been allowed the option of using an alternative valuation method subject to certain conditions.

2. Introduction of minimum haircut requirements

A haircut is the discount applied on the market value of Treasury Bills and Treasury Bonds when such Treasury Bills and Treasury Bonds are used for repurchase and reverse repurchase transactions. A haircut is a universally accepted concept that is developed to mitigate the risk posed to the lender due to adverse movements in the price of underlying securities. In the past, haircut percentages for securities used for repurchase and reverse repurchase

1 DDPs are persons appointed as DDPs in terms of the RSSO and LTBO, and at present include all Licensed Commercial Banks and Primary Dealers Companies.

8

transactions varied greatly among DDPs. However, in order to introduce a degree of standardisation to the repo market, the new Directions imposed the following minimum haircut requirements, at the time of entering into repurchase and reverse repurchase transactions, which are based on the remaining term to maturity of the Treasury Bill or the Treasury Bond, excluding transactions between two Direct Participants (DPs)[2].

Table B 12.1
Minimum haircut requirements

Remaining Term to Maturity of the Eligible Security	Minimum Haircut (%)
up to 1 year	4.0
more than 1 year and up to 3 years	6.0
more than 3 years and up to 5 years	8.0
more than 5 years and up to 8 years	10.0
more than 8 years	12.0

3. Streamlining the sale, substitution and replenishment of securities used for repurchase and reverse repurchase transactions

While the existing regulatory framework contained provisions to safeguard the interest of both lenders and borrowers in repurchase and reverse repurchase transactions, the new Directions introduced several further measures including the prohibition of outright selling of securities received by a DDP as collateral for reverse repurchase transaction and requiring DDPs to simultaneously substitute securities used for repurchase transactions if such securities are to be used by the DDPs. Further, the new Directions require DDPs to allocate or obtain additional securities, depending on the type of transaction, if the market value of securities used for a repurchase or reverse repurchase transaction falls below the maturity value of the transaction at any time prior to its maturity.

2 DPs are persons appointed as DPs in terms of the RSSO and LTBO, and at present include the CBSL, all Licensed Commercial Banks, Primary Dealers Companies, Employees' Provident Fund (EPF) and the Central Depositary System of the Colombo Stock Exchange.

4. Improving accountability and risk management practices of DDPs

The new Directions, while mandating certain key requirements with respect to repurchase and reverse repurchase transactions, recognise the importance of robust internal structures in DDPs to ensure the safety and soundness of the repurchase and reverse repurchase market. Accordingly, the responsibilities of the Board of Directors of DDPs, roles of the internal and external auditors, risk management and compliance functions of DDPs are drawn.

5. Introduction of penalties

While the existing framework provided for several regulatory actions that could be taken against DDPs who fail to comply with the requirements with respect to repurchase and reverse repurchase transactions, the new Directions impose financial penalties to further curb such non-compliances.

Expected Benefits to the Government Securities Market and its Participants

Tradability of government securities, in terms of both outright and repo trading, is a key factor affecting the cost of funds for the government, as investors prefer to invest in liquid securities. These new Directions on repurchase and reverse repurchase transactions in Treasury Bills and Treasury Bonds will further strengthen the market practices relating to such transactions and thereby improve the tradability of government securities.

Further, protection of DDPs and their customers who engage in repurchase and reverse repurchase transactions will be further strengthened as the measures introduced by these Directions are effectively coupled with safeguards already put in place by the CBSL, such as the Short Message Service (SMS) and e-mail notification system for CDS accountholders, whereby security movements with respect to repurchase and reverse repurchase transactions are notified to customers.

The above benefits will lead to the development of the government securities market as a whole and enhance investor confidence.