

Recharacterisation of repurchase and reverse repurchase agreements: the Nigerian perspective

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Repurchase agreements and reverse repurchase agreements

Repurchase agreements ('repos') are undertakings where a party buys securities from a counterparty for a specified price with an agreement that the counterparty will repurchase the securities at a later date. A reverse repo is the flip side of a repo. The term repo or reverse repo may be applied to the same transaction, depending on the perspective of the parties. Repos and reverse repos have similar characteristics to secured lending agreements, and may be said to resemble collateralised borrowing/lending.^[1]

However, in repos, title to the security transfers between the parties, which means that on default by one of the parties, the other party may sell the securities to offset the cash debt or hold on to the cash paid to set off the securities debt.

Repos operate in the money market division of the Nigerian market, serving as low-risk, flexible and short-term investments adaptable to a wide range of uses. Repos may be structured to provide for the repurchase of the securities at a higher price or at the same price, but with interest. Repos/reverse repos may be used by market regulators to maintain the liquidity levels of the market and ensure the achievement of long-term monetary policies.^[2]

Facilitation of repos and reverse repos in Nigeria

On 2 April 2012, the Central Bank of Nigeria (CBN) issued Guidelines for the Conduct of Repurchase Transactions Under CBN Standing Facilities (the 'Guidelines') to all deposit money banks and discount houses. In the Guidelines, the CBN offered to enter into repo transactions under its standing lending facility (SLF) and term repurchase facility (TRF), to provide naira (N) liquidity to institutions that are unable to access funds on the interbank market, and to set an upper limit on rates. The SLF is an overnight facility with settlement for the same day value, whereas the TRF is a term facility that may be transacted for rates and periods as published by the CBN. The SLF and TRF are only available to banks and discount houses that have executed the Nigerian Master Repurchase Agreement (NMRA) with the CBN, and the Guidelines are to be read in conjunction with the NMRA, which governs all repos/reverse repos between parties that executed the NMRA. The SLF is an overnight facility, whereas the TRF is a term facility. Nigerian Treasury bills, Federal Government bonds, CBN bills and Asset Management Corporation of Nigeria (AMCON) bonds may serve as the underlying securities in repo transactions under the SLF and TRF.

The Nigerian Stock Exchange (NSE) issued Operational Guidelines for Fixed Income Market Makers (the 'Operational Guidelines'), which are applicable to all dealing members registered as fixed income market-makers (FIMMs) in the NSE. The Operational Guidelines are pursuant to the introduction of a fixed income trading platform at the NSE, and provide that FIMMs are required to make binding two-way quotes (bid/offer) through the NSE's automated trading system at which FIMMs are prepared to deal in all defined fixed income securities listed on the NSE. The Operational Guidelines define the offer for repo/reverse repo transactions in terms of interest rates, that is, the rate at which a quoting party is willing to reverse repurchase a security. A bid for repo/reverse repo transactions is expressed in terms of the interest rate at which the quoting party is willing to repurchase a security. The eligible securities to be traded under the Operational Guidelines include Federal Government bonds, state bonds and corporate bonds.

The Fixed Income Securities Investment Clients Services (FISICS) Rules of the FMDQ OTC Securities Exchange (the 'Exchange') provide that dealing members licensed to make the market in fixed income securities listed and traded on the Exchange are prohibited from engaging in repo transactions with the securities of clients without the express written consent/authorisation of the client.^[3] This means that the opportunity to engage in repos is available provided the client gives written consent.

Regulators in the Nigerian financial sector are making significant steps and issuing guidelines to facilitate repo transactions; however, it appears that the Nigerian judiciary is yet to catch up with regards to the legal characterisation and concept of repos.

Recharacterisation of repos and reverse repos

Recharacterisation may be defined as the treatment of a transaction in a manner different from the way in which the parties had described the transaction. Essentially, courts may interpret the transaction to be of a different legal characterisation than that which the parties allege the transaction to be.

Repos and reverse repos run the risk of recharacterisation by courts, that is, courts characterise the transaction as being a secured lending facility where the counterparty is giving a loan to a party and receiving the securities as collateral or vice versa, as opposed to a sale with an agreement to repurchase. The problem with such recharacterisation is that the agreement would then be interpreted to mean that the counterparty only has a security interest over the securities rather than having the legal title vested in him/her,^[4] leading to the possibility that the counterparty does not have any rights over the securities, as the parties would not have intended to create a security interest and therefore, would not have performed the formalities required to establish a security interest, and the counterparty becomes an unsecured creditor.^[5]

The attitude of foreign courts has evolved over time towards a recognition of repos, which have been recognised as sales and separate transactions from secured lending facilities (eg, the United Kingdom cases, *Welsh Development Agency v Export Finance Co* (1992) BCC 270 and *Orion Finance Limited v Crown Finance Management Limited* (1996) BCC 621). These cases serve as *locus classicus* on repo transactions.

These cases show that the UK judiciary recognises the validity and legality of repurchase. Unfortunately, in Nigeria, there is a dearth of cases on repos, and courts are yet to have the opportunity to deal with the issue of recharacterisation of repos. However, courts have laid down principles they would consider in the recharacterisation of an agreement.

Recharacterisation: the attitude of the Nigerian courts

The courts in Nigeria laid down principles they would consider in the recharacterisation of a transaction in the case of *Mohamadu Jajira v Northern Brewery Company Limited* [1972] NCLR 313 and *Gaya v J Allen & Co Limited* [1976] 1 F.N.R. 31. Although these cases were not regarding repos in particular, they relate to the recharacterisation of an agreement from a sale to secured financing. The court set out the following test to determine the characterisation of a transaction:

- the nature of the legal substance of the transaction as contained in the contract of sale;
- whether the legal substance of the transaction as contained in the contract of sale conforms with the definition of a sale or contract of sale under the provisions of the Sale of Goods Act;
- whether the contract of sale contains language that evidences a different type of legal transaction, such as further assurances, negative pledges, modification of property laws, restrictions against the free disposal of assets, or the right to reacquire the purchased goods on the return of the purchase money or other forms of mortgage language, that does not meet the requirements of a sale; and
- whether the purchaser is obligated to pay the seller any profit or income made on any future disposition of the receivables.

From the above principles, it can be inferred that repos, as fundamentally understood, may be subject to recharacterisation by the Nigerian courts, considering that a repo/reverse repo essentially provides for the repurchase/sale of the securities from/to the counterparty for cash at a later date, which may be interpreted by the court to be a provision for the right to reacquire the purchased security on the return of the purchase money; hence, a different type of legal transaction from a 'true sale'. Alternatively, courts may hold that the transfer of title is inchoate until the requirements of the laws governing the transfer of securities are met by the parties.

It should be noted that the Securities and Exchange Commission (SEC) Rules and Regulations (the 'SEC Rules') holds that security lending transactions should provide for the absolute transfer of title of the securities and collateral in transactions between the lending agent and a borrower. The SEC Rules are made pursuant to the Investment and Securities Act 2007 (the 'ISA'), which defines security lending to include repos/reverse repos.

Nevertheless, the provisions of the ISA and SEC Rules do not necessarily cover repos/reverse repos as transacted in the Nigerian money markets because securities lending is the borrowing of securities for a term on the provision of collateral, which may be cash or other securities, whereas in repos, a party actually buys the securities (no provision of collateral) and title is transferred to the buyer as a result of the sale, with a provision for repurchase at a later date.

As stated, the above Nigerian cases are not specifically regarding repos, and there are no current Nigerian cases on repos; however, decided UK cases on the recharacterisation of repos/reverse repos, such as *Welsh Development Agency v Export Finance Co* and *Orion Finance Limited v Crown Finance Management Limited*, may act as persuasive authority to the Nigerian courts.

Conclusion

The Nigerian financial market has embraced repo and reverse repo transactions in a bid to boost the liquidity needed for a sustainable bond market.

However, the Nigerian legal system is yet to capture the distinctive characteristics of repos/reverse repos, which means that there is a lacuna, and specific provisions have to be made to cover repos/reverse repos as operated in the Nigerian money market.

In addition, there is a need for the SEC, as a regulatory body, to clarify the distinction between repo transactions and securities lending transactions, and issue specific rules/regulations guiding the conduct of repo transactions in the Nigerian securities market.

Notes

[1] Stephen A Lumpkin, 'Repurchase and Reverse Repurchase Agreements' Instruments of the Money Market, 6th ed, Federal Reserve Bank of Richmond
www.richmondfed.org/~media/richmondfedorg/publications/research/economic_review/1987/pdf/er730102.pdf
 (http://www.richmondfed.org/~media/richmondfedorg/publications/research/economic_review/1987/pdf/er730102.pdf) accessed 29 January 2018.

[2] *Ibid.*

[3] FISICS Rules of the FMDQ-OTC Securities Exchange, Rule 4.5.

[4] International Capital Market Association, 'Why is it Important to Document Repos?' www.icmagroup.org/Regulatory-Policy-and-Market-Practice/repo-and-collateral-markets/icma-ercc-publications/frequently-asked-questions-on-repo/18-why-is-it-important-to-document-repo (http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/repo-and-collateral-markets/icma-ercc-publications/frequently-asked-questions-on-repo/18-why-is-it-important-to-document-repo) accessed 29 January 2018.

[5] *Ibid.*

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