Repos of Loans - Now Possible

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Repurchase agreements or repos are now the legal structure most commonly used for the provision of funding between financial institutions. Up to now, legal risk issues have meant that repos have only been used to provide funding against securities. Now, legal changes that remove these legal risk issues mean that repos can also be used to provide funding against loans.

Mechanics of repos

A repo is an agreement between two parties whereby: (i) on a date (the "purchase date") one party (the "seller") sells the other party (the "buyer") a financial asset at a specified price (the "purchase price"); and (ii) the seller and the buyer agree that the seller will repurchase from the buyer an equivalent financial asset at a fixed price (the "repurchase price") on a specified future date (the "repurchase date"). The repurchase price is greater than the purchase price. The difference represents the return to the buyer on the purchase price over the period between the purchase date and the repurchase date (such period, the "**repo term**"). Under the terms of the repo, the buyer pays over to the seller any payments made on the financial asset during the repo term and the buyer agrees that any voting or instruction rights in relation to the financial asset are to be exercised by the buyer as instructed by the seller.

Advantages of repos over secured loans

Economically, the buyer under the repo is advancing funds to the seller in the same way that a lender might advance funds in return for security. The advantages of a repo over a secured loan for the buyer are:

(i) The buyer can sell the financial asset provided it acquires and sells an equivalent financial asset on the repurchase date. A lender with security over a financial asset has no powers to deal with it until there is a default by the borrower and the security becomes enforceable.

(ii) In the event that the seller does not pay the repurchase price on the repurchase date, the buyer can immediately sell the financial asset, realise the proceeds and claim against the seller for any deficiency. Enforcement of security is more complicated and time-consuming.

(iii) Security granted by a company over most types of financial assets needs to be registered at Companies House within 21 days of its creation or it is ineffective. As a repo does not create security no registration needs to be made at Companies House.

Repos are widely used by financial institutions providing funds to, or raising funds from, other institutions because of their ease of execution and their advantages compared to lending on security.

Recharacterisation risk for repos

One of the legal risks for repos is that the courts determine that the repo is not a sale and an agreement to repurchase, but rather a loan to the seller and security given by the seller. This risk is termed 'recharacterisation risk.' If the seller under the repo is a UK company, then in such case the security will not be effective as it will not have been registered with Companies House. The buyer will be left with only an unsecured claim against the seller for the repurchase price.

The recharacterisation risk of a repo is minimised where the terms of the repo are such that what is repurchased is not the securities originally sold, but equivalent securities. In the case of a repo of securities, it is easy to conceive that what can be repurchased is identical securities, i.e. securities of the same issuer and class and interchangeable with those sold to the buyer, but not necessarily the same ones as where sold to the purchaser. However, in the case of a repo of a loan, any repurchase must necessarily be of the same loan as was sold to the buyer, as the legal nature of loans is such that different interests in a loan are not interchangeable in the same way as securities. Accordingly, the recharacterisation risk of a repo of loans was considered too high for such a repo to be entered into.

Effect of Financial Collateral Directive on repos

The 2002 EU Financial Collateral Directive (the "Financial Collateral Directive"),[1] implemented in the UK by the Financial Collateral Arrangements (No. 2) Regulations 2003 (the "2003 Regulations"),[2] removed the recharacterisation risk in relation to repos in respect of financial collateral, as defined therein, where the parties to the repo are corporates (and not natural persons), by providing that a transaction of the nature of a repo shall be enforced in accordance with its terms. However, the definition of financial collateral was limited to cash and financial instruments and did not include loans.

Extension of Financial Collateral Directive to repos of credit claims

Since 6 April 2011, amendments to the 2003 Regulations made by the Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment)Regulations 2010 (the "2010 Regulations")[3] have implemented in the UK EU Directive 2009/44/EC which, among other things, extends the definition of financial collateral therein to include credit claims. A repo entered into by a UK company as seller in respect of credit claims will now no longer be subject to recharacterisation risk.

Limitations on Application of Financial Collateral Directive

However, there are significant limitations on the scope of application of the amended Financial Collateral Directive and the 2010 Regulations. First, not all loans come within the scope of the definition of "credit claims." The definition of "credit claims" is limited to claims arising from agreements under which credit institutions, i.e. banks or other deposit-taking entities, agree to grant credit in the form of a loan. Thus, the 2010 Regulations will not apply to repos of loans originated by non-bank lenders. Secondly, the amended Financial Collateral Directive may not apply if the seller under the repurchase agreement is not situated in the European Economic Area (the "EEA")[4] or if the repo is governed by the law of a non-EEA state.

Despite these limitations, Directive 2009/44/EC and the 2010 Regulations should nonetheless facilitate the raising of finance by means of a repo against loans and should contribute to a more liquid European loan market.

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[1] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

[2] Statutory Instrument No. 3226/2003.

[3] Statutory Instrument No. 2993/2010.

[4] EU countries plus Norway, Iceland and Liechtenstein.