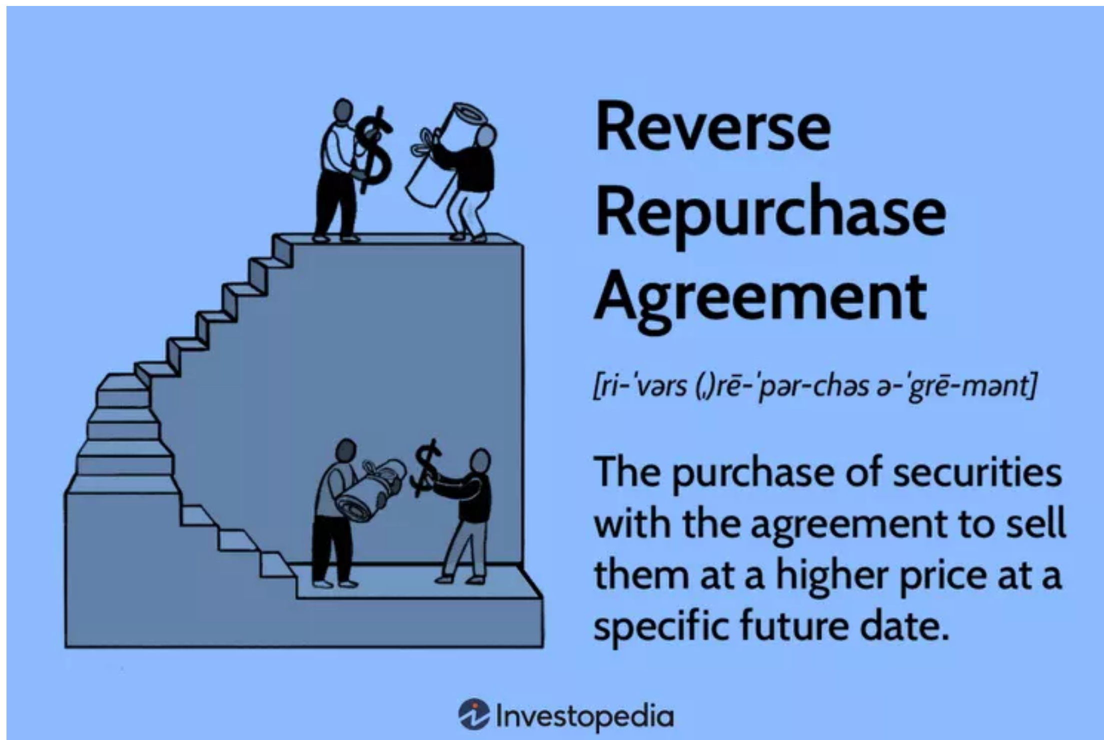
Investopedia LIVE

What Is a Reverse Repurchase Agreement (RRP)? How It Works, With Example

By JAMES CHEN Updated August 03, 2023

Reviewed by GORDON SCOTT

Fact checked by VIKKI VELASQUEZ



Jessica Olah / Investopedia

Investopedia

LIVE

What Is a Reverse Repurchase Agreement (RRP)?

A reverse repurchase agreement (RRP), or reverse repo, is the sale of securities with the agreement to repurchase them at a higher price at a specific future date. A reverse repo refers to the seller side of a repurchase agreement (RP), or repo.

These transactions, which often occur between two banks, are essentially collateralized loans. The difference between the original purchase price and the buyback price, along with the timing of the transaction (often overnight), equates to interest paid by the seller to the buyer. The reverse repo is the final step in the repurchase agreement, closing the contract.

KEY TAKEAWAYS

- A reverse repurchase agreement is a short-term agreement to sell securities in order to buy them back at a slightly higher price.
- Repurchase agreements (RPs, or repos) and reverse repos are used for short-term lending and borrowing, often overnight, for banks looking to fulfill their reserve requirements.
- Central banks use repos and reverse repos to add and remove from the money supply via open market operations.

How Reverse Repurchase Agreements (RRPs) Work

Investopedia

LIVE

used to raise short-term capital. Reverse repurchase agreements (RRPs, or reverse repos) are the seller end of a repurchase agreement. [1] These financial instruments are also called collateralized loans, buy/sell back loans, and sell/buy back loans.

Reverse repos are commonly used by businesses like lending institutions or investors to access short-term capital when facing cash flow issues. In essence, the borrower sells a business asset, equipment, or even shares in its company. Then, at a set future time, the lender sells the asset back for a higher price. [2]

The higher price represents the interest to the buyer for loaning money to the seller during the duration of the deal. The asset acquired by the buyer acts as collateral against any default risk that it faces from the seller. Short-term RRPs hold smaller collateral risks than long-term RRPs because, over the long term, assets held as collateral can often depreciate in value, causing collateral risk for the buyer. [1]

In a macro example of RRPs, the Federal Reserve Bank uses repos and RRPs to provide stability in lending markets through open market operations (OMOs). The RRP transaction is used less often than a repo by the Fed, as a repo puts money into the banking system when it is short, whereas an RRP borrows money from the system when there is too much liquidity. The Fed conducts RRPs to maintain long-term monetary policy and control capital liquidity levels in the market. [3]

FAST FACT

Part of the business of repos and RRPs is growing, with third-party collateral management operators providing services to develop RRPs to provide quick funding to businesses in need. As quality collateral is sometimes difficult to find, businesses are taking advantage of their assets as a quality way to fund expansion and equipment acquisition through the use of tri-party RRPs, resulting in repo agreement opportunities for investors. This industry is known as collateral management optimization and efficiency.

Reverse Repurchase Agreements vs. Buy or Sell Backs

An RRP differs from buy or sell backs in a simple way. Buy or sell back agreements legally document each transaction separately, providing clear separation in each transaction. In this way, each transaction can legally stand on its own without the enforcement of the other. RRPs, on the other hand, have each phase of the agreement legally documented within the same contract and ensure the availability and right to each phase of the agreement.[4]

Lastly, in an RRP, although collateral is in essence purchased, the collateral generally never changes physical location or actual ownership. If the seller defaults against the buyer, then the collateral would need to be physically transferred.

FAST FACT

Repos and reverse repos are two sides of the same coin, reflecting the role of each party in the transaction. Repo refers to the buyer side of a repurchase agreement, while reverse repo refers to the seller side.

Example of Reverse Repurchase Agreements

Let's say Bank ABC currently has excess cash reserves, and it is looking to put some of that money to work. Meanwhile, Bank XYZ is facing a reserve shortfall and needs a temporary cash boost. Bank XYZ may enter a reverse repo agreement with Bank ABC, agreeing to sell securities for the other bank to hold overnight before buying them back at a slightly higher price. From the perspective of Bank ABC, which buys the securities and agrees to sell them back at a premium the next day, the transaction is a repurchase agreement. [5]

How Does a Reverse Repurchase Agreement Work?

In a reverse repurchase agreement (RRP, or reverse repo), a party sells securities to a counterparty with the stipulation that it will buy them back at a slightly higher price. The agreement functions much like a collateralized loan. The original seller (engaging in a reverse repurchase agreement) receives an infusion of cash, while the original buyer (engaging in a repurchase [repo] agreement) essentially provides a loan and earns interest from the higher resale price. In general, the assets that

Investopedia

LIVE

What Is the Benefit of a Reverse Repo?

In a reverse repo, a party in need of cash reserves temporarily sells a business asset, equipment, or even shares in another company, with the stipulation that it will buy the assets back at a premium. Like other types of lenders, the buyer of the assets in a repo agreement earns money for providing a cash boost to the seller, and the underlying collateral reduces the risk of the transaction. [1]

How Does the Federal Reserve Use Reverse Repos?

When the Federal Reserve uses a reverse repo, the central bank initially sells securities and agrees to buy them back later. In these cases, the Fed borrows money from the market, which it may do when there is too much liquidity in the system. Regular repurchase agreements (repos), in which the Fed plays the role of the lender by buying securities and then selling them back, are a more common central bank measure to inject additional reserve balances into the banking system. [6] The Fed is not the only central bank to use this liquidity-maintaining method. The Reserve Bank of India also uses repos and reverse repos as they work to stabilize the economy through the liquidity adjustment facility.

The Bottom Line

A reverse repurchase agreement (RRP), or reverse repo, refers to the seller side of a repurchase agreement (repo). The party executing the reverse

agreement is akin to taking out a short-term loan, with the underlying assets serving as collateral.

ARTICLE SOURCES ▼

Related Terms

Repurchase Agreement (Repo): Definition, Examples, and Risks

A repurchase agreement is a form of short-term borrowing for dealers in government securities. more

Term Repurchase Agreement: Meaning, Benefits, Requirements

Under a term repurchase agreement, a bank will agree to buy securities from a dealer and then resell them a short time later at a specified price. more

What Are Open Market Operations (OMOs), and How Do They Work?

The Federal Reserve uses open market operations (OMO) such as buying or selling U.S. Treasuries to adjust the federal funds rate for monetary policy. more

What Is Loan Stock? How It Works and Potential Risks