

Repurchase Agreements

A Core Liquidity Investment



Summary

Local government investment pools (LGIPs) are one of the most common investment products utilized by state and local governments nationwide. Because public funds must be protected while remaining liquid, LGIPs typically invest in low-risk, short-term instruments. One of the most common investments utilized in LGIPs are repurchase agreements, or “repo(s).” Repos are widely used in money market funds and LGIPs because they support the key investment objectives: safety¹, liquidity, and yield.

Additionally, repos allow investment managers to maintain flexibility in managing the pool’s cash flows. Because local government participants may deposit or withdraw funds frequently, LGIP managers must ensure that the portfolio contains enough short-term investments to meet these needs. For LGIPs that follow the rules of GASB 79, 10% of the assets must have maturity of one day and 30% must mature in seven days or less. As a result, repos serve as a core investment to meet short-term liquidity needs.

Key Features



Safety

Safety is achieved through high-quality collateral, over-collateralization, and the involvement of a third-party custodian



Liquidity

Liquidity is maintained because repos typically mature quickly, often overnight, allowing the pool to meet participant withdrawal requests



Yield

Yield is generated through the interest earned on the short-term loan to the dealer

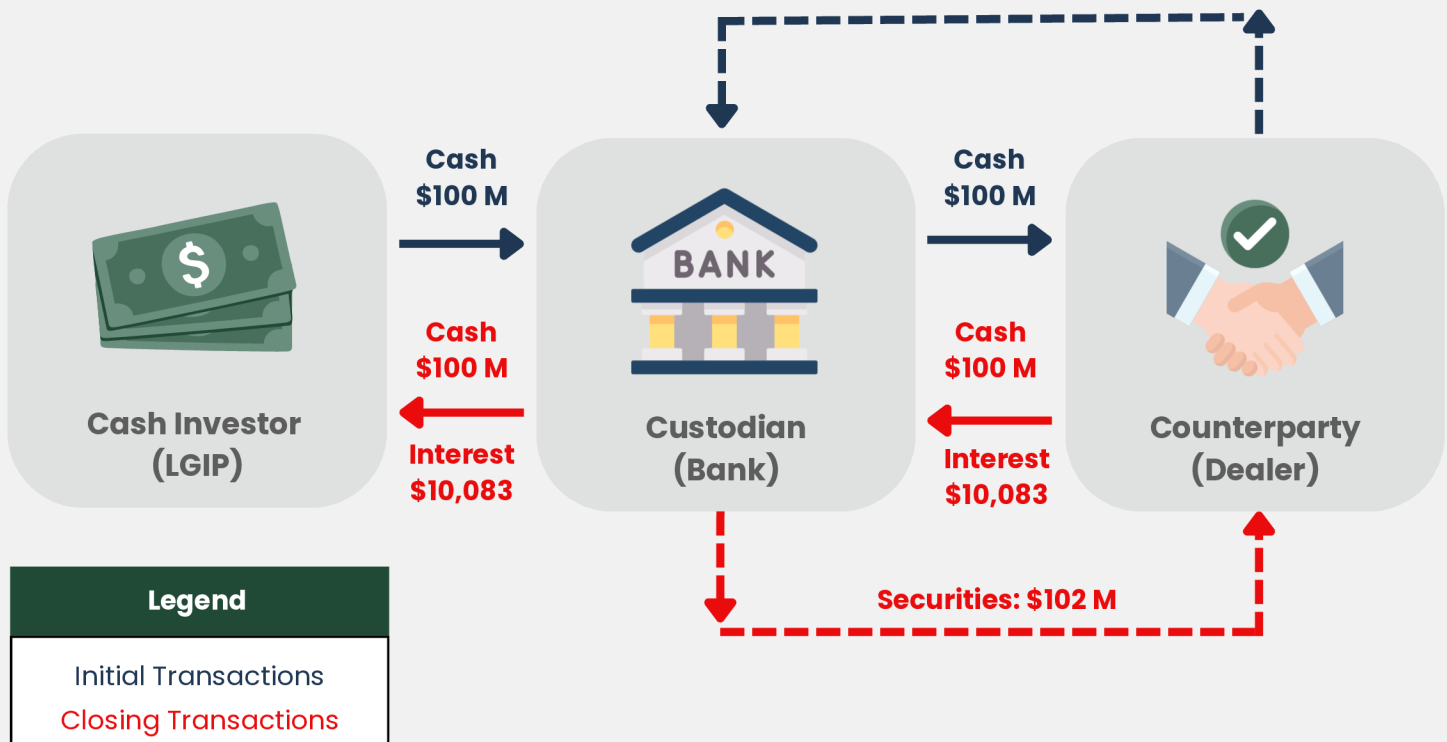
¹While our conservative investment approach promotes safety, investing in securities carries varying degrees of risk and we cannot guarantee safety of principal.

Repurchase Agreement Details

A repurchase agreement is a short-term borrowing and lending arrangement involving securities. In a repo transaction, one party (dealer) sells securities to another party (LGIP) with the simultaneous agreement to repurchase those securities at a specified price on a future date. Economically, the transaction functions like a secured loan. In this instance, the LGIP usually acts as the cash investor. It provides cash to a financial institution—often a bank or dealer—in exchange for securities as collateral. From the perspective of a dealer, a repo is used as a funding mechanism to purchase securities for its inventory. These securities typically include U.S. Treasury securities, federal agency securities, or other highly rated government-backed instruments. For those LGIPs that are rated, credit rating agency guidelines will also come into play. The maturity of repo agreements is typically overnight, although term repos lasting several days or weeks may also be used depending on liquidity needs. The repo structure allows the LGIP to earn a return similar to overnight federal funds while maintaining a high level of safety and liquidity. The example below depicts a flow of funds for a \$100 million repurchase agreement at a yield of 3.63%. The LGIP wires \$100 million to the custodian bank, the dealer delivers \$102 million of securities (\$100 million of securities plus \$2 million for over-collateralization).

When the transaction closes, the dealer sends back \$100 million of cash plus \$10,083 of interest, and the custodian releases the securities back to the dealer. Typically, when a dealer continues to roll a repo with an LGIP, the collateral does not move back and forth daily. The collateral continues to be held by the custodian, but the dealer delivers interest earnings daily.

Tri-Party Repo Flow of Funds



Safety Features

In a tri-party repo, the custodian bank manages collateral on behalf of both parties. This arrangement simplifies operational processes and enhances risk management because the custodian is responsible for holding the collateral, valuing it daily, and ensuring that the collateral meets agreed-upon requirements.

Under this structure, the custodian bank performs several critical functions. First, it holds the securities collateral in a segregated account, ensuring that the collateral is protected and not commingled with the dealer's own assets. Second, the custodian marks the collateral to market daily. If the market value of the collateral falls below the required level, the dealer must provide additional securities to maintain the agreed collateralization level. Third, the custodian handles settlement and administrative tasks, such as transferring securities and cash at the start and end of the transaction. These services reduce operational risk and increase transparency for an LGIP.

To further reduce risk, repo transactions typically include over-collateralization, meaning the market value of the pledged securities exceeds the amount of cash invested. For example, a repo agreement might require collateral equal to 102 percent of the cash provided. If an LGIP invests \$100 million in a repo, the broker-dealer might be required to pledge \$102 million worth of eligible securities. This "haircut" helps protect the investor in case the value of the collateral declines before the transaction matures.

Advances in the Repo Market

The repo market is a critical element to the plumbing of financial markets worldwide. According to the Office of Financial Research (OFR), the U.S. repo market size—measured as daily average exposures—is approximately \$12.6 trillion². Of this amount, \$4.4 trillion is centrally cleared, \$3.1 trillion is tri-party and \$5.0 trillion is bilateral. While the repo market operates efficiently most of the time, there have been episodes of Treasury-market stress (e.g. in 2014; a repo spike in September 2019; and the March 2020 "dash for cash"). As a result, the Securities and Exchange Commission (SEC) concluded that too much Treasury and repo activity occurred outside central clearing, creating counterparty and liquidity risk. The SEC has moved to push ahead reforms that require a path to central clearing in the U.S. Treasury market.

Effective June 30, 2027, the SEC will require treasury repurchase agreements to be centrally cleared through the Fixed Income Clearing Corporation (FICC), a DTCC subsidiary that acts as a central counterparty. Once a repo trade is cleared, FICC becomes the buyer to every seller and the seller to every buyer, guaranteeing settlement. This makes FICC repos systemically more important than traditional tri-party repos going forward. It is important to note that state and local governments are explicitly excluded from the SEC's Treasury and repo clearing rule. However, LGIPs are still affected because their dealer counterparties must increasingly clear Treasury repo through FICC, which changes dealer balance-sheet usage, pricing, and the availability of uncleared tri-party repo.

²www.financialresearch.gov/the-ofr-blog/2025/12/04/sizing-us-repo-market

Conclusions

Repurchase agreements are a fundamental investment of many LGIPs. By functioning as short-term, secured lending transactions, repos allow LGIPs to invest excess funds safely while maintaining high liquidity. Tri-party arrangements add an additional layer of operational control and transparency through the involvement of a custodian bank that manages and values collateral. High-quality collateral and over-collateralization further protect public funds. In the future, centralized clearing of repos through FICC will eliminate counter party risk and improve liquidity in times of financial stress. Together, these mechanisms help ensure that LGIPs can achieve their primary goal: safeguarding public money while generating stable returns for participating local governments.

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