ECONOMIC
COMMENTARY

Seeking Safety
by E.J. Stevens

4. See Repurchase Agreements, Cleveland, Public Inspection Copy, Federal Reserve Bank of Cleveland (1985) and “It’s 8:00 AM. Do you know where your collateral is?”, Federal Reserve Bank of New York, 1985.

5. There are two types of repurchase agreements: an open market agreement (also known as “ Repos”) and a Treasury bill agreement (also known as a "T")

6. SEC rules for nonexempt brokers and dealers in interstate commerce specify a lower $1 million cutoff.

7. Other than those used by credit unions and other exempt associations.

8. Another area of ambiguity is whether a repurchase agreement is a security, sale and repurchase transaction, but the regulation specifically avoids any attempt to resolve this legal issue.

9. The Government Securities Act of 1986, enacted last October, is in the process of being implemented. Treasury Department prepared regulations under the Act (Federal Register Vol. 52) were suspended by E.J. Stevens at the request of the author and not yet issued as of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System.

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ness; 2) financial institutions, notably banks; 3) security brokers or dealers; 3) per-
sons who are agents of the third group
involving: A) issuing and redeeming
government securities market, not the protection
of customers.

2. The class of securities is that defined as
covered by a statement made by the
Secretary of the Treasury to which
§ 531.2 (a)(1) (2002). This means that
the entity involved in the transaction is
required to maintain control of the security
in a segregated customer account.

Abuses and Remedies

Box 1
Repurchase Agreements

Repurchase agreements are temporary transactions consisting of the sale of a security and a promise to "re-purchase" it. The timing on the pur-
chase promise varies. A repurchase agreement specifies the number of days for which
the money over-night, or for a specified number of days. The "purchased"
securities are usually called "collateral" to guarantee the safety of the invested
funds. The party offering to sell securities and then buy them back later is
making a repurchase agreement, also referred to as repo or RP. The
other party, which is offering to provide money to purchase those securi-
ties and receive them back the next day, is making a reverse repurchase
agreement, sometimes shortened to reverse repo or RRP.

Extracted from: "Repurchase Agreements," Public Information Depart-
ment, Federal Reserve Bank of Cleveland [1985].

2. The class of securities is that
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Box 1 Repurchase Agreements

Repurchase agreements are temporary transactions consisting of the sale of a security and a promise to "repurchase" it. The timing on the pur- chase promise varies. A repurchase agreement is a formal written money agreement, usually for a specified number of days. The "purchased" securities are used as "collateral" to guarantee the safety of the invested funds. The party offering to sell securities and then buy them back later is making a repurchase agreement, also referred to as repo or RP. The other party, which is offering to provide money to purchase those securities and receive the repurchase agreement, may be a government securities broker or dealer; a financial institution, such as a bank; or an entity that specializes in repurchase agreements. The agreements that result may be made with a single customer or with a group of customers.

The concept of repo is not unique to the United States. It is used extensively in other countries as well, such as Japan, where it is known as "contraparte." A Japanese customer who needs cash can sell a security to a securities firm, agreeing to repurchase it at a specific date and at a specified price. The securities firm then uses the proceeds of the sale to provide the customer with cash. Alternatively, the securities firm may use the proceeds of the sale to finance a loan to a customer who needs funds for a short period of time. The customer then repurchases the security at the agreed-upon price on the agreed-upon date.

There is a wide variety of repo transactions. Some are short-term, involving securities with maturities of one day or less. Others are longer-term, involving securities with maturities of one week or longer. Some involve government securities, while others involve corporate or mortgage-backed securities. Some involve securities that are registered in the name of the seller, while others involve securities that are registered in the name of the buyer.

Regardless of the specific terms of a repo transaction, the basic concept is that the seller of the security agrees to repurchase it at a later date, usually at a higher price than the original sale price. This makes it possible for the seller to borrow money at a lower interest rate than if the security were sold outright.

Abuses and Remedies

Basic, it is impossible to imagine regulations that would prevent all investor losses incidental to transactions in government securities. Existing federal investor and deposit insurance plans do not fully cover these losses. As a result, the government securities broker or dealer is exposed to the risk of loss in the event of a default by a customer.

In order to protect the government securities broker or dealer from this risk, it is important to have a strong legal framework in place to ensure that customers who default on their obligations will be held accountable. This can be achieved through a variety of means, including the imposition of strict legal standards for the conduct of brokers and dealers, as well as the implementation of comprehensive regulations that require brokers and dealers to maintain adequate capital and liquidity reserves, and to have in place robust internal control systems.

The proposed regulations specify that, when a government securities broker or dealer enters into hold-in-custody repurchase agreements, including over-the-counter repurchase agreements, it must maintain possession of the securities at all times, with written confirmation of the initiation of the transaction and of the completion of the transaction. These regulations also require that the broker or dealer maintain adequate capital and liquidity reserves, and have in place robust internal control systems.
customers with more reliable information about the business behavior to be expected from government securities brokers and dealers. The regulations involve three aspects of financial responsibility. First, the past history of brokers and dealers will be open to scrutiny. All government securities brokers and dealers must notify the appropriate regulatory authority of their business. In the case of registered brokers and dealers, this means the Securities and Exchange Commission (SEC), in the case of nonregistered government securities brokers and dealers, it means the Federal Reserve Bank of New York (FRB). Second, firms must demonstrate that they maintain capital adequate to the market positions they hold. This is to be monitored through periodic reports of a firm’s capital relative to the degree of risk it takes. Capital guidelines, similarly to other government securities brokers and dealers, this means the Federal Reserve Bank of New York, 1985.

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Investors seeking safety frequently purchase U.S. government securities. Nonetheless, some investors lost over $750 million operating in the government securities market within the past five years. These losses were not incurred because of a policy failure or any kind of debt, or even because of falling prices of outstanding government securities (in fact, prices were rising much of this time). Rather, losses arose from failures of securities firms with whom the investors were dealing. And out of the ensuing debate and calls for reform has come the Government Securities Act of 1986.

What is notable about the Government Securities Act of 1986 is that it imposes federal regulation on institutions because they do business in the government securities market, rather than on only some institutions that happen to do business in that market. Until now, it was possible to go into business free of any federal securities market or financial institution regulation as long as the business was respected to being a broker or dealer in exempt securities, principally U.S. government securities.

The Government Securities Act of 1934 (federated Securities and Exchange Commission (SEC) regulation of participants in non-exempt securities markets, and the banking quizzes of the 1934’s federated modern deposit institution regulation. Together, these instances of regulatory provision to protect (some would say overprotective) layer of regulatory insulation. But the government securities market remained a unique area of unregulated financial business. Some are among the more than three dozen “primary” dealers who report their trading and financing activity and securities positions daily to the Federal Reserve Bank of New York as a precondition for engaging in transactional brokers and dealers of U.S. Treasury System Open Market Account. Factors precipitating the new legislation and regulations do not center on these firms, but on questionable practices—sometimes outright fraud—on the part of a number of other unregulated government securities dealers.

Without entering into a complete or detailed recital of the provisions of the proposed regulations required by the Government Securities Act of 1986, this Economic Commentary sketches key factors protecting against troublesome past practices.

The Government Securities Market: It seems a shock to some people to find that investing in U.S. government-related securities might be risky. Holding a “Treasury bill as a safe asset” in three aspects protective (some would say oversupervise) layer of regulatory insulation. But the government securities market remained a unique area of unregulated financial business. Some are among the more than three dozen “primary” dealers who report their trading and financing activity and securities positions daily to the Federal Reserve Bank of New York as a precondition for engaging in transactional brokers and dealers of U.S. Treasury System Open Market Account. Factors precipitating the new legislation and regulations do not center on these firms, but on questionable practices—sometimes outright fraud—on the part of a number of other unregulated government securities dealers.

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