

Research Department  
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## Retail RPs

Retail repurchase agreement (retail RP) is hardly a household term. Yet, in the last eighteen months it has emerged as an important financial instrument, rivaling in popularity the more familiar deposit instruments offered by banks and savings and loan associations. Lacking the authority to offer a consumer deposit instrument competitive with money market mutual funds, these depository institutions have turned to retail RPs as a means of retaining household funds.

Retail repurchase agreements combine the advantages of a market rate of return and short maturity in an instrument that could be viewed as a collateralized loan to the issuing financial institution. They are available to consumers in minimum denominations of \$1,000 or even lower. The high yields, liquidity and low minimum investment requirements of retail RPs—a combination of features that are only now appearing in consumer deposit instruments—have made this instrument extremely popular. As of August 1982, the outstanding amount of retail RPs had grown to an estimated \$21.0 billion nationally.

Despite the attractiveness of retail RPs, this type of uninsured non-deposit instrument may entail risks not associated with federally insured deposits. Therefore, an investor must evaluate the risk/return tradeoff before purchasing them.

### Rising popularity

All repurchase agreements—whether wholesale, which normally trade in minimum denominations of \$1 million, or retail—involve two transactions: the sale of a financial asset (usually U.S. Treasury or Federal agency securities) and the repurchase of that asset by the original seller. The terms of both transactions are agreed upon in advance, with the original seller agreeing to repurchase the securities for a higher price than the original sales price.

While this two-part transaction seems unusually complex, in practice, repurchase agreements have become a relatively convenient way for borrowers (most notably, securities brokers/dealers and depository institutions) to obtain short-term funds. In effect, the securities sold to the investor in the initial transaction are collateral for the loan that the investor is making to the seller. Likewise, the higher price the seller pays to repurchase the securities at a later date represents the repayment of the principal and interest on the loan.

The dramatic upward trend in market interest rates over the last decade, combined with interest rate and maturity restrictions, fostered more extensive use of retail RPs. Securities brokers and dealers traditionally have relied on the RP vehicle to finance their holdings of securities. Depository institutions also came to rely on wholesale RPs to hold onto liquid balances of corporations and state and local governments. During the 1970s, wholesale RPs became an important source of short-term funds for banks, supplementing Fed funds, large denomination time deposits (CDs), Eurodollar borrowings and other managed liabilities.

In the 1980s, the persistently high level of market interest rates spurred an even broader application of the RP instrument, namely, its use in transactions between a depository institution and its retail customers. By setting aside a pool of U.S. government and/or Federal agency securities as backing for its retail RPs, a depository institution could sell shares in that pool in denominations less than \$100,000 and agree to repurchase them at a later date. As of recently this type of instrument, which is not a deposit and is not subject to reserve requirements or deposit-rate ceilings, has also been authorized with an automatic renewal feature and without maturity restrictions.

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Depository institutions have had the authority to offer retail repurchase agreements as an instrument to compete with money market funds since August 1979, when the banking regulators exempted short-term, small-denomination RPs from deposit-rate ceilings. But neither banks nor thrifts took advantage of the opportunity to any significant extent until summer 1981, when they began offering retail RPs at premium rates to attract All-Savers deposits and to cut the outflow of balances to money market funds.

The response was overwhelming. By September 1981, retail RPs outstanding had grown to \$13.3 billion. While a substantial portion of these funds was subsequently transferred to All-Savers certificates, many investors preferred the liquidity retail RPs offered. More recently, retail RPs have also become popular as the market-return instrument used to invest "excess" checking balances arising from deposit "sweeping" arrangements.

#### **Risk**

While retail RPs are in some respects more attractive than presently available deposit instruments, they are by no means a perfect substitute for them. Indeed, since retail RPs are not deposits, investors' funds are not insured by either the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation.

Of course, retail RPs are backed by a pool of U.S. government and/or Federal agency securities. And to protect the investor, regulatory authorities require that the market value of that pool be at least equal to the principal of the issuing institution's obligation as of the date of the issuance of the RPs. This requirement, however, does not eliminate all risks associated with retail RPs. Two risk factors, in particular, are discussed here.

#### **Perfected security interest**

First, because the safety of a retail-RP holder's investment depends on the pool of securities that is offered as security, investors' ability to dispose of that pool in the event of default

by the issuing institution is of paramount importance.

In legal parlance, investors in retail RPs must have a *perfected security interest* in the underlying pool of securities for their investment to be protected against the issuing institution's default. Otherwise, the retail RP investors would be treated as general (unsecured) creditors of the failed institution and would only receive their proportionate share of the proceeds of the institution's total liquidated assets after the depositors and others with senior claims on the institution's assets had been satisfied. Without a perfected security interest, then, retail RP investors run the risk of losing some or all of their investment.

Unfortunately, the existence of a perfected security interest in the underlying pool of securities is frequently difficult to ascertain. It is possible that a court might decide that the retail RP investors did not have a perfected security interest under relevant state law despite good faith reports on the part of the failed institution to establish one. Generally, "perfection" requires transfer of the underlying securities to the custody of a third party (such as a bank), which would hold the securities for the account of the *customer*, not the issuing institution.

The investors in the retail RP program set up by the failed Mount Pleasant Bank and Trust Company in Iowa, for example, found to their dismay that they may not have had a perfected interest in the securities underlying their RPs. The FDIC recently ruled in this particular case that it will not regard the RP holders' claims on any of the bank's assets as having precedence over claims of depositors and other general creditors of the bank. As a result, these investors may stand to lose some or all of the \$350,000 or more they had invested.

In the final analysis, since the existence of a perfected security interest is frequently ambiguous, an investor seeking to minimize the risk of loss from the absence of a perfected

security interest must evaluate the financial soundness of the issuing institution. Next, the investor must decide whether the risk of an adverse ruling regarding the existence of a perfected security interest (should the institution fail) is outweighed by the yield.

#### **Value of collateral**

The second risk factor associated with retail repurchase agreements is related to the changing market value of the pool of securities backing the retail RP program. If market interest rates were to rise substantially, it is possible that the market value of the securities that are backing the retail RPs could fall sufficiently to reduce the value of the individual investor's share in that pool of securities. As long as the issuing institution is able to meet its obligation to repurchase RP investors' shares at the specified price (yield), the risk of adverse movements in interest rates will be borne by the institution. However, if the institution fails, and the market value of the securities has fallen, the investor in retail RPs could find that the collateral backing her investment was insufficient to protect the whole of her principal and interest.

A financially sound institution generally attempts to minimize this risk by issuing a lower aggregate amount of retail RPs than the total market value of the pool of securities that is backing them. In this way, the issuing institution provides a cushion that helps to preserve the investors' share value against unforeseeable interest rate movements.

Obviously, the larger is the pool of underlying securities relative to the total amount of retail RPs issued, the greater is the investor's protection against adverse movements in market

interest rates, even if the issuing institution were to fail. On the other hand, the larger the "cushion" provided by the issuing institution, the lower will be the yield offered by that institution since such interest rate protection is costly to provide.

And again, such protection is not the equivalent of deposit insurance; there is likely to remain some risk of loss from particularly large upward swings in interest rates. The investor must decide whether the yield being offered is adequate compensation for that risk.

#### **Institutional backing**

In sum, retail repurchase agreements, whether offered by banks or savings and loan associations, involve some risk of loss. The existence of risk does not necessarily make them an unwise investment, of course. However, the potential investor should examine carefully the elements of the individual programs offered as well as the overall soundness of the issuing institutions before deciding whether the compensation offered is adequate for the risks he or she is assuming.

Like any other investment vehicle, the safety of retail RPs depends ultimately on the issuing institution's ability to meet its obligations. An institution that investors regard as financially sound will be able to offer a lower yield on its obligations, including retail RPs, than would be the case for an institution for which investors feel the likelihood of failure is consequential. Retail RP investments, then, need to be evaluated in light of this risk/return tradeoff.

**Barbara Bennett and Gary C. Zimmerman**

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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**  
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/27/82	Change from 10/20/82	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	162,063	- 656	8,942	5.8
Loans (gross, adjusted) — total#	142,401	- 607	10,170	7.7
Commercial and industrial	45,617	- 338	5,947	15.0
Real estate	57,550	- 24	2,488	4.5
Loans to individuals	23,393	10	126	.5
Securities loans	2,308	- 259	888	63.0
U.S. Treasury securities*	6,618	30	1,000	17.8
Other securities*	13,044	- 79	- 2,228	- 14.6
Demand deposits — total#	38,732	- 872	- 170	- 0.4
Demand deposits — adjusted	28,004	146	17	0.0
Savings deposits — total	31,721	- 167	2,444	8.3
Time deposits — total#	100,090	- 778	14,379	16.8
Individuals, part. & corp.	89,878	- 807	12,137	15.6
(Large negotiable CD's)	37,475	- 831	4,367	13.2
<b>Weekly Averages of Daily Figures</b>	<b>Week ended 10/27/82</b>	<b>Week ended 10/20/82</b>	<b>Comparable year-ago period</b>	
<b>Member Bank Reserve Position</b>				
Excess Reserves (+)/Deficiency (-)	123	89		72
Borrowings	3	1		13
Net free reserves (+)/Net borrowed(-)	120	88		59

\* Excludes trading account securities.

# Includes items not shown separately.

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