FEDERAL RESERVE BANK OF NEW YORK

AT CIRNo 9282(a)

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RETAIL AND WHOLESALE REPURCHASE AGREEMENTS

To the Chief Executive Officer of Each State Member Bank in the Second Federal Reserve District:

The usage by banking organizations for funding purposes of repurchase agreements involving U.S. government or agency securities has increased dramatically over the past several months. Although to date there have been few problems associated with this activity, we believe that it is appropriate to bring to your attention some considerations to reinforce your awareness of the need to proceed cautiously in offering these instruments.

With respect to retail repurchase agreements (retail repos), bank management should bear in mind that in some cases it is dealing with customers who do not normally engage in large denomination, money market transactions. In addition, because of the complex nature of retail repos and the possibility that retail repos may be confused with insured deposits by the general public, all material facts of a retail repo transaction should be disclosed to the customer. As you are probably aware, the Securities and Exchange Commission has taken the position that the antifraud provisions of Federal securities laws apply to the sale of retail repos, and these instruments may be further subject to various State securities laws. Banking organizations engaging in or planning to engage in the sale of retail repos are urged to consult and obtain the opinion of legal counsel competent in the field of securities laws to determine what constitutes sufficient disclosure to customers as well as to ensure compliance with the antifraud and other applicable provisions of Federal and State securities laws.

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The face of all retail repurchase agreements should state conspicuously and in bold-face type that "the obligation is not a deposit and is not insured by the Federal Deposit Insurance Corporation," and care should be taken to avoid the potential misrepresentation that retail repos are guaranteed by the U.S. government. In addition to ensuring that retail repos are not misconstrued as insured deposits, we believe that, at a minimum, the following information concerning retail repos should be communicated to customers:

1. The nature and terms of retail repos, including interest rates paid, maturities and any prepayment fees.
2. A description of and approximate market value of the underlying security or fractional interest thereof collateralizing the agreements.
3. A statement that the interest paid on a retail repo is not necessarily related to the yield on the underlying collateral.
4. A statement that the bank will pay at maturity a fixed amount, including interest on the purchase price, regardless of any fluctuation in the market value of the underlying collateral.
5. A statement that general banking assets will most likely be used to satisfy the bank's obligation rather than proceeds from the sale of the underlying security.
6. A statement that the market value of the collateral could depreciate before the maturity of the agreement, thus making the investor an unsecured creditor of the bank for the difference between the repurchase price of the retail repo and the market value of the underlying collateral.
7. Information advising the customer whether he or she has a perfected lien on the underlying collateral under state law, and whether it is being held by an independent trustee or custodian. If the customer does not have a perfected security interest, the legal consequences, including the possibility of becoming an unsecured general creditor, should be described.
8. Appropriate information regarding the bank and its financial condition.

If the retail repo agreement itself does not include all material disclosures, the face of the agreement should make specific reference to other documents provided to the customer containing sufficient material disclosures.

Care should also be taken with respect to the advertising and marketing of retail repos. All advertisements, announcements, and solicitations for retail repos

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should state that they are not deposits of the issuing bank and are not insured by the FDIC. Advertisements and other documents provided to the customers that refer to the underlying U.S. Government or agency obligations securing retail repos should disclose sufficient information to avoid the potential misrepresentation that retail repos are guaranteed by the U.S. government.

As a matter of prudent banking practice and in order to provide a cushion of protection for individuals who purchase retail repos, the market value of the underlying security should be equal to or exceed the purchase price of the retail repo at the time of issuance. In addition, in order to avoid the potential for conflicts of interest, a bank should not sell its retail repos to its own trust department or to trust agency accounts over which it or any affiliate has investment discretion.

Since both retail and large denomination wholesale repurchase agreements are in many respects equivalent to short-term borrowings at market rates of interest, banks engaging in repurchase agreements should carefully evaluate their interest rate risk exposure at various maturity levels, formulate policy objectives in light of the institution's entire asset and liability mix, and adopt procedures to control mismatches between assets and liabilities. The degree to which a bank borrows through repurchase agreements also should be analyzed with respect to its liquidity needs, and contingency plans should provide for alternate sources of funds in the event of a run-off of repurchase agreement liabilities.

Bank management also should be aware of certain considerations and potential risks associated with wholesale repurchase agreements entered into in large volume with institutional investors and/or brokers. If the value of the underlying securities exceeds the price at which the repurchase agreement was sold, the bank could be exposed to the risk of loss in the event that the buyer is unable to perform and return the securities. The possibility of this occurring would obviously increase if

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the securities are physically transferred to the institution or broker with which the bank has entered into the repurchase agreement. Moreover, if the securities are not returned, the bank could be exposed to the possibility of a significant write-off to the extent that the book value of the securities exceeds the price at which the securities were originally sold under the repurchase agreement. For this reason, banks should obtain sufficient financial information on and analyze the financial condition of those institutions and brokers with whom they engage in repurchase transactions.

Federal Reserve examiners will be asked to review each bank's internal procedures and practices for consistency with the considerations discussed above.

ANTHONY M. SOLOMON,
President.

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