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RONALD B. GRAY
EXECUTIVE VICE PRESIDENT

At. Cir. No. 9463(a)

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Chief Executive Officers of State Member Banks and
Bank Holding Companies in the Second Federal Reserve District

During recent months banks and securities brokers have been showing an increasing interest in transactions involving the lending of tax-exempt securities. Basically, these transactions are intended to enable banks to increase yields on their investment securities portfolios and to realize unused tax benefits. As interest continues to grow, we believe you should know our views on this activity.

Specifically, these transactions can possibly increase yields on securities, but they can also entail certain risks to banking organizations. Because of the risks associated with this activity, we believe that financial institutions should proceed cautiously in this area and make certain that the various risks are fully understood and appropriately addressed before embarking on the activity.

For your information, we have attached a brief summary of the two principal risks involved with lending of tax-exempt securities and some procedural considerations that may be helpful. If you have any additional interest in this subject, we would be pleased to forward to you our examination guidelines. In this regard you may contact John M. Casazza, Assistant Chief Examiner in our Bank Examinations Department (Tel. 212 - 791-5895).

Sincerely,

Attachment

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BACKGROUND INFORMATION ON LENDING TAX EXEMPT SECURITIES

Risk of Loss if Transactions are Classified as Sales

Banks should seek the advice of their attorneys and accountants in developing their "lending of securities" agreements so that they will be recognized as loans -- instead of as sales -- of the securities. Banks should also pay close attention to the term of the loans, and to the need for securities that are substantially similar to those that are borrowed to be returned to the banks, because failure to do so could result in the transactions' classification as sales. To date the IRS has not ruled specifically that these transactions are definitely loans as opposed to sales. If on an individual basis the IRS were to argue that the loan was in fact a sale, a bank would be forced to recognize a decline in the market value of the municipals as a loss -- an event which could have serious implications for the earnings and capital adequacy of the bank, depending on the volume of the activity. One way to reduce the possibility that substantially similar securities would not be returned, would be to arrange for the loaned securities to be held by a third party custodian for the benefit of the borrowing broker or end investor. This custodian could be responsible for notifying the dealer or lending bank if the loaned securities are sold or pledged, thereby giving the broker and lending bank time to ensure that other identical or substantially similar securities are obtained and returned by the bank.

Credit Risk Associated with Transactions

Once a bank has loaned some of its tax-exempt securities to a broker the bank becomes subject to the same credit risk considerations associated with other types of loans. The broker's ability to repay the loan by returning the borrowed securities will depend on the type of financial arrangements the broker has entered into regarding the tax-exempt and taxable securities, the conditions of the securities markets during the term of the loan, and, of course, on the financial strength of the broker. Adverse market conditions may seriously affect a broker's ability to return the borrowed municipals if the broker is in poor financial condition. Therefore, banks should carefully analyze the credit risk associated with these transactions and limit the amount of their loan exposure with individual brokers.

Procedural Considerations

Because the transactions do entail certain risk, the risks involved should be identified and analyzed thoroughly prior to engaging in this activity. Care should be taken to structure the lending arrangements and transactions properly and to maintain adequate internal controls over this activity. Particularly, as a matter of prudence, these transactions should be fully collateralized with readily marketable high grade investment quality securities, and the collateral should be revalued at least on a monthly basis, with any short falls corrected. An organization's aggregate exposure to potential loss on all such transactions should be within preestablished limits. In addition, appropriate documentation of the analyses performed and of the transactions should be maintained. Finally, the effect on a bank's liquidity of engaging in these transactions and of lending and pledging securities should be carefully evaluated.

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