

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 9948]
[November 13, 1985]

SUPERVISORY POLICY ON REPURCHASE AGREEMENTS

*To All State Member Banks, Bank Holding Companies, and Edge
and Agreement Corporations in the Second Federal Reserve District,
and Others Concerned:*

On October 22, 1985, the Federal Financial Institutions Examination Council recommended approval of a uniform Supervisory Policy on Repurchase Agreements of Depository Institutions with Securities Dealers and Others. The Board of Governors of the Federal Reserve System has announced its adoption of that policy. Following is the text of the Board's statement in this matter:

The Federal Reserve Board has announced the adoption of a supervisory policy on repurchase agreement transactions. The adoption of this policy had been recommended by the Federal Financial Institutions Examination Council.

The policy statement is intended to provide financial institutions with minimum safety and soundness guidelines for managing credit risk exposure. It also provides guidance related to the possession or control of securities involved in repurchase agreement transactions. In addition, the policy points out the need for full collateralization, maintenance of agreed upon collateral margins and frequent mark-to-market procedures.

Depository institutions doing business with unregulated government securities dealers are urged to verify that these dealers are complying with the Federal Reserve Bank of New York's minimum capital guidelines.

Depository institutions should contact their District Federal Reserve Banks with questions concerning the procedures for obtaining control of U.S. Treasury securities and certain agency obligations through the Federal Reserve's book-entry system.

Enclosed — for member banks, bank holding companies, and Edge and Agreement Corporations — is the text of the policy statement on repurchase agreements adopted by the Board of Governors. Additional copies of that text will be furnished upon request directed to our Circulars Division (Tel. No. 212-791-5216).

Questions regarding this matter may be directed to A. John Maher, Assistant Chief Examiner (Tel. No. 212-791-5194).

E. GERALD CORRIGAN,
President.

Federal Financial Institutions Examination Council
Supervisory Policy

REPURCHASE AGREEMENTS OF DEPOSITORY INSTITUTIONS WITH
SECURITIES DEALERS AND OTHERS

Purpose

Depository institutions and others involved with the purchase of United States Government and Agency obligations under agreements to resell (reverse repurchase agreement),^{1/} have sometimes incurred significant losses. The most important factors causing these heavy losses have been inadequate credit risk management and the failure to exercise effective control over securities collateralizing the transactions.^{2/}

The following minimum guidelines address the need for managing credit risk exposure to counterparties under securities repurchase agreements and for controlling the securities in those transactions, and should be followed by depository institutions that enter into repurchase agreements with securities dealers and others.

Depository institutions that actively engage in repurchase agreements are encouraged to have more comprehensive policies and controls to suit their particular circumstances. The examining staffs of the Federal bank, thrift and credit union supervisory agencies will review written policies and procedures of depository institutions to determine their adequacy in light of these minimum guidelines and the scope of each depository's operations.

1/ In order to avoid confusion among market participants who sometimes use the same term to describe different sides of the same transaction, the term "repurchase agreement" will be used in the balance of this statement to refer to both repurchase and reverse repurchase agreements. A repurchase agreement is one in which a party that owns securities acquires funds by transferring the securities to another party under an agreement to repurchase the securities at an agreed upon future date. A reverse repurchase (resale) agreement is one in which a party provides funds by acquiring securities pursuant to an agreement to resell them at an agreed upon future date.

2/ Throughout this document repurchase agreements are generally discussed in terms of secured credit transactions. This usage should not be deemed to be based upon a legal determination.

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I. Credit Policy Guidelines

The apparent safety of short-term repurchase agreements which are collateralized by highly liquid, U.S. Government and Federal agency obligations has contributed to an attitude of complacency. Some portfolio managers have underestimated the credit risk associated with the performance of the counterparty to the transaction, and have not taken adequate steps to assure control of the securities covered by the agreement.

All depository institutions that engage in securities repurchase agreement transactions should establish written credit policies and procedures governing these activities. At a minimum, those policies and procedures should cover the following:

A. Written policies should establish "know your counterparty" principles. Engaging in repurchase agreement transactions in volume and in large dollar amounts frequently requires the services of a counterparty who is a dealer in the underlying securities. Some firms which deal in the markets for U.S. Government and Federal agency securities are subsidiaries of, or related to, financially stronger and better known firms. However, these stronger firms may be independent of their U.S. Government securities subsidiaries and affiliates and may not be legally obligated to stand behind the transactions of related companies. Without an express guarantee, the stronger firm's financial position cannot be relied upon in assessing the creditworthiness of a counterparty.

It is important to know the legal entity that is the actual counterparty to each repurchase agreement transaction. A depository institution should know about the actual counterparty's character, integrity of management, activities, and the financial markets in which it deals. Depository institutions should be particularly careful in conducting repurchase agreements with any firm that offers terms that are significantly more favorable than those currently prevailing in the market.

In certain situations depository institutions may use, or serve as, brokers or finders in order to locate repurchase agreement counterparties or particular securities. When using or acting as this type of agent the names of each counterparty should be fully disclosed. Depository institutions should not enter into undisclosed agency or "blind brokerage" repurchase transactions in which the counterparty's name is not disclosed.

B. Dealings with unregulated securities dealers. A dealer in U.S. Government and Federal agency obligations is not necessarily a Federally insured bank or thrift, or a broker/dealer registered with the Securities and Exchange Commission. Therefore, the dealer firm may not be subject to any Federal regulatory oversight.

A depository institution doing business with an unregulated securities dealer should be certain that the dealer voluntarily complies with the Federal Reserve Bank of New York's minimum capital guideline, which currently calls for liquid capital to exceed measured risk by 20 percent (that is, the ratio of a dealer's liquid capital to risk of 1.2:1). This ratio can be calculated by a dealer using either the Securities and Exchange Commission's Net Capital Rule for Brokers and Dealers (Rule 15c3-1) or the Federal Reserve Bank of New York's Capital Adequacy Guideline for United States Government Securities Dealers. To ensure that an unregulated dealer complies with either of those capital standards, it should certify its compliance with the capital standard and provide the following three forms of certification:

- (1) A letter of certification from the dealer that the dealer will adhere on a continuous basis to the capital adequacy standard;
- (2) audited financial statements which demonstrate that as of the audit date the dealer was in compliance with the standard and the amount of liquid capital; and
- (3) a copy of a letter from the firm's certified public accountant stating that it found no material weaknesses in the dealer's internal systems and controls incident to adherence to the standard.³

C. Periodic evaluations of counterparty creditworthiness should be conducted by individuals who routinely make credit decisions and who are not involved in the execution of repurchase agreement transactions.

Prior to engaging in initial transactions with a new counterparty, depository institutions should obtain audited financial statements and regulatory filings (if any) from its counterparties, and should insist that similar information be provided on a periodic and timely basis in the future. Recent failures of government securities dealers have typically been foreshadowed by delays in producing these statements. Many firms are registered with the Securities and Exchange Commission as broker/dealers and have to file financial statements and should be willing to provide a copy of these filings.

^{3/} This letter should be similar to that which must be given to the SEC by registered broker/dealers.

The counterparty credit analysis should consider the financial statements of the entity that is to be the depository institution's counterparty as well as those of any related companies that could have an impact on the financial condition of the counterparty. When transacting business with a subsidiary, consolidated financial statements of a parent are not adequate. Repurchase agreements should not be entered into with any counterparty that is unwilling to provide complete and timely disclosure of its financial condition. As part of this analysis, the depository institution should make inquiry about the counterparty's general reputation and whether there have been any formal enforcement actions against the counterparty or its affiliates by State or Federal securities regulators.

D. Maximum position and temporary exposure limits for each approved counterparty should be established based upon credit analysis performed. Periodic reviews and updates of those limits are necessary.

Individual repurchase agreement counterparty limits should consider overall exposure to the same or related counterparty throughout the depository institution. Repurchase agreement counterparty limitations should include the overall permissible dollar positions in repurchase agreements, maximum repurchase agreement maturities and limits on temporary exposure that may result from decreases in collateral values or delays in receiving collateral.

E. Lending Limitations. Federally-chartered savings institutions and Federal credit unions are subject to all Federal regulations in this area. State-chartered banks or savings institutions should consult with their counsel and/or state banking or thrift authorities as to the applicability of state lending restrictions to repurchase transactions.

Except as otherwise provided in applicable agency regulations and State law, it should be assumed that unless the depository institution's interest in securities held as collateral under a repurchase agreement is assured, a repurchase agreement transaction with any single counterparty will be subject to the lending limitations applicable to that institution. Conversely, the market value of securities sold under a repurchase agreement in excess of the amount of proceeds received by the depository institution could be viewed as an unsecured extension of credit to the repurchase agreement counterparty subject to the depository institution's lending limits.

The application of lending limitations on loans by national banks to certain types of repurchase transactions is currently under review by the Comptroller of the Currency. Until this review is completed, national banks as a matter of prudent banking should treat repurchase agreements as if they are subject to the lending limit unless the bank has control of the underlying securities.

II. Guidelines for Controlling Repurchase Agreement Collateral

Repurchase agreements can be a useful asset and liability management tool, but repurchase agreements can expose a depository institution to serious risks if they are not managed appropriately. It is possible to reduce repurchase agreement risk if the depository institution negotiates written agreements with all repurchase agreement counterparties and custodian banks. Compliance with the terms of these written agreements should be monitored on a daily basis. If prudent management control requirements of repurchase agreements are too burdensome for a depository institution, other asset/liability management tools should be used.

The marketplace perceives repurchase agreement transactions as similar to lending transactions collateralized by highly liquid Government securities. However, experience has shown that the collateral securities will probably not serve as protection if the counterparty becomes insolvent or fails, and the purchasing institution does not have control over the securities. This policy statement provides general guidance on the steps depository institutions should take to protect their interest in the securities underlying repurchase agreement transactions (see "C. Control of Securities," page 6). However, ultimate responsibility for establishing adequate procedures rests with management of the institution. Management should obtain a written legal opinion as to the adequacy of the procedures utilized to establish and protect the depository institution's interest in the underlying collateral.

General Requirements

A. A written agreement specific to a repurchase agreement transaction or master agreement governing all repurchase agreement transactions should be entered into with each counterparty. The written agreement should specify all the terms of the transaction and the duties of both the buyer and seller. Senior managers of depository institutions should consult legal counsel regarding the content of the repurchase and custodial agreements. The repurchase and custodial agreements should specify, but should not be limited to, the following:

- o acceptable types and maturities of collateral securities;
- o initial acceptable margin for collateral securities of various types and maturities;
- o margin maintenance, call, default and sellout provisions;
- o rights to interest and principal payments;
- o rights to substitute collateral; and
- o the persons authorized to transact business on behalf of the depository institution and its counterparty.

B. Confirmations. Some repurchase agreement confirmations may contain terms that attempt to change the depository institution's rights in the transaction. The depository institution should obtain and compare written confirmations for each repurchase agreement transaction to be certain that the information on the confirmation is consistent with the terms of the agreement. The confirmation should identify specific collateral securities.

C. Control of Securities. As a general rule, a depository institution should obtain possession or control of the underlying securities and take necessary steps to protect its interest in the securities. The legal steps necessary to protect its interest may vary with applicable facts and law and accordingly should be undertaken with the advice of counsel. Additional prudential management controls may include:

- (1) Direct delivery of physical securities to the institution, or of book-entry securities by appropriate entry in an account maintained in the name of the depository institution by a Federal Reserve Bank which maintains a book-entry system for U.S. Treasury securities and certain agency obligations (for further information as to the procedures to be followed, contact the Federal Reserve Bank for the District in which the depository institution is located);
- (2) delivery of either physical securities to, or in the case of book entry securities, making appropriate entries in the books of a third party custodian designated by the depository institution under a written custodial agreement which explicitly recognizes the depository institution's interest in the securities as superior to that of any other person; or
- (3) appropriate entries on the books of a third party custodian acting pursuant to a tripartite agreement with the depository institution and the counterparty, ensuring adequate segregation and identification of either physical or book-entry securities.

Where control of the underlying securities is not established, the depository institution may be regarded only as an unsecured general creditor of the insolvent counterparty. In such instance, substantial losses are likely to be incurred. Accordingly, a depository institution should not enter into a repurchase agreement without obtaining control of the securities unless all of the following minimum procedures are observed: (1) it is completely satisfied as to the creditworthiness of the counterparty; (2) the transaction is within credit limitations that have been pre-approved by the board of directors, or a committee of the board, for unsecured transactions with the counterparty;

(3) periodic credit evaluations of the counterparty are conducted; and (4) the depository institution has ascertained that collateral segregation procedures of the counterparty are adequate. Unless prudential internal procedures of these types are instituted and observed, the depository institution may be cited by its financial supervisory agency for engaging in unsafe or unsound practices.

All receipts and deliveries of either physical or book-entry securities should be made according to written procedures, and third party deliveries should be confirmed in writing directly by the custodian. It is not acceptable to receive confirmation from the counterparty that the securities are segregated in a depository institution's name with a custodian; the depository institution should, however, obtain a copy of the advice of the counterparty to the custodian requesting transfer of the securities to the depository institution. Where securities are to be delivered, payment for securities should not be made until the securities are actually delivered to the depository institution or its agent. The custodial contract should provide that the custodian takes delivery of the securities subject to the exclusive direction of the depository institution.

Substitution of securities should not be allowed without the prior consent of a depository institution. The depository institution should give its consent before the delivery of the substitute securities to the depository institution or a third party custodian. Any substitution of securities should take into consideration the following discussion of "margin requirements."

D. Margin Requirements. The amount paid by a depository institution under the repurchase agreement should be less than the market value of the securities, including the amount of any accrued interest, with the difference representing a predetermined margin. Factors to be considered in establishing an appropriate margin include the size and maturity of the repurchase transaction, the type and maturity of the underlying securities, and the creditworthiness of the counterparty. Margin requirements on U.S. Government and Federal agency obligations underlying repurchase agreements should allow for the anticipated price volatility of the security until the maturity of the repurchase agreement. Less marketable securities may require additional margin to compensate for less liquid market conditions. Written repurchase agreement policies and procedures should require daily mark-to-market of repurchase agreement securities to the bid side of the market. Repurchase agreements should provide for additional securities or cash to be placed with the depository institution or its custodian bank to maintain the margin within the predetermined level.

Margin calculations should also consider accrued interest on underlying securities and the anticipated amount of accrued interest over the term of the repurchase agreement, the date of interest payment and which party is entitled to receive the payment. In the case of pass-through securities, anticipated principal reductions should also be considered when determining margin adequacy.

E. Prudent management procedures should be followed in the administration of any repurchase agreement. Longer term repurchase agreements require management's daily attention to the effects of securities substitutions, margin maintenance requirements (including consideration of any coupon interest or principal payments) and possible changes in the financial condition of the counterparty. Engaging in open repurchase agreement transactions without maturity dates may be regarded as an unsafe and unsound practice unless the depository institution has retained rights to terminate the transaction quickly to protect itself against changed circumstances. Similarly, automatic renewal of short-term repurchase agreement transactions without reviewing collateral values and adjusting collateral margin may be regarded as an unsafe and unsound practice. If additional margin is not deposited when required, the depository institution's rights to sell securities or otherwise liquidate the repurchase agreement should be exercised without hesitation.

F. Overcollateralization. A depository institution should use current market values, including the amount of any accrued interest, to determine the price of securities that are sold under repurchase agreements. Counterparties should not be provided with excessive margin. Thus, the written repurchase agreement contract should provide that the counterparty must make additional payment or return securities if the margin exceeds agreed upon levels. When acquiring funds under repurchase agreements it is prudent business practice to keep at a reasonable margin the difference between the market value of the securities delivered to the counterparty and the amount borrowed. The excess market value of securities sold by a depository institution may be viewed as an unsecured loan to the counterparty subject to the unsecured prudential limitations for the depository institution and should be treated accordingly for credit policy and control purposes.