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BY MESSENGER

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Attention: 2002-64

Ladies and Gentlemen:

This comment letter is filed on behalf of a client of this firm with respect to the interim final rule with request for comment that appeared at pages 77909-77918 of the Federal Register on December 20, 2002 ("Interim Rule") relating to transactions with affiliates.

The purpose of this letter is to comment on the question posed by the Office of Thrift Supervision ("OTS") on page 77914 of the Federal Register. OTS requested comment on whether it should retain in Section 563.41(c)(1)(ii) of the Interim Rule the provisions governing the treatment of purchases of assets that are subject to agreements to repurchase ("reverse repurchase agreements" or "reverse repos").

Recommendation

For the reasons set forth below, we believe OTS should conform its treatment of reverse repos to that of the Board of Governors of the Federal Reserve System ("FRB") and, therefore, delete the language in Section 563.41(c)(1)(ii) that classifies a reverse repo as a loan or other extension of credit for the purposes of Section 11(a) of the Home Owners' Loan Act ("HOLA"), 12 U.S.C. § 1468(a)(1)(A). However, if for any reason OTS does not make this deletion, it is imperative that OTS retain the portion of Section 563.41(c)(1)(ii) that excludes from this general treatment as a loan or other extension of credit a reverse repo that meets all of the requirements of Section 563.41(c)(1)(ii)(A), (B) and (C).

Analysis

Section 11(a) of HOLA is the statutory provision that addresses directly the ability of a savings association to engage in reverse repos with its affiliates. Section 11(a) subjects a savings association to Sections 23A and 23B of the Federal Reserve Act ("FRA"), 12 U.S.C. §§ 371c, 371c-1, as if the savings association were a member bank, except that two additional prohibitions are imposed on certain transactions between savings associations and their affiliates. One of the additional prohibitions is a ban against a savings association making a loan or other extension of credit to any affiliate engaged in activities not permissible for a bank holding company. 12 U.S.C. § 1468(a)(1)(A). In addition, Section 11(a)(4) of HOLA authorizes the OTS Director to "impose such additional restrictions on any transaction between any savings association and any affiliate of such savings association as the Director determines to be necessary to protect the safety and soundness of the savings association and any affiliate of such savings association." 12 U.S.C. § 1468(a)(4).

A reverse repo, pursuant to which a savings association purchases securities from an affiliate subject to an agreement to sell the identical securities back to the affiliate at a later date, clearly falls within the meaning of "a purchase of assets, including assets subject to an agreement to repurchase, from the affiliate" under Section 23A(b)(7)(C) of the FRA, 12 U.S.C. § 371c(b)(7)(C), and, therefore, does not come within the meaning of "a loan or extension of credit to the affiliate," which is listed as a separate, distinct and mutually exclusive type of covered transaction under Section 23A(b)(7)(A), 12 U.S.C. § 371c(b)(7)(A).

There is no dispute that a reverse repo is treated under Section 23A as a purchase of assets subject to repurchase, rather than as a loan or extension of credit. The express language of Section 23A(b)(7)(C) clearly applies to a reverse repo; and the FRB staff, which for many years has had the primary role in interpreting the application of Section 23A to all types of insured banks and savings associations, has consistently followed a long-standing position, based upon the unambiguous language of the statute, that a reverse repo is a purchase of assets subject to repurchase and not a loan or other extension of credit for the purposes of Section 23A. In fact, the FRB staff has indicated to us informally that the FRB has not issued any regulations, policy statements or legal opinions confirming that a reverse repo is not treated as a loan or other extension of credit for the purposes of Section 23A because of the explicitness of the statutory language that treats a purchase of assets subject to an agreement to repurchase as separate from and different than a loan or other extension of credit.[1]

[1] The term "loans or other extensions of credit" is also defined in the Office of the Comptroller of the Currency regulations implementing the loans-to-one-borrower restrictions of 12 U.S.C. § 84 so as to exclude the purchase of securities by a bank subject to an agreement to repurchase the securities where the bank purchases Type I securities and has assured control over, or has established its rights to, the Type I securities as collateral. 12 C.F.R. § 32.2(k)(1)(iii). The OTS regulation imposing loans-to-one-borrower limitations on savings associations provides that the term "loans and extensions of credit" thereunder has the meaning set forth in 12 C.F.R. § 32, although the OTS regulation expressly reserves the authority to deem other arrangements that are, in substance, loans and extensions of credit to be encompassed by this term. 12 C.F.R. § 560.93(b)(4).

Consistent with this long-standing position, Regulation W, recently adopted by the FRB, 67 Fed. Reg. 76560 (Dec. 12, 2002), does not specifically address this issue.

Since Section 11(a) of HOLA determines the extent to which Sections 23A and 23B apply to savings associations and incorporates the basic rule that Sections 23A and 23B generally apply in the same manner to savings associations as they do to member banks, the same definitions and characterizations used in interpreting Sections 23A and 23B clearly should be used to interpret and administer Section 11(a). Under this principle, a reverse repo between a savings association and an affiliate is a purchase of assets subject to repurchase under Section 11(a) and not a loan or other extension of credit. As a consequence, unless additional restrictions are authorized under the specific standard incorporated in Section 11(a)(4) referred to above, a reverse repo between a savings association and an affiliate must be subject to the applicable requirements and exceptions established under Section 23A for a purchase of assets subject to repurchase, and cannot be subject to the absolute prohibition applicable under Section 11(a) to a loan or other extension of credit to an affiliate engaged in activities impermissible for a bank holding company.

As indicated above, Section 11(a)(4) of HOLA authorizes the OTS Director to impose additional restrictions on transactions between a savings association and an affiliate beyond those authorized under Sections 23A and 23B, but only if the OTS Director determines such additional restrictions are necessary to protect the safety and soundness of the savings association. However, to the best of our knowledge, we are unaware of any information or analysis ever having been presented by OTS to support the position that reverse repos must be barred between savings associations and affiliates engaged in activities not authorized for bank holding companies in order to protect the safety and soundness of the savings association.

When it was enacted as part of Section 301 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), the apparent basis for the bar imposed under Section 11(a)(1)(A) of HOLA against loans or other extensions of credit by a savings association to affiliates engaged in activities not authorized for bank holding companies must have been the ongoing concern of Congress with allowing the integration of banking and commercial activities. This must be true because we are unable to conceive of any rationale for concluding that reverse repos with an affiliate engaged in activities not authorized for bank holding companies raise any more safety and soundness concerns than reverse repos with an affiliate engaged solely in activities authorized for bank holding companies. Therefore, absent demonstrable safety and soundness concerns, there is no reasonable or valid statutory basis for OTS to treat reverse repos as loans or other extensions of credit for the purposes of Section 11(a).

Moreover, treating reverse repos as a purchase of assets does not cause these types of transactions to be exempt from restrictions under Sections 23A and 23B. Rather, such treatment still subjects reverse repos to the quantitative limits and other restrictions of Section 23A, unless other specific exemptions apply, as well as to all of the requirements of Section 23B.

The fact that reverse repos have certain financial characteristics similar to loans and are treated as loans or other extensions of credit, rather than as purchases of assets, for certain accounting or other regulatory purposes, should not affect the determination whether reverse repos are loans or extensions of credit under Section 11(a). The definition of a loan or extension of credit for the purpose of Section 11(a) is dependent solely upon and must track the definition of a loan or extension of credit under Section 23A.

Repos and reverse repos have for many years been treated by the financial and securities markets as a separate and distinct class of transaction from secured loans. The repo and reverse repo market is extraordinarily large, with average daily aggregate outstandings in 2002 estimated by the Bond Market Association to be in excess of $3.6 trillion. This large, distinctive market in repos and reverse repos reflects two characteristics that distinguish repos and reverse repos from secured loans. First, securities transferred pursuant to a repo or reverse repo are treated significantly differently under the federal insolvency laws compared to assets pledged as collateral for loans. Special provisions in the Bankruptcy Code and the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") allow repo and reverse repo buyers to liquidate purchased securities upon default without being subject to an automatic stay or similar delays or prohibitions. Second, the buyer under a repo or reverse repo transaction normally has the right to resell or pledge the purchased securities during the term of the transaction. Upon maturity of the repo or reverse repo, the buyer can satisfy its resale obligation by transferring fungible securities. In contrast, the lender on a secured loan normally must retain the collateral at all times without repledging it.

Given the distinctive nature of repos and reverse repos compared to secured loans or other extensions of credit, it would be clearly incorrect to conclude that reverse repos should be lumped with loans or other extensions of credit under Section 11(a) because reverse repos are treated in the same manner as loans or extensions of credit for certain other separate and different accounting or regulatory purposes.

Moreover, the following legislative history of Section 11(a) reinforces the conclusion that a reverse repo is not to be treated as a loan or extension of credit under Section 11(a). Immediately prior to the enactment of Section 11(a) in 1989 as part of FIRREA, transactions between a savings association and its affiliates had been subject to limitations imposed in 1988 under Sections 408(d) and (p) of the National Housing Act, 12 U.S.C. § 1730a(d), (p) (1988).

Sections 408(d) and (p) provided, as does Section 11(a), that transactions with affiliates engaged only in activities authorized for bank holding companies were subject to Sections 23A and 23B of the FRA. However, Section 408(d) provided that transactions with affiliates engaged in other types of activities were subject to a different framework that included a lengthier list of prohibitions than the two types of transactions prohibited by FIRREA under Section 11(a): (1) a loan or other extension of credit to an affiliate; and (2) a purchase of or investment in securities issued by an affiliate (other than a subsidiary).

Section 408(d) prohibited, as separate and distinct types of transactions, the ability to: (1) "purchase securities or other assets or obligations under repurchase agreement from any affiliate;" (2) with certain limited exceptions, "make any loan, discount, or extension of credit to . . . any affiliate . . . or . . . any third party on the security of property acquired from any affiliate, or with knowledge that the proceeds of any such loan, discount, or extension of credit, or any part thereof, are to be paid over to or utilized for the benefit of any affiliate. . . .;" (3) invest in the securities of an affiliate; (4) accept the securities of an affiliate as collateral for a loan or extension of credit; (5) guarantee the repayment of, or maintain any compensating balance for, any loan or extension of credit granted to an affiliate; and (6) subject to prior regulatory approval, above certain de minimis amounts purchase assets from, or sell assets to, an affiliate or enter into a contract to provide services to an affiliate.

Thus, immediately prior to the enactment of Section 11(a) in 1989, purchases of assets subject to repurchase were listed and treated separately from loans or extensions of credit and both categories were generally prohibited between a savings association and affiliates engaged in activities impermissible for bank holding companies. As a result of the enactment of FIRREA, purchases of assets subject to repurchase became subject uniformly to Sections 23A and 23B, while the treatment of loans or other extensions of credit remained bifurcated for the two different classes of affiliates. Thus, the legislative history reflects the inclusion in the predecessor to Section 11(a) of both purchases of assets subject to repurchase and loans and other extensions of credit and then the elimination of purchases of assets subject to repurchase along with several other categories of affiliate transactions from those types of transactions barred between a savings association and affiliates engaged in activities impermissible for a bank holding company. This legislative history also strongly supports the conclusion that purchases of assets subject to repurchase are not to be included within the term "loan or other extension of credit" for the purposes of Section 11(a) of HOLA.

In summary, the legal analysis is compelling that in the context of Section 11(a) of HOLA – which is the only relevant context -- a reverse repo is a purchase of assets and not a loan or other extension of credit and, therefore, should be treated as a purchase of assets for purposes of Section 563.41(c) of the OTS Regulations.

However, if for any reason OTS does not delete the language in Section 563.41(c)(1)(ii) treating a reverse repo with an affiliate generally as a loan or other extension of credit, it is imperative that OTS retain the portion of Section 563.4(c)(1)(ii) that excludes from this general treatment as a loan or other extension of credit a reverse repo that meets all of the requirements of Section 563.41(c)(1)(ii)(A), (B) and (C). Our client has engaged in reverse repo transactions with its federal savings association subsidiary that have been in compliance with all of the foregoing requirements of Section 563.41(c)(1)(ii) since the predecessor regulation to Section 563.41(c) was issued by OTS in August of 1998. These reverse repos have benefited both parties to the transactions. During this period, OTS has never criticized any aspects of these reverse repo programs in any of its periodic safety and soundness examinations of the federal savings association. To the best of our knowledge, there is absolutely no basis whatsoever to terminate the exception in Section 563.41(c)(1)(ii) for the limited types of transactions described

therein, if, for any reason, OTS retains the language in Section 563.41(c)(1)(ii) providing that, in general, a reverse repo is to be treated as a loan or other extension of credit.

Please call me at (202) 778-9350 if you have any questions, or would like any additional information, concerning any of the matters discussed in this comment letter.

Sincerely,

Ira L. Tannenbaum

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