

Memo 1994-14 Repurchase Agreements with Municipalities

TO: All State Chartered Banks
FR: Kevin Glendening, Assistant Deputy Commissioner
DT: June 10, 1994
RE: Repurchase Agreements with Municipalities

A recent Attorney General's opinion (no. 94-14) pertaining to K.S.A. 12-1675 states that when a municipality enters into a repurchase agreement, the underlying security must be delivered to the municipality purchaser or an independent third party custodian which may include the state treasurer. The actual transfer of ownership and control of the security used in a repurchase arrangement is also known as a "delivery versus payment" type of repo.

The purpose of this memo is to provide banks general guidance on A) the appropriate structure of this type of repurchase agreement and B) the method of accounting for these agreements on the bank's books. Banks who currently are or who in the future plan to engage in repo activities with municipalities are encouraged to review the AG's opinion and related issues with their legal and accounting staff. Our examiners will be reviewing these repurchase agreements for compliance with the applicable statute and related AG opinion at future examinations.

STRUCTURE OF REPO

A number of people have asked how a repo agreement with a municipality would work under the delivery versus payment method. There are a number of variables which may enter into any specific repo agreement (described below), however, the following general elements would be common to all repos of this type:

The seller (bank) would instruct its correspondent to deliver the security to the safekeeping/custodial account of the buyer (muni). Once the security is transferred to the buyer's (muni) account it will no longer appear in the seller's (bank) safekeeping account, and a confirmation would be sent to the seller (bank) showing the withdrawal of the security from their account. When the repo transaction matures, the buyer (muni) must notify the custodian/correspondent to return the security to the safekeeping account of the seller (bank).

Generally, the municipality must have a safekeeping/custodial account in order to carry out these transactions. It appears that in many cases, the bank will set up the safekeeping/custodial account at its correspondent as a service to the municipality. The municipality and/or its custodian, however, would be the account holder and the bank would not have access to it.

Depending on the terms of the repo agreement, the seller (bank) may or may not receive maturity notices or credit advices on the security used for the repo, although if possible banks are encouraged to do so. Likewise, the treatment of interest payments received on the security during the term of the repo should also be covered in the agreement. These issues will require the seller (bank), for their own benefit, to keep accurate records of the securities used for these repos since they may not receive notices from the correspondent.

"Book Entry" securities, those for which actual certificates are not generally issued, may be divided and sold, generally in increments of \$5,000. It is our understanding that virtually all government sponsored securities are issued as book entry. Based on this assumption, a bank could, as an example, sell off portions of a large denomination security to different municipalities, transferring ownership of their respective portions to each. This would appear to eliminate any problem of a bank using large securities for smaller repo arrangements. In these instances, the buyer (muni) would be issued a safekeeping receipt for their portion of the security purchased and the seller (bank) would be issued a new safekeeping receipt for that portion of the security retained.

It's important to remember that the Attorney General's opinion referenced above

pertains to public funds money only. Individuals or private sector interest could, in theory, negotiate with the bank for whatever terms they desire. In any event, the repo agreement should clearly spell out the terms of the arrangement.

ACCOUNTING FOR REPO

Consistent with Call Report treatment of repurchase agreements and GAAP, the bank may continue to carry the security involved in the repo on their books for recordkeeping purposes. The bank should segregate those securities used for repos under a separate asset account such as "Bonds held for repo" or similar category. The money received from the municipality for their purchase of the repo would be debited to a cash and due account, and an offsetting entry on the liability side of the ledger to "Outstanding repos" or similar account would be made. It should be remembered that the bank's retention of the repo security on their books for recordkeeping purposes does not alter the AG opinion's requirement for the transfer of ownership.