INTERPRETIVE LETTER 89-9 (AUGUST 29, 1989)

State bank may engage in fixed coupon dollar repo and dollar roll transactions subject to satisfying the criteria established for national banks by the Office of the Comptroller of the Currency.

Previously you forwarded to this Agency materials concerning dollar repo/dollar roll transactions and inquired whether Illinois state banks could engage in transactions involving dollar repos and dollar rolls.

Preparation of yield-maintenance agreements must include compliance with Section 33 of the Illinois Banking Act ("Act"). That section generally limits each state bank to purchasing marketable investment securities for its own account from any one maker or obligor in a total amount which would not exceed 20% of the bank's capital and surplus. Exceptions to, and exemptions from, the general limitations upon marketable investment securities including United States Government obligations and municipal obligations, are listed in Sections 34 and 35 of the Act.

The Office of the Comptroller of the Currency ("OCC") has established criteria for fixed-coupon dollar repos and dollar rolls which must be satisfied in order for them to be treated as financing transactions rather than as sales. The conditions which must be satisfied for fixed-coupon dollar repos are:

> 1) The securities must be collateralized by similar mortgages (e.g., single-family residential mortgages for single-family residential mortgages);
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> 2) The replacement security must be issued by the same entity that issued the original security, and must be identical in form and type (e.g., GNMA I for GNMA I);
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> 3) The securities must have the same original stated term to maturity (e.g., 30 years), and the expected remaining life must be nearly identical;
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> 4) The securities must have identical coupon interest rates;
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> 5) The securities must have approximately the same market yield;
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> 6) The aggregate principal amounts of mortgage-backed securities ("MBSs") given up and MBSs forward-purchased in the transaction must be within industry-established parameters for good delivery if the gains or losses in the difference in aggregate principal amounts are recognized in current noninterest income or expenses. The Public Securities Association ("PSA") currently defines good delivery as a 2.5% gain or loss in aggregate principal amounts;

7) The bank must own the MBS and hold it in its portfolio for a reasonable period of time. The minimum holding period for the security is the number of days to the next issuance date of the MBS by the issuing agency (generally 30 days); and

8) The settlement term on the dollar repo cannot exceed twelve months from the initial transaction date.

The conditions which must be satisfied following a dollar roll are:

1) Within twelve months from the date of the initial sale and forward-buy transaction, the bank must accept delivery, close out its forward position, fund and place the MBS in its investment portfolio. In order for future dollar repos using these reacquired securities to be accounted for as financings, the security must be acquired, and the security must remain in the bank's possession at least until the next issuance date of the MBS (generally 30 days). The funding for the retention of the security for this holding period must come from a source independent of the securities transactions, such as deposits or federal-funds lines. This mandatory delivery condition is intended to demonstrate the bank's ability to fund the purchase of the securities and intent to hold the securities for investment purposes; and

2) At all times during the rollover or extension period, the bank must be able to demonstrate its ability to fund the reacquisition of the MBSs and close out its forward position.

This Agency takes the position that the reasons underlying the above OCC parameters support applying the parameters to Illinois state banks due to their sound accounting treatment for financing transactions.

Dollar repos and dollar rolls offer banks additional sources of financing as well as the potential to improve earnings. This Agency will offer no objection to Illinois state banks engaging in dollar repo/dollar roll transactions subject to satisfying the above criteria.

[NOTE: The OCC guidelines can be found in Sections 203.1 and 203.3 of the Comptroller's Handbook for National Bank Examinations.]