INTERPRETIVE LETTER 89-12 (OCTOBER 19, 1989)

State bank may not extend line of credit secured by a reverse repurchase agreement collateralized by the bank's own pledge of its government securities.

You have requested an answer to concerns about using a reverse repurchase agreement as collateral for a loan involving * Bank (hereafter "Bank").

The Bank has proposed to enter into two related transactions with a customer. The first transaction would involve a reverse repurchase agreement. The customer would lend $500,000 to the Bank in exchange for the Bank's pledge of government securities amounting to at least $500,000 as collateral. In the second transaction, the Bank would extend a $500,000 line of credit to the customer. In exchange, the customer would assign his rights in the reverse repurchase agreement as collateral.
Subsection 37(2) of the Illinois Banking Act (hereafter "Act") (Ill. Rev. Stat. 1989, ch. 17, par. 347(2)) states:

> It shall not be lawful for a state bank to make any loan or discount on the security of...its own debentures or evidences of debt which are...junior or subordinate in right of payment to deposit or other liabilities of the bank.

The reverse repurchase agreement would constitute an evidence of debt of the Bank. If the Bank acquired the customer's rights in the agreement due to the customer's default, the Bank would have the same rights to its own government securities as the customer had. Since the Bank could not be a creditor of itself, it would therefore have the same rights to the government securities as it had prior to the reverse repurchase agreement. The Bank's rights in and ownership of its own assets are, as a rule, subject to deposit and other liabilities of the Bank. Consequently, the reverse repurchase agreement would appear to be an evidence of a Bank debt subordinate to deposit and other liabilities of the Bank which could not be used to secure a line of credit to the customer without violating Subsection 37(2) of the Act.

In addition to this Agency's concerns arising from the statutory interpretation of Subsection 37(2) of the Act, this Agency has important safety and soundness concerns about the proposed transactions. The reverse repurchase agreement might permit the Bank to use the customer's money in order to earn interest. The Bank, though, would only have a short period of time to use the funds in that manner since terms of reverse repurchase agreements generally last for very limited periods of time. On the other hand, the line of credit would represent a long-term commitment by the Bank to lend money to the customer, from time to time, up to a maximum of $500,000 secured only by the reverse repurchase agreement. The result of the two transactions would leave the Bank with an unsecured long-term commitment (i.e., $500,000 line of credit) once the term of the reverse repurchase agreement expired. This Agency perceives that it is neither a safe, sound nor prudent banking practice for a bank to engage in the aforementioned proposed transactions where the net result would be to leave the bank with such a large unsecured

long-term commitment. The short-term potential interest income from the use of the customer's funds may not be worth the long-term commitment to which the Bank would be tied.