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SHORING-UP YOUR REPURCHASE AGREEMENTS

ILLINOIS BANKERS ASSOCIATION WEBINAR

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CURRENT ISSUE-

- Expiration of FDIC unlimited coverage of funds in noninterest-bearing transaction accounts
 - *December 31, 2012*
 - *How to protect customers with over \$250,000 on deposit?*
 - Repurchase Agreements (“repos”); or
 - Other out-of-bank sweep services.

REPURCHASE AGREEMENTS-

➤ Papering the transaction:

- *International form of master repurchase agreement with specific terms in addendum (SIFMA/ICMA)*
- *Simplified terms and conditions in stand-alone agreement*
- *Treasury Management Services Master Agreement with T&Cs or an addendum for repos*

TECHNICALITIES-

- A “repo” is technically:
 - *The “sale”*
 - *Of a fractional interest in a U.S. government or agency security*
 - *To a bank customer, using excess deposit funds*
 - *Coupled with the bank’s obligation to repurchase the interest at an agreed-upon date*
 - *May be a daily sweep at the close of business or for a term*

TECHNICALITIES-

➤ Formalities of the sale:

➤ *Applicable law –UCC Article 8*

➤ *Three ways to “sell” an “uncertificated security” held by a “securities intermediary” (custodian):*

➤ The buyer (customer) becomes the security owner by transfer to its name;

➤ The custodian agrees in writing to comply with the orders of the buyer to transfer or sell the security (in a contract between the custodian and the bank or the buyer);

➤ Another person having control agrees to hold for the buyer.

TECHNICALITIES-

- Formalities of sale, continued:
 - *UCC Article 8 is based on the concept of “control”*
 - *The buyer must take whatever steps are necessary to place itself in a position where it can have the securities sold, without further action of the seller/owner.*
 - The details of the arrangement may be spelled out in a contract.
 - There can even be dual rights to issue orders to the custodian.

RE-CHARACTERIZATION-

- May be viewed legally as a secured financing:
 - *Customer “loans” the bank its excess deposit funds*
 - *Secured by the security*
 - *Security interest is released when the bank repays the loan*
 - *UCC Article 9 governs secured financings*
 - *Must “perfect” the security interest or it is lost in receivership*

RE-CHARACTERIZATION-

➤ Perfection of Security Interest:

- *Article 9 leads back to Article 8 –same result*
- *Three ways to “perfect” an “uncertificated security” held by a “securities intermediary” (custodian):*
 - *The buyer/secured party becomes the security owner by transfer to its name;*
 - *The custodian agrees in writing to comply with the orders of the buyer/secured party to transfer or sell the security (in a contract between the custodian and the bank or the buyer);*
 - *Another person having control agrees to hold for the buyer.*

THE PROBLEM-

- Custodians do not want to know the name of the bank's customer (let alone take orders from it) and they generally will not enter into agreements.
 - *For non-automated term repos and repos with Illinois political subdivisions – **FIND A NEW CUSTODIAN***
 - *Illinois law requires a first priority perfected security interest in favor of political subdivisions*
 - If the bank takes Illinois state funds, it has the right forms – the State does this perfectly
 - *Make the custodian know who it holds for.*

THE PROBLEM II-

- Pre-arranged, automated sweep repos (usually daily):
 - *Custodians really do not want to know the name of the bank's customer.*
 - *Leaving no way to technically "sell" and repurchase the security and no way to technically "perfect" the security interest.*

THE PROBLEM III-

➤ FDIC Complications:

- *In 2009, FDIC issued regulations on the process it will take to determine deposit account balances for insurance coverage/receivership purposes.*
- *In dealing with sweep repurchase agreements, the FDIC determined that it would recognize the customer's interest if:*
 - *the customer becomes either the legal owner or*
 - *obtains a perfected security interest.*

THE PROBLEM III-

➤ FDIC Complications:

➤ *According to the FDIC, sweeps must be properly executed or*

➤ They must be treated as deposits on the CALL report and

➤ They would be treated as deposits upon bank failure.

The result – tough to comply

➤ *The FDIC received lots of comments and issued FAQs to address the problem.*

FDIC SOLUTION-

➤ FDIC's response on pre-arranged, automated sweep repos:

➤ *According to the FDIC FAQs, "proper execution" of a sweep repo requires:*

- 1) The particular security in which the customer has an interest has been identified, and this identity is indicated on the required daily confirmation statement
- 2) The customer has "control" of the security
- 3) There is no substitution permitted during the term of the repurchase agreement

FDIC SOLUTION-

- Result of FDIC Position on Pre-arranged, automated sweep repos:
 - **Bulk segregation or pooling of repurchase collateral without identification of specific assets does not result in an identified interest.**
 - **Confirming only “various securities” as collateral is not sufficient.**

FDIC SOLUTION-

- For **“Proper Execution,”** the FDIC required:
 - *Elimination of the right to substitute collateral in the repo agreement, so that the collateral securities listed on the confirmation will match the collateral securities being held by the buyer, and*
 - *Bank must agree to serve as buyer’s agent and, in the event of default, buyer will have the right to direct the bank to sell the collateral securities and apply the proceeds in satisfaction of any bank liability.*

CONTRACT LANGUAGE-

Segregation of Collateral: To the extent required by applicable law, all Collateral will be segregated from other securities in Bank's possession and shall be identified as subject to this Agreement. **The Bank is not permitted to substitute other securities for those subject to this Agreement and waives the rights to substitution set forth in the required disclosure below.**

Required Disclosure for Transactions in which the Seller Retains Custody of the Purchased Securities

Seller is not permitted to substitute other securities for those subject to this Agreement and therefore must keep Buyer's securities segregated at all times, unless in this Agreement Buyer grants Seller the right to substitute other securities. If Buyer grants the right to substitute, this means that Buyer's securities will likely be commingled with Seller's own securities during the trading day. Buyer is advised that, during any trading day that Buyer's securities are commingled with Seller's securities, they may be subject to liens granted by Seller to third parties and may be used by Seller for deliveries on other securities transactions. Whenever the securities are commingled, Seller's ability to resegment substitute securities for Buyer will be ~~subject to Seller's ability to satisfy any lien or to obtain substitute securities.~~

CONTRACT LANGUAGE-

Security Interest and Your Rights on Bank's Default: Although the parties intend that all transactions hereunder be sales and purchases and not loans, in the event any such transactions are deemed to be loans, Bank shall be deemed to have pledged to Buyer as security for the performance by Bank of its obligations under each such transaction, and shall be deemed to have granted to Buyer a security interest in, all of the Collateral with respect to all transactions hereunder and all income thereon and other proceeds thereof.

Although the Collateral may be guaranteed as to principal and interest by the federal government or by the issuing federal agency, any such guarantee runs only to Bank by virtue of its ownership of the Collateral and does not extend to Buyer. Buyer must therefore look to Bank and its general assets as the source of payment of the repurchase obligation. To collateralize Bank's repurchase obligation, a security interest in the Collateral is transferred to Buyer. In most instances a security interest will assure Buyer that in the event of default Bank's obligation to pay the repurchase price will be satisfied through liquidation of the Collateral and distribution of the proceeds. It is possible that Bank may grant a security interest in its assets to a third party that achieves a higher priority in the Collateral than the security interest granted to Buyer.

CONTRACT LANGUAGE-

(Continued)

Notwithstanding a security interest, however, a situation could arise in which the market value of the Collateral has depreciated to a level below the total amount of Bank's obligations under this Agreement. In that situation, Buyer will become unsecured to the extent of the disparity between the market value of the Collateral and the total obligations owed by Bank under this Agreement. The loss of the security interest will leave Buyer in the position of a general creditor of Bank for the amount of the disparity. Bank will, however, use reasonable efforts to at all times maintain the market value of the Collateral at a level sufficient to fully collateralize the Bank's obligation.

Bank will act as Buyer's agent, and in the event of default, Buyer will have the right to direct Bank to sell the Collateral and apply the proceeds in satisfaction of any Bank liability hereunder.

FDIC SOLUTION-

➤ Required Disclosures:

- *Beginning July 1, 2009, Banks were required to prominently disclose if funds are FDIC insured or if customer is secured or unsecured creditor of receivership*
 - On all new sweep contracts
 - In connection with all renewals
 - Within 60 days after July 1, 2009 and annually thereafter to all exiting customers

FDIC SOLUTION-

- Treatment of sweep repurchase on bank closing:
 - *Customer will be protected*
 - Assuming bank in a P&A will complete the sweep back into the bank account; or
 - The receiver will pay the customer in full.

CONTRACT LANGUAGE-

FDIC Receivership: In the event of insolvency of Bank, the Federal Deposit Insurance Corporation (“FDIC”), which acts as receiver of failed banks, will recognize Buyer as a secured creditor, except to the extent provided above with respect to depreciation in market value of the Collateral. Buyer’s swept funds should be fully protected.

After a bank failure, the manner in which the FDIC may treat swept funds will depend on the nature of the transaction structured by the FDIC to resolve the failure. In a purchase and assumption transaction, the Collateral and the underlying repurchase arrangement will be transferred by the FDIC to an acquiring institution. Under that transaction structure, the funds normally would be swept back into Buyer's Designated Account at the required time following the failure, thus giving Buyer full access to these funds at that point. If the FDIC structures the transaction as a payoff of insured deposits, Buyer would receive a check or other payment from the FDIC to reacquire Buyer's interest in the Collateral according to the FDIC’s normal procedures.

TAKE-AWAY'S-

- Check the bank's **repo agreement** form to make sure it complies with the FDIC rules.
- For term or political subdivision repos, make sure the custodian can execute **perfection**.
- Reach out to each effected customers and remind them that the FDIC unlimited coverage is expiring and explain that the bank has a **solution**.

SOURCES OF APPLICABLE LAW-

| Product | FDIC Law | Other Law |
|---------------------------|--|--|
| <p>Sweep Repos</p> | <ul style="list-style-type: none"> • Revised 12 CFR 360.8 Method for Determining Deposit and Other Liability Account Balances at a Failed Depository Institution • FIL-39-2009 FAQ's including "Proper execution" of repo sale/perfection of security interest | <ul style="list-style-type: none"> • Articles 8-9 of the UCC • Government Securities Regulations • Regulation D limits on transfers • Reserve requirements • Truth in Savings |