



REGULATORY INTERPRETATION 2000-RI-01

Date: March 6, 2000

Subject: Acceptance of Mutual Funds that enter into Short-Term, Liquidity-Driven Repurchase Agreements as Collateral

Request Summary:

A Federal Home Loan Bank (Bank) has requested that the Federal Housing Finance Board (Finance Board) determine that the Bank may accept, as eligible collateral under 12 C.F.R. § 950.9(a)(5) (formerly section 935.9(a)(5)), shares of mutual funds that enter into certain limited types of repurchase agreements (Repos). The Bank has requested that the interpretation apply only to Repos that: (1) are short term, *i.e.*, have an original maturity of 90 days or less; (2) are readily convertible, in the opinion of the Bank, to known amounts of cash; and (3) the Bank has determined that, on a case by case basis, the fund enters into for liquidity rather than investment purposes.

Background:

Finance Board regulations allow the Banks to accept as collateral securities representing equity interests in eligible advances collateral, provided that the underlying assets qualify either as: (1) eligible collateral under section 950.9(a)(1) or (2) or (2) cash or cash equivalents. *See* 12 C.F.R. § 950.9(a)(5).

The Bank has indicated that it has established a policy concerning which short-term, highly liquid investments are to be treated as cash equivalents. In its credit policy, the Bank defines cash equivalents as highly liquid investments that both (a) are readily convertible into known amounts of cash and (b) have a remaining maturity of 90 days or less at the acquisition date such that the investment is so near its maturity that it presents insignificant risk of change in value because of changes in interest rates. The Bank indicated that items that generally qualify as cash equivalents under the two-part test include 90-day treasury bills and notes, commercial paper, certificates of deposit, money market funds, and federal funds sold.

The Bank believes that certain Repos that meet the Bank's "cash equivalent" criteria, and that the Bank has determined are entered into for liquidity purposes, are cash equivalents under section 950.9(a)(5)(ii). Alternatively, the Bank indicated that it believes that Repos that meet the Bank's "cash equivalent" criteria and are entered into for liquidity purposes should, because of their characteristics, be treated as cash equivalents for purposes of section 950.9(a)(5)(ii). Therefore, the Bank has requested that the Finance Board interpret section 950.9(a)(5) as permitting the Bank to accept mutual funds with certain Repos as collateral for advances.

Analysis:

Section 10 of the Federal Home Loan Bank Act (Act) grants each Bank authority to make secured advances to its members. *See* 12 U.S.C. § 1430(a). The Act enumerates the types of collateral that are eligible to secure Bank advances, which include, among other things, current whole first mortgage loans on improved residential property and securities representing a whole interest in such mortgages; and securities that are issued, guaranteed, or insured by the United States Government, or any agency thereof. *See* 12 U.S.C. § 1430(a)(1) and (2). The Finance Board Advances Regulation implements and clarifies the statutory requirements of section 10 of the Act. *See* 12 C.F.R. part 950.

On April 6, 1999, the Finance Board published in the *Federal Register* a final rule amending its Advances Regulation to allow the Banks to accept as collateral securities representing an equity interest in eligible collateral. The rule provides that Banks may accept as collateral any security the ownership of which represents an undivided equity interest in underlying assets, all of which qualify either as (i) eligible collateral under section 950.9(a)(1) or (a)(2) or (ii) cash or cash equivalents. *See* 12 C.F.R. § 950.9(a)(5). This provision was intended to permit Banks to accept eligible collateral through the vehicle of mutual fund shares, or similar equity investments held by a member. In recognition of the fact that every mutual fund must hold a small amount of cash or safe short-term investments in order to maintain sufficient liquidity, the Finance Board determined that such liquidity-related investments should not disqualify the shares of such a fund as means through which a Bank may obtain a security interest in otherwise-eligible collateral.

The Finance Board did not define the term “cash equivalent” in the regulation. The Financial Accounting Standards Board (FASB) defines cash equivalents for financial reporting purposes as short-term, highly liquid investments that are both: (a) readily convertible into cash and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. *See* FAS 95 ¶ 8-10. FASB also states that generally, only investments with original maturities of three months or less qualify under that definition. *See id.*

A Repo is a type of transaction in which a money market participant acquires immediately available funds by selling securities and simultaneously agreeing to repurchase the same or similar securities after a specified time at a given price that typically includes interest at an agreed-upon rate.¹ Repos usually are arranged with short terms to maturity – overnight or a few days – while longer-term Repos are arranged for standard maturities of one, two, and three weeks and one, two, three, and sometimes six months.²

Investors such as mutual funds derive benefits from Repos as they enable them to earn a return above the risk-free rate on Treasury securities without sacrificing liquidity.³ Repos also offer greater flexibility than other money market instruments because their maturities can be tailored precisely to meet diverse investment needs. In contrast, certificates of deposit have minimum maturity at issue of seven days, and commercial paper is seldom written with maturities as short as a day.

The Bank stated that for cash management purposes, mutual fund portfolios typically hold securities, pursuant to Repos, that represent short-term investments as part of their daily cash management activities. The Bank further stated that a mutual fund’s ability to enter into Repos, typically with a maturity of less than 90 days, allows the excess cash in the fund to be invested

¹ Federal Reserve Bank of Richmond, Instruments of the Money Market (7th ed. 1993) at 59.

² *Id.* at 60.

³ *Id.* at 67.

without losing liquidity or incurring price risk. The Bank indicated that even mutual funds with particularly restrictive investment limitations, such as those limited to mortgage loans, government securities, and agency securities typically use Repos to maintain a liquidity position and manage the fund.

The Bank has requested that the regulatory interpretation apply only in cases where (1) the Repos have an original maturity of 90 days or less; (2) the Repos are readily convertible, in the opinion of the Bank, to known amounts of cash; and (3) the Bank has determined, on a case-by-case basis, the fund enters into the Repos for liquidity rather than investment purposes. Staff believes that Repos with these characteristics may be considered cash equivalents for the purpose of determining compliance with section 950.9(a)(5).

Interpretation:

The Bank may consider Repos held by a particular mutual fund to be cash equivalents under 12 C.F.R. § 950.9(a)(5) if the Bank determines that: (1) the fund in question enters into the Repos solely for liquidity purposes and not for other investment purposes; (2) the Repos are readily convertible into known amounts of cash; and (3) the Repos have an original maturity of 90 days or less. The Bank may accept as collateral for advances shares of mutual funds holding such Repos if the other requirements of 12 C.F.R. § 950.9(a)(5) are also met.

A Regulatory Interpretation applies only to the particular transaction or activity proposed by the requestor, may be relied upon only by the requestor, and is subject to modification or rescission by action of the Board of Directors of the Finance Board. 12 C.F.R. pt. 907.