

Statement regarding repurchase agreements entered into by banking institutions

Issued by Dr C.L. Stals, Governor of the South African Reserve Bank

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Banks and discount houses have been using repurchase agreements that do not appear on their balance sheets on an increasing scale as a funding mechanism. At the end of February 1990 unexpired repurchase agreements entered into by banks amounted to R11,1 billion, which represented almost 10 per cent of the total on-balance-sheet liabilities to the public of all banks taken together. Comparable figures for discount houses at the end of March 1990 amounted to R4,0 billion and 266 per cent, respectively. In the case of individual banks the ratio of off-balance-sheet funding commitments (in the form of repurchase agreements) to comparable on-balance-sheet liabilities to the public at the end of February 1990 ranged from 0 per cent for banks that do not make use of this device to 550 per cent. Corresponding ratios for discount houses as at the end of March 1990 ranged from 88 to 430 per cent. In addition, referring once again to some individual institutions and comparing "on" as well as "off"-balance-sheet funding commitments with capital and reserves, imprudently high gearing ratios exist.

The Reserve Bank is of the opinion that the conclusion of a repurchase agreement is in substance a funding operation. It carries risks which are similar to those associated with normal on-balance-sheet funding operations, and should therefore be subject to the same minimum prudential requirements. Most repurchase agreements are in fact used specifically as an alternative funding mechanism in order to avoid such prudential requirements.

The inevitable result is that the institution itself and its depositors carry a greater risk exposure as some of its commitments are not subject to appropriate prudential requirements. All depositors and shareholders may not always be aware of these additional risk exposures because off-balance-sheet risks are not always fully disclosed.

Another undesirable consequence of banking institutions' enhanced risk exposures (emanating from the avoidance of prudential requirements) is that an undue responsibility is placed on the Reserve Bank in its capacity as lender of last resort to the banking system. Moreover, the Reserve Bank as supervisory authority does its utmost to protect the cash and savings of the public placed with registered deposit-taking institutions, and must therefore satisfy itself that all these institutions comply with the established statutory minimum prudential requirements.

The off-balance-sheet activities by banks also detract from the reliability of monetary analyses for monetary policy purposes. These practices lead to understatement

of the size, and also to distortions of, the real changes in the money supply or total bank lending. In order to further safeguard the soundness of banking in South Africa and improve the quality of banking statistics, it is anticipated that in revised banking legislation (as proposed in the Deposit-taking Institutions Bill) which is now being finalised for tabling in Parliament and which is likely to come into effect by the end of 1990, deposit-taking institutions will have to meet the prudential requirements provided for in respect of their "on" as well as "off"-balance-sheet commitments and claims. It is advisable, therefore, that during the next few months banking institutions prepare themselves for compliance with the more broadly based prudential requirements. The principles embodied in the proposed prudential requirements as well as the proposed new basis for such requirements are set out in the proposed Bill which was recently circulated for comment and information to all banking institutions, mutual building societies and building societies. The intention is to develop the details of these requirements in consultation with the relevant institutions during the remainder of 1990 and to embody such details in the regulations to be made in terms of the proposed Bill.

The proposed new legislation *inter alia*, provides for a comprehensive review of prudential requirements for banking institutions and building societies, the gradual phasing out of call money with discount houses as liquid assets and for matters relating to the deposit-taking activities of institutions not registered as banks or building societies.

It is recognised that piecemeal implementation of the new requirements will have a disruptive impact on trading activities in the money and capital markets and will also have a material influence on bank margins. However, to avoid any further erosion of prudential provisioning under the existing regulatory regime – with a view to safeguarding the interests of depositors and shareholders as well as the financial soundness of the banking system – the measures mentioned below are now introduced by the Reserve Bank and, where necessary, will be contained in Rules which will be issued shortly by the Bank in terms of Proclamation No. R.184 of 1967. To avoid possible disruption of normal security dealing the Rules may provide for certain exemptions and will, in this respect, be compiled after consultation with appropriate parties.

The premise is accepted that repurchase agreements (which include any agreement in terms of which funds are acquired through the sale of a security and which is coupled to the condition that the seller of such security is obliged to repurchase the same or any other security on a specific future date or within a fixed period of time) entered into by banks, discount houses,

mutual building societies and building societies, in substance represent the acquisition of funds by these institutions against some form of collateral. Accordingly banks and all building societies will in future be required to report the value of all securities sold under repurchase agreements on their balance sheets at repurchase prices, and to record similar amounts on their balance sheets as liabilities to the public, which will be subject to reserve balance and liquid asset requirements. All repurchase agreements by discount houses will in future similarly be recorded on their balance sheets and be subject to the provisions of the Banks Act, 1965.

Banking institutions other than discount houses

As an interim measure, it has been decided, in the case of individual banks to exempt from the reserve balance and liquid asset requirements imposed by the Banks Act, 1965, an amount equal to the amount of liabilities arising from the conclusion of repurchase agreements outstanding as at the end of February 1990, as reported to the Registrar of Banks in their monthly returns of BA Form 7 for February 1990. Only the amount of repurchase agreements by banks in excess of this amount will, as from the date of certification of their monthly returns of BA Form 7 for May 1990, be subject to prudential requirements imposed by the Banks Act, 1965. This exemption will lapse on the date when the proposed new legislation as contained in the Deposit-taking Institutions Bill comes into operation.

These measures will entail that –

- (i) commitments by banks in respect of repurchase agreements will henceforth have to be reported on their balance sheets; and
- (ii) the value of repurchase agreements concluded by banks in excess of the amount reported in returns of BA Form 7 for February 1990 will, as from the date of certification of the BA Form 7 return for May 1990, be subject to the normal statutory reserve balance and liquid asset requirements imposed by the Banks Act, 1965.

Rules will also be issued by the Reserve Bank to avoid –

- (i) the maintenance of reserve balance and liquid asset requirements by banks in respect of repurchase agreements concluded by these institutions with the Reserve Bank or the Corporation for Public Deposits;
- (ii) that double reserve balance and liquid asset requirements are maintained in respect of repurchase agreements concluded between banks; and
- (iii) that an asset, which forms the basis of a repurchase agreement and which will in future be required to be reported on balance sheet, is regarded as

encumbered and thus required to be deducted from paidup capital and unimpaired reserves as required by section 1(5) of the Banks Act, 1965.

Discount houses

All repurchase agreements concluded by discount houses will henceforth also have to be reported on their balance sheets. The provisions of section 22 of the Banks Act, 1965, which contain limitations on transactions concluded by discount houses, will, however, not be applicable to repurchase agreements concluded by discount houses up to an amount equal to the value of repurchase agreements concluded by them and outstanding as at the end of February 1990, as reported in returns submitted to the Reserve Bank. As with the banks, the limitations will also not be applicable to repurchase agreements concluded with the Reserve Bank and the Corporation for Public Deposits, whereas all provisions of the Banks Act, 1965, will, as from 21 June 1990, be applicable to repurchase agreements concluded by discount houses in excess of the amount of such agreements recorded in the monthly return for February 1990 to the Reserve Bank. All provisions of the Deposit-taking Institutions Bill will be applicable to discount houses when that Bill, as approved by Parliament, comes into operation.

Building societies

Mutual building societies and building societies are at present not involved in repurchase agreements as part of their funding operations to any great extent. Although it will in future also be expected of them to record repurchase agreements on balance sheet, it is not at this stage thought appropriate to issue any formal directive to these societies in this regard. Building societies will be subject to similar requirements as banking institutions once the proposed Deposit-taking Institutions Bill is enacted. In the meantime, however, the co-operation of the societies will be solicited towards the recording of all repurchase agreements on balance sheet and the Reserve Bank will not hesitate, if this is deemed desirable, to prepare and propose amending legislation to Parliament or to take other measures to rectify unacceptable situations in respect of repurchase agreements concluded by mutual building societies and building societies.

The regular statutory returns submitted by banking institutions, mutual and equity building societies to the Registrar of Banks or of Building Societies will, if necessary, be adapted to provide for data concerning repurchase agreements. Banking institutions, mutual building societies and building societies will shortly be requested by the Registrar of Banks and of Building Societies to submit certified analyses of repurchase agreements concluded by them and outstanding at the end of March 1990.

The prohibitions contained in Circular No. RB 160, issued in July 1979, covering *inter alia* the conclusion of repurchase agreements in respect of fictitious assets and by way of simulated transactions, remain in force and will also be made applicable to mutual and equity building societies.

In conclusion, the Reserve Bank wishes to reiterate that these interim measures in anticipation of the promulgation of new regulations, after the enactment of the Deposit-taking Institutions Bill, are designed (i) to avoid any further erosion of prudential provisioning by banks under the existing regulatory regime, without, however, (ii) distorting the existing competitive positions of individual institutions.

It is fully recognised that there remains a need for further consultation and investigation with regard to the impact of the enactment of the proposed Bill on the proper development of a securities market in South Africa.