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Supplemental Guidance Notes to Annex I

Supplemental Terms and Conditions

The Bond Market Association (formerly PSA) would like to call your attention to an important accounting development that will impact the funding markets.

On June 28, 1996, the Financial Accounting Standards Board issued Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (“FASB 125”), which institutes new accounting rules for generally accepted accounting principles (“GAAP”) applicable to all transactions involving transfers of financial assets, including repurchase agreement and buy/sell back transactions and transfers of collateral constituting financial assets in connection with secured financing transactions.

Under FASB 125, the accounting for repurchase transactions may change depending on the terms of the transaction. In particular, if the repo buyer has the right to sell or re-pledge the repo securities, and if a repo seller does not maintain control over the repo securities - by not having the right to substitute securities or terminate the transaction on short notice - the repo buyer will generally be required to record both the securities as well as an obligation to return the securities, thereby “grossing up” its balance sheet. The repo seller will generally be required to reclassify the repo securities from securities inventory to receivable for securities pledged as collateral.

Paragraph 8 of the Master Repurchase Agreement (the “Agreement”) provides that a repo buyer is free to transfer, sell, pledge or re-hypothecate the repo securities. Paragraph 9(a) of the Master Repurchase Agreement provides that the parties to a Repurchase Transaction can agree that the repo seller has substitution rights with respect to the repo securities. In order to enable market participants to mitigate the potential impacts of FASB 125 on their balance sheets, a significant number of Association members active in the repo markets requested that the Association publish a standard provision that allows a repo seller to retain effective control over the transferred repo securities by documenting a right of substitution on the part of the repo seller or a right to terminate a transaction prior to maturity on short notice to the repo buyer. Market participants also preferred not to fundamentally alter the existing trading practices and economic expectations of the repo market.

Attached is Annex I (Supplemental Terms and Conditions) that incorporate this suggested standard provision, previously published as Repo Trading Practices Guideline Update No. 96-1.

The optional substitution/termination provision contained in both of these forms is intended to both provide for a right of substitution/termination on the part of the repo seller and prescribe a methodology for quantifying economic loss suffered by the repo buyer as a direct consequence of the repo seller’s exercise of its substitution/termination right. The provision is intended to make the repo buyer economically “whole”. In other words, although the repo seller would maintain effective control over the asset transferred in the repo transaction, the repo buyer would not suffer economically because the loss provision is intended to place the buyer in the same position it would have been had the transferor not effectuated that control through the exercise of the substitution/termination right.

The attached Annex I also contains a short time frame for notice of substitution. The provision reflects the current Association Restated Repo Trading Practices Guidelines (Paragraph M.3.) by providing that notice of substitution should be provided by 10 am (New York time) for substitutions to occur on the same business day, and if notice of substitution is given after 10 am (New York time), substitution would occur on the next business day. The Funding Division Trading Practices Committee views such period as the minimal time frame necessary to effectuate the exercise of the contractual right and determine the appropriate dollar amount consistent with the contractual “make whole” provision. Parties may agree on different notice periods.

As always, the Association recommends that market participants consult with their legal and accounting advisors concerning the desirability of use of this Annex I (Supplemental Terms and Conditions) with respect to its firm’s particular needs and circumstances.