BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

September 29, 1982

The Honorable Robert J. Dole
Chairman
Subcommittee on Courts
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am writing to convey my views concerning proposed technical amendments to the Bankruptcy Reform Act of 1978 ("Code") that I understand will be considered by the Senate Judiciary Committee to exempt repurchase transactions ("repos") from the automatic stay provisions of the Code. These amendments are being proposed because recent developments in the repo market--including the bankruptcy of a dealer in this market--have pointed up a number of legal inconsistencies concerning risks involved in what had been thought to be a riskless transaction.

Repos are contractual agreements for the sale or loan of a security which include a provision requiring the seller or lender to take back the security at a fixed price plus, in many cases, an additional sum representing a yield on the investment. They are especially attractive to market participants because of their flexibility as to maturity and the amount that may be invested. Repos are used by a wide range of entities in addition to government securities dealers, including states, municipalities and other public bodies, financial institutions, and pension funds, to employ funds on a secure basis through temporary acquisitions of various kinds of securities, including U.S. government and agency securities, bankers' acceptances and CDs.

In addition, repos are a very important tool used in Federal Reserve open market operations and in financing the national debt. Therefore, because of this widespread use in very large amounts, it is important that the repo market be protected from unnecessary disruption.

A recent decision of the Bankruptcy Court highlights the need to review the structure of the rules affecting the treatment of repos under the Code. In a proceeding arising out of the failure of Lombard-Wall, Inc., the Bankruptcy Court in the Southern District of New York held that the holder of securities subject to a repurchase agreement was covered by the automatic stay of the Code, and that this holder was precluded from closing out its position with the debtor.

This decision casts doubt, in a bankruptcy context, on the liquidity and safety of repos. The decision not only subjected the repo participant involved in that case to unanticipated liquidity pressures, but it also exposed that participant to an increased risk of capital loss because of potential changes in interest rates. If repos are subject to the automatic stay in bankruptcy, the rippling effect of the potential loss of liquidity or capital on market participants could generally disrupt the repo market and cause an otherwise manageable and isolated problem to become generalized.

The proposed technical amendments would resolve these legal uncertainties by exempting repo transactions from the automatic stay in bankruptcy. A similar approach was taken under legislation enacted earlier this year which exempts stock brokers, security clearing agencies, commodity brokers and forward contract merchants from the automatic stay. These recent amendments, according to the House Report (No. 97-420), were intended to minimize the disruptive effects arising out of the "insolvency of one commodity or security firm," and to prevent such effects "from leading to the insolvency of other firms and possibly threatening the collapse of the affected market."

The proposed legislation has the same objective but would take a somewhat different approach. Instead of protecting certain classes of market participants, it would exempt a particular class of transactions--the repo. Because of the uniqueness of this market, I believe this is a reasonable approach.

The normal process in evaluating legislation of this kind would involve a great deal more public discussion, including an opportunity for the public to be heard at Congressional hearings, and I would usually prefer that changes of the kind now under consideration follow this route. I also believe that we should act in a manner that maintains market discipline on participants to assure the creditworthiness of the entities with which they deal.

On balance, I believe it is important to take the present opportunity to enact legislation to clarify the rules applicable to repos and to avoid what I believe to be major possibilities for disruption in the repo market. However, in this context, I believe that it would be preferable to draw the legislation in a relatively narrow manner and to confine its application to the key repo markets in U.S. government and agency securities,

bankers' acceptances and certificates of deposits. A technical amendment to the Code limited in this manner would, in my view, be justified and should be enacted at the present time.

Sincerely,

Paul A. Volcker