

§ 301.2 Definitions.

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(rr) *Meat*. The part of the muscle of any cattle, sheep, swine, or goats that is skeletal or that is found in the tongue, diaphragm, heart, or esophagus, with or without the accompanying and overlying fat, and the portions of bone (in bone-in product such as T-bone or porterhouse steak), skin, sinew, nerve, and blood vessels that normally accompany the muscle tissue and that are not separated from it in the process of dressing. As applied to products of equines, this term has a comparable meaning.

(1) Meat does not include the muscle found in the lips, snout, or ears.

(2) Bone includes hard bone and related components such as bone marrow and spinal cord.

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PART 318—ENTRY INTO OFFICIAL ESTABLISHMENTS; REINSPECTION AND PREPARATION OF PRODUCTS

3.–4. The authority citation for part 318 is revised to read as follows:

Authority: 7 U.S.C. 138f, 450, 1901–1906; 21 U.S.C. 601–695; 7 CFR 2.7, 2.18, and 2.53.

5. Section 318.24 is revised to read as follows:

§ 318.24 Product prepared using advanced meat/bone separation machinery; process control.

(a) *General*. Meat, as defined in § 301.2 of this chapter, may be derived by mechanically separating skeletal muscle tissue from the bones of livestock using advances in mechanical meat/bone separation machinery and systems that, in accordance with this section, recover meat without crushing, grinding, pulverizing, or otherwise incorporating hard bone or bone-related components.

(b) *Process control*. As a prerequisite to labeling or using product derived by mechanically separating skeletal muscle tissue from livestock bones as meat, the operator of an establishment must implement and document procedures that ensure the establishment's production process is in control.

(1) The production process is not in control if any provision of paragraph (c)(1) of this section applies to the resulting product.

(2) The documentation must include a description of the procedures that the establishment has implemented and information that substantiates the effectiveness of these procedures to prevent the incorporation of hard bone and bone-related components, including bone marrow and spinal cord, into the resulting product (e.g., information on

the characteristics of resulting product when equipment is operated pursuant to manufacturer specifications; records of establishment monitoring and verification activities).

(3) The establishment must make available to inspection program personnel the documentation described in paragraph (b)(2) of this section and any other data generated using these procedures.

(c) *Noncomplying product*. (1) Notwithstanding any other provision of this section, product that is recovered using mechanical meat/bone separation machinery is not meat under any one or more of the following circumstances.

(i) *Bone solids*. The product's calcium content is more than 130.0 mg per 100 grams.

(ii) *Bone marrow*. (A) The product includes more than a negligible amount of bone marrow, as determined by the presence of bone marrow in bones entering the recovery system and its absence or presence in a measurably lower amount (e.g., by weight) in bones exiting the recovery system.

(B) The difference between the product's iron content and the product's protein content multiplied by 0.067 for a beef product or by 0.034 for a pork product is more than 1.80 mg per 100 grams (i.e., [iron content—(protein content x 0.067)] > 1.80 mg per 100 grams of beef product or [iron content—(protein content x 0.034)] > 1.80 mg per 100 grams of pork product) (as a measure of excess iron from bone marrow): *Provided*, That when the operator of an establishment has verified and documented the ratio of iron content to protein content in the skeletal muscle tissue attached to bones prior to their entering the recovery system, based on analyses of hand-trimmed samples, that value is to be substituted for the multiplier 0.067 or 0.034 (as applicable) with respect to product that the establishment mechanically separates from those bones.

(iii) *Spinal cord*. The product includes spinal cord, as determined by the presence of spinal cord in bones entering the recovery system and its absence or presence at a lower level in bones exiting the recovery system or by the identification of central nervous system tissue in the product.

(2) If product that may not be labeled or used as meat in accordance with this section meets the requirements of § 319.5(a) of this chapter, it may bear the name "Mechanically Separated (Species)".

PART 320—RECORDS, REGISTRATION, AND REPORTS

6. The authority citation for part 320 is revised to read as follows:

Authority: 21 U.S.C. 601–695; 7 CFR 2.7, 2.18, and 2.53.

§ 320.1 [Amended]

7. Paragraph (b)(10) of § 320.1 is amended by removing "of calcium content in meat derived from" and adding, in its place, "documenting control of the production process using".

Done at Washington, DC, on April 3, 1998.

Thomas J. Billy,

Administrator.

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DEPARTMENT OF THE TREASURY**Office of Thrift Supervision****12 CFR Part 563**

[No. 98–35]

RIN 1550-AB16

Transactions with Affiliates; Reverse Repurchase Agreements

AGENCY: Office of Thrift Supervision, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Office of Thrift Supervision (OTS) is proposing to revise its regulations on transactions with affiliates. Specifically, the OTS proposes to clarify that it will treat reverse repurchase agreements, with one limited exception, as loans or other extensions of credit for the purposes of section 11(a)(1)(A) of the Home Owners' Loan Act (HOLA). Therefore, a savings association generally may not enter into a reverse repurchase agreement with an affiliate that is engaged in non-bank-holding company activities.

DATES: Comments must be received on or before June 12, 1998.

ADDRESSES: Send comments to Manager, Dissemination Branch, Records Management and Information Policy, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention Docket No. 98–35. These submissions may be hand-delivered to 1700 G Street, NW., from 9:00 a.m. to 5:00 p.m. on business days; they may be sent by facsimile transmission to FAX Number (202) 906–7755 or by e-mail public.info@ots.treas.gov. Those commenting by e-mail should include their name and telephone number. Comments will be available for

inspection at 1700 G Street, NW., from 9:00 a.m. until 4:00 p.m. on business days.

FOR FURTHER INFORMATION CONTACT:

Valerie J. Lithotomos, Counsel (Banking and Finance), (202) 906-6439; or Karen A. Osterloh, Assistant Chief Counsel, (202) 906-6639, Regulations and Legislation Division, Chief Counsel's Office, or Donna Deale, Manager, (202) 906-7488, Supervision Policy, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

Section 11(a)(1) of the Home Owners' Loan Act (HOLA) applies the provisions of sections 23A and 23B of the Federal Reserve Act (FRA) to every savings association to the same extent as if the thrift were a member bank of the Federal Reserve System. Section 11(a)(1) also imposes several additional restrictions on a savings association's transactions with affiliates beyond those found in sections 23A and 23B of the FRA. Specifically, section 11(a)(1)(A) states that "no loan or other extension of credit may be made to any affiliate unless that affiliate is engaged only in activities described in section 10(c)(2)(F)(i) of the HOLA." As defined by 12 CFR 584.2-2, these activities include activities approved for bank holding companies by regulation, 12 CFR 225.25, or by case-by-case order of the Federal Reserve Board, 12 CFR 225.23. Thus, under section 11(a)(1)(A) a thrift may not make a loan or other extension of credit to an affiliate engaged in non-bank holding company activities (non-banking affiliate).

Congress enacted this prohibition to "reflect . . . the fact that affiliates of savings associations can engage in a far greater range of activities than affiliates of banks, and can thus expose the savings association to greater risks." The OTS believes this statement incorporates three distinct but overlapping policies.

- The purpose of the prohibition in section 11(a)(1)(A), together with other specific restrictions in section 11(a), is to protect the thrift from all forms of risk, including credit risk, presented by non-banking affiliates. These risks are not fully addressed by sections 23A and 23B of the FRA.

- Because the creditors that are ultimately exposed to the greater risks in these transactions are the depositors and the deposit insurance fund, section 11(a)(1)(A) operates to ensure that thrift deposits do not serve, via an extension of credit, as a source of funds for the activities of a non-banking affiliate.

- As a corollary of the second policy, the deposit insurance fund should not support the risks of default by a non-banking affiliate.

The OTS is aware that there may be situations where savings associations have entered into repurchase and reverse repurchase agreements with their non-banking affiliates. For example, in one instance, a thrift planned to sell United States Treasury securities to its holding company, subject to the thrift's agreement to repurchase the securities after a pre-determined period, several years later. Using reverse repurchase agreements,¹ the savings association would also purchase United States Treasury securities from the holding company, subject to the holding company's agreement to repurchase on an overnight (or next-business-day) basis. The holding company, in effect, would use the overnight purchases to manage its available cash. At all times, the savings association's obligation to repurchase securities under its agreement would exceed the holding company's obligation to repurchase securities under its agreement.

These arrangements raise the question whether a reverse repurchase agreement is a loan or other extension of credit for the purposes of the prohibition in section 11(a)(1)(A) of the HOLA. Section 11(a)(1)(A) does not define "loan or other extension of credit." Thus, the face of the statute does not compel a legal conclusion that reverse repurchase agreements are, or are not, prohibited.²

¹ A sale of securities subject to an agreement to repurchase is known as a "reverse repurchase agreement" when a bank or thrift is the purchaser of the securities. See M. Stigum, *The Repo and Reverse Markets* 4 (1989).

² We recognize that the definition of "covered transaction" under section 23A(b)(7) of the FRA lists "a purchase of assets, including assets subject to an agreement to repurchase" separately from "a loan or extension of credit." See 12 U.S.C. 371c(b)(7)(A), (C). The fact that a reverse repurchase is considered to be an asset purchase, rather than an extension of credit under section 23A of the FRA, however, is not controlling here.

Although section 23A and section 11(a)(1)(A) are both designed to prevent abuses by affiliates, the two statutes pursue this goal differently. Section 23A identifies a class of covered transactions that threaten prudent business relationships and places various restrictions on the transactions. Some restrictions apply to all transactions. Others apply only to certain types of covered transactions. (E.g., loans and extensions of credit are subject to specific collateralization requirements. Purchases, including purchases that are subject to a repurchase agreement, are subject to a prohibition on the purchase of low quality assets.) Thus, to impose the appropriate restrictions, section 23A must distinguish between covered transactions that are reverse repurchase agreements and loans and covered transactions that are other extensions of credit.

Moreover, we note that section 11(a)(1)(A) of the HOLA does not specifically incorporate the

Accordingly, the OTS has decided to resolve this issue through today's rulemaking. While the agency does not believe that such agreements are common, it believes that setting clear regulatory standards will help to avoid future uncertainty.

The OTS is proposing to treat most reverse repurchase agreements as loans or other extensions of credit. Section 11(a)(1)(A) of the HOLA provision focuses on prohibiting transactions with non-banking affiliates that would transfer credit and other risks to the thrift. As a general matter, a reverse repurchase agreement with a non-banking affiliate bears many of the economic characteristics of a loan or extension of credit to such an affiliate. The savings association transfers funds to the affiliate, expecting to be repaid when the company repurchases the assets. The purchased assets essentially amount to collateral, since the savings association is required to return the assets at the time of repurchase. The savings association earns a pre-determined rate of interest under the agreement. The principal risk to the savings association, its depositors and the deposit insurance fund is credit risk—the possibility that the affiliate will default on its obligation to make the repurchase.

Of course, in the example cited above, the risk is ameliorated significantly because the thrift is able to dispose of United States Treasury securities, a highly liquid, federally guaranteed form of collateral. The risk is further ameliorated by the offsetting repurchase agreements between the thrift and the holding company under which the thrift is, at all times a net debtor to the holding company. Accordingly, as discussed more fully below, the OTS is proposing to exclude such a connected set of transactions from the regulatory prohibitions.

II. General Description of Proposed Rule

To address this and similar arrangements, the OTS is proposing to revise 12 CFR 563.41(a)(3) to clarify that it will generally treat reverse repurchase agreements as loans or other extensions of credit for the purposes of section 11(a)(1)(A) of the HOLA. Such agreements between a thrift and a non-

definition of covered transaction under section 23A. In light of the numerous other cross-references to section 23A of the FRA that are contained in section 11 of the HOLA, it is reasonable to conclude that if Congress had intended to restrict "loans or other extensions of credit" only to those transactions that are loans and extensions of credit for the purposes of section 23A, it would have included a specific cross-reference to that statute.

banking affiliate would, therefore, be prohibited.

The proposed regulation also would outline circumstances in which the OTS would not treat reverse repurchase agreements as loans or other extensions of credit under section 11(a)(1)(A) of the HOLA. These circumstances would be ones in which the agreements are consistent with the policies underlying section 11(a)(1)(A) of HOLA and section 563.41 of the OTS regulations—avoidance of the use of insured deposits as a source of funds for a non-banking affiliate, substantial elimination of credit risk posed by the non-banking affiliate, and protection of the insurance fund. Specifically, the proposed rule would not treat a reverse repurchase agreement as a loan or other extension of credit if the agreement is part of a set of transactions that meet the following requirements:

- In order that the agreements not channel insured deposits to the non-banking affiliate, there must be offsetting repurchase agreements between the thrift and the affiliate under which the thrift sells assets subject to an agreement to repurchase. At all times, when the agreements are netted, the thrift must be a net debtor to the affiliate.

- To make credit risk *de minimis*, and to avoid a risk to the insurance fund, the assets purchased under the agreements must be United States Treasury securities and the remaining term of securities purchased by the savings association must exceed the term of the reverse repurchase agreement. The OTS specifically solicits comment on whether, to reduce interest rate risk further, a cap should be placed on the length of time by which the remaining term of the securities may exceed the term of the reverse repurchase agreement.

There may be other common types of reverse repurchase transactions that avoid the use of insured deposits as a source of funds for an affiliate, substantially eliminate credit risk, and protect the insurance fund from risk of loss. Accordingly, the OTS specifically requests comments on such other agreements. Commenters addressing this issue should describe the nature of the agreements, and should explain how the agreements are consistent with the purposes of section 11(a)(1)(A).

III. Executive Order 12866

The Director of the OTS has determined that this proposed rule does not constitute a “significant regulatory

action” for the purposes of Executive Order 12866.

IV. Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the OTS certifies that this proposed rule will not have a significant impact on a substantial number of small entities. The proposed rule would prohibit all savings associations from entering into reverse repurchase agreements with non-banking affiliates, except under very limited circumstances. Thrifts currently engage in few reverse repurchase agreements with affiliates. The OTS is not aware of any small savings association that is currently engaging in transactions that would be prohibited by this rule. Accordingly, a regulatory flexibility analysis is not required.

V. Unfunded Mandates Act of 1995

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (unfunded Mandates Act), requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a federal mandate that may result in expenditure by state, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OTS has determined that the proposed rule will not result in expenditures by state, local, or tribal governments or by the private sector of \$100 million or more. Accordingly, this rulemaking is not subject to section 202 of the Unfunded Mandates Act.

List of Subjects in 12 CFR Part 563

Accounting, Advertising, Crime, Currency, Investments, Reporting and recordkeeping requirements, Savings associations, Securities, Surety bonds.

Accordingly, the Office of Thrift Supervision proposes to amend Part 563, chapter V, title 12, Code of Federal Regulations as set forth below:

PART 563—OPERATIONS

1. The authority citation for part 563 continues to read as follows:

Authority: 12 U.S.C. 375b, 1462, 1462a, 1463, 1464, 1467a, 1468, 1817, 1820, 1828, 3806; 42 U.S.C. 4106.

2. Section 563.41 is amended by revising paragraph (a)(3) to read as follows:

§ 563.41 Loans and other transactions with affiliates and subsidiaries.

(a) * * *

(3) A savings association (or its subsidiary) may not make a loan or other extension of credit to an affiliate, unless the affiliate is engaged solely in activities described in 12 U.S.C. 1467a(c)(2)(F)(i), as defined in § 584.2-2 of this chapter. For the purposes of this paragraph (a)(3), a loan or other extension of credit includes a purchase of assets from an affiliate that is subject to the affiliate's agreement to repurchase the assets. Such a purchase of assets, however, will not be considered a loan or other extension of credit if the savings association (or subsidiary) has entered into a transaction or series of transactions that meets all of the following requirements:

(i) The savings association (or its subsidiary) purchases United States Treasury securities from the affiliate, the affiliate agrees to repurchase the securities at the end of a stated term, the remaining term of the securities purchased by the savings association (or its subsidiary) exceeds the term of the affiliate's repurchase agreement, and the savings association (or subsidiary) has ensured its right to dispose of the securities at any time during the term of the agreement and upon default.

(ii) The affiliate purchases United States Treasury securities from the savings association (or its subsidiary) and the savings association (or subsidiary) agrees to repurchase the securities at the end of a stated term.

(iii) The aggregate amount of the affiliate's outstanding obligations to repurchase securities from the savings association (or its subsidiary) under the repurchase obligation described at paragraph (a)(3)(i) of this section, at all times, is less than the aggregate amount of the savings association's (or subsidiary's) outstanding obligations to repurchase securities from the affiliate under paragraph (a)(3)(ii) of this section;

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Dated: April 2, 1998.

By the Office of Thrift Supervision.

Ellen Seidman,

Director.

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