COMMITTEE ON SECURITIES LENDING

October 19, 2012

Via Electronic Submission

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW.
Washington, DC 20551

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Office of the Comptroller of the Currency
250 E Street SW.
Washington, DC 20219

Re: Basel III Proposals

Federal Reserve Docket No. R–1442
FDIC RIN 3064-AD95, 3064-AD96 and 3064-D97
OCC Docket ID OCC–2012-0008, 2012-0009 and 2012-0010

Ladies and Gentlemen:

The Committee on Securities Lending of the Risk Management Association ("RMA")[1] welcomes the opportunity to submit this letter to the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC", and together with the Board and the FDIC, the "Agencies") on behalf of several of its members who participate in the securities lending market as agent banks. These members include securities lending agents ("agent banks") such as The Bank of New York Mellon Corporation, Citibank, N.A., Northern Trust Corporation, Frost Bank and State Street Corporation, among others.

1 The Committee acts as a liaison for RMA member institutions involved in agent lending functions within the securities lending industry, by providing products and services including hosting several forums, conferences and training programs annually and sharing aggregate composite securities lending market data free of charge.

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This letter will address issues of concern to agent banks, by virtue of their borrower default indemnification, raised in three notices of proposed rulemaking ("NPRs") intended to implement the Basel Committee on Banking Supervision's (the "BCBS") Basel III capital framework in the United States, in conjunction with and in a manner consistent with the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or "Dodd-Frank").[2] Unfortunately, rather than easing aspects of the Basel III framework to compensate for additional regulatory burdens imposed by Dodd-Frank, the Agencies appear to have taken a "highest common denominator" approach, seeking to impose almost wholesale the Basel III framework (and in some cases imposing more stringent regulations) *in addition to* the Dodd-Frank regulatory regime, resulting in a worst of both worlds impact on the U.S. financial sector in general and agent banks in particular. In order to avoid placing the U.S. banking industry, and securities lending activities in particular, at a competitive disadvantage internationally, the RMA urges the Agencies to reconsider the full-scale implementation of the Basel III framework, easing Basel III where possible, in recognition of the fact that the Dodd-Frank regulatory framework has already imposed significant ongoing costs on the industry. As explained more fully below, the RMA respectfully submits that the adoption of the NPRs, as proposed, could lead to a decline in securities lending markets and further reduce market liquidity.

Section I of this letter summarizes the parties to and nature of a typical securities lending transaction and the size of the market more generally. Sections II, III and IV then address issues of particular concern to agent banks raised in the Capital NPR, the Standardized Approach NPR and the Advanced Approaches NPR, respectively.

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2 Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792 (Aug. 30, 2012) ("Capital NPR"); Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements; 77 Fed. Reg. 52,888 (Aug. 30, 2012) ("Standardized Approach NPR"); Regulatory Capital Rules: Advanced Approach Risk-Based Capital Rule; Market Risk Capital Rule; 77 Fed. Reg. 52,978 (Aug. 30, 2012) ("Advanced Approaches NPR").

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I. Agency Securities Lending: Summary of Parties, Activity and Market

Agency securities lending activity is a traditional bank activity[3] that supports global capital markets activities and facilitates trade settlement. By effectively increasing the supply of securities available for these and other market activities, securities lending improves global market liquidity and enhances price discovery.[4]

A. Parties to securities lending transactions and nature of activities

Securities lenders largely consist of institutions such as public and private pension funds, Employee Retirement Income Security Act ("ERISA") plans, endowment funds of not-for-profit institutions, insurance companies, mutual funds, and other similar entities or funds into which such entities invest. Borrowers in securities lending transactions largely consist of registered broker-dealers, banks and other financial institutions.

Through securities lending programs, agent banks act as intermediary agents to facilitate loans of securities on behalf of securities lenders (the clients of the agent banks, or "lending clients") to qualified borrowers. Securities generally are lent pursuant to a (i) securities lending authorization agreement between the securities lender and the agent bank, and (ii) securities borrowing agreement between the borrower and the agent bank (on behalf of the securities lenders). Pursuant to these agreements, the lending clients (and, directly or indirectly, the agent banks) have a security interest in and lien on the collateral provided by the borrower in an amount in excess of the value of the loaned securities, usually by a margin of 2% to 5% depending on certain characteristics of the loaned securities. The collateral in securities lending transactions is marked to market daily to ensure appropriate excess collateral is consistently maintained.

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3 Securities lenders seek out agency securities lending services from agent banks in order to obtain additional incremental revenues. Agency securities lending activities developed initially as an outgrowth of agent banks' custody and related activities, and have long been regulated, examined and treated by regulators as traditional banking services. *See, e.g.*, Securities Lending, Federal Financial Institutions Examination Council, Supervisory Policy (1985) (addressing appropriate regulatory guidelines for the growing securities lending industry); Letter from J. Virgil Mattingly, General Counsel, Board, William F. Kroener, General Counsel, FDIC, and Julie L. Williams, General Counsel, OCC, to the Securities and Exchange Commission (the "SEC") (Dec. 10, 2002) (indicating that interagency guidelines "ensure that banks conduct their securities lending activities in a safe and sound manner and consistent with sound business practices, investor protection considerations and applicable law").

4 *See* Committee on Payment and Settlement Systems of the central banks of Group of Ten countries and Technical Committee of the International Organization of Securities Commissions, *Securities lending transactions: market development and implications* (July 1999), *available at* http://www.bis.org/publ/cpss32.pdf.

At the end of the loan, the securities lender must return to the borrower the same amount of collateral provided by the borrower. In periods when interest rates are more than *de minimis*, the securities lender pays the borrower a negotiated "loan rebate fee" on the cash collateral received. The securities lender receives all revenues from the cash collateral pool (and, as described below, is responsible for all losses) that are allocated to its cash collateral invested, less the borrower's loan rebate fee. A fee is paid to the agent bank that is generally a percentage of the lender's net revenue from the cash collateral pool less rebate rates paid on loans. A diagram showing the structure of a typical securities lending transaction is attached as Exhibit A.

B. Borrower default indemnification by agent banks

As a matter of standard market practice developed over the past several decades, agent banks provide securities replacement guarantees, or indemnification for borrower default (which is typically defined by contract as the failure of the borrower to return the borrowed securities or satisfy its obligation to deliver additional collateral to maintain the requisite amount of excess collateral) to the substantial majority of their lending clients pursuant to their securities lending authorization agreements. This practice is commonly referred to as "borrower default indemnification." Securities lending authorization agreements typically provide that lending clients are indemnified by the agent banks for any deficiencies in collateral in the event of a borrower default. The vast majority of lending clients (both domestic and non-U.S.) focus on risk avoidance and see the securities replacement guarantee as providing both protection to their programs and a validation of the strength of their agent banks' risk management systems. Moreover, many lending clients (*e.g.*, clients subject to ERISA) are required under U.S. law to receive borrower default indemnification by an agent bank in their securities lending program under defined circumstances.[5] Certain states and municipalities also require indemnification from the lending agent, either by statute or by policy, as a condition to their funds' participation in securities lending.[6] In addition, the Securities and Markets Stakeholder Group of the European

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5 *See* Prohibited Transaction Exemption (PTE) 2006-16, Class Exemption To Permit Certain Loans of Securities by Employee Benefit Plans, 71 Fed. Reg. 63,786 (Oct. 31, 2006) (requiring in the case of securities lending transactions involving (i) certain types of foreign banks or broker-dealers as borrowers or (ii) certain types of collateral, including U.S. and non-U.S. securities, defined in the exemption as "Foreign Collateral," that a U.S. bank or broker-dealer "Lending Fiduciary" indemnify the lending plan for borrower default).

6 *See*, *e.g.*, Texas Government Code § 825.303(b)(3) (stating that in order for a bank to be eligible to lend securities on behalf of a Texas Public Fund, the bank must "execute an indemnification agreement satisfactory in form and content to the retirement system fully indemnifying the retirement system against loss resulting from borrower default."); New York State Teachers' Retirement System Investment Policy Manual, Securities Lending Section 3 (October 2011), *available at* www.nystrs.org/main/library/IPM2011.pdf (requiring that the agent lender indemnify the System for losses resulting from a default by the borrower); New Mexico State Investment Council Securities Lending Policy (December 2006), *available at* http://www.sic.state.nm.us/PDF%20files/Section_15_Seclend_12142006.pdf (requiring that the Investment Office staff execute securities lending contracts that include: "At least the standard securities lending industry indemnification against borrower default."); City Of Seattle Statement Of Investment Policy, *available at* http://www.cityofseattle.net/executiveadministration/invpol.htm (authorizing the Director of Executive Administration of the City of Seattle, "under the supervision of the Mayor and consistent with policy direction given by the Director of Finance, to invest all moneys in the City Treasury which in the judgment of the Director are in excess of current City needs in... providing indemnification against borrower insolvency.").

Securities and Markets Authority ("ESMA") has recommended that the securities lending agent be required to indemnify Exchange Traded Funds and other UCITS (Undertaking for Collective Investment in Transferable Securities) funds that loan securities.[7] More generally, in the experience of RMA members, the vast majority of plan policies of securities lending clients, whether or not required to by law, mandate that agent banks provide borrower default indemnification. If U.S. agent banks cease their securities replacement guarantee programs, clients may terminate their participation in securities lending programs or move their business elsewhere.

Thus elimination of the replacement guarantee, to avoid the capital issues raised herein, is not feasible as a legal and practical matter. Indeed, if a large number of lending clients determine to leave the market, this would not only reduce income at agent banks, but would also limit the amount of securities available in the markets for trade settlement and other vital financial market activities. A number of academic studies have shown that reduced lending supply could reduce liquidity in the broader market.[8] Because of the daily marking to market and contractual protections provided in the securities lending agreement, as a practical matter the economic risk to a bank as a result of indemnification is that the borrower defaults immediately before a material intraday price movement in the loaned securities or collateral.

C. Overview of the securities lending market

In the U.S. lending market (where both lender and borrower are in the U.S.), cash is taken as collateral for more than 85% of securities loans.[9] Loans are over-collateralized by a margin of typically 2% to 5%, depending on the jurisdiction of the loaned securities' issuance and the type of collateral provided. Cash collateral is reinvested in securities, sometimes in collective investment vehicles (or cash collateral pools) in both the U.S. and abroad.

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7 *See* European Securities and Markets Authority, *Consultation paper: ESMA's guidelines on ETFs and other UCITS issues, ESMA/2012/44* 42, 68, 75 (Jan. 30, 2012), *available at* http://www.esma.europa.eu/consultation/Consultation-ESMA-guidelines-regulatory-framework-ETFs-and-other-UCITS-issues.

8 *See, e.g.*, Pedro A.C. Saffi & Karl Sigurdsson, *Price Efficiency and Short Selling* 821-852 (Am. Fin. Ass'n New Orleans Meeting Paper) (2010), *available at* http://ssrn.com/abstract=949027 (showing through an analysis of weekly data on share lending supply and borrowing fees from 26 markets that lending supply has a significant impact on efficiency, in that stocks with higher short-sale constraints, measured by low lending supply, have lower price efficiency). In addition, a number of studies have shown that constraints on short-selling negatively affect market liquidity. Given that short-selling is dependent on securities lending, it follows that a reduction in lending supply would reduce market liquidity. *See e.g.*, Ekkehart Boehmer, Charles M. Jones & Xiaoyan Zhang, *Shackling Short Sellers: The 2008 Shorting Ban* (2009), *available at* http://ssrn.com/ abstract=1412844 (showing through a study of spreads, price impacts, firm-level volatility and other data during the 2008 ban on short sales that shorting restrictions negatively impact liquidity and market quality); Douglas W. Diamond & Robert E. Verrecchia, *Constraints on short-selling and asset price adjustment to private information*, 18 Journal of Fin. Econ. 277-311 (1987) (predicting that if there are constraints on ability to sell securities short, prices will adjust more slowly to negative information).

9 *See* Bank of England Quarterly Bulletin 2011 Q3: *Developments in the global securities lending market*, *available at* www.bankofengland.co.uk/publications/quarterlybulletin/qb110303.pdf ("Bank of England Quarterly Bulletin"), Chart 2 at 226.

As of second quarter of 2012, RMA data showed over $1.1 trillion of securities on loan in the global securities lending market. RMA composite figures for the second quarter of 2012, compiling responses of 14 member institutions, reflected $6.5 trillion of U.S. lendable assets and $3 trillion of non-U.S. lendable assets in the securities lending market, of which over $520 billion of U.S. securities and $180 billion of non-U.S. securities were on loan against cash collateral.[10] The current volume of securities on loan represents a decrease of approximately 50% from pre-financial crisis volumes. Market participants do not expect volumes to return to pre-crisis levels due to regulatory and other systemic changes brought on by the financial crisis.

D. Agency securities lending during the financial crisis

In an informal survey of RMA members involved in the drafting of this letter: (i) many with the largest securities lending operations have never experienced any losses as a result of borrower-default indemnification; and (ii) none has incurred material losses as a result of the indemnification. If the Agencies choose to ignore these experiences, and proceed to implement the NPRs as proposed, the result could be an interruption to or further compression of the securities lending market that could materially impair access to securities, driving down liquidity and in turn impeding price discovery. The loss in revenues associated with such a decline in securities lending would reduce returns to government plans and other lending clients, which reap 80% to 85% of the revenues raised by each agency securities lending transaction. The combined effect of such events could potentially lead to vast disruptions in the capital markets at the very time market liquidity is critical to promoting economic recovery in the United States and worldwide.

As previously mentioned, agent banks acting as intermediaries (*i.e.*, the RMA Members) include some of the largest agent banks in the world, such as Citibank, The Bank of New York Mellon Corporation, Northern Trust Corporation and State Street Corporation, among others. As the foregoing data demonstrates, these agent banks perform a function that is critical to the U.S. (and global) economies. As discussed in the following sections, we believe the NPRs would materially impair the agency securities lending activities of agent banks. A central theme of the letter is that the special characteristics of securities lending (daily posting of high quality, liquid collateral, the effects of "right way" risk, as well as the sophisticated oversight and risk mitigation systems of the agent banks) substantially mitigate the economic risk of providing these critical and expected services to lending clients, and therefore the NPRs impair securities lending activities inappropriately relative to the risks posed by such activities.

[10] RMA Quarterly Composite Data on Securities Lending, Second Quarter 2012, available to the Agencies upon request in connection with their review of this comment letter and implementation of the Proposals.

II. Capital NPR

A. Supplementary Leverage Ratio

In addition to requiring continued compliance with an enhanced on-balance sheet asset-based leverage ratio, the Capital NPR would require agent banks subject to the advanced approaches to satisfy a supplementary leverage ratio of 3% of tier 1 capital to "total leverage exposure." The new measure of total leverage exposure is designed to capture off-balance sheet exposures not included in the existing leverage ratio. The stated purpose of the new leverage ratio including such a broad-brush measure of total exposure is to encourage large institutions to maintain liquidity with respect to, and constrain the build-up of, what is deemed to be excessive off-balance sheet leverage in the banking system among large banking institutions.

Due to the BCBS's ongoing observations and international discussions regarding the most appropriate measure of exposure for repo-style transactions, the Capital NPR maintains the current on-balance sheet measurement of such transactions for purposes of calculating total leverage exposure. However, the Capital NPR further notes that the Agencies will consider including repo-style transactions in the calculation of total leverage exposure in the future, to reflect results of international discussions and ongoing quantitative analysis of the exposure method for repo-style transactions. The supplementary leverage ratio currently is proposed to become a formal requirement on January 1, 2018.

The RMA appreciates that the Agencies have not included an off-balance sheet measure of securities lending exposures in the denominator of the supplementary leverage ratio, and hereby formally requests that the Agencies include the RMA and agent banks in any discussions regarding the possible inclusion of repo-style transactions in a bank's total exposure calculations for leverage ratio purposes. As discussed further in this section, the RMA strongly supports the indefinite use of only the on-balance sheet measurement of exposure for all repo-style transactions, and at a minimum, for securities finance transactions specifically.

1. *Because securities lending transactions are fully collateralized and marked to market daily, they result in minimal actual exposure for agent banks for the reasons discussed below.*

The securities replacement guarantees provided in connection with agency securities lending transactions result in minimal actual off-balance sheet exposure for agent banks. An agent bank's exposure is only the deficiency, if any, between the mark to market amount of the collateral posted and the repurchase price of the securities that the borrower failed to return (which risk is further reduced by any excess margin of collateral maintained). The likelihood of this exposure resulting in material losses to agent banks is low since the borrower's obligation to return loaned securities is typically secured by an excess amount (generally 102% to 105%, and sometimes up to 110%) of cash or liquid securities collateral (often including OECD government securities).

Collateral is marked to market daily. In marking to market, the daily mark is set based on the prices at close of business on the prior day, and any additional required collateral is posted the same day. In the event of a borrower default, the agent bank would first look to the marked to market collateral posted, substantially reducing any risk of loss to the bank.[11] Unto itself, low or no losses (and thus low or no loss of liquidity) by agent banks warrants excluding these exposures from the supplemental leverage ratio.

The concept of "right-way" credit risk also applies to many securities lending transactions. For example, in the case of a loan of equity securities against cash or sovereign collateral, an agent bank's liability under a securities replacement guarantee is contingent upon both of the following market events happening concurrently: (i) the default of a borrower (typically a major broker-dealer) and (ii) a rally in the equity market that leads to the value of securities on loan appreciating beyond the level of collateralization related to the prior day's marking to market. Such a confluence of events has proven highly unlikely.

Even the nominal risk resulting from the above, however, overstates the actual risk posed by securities lending activities. Additional limits on agent banks' liability under securities replacement guarantees are incorporated into agent banks' standard securities lending agreements. Significantly, in the event that cash collateral is posted, the beneficial owner (the lending client) is responsible for selecting the manager of any reinvested cash collateral (the manager may be the agent bank or another party) and approving the investment guidelines. Pursuant to the securities lending authorization agreement (except in very limited cases where cash collateral is reinvested by way of indemnified reverse repurchase transactions and agent banks indemnify beneficial owners against default risk), the beneficial owner bears the risk of any principal investment loss, and the agent bank bears no responsibility for shortfalls of cash collateral due to any loss on reinvestment. As such, the agent bank's obligation under the securities replacement guarantee is not increased when the cash collateral is reinvested. Moreover, securities replacement guarantee provisions under agency securities lending agreements typically have a number of additional caveats and conditions. These may include, for example, an exclusion of defaults resulting from administrative errors, limitations on liability for actions of third parties.

Legislative changes from the financial crisis further reduce agent bank risk. Under the Orderly Liquidation Authority ("OLA"), as set forth in Title II of the Dodd-Frank Act and FDIC regulations promulgated thereunder, the treatment of securities lending and borrowing agreements further reduces borrower insolvency risk to agent banks relative to Securities Investor Protection Corporation ("SIPC") procedures in the case of a broker-dealer insolvency and default. The most significant broker-dealer borrowers participating in U.S. agent banks' securities lending programs are companies that likely would be subject to OLA procedures in the event of an insolvency.[12]

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11 As discussed previously, an informal survey of RMA members involved in the drafting of this letter indicates that many members with the largest securities lending operations have never experienced any losses as a result of borrower-default indemnification, and that none has incurred material losses as a result of the indemnification.

12 *See* Dodd-Frank Act §§ 201(a)(7), 201(a)(8), 203; Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 41,626 (Jul. 15, 2011).

While OLA generally provides that the Securities Investor Protection Act ("SIPA") controls in the event of the insolvency of a broker-dealer, OLA states specifically that its provisions apply to "qualified financial contracts" ("QFCs"), including securities lending agreements. More specifically, while SIPA provides for an automatic stay, generally for up to five days or more, if securities collateral is provided by an insolvent borrower broker-dealer, the OLA procedures provide for a maximum of one business day stay on these arrangements.[13] If the FDIC determines to transfer the securities borrowing agreement to a "bridge financial company," that company will assume all the borrower's obligations under any QFCs.[14] Once transferred to the bridge, the securities borrowing agreement would have the same economic consequences as if a default had never occurred, and could be continued or terminated by the agent bank to the same extent as if an insolvency never occurred. If for some reason the securities borrowing agreement is not transferred to the bridge at the conclusion of the one business day stay, the agent bank still has a subrogated right to the securities lender's secured claim on the collateral and may immediately liquidate the collateral to cover the securities replacement guarantee. Thus, whether or not the relevant securities borrowing agreement is transferred to a bridge financial company, the OLA procedures provide greater speed and certainty in resolving these arrangements than would be provided in a SIPC proceeding.

2. *The on-balance sheet measurement of exposure more than adequately reflects the minimal risk associated with securities lending transactions.*

The rationale for excluding securities finance transactions from the supplemental leverage ratio extends beyond even the low actual liquidity risk such transactions present. The severe risk-weightings associated with counterparty-based activities, such as securities lending, makes the basis for excluding this minimal risk from the new measure all the more compelling. Under the Standardized Approach NPR, exposures to broker-dealers are proposed to be assigned a 100% risk weight. Although as described below the RMA believes the increased risk-weightings assigned to exposures to broker-dealers are unjustified, to the extent they are maintained or remain significant in the final rules, an increased risk-weighting would further buttress the argument that the on-balance sheet measurement of exposure fully captures the minimal risks associated with repo-style transactions. In any event, numerous other provisions in the Dodd-Frank Act – single-counterparty credit limits, enhancements to bank lending limits, and resolution planning, among others – collectively help to mitigate any concerns associated with exposures under repo-style transactions. Given the cumulative impact of these significant enhancements to the regulatory framework mandated by Dodd-Frank, agent banks should not be subject to a supplementary leverage ratio that includes off-balance sheet measurements of exposure for repo-style transactions. To require otherwise would be to potentially restrict the ability of agent banks to engage in securities lending transactions with counterparties and relative to international peers, with resulting negative impacts on U.S. market efficiency and liquidity.

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13 *See* Dodd-Frank Act §§ 210(c)(8)(D)(i) and (ii).

14 *Id.* at § 210(c)(9).

B. Deduction of Investments in Covered Funds from Tier 1 Capital

The Capital NPR would require a banking organization to deduct from tier 1 capital the aggregate value of its investments in pooled investment vehicles deemed "covered funds" for purposes of section 13 of the Bank Holding Company Act of 1956 (the "Volcker Rule") and its implementing regulations. As we discussed in our previous letter regarding implementation of the Volcker Rule by the Agencies and the Commodity Futures Trading Commission (the "CFTC") and the SEC, securities lending cash collateral pools should not be considered covered funds for purposes of the Volcker Rule, because (i) cash collateral pools are not the types of activities intended to be limited by the Volcker Rule; (ii) cash collateral pools do not involve the investment of agent banks' own capital to create return or the conflicts of interest that may result from such investments; and (iii) as a customary element of securities lending services, cash collateral pools are a longstanding, well-regulated banking product that stems from agent banks' custody, advisory and agent lending services.[15] However, agent banks may be deemed to make nominal investments in the pools, purely to establish the structure (*e.g.*, to appoint a general partner of a pool) or other administrative reasons. Because of the arguments set forth in the Volcker Rule letter and summarized above, we therefore request confirmation that any nominal investment in these pools merely to establish them or for administrative purposes would not be subject to deduction from tier 1 capital under the Capital NPR.

III. Standardized Approach NPR

As the Agencies are aware, section 171 of the Dodd-Frank Act (commonly referred to as the "Collins Amendment") will require agent banks subject to the advanced approaches to calculate risk-based capital under both the Standardized and Advanced Approaches NPR, and use the more stringent of the two calculations to determine their capital ratios. This dual calculation requirement will likely impose significantly higher capital charges on securities lending transactions under the Standardized Approach NPR, capital charges that are disproportionate relative to the actual risk these transactions present. Anticipating that several agent banks will become subject to this dual calculation requirement and the associated capital "penalty" for securities lending transactions, we offer comments on the Standardized Approach NPR below.

A. Treatment of Exposures to Securities Firms

The Basel framework, as amended by Basel III, does not alter the view that securities firms that meet certain requirements be treated like exposures to U.S. depository institutions, which are generally subject to a 20% risk weight. Thus, the treatment of exposures to securities firms under the Agencies' current risk-based capital rules is entirely consistent with the Basel framework. The Standardized Approach NPR, however, would drastically increase the risk-weight of exposures to

[15] *See* Letter from the RMA Securities Lending Association, to the Agencies, the CFTC and the SEC (Feb. 13, 2012), *available at* http://www.fdic.gov/regulations/laws/federal/2011/11c155ad85.pdf.

securities firms, requiring agent banks to treat such exposures as corporate exposures subject to a 100% risk weight.

The RMA does not believe such a departure from the historical Basel framework and current risk-based capital rules is warranted or justified by historical experience. There is insufficient evidence to support this proposed five-fold increase in the risk weight of exposures to securities firms. As noted above, an informal survey of RMA members involved in the drafting of this letter indicates that many with the largest securities lending operations have never experienced any losses as a result of borrower-default indemnification and none have incurred material losses as a result of the indemnification. Because the existing approach has worked well historically with limits on counterparty-based activities, and securities lenders have not experienced any material losses as a result of exposures to securities firms, the RMA urges the Agencies to reconsider this upward revision of the risk weights associated with exposures to securities firms.

With few exceptions, the borrowers in securities lending transactions are broker-dealers. Despite the Agencies' suggestion that the risk profiles of depository institutions and securities firms are dissimilar, the RMA notes that in several important respects they are quite similar. First, both depository institutions and broker-dealers are heavily regulated and supervised. Moreover, they also have capital requirements that vary according to perceived activity risk. Such extensive regulation and supervision significantly reduces the risk profiles of both broker-dealers and depository institutions relative to those of other corporations. Second, many of the larger broker-dealers are themselves affiliated with financial holding companies supervised by the Board on an enterprise-wide basis, especially after Dodd-Frank.

Moreover, as discussed in detail above in section II.A.1 above, the OLA reduces borrower insolvency risk to agent banks relative to SIPC procedures in the case of a broker-dealer default by providing for an orderly resolution process that includes a one business day stay. Because most borrowers participating in U.S. agent banks' securities lending programs are broker-dealers that could be subject to OLA procedures in the event of a large-scale default, agent banks and their lending clients can expect greater speed and certainty in resolving these arrangements, thus further reducing the risk associated with exposures to such entities. For all of these reasons, the RMA believe that the risks associated with exposures to broker-dealers of the type that are typical in securities lending transactions are more akin to capital requirements associated with exposures to U.S. depository institutions than to corporations.

Finally, the RMA notes that an increase in such risk weights relative to the risk weights assigned such exposures under the Basel framework would represent yet another instance where the capital rules applicable to U.S. agent banks would be more stringent than either the Basel framework or Dodd-Frank require. Because the cumulative effect of Basel III and Dodd-Frank on U.S. agent banks already will result in a significant competitive disadvantage for U.S. institutions relative to their global competitors, the Agencies should be very cautious when considering rules (for example, when considering how to implement the Volcker Rule in a manner consistent with congressional intent) that extend beyond the requirements of either Basel III or Dodd-Frank, thus further constraining the ability of U.S. institutions to compete effectively in the global marketplace.

For all of the foregoing reasons, the RMA submits that the Agencies should maintain a 20% risk weight for all broker-dealers. However, even if for whatever reason the Agencies determine that securities firms that are not affiliated with agent banks are sufficiently dissimilar to depository institutions to justify the proposed increased risk weighting despite the arguments set forth above, the RMA strongly urges the Agencies to treat exposures to broker-dealers that are affiliated with banking organizations or are otherwise subject to consolidated oversight in the same fashion as exposures to U.S. depository institutions by assigning a 20% risk-weight. In the alternative, the RMA requests that agent banks be permitted to utilize their own internal ratings to assign a 20% risk weight to their highest quality securities firm counterparties. Such an approach is consistent with the regime governing the determination of eligible collateral under the Standardized Approach NPR and the calculation of probability of default (PD) under the advanced approaches.

B. Simple VaR and IMM Not Expressly Permitted for Exposure Amounts

The RMA strongly believes that the Agencies should permit agent banks to use the simple value-at-risk ("simple VaR") or internal models methodology ("IMM") approaches (together, the "Models-Based Approaches") to calculate capital requirements, and this letter focuses on the basis to permit the Models-Based Approaches for securities finance transactions in particular for purposes of the Standardized Approach NPR. More specifically, the Models-Based Approaches allow agent banks to use sophisticated, model-based analyses to calculate capital requirements that are closely reflective of the actual risks associated with securities lending transactions. Through the use of modeling that takes into account risk mitigating factors such as asset correlation, the Models-Based Approaches ensure that securities lending transactions are subject to capital requirements proportional to their actual risk, rather than the less sophisticated, more blunt approach permitted by either the haircut approach or simple model. Indeed, the haircut and simple models actually penalize risk-avoiding behavior by often favoring uncorrelated rather than correlated and diversified lending and borrowing positions.[16]

If the Agencies are concerned that agent banks will differ in their implementation of the Models-Based Approaches, the RMA supports an approach whereby agent banks would be permitted to use a VaR-based framework, with the Agencies themselves providing the relevant volatilities and correlations that would be input into the VaR calculation. Although this approach would not measure risk with the same level of granularity as agent banks' existing models, it

[16] In the analogous area of proposed counterparty exposure limitations, members of the Federal Advisory Council ("FAC") noted to the Board that they "are concerned that the Federal Reserve's intended approach [which, as here, does not include a VaR or IMM approach] lacks risk sensitivity." FAC, *Federal Advisory Council's written views provided to the Board regarding the Proposed Rules* 12 (Feb. 3, 2012), *available at* http://ww.federalreserve.gov/SECRS/2012/February/20120224/R-1438/R-1438_022412_105569_53530202900_1.pdf.

would permit agent banks to take into account correlations between and among asset classes in their risk-based capital calculations, thereby ensuring that risk-mitigating behavior is encouraged, rather than penalized. Similarly, some of the benefits of diversification and correlations may be achieved through a multi-dimensional matrix of haircuts based on combinations of loaned securities and collateral received. However, such an approach would require more effort on the part of regulators and the industry, while not achieving as much of the benefits afforded by a VaR-based approach.

The RMA strongly believes that the Collins Amendment does not prohibit the use of the Models-Based Approaches. Since the Board permitted the use of the Models-Based Approaches[17] (and more generally, variations from Basel I that more closely correlated capital charges with actual risk) prior to the enactment of Dodd-Frank, the Models-Based Approaches should constitute "generally applicable" capital requirements for purposes of the Collins Amendment. Although the Collins Amendment requires that whatever capital requirements the Agencies impose not be less stringent or quantitatively lower than the "generally applicable" baseline, it clearly does not require that a "generally applicable" capital requirement in force at the time of Dodd-Frank's enactment be abandoned.

If the Agencies discontinue permitting the use of the Models-Based Approaches, the resulting negative impacts on the securities lending market could be significant. The requirement under the Collins Amendment for certain agent banks to apply both the Standardized and Advanced Approaches will force agent banks to incur a substantial capital penalty on these transactions, even under the "haircut" approach (which, according to a preliminary assessment conducted by one of our members, would require ten to fifteen times the capital required under the Models-Based Approaches for some transactions) to the treatment of collateralized transactions, with the result that securities lending transactions will be subject to capital requirements far out of proportion to the risks they represent.[18] Such an outcome would place agent banks subject to the NPRs at a competitive disadvantage vis-à-vis foreign banks who are able to use the Models-Based Approaches, and, may result in agent banks scaling back their securities lending activities.

C. Treatment of Central Counterparties

The Standardized and Advanced Approaches NPRs encourage the use of central counterparties ("CCPs") to promote transparency, multilateral netting and robust risk management practices. For any repo-style transaction that is a cleared transaction, the trade exposure amount would be the exposure amount calculated under the collateral haircut approach plus the fair value of the collateral posted by the clearing member client bank that is held by the CCP in a manner

[17] *See* Board Letter to Gregory J. Lyons (Nov. 8, 2005); Board Letter to Gregory J. Lyons (May 14, 2003) (together, the "State Street Letters"); OCC Interpretive Letter No. 1105 (Sept. 18, 2008); OCC Interpretive Letter No. 1066 (Nov. 8, 2005) (together, the "OCC VaR Letters").

[18] This low level of actual risk is evidenced by the very low risk weightings historically applied under the banking book capital rules. *See* 12 CFR Part 3, App. A § 3(b)(1)(v), fn 15 and related text; 12 CFR Part 225 App. A § III.D.1.c.; State Street Letters; OCC VaR Letters.

that is not bankruptcy remote. The Standardized Approach NPR provides a mechanism for clearing member clients to apply a 2% risk weight to trade exposure amounts with a qualifying CCP ("QCCP"), provided the collateral posted is protected. In the Standardized Approach NPR, the Agencies state their belief that omnibus accounts (accounts set up by clearing entities for non-clearing members) in the U.S. should qualify as QCCPs. Otherwise, a banking organization that is a clearing member client would apply a 4% risk weight to the trade exposure amount.

The treatment of cleared transactions under the Standardized and Advanced Approaches NPRs is fundamentally at odds with the way securities lending transactions are currently structured. In particular, the NPRs fail to include within the category of cleared transactions (i) transactions where a banking organization either acts as a financial intermediary and enters into an offsetting transaction with a CCP or (ii) transactions where a banking organization guarantees the performance of a client to a CCP within the category of cleared transactions. As a result, virtually all securities lending transactions would fail to qualify as cleared transactions, even if they were conducted through a CCP. Under the NPRs, agent banks would therefore be forced to treat cleared securities lending transactions as OTC derivatives transactions for capital purposes, with the result being that a cleared securities lending transaction could be subject to a higher capital charge than the same transaction conducted bilaterally. The Agencies claim to seek to provide greater incentives for market participants to clear transactions, and yet, with respect to securities lending transactions, the NPRs create incentives pointing in precisely the opposite direction.

Setting aside this fundamental incongruity, there are significant legal and market impediments to conducting securities lending transactions through CCPs. Perhaps most significant, certain categories of beneficial owners, including ERISA plans and mutual funds, are prohibited under existing law and regulation from lending securities to a CCP.[19] These beneficial owners would therefore be forced out of the market if securities lending transactions were required to be conducted through a CCP, with resulting negative impacts on these beneficial owners and the ultimate owners of the securities themselves (*e.g.*, pension beneficiaries and mutual fund shareholders). In addition, because beneficial owners of securities must be over-collateralized at no less than 100 percent of the value of securities loaned, the shared margin regimes that are a hallmark of CCP arrangements would be unworkable as applied to beneficial owners. For example, a requirement for an ERISA plan to contribute 102% of the value of its loaned securities to the CCP's margin and default fund could be considered a violation of ERISA regulations. Further impediments arise from the fact that many CCP participants would be unlikely to meet the creditworthiness standards required of securities borrowers. In effect, a CCP would require beneficial owners to "trade down" in the credit quality of securities borrowers, an outcome that is of significant concern to beneficial owners and agent lenders.

In addition, requiring securities lending transactions to be conducted through CCPs would be unworkable in light of the single-counterparty credit limit ("SCCL") under section 165 of the Dodd-Frank Act.[20] Because exposures to CCPs are subject to the SCCL, banking organizations

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[19] *See, e.g.*, 29 C.F.R. 2550.404a-1 (investment duties for ERISA plan fiduciaries).

would quickly find themselves in breach of the SCCL if securities lending transactions were moved to CCPs. While the RMA estimates that as many as 20 CCPs would be required to handle the volume of securities lending transactions currently conducted by U.S. agent banks, only a few CCPs currently either offer or are developing the capability to handle securities lending transactions. Quite simply, CCPs currently do not have the capacity to handle the volume of securities lending transactions needed to prevent a massive breach of the SCCL.

For the foregoing reasons, we submit that requiring that securities lending transactions be conducted through a CCP is, quite simply, currently unworkable as a practical matter. The practical and administrative difficulties described above would inevitably arise if a CCP requirement were imposed, with resulting marketplace disruptions that could pose significant risks, not only to agent banks but to other market participants as well. We believe that it would be far easier, and far more sensible, for the Agencies to make the appropriate adjustments to the NPRs to ensure capital treatment for securities lending transactions that is proportional to the actual risks presented by these transactions.

D. Collateralized Transactions

1. The RMA supports the Agencies' decision to expand the types of eligible collateral.

Under the Standardized Approach NPR, the types of eligible risk-mitigating collateral have been expanded to include publicly traded equities, convertible bonds, and short- and long-term debt. In the U.S., securities lending collateral has historically consisted primarily of cash and U.S. government securities, largely because of restrictions on the types of collateral broker-dealers have been permitted to post. However, the RMA supports expansion of the types of permissible risk-mitigating collateral as a matter of general principle. Abroad, securities lending collateral historically has encompassed a broader variety of assets, including equities and debt securities. For example, 47% of securities on loan globally, valued at $944 billion, are loaned against non-cash collateral.[21]

We note that even in the U.S., non-cash collateral is becoming more common. The expansion of the universe of permissible risk-mitigating collateral under the Standardized Approach NPR will enable U.S. agent banks to compete more effectively and on a more level playing field with international agent banks. In addition, because more worldwide systems have been developed in tandem with the expansion in the types of acceptable collateral in the U.S., agent banks will benefit from an increased ability to successfully mitigate capital risk associated with securities lending transactions on an ongoing basis.

[20] The section 165 SCCL is an example of a Dodd-Frank requirement that could, if not implemented appropriately, have a disproportionately negative impact on agency securities lending, an impact that would be additive to the potential negative impacts of the NPRs.

[21] Data Explorers global composite data as of September 28, 2012.

2. *The Agencies should not apply a 20% haircut to sovereign collateral under the simple approach.*

The Standardized Approach NPR provides that a banking organization may recognize the risk-mitigating effects of financial collateral using the simple approach, described in section II.F.2(c) of the Standardized Approach NPR.[22] Under the simple approach, in all cases the collateral and the exposure would be required to be denominated in the same currency. Generally, the risk weight assigned to the collateralized portion of the exposure would be no less than 20%. However, a banking organization may assign a 0% risk weight to the collateralized portion of an exposure where the financial collateral is cash, or where the financial collateral is an exposure to a sovereign that qualifies for a 0% risk weight, *and the banking organization has discounted the market value of the collateral by 20%.*

The RMA does not believe a 20% discount applied to sovereigns is warranted. Assuming the discount is meant to address volatility risk, the fact that securities lending collateral is marked to market daily, with a position margin, sufficiently addresses that risk. Indeed, this is the approach that the U.S. framework has historically taken and which the international Basel framework maintains.

Forcing securities lending agent banks to apply a 20% discount to sovereign collateral would require securities lending agents to require an amount of collateral far in excess of what the market will bear, if they were to accept collateral in any form other than cash. In contrast to the Agencies' stated goal of expanding the types of permissible risk-mitigating collateral, this requirement would in effect force securities lenders to either accept only cash as collateral, or use the collateral haircut approach to account for collateralized transactions. Because the daily mark-to-market of securities lending collateral already addresses volatility risk, the RMA urges the Agencies to permit agent banks to assign, as has been the case historically, a 0% risk weight to the collateralized portion of an exposure where the financial collateral is an exposure to a sovereign that qualifies for a 0% risk weight, without requiring the agent bank to discount the market value of the collateral by 20%.

3. *The haircut approach would impose excessive capital requirements on securities lending transactions.*

The Standardized Approach NPR would apply collateral haircuts on non-cash securities lending collateral at the same level as securities held as a long-term asset or as static security for a long-term asset. As discussed throughout this comment letter, securities lending collateral (both cash and non-cash) is marked to market daily, and tracking and coverage systems are very

[22] We are aware that the Standardized Approach NPR also provides for a collateral haircut approach to the treatment of repo-style transactions. However, some agent banks may choose to use the simple approach, and should not be unduly penalized for making this choice. As discussed above, another way for the Agencies to avoid the imposition of an undue capital penalty would be to permit the use of the Models-Based Approaches to determine capital requirements for securities lending transactions.

sophisticated, ensuring continuous collateral coverage of at least 102% or more (depending on the type of collateral). Given that collateral management in agent securities lending programs is generally active and dynamic in the securities lending space, securities lending collateral should receive more favorable capital treatment than securities held as a static investment or long-term asset. The RMA proposes that, provided the non-cash collateral posted in securities lending transactions is readily marketable, exposures should be subject to a 0% capital charge. More generally, as discussed above concerning the appropriate inclusion of the Models-Based Approaches in the Standardized Approach, the collateral haircut approach substantially overstates the risks of securities lending transactions and its capital charges for these transactions should therefore be reduced substantially accordingly.

To demonstrate the negative impact of the collateral haircut requirement, assume that an agent lender lends $1.00 billion of IBM stock and it is collateralized with $1.02 billion of Microsoft ("MSFT") stock. Under the Standardized Approach NPR, risk weighted assets for this transaction would be (1.00B * 1.106) - (1.02B * .894) = $.19142 billion. Using a 3 year history from July 1, 2008 through June 30, 2011 (so as to capture the recent credit crisis) the 5 day (using square root of time) volatilities at the 99th percent confidence level are 8.93% and 11.87%, thereby implying that 10.6% is an appropriate haircut. However, using the same methodology, the volatility of changes in a portfolio of IBM less changes in MSFT would be 9.33%, which is less than half of the 21.2% combined haircut under the Standardized Approach NPR. If one examines the actual 99th percentile changes for each security over this period (using the square root of time) the change are slightly higher at 10.15% and -13.86%, but the combined change remains at 9.89%. Further, if one examines the actual 5 day changes, which are 12.60% and -14.71%, the combined move would be 10.09%, still less than half of the combined haircuts that would be levied on such a transaction under the Standardized Approach NPR.

4. *The currency mismatch adjustment under the haircut approach is unwarranted.*

The Standardized Approach would permit an agent bank to recognize the risk mitigating effect of collateral that secures a securities lending transaction using the collateral haircut approach, subject to certain conditions. The agent bank would determine the exposure amount for an eligible repo-style transaction or netting set, in part, by applying an 8% haircut to "the absolute values of the net position of instruments and cash in a currency that is different from the settlement currency."[23] The currency differential haircut does not change depending on which currencies are in use on the loan and collateral sides, thus ignoring any correlations among currency fluctuations. We note that securities lending transactions in which there is a currency

[23] 77 Fed. Reg. 92,510.

mismatch typically require a higher collateral margin than those with no currency mismatch (*i.e.*, 105%, rather than 102%). For this reason, we do not believe that a currency mismatch haircut is warranted, because pursuant to longstanding industry practice to promote safe and sound behavior the foreign exchange rate volatility risk associated with any currency mismatch is already factored into the decision to require a higher margin of collateral in such transactions.

Nevertheless, if the Agencies determine to require a haircut to capture risk associated with foreign exchange rate volatility, we suggest that such a haircut be more closely aligned with the magnitude of foreign exchange rate volatility risk that may be associated with a given currency combination. In other words, collateral in a currency associated with a country with a more favorable OECD Country Risk Classification ("CRC") should be subject to a smaller haircut than collateral in a currency associated with a less favorable CRC, in recognition of the fact that the U.S. dollar volatility is not very significant in respect to the former.

In addition, we ask the Agencies to define the term "settlement currency", as used in § .__37(c)(2) of the Standardized Approach NPR. Please confirm that "settlement currency" means the currency of the loan exposure, rather than the currency of the collateral, for purposes of securities lending transactions.

Finally, we note that netting sets commonly consist of groups of loans and collateral in multiple currencies. It would be very difficult, from a systems perspective, for an agent bank to determine when a currency mismatch actually exists with respect to a particular set of securities lending transactions. Especially in the case of transactions collateralized with non-cash collateral, the association between a specific loaned security and a particular collateral asset is not typically maintained, as baskets of securities can be pledged as collateral by the counterparty against multiple lending transactions. Therefore, it is usually not possible to identify particular collateral and loan combinations in order to determine whether a currency mismatch haircut potentially needs to be applied.

E. 5000 Trades

Consistent with the Basel III framework, the Standardized Approach NPR would require an agent bank to assume a holding period of 20 business days for collateral under the collateral haircut method for netting sets where the number of trades exceed 5000 at any time during the quarter. We request clarification with respect to two aspects of this provision. First, we understand, based on discussions with Board staff, that a holding period of 20 business days resulting from the 5000-trade threshold will be applied on a counterparty-by-counterparty (rather than aggregate book) basis, and only will be triggered in the event there are 5000 open trades with a single counterparty within a single netting set in a given quarter. Second, we request confirmation that in computing the number of securities lending loans with a single counterparty, an agent bank is only required to compute borrower-facing loans. In many cases, a single borrower-facing trade is allocated to multiple securities lending clients (in other words, the securities lent to a single borrower, the counterparty, are drawn from more than one lending client accounts). For purposes of the 5000-trades limitation, only borrower-facing trades, not securities lending client-facing allocations, should be counted as the exposure is to the counterparty. Further, we request that an average number of open trades over some specified time period be used for determining the 5,000 trade threshold rather than the maximum level, so as not to be overly punitive in the event that the number of trades was to spike on a given day.

As a separate matter, we question whether this requirement may reduce the incentive for agent lenders to enter into netting agreements with counterparties. The greater the amount of business captured under a netting set the higher the probability that the 5,000 trade threshold will be tripped. Under the Standardized Approach NPR, for example, agent lenders will only be able to recognize netting benefits for cross-currency exposures, and the potential penalty for exceeding 5,000 trades may outweigh the netting benefits. Further, large agent lenders most likely to trip the 5,000 trade threshold are likely to have in place default administration plans that would either utilize internal or external broker-dealer capabilities to administer the required collateral liquidation and security buy-ins that would be required. From the historical perspective of RMA members, well over 90% of collateral liquidation and securities buy-ins take place in under 5 days, with a weighted average of approximately two days. Inappropriate application of the 5,000 trade threshold may force agent banks to reduce the diversification of their transactions, and transact in loan portfolios more heavily concentrated in individual securities. The market movements that could potentially result if an agent lender were forced to liquidate these less-diversified portfolios could potentially create <u>more</u> risk than would otherwise be the case if the 5000 trades threshold is applied appropriately.[24]

F. Margin Disputes

The Standardized Approach NPR would require that, if there are more than two margin disputes concerning a netting set over the previous two quarters, an agent bank must use a holding period that is at least two times the minimum holding period otherwise applicable to that netting set. As an overarching matter, we suggest that margin disputes be resolved through the normal dispute resolution mechanisms provided for in the securities lending and netting agreements entered between agent banks, lending clients and borrowers, and should not result in a capital impact on the treatment of the entire netting set. Without further clarity concerning the definition of "margin dispute," the Standardized Approach NPR would create significant problems from a systems tracking perspective, because it would be difficult for an agent bank to determine what constituted a "dispute" or when a dispute actually occurred. A trigger based on margin disputes seems inappropriate for securities lending transactions, as unlike other types of transactions (*e.g.*, OTC derivatives transactions), securities lending transactions are marked to market daily and therefore require frequent communication and reconciliation between transaction counterparties. For these reasons, the RMA does not believe it is appropriate to increase the holding period of an entire netting set based on a two margin dispute trigger. Nor is the RMA of the opinion that the

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[24] In this regard, we note that U.S. agent lenders most likely to exceed the 5,000 trade limit will likely be subject to the SCCL.

existence of two margin disputes with respect to a netting set is a likely indicator of risk. Because securities lending transactions are over-collateralized, even in cases where margin disputes exist, it would be highly unusual for a securities loan to be less than fully collateralized. Further, excess collateral within a netting set can be used across transactions, and would be even more unusual for the entire netting set to be less than fully collateralized when viewed on a portfolio basis.

At a minimum, we suggest that a materiality standard be established in order for a margin dispute to qualify as a trigger requiring an increase in the holding period applicable to the relevant netting set. If the Agencies choose to retain the two margin disputes trigger, the RMA proposes that, in order for a margin dispute to count towards the holding period trigger, it should involve one party taking formal legal action to seek remedies in accordance with the terms of the securities lending or netting agreement governing the applicable transaction. Such a limitation would reduce the ambiguity associated with determining when and what constituted a margin dispute, and therefore, would help mitigate the systems tracking difficulties that the requirement would impose on agent banks if implemented as drafted.

IV. Advanced Approaches NPR

Most agent banks are subject to the advanced approaches, and therefore will be affected by issues arising under the Advanced Approaches NPR. Please refer to sections III.C, III.E and III.F for comments regarding the rules establishing triggers of 5000 trades per quarter and two margin disputes per netting set to determine the applicable holding period an agent bank would be required to assume with respect to securities lending collateral, and for comments regarding the treatment of CCPs, which apply with equal force to agent banks subject to the advanced approaches.

A. 1.25 Multiplier and Correlation Factor for Financial Institution Exposures

The Advanced Approaches NPR would require agent banks subject to the advanced approaches to apply a multiplier of 1.25 to the correlation factor for wholesale exposures to unregulated financial institutions or regulated financial institutions with consolidated assets of greater than or equal to $100 billion.

The express intent of this provision is to reduce interdependency among institutions. We believe that single counterparty credit limits already more than adequately address the perceived problems with excessive interconnectivity risk, and urges the Agencies to reconsider further penalizing transactions undertaken with such large counterparties. Otherwise, like many other provisions in the NPRs, this would be an example of the dual burden of Dodd-Frank and Basel III imposing inappropriate composite burdens on U.S. banks and placing them at a disadvantage internationally.

In addition, the proposed calculation of the correlation factor within the Advanced Approaches NPR is inconsistent and more punitive than the requisite correlation factor provided for by Basel III, the result of what we believe to be an inadvertent drafting error on the part of the Agencies. Under Basel III, the correlation factor for large counterparties and unregulated financial institutions is expressed by the following formula:

$$1.25 \text{ X } (0.12 + 0.\mathbf{12} \text{x} e^{-50 \text{x} PD})$$

Whereas, under the Advanced Approaches NPR, the formula is as follows:

$$1.25 \text{ X } (0.12 + 0.\mathbf{18} \text{x} e^{-50 \text{x} PD})$$

We believe that the use of the natural logarithm multiplier .18, rather than .12, is an inadvertent transposition of the multiplier from the correlation formula applicable to High-Volatility Commercial Real Estate Exposures, which provides for a multiplier of .18. We request that the Agencies replace the .18 multiplier with a .12 multiplier so that the formula is consistent with Basel III. If the Agencies failed to correct this error, the impact could be significant: for example, the RMA has determined that for an overnight securities lending transaction, the use of a .18 multiplier may result in a correlation factor that is as much as 30% higher than would otherwise be the case if the correlation factor were .12.

B. Qualifications in definition of "Master Netting Agreement"

The RMA also requests that the Agencies re-visit and appropriately clarify the definition of "Qualifying Master Netting Agreement" in the final rules. This definition is not expressly included in the Advanced Approaches NPR, however the term is embedded in the Advanced Approaches NPR's definition of "Qualifying Cross-Product Master Netting Agreement," and in any event is important to the risk mitigating efforts of agent banks.

More specifically, subsection (2) of the definition of "Qualifying Master Netting Agreement" currently discusses the need for the bank to have the legal right to "accelerate, terminate, and close-out on a net basis all transactions under the agreement" in the event of default. Of specific relevance to this comment letter, subsection 2 then further states "provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions." The RMA fully understands and agrees with the need for comfort that the provisions of a master netting agreement will be effective upon a counterparty default. However, as the Agencies are aware, under SIPA there is a limited "stay" in the case of a securities collateral (but not cash collateral) provided with respect to a securities lending transaction by an insolvent U.S. broker-dealer, which could raise a technical question as to the ability of a master services agreement with a U.S. broker dealer to fully meet the requirements of the advanced approaches. Likewise, under OLA, there is a one day "stay" for both securities and cash collateral. As the Agencies are aware, there is no substantive issue in this regard, however, because SIPC has effectively removed any concerns about the duration or ramifications of this stay via a series of letters providing that SIPC would expect to consent to a close-out of a repurchase/securities lending transaction (and urge the trustee to consent) upon receipt of an affidavit of the counterparty to the SIPC member attesting that the affiant has no knowledge of fraud in the transaction and that it has either acquired the rights of an owner of assets received in the transaction or a perfected security interest therein.[25]

U.S. broker-dealers are the counterparties to a large number of master repurchase agreements, and as a result the RMA wants to remove any ambiguity as to the treatment of qualifying master repurchase agreements with those counterparties for purposes of the advanced approaches rules. As a result, in accordance with discussions with the staff of the Board, the RMA is hereby formally requesting that in connection with the finalization of the Advanced Approaches NPR the Agencies revise the definition of Qualifying Master Netting Agreement to reflect the absence of actual stay risk with US broker-dealer counterparties. This could be done, for example, by revising the proviso quoted above to either include the phrase "beyond that addressed by standard industry practice" after the word "stayed," or adding at the end of the proviso "unless the stay is only limited for a brief period pursuant to a recognized regulatory or industry practice." In this regard, the RMA also supports any efforts to clarify the proviso to cover technical stays that may be involved with counterparties other than U.S. broker-dealers (*e.g.*, banks).

V. <u>Conclusion</u>

We appreciate the opportunity to file this letter with the Agencies as they prepare the final rulemakings implementing the Basel III framework in the United States. As the Agencies consider our comments, we ask that they remain cognizant of the demonstrated safety and soundness of agency securities lending activities, the importance of agency securities lending activities to beneficial owners and agent banks, and the relationship between a robust securities lending market and overall market liquidity. More generally, we ask the Agencies to remain cognizant of the relationship between the NPRs and other regulatory reforms resulting from the Dodd-Frank Act, and how, without careful consideration and calibration, the cumulative impact of these changes may unnecessarily reduce banking organizations' ability to serve their crucial financial intermediation function, of which agency securities lending activities are only one facet. Finally, we ask the Agencies to consider the underlying principle that regulatory capital requirements should reflect the underlying risk of activities subject to such requirements, and whether the NPRs as proposed adhere to this principle with respect to agency securities lending activities.

Sincerely,

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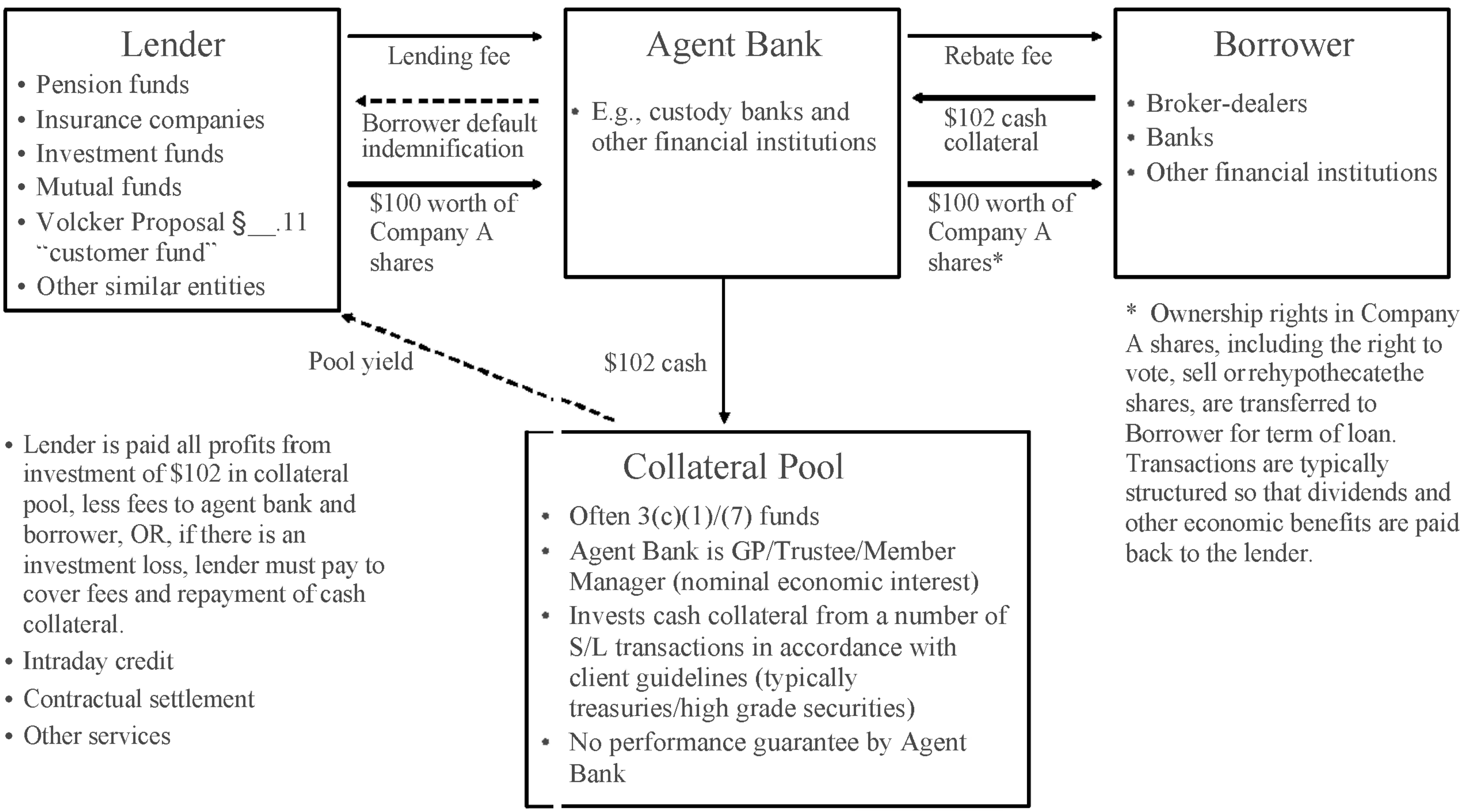
[25] *See, e.g.*, SIPC Letter to Omar Otzan (June 25, 2002); SIPC Letter to J. Eugene Marans, Esq. (Aug. 29, 1988).

Christopher R. Kunkle
Director, Securities Lending
The Risk Management Association

Jason P. Strofs
Chairman, RMA Executive Committee
The Risk Management Association

Exhibit A


Lender
• Pension funds
• Insurance companies
• Investment funds
• Mutual funds
• Volcker Proposal §__.11 "customer fund"
• Other similar entities
Lending fee
Borrower default indemnification
$100 worth of Company A shares
Agent Bank
• E.g., custody banks and other financial institutions
Rebate fee
$102 cash collateral
$100 worth of Company A shares*
Borrower
• Broker-dealers
• Banks
• Other financial institutions
* Ownership rights in Company A shares, including the right to vote, sell or rehypothecate the shares, are transferred to Borrower for term of loan. Transactions are typically structured so that dividends and other economic benefits are paid back to the lender.
Pool yield
$102 cash
• Lender is paid all profits from investment of $102 in collateral pool, less fees to agent bank and borrower, OR, if there is an investment loss, lender must pay to cover fees and repayment of cash collateral.
• Intraday credit
• Contractual settlement
• Other services
Collateral Pool
• Often 3(c)(1)/(7) funds
• Agent Bank is GP/Trustee/Member Manager (nominal economic interest)
• Invests cash collateral from a number of S/L transactions in accordance with client guidelines (typically treasuries/high grade securities)
• No performance guarantee by Agent Bank