COMMITTEE ON SECURITIES LENDING

April 30, 2012

Via e-mail

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
E-mail: regs.comments@federalreserve.gov

Re: Dodd-Frank Section 165: Enhanced Prudential Standards for Covered Companies

Comment Letter on Issues Concerning Application of Proposed Rulemaking's Single-Counterparty Credit Limits to Agency Securities Lending and Related Transactions

Federal Reserve Docket No. 1438 and RIN 7100-AD-86

Dear Ms. Johnson:

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 (the "Board") on behalf of several of its members that participate in the securities lending industry as agent banks on behalf of their clients. These members include securities lending agents ("agent banks") such as The Bank of New York Mellon Corporation, Citibank, N.A., JP Morgan Chase & Co., Northern Trust Corporation and State Street Corporation, among others.

[1] The RMA Committee on Securities Lending 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 specifically addresses the Board's proposed rules implementing the single-counterparty credit limits mandated by Section 165(e) of the Dodd-Frank Act,[2] which are a subpart of the proposed rulemaking implementing the enhanced prudential standards set forth in Sections 165 and 166 of the Dodd-Frank Act (the "Proposed Rules").[3] The Proposed Rules impact agent banks as a result of the securities replacement guarantee, or borrower default indemnification, that is provided by agent banks to their lending clients as part of their agency securities lending programs.

The RMA task force principally is concerned that the Proposed Rules significantly overstate actual exposures relating to the securities replacement guarantee. Under an application of the Proposed Rules as currently drafted, such an overstatement of exposure would cause agent banks to curtail significantly transactions with large counterparties and collateral issuers. Such restrictions thus could severely impair long-established bank securities lending agent activities as well as other relationship-driven activities of many of RMA's members, while also impacting market liquidity by reducing the volume of securities available for loan.

This letter discusses why it would be inappropriate for Section 165(e)'s concentration limits to inhibit the operation of banks' traditional agent lending activities to such a significant extent and details some approaches to address these concerns.

The analysis set forth in this letter supports the following conclusions:

- The securities replacement guarantee protection provided by agent banks as a standard market practice is a common feature in agency securities lending that is highly valued by institutional lending clients.

- As a policy matter, indemnified agency securities lending does not pose the systemic counterparty risks Section 165(e) was meant to address and is already a well-regulated, well-established bank-level activity at agent banks.

- As applied to agency securities lending activities, the Proposed Rules as currently drafted give rise to a number of concerns, including the following:

    - As to securities replacement guarantees (also called borrower default indemnification) provided in connection with agency securities lending services, the sections of the Proposed Rules implementing the single-counterparty credit limits grossly overstate exposure risk associated with this market practice, by, among other things, not taking into account correlations between securities lent and collateral received. This, in turn, may lead to the following adverse outcomes:

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2 Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010) (the "Dodd-Frank Act").

3 Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012). The Proposed Rules implementing Single-Counterparty Credit Limits are set forth in Subpart D.

   - It could limit U.S. agent banks' ability to lend to high-quality borrowers under their indemnified agency lending programs;
   - If agent banks are discouraged from offering securities replacement guarantees to their lending clients, many lenders (in some cases, to comply with law or policy) may (i) withdraw supply from the market, (ii) move their business to foreign banks or other financial entities not subject to the exposure limits, or (ii) in the case of some larger lenders, potentially run their own lending programs without the risk control systems and expertise of agent banks; and
   - Reduced lending supply caused by a withdrawal of securities lenders from the market could both reduce liquidity in the broader market and reduce returns for those government plans and other clients who exited from lending.

  - As to collateral, under the Proposed Rules' method of calculating net exposure by shifting exposure to the collateral issuer, the Proposed Rules could significantly impact agent banks' abilities (i) to facilitate securities lending transactions in which the borrower posts high-quality foreign sovereign or other highly liquid non-cash collateral and (ii) to compete in non-U.S. markets where non-cash collateral is predominant.

  - In all cases, the method of calculation of counterparty exposure prescribed by the Proposed Rules is vastly different from the methods used by agent banks to comply with current regulatory requirements and presents acute implementation issues.

- Such inappropriate outcomes could be remedied in the following ways, beginning with those that most closely align with appropriate regulatory treatment:

  1. Provide agent banks with the option to use the simple Value at Risk ("<u>VaR</u>") modeling methods that a number of agent banks currently use to comply with capital rules to calculate net credit exposure, consistent with Basel II methodologies approved by regulatory agencies for use by such agent banks under the Basel I framework, instead of the static, uncorrelated haircuts set forth in Table 2 of the Proposed Rules;

  2. If the Board is concerned with standardizing banks' modeling methodologies to ensure control over their application for purposes of the single-counterparty credit limits, provide agent banks with the option to use a simple VaR model with a standardized set of assumptions and other inputs specified by the Board; or

  3. Use more "reasoned" haircuts to calculate net credit exposure.

- In addition to some of the revisions to the calculation of net credit exposure listed above, we ask that the Board address further implementation issues under the Proposed Rules with solutions including, among others:

  - An exemption for certain high-grade foreign sovereign debt, which is often posted as non-cash collateral by borrowers,

- Appropriate treatment of invested cash collateral and cash collateral pools,
- A more appropriate definition of "subsidiary," and
- A more extended applicability timeline and grace period for non-compliance.

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I. **Overview of the agency securities lending market and the securities replacement guarantee.**

A. Market overview.[4]

Institutions participating in securities lending transactions support capital markets activities and facilitate trade settlement.[5] By effectively increasing the supply of securities available for these and other market activities, securities lending improves global market liquidity.

Agency securities lending services and the related provision of securities replacement guarantees are industry standard market practices at agent banks. These services have been a customary outgrowth of agent banks' custody and related activities for decades, and have long been regulated, examined and treated by regulators as traditional banking services.[6] RMA Committee on Securities Lending constituents provide custodial and securities lending services both in and outside the United States, and both custodial and non-custodial banks provide agency securities lending services. U.S. agent banks acting as securities lending intermediaries include some of the largest financial institutions in the world, such as Citibank, N.A., JP Morgan Chase, Bank of New York Mellon, Northern Trust, State Street and others.

As of April 20, 2012, Data Explorers composite figures showed over $1.5 trillion of securities on loan through agent lenders in the global securities lending market, of which just over $1 trillion represents securities loans at U.S. agent banks that RMA believes will be affected by the Proposed Rules.[7] On April 20, the total daily revenue associated with these volumes was approximately $26 million, of which $22.5 million was associated with those U.S. agent banks that will be affected by the Proposed Rules, according to data provided by responding institutions.[8] Not all lending clients participate in providing market data, however, and the revenue figures only represent a snapshot as of a single day. Due to seasonality and

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4 For a more detailed description of the components of indemnified agency securities lending transactions, see Appendix I.

5 The discussion and analysis in this comment letter focuses on the securities lending industry and indemnified agency securities lending in particular. However, the analysis generally applies to all types of securities financing transactions as such are defined under the Basel III framework (i.e., "transactions such as repurchase agreements, reverse repurchase agreements, security lending and borrowing." Basel Committee on Banking Supervision, Basel III: A global regulatory framework for more resilient banks and banking systems (Dec. 2010, rev Jun. 2011), *available at* http://www.bis.org/publ/bcbs189.htm, at footnote 54. Thus, to the extent applicable, references in this comment letter to "securities lending transactions" may be read to include other securities financing transactions as well, and all proposals set forth in this comment letter apply equally to all types of securities financing transactions.

6 *See, e.g.*, Securities Lending, Federal Financial Institutions Examination Council, Supervisory Policy (1985).

7 Data Explorers global agent lending composite data as of April 20, 2012.

8 Id.

other factors, RMA believes the annual revenues associated with affected U.S. agent banks to be in the range of $10 to $12 billion. RMA composite figures for the fourth quarter of 2011, compiling responses of 13 member banks, showed $6 trillion of U.S. lendable assets and $3 trillion of non-U.S. lendable assets worldwide.[9] 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.

As discussed in greater detail in Section II.C.4., the implementation of the Proposed Rules as currently drafted would place significant limitations on U.S. agent banks' indemnified agency securities lending programs. This would likely lead many lending clients to withdraw from the U.S. agency lending market and either terminate their programs or move their business to non-U.S. agents or other agents not subject to the single-counterparty credit limits. Specifically, RMA's constituent members estimate that securities on loan at U.S. agent banks could decrease by up to 30% to 50% from the already reduced post-financial crisis levels, representing another $4 to $6 billion in total lost revenues.[10] Such a loss in revenues certainly would affect the business of U.S. agent banks, which are typically allocated 15% to 20% of such revenues in fees. However, it also would materially impair returns to government plans and other lending clients, which benefit from the remaining 80% to 85% of revenues raised by each agency securities lending transaction.

More generally, a significant decrease in volume of securities available for loan would impair broader access to securities, driving down liquidity and in turn impeding price discovery in the U.S. and global markets. This could potentially create disruptions in the capital markets at the very time market liquidity is critical to promote economic recovery in the United States and worldwide.

B. The securities replacement guarantee, provided as a matter of market practice in agency securities lending transactions, results in minimal overnight counterparty credit exposure at agent banks.

As described in more detail in Appendix I, agency securities lending transactions result in counterparty credit exposure for agent banks due to the securities replacement guarantees provided in connection with these transactions. As a matter of standard market practice, agent banks provide securities replacement guarantees, or indemnification for borrower default, to their lending clients pursuant to their securities lending agreement. As discussed further in Section II.C.4., 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

9 RMA Quarterly Composite Data on Securities Lending, Fourth Quarter 2011, available to the Board upon request in connection with the Board's review of this comment letter and implementation of Section 165(e) of the Dodd-Frank Act.

10 These estimates are based on a review of exposures to large counterparties and sovereign issuers of collateral, as well as expectations of clients exiting the program if agent banks were forced to reduce their indemnification programs. In addition, to implement the final concentration limits, banking institutions will likely set a general buffer of 15 - 20% of the total counterparty limits at the parent level in order to avoid inadvertent non-compliance, and allocate the reduced amount across their businesses.

programs and a validation of the strength of their agent banks' risk management systems. Moreover, a number of lending clients are required by law or policy to receive securities replacement guarantees from their lending agents.[11] Currently RMA member agent banks provide indemnification to nearly all of their clients, both domestic and offshore, whether or not the agent banks act as custodians.

The amount at risk to the agent bank under a securities replacement guarantee is only the difference, 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). To be clear, securities replacement guarantees only result in counterparty exposure to the borrower; agent banks do not have any direct exposure to securities lenders as a result of indemnified agency securities lending transactions.

Any exposure to counterparties for agent banks under securities replacement guarantees is subject to a number of limitations. Foremost, securities lending transactions typically are secured by an excess amount (102% to 105%, and sometimes up to 110%, of the value of the securities on loan) of cash or liquid securities collateral. Collateral is marked to market daily. In marking to market, the daily mark is made based on the prices at close of 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, reducing risk of loss to the bank.

Further improving their risk profile, 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: (1) the default of a borrower (typically a major broker-dealer) and (2) 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 is highly unlikely.

In addition, Orderly Liquidation Authority ("OLA") treatment of securities lending and borrowing agreements further reduces borrower insolvency risk to agent banks relative to Securities Investor Protection Corporation procedures in the case of a broker-dealer default. The most significant broker-dealer borrowers participating in U.S. agent banks' securities lending programs are companies that could be subject to OLA procedures in the event of a large-scale default.[12] In the event an insolvent borrower defaults on its obligations under its securities borrowing agreement, the OLA procedures provide for a maximum of one business day stay on "qualified financial contracts" ("QFCs"), including securities borrowing agreements.[13] If the FDIC determines to transfer the securities borrowing agreement to a

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11 See footnote 32 and accompanying text.

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. 41626 (Jul. 15, 2011).

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

"bridge financial company," that company will assume the borrower's obligations under the QFC.[14] Through discussions with the Board throughout the rulemaking process, RMA understands that virtually all QFCs are likely to end up in a bridge company. 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 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 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 Securities Investor Protection Corporation proceeding.

Further limits to agent banks' liability under securities replacement guarantees are set forth in 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 reinvestment of the cash collateral (whether the agent bank or otherwise) and approving the investment guidelines. Pursuant to the securities lending agreement (except in the case that cash collateral is reinvested by way of indemnified reverse repurchase transactions, discussed further in Section III.D.3.), 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 and a cap on agent bank liability at the market value of loaned securities at the time of the borrower default.

Particularly given all of the limits on agent banks' exposure under securities replacement guarantees, such guarantees are in no event the equivalent of unconditional guarantees of borrower performance. More generally, securities lending and borrowing transactions have historically been considered safe by banking regulators, as is evidenced by the treatment of such transactions under the banking book capital rules, which themselves are intended to capture credit exposure. In the case of cash-collateralized loans, both the Board and the OCC capital rules give indemnified agency securities lending transactions with over 100% cash collateral a zero percent risk weighting.[15] In the case of securities collateral, VaR models approved by regulators for use by a number of agent banks and verified by accountants provide for a very low risk weight.[16] The capital rules have been proven appropriate, as very

[14] Dodd-Frank Act § 210(c)(9).

[15] *See* 12 CFR Part 3, App. A §3(b)(1)(v), fn 15 and related text. *See also* 12 CFR Part 225 App. A § III.D.1.c.

few borrower defaults have resulted in losses to agent banks, and any such losses have been immaterial.

II. Purposes of the single-counterparty exposure limits and application to agency securities lending and borrowing transactions.

A. Purposes.

Congress' purpose behind imposing concentration limits on large banks and nonbank financial institutions is to address the risks posed by the interconnectedness of those companies and their counterparties. Specifically, the statute provides: "In order to limit the risks that the failure of an individual company could pose to a nonbank financial company supervised by the Board of Governors or a bank holding company [with total consolidated assets equal to or greater than $50 billion]..., the Board of Governors shall prescribe standards that limit such risks."[17]

Furthering this purpose, the Board notes in the background to the Proposed Rules that the single-counterparty exposure limits address aspects of two issues in the financial system exposed by the financial crisis: First, they aim to decrease the "risk that the failure of large financial companies poses to the financial stability of the United States and the global financial system" and specifically the systemic risk caused by "interconnectedness of large, systemically important firms – the degree to which they extended each other credit and served as over-the-counter derivative counterparties to each other."[18] Second, they address "inadequacies in the U.S. supervisory approach to single-counter party credit concentration limits, which failed to limit the interconnectedness among and concentration of similar risks within large financial companies that contributed to a rapid escalation of the crisis" (i.e., bank level, rather than holding company level credit limits, and exclusion of "credit exposures generated by derivatives and some securities financing transactions").[19]

Thus, by their express terms, the concentration limits under Dodd-Frank are principally intended to (1) limit the risks to large U.S. financial institutions posed by the potential failure of other heavily interconnected entities, and (2) prevent potential avoidance of regulation and oversight by moving activities resulting in credit exposure to the holding company level. As discussed below, indemnified agency securities lending by banks is not the type of activity that Congress intended to limit by Section 165(e); nevertheless, the Proposed Rules as currently drafted would inappropriately limit agent banks' ability to provide this service to

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16 *See* FRB Interpretive Letter, dated May 14, 2003, to Gregory J. Lyons; *see also* FRB Interpretive Letter, dated August 15, 2006, to Gregory J. Lyons (together, the "State Street Letters"). *See also* OCC Interpretive Letter No. 1066 (Nov. 8, 2005) and OCC Interpretive Letter No. 1105 (Sept. 18, 2008) (together, the "OCC VaR Letters").

17 Dodd-Frank Act § 165(e)(1).

18 Proposed Rules at 612.

19 Proposed Rules at 612.

their customers. In fact, the Proposed Rules do not reward, but rather penalize, risk-mitigating behavior of banks.

B. Agency securities lending transactions do not pose the systemic risks and regulatory concerns that Section 165(e) was intended to address.

Agency securities lending transactions do not pose the systemic counterparty exposure risks Section 165(e) was intended to address. As discussed in detail in Section I.B. above, in agency lending, credit exposure results only from securities replacement guarantees, which exposure is significantly mitigated by full or excess collateralization as well as a number of limitations to agent bank liability under the guarantees. This low level of risk is evidenced by the very low risk weightings applied by the banking book capital rules, which themselves are focused on credit risk.[20]

Moreover, regarding the regulatory concerns that the concentration limits are meant to address, agency securities lending transactions take place at the bank level of relevant banking institutions and are already significantly regulated. As noted above, the new concentration limits are intended to address exposures in the financial institution other than at the bank level that were not previously regulated. Securities lending and borrowing transactions have been regulated and examined for years, with the first policy statement on securities lending practices issued by regulators in 1985.[21]

C. Issues with inappropriate application of current Proposed Rules to agency securities lending transactions.

1. *Gross overstatement of risk associated with securities replacement guarantees.*

The Proposed Rules raise a number of concerns as they may be interpreted to apply to agency lending activities with securities replacement guarantees. The first of these concerns is a gross overstatement of net credit exposure for the securities replacement guarantee. As previously discussed, the only credit exposure of agent banks under agency securities lending transactions results from securities replacement guarantee obligations, which are limited by full marked to market collateralization and other caveats. The haircuts used in the Proposed Rules do not recognize the risk-mitigating value of positive correlations between securities on loan and collateral securities. Rather, they apply a static, flat haircut (or add-on) to both the collateral received and the securities on loan and an additional flat haircut where loaned securities and collateral differ in currency, as well as an inappropriately long holding period.

[20] *See* 12 CFR Part 3, App. A § 3(b)(1)(v), fn 15 and related text. *See also* 12 CFR Part 225 App. A § III.D.1.c.; State Street Letters and OCC VaR Letters.

[21] *Securities Lending*, Federal Financial Institutions Examination Council, Supervisory Policy (1985) (addressing appropriate regulatory guidelines for the growing securities lending industry); *see also* Comment Letter to the SEC from J. Virgil Mattingly, Board; William F. Kroener, FDIC; and Julie L. Williams, OCC (Dec. 10, 2002) (giving as an example the interagency guidelines adopted by the banking agencies to "ensure that banks conduct their securities lending activities in a safe and sound maker and consistent with sound business practices, investor protection considerations and applicable law").

This overstatement of exposure would inappropriately limit U.S. agent banks' ability to lend their lending clients' assets to high quality, high volume counterparties under their indemnified agency securities lending programs. In turn, as discussed further below under Section II.C.4., this could lead to a reduced securities lending supply, reducing returns to lending clients and more generally restricting liquidity in the market.

The current proposal does not recognize any positive correlation of securities both lent and received as collateral, as well as of foreign exchange movements. Instead, Table 2 under Subpart D of the Proposed Rules sets forth a static haircut for each type of security, whether such security is loaned or taken as collateral. It also provides that, where the currency denomination of the collateral differs from the currency denomination of the credit transaction, an additional haircut of 8% will apply.[22] As is the case with the collateral haircuts, the currency differential haircut under the Proposed Rules remains static no matter which currencies are in use on the loan and collateral sides, thus ignoring any correlations among currency fluctuations. In transactions comprising a material part of many agent banks' books, currencies of loaned securities and collateral differ, making this approach problematic.

Agent banks typically take excess collateral from the borrower, marked to market daily based on the value of the securities on loan and, if non-cash collateral is provided, the value of the collateral. Particularly in light of the daily mark to market practices, the haircuts implemented under the Proposed Rules ascribe an undue amount of exposure risk to both the borrower and the issuer of the collateral securities. Indeed, within Regulation Y, securities lending and repurchase transaction haircuts may be divided by the square root of two, to reflect a five-day liquidation period, rather than the ten-day period for other transaction types.[23] However, the haircuts prescribed under Proposed Rules assume a ten-day liquidation period for all credit transactions.

As an example of the overstatement of exposure risk under an application of the Proposed Rules, an agent bank may lend (1) $100 million of IBM and $100 million of Dell against $204 million in cash collateral to one broker and (2) $100 million of IBM and taking $102 million of Dell as collateral with another broker. The agent bank has twice as much notional exposure and a great deal more market exposure to the first broker. In terms of idiosyncratic risk, the agent bank would have similar exposures to both brokers. However, under the Proposed Rules, the agent bank will be creating a larger net credit exposure with the second broker. This is because the methodology prescribed assumes a correlation of 1.00 for all lent securities in the first transaction. However, the assumed correlation between lent securities and collateral in the second transaction is negative 1.00. For loaned securities and collateral from different asset classes, such as equities versus fixed income, a case may be made for such a treatment. However, within the same asset class (i.e. equities against equities) this treatment is overly punitive and without merit.

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[22] Proposed Rules, footnote 207.

[23] *See* 12 CFR Part 225 App. G, Part IV, §32(b)(2)(ii)(A). *See also* 12 CFR Part 225 App. G, Part IV, §32(b)(2)(iii)(A)(2).

Our member banks have performed analyses using randomly selected loan and collateral portfolios and found that the use of non-cash collateral typically results in a lower VaR compared to cash collateral, but within the framework under the Proposed Rules, the single-counterparty aggregate net credit exposure as calculated will increase exponentially. (See Exhibit A.)

Not only does this treatment encourage agent banks to enter into transactions that may create greater actual exposure at the expense of better hedged transactions, but it also creates issues within the industry based on its interaction with provisions within the Basel III liquidity measures. When a securities lender takes cash collateral, it is usually invested in short term money market instruments (typically within Securities Exchange Commission Rule 2a-7[24] requirements for money market funds). Once the Basel III requirements are implemented, the expectation is that the availability of such reinvestment options will decrease, thereby increasing the attractiveness of non-cash loans. However, as described below, the provisions within the Proposed Rules will severely limit agent banks' and securities lenders' participation in this alternative.

2. *Exposure limits may impact ability to accept certain collateral.*

The Proposed Rules also could impact agent banks' ability to accept certain non-cash collateral, particularly foreign sovereign collateral, which is subject to the exposure limits. This could lead to a potentially perverse result of banks being unable to accept collateral from high quality foreign sovereigns with credit quality comparable to that of the United States, due to the fact that they have reached or are near the exposure limit for those sovereigns.

Globally, 52% of securities on loan are loaned against non-cash collateral. This amounts to $776 billion of predominantly non-U.S. loaned securities.[25] Although cash remains the major form of collateral taken in securities lending transactions in the United States, the U.S. market will likely see an increase in non-cash collateral driven by market trends and other regulatory changes affecting both the U.S. and global markets. These include liquidity requirements under Basel III, regulatory changes associated with central clearing for derivative products and overall increased capital requirements. Under this scenario, as other post-financial crisis regulatory frameworks also impose more stringent requirements, agent banks could be even more detrimentally affected by the Proposed Rules as they are currently drafted.

Because sovereign collateral is accepted in respect of loans to many different borrower counterparties, the exposure to a foreign sovereign collateral issuer would involve the sum of exposures to all borrower counterparties that provide such sovereign issuer's debt as collateral. Thus, in order for the agent bank to experience a meaningful loss due to a default by that foreign sovereign, a number of such borrower counterparties would need to default within the same liquidity timeframe as the sovereign issuer. Such a scenario of simultaneous defaults across the collateral issuer and multiple counterparties is extremely unlikely.

[24] 17 CFR § 270.2a-7.

[25] Data Explorers global composite data as of March 12, 2012.

In addition, the inflexible limits on sovereign debt exposure under the Proposed Rules are particularly troublesome. A significant percentage of non-cash collateral in U.S. indemnified agency lending programs consists of non-U.S. sovereign debt, the vast majority of which is limited to obligations of fewer than ten high-grade sovereign countries. Under the Proposed Rules, which contemplate notional shifting to the collateral issuer, U.S. agent banks would run a significant risk of tripping the proposed single-counterparty credit limits for a number of such sovereigns. This would severely restrict U.S. financial institutions' ability to lend outside the United States, putting such U.S. institutions at a grave disadvantage to their international counterparts.

Next, the current treatment of foreign sovereign debt under the Proposed Rules leads to a number of perverse results in application of the rule. First, agent banks likely will hit their exposure limits for top sovereign collateral issuers and may have difficulty finding high quality replacement collateral to accept that satisfies agent banks' credit guidelines. Potentially accelerating this issue is the fact that the same absolute haircuts are assigned to securities types whether they are on the loan or the collateral side of a securities lending transaction. Thus, because higher quality sovereigns are subject to lower haircuts than lower quality sovereigns, when such sovereign debt collateral is applied to reduce the net credit exposure to a securities borrower, the amount of exposure applied to the collateral issuer's limit would be higher in the case of higher quality sovereigns.

Finally, where the same sovereign issuer (as with any issuer) is on both the loan and the collateral side of a securities lending transaction, the full loan amount increased by the collateral haircut add-on is applied across the relevant borrower's and foreign issuer's limits. This result is inappropriate because a default by the foreign issuer would concurrently decrease the agent bank's exposure under both the securities replacement guarantee and the collateral. By way of example, if €100 million in German five-year bunds are lent, and €102 million in German ten-year bunds are received as collateral, the agent lender would record €2.04 million in net credit exposure to the borrower and €99.96 million in credit exposure to Germany, even though, if Germany defaulted, the agent bank's replacement guarantee obligations would fall to zero.

In sum, as stated above, as the current Proposed Rules apply to both securities replacement guarantees and collateral under agency securities lending transactions, agent banks would not be rewarded for, and in fact would be penalized by, engaging in the low risk behavior associated with focusing on high quality borrowers, correlations between lent securities and collateral and high quality foreign country collateral.

3. *Difficulty of implementation.*[26]

Furthermore, in the case of both securities replacement guarantees and collateral, the method of calculation of counterparty aggregate net credit exposure required under the Proposed Rules poses a number of implementation concerns associated with aggregating and tracking counterparty exposures. First, determining aggregate net credit exposure to a

[26] This subsection addresses Question 36 of the Proposed Rules: "Question 36: What impediments to calculating gross credit exposure in the manner described above would covered companies face?"

counterparty may be impossible for a covered company based on lack of information as to, and difficulty in determining, updating and tracking the counterparty's "subsidiaries" as defined under the Proposed Rules. Specifically, aggregate net credit exposure subject to the specified limits is defined as the "sum of all net credit exposures of a covered company to a single counterparty," where "counterparty" includes all subsidiaries of a company.[27] "Subsidiary" in turn is currently defined very broadly as a "company that is directly or indirectly controlled by the specified company,"[28] and a company "controls" another company if it (1) owns, controls, or holds with power to vote 25% or more of a class of voting securities of the company; (2) owns or controls 25% or more of the total equity of the company; or (3) consolidates the company for financial reporting purposes.[29] Where counterparties are not public, and even in the case of minority equity subsidiaries of public companies, it will be nearly impossible for agent banks to determine all of the necessary information to track consolidated counterparty exposures on a real-time basis without commitments from each counterparty to provide and update this information.

Presenting even more acute tracking concerns, where non-cash collateral is accepted, under the prevailing form of securities lending agreement, the counterparty can pledge collateral that is of higher quality than the collateral to which the agent bank initially agreed on behalf of the lender. For example, under a securities lending transaction or reverse repurchase agreement under which equities are lent, a counterparty can provide U.S. Treasuries in lieu of equities. Further, in a tri-party repurchase transaction, parameters are set to generate lists of acceptable collateral within specific filters based on the quality of the collateral issuer. Although the collateral accepted must meet the acceptable parameters, the actual collateral is generally not known until the day following the transaction date, and by the time it will be entered into the agent bank's systems, the ability for remediation is limited. For example, an agent bank may have used the maximum amount of German sovereign debt it can apply as collateral under its concentration limits, but a counterparty may still provide German sovereign collateral at the time of the transaction if it has not yet been determined that the limit has been reached. Agent banks would need to build in additional buffers to their internal lending limits within their current filters and across multiple borrower counterparties to ensure limits are not exceeded in respect of collateral issuers (see, e.g., the discussion of the double-default scenario in respect of foreign sovereign collateral issuers above under Section II.C.2.).

Finally, as both agent banks and regulators are aware, the method of aggregating and tracking counterparty net credit exposures prescribed by the Proposed Rules is vastly different

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27 Proposed Rules § 252.92(k)(2). The full definition reads: "*Counterparty* means (1) With respect to a natural person, the person, and members of the person's immediate family; (2) With respect to a company, the company and all of its subsidiaries, collectively; (3) With respect to the United States, the United States and all of its agencies and instrumentalities (but not including any State or political subdivision of a State) collectively; (4) With respect to a State, the State and all of its agencies, instrumentalities, and political subdivisions (including any municipalities) collectively; and (5) With respect to a foreign sovereign entity, the foreign sovereign entity and all of its agencies, instrumentalities, and political subdivisions, collectively."

28 Proposed Rules § 252.92(jj).

29 Proposed Rules § 252.92(i).

from the methods used by agent banks to comply with current regulatory requirements, including Basel I, Basel II and, in the near future, Basel III. In addition to the time and expense involved in building such systems, this may create confusion and uncertainty both at banks and at the agencies who supervise them as to how to measure most appropriately agent banks' financial stability. As the capital rules are also intended to regulate credit exposure, there is no reason for a great disparity in calculation methodology across the rules. More generally, coordination with international capital rules also promotes regulators' longstanding goal of harmonizing financial markets regulations across domestic and multinational regulatory frameworks.

4. *Market impacts.*

As discussed further in this section, implementation of the single-counterparty concentration limits under the Proposed Rules as currently drafted would potentially materially impact not only agent banks but also their lending clients and the general financial markets. In terms of volume, given the treatment of non-cash collateral and the limit on the amount of top tier sovereign debt that may be received as collateral, RMA constituent members expect the U.S. agency securities lending market to decrease by as much as 30% to 50% upon implementation of the concentration limits under the Proposed Rules, representing approximately \$4 to \$6 billion in total revenues.[30] As agent banks' fees count for only 15% to 20% of such revenues, this effectively could result in a loss of up to \$3 to \$5 billion of revenues by lending clients such as pension plans and mutual funds. Outside of the U.S., non-cash trades are more prevalent due to the limited availability of short term instruments that fit within prudent reinvestment parameters. As previously noted, as Basel III is implemented, the availability of such issues will be further squeezed, thereby putting additional pressure on agent banks to enter into non-cash collateral trades.

Impact on agent banks and lending clients.

If the final regulations implementing Section 165(e) act to limit large U.S. banks' and financial institutions' ability to facilitate certain securities lending transactions with a securities replacement guarantee, U.S. agent banks would be put at a significant competitive disadvantage against both smaller U.S. banks and non-bank entities and non-U.S. institutions, which are not subject to such restrictions. The disadvantage would be particularly severe with respect to the growing use of securities as collateral, as well as on the relative inability of U.S. banks to take highly rated foreign sovereign collateral, which is generally viewed as safe collateral by other global banking institutions.

As noted above, the provision by agent banks of securities replacement guarantees is a longstanding industry practice, expected by lending clients as part of agent banks' securities lending services. To the majority of lending clients, the securities replacement guarantee both provides protection to their programs and validates the strength of their agent banks' risk management systems. Receipt of securities replacement guarantees is especially important to many lending clients (particularly mutual funds, foreign central banks, government plans and ERISA plans) given that a primary focus is to limit portfolio risk from these activities.

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[30] See footnote 10 for a description of the assumptions behind this estimate.

As a result, if U.S. agent banks cease providing securities replacement guarantees, many lending clients (including public and private pension plans and mutual funds), are very likely to withdraw from the market or move their business to foreign banks or other financial entities able to provide such protection, and larger lenders may seek to operate their own lending programs without the risk control systems and expertise of agent banks. Indeed, many lending clients are required by U.S. law to receive borrower default indemnification by an agent bank in their securities lending program (e.g., clients subject to the Employee Retirement Income Security Act of 1974 ("ERISA")[31] under defined circumstances). Certain states and municipalities also require an indemnification from the lending agent, either by statute or by policy, as a condition to their funds' participation in securities lending.[32] In addition, the Securities and Markets Stakeholder Group ("SMSG") of the European Securities and Markets Authority ("ESMA") has recommended that the securities lending agent must be required to indemnify Exchange-Traded Funds and other UCITS (Undertaking for Collective Investment in Transferable Securities) funds that loan securities.[33] 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 must provide borrower default indemnification. Such clients may elect to shut down their securities lending programs or move their business elsewhere if U.S. agent banks subject to the Proposed Rules remove their securities replacement guarantee programs.

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31 *See* Prohibited Transaction Exemption (PTE) 2006-16, Class Exemption To Permit Certain Loans of Securities by Employee Benefit Plans, 71 Fed. Reg. 63786 (Oct. 31, 2006), which requires, 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.

32 We have not performed an exhaustive review, but list some examples here. *See, e.g.*, Texas Government Code § 825.303(b)(3), which states 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." *See also, e.g.,* New York State Teachers' Retirement System Investment Policy Manual (October 2011), *available at* www.nystrs.org/main/library/IPM2011.pdf, Securities Lending section, at 3, which requires that the agent lender indemnifies the System for losses resulting from a default by the borrower. *See also, e.g.,* 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, which requires that the Investment Office staff will execute securities lending contracts that include "At least the standard securities lending industry indemnification against borrower default." *See also, e.g.,* City Of Seattle Statement Of Investment Policy, *available at* http://www.cityofseattle.net/executiveadministration/invpol.htm, which authorizes 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."

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

Such a scenario would likely result in a loss of significant market share to non-U.S. agent banks and non-bank entities, putting further strain on U.S. agent banks, which rely on their agency securities lending practices as a significant source of income. Indeed, a combination of the curtailment of transactions involving certain borrower counterparties or types of collateral necessitated by the concentration limits and the loss of market share to banks and non-bank financial institutions not subject to the limits could force some U.S. agent banks to leave the indemnified agency securities lending business.

Moreover, if agent banks are not able to provide securities replacement guarantees to their lending clients, it is not just revenue from the banks' securities lending divisions that is at risk. Rather, a decline in the securities lending business at the largest U.S. custody banks would likely lead to a decline in revenues in other businesses at these banks as well, as the largest securities lending clients may be enticed to move other parts of their banking relationships (such as custodial and related services) elsewhere once they no longer receive indemnified agency securities lending services at their U.S. agent bank. At many large agent banks, the largest securities lending clients overlap with the largest clients of the bank as a whole, and providing indemnified securities lending services is vital to maintaining a healthy relationship with such clients. Such concerns highlight the statutory requirement of the Board to "adapt the required standards as appropriate in light of any predominant line of business of such company, including assets under management or other activities for which particular standards may not be appropriate."[34]

Impact on the financial markets.

If a large number of lending clients determine to leave the market, this would not only reduce their income and income at agent banks, but it 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.[35] Moreover, if foreign central banks and other sovereign lending clients reduce their lending activities with U.S. agent banks, the reduced supply of securities available

34 Dodd-Frank Act § 165(b)(3)(D).

35 *See, e.g.*, Saffi, Pedro A., and Kari Sigurdsson, 2007, Price efficiency and short-selling, FA 2008 New Orleans Meetings Paper, IESE Business School Working Paper No. 748, Review of Finance Studies, Vol. 24, No. 3, pp. 821-852, 2011, *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 depends on securities lending supply, it follows that a reduction in lending supply would reduce market liquidity. *See e.g.*, Boehmer, Ekkehart, Charles M. Jones and 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). *See also* Diamond, Douglas W. and Robert E. Verrecchia, 1987, Constraints on short-selling and asset price adjustment to private information, Journal of Financial Economics 18, 277-311 (cited in Boehmer as predicting that if there are shorting constraints, prices will adjust more slowly to negative information).

to lend could negatively impact the U.S. Treasuries market at a time when the need for U.S. Treasuries will increase due to regulatory changes under Basel III and otherwise.

On the borrower side, if the Proposed Rules limit agent banks' exposure to certain broker-dealers as securities borrowers, this could impact such broker-dealers' ability to meet their delivery requirements under trades and consequently cause disruption in the financial markets. The broker-dealers with the highest demand would run the highest risk of being impacted by the concentration limits. Agent banks would have difficulty dispersing such broker-dealers' borrowing activity to other borrowers that meet agent lenders' credit standards.

5. *Complex issues involved in setting single-counterparty credit limits require careful consideration.*

The Board extended the public comment period for the Proposed Rules for an extra month "[d]ue to the range and complexity of the issues addressed in the rulemaking."[36] As discussed in detail above in this Section II.C., RMA agrees that the issues surrounding the rulemaking, particularly the single-counterparty credit limits, are exceedingly complex. It follows that careful research and review of the potential effects of the rulemaking is required before a final rule is implemented.

As set forth below in Section III.D., RMA urges the Board to take the maximum allotted time to develop an appropriate rule, potentially promulgating an additional proposed rulemaking with further opportunity for comment before issuing a final rule.

III. Proposed Resolutions.

In order to address concerns regarding the methodology for calculating exposure under securities lending and other securities financing transactions[37] under the Proposed Rules, RMA proposes the following solutions, beginning with those that most closely align with appropriate regulatory treatment:

A. Allow use of the VaR methodology currently used by a number of banks to calculate risk capital, consistent with Basel II methodologies approved by regulators for use by such banks under the Basel I framework (this is the most appropriate solution as it is dynamic and most closely reflects dynamic correlations among securities);

B. Allow use of a simple, uniform VaR model with inputs dictated by the Board; or

C. Allow use of a haircut matrix reflecting static correlations between different types of loaned securities and collateral.

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[36] Press release extending comment period for the Proposed Rules to April 30, 2012 (Mar. 2, 2012), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20120302a.htm.

[37] See footnote 5.

In addition, we propose a number of further revisions to the Proposed Rules to address implementation issues separate from the methodology used to calculate credit exposure. These include an exemption for certain very high-grade foreign sovereign obligations from the single-counterparty credit limits in the same manner that U.S. Treasuries and other U.S. obligations are exempt, proper treatment of reinvested cash collateral, a workable definition of "subsidiary," and appropriate implementation timelines and grace periods for unintentional breaches of the limits.

A. **The final rule should allow banks to use their approved VaR methodology to calculate exposure associated with securities financing transactions.**

In response to Questions 35 and 42 of the Proposed Rules,[38] RMA urges that the Proposed Rules should be amended to allow agent banks to use the VaR model previously recognized by the Board in exemptions to Basel I and consistent with Basel II and risk capital rules, which also address credit exposure.[39] As discussed below, the VaR model is the most appropriate methodology to be used for measuring counterparty exposure risk, and is the simplest to implement due to the fact that a number of agent banks already use it to calculate risk capital under current regulatory requirements. The usage of these models, in turn, is reviewed on a regular basis during bank examinations and also is evaluated by auditors.

As discussed at length in Section II.C., in the case of securities financing transactions, straight haircuts are a crude approach to measuring counterparty exposure as they look at gross exposure and collateral in isolation and do not factor in portfolio diversification and correlation benefits. Indeed, members of the Federal Advisory Council ("FAC")[40] have noted to the Board that they "are concerned that the Federal Reserve's intended approach lacks risk sensitivity and that there is insufficient information regarding the potential impact of the rule on market liquidity and credit availability. The FAC recommends a thorough impact assessment, along with attempts to align the rule as closely as possible with prevailing market standards."[41] Addressing the FAC's concerns, the VaR methodology is designed to provide sensitivity to the volatility of loan and collateral positions as well as to reflect the correlation of loaned securities to collateral securities in the case of non-cash collateral. The VaR models used by agent banks also reflect correlations related to foreign exchange differences and can be adjusted to the appropriate liquidation and buy-in period for collateral and loan securities, respectively.

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[38] Question 35 of the Proposed Rules asks: "What alternative or additional valuation rules should the Board consider for calculating gross credit exposure?" Question 42 of the Proposed Rules asks: "Should a covered company be able to use its own internal estimates for collateral haircuts as permitted under Appendix G to Regulation Y?"

[39] *See* State Street Letters and OCC VaR Letters.

[40] Created by the Federal Reserve Act, the FAC was formed and empowered, among other things, to consult with the Board on matters within the jurisdiction of the Board. 12 USC §§ 261, 262.

[41] Federal Advisory Council's written views provided to the Board regarding the Proposed Rules (Feb. 3. 2012), *available at* http://www.federalreserve.gov/SECRS/2012/February/20120224/R-1438/R-1438_022412_105569_535302029000_1.pdf ("FAC February 2012 Written Views"), at 12.

Moreover, as the "prevailing market standard" used by agent banks to conform to other regulatory requirements, the VaR model is the simplest method to apply appropriate risk weights to counterparty exposure for purposes of the single-counterparty exposure limits. To wit, VaR is already used by a number of agent banks to calculate risk capital pursuant to exemptions to Basel I and consistent with Basel II and the capital rules. As such, VaR is transparent and verifiable, and banks would need to implement far fewer system changes in order to comply with the new concentration limit regulations. Agent banks' VaR models have already been validated by independent accountants and the banking agencies for use in connection with bank capital requirements, so minimal further system verification would need to be performed by the Board.

Agency action requested: We request that the Board amend the Proposed Rules to provide agent banks and other covered companies with the option to use a dynamic VaR methodology to calculate net credit exposure under securities financing transactions. The VaR models used by covered companies would not require separate and distinct Board approval for application of the single-counterparty credit limits if such models are approved for use in calculating capital usage.

B. The VaR model may be adjusted by the Board to ensure uniformity in application.

If the Board is concerned about control over application of VaR models to the single-counterparty credit limits (despite the fact that such models have been approved for use by a number of agent banks for capital purposes), the Board may set specific "inputs" to the VaR model (as in the standardized VaR model) used by agent banks to calculate counterparty credit exposure associated with securities financing transactions. Specifically, the Board could determine the assumptions and confidence levels used in a simple, uniform VaR model to be applied across banks. Although this would not be able to measure exposure as optimally as the dynamic VaR models currently used by agent banks, use of such a uniform model would still reflect risk correlations not reflected in the "haircut" approach under the current Proposed Rules.

Agency action requested: If the Board believes that the objectives of the Proposed Rules would not be effectively satisfied by allowing agent banks and other covered companies to use their own approved VaR models to measure net credit exposure, we request that the Board amend the Proposed Rules to allow covered companies to use a simple VaR model with inputs mandated by the Board to calculate net credit exposure under securities financing transactions.

C. At a minimum, the Proposed Rules should be amended to use more "reasoned" haircuts in the case of securities financing transactions.

If, despite the foregoing, the Board requires a standardized haircut-based methodology to calculate counterparty net credit exposure associated with securities financing transactions, the RMA strongly submits that the final rule should provide more reasoned haircuts that more accurately reflect counterparty exposure under such transactions. We suggest supplementing Table 2 of Subpart D of the Proposed Rules with a matrix showing different haircuts for various loaned securities/collateral type combinations applicable to securities financing transactions. In addition to increased sensitivity to correlations between securities or cash on loan and the type of collateral provided, such a haircut matrix would also reflect an appropriate holding period, daily mark to market collateral provided and other appropriate assumptions related to securities financing transactions. An additional matrix would be necessary to ascribe market appropriate foreign exchange haircuts, which should be applied based on a net exposure to each currency combination. This matrix-based approach, although an improvement over the haircuts in the proposed rule, would not be as dynamic and effective in measuring risk compared to the VaR methodology and would likely still materially overstate actual exposures.

If such an approach is desired by the Board, RMA offers to participate in a study collectively with the Board using a third party institution in order to prepare a matrix that most appropriately weights risk for all credit transaction and collateral combinations applicable to securities financing transactions.

Agency action requested: If the Board does not authorize use of a VaR-based methodology as proposed above, we request that the Board include in subpart D to the Proposed Rules a matrix setting forth haircuts associated with various combinations of cash or securities on loan and collateral, for purposes of calculating counterparty net credit exposure under securities financing transactions. Also, we request that the Board include an additional matrix setting forth market-appropriate haircuts to be applied where the currency of the loan differs from the currency of the collateral provided. In order to prepare such matrixes, the Board should commission a study by an independent third party institution and request participation by industry groups, including the RMA.

D. **Certain additional implementation issues should be addressed.**

In addition to the above proposed solutions addressing the methodology of calculating counterparty net credit exposure under securities financing transactions, RMA proposes the following further revisions to the Proposed Rules addressing additional implementation issues raised in this comment letter.

1. *Treatment of foreign sovereign debt.*

As discussed in Section II.C., the Proposed Rules apply the same straight haircuts to all foreign sovereign debt of countries rated OECD Country Risk Classification ("CRC") levels 0-1, and the same (higher) straight haircuts to sovereign debt of countries rated OECD CRC levels 2-3.[42] In addition, if sovereign debt posted as collateral is of a different currency than the currency denomination of the relevant credit transaction, an additional 8% haircut will

[42] Proposed Rules, Table 2, at 654.

apply.[43] We submit that this is an illogical result as it imposes haircuts on non-U.S. securities which are in most cases at least as highly rated from a credit perspective as their U.S. counterparts. As stated above in Section II.C.2., such treatment could result in agent banks being unable to accept high quality sovereign debt if they have met their exposure limits for such sovereigns.

Under any methodology to calculate counterparty net credit exposure where notional shifting is applied to collateral, even where any haircuts applied to foreign sovereign debt would be rationalized, covered banks will still run a high risk of hitting the 25% credit exposure limit under the current Proposed Rules for certain high-quality foreign sovereigns.

Carve out of certain sovereign exposures. In response to Question 26 of the Proposed Rules,[44] RMA believes the most appropriate way this situation should be remedied is to align treatment of high-grade foreign sovereigns with the interagency proposed market risk rules. Specifically, the RMA proposes an additional exemption pursuant to § 252.97 of the Proposed Rules for OECD government securities with CRCs of 0 or 1 as well as for their guaranteed agencies and instrumentalities and central banks in such countries. Such an exclusion would be consistent with treatment under the recent interagency proposed rule addressing the risk-based capital guidelines, which assigns a risk weighting of zero for exposure to countries with CRCs of 0 or 1.[45] The RMA acknowledges that the proposed market risk rules have not yet been finalized and may be further revised (for example, requirements may be added for the zero risk weighting that the relevant country has not recently defaulted on its obligations or received relief from the International Monetary Fund). The RMA believes that the two rules should be aligned given that both are focused on credit risk.

Agency action requested: We propose that the final rule includes an additional exemption pursuant to § 252.97 or corresponding section as follows: "Direct claims on, and the portions of claims that are directly and fully guaranteed as to principal and interest by, foreign sovereign countries with OECD CRC 0 or 1 and their agencies and instrumentalities, claims on which are explicitly guaranteed by such sovereign countries, and by central banks in such countries."

2. *Netting of exposures to same issuer*.

In addition, as discussed in Section II.C., net credit exposure is assigned to an issuer (usually a foreign sovereign under these circumstances) even in the event that both the

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43 Proposed Rules, fn 207.

44 Question 26 of the Proposed Rules asks: "Should certain credit exposures to foreign sovereign entities be exempted from the limitations of the proposed rule—for example, exposures to foreign central banks necessary to facilitate the operation of a foreign banking business by a covered company?"

45 *See* Risk-Based Capital Guidelines: Market Risk: Alternatives to Credit Ratings for Debt and Securitization Positions, 76 Fed. Reg. 79380 (December 21, 2011) ("Risk-Based Capital Proposed Rule"), Table 2, at 79402.

securities on loan and the collateral provided are issued by the same sovereign country, an inappropriate result. To address this, we propose that agent banks be permitted in such cases to reduce the credit exposure to the borrower by the adjusted market value of the collateral under the rule (whether this is calculated by use of a VaR-based volatility or a haircut) without shifting such credit exposure to the collateral issuer. For example, if €100 million in German five-year bunds are lent, and €102 million in German ten-year bunds are received as collateral, applying the current haircuts under the Proposed Rules but while using such permitted netting, the agent lender would record €2.04 million in net credit exposure to the borrower and €0 in credit exposure to Germany.

Agency action requested: We propose that, in the event that both the securities on loan and the collateral provided are issued by the same issuer, a covered company shall be permitted to subtract the adjusted market value of the collateral from the gross credit exposure to the borrower under such transaction, and will not be required to include such adjusted market value of the collateral when calculating its gross credit exposure to the collateral issuer.

3. *Reinvested cash collateral.*

In the case of cash collateral, the cash provided by the borrower is generally reinvested either for the individual account of the securities lending client or through collateral pools. We believe that cash collateral provided by the borrower should be deemed "held on deposit," even in the event it is reinvested on behalf of the lending client, consistent with both the Board's and the OCC's capital rules.[46] If invested cash collateral is not deemed held on deposit in the calculation of the agent bank's net credit exposure to the relevant counterparts, this could create uncertainty as to how the collateral would be treated under the Proposed Rules.

Except in the special case described below, agent banks have no exposure to the gains and losses of invested cash collateral – instead, the cash is invested solely for the account of and at the risk of the principal lender. Thus, agent banks should not be characterized as having either (i) uncollateralized credit exposure to the borrower or (ii) any credit exposure to the issuers of the securities in which the collateral is invested, once the cash is invested through individual accounts or pools.

RMA requests that the Board provide clarification in the final rule or the preamble thereto that the full amount of cash collateral provided by the borrower will be deducted from the credit exposure of the agent bank, including after the cash collateral is reinvested on behalf of the lender. This is consistent with the Board's capital rules, which give zero risk weight to indemnified agency lending transactions secured by cash collateral so long as the agent bank does not guarantee investment performance of the pool or individual investment account.

Special case: indemnified repo. In a small percentage of cash collateralized agency securities lending transactions, the cash collateral is reinvested on behalf of the lender by way

[46] *See* 12 CFR Part 225 App. A § III.D.1.c.; 12 CFR Part 3, App. A §3(b)(1)(v), fn 15 and related text.

of one or more indemnified reverse repurchase ("indemnified repo") transactions (e.g., lending the cash collateral in a transaction fully collateralized by highly liquid and marketable securities, such as U.S. government-guaranteed securities). In such a transaction, the agent bank indemnifies the lending client against the risk of default of the repo counterparty. (Here, the agent bank is only liable for the shortfall, if any, between the value of the securities collateral and the cash on loan.) The indemnified repo transaction is also subject to daily mark to market and immediately terminable in the event of counterparty default.

In the case of reinvestment of cash collateral pursuant to indemnified repo transactions, the State Street Letters and the OCC VaR Letters acknowledged that indemnified repo does pose some credit risk, but concluded that fully excluding the cash from eligible collateral does not properly reflect the additional risk. (Instead, these letters supported the VaR method for calculating the total exposure of the bank under the combined indemnified agency lending and indemnified repo transactions.)[47] Note also that any additional exposure risk involved in an indemnified repo transaction would be taken into account under § 252.94(a)(5) of the Proposed Rules (regarding reverse repurchase agreements).

Agency action requested: Please clarify in the final rule that, in the case of cash collateral provided under an indemnified agent lending transaction that is invested, whether through an individual account or a pooled account (including investments in one or more indemnified repo transactions):

(A) if the Board determines to follow either of the approaches outlined in Section III.A. and III.B., the VaR method may be used for the potential future exposure (PFE) component in the calculation of the total net credit exposure under the combined indemnified agency lending and indemnified repo transactions; or

(B) if the Board determines to follow the approaches outlined in Section III.C, the full amount of such cash collateral shall be deducted from the credit exposure to the relevant borrower counterparty to achieve the "net credit exposure" of such transaction, and in the case of reinvestment of collateral in an indemnified repo transaction, please further clarify that the indemnified repo transaction will be treated separately from the indemnified agency lending transaction (pursuant to § 252.94(a)(5)) for purposes of calculating aggregate net credit exposure to a counterparty.

4. *Cash collateral pools.*

Even though agent banks are not subject to any investment risk for securities held by cash collateral pools and manage them in a fiduciary capacity, the threshold of 25% ownership of voting securities under the definition of "subsidiary" may under a literal reading of the Proposed Rules make some cash collateral pools managed by agent banks (as trustee, general partner or managing member) subject to the single-counterparty credit limits. As previously noted, agent banks have no principal investment risk as to the collateral pools; rather,

47 *See* State Street Letters and OCC VaR Letters.

investments are held by the pools at the total risk of the securities lender. Thus, reinvestment pools held in a fiduciary capacity by agent banks should be clearly excluded from the limits regardless of technical voting rights to avoid improper results.

5. *Definition of "counterparty," "subsidiary" and "control" in general.*

In response to Questions 22 and 23 of the Proposed Rules,[48] as discussed in Section II.C., the current nesting definitions of "counterparty," "subsidiary" and "control" are so broad that in many cases a covered company would not be able to determine what are the subsidiaries of its counterparties, exposure to which must be included in its calculation of aggregate net credit exposure to that counterparty. We propose that the definition of "control" be revised in the final rule such that the defined term "subsidiary" includes a narrower group of more readily discernible companies. Specifically, under the final rule, subsidiaries should only include those companies consolidated with the relevant parent company for U.S. Generally Accepted Accounting Principles (GAAP) purposes, and which are majority-owned by the relevant parent company. Moreover, in response to the second part of Question 25 of the Proposed Rule,[49] it should be clarified that in no event should exposures to a company controlled by a foreign sovereign entity be included in the exposure to that foreign sovereign.

Agency action requested: Please revise the definition of "control" in § 252.92(i) or corresponding section of the final rule to include only subsidiaries consolidated with the relevant company for purposes of complying with U.S. Generally Accepted Accounting Principles (or foreign equivalent, if applicable) and of which the relevant company owns a majority of voting shares.

In addition, please clarify in the definition of "control," the definition of "counterparty" or the definition of "subsidiary" in §252.92 or corresponding section of the final rule that exposures to a company controlled by a foreign sovereign entity will not be included in the exposure to that foreign sovereign entity.

Finally, please revise the definition of "subsidiary" in § 252.92(jj) or corresponding section of the final rule by adding the following proviso:

"*provided*, that "subsidiary" shall not include any fund established by a banking organization acting as a securities lending intermediary or an affiliate of such banking organization, where such fund invests cash collateral pledged by one or more borrowers in connection with one or more securities lending transactions."

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48 Question 22 of the Proposed Rules asks: "Is the approach of including all subsidiaries of a covered company in the definition of covered company for purposes of the proposed rule appropriate? If not, explain why not." Question 23 of the Proposed Rules asks: "Should the Bank Holding Company Act/Regulation Y definition of ''control'' be adopted for purposes of the proposed rule? Are there alternative approaches to defining when a company is a subsidiary of another the Board should consider?"

49 The second part of Question 25 of the Proposed Rules asks: "Should exposures to a company controlled by a foreign sovereign entity be included in the exposure to that foreign sovereign entity?"

6. *Attribution Rule.*

§ 252.94(b) of the Proposed Rules implements the "Attribution Rule" set forth in Section 165(e)(4) of the Dodd-Frank Act. § 252.94(b) of the Proposed Rules provides that a covered company must treat any of its transactions with any person as a credit exposure to a counterparty to the extent the proceeds of the transaction are used for the benefit of, or transferred to, that counterparty.

As properly noted by the Board in the preamble to the Proposed Rules, application of this provision as drafted can lead to inappropriate results: "The Board notes that an overly broad interpretation of the attribution rule in the context of section 165(e) would lead to inappropriate results and would create a daunting tracking exercise for covered companies…The Board thus proposes to minimize the scope of application of this attribution rule consistent with preventing evasion of the single-counterparty credit limit."[50] However, the language in the rule itself does not include any limits to the scope of application of the Attribution Rule. In order to prevent potential excessive application, in response to Question 40[51] under the Proposed Rules, we propose amending the provision in the Proposed Rule to apply more clearly only to the preventing of evasion of the single-counterparty credit limit.

Agency action requested: We ask that the Board please amend § 252.94(b) of the Proposed Rules to clearly provide that this attribution rule will only be applied consistent with preventing evasion of the single-counterparty credit limit.

7. *Timeline; Grace Period.*

The Proposed Rules contemplate that the effective date for the single-counterparty credit limits will be October 1, 2013 for all entities that are covered companies as of September 30, 2012.[52] However, the Board is authorized under the statute to extend the period until July 21, 2015.[53] RMA understands the Board has received numerous industry requests to extend the implementation timeline. Significantly, in their meeting with the Board on February 3, 2012, members of the FAC "expressed broad concerns regarding the significant operational and compliance obligations inherent in the Federal Reserve's approach, including

50 Proposed Rules at 618.

51 Question 40 of the Proposed Rules asks: "The Board requests comment on whether the proposed scope of the attribution rule is appropriate or whether additional regulatory clarity around the attribution rule would be appropriate. What alternative approaches to applying the attribution rule should the Board consider? What is the potential cost or burden of applying the attribution rule as described above?"

52 Proposed Rules § 252.91(a)(2).

53 Dodd-Frank Act § 165(e)(7)(B).

substantial information technology expenditures. This may require an extended implementation timeline for some aspects of the rule."[54]

RMA's members agree that implementation of the single-counterparty credit limits in any form will require an extended transition period at agent banks. In response to Question 21 of the Proposed Rules,[55] given the need for additional consideration of the impact of the proposed exposure calculation methods as well as the significant systems adjustments any application of the concentration limits would require at agent banks, we strongly urge the Board to use the full authorized extension.

Agency action requested: Please amend § 252.91(a)(2) or corresponding section of the final rule to change references to "October 1, 2013" to "July 21, 2015."

The Proposed Rules grant a 90 day grace period for non-compliance under certain circumstances, but provide that the Board will have to grant approval for such grace period in any circumstance and require that the covered company engage in no additional transactions with the relevant counterparty without Board approval during the grace period.[56] In response to Question 58 of the Proposed Rules,[57] under the limited circumstances enumerated in the Proposed Rules, which are out of the control of the relevant bank, the 90-day grace period should be automatic, and, as discussed further below, additional credit transactions with the affected counterparty should not be prohibited at least during a shorter cure period at the beginning of such grace period.

Regarding an additional cure period, in response to Question 57,[58] the final rule should provide a cure period of five business days in the event of inadvertent non-compliance under any circumstance, during which time the relevant bank would not be required to cease transactions with the relevant counterparty. The bank would promptly notify the Board of such breach once it is identified. It would be difficult if not impossible for an agent bank to cease trading immediately with a certain counterparty internationally – some additional time must be built in for banks to give notice to their foreign branches to cease trading.

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54 FAC February 2012 Written Views, at 12.

55 Question 21 of the Proposed Rules asks: "Should the Board consider a longer phase-in for all or a subset of covered companies?"

56 Proposed Rules § 252.96(b).

57 Question 58 of the Proposed Rules asks: "Is the 90-day cure period appropriate and is it appropriate to generally prohibit additional credit transactions with the affected counterparty during the cure period? If not, why not?"

58 Question 57 of the Proposed Rules asks: "Are there additional non-compliance circumstances for which some cure period should be provided?

Agency action requested:

(A) Please revise the sentence in § 252.96(b) or corresponding section of the final rule commencing with "In granting approval" in its entirety as follows:

"The special temporary credit exposure limit provided under this section 252.96 shall be applicable to any covered company that is not in compliance with this subpart solely due to one or more of the following circumstances:

(1) A decrease in the covered company's capital stock and surplus.

(2) The merger of the covered company with another covered company.

(3) A merger of two unaffiliated counterparties.

(4) Any other circumstance the Board determines is appropriate."

(B) Please add the following as a new paragraph (d) to § 252.96 or corresponding section of the final rule:

"(d) *Cure period.* Notwithstanding anything to the contrary in this section 252.96, if a covered company is not in compliance with this subpart with respect to a counterparty for any reason, the covered company will not be subject to enforcement actions for a period of five business days (or such other period determined by the Board to be appropriate to preserve the safety and soundness of the covered company or U.S. financial stability) if the covered company notifies the Board of such breach promptly upon identifying such breach and uses reasonable efforts to return to compliance with this subpart during this period. The covered company shall not be prohibited from engaging in additional credit transactions with such counterparty during this cure period."

IV. Conclusion.

In sum, as currently drafted, the Proposed Rules overstate credit exposure risk related to securities lending and other securities financing transactions, due to the fact that, among other things, the Proposed Rules do not recognize correlations between securities on loan and collateral, the benefits of portfolio diversification, or right-way credit risk. In addition, the Propose Rules include a number of further issues, including improper adverse treatment of quality foreign sovereigns, overbroad definitions of "counterparty" and "subsidiary," a lack of clarity surrounding certain other provisions and an insufficient timeline for compliance.

If applied to indemnified agency securities lending transactions as currently drafted, the Proposed Rules would unjustifiably and severely restrict the ability of U.S. agent banks to provide the securities replacement guarantees, which have been overseen by banking law and regulators and which have been a standard part of their lending programs for decades. Agent bank data demonstrates that without these replacement guarantees, which lending clients see not only as protection but also validation of bank program risk systems, lending clients would move this business elsewhere (e.g., foreign banks), shut down their lending programs (and thus lose a source of stable revenue), or incur the additional expense and risk of seeking to manage their programs themselves. Moreover, given that custody related services are both bundled and very competitive, U.S. banks are likely to lose more than simply revenues from securities lending services if they cannot provide securities replacement guarantees. Rather, U.S. agent banks may suffer the loss of entire banking relationships if historical securities lending services must be terminated. To summarize, the Proposed Rule would impair (1) U.S. agent banks, both from an immediate revenue perspective and from a long-term competitive perspective vis-a-vis their foreign counterparts; (2) lending clients, by removing a source of economic protection and risk systems validation that they have relied on for decades, potentially leading to a loss of substantial revenue; and (3) the market more generally, by removing a vital source of liquidity for broker-dealers and the financial services industry more generally.

We encourage the Board to take the time to consider these issues fully, and we strongly encourage the Board to adopt the proposals we have set forth in this letter. Our proposals, particularly those that are based on the VaR methodologies that are at the core of the international capital rules, reward risk-mitigating behavior by recognizing correlations between securities. Particularly given that the capital rules themselves are focused on credit risk, the preferred proposed approach appropriately calibrates accurate credit exposures, is consistent with bank systems that are regularly examined and audited, and also serves the larger objective of consistency between similar regulatory frameworks. Similarly, our proposed treatment of foreign sovereigns is fully consistent with the interagency guidance as set forth in the proposed U.S. interagency market risk rules, and thus reflects the most comprehensive thinking of all of the U.S. banking agencies as to the appropriate approach to calibrate these exposures.

We acknowledge that the issues raised by the single-counterparty credit limits are exceedingly complex. If desired by the Board, the RMA would be pleased to assist the Board in the development of any of the proposals discussed in this letter or in any other manner as the Board undertakes to implement the statute appropriately and effectively. Finally, due to the significant systems adjustments that covered agent banks will need to implement in order to conform to the single-counterparty credit limits under any of the proposals, we urge the Board to extend the compliance period to 2015.

Sincerely,

Christopher R. Kunkle
Director
Securities Lending & Market Risk
Risk Management Association

Michael P. McAuley
Chairman
Committee on Securities Lending
Risk Management Association

Appendix I: Overview of agency securities lending transactions

Securities lenders largely consist of institutions such as public and private pension funds, ERISA plans, endowment funds of not-for-profit institutions, insurance companies, investment funds, and other similar entities or funds into which such entities invest. Borrowers in securities lending transactions largely consist of broker-dealers, banks and other financial institutions.

Through agency securities lending programs, agent banks act as intermediaries to facilitate loans of eligible securities by securities lenders (the clients of the agent banks, or "lending clients") to qualified borrowers. Securities generally are lent pursuant to (i) a securities lending authorization agreement between the securities lender and the agent bank, and (ii) a securities borrowing agreement between the borrower and the agent bank (acting in an agency capacity).

Loans are typically over-collateralized by a margin of 2% to 5%, depending on the type of collateral provided and certain characteristics of the securities on loan. In some cases where loaned securities are in very high demand, margins may exceed 10%. The lending clients (and, typically by way of subrogation rights granted pursuant to the securities lending agreement, the agent banks) have a security interest in and lien upon the collateral provided by the borrower. At the beginning of a trade, collateral is accepted by the agent bank (and in the case of securities taken as collateral, the trade moving such collateral is allowed to settle) before, or concurrent with in the case of a delivery versus payment (DVP) market, the agent bank delivers the securities on loan to the borrower. Similarly, at the end of a trade, the agent bank releases the collateral back to the borrower concurrently with or after receiving the securities on loan.

As a standard market practice, agency securities lending agreements also typically provide that lending clients (or their investors) are indemnified by the agent banks for any deficiencies in collateral in the event of a borrower default, usually in the form of failure to return the borrowed securities (i.e., the agent banks guaranty payment of any shortfall between the value of the collateral and the value of the securities). This service is commonly referred to as "borrower default indemnification," or a "securities replacement guarantee."

Diagrams showing the structure of typical agency securities lending transactions using fixed income and cash collateral are attached as Exhibits B-1 and B-2.

Typical collateral practices.

In general, at this time, cash represents the predominant form of collateral provided in U.S. transactions, with securities more often provided as collateral in non-U.S. transactions. According to recent data, cash collateral is applied against $708 billion of predominantly U.S. securities, representing 48% of global loaned securities.[59] In the U.S. lending market, currently cash is taken as collateral for more than 85% of securities loans,[60] although this percentage will likely decrease in the coming years due to other regulatory changes.

Cash collateral is typically reinvested for the benefit of, and at the risk of, the lending client in securities in both the U.S. and abroad. Cash reinvestment may be managed through individual accounts or pools. According to RMA composite figures for the fourth quarter of 2011, compiling responses of 14 member banks, 72% of the composite U.S. Dollar cash reinvestment portfolio is comprised of A1/P1 rated repurchase agreements and other short-term instruments, and an additional 15% is comprised of short term instruments that conform to SEC Rule 2(a)(7) requirements for money market funds.

[59] Data Explorers global composite data as of March 12, 2012.

[60] *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.

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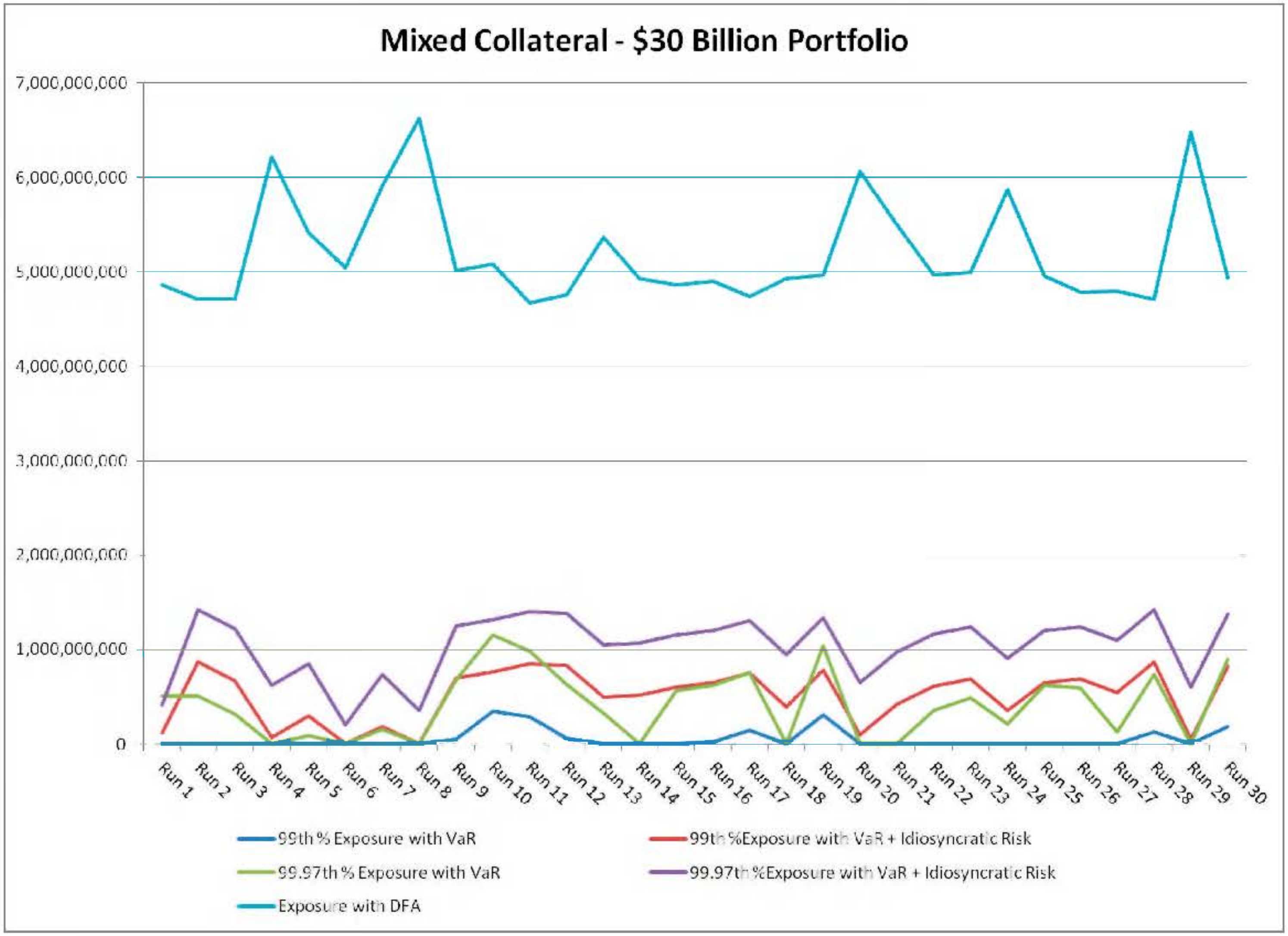
Randomly Generated Loan and Collateral Portfolios

- We created randomly generated loan and collateral portfolios using a representative subset of securities that a typical agent lender would loan and receive as collateral.
- Randomly generated portfolios consist of the following security types:
    - Six Diverse U.S. Equity Sectors
    - Six Diverse Non-U.S. Equity Sectors
    - U.S. and Non-U.S. AA corporate bonds
    - 7 Countries Government Bonds, including U.S.
    - Six Currencies
- Randomly generated portfolios were created using a mix of collateral, only non-cash collateral and only cash collateral.
- Exposure based on Value at Risk, including a 5% idiosyncratic risk add-on for equities and corporate bonds were calculated and compared to the exposures under the Proposed Rules ("DFA").
- DFA exposures were significantly higher in all cases, the difference between DFA calculations and VaRs was most significant for non-cash collateral trades.


Mixed Collateral - $30 Billion Portfolio
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Run 4
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Run 6
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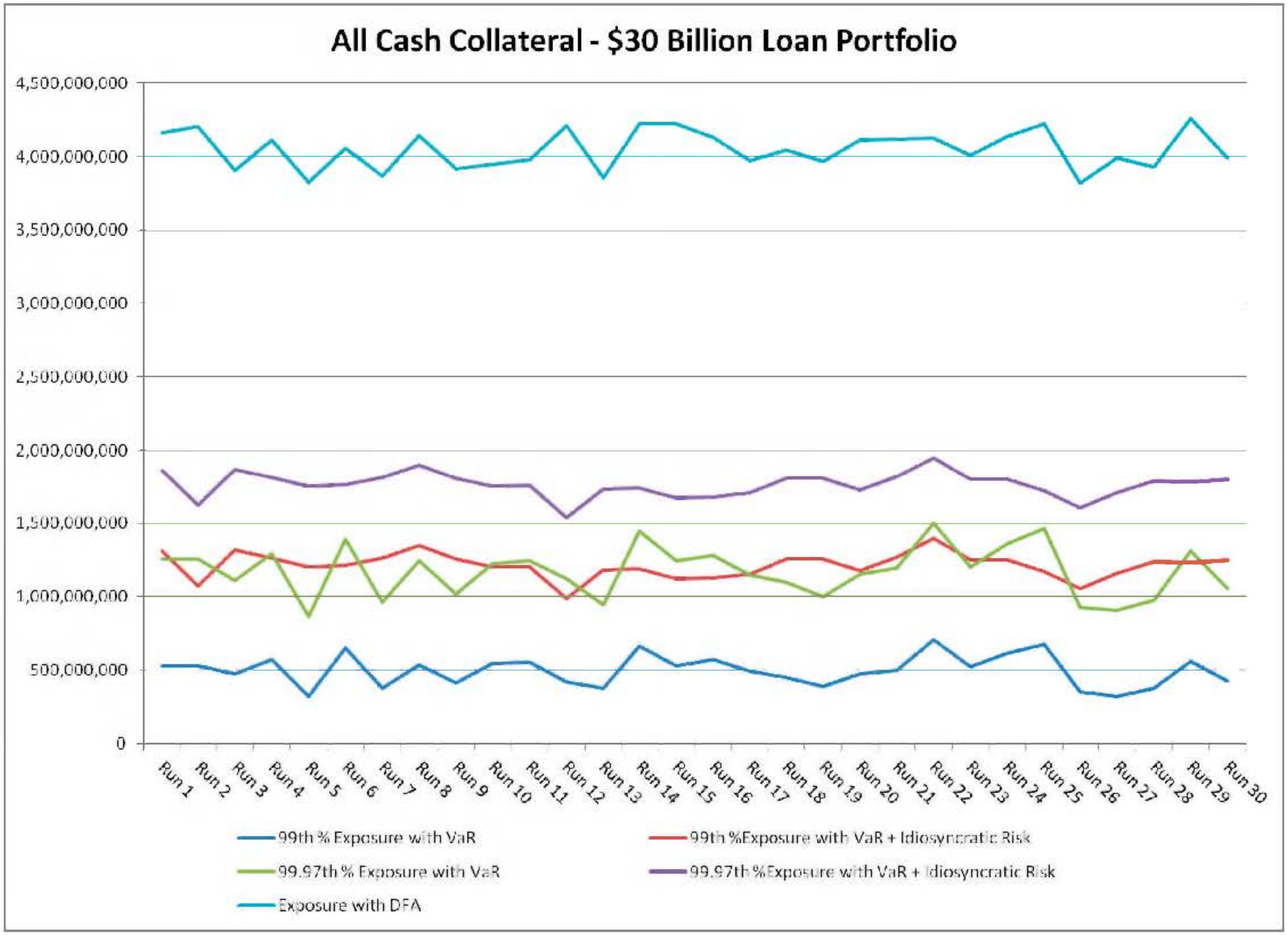
Run 30
99th % Exposure with VaR
99th %Exposure with VaR + Idiosyncratic Risk
99.97th % Exposure with VaR
99.97th %Exposure with VaR + Idiosyncratic Risk
Exposure with DFA


All Cash Collateral - $30 Billion Loan Portfolio
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Run 3
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Run 6
Run 7
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Run 9
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Run 27
Run 28
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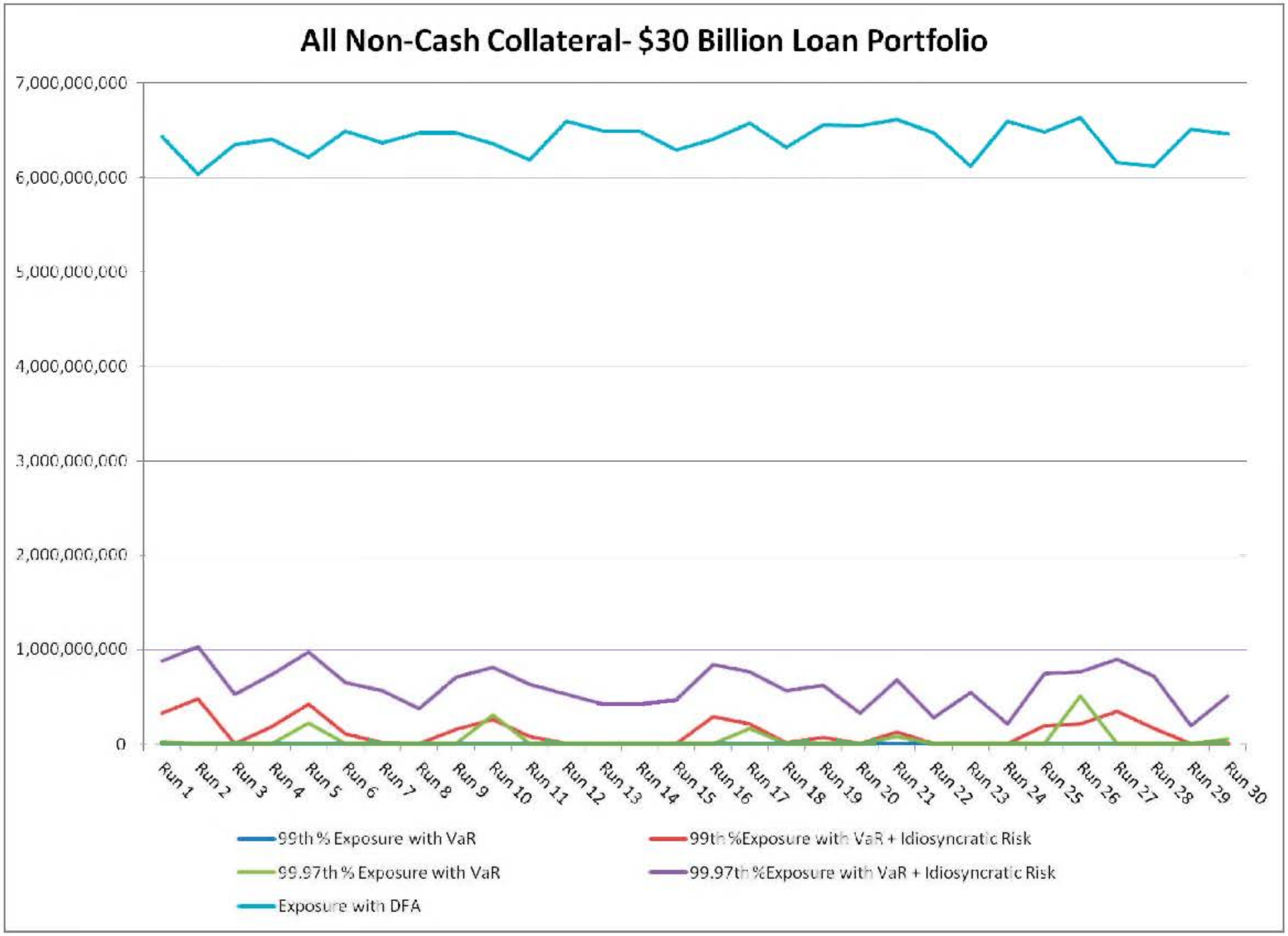
Run 30
99th % Exposure with VaR
99th %Exposure with VaR + Idiosyncratic Risk
99.97th % Exposure with VaR
99.97th %Exposure with VaR + Idiosyncratic Risk
Exposure with DFA


All Non-Cash Collateral- $30 Billion Loan Portfolio
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4,000,000,000
3,000,000,000
2,000,000,000
1,000,000,000
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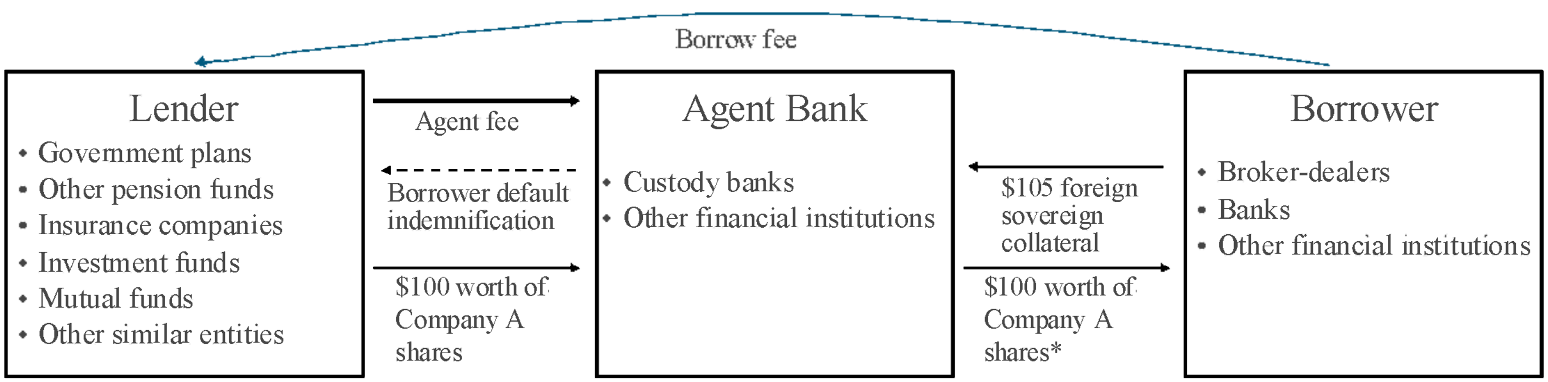
Run 1 Run 2 Run 3 Run 4 Run 5 Run 6 Run 7 Run 8 Run 9 Run 10 Run 11 Run 12 Run 13 Run 14 Run 15 Run 16 Run 17 Run 18 Run 19 Run 20 Run 21 Run 22 Run 23 Run 24 Run 25 Run 26 Run 27 Run 28 Run 29 Run 30
99th % Exposure with VaR
99th %Exposure with VaR + Idiosyncratic Risk
99.97th % Exposure with VaR
99.97th %Exposure with VaR + Idiosyncratic Risk
Exposure with DFA

Typical Securities Loan Structure
(Fixed Income Collateral)



* 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 Lender.

Typical Securities Loan Structure
(Cash Collateral)