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March 29, 2007

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
ATTN: Docket No. 06-09

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
ATTN: Docket No. R-1261

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 1550-AB56

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2006-33

Re: Risk-Based Capital Standards: Advanced Capital Adequacy Framework

Ladies and Gentlemen:

The Risk Management Association's Committee on Securities Lending (the "RMASL") appreciates the opportunity to comment on the joint notice of proposed rulemaking (the "NPR") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (together, the "Agencies") regarding the proposed Risk-Based Capital Standards: Advanced Capital Adequacy Framework (implementing the International Convergence of Capital Measurement and Capital Standards: A Revised Framework (the "New Accord" or "Basel II") in the U.S.). This letter responds to the Agencies' request in the NPR for industry comment, and focuses on certain of the Credit Risk Mitigation ("CRM") aspects of the NPR (member firms may also comment individually on the NPR as a whole).

The Risk Management Association, of which the RMASL is a component, has a membership of more than 3,000 financial services providers, and is a professional association founded in 1914 that specializes in promoting enterprise risk management

practices for financial institutions. The RMASL was formed in 1983, with an objective to promote sound securities lending practices within its members and the industry.

As discussed in more detail below, securities lending transactions have historically been low-risk transactions, yet they serve an important function in the operation of securities markets by enhancing market efficiency and providing an important source of liquidity. In addition, securities lending has increased as a global activity in recent years, bringing U.S. institutions into direct competition with foreign banks. Therefore, the RMASL believes it is necessary for the treatment of securities lending institutions under Basel II, as implemented in the U.S., to provide U.S. institutions with sufficient flexibility to compete with their foreign competitors and to serve the needs of foreign counterparties.

In general, the RMASL supports the NPR's treatment of securities lending transactions and believes that such treatment will result in risk-based capital requirements more closely aligned with the risk arising from such transactions. However, as discussed in more detail below, the RMASL believes that certain improvements should be made with regard to various aspects of the NPR's treatment of securities lending transactions.

More specifically, Section I below provides a brief background on securities lending, and Section II provides the RMASL's specific comments to certain CRM aspects of the NPR.

I. Securities Lending Background

Securities lending involves the temporary exchange of securities, usually for cash or other securities (or occasionally a mixture of cash and securities), with an obligation to redeliver a like quantity of the same securities at a future date. A typical securities lending transaction for a bank involves three parties: a lender (generally a bank customer), an intermediary agent (generally the bank) and a borrower (generally either a broker-dealer or a bank).[1] The lender transfers title of securities temporarily to the borrower, but retains the economic rights of an owner of such securities and generally has the power to terminate a loan at any time and to recall the loaned securities. The borrower secures its obligation to the lender by posting collateral with the intermediary in the form of cash or marketable securities with a value that fully covers the value of the

[1] A bank may also, in some circumstances, act as principal in lending securities. In that case, either (1) only two parties will be involved in the transaction: the (bank) lender and the borrower, or (2) the bank will act as the counterparty for each of the borrower and the lender.

securities borrowed plus some additional margin. The borrower typically uses the loaned security to satisfy its settlement obligations to third parties (in connection with short sales or otherwise) and the lender is compensated for the use of its security.

The intermediary acts as agent for the lender, generally by negotiating with borrowers and administering the loans (including marking the collateral to market to ensure a positive margin is maintained), all for agreed upon compensation. For competitive reasons and consistent with prevailing industry practices, the intermediary bank often indemnifies the lender against the risk that the borrower may fail to return the borrowed securities. It is widely recognized that securities lending serves an important function in the operation of securities markets by enhancing market efficiency and providing an important source of liquidity to the securities markets.[2] As a general matter, securities lending transactions, including transactions in which the bank acts as agent for a customer and indemnifies the customer against loss, are included within the definition of repo-style transactions in the NPR.

II. Comments to Certain CRM Aspects of the NPR

As noted above, the RMASL generally supports the NPR's treatment of securities lending transactions and believes that such treatment will result in risk-based capital requirements more closely aligned with the risk arising from such transactions. However, the RMASL believes that certain improvements should be made with regard to various aspects of the NPR's treatment of securities lending transactions, especially in light of their historically low risk. The following are the RMASL's comments to certain of the CRM aspects of the NPR applicable to securities lending transactions.

A) *Definition of Repo-Style Transaction*

In order for a securities lending or borrowing transaction to be considered a repo-style transaction under the NPR, and therefore eligible for a bank or broker-dealer to recognize the risk mitigating effect of financial collateral securing such securities lending or borrowing transaction, the transaction must be "executed under an agreement that provides the bank the right to accelerate, terminate, and close-out the transaction on a net

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[2] *See generally* Securities Lending Transactions: Market Development and Implications, report prepared by the Technical Committee of the International Organization of Securities Commissioners and the Committee on Payment and Settlement Systems (July 1999).

basis and to liquidate or set off collateral promptly upon an event of default (including upon an event of bankruptcy, insolvency or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions"[3] ("Criterion (iii)"). This "requirement is met where all transactions under the agreement are (i) executed under U.S. law and (ii) constitute 'securities contracts' or 'repurchase agreements' under section 555 or 559, respectively, of the Bankruptcy Code (11 U.S.C. 555 or 559), qualified financial contracts under section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or netting contracts between or among financial institutions under sections 401-407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401-4407) or the Federal Reserve Board's Regulation EE (12 CFR part 231)."[4]

As noted in Question 35 of the NPR, a substantial portion of securities lending and borrowing transactions would not be eligible for certain exemptions from bankruptcy or receivership laws because the bank's counterparty is not subject to such laws, and therefore transactions with such counterparties would not satisfy this requirement. Accordingly, due to this requirement under the NPR, a substantial portion of securities lending and borrowing transactions would not qualify as repo-style transactions, and therefore banks and would not be permitted to recognize the risk mitigating effects of collateral securing such transactions. For example, securities lending or borrowing transactions with a sovereign entity generally would not meet this requirement, nor would transactions with certain domestic entities, such as insurance companies and pension funds. As discussed in more detail below, the RMASL submits that this requirement is unduly restrictive, especially given the low risk associated with securities lending and borrowing transactions.

We note that this Criterion (iii) is similar to a condition included in an interagency interim rule issued in December 2000[5] which revised the risk-based capital treatment for cash collateral posted in connection with securities borrowing transactions to better reflect the low risk of such transactions (the "Interim Rule").[6] With regard to the

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3 71 Fed. Reg. 55830 at 55868 (Sept. 25, 2006).

4 *Id.*

5 65 Fed. Reg. 75856 (Dec. 5, 2000).

6 In order to be eligible for the revised treatment provided for in the Interim Rule, the securities borrowing transaction must have been "a securities contract for the purposes of section 555 of the

treatment of securities borrowing transactions, the Agencies (other than the Office of Thrift Supervision, which was not involved in the issuance of the Interim Rule) recognized that this condition caused the scope of the Interim Rule to be too narrow, especially in light of the fact that defaults on securities borrowing transactions have been extremely rare, and defaults resulting in losses even more rare. Accordingly, the Agencies issued a final rule in February 2006[7] (the "Final Rule") which expanded the scope of the Interim Rule to include transactions that are either overnight or unconditionally cancelable at any time by the borrower.[8]

The RMASL submits that the need for the inclusion of such transactions within the definition of repo-style transactions is no less compelling than the need which led to the issuance of the Final Rule. In addition, we note that the inclusion of such transactions within the Final Rule has not led to any losses for any banks or broker-dealers since the issuance of the Final Rule in February 2006. Accordingly, the RMASL submits that securities borrowing transactions that do not fit within Criterion (iii) but which are either overnight or unconditionally cancelable at any time by the borrower should be included within the definition of repo-style transactions under the U.S. implementation of Basel II.

Similarly, the RMASL submits that securities lending transactions that do not fit within Criterion (iii) but which are either overnight or unconditionally cancelable at any time by the lender should be included within the definition of repo-style transactions under the U.S. implementation of Basel II. We note that securities lending transactions, like the securities borrowing transactions that were the subject of the Interim Rule and the Final Rule, are low-risk transactions for banks, as evidenced by the fact that losses to agent

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Bankruptcy Code (11 U.S.C. 555), a qualified financial contract for the purpose of section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions for the purposes of sections 401-407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401-4407), or the Board's Regulation EE (12 CFR Part 231)." *Id* at 75857.

[7] 71 Fed. Reg. 8932 (Feb. 22, 2006).

[8] The borrower must also have "conducted sufficient legal review to reach a well-founded conclusion that (1) the securities borrowing agreement executed in connection with the transaction provides the [borrower] the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of counterparty default and (2) under the law governing the agreement, its rights under the agreement are legal, valid, binding and enforceable." *Id.* at 8934.

bank lenders arising from defaults of such transactions have been extremely rare. Accordingly, including such securities lending transactions within the scope of the definition of repo-style transactions would more appropriately align the capital requirements for such transactions with their risk. Furthermore, including such transactions within the definition of repo-style transactions in this way would provide a capital treatment for U.S. banking organizations that is more in line with the capital treatment applied to their foreign competitors, as provided in the New Accord.[9] The RMASL submits that, given the global nature of the securities lending industry, such a change is necessary to provide U.S. institutions with the flexibility to compete in this area with their foreign competitors.

B) *Collateral and Risk Mitigation*

With regard to the definition of financial collateral, the RMASL submits that the requirement for a first priority security interest is not always feasible in the case of collateral held by third-party custodians, trustees or securities intermediaries, since such parties typically require that they be granted a security interest in any assets or funds held in order to secure payment of fees, contractual proceeds, overdrafts or other amounts in connection with such custodial activities. However, we note that, given the maintenance of a positive margin of collateral and daily marking to market, such third-party transactions are low-risk transactions for banks. Accordingly, the RMASL submits that, in order to recognize the CRM value of collateral securing such third-party securities lending transactions, the requirement for a perfected, first priority security interest should be satisfied if the bank's perfected security interest is subject only to the lien of the third party custodian.

We also note that, although parties to securities lending transactions customarily refer to the transfer of funds intended to secure the redelivery of borrowed securities as "cash collateral", it is not clear that the name properly describes the transfer or that this transfer

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[9] Pursuant to the New Accord, in order for banks to recognize the effect of master netting agreements on repo-style transactions, such master netting agreements must, among other things, "provide the non-defaulting party the right to terminate and close-out in a timely manner all transactions under the agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty" and "allow for the prompt liquidation or setoff of collateral upon the event of default." *See* Paragraph 173 of the New Accord.

could properly be classified as a grant of a security interest.[10] Accordingly, a requirement in Basel II for a perfected, first priority security interest could lead to some uncertainties and confusion in the case of cash collateral. Accordingly, the RMASL submits that it may be beneficial to modify the definition of financial collateral to make clear that cash must be immediately available to the bank upon default and to further limit the requirement for a perfected, first priority security interest to collateral other than cash.

With regard to determining EAD for counterparty credit risk and recognizing collateral mitigating that risk, the RMASL believes that debt securities rated lower than one category below investment grade and other securities that do not meet the definition of financial collateral should be recognized for their CRM value. As indicated above, securities lending transactions are low-risk transactions for banks, as evidenced by the fact that losses to agent bank lenders arising from defaults of such transactions have been extremely rare. Furthermore, as indicated above, the risk of loss from such transactions is very low due to the maintenance of a positive margin of collateral and the daily marking to market. Therefore, the external rating of a security is generally not the critical issue with respect to its CRM value; rather, it is generally the liquidity of a security that is critical. Accordingly, the RMASL submits that lower rated securities and other securities that do not meet the definition of financial collateral in the NPR, but which are sufficiently liquid, should have their CRM value recognized under the U.S. implementation of Basel II. Similarly, given this low risk for securities lending transactions, the RMASL believes that a broad range of credit derivatives should be recognized as CRM for such transactions.

III. Conclusion

As discussed above, the RMASL generally supports the NPR's treatment of securities lending transactions and believes that such treatment will result in capital requirements that are more closely aligned with the risk arising from such transactions. However, as noted above, the RMASL believes that certain improvements should be made with regard

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[10] Article 9 of the Uniform Commercial Code ("UCC"), which governs the grant or creation of security interests in personal property, covers security interests in "money" (*see e.g.*, UCC § 9-301(3)), but only provides for perfection of a securities interest in money by "possession" (UCC § 9-312(b)(3)). It is not clear whether anything other than coin or currency is contemplated. Because the cash transfers in a typical securities lending arrangement would not involve the physical transfer and retention of possession of money, such transfer may not properly be described as a grant of a security interest.

to various aspects of the NPR's treatment of securities lending transactions, especially in light of the historically low risk of such transactions. For example, the RMASL submits that Basel II, as implemented in the U.S., should include transactions that are either overnight or unconditionally cancelable at any time by the appropriate party within the definition of repo-style transactions. In addition, the RMASL believes that changes should be made to the requirement of a perfected, first priority security interest in certain circumstances, and that the risk mitigating effects of a broader range of collateral should be recognized.

The RMASL submits that these changes would more appropriately align the capital requirements for securities lending transactions with their low risk, and provide a capital treatment for U.S. banking organizations that is more in line with the capital treatment applied to their foreign competitors.

Very truly yours,

W. Tredick McIntire
Chairman
The Risk Management Association Committee on Securities Lending