COMMITTEE ON SECURITIES LENDING

June 3, 2016

Via electronic submission

Robert deV. Frierson, 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: Single-Counterparty Credit Limits for Large Banking Organizations (Docket No. R-1534; RIN 7100-AE 48)

Dear Mr. Frierson:

The Securities Lending Committee of the Risk Management Association ("RMA Committee")[1] welcomes the opportunity to submit this letter to the Board of Governors of the Federal Reserve System (the "Federal Reserve") 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, BMO Harris, Citibank, N.A., Deutsche Bank, JPMorgan Chase Bank, N.A., The Northern Trust Company and State Street Bank & Trust, among others.

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

This letter addresses the Federal Reserve's re-proposal of the single-counterparty credit limits ("SCCL") mandated by Section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Re-Proposal").[2] The Re-Proposal impacts Agent Banks as a result of the borrower default indemnification that they provide their lending clients as a part of the Agent Banks' agency securities lending programs. The RMA Committee believes that the Federal Reserve could pursue the regulatory goals underlying the Re-Proposal with less complexity and less opportunity for regulatory arbitrage if the SCCL adopted either the methodologies described in this letter or those that are already in use for the calculation of similar exposures.

The RMA Committee is concerned that the Re-Proposal continues to significantly overstate actual exposures relating to the borrower default indemnification. Under an application of the Re-Proposal as currently drafted, such an overstatement of exposure would cause Agent Banks to curtail significantly transactions with large counterparties and collateral issuers. Such restrictions could severely impair long-established bank securities lending agent activities as well as other activities of many lending clients, while also promoting regulatory arbitrage and impacting securities market liquidity by reducing the volume of securities available for loan.

This letter discusses why the measure for exposure set forth in the Re-Proposal presents significant issues both from a conceptual standpoint and as a practical matter, and provides several concrete alternatives to the proposed measure.

I. Executive Summary

- The Federal Reserve should adopt the Basel Committee on Banking Supervision (the "Basel Committee")'s proposed methodology for measuring exposures from repo-style transactions. We believe that the Basel Committee's proposal (the "Basel Proposal") improves upon the methodology in the Re-Proposal by allowing increased recognition of: (i) correlations between long and short positions and (ii) the risk mitigating benefits of diversification. We also believe that the Basel Proposal would be simple to implement, contrary to what the Federal Reserve suggests. Finally, use of the Basel Proposal would promote global, consistency and should reduce opportunities for cross-product and cross-border arbitrage. In contrast, the approach set forth in the Re-Proposal is fundamentally flawed, conceptually unsound, promotes poor risk management practices, creates significant arbitrage opportunities between physical and synthetic securities lending, negatively impacts market liquidity and may eliminate a low-risk stream of revenue for pensioners, shareholders and retail investors.

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[2] *See* Federal Reserve, *Single-Counterparty Credit Limits for Large Banking Organizations*, 81 Fed. Reg. 14,328 (Mar. 16, 2016).

- The Federal Reserve should allow a more flexible range of approaches for measuring exposures until such time as it decides to adopt the Basel Proposal (or a similar Basel Committee proposal) for the purposes of the Federal Reserve's regulatory capital rules. In particular, the RMA Committee requests that, with respect to "repo-style transactions" subject to bilateral netting agreements, covered companies (including Agent Banks) be permitted to apply any methodology that the covered company is permitted to use under the Federal Reserve's risk-based capital rules or, subject to approval by the Federal Reserve, a methodology used by the covered company for internal risk management purposes.

- The definition of "eligible collateral" should be made consistent with the definition of "financial collateral" under the Federal Reserve's regulatory capital rules. The list of "eligible collateral" set forth in the Re-Proposal is overly narrow, and should be expanded to include gold bullion, private-label mortgage- or asset-backed securities and money market fund shares or other mutual fund shares (for which shares are publicly quoted daily).

II. Background on Agency Securities Lending[3]

Institutions that participate in securities lending transactions support capital markets activities and facilitate trade settlement.[4] By increasing the supply and availability of securities for these and other market activities, securities lending improves global market liquidity. A joint report produced by The International Organization of Securities Commissions concluded that "securities lending is an integral component of nearly all active securities markets," that "[t]he securities-driven market increases the liquidity of securities markets by providing a means for participants to borrow securities on a temporary basis" and that "[t]he growth of securities lending is attributable in large measure to the positive effects securities lending has had on both investment activity and securities settlement arrangements."[5]

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[3] For a more detailed description of the components of indemnified agency securities lending transactions, see Appendix II.

[4] The discussion and analysis in this comment letter focus on the securities lending industry and indemnified agency securities lending in particular. Nonetheless, the analysis contained herein applies generally to all types of repo-style transactions conducted on both a principal and agency basis, including repurchase, reverse repurchase agreements, securities lending and borrowing transactions. Thus, to the extent applicable, references in this comment letter to "securities lending transactions" may be read to include other repo-style transactions; all proposals set forth in this comment letter apply equally to all types of repo-style transactions.

[5] *See, e.g.*, International Organization of Securities Commissions, Securities Lending Transactions: Market Development and Implications 55 (July 1999), *available at* http://www.bis.org/cpmi/publ/d32.pdf.

Agency securities lending services and the related provision of borrower default indemnifications 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] Members of the RMA Committee provide custodial and securities lending services both in and outside of the United States; Agent Banks acting as securities lending intermediaries include many of the largest financial institutions in the world.

As discussed in greater detail in Section III below, the implementation of the Re-Proposal as currently drafted would place significant limitations on U.S. Agent Banks' indemnified agency securities lending programs that are not commensurate with the relatively low-risk profile of these activities. In an informal survey of RMA members involved in the drafting of this letter: (i) many members with the largest securities lending operations have never experienced any losses as a result of borrower-default indemnification and (ii) no members have incurred material losses as a result of the indemnification. These limitations likely would lead many lending clients to withdraw from the U.S. agency lending market and terminate their programs, or move towards synthetic alternatives.

As discussed in Section IV below, 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 securities markets. This potentially could create disruptions in the capital markets at the very time market liquidity is critical to promote continued economic recovery in the global marketplace. It would be reasonable to conclude that the disruptions to liquidity from the absence of securities for loan would be most acutely felt during those times of financial distress that the Re-Proposal is intended to prevent.

III. Specific Concerns and Recommendations

A. Recommendation: The Federal Reserve should adopt the Basel Committee's proposed methodology for measuring exposures from repo-style transactions.

The Re-Proposal would require an Agent Bank to calculate its net credit exposure for securities lending transactions with a counterparty subject to a bilateral netting agreement by using the collateral haircut approach referenced in the Federal Reserve's Regulation Q, pursuant to which the Agent Bank would be required to use standard

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

supervisory haircuts (the "Collateral Haircut Approach").[7] The Re-Proposal would not permit Agent Banks to measure such exposure using any of the other methods available under Regulation Q, including the internal models or simple VaR methodologies.[8]

Question 20 of the Re-Proposal asks whether the Federal Reserve should consider alternative approaches to measuring the net credit exposure from repo-style transactions.[9] The RMA Committee respectfully submits that, particularly for long-proven safe and sound activities like agency securities lending, the Collateral Haircut Approach is overly conservative and grossly overstates the risks attributable to agency securities lending transactions. As noted in Section II above, the RMA members involved in the drafting of this letter, representing a large majority by value of all agency securities lending transactions, have never incurred material losses as a result of their indemnification.

The RMA Committee proposes that the Collateral Haircut Approach therefore be replaced by the methodology proposed by the Basel Committee in its December 2015 consultation on "Revisions to the Standardised Approach for credit risk," as discussed in more detail in Section III.A.2 below.[10] Although the Federal Reserve has suggested that the Basel Proposal would "increase the complexity of the framework" and "potentially make the framework susceptible to arbitrage," the RMA Committee respectfully submits that, to the contrary, the Basel Proposal would be a simple and transparent alternative to the Collateral Haircut Approach that would leave very little room for arbitrage. In fact, adopting the Basel Proposal would promote international consistency and reduce the opportunities for cross-border regulatory arbitrage.

1. The Collateral Haircut Approach is overly conservative and not sufficiently risk sensitive.

The Collateral Haircut Approach relies on a table of supervisory haircuts that vary with a number of factors, including the credit rating of the instrument, the identity of the issuer and the instrument's residual maturity. The table of supervisory haircuts and accompanying formula, however, lack both granularity and risk-sensitivity, in particular,

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7 *See* Proposal § 252.74(b).

8 *See* 12 C.F.R. 217.132(b)(3), (d).

9 *See* Federal Reserve, *Single-Counterparty Credit Limits for Large Banking Organizations*, 81 Fed. Reg. 14,328, 14,338 (Mar. 16, 2016).

10 *See* Basel Committee on Banking Supervision, *Revisions to the Standardised Approach for credit risk* (December 10, 2015), *available at* http://www.bis.org/bcbs/publ/d347.pdf. The RMA Committee would also consider supporting whichever approach the Basel Committee decides to adopt in its final revisions to its Standardised Approach for credit risk.

by failing to take into account the effects of correlation between the securities loaned and collateral posted that are likely to exhibit themselves during times of stress. Instead, the Collateral Haircut Approach focuses solely on the assumed volatility of each component of the exposure in isolation, and implies that the assets on loan are perfectly negatively correlated with the assets taken as collateral, specifically by requiring banking organizations to take a fixed negative haircut on the value of the loan exposure while taking a fixed positive haircut on the value of the collateral.

It would be extremely unrealistic to assume that the price of the security lent would always rise simultaneously with a fall in the price of the collateral during a time of stress, and for each instrument, always by the same fixed percentage. For example, a large systemic shock may cause prices across many asset classes to fall, causing the value of both securities loaned and collateral posted to fall simultaneously. Furthermore, the table of haircuts does not recognize the possibility of a "flight to quality" during times of stress, where certain classes of securities (*e.g.*, equities and corporate bonds lent) would be expected to fall in price while the price of "safe" assets (*e.g.*, U.S. Treasuries collateral) would be expected to rise.

Furthermore, the Collateral Haircut Approach assumes a perfect positive correlation among assets within an Agent Bank's securities loan portfolio and similarly among assets in its collateral portfolio by assuming the same haircut for asset classes regardless of the composition of a portfolio and by assuming that the securities loaned will always increase in price while collateral will always decrease in price. This assumption fails to recognize the risk-mitigating benefits provided by portfolio diversification. In the same way that it would be unreasonable to assume that all securities lent and all collateral posted are perfectly negatively correlated across all asset classes, it would be equally inappropriate to assume that the price of assets on the same side of an exposure would move perfectly in sync with each other. In reality, an Agent Bank that maintains a well-diversified portfolio of loaned securities (or of collateral) is protected against shocks to specific asset classes. By failing to recognize the benefits of such diversification, the Collateral Haircut Approach fails to encourage Agent Banks to pursue a safe-and-sound practice. This overstatement of risk effectively eliminates a large incentive for Agent Banks to enter into qualifying master netting agreements with respect to repo-style transactions.

As an example of the overstatement of exposure risk under an application of the Collateral Haircut Approach, an Agent Bank may lend (1) $100 million of IBM and $100 million of Apple against $204 million in cash collateral to one broker and (2) $100 million of IBM and take $102 million of Apple as collateral with another broker.[11] The Agent Bank has twice as much notional exposure and a great deal more market exposure

[11] We assume, for the purposes of the analysis, that each set of transactions qualify as "repo-style transactions" conducted under a "qualifying master netting agreement." *See, e.g.*, 12 C.F.R. 217.2.

to the first broker. In terms of idiosyncratic risk, the Agent Bank would have similar exposures to both brokers. However, under the Re-Proposal, the Agent Bank must record a larger net credit exposure to the second broker. In particular, the net credit exposure amount to the first broker would be approximately $17.2 million, while the net exposure amount to the second broker would be approximately $19.4 million. More details on the calculations in this example can be found in Appendix I.

This difference is attributable largely to the methodology's assumption of a perfect negative correlation between lent securities and collateral in the second transaction. 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. In particular, an exposure measure based on these assumptions is particularly ill-equipped to deal with a rising interest rate environment in which equity-for-equity loans would be more safely collateralized than loans secured by U.S. Treasury securities.

The result is a gross overstatement of the risk associated with such activity, and would have the effect of inappropriately limiting Agent Banks' ability to lend their lending clients' assets to high-quality, high-volume counterparties under their indemnified agency securities lending programs. Ultimately, as discussed above, this could lead to a reduced securities lending supply, reducing returns to lending clients and more generally restricting liquidity in the market.

2. The Basel Proposal is more risk sensitive, appropriately conservative, simple to implement and fully transparent.[12]

The Basel Proposal addresses both concerns highlighted above in Section III.A.1, that the Collateral Haircut Approach does not allow for appropriate recognition of correlations between securities lent and collateral taken, and that it does not allow for recognition of diversification in loan or collateral portfolios. The Basel Proposal attempts to address the first point by incorporating partial netting of loan and collateral haircut amounts within the exposure calculation. The Basel methodology prevents exposures from being netted down entirely, increasing the credibility of the approach. The Basel Proposal addresses the latter concern by scaling down a portion of the exposure for portfolios with a large number of (diversified) positions. Although the Basel Proposal is not as risk sensitive as the internal models or simple VaR methodologies, the RMA Committee believes that it represents a significant improvement

[12] Regardless of whether the Basel Committee decides to adopt the Basel Proposal, the RMA Committee would support an approach that permitted recognition of correlation between securities lent and collateral posted and that recognized the potential for Agent Banks to reduce their potential exposure at default by diversifying the portfolio of securities loaned or collateral accepted.

over the Collateral Haircut Approach. A mathematical description of the Basel Proposal can be found in Appendix I.

To illustrate the improved risk sensitivity of the Basel Proposal, consider the example in Section III.A.1 above. Under the Basel Proposal, the net credit exposure amount to the borrower to whom the Agent Bank lends $100 million of IBM and $100 million of Apple against $204 million in cash collateral would be approximately $13.5 million whereas the net credit exposure to the borrower to whom the Agent Bank lends $100 million of IBM against $102 million of Apple would be approximately $7.2 million. The Agent Bank's credit exposure to the second broker therefore would be lower than its exposure to the first broker, consistent with the economic reality of the transaction. Note that this difference is attributable to the fact that the Basel Proposal permits the partial netting of haircut amounts and recognizes the diversity of positions within a netting set. More details on the calculations in this example can be found in Appendix I.

In light of the foregoing, the RMA Committee disagrees that the Basel Proposal would "increase the complexity of the framework" and "potentially make the framework susceptible to arbitrage." Fundamentally, the Basel Proposal represents a simple modification to one component of the Collateral Haircut Approach. As modified, the exposure methodology would remain an extremely straightforward computation, based largely on currently available data and supervisory inputs supplied by the Federal Reserve, and would resemble the "current exposure methodology" (the "CEM") currently implemented to measure derivatives exposures under the Federal Reserve's Regulation Q.[13] It is important to highlight that the Basel Proposal would not require any additional data from either Agent Banks or the regulators to implement; it would leverage data that is already used in the Collateral Haircut Approach (except data on the number of exposures in a netting set, which Agent Banks collect as a part of their internal risk management). Given the strong similarity, the RMA Committee submits that the Basel Proposal would not be any more difficult to implement than the CEM.

By virtue of the Basel Proposal's simplicity and the transparency of its inputs, it is difficult to see how this framework would be susceptible to arbitrage to a greater extent than the Collateral Haircut Approach, as the Re-Proposal suggests. In contrast, allowing disparate capital treatment between traditional, physical securities lending and its synthetic equivalents could in fact motivate banks to find opportunities for arbitrage through alternative structures. In particular, the Re-Proposal appears to incentivize Agent Banks and borrowers to move the securities lending market to synthetic equivalents. Although the vast majority of securities lending transactions involve the physical delivery of securities, the RMA Committee notes that, in recent years, brokers have increased their

[13] *See, e.g.*, 12 C.F.R. 217.34(a).

offerings of economically equivalent synthetic alternatives to traditional, physical securities lending.[14]

B. Recommendation: The Federal Reserve should allow a more flexible range of approaches for measuring exposures until such time as it decides to adopt the Basel Proposal (or a similar Basel Committee proposal) for the purposes of the Federal Reserve's regulatory capital rules.

As discussed above in Section III.A, the Re-Proposal would require Agent Banks to use the Collateral Haircut Approach to measure their credit exposure for agency securities lending transactions. In contrast, the Re-Proposal would permit covered companies to measure their exposures from derivatives subject to qualifying master netting agreements using any methodology that the covered company is permitted to use under the Federal Reserve's risk-based capital rules. In other words, if a covered company were permitted to use the internal models methodology to calculate its exposure to derivatives under Regulation Q, it would be able to use the internal models methodology to calculate its credit exposure under the Re-Proposal.

The RMA Committee requests that, until the Federal Reserve decides whether to adopt the Basel Proposal (or whichever methodology the Basel Committee adopts in its final framework) for the purposes of its regulatory capital rules, that covered companies (including Agent Banks) be permitted to use a range of approaches similar to the approach that the Federal Reserve has proposed for calculating gross credit exposures for derivatives.

In particular, the RMA Committee requests that, with respect to "repo-style transactions" subject to bilateral netting agreements, covered companies (including Agent Banks) be permitted to apply any methodology that the covered company is permitted to use under the Federal Reserve's risk-based capital rules or, subject to approval by the Federal Reserve, a methodology used by the covered company for internal risk management purposes.[15] Allowing for a range of approaches would bring the measurement of exposures for repo-style transactions in line with the methodology for derivatives and thereby discourage regulatory arbitrage.[16]

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[14] For example, many brokers now offer synthetic products that are economically equivalent to traditional, physical securities lending using derivatives, such as total return swaps or contracts for difference.

[15] Allowing covered companies to apply any method that the covered company employs for risk management purposes, with Federal Reserve approval, would help prevent disparate capital treatment of the same transactions conducted at differently sized banks.

[16] Aligning the approaches also would discourage arbitrage by ensuring that cash transactions and their synthetic equivalents are subject to similar credit limits.

C. Recommendation: The definition of "eligible collateral" should be made consistent with the definition of "financial collateral" under the Federal Reserve's regulatory capital rules.

As discussed above, the Re-Proposal would only permit covered companies to recognize the risk mitigating benefits of "eligible collateral," defined to include cash on deposit with the covered company (including cash held for the covered company by a third-party custodian or trustee), investment grade debt (other than mortgage- or asset-backed securities and resecuritization securities, unless issued by a U.S. government-sponsored enterprise) that are bank-eligible investments, publicly traded equities and publicly traded convertible bonds.[17]

Notably, the range of permissible collateral under the Re-Proposal would be significantly narrower than what constitutes "financial collateral" under the Federal Reserve's capital rules. In particular, the Re-Proposal would not permit gold bullion, private-label mortgage- or asset-backed securities, money market fund shares or other mutual fund shares (for which shares are publicly quoted daily) to serve as "eligible collateral," even though each such instrument could qualify as "financial collateral" for the purposes of the Federal Reserve's Regulation Q.

Question 21 of the Re-Proposal asks whether the list of "eligible collateral" should be broadened or narrowed.[18] We urge the Federal Reserve to broaden the list to align the definition of "eligible collateral" for the purposes of the single-counterparty credit limits with the definition of "financial collateral" under the Federal Reserve's Regulation Q. We see merit in aligning the exposure measure under the Re-Proposal with the corresponding exposure measure under its regulatory capital rules, and would urge the Federal Reserve to adopt those measures wholesale, rather than piecemeal. Aligning the two definitions would achieve consistency and harmony with the capital rules, and would prevent the same transaction from being measured in different ways for the purposes of rules that both deal with credit exposures.

IV. Impact of Excessively Limiting Agency Securities Lending

As discussed below, implementation of the single-counterparty concentration limits under the Re-Proposal as currently drafted has the potential to materially impact not only Agent Banks, but also their lending clients and the financial markets at large.

1. Impact on Agent Banks and lending clients.

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17 *See* Proposal § 252.71(k), 252.74(b)(2).

18 *See* Federal Reserve, *Single-Counterparty Credit Limits for Large Banking Organizations*, 81 Fed. Reg. 14,328, 14,339 (Mar. 16, 2016).

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 borrower default indemnification, U.S. Agent Banks would be put at a significant competitive disadvantage against both non-bank entities and non-U.S. institutions, which are not subject to such restrictions, creating opportunity for regulatory arbitrage. A decline in the securities lending business at the largest U.S. custody banks also 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 (including non-U.S. Agent Banks and foreign non-bank entities) once they no longer receive indemnified agency securities lending services at their U.S. Agent Bank. The disadvantage would be particularly severe with respect to the growing use of securities as collateral.

As noted above, the provision by Agent Banks of borrower default indemnifications is a longstanding industry practice, expected by lending clients as part of Agent Banks' securities lending services. To the majority of lending clients, the borrower default indemnification both provides protection to their programs and validates the strength of their Agent Banks' risk management systems. Receipt of borrower default indemnifications is especially important to many lending clients (particularly mutual funds, foreign central banks, government plans and ERISA plans) given institutional preference to limit portfolio risk from these activities.

As a result, if U.S. Agent Banks cease providing borrower default indemnifications, 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")[19] 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.[20] In addition, the Securities and Markets

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19 *See* Prohibited Transaction Exemption (PTE) 2006-16, Class Exemption To Permit Certain Loans of Securities by Employee Benefit Plans, 71 Fed. Reg. 63,786 (Oct. 31, 2006), 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.

20 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

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 ("ETFs") and other UCITS (Undertaking for Collective Investment in Transferable Securities) funds that loan securities.[21] More generally, in the experience of RMA Committee 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 Re-Proposal remove their borrower default indemnification programs. The loss in revenues associated with a continuing decline in securities lending would further reduce returns to government plans and other lending clients, which on average reap 80% to 85% of the revenues of agency securities lending transactions.

2. Impact on the financial markets.

If a large number of lending clients decided to leave the market, the amount of securities available in the markets for trade settlement and other vital financial market activities would fall drastically. A number of academic studies have shown that reduced lending supply could reduce liquidity in the broader market.[22] The decline could also

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against loss resulting from borrower default." *See also, e.g.,* New York State Teachers' Retirement System Investment Policy Manual (Oct. 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 (Dec. 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 "[a]t 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."

21 *See* ESMA, 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.

22 *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

result in reduced availability of high-quality liquid assets to meet new swaps collateral and other regulatory mandates, and a shift of the securities lending business to non-banks which may fall outside the reach of the bank prudential and supervisory framework.

On the borrower side, if the Re-Proposal limits 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 (and whose default would arguably pose the greatest risk to financial stability) 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.

V. Conclusion

In conclusion, we encourage the Federal Reserve to take the time to consider these issues fully, and we strongly encourage the Federal Reserve to adopt the proposals set forth in this letter. The RMA Committee is aware of remarks by U.S. regulators regarding the perceived systemic risks presented by securities financing transactions, particularly with respect to the perceived volatility of securities financing activities as a short-term funding market vulnerable to "runs."[23] We strongly disagree with the suggestion that properly conducted and structured agency securities lending transactions present heightened risks to financial stability; to the contrary, agency securities lending transactions are recognized as well-established, safe and sound activities that rarely produce significant losses to entities involved in the program and are unlikely to lead to systemic concerns. As stated above, there have been no material losses among the major Agent Banks as a result of indemnification, including the environment immediately following the default of Lehman Brothers. Nonetheless, if regulators wish to affirmatively address any perceived macroeconomic concerns, such concerns could be more than adequately addressed by the Basel Proposal, which appropriately calibrates credit exposures, is consistent with bank systems that are regularly examined and audited,

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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).

[23] *See, e.g.*, Daniel K. Tarullo, Governor, Fed. Reserve Sys., Remarks at the Peterson Institute for International Economics: Evaluating Progress in Regulatory Reforms to Promote Financial Stability (May 3, 2013); Janet L. Yellen, Vice Chair, Fed. Reserve Sys., Regulatory Landscapes – a US Perspective, Speech at the International Monetary Conference (June 2, 2013).

and also services the larger objective of consistency between similar regulatory frameworks.

If desired by the Federal Reserve, the RMA Committee would be pleased to assist the Federal Reserve in the development of any of the recommendations discussed in this letter or in any other manner as the Federal Reserve undertakes to implement the statute appropriately and effectively.

Sincerely,

Fran Garritt

Director
Securities Lending & Market Risk
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Jason P. Strofs

Chairman
Committee on Securities Lending
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Appendix I

Comparison of Basel Proposal and Collateral Haircut Approach

Mathematical Description

The Basel Proposal improves the risk sensitivity of the Collateral Haircut Approach by modifying the formula used to incorporate haircuts into the measure of exposure. Under the Collateral Haircut Approach, this term is expressed as $\sum_s(E_s \cdot H_s)$, where E_s represents the absolute value of the net position in a given instrument (or in gold) and H_s represents the haircut applicable to that instrument (or gold). The Basel Proposal would replace this with the following formula: $EAD = 0.4 \cdot net\ exposure + 0.6 \cdot gross\ exposure/\sqrt{N}$, where $gross\ exposure = \sum_s(E_s \cdot |H_s|)$ and $net\ exposure = |\sum_s(E_s \cdot H_s)|$. In this formula, E_s is the net current value of each instrument in the netting set (always a positive value), and H_s is the haircut appropriate to E_s as described in the table of haircuts under the Collateral Haircut Approach (which could be negative). N is the number of different instruments contained in the netting set, except that issuances where the value of E_s is less than one tenth the value of the largest E_s in the netting set are not included in the count.

Scenarios for Comparison

Transaction 1

Agent Bank lends $100 million of IBM and $100 million of Apple against $204 million in cash collateral to one broker.

Transaction 2

Agent Bank lends $100 million of IBM and takes $102 million of Apple as collateral with another broker.

Collateral Haircut Approach Calculations

Dollars Expressed in Millions

$EAD = \sum E - \sum C + \sum_s(E_s \cdot H_s)$[24]

Transaction 1

$\sum E$ = $200 (total value of securities on loan)
$\sum C$ = $204 (total value of collateral)

[24] We assume that all amounts are in U.S. dollars such that there is no foreign exchange haircut.

E_{IBM} = \$100 (absolute value of the IBM position)
H_{IBM} = 10.6% (haircut on IBM stock)[25]
E_{Apple} = \$100 (absolute value of the Apple position)
H_{Apple} = 10.6% (haircut on Apple stock)
E_{Cash} = \$204 (absolute value of the cash position)
H_{Cash} = 0% (haircut on cash)

$\sum_s(E_s \cdot H_s) = E_{IBM} \cdot H_{IBM} + E_{Apple} \cdot H_{Apple} + E_{Cash} \cdot H_{Cash}$ = \$100×0.106 + \$100×0.106 + \$204×0 = \$21.2

EAD = \$200 – \$204 + \$21.2 = **\$17.2**

Transaction 2

$\sum E$ = \$100 (total value of securities on loan)
$\sum C$ = \$102 (total value of collateral)
E_{IBM} = \$100 (absolute value of the IBM position)
H_{IBM} = 10.6% (haircut on IBM stock)
E_{Apple} = \$100 (absolute value of the Apple position)
H_{Apple} = 10.6% (haircut on Apple stock)

$EAD = \sum_s(E_s \cdot H_s) = E_{IBM} \cdot H_{IBM} + E_{Apple} \cdot H_{Apple}$ = \$100×0.106 + \$102×0.106 = \$21.412

EAD = \$100 – \$102 + \$21.412 ≈ **\$19.4**

Basel Proposal Calculations
Dollars Expressed in Millions

$$EAD = \sum E - \sum C + 0.4 \cdot net\ exposure + 0.6 \cdot gross\ exposure/\sqrt{N}$$

or more precisely

$$EAD = \sum E - \sum C + 0.4 \cdot |\sum_s(E_s \cdot H_s)| + 0.6 \cdot \sum_s(E_s \cdot |H_s|)\ /\sqrt{N}$$

[25] The 15% standard supervisory haircut for main index equities is multiplied by $1/\sqrt{2}$ to reflect a shorter holding period of 5 business days for "repo-style transactions." The amount is rounded to the nearest tenth of a percent for ease of presentation.

Transaction 1

$\sum E = \$200$	(total value of securities on loan)
$\sum C = \$204$	(total value of collateral)
$E_{\text{IBM}} = \$100$	(absolute value of the IBM position)
$H_{\text{IBM}} = 10.6\%$	(haircut on IBM stock)
$E_{\text{Apple}} = \$100$	(absolute value of the Apple position)
$H_{\text{Apple}} = 10.6\%$	(haircut on Apple stock)
$E_{\text{Cash}} = \$204$	(absolute value of the cash position)
$H_{\text{Cash}} = 0\%$	(haircut on cash)
$N = 2$	(number of different instruments in the netting set)[26]

$$net\ exposure = \left|\sum_s (E_s \cdot H_s)\right| = \left|E_{\text{IBM}} \cdot H_{\text{IBM}} + E_{\text{Apple}} \cdot H_{\text{Apple}} + E_{\text{Cash}} \cdot H_{\text{Cash}}\right| = |\$100\times0.106 + \$100\times0.106 + \$204\times0| = \$21.2$$

$$gross\ exposure = \sum_s (E_s \cdot |H_s|) = E_{\text{IBM}} \cdot |H_{\text{IBM}}| + E_{\text{Apple}} \cdot |H_{\text{Apple}}| + E_{\text{Cash}} \cdot |H_{\text{Cash}}| = \$100\times|0.106| + \$100\times|0.106| + \$204\times|0| = \$21.2$$

$$EAD = \$200 - \$204 + 0.4\times\$21.2 + 0.6\times\$21.2/\sqrt{2} \approx \mathbf{\$13.5}$$

Transaction 2

$\sum E = \$100$	(total value of securities on loan)
$\sum C = \$102$	(total value of collateral)
$E_{\text{IBM}} = \$100$	(absolute value of the IBM position)
$H_{\text{IBM}} = 10.6\%$	(haircut on IBM stock)
$E_{\text{Apple}} = \$100$	(absolute value of the Apple position)
$H_{\text{Apple}} = -10.6\%$	(haircut on Apple stock)
$N = 2$	(number of different instruments in the netting set)

$$net\ exposure = \left|\sum_s (E_s \cdot H_s)\right| = \left|E_{\text{IBM}} \cdot H_{\text{IBM}} + E_{\text{Apple}} \cdot H_{\text{Apple}}\right| = |\$100\times0.106 + \$102\times-0.106| = \$0.212$$

$$gross\ exposure = \sum_s (E_s \cdot |H_s|) = E_{\text{IBM}} \cdot |H_{\text{IBM}}| + E_{\text{Apple}} \cdot |H_{\text{Apple}}| + E_{\text{Cash}} \cdot |H_{\text{Cash}}| = \$100\times|0.106| + \$102\times|-0.106| = \$21.412$$

$$EAD = \$100 - \$102 + 0.4\times\$0.212 + 0.6\times\$21.412/\sqrt{2} \approx \mathbf{\$7.2}$$

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[26] We assume that cash is not a "security issue" for the purposes of N, such that N = 2 for both netting sets.

Appendix II

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."

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

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 data from the first quarter of 2016, cash collateral is applied against approximately $637 billion of securities, representing approximately 58%

of global loaned securities. In the market for U.S. securities, currently cash is taken as collateral for more than 67% of securities loans, although this percentage likely will continue to decrease in the coming years due to other regulatory changes.[27]

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. Common reinvestment options include overnight repurchase agreements, money market funds or other similar liquid short-term instruments.

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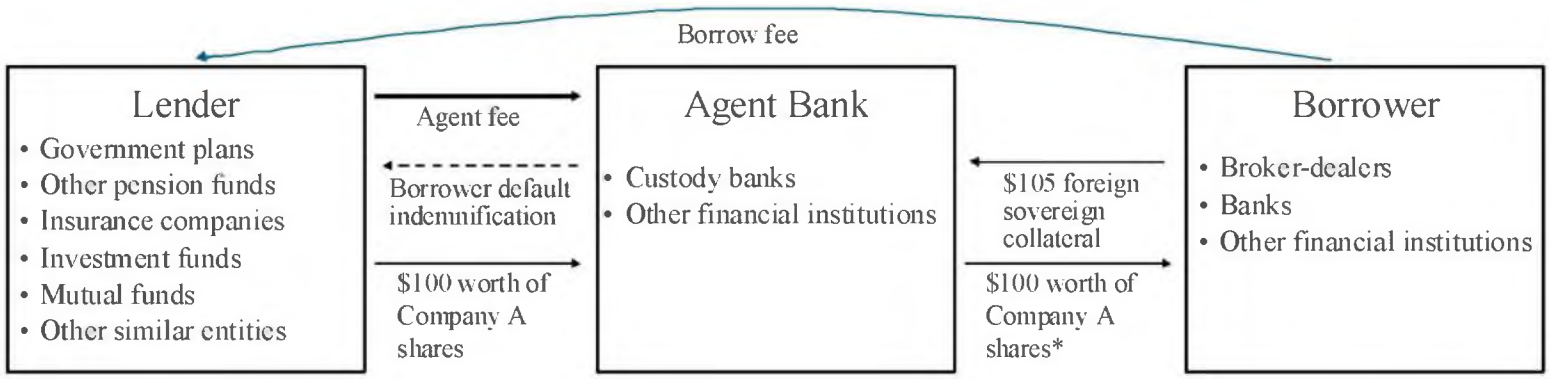
[27] Data is based on a securities lending industry composite compiled by the RMA.

Exhibit II-A
Typical Securities Loan Structure
(Fixed Income Collateral)

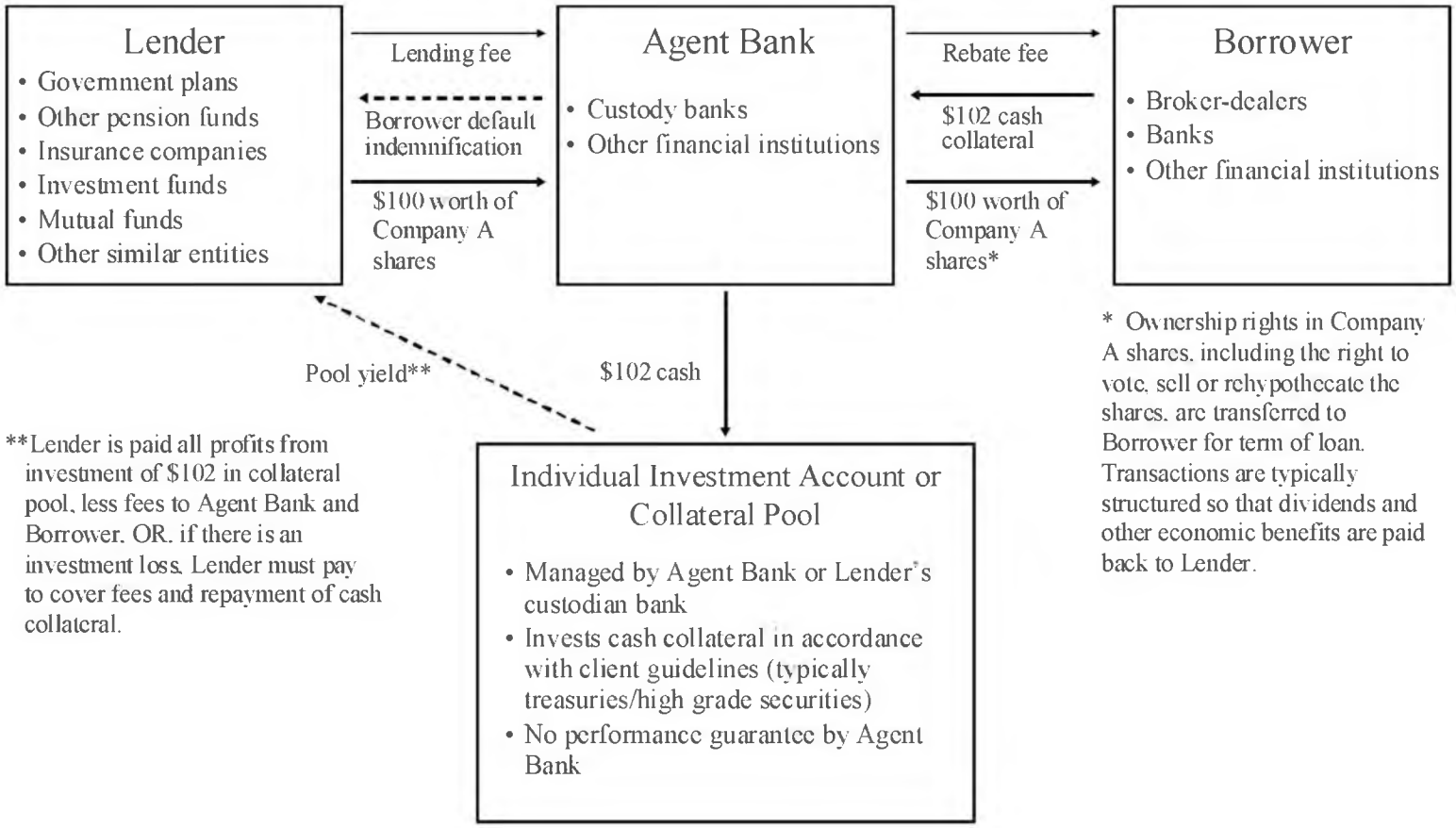


* Ownership rights in Company A shares, including the right to vote, sell or rehypothecate the shares, are transferred to Borrower for term of loan. Transactions are typically structured so that dividends and other economic benefits are paid back to Lender.

Exhibit II-B

Typical Securities Loan Structure

(Cash Collateral)



**Lender is paid all profits from investment of $102 in collateral pool, less fees to Agent Bank and Borrower. OR, if there is an investment loss, Lender must pay to cover fees and repayment of cash collateral.

* 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.

Appendix III

Overview of Borrower Default Indemnification

As described in more detail in Appendix II, agency securities lending transactions result in counterparty credit exposure for Agent Banks due to the borrower default indemnifications provided in connection with these transactions. As a matter of standard market practice, Agent Banks provide borrower default indemnifications, or indemnification for borrower default, to their lending clients pursuant to their securities lending authorization agreements. The vast majority of lending clients (both domestic and non-U.S.) focus on risk avoidance, and see the borrower default indemnification as providing both protection to their 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 borrower default indemnifications from their lending agents.[28] Currently, RMA Committee member Agent Banks provide indemnification to the vast majority of their clients, both domestic and offshore, whether or not the Agent Banks act as custodians.

The amount at risk to an Agent Bank under a borrower default indemnification is only the difference, if any, between the most recent mark-to-market amount of the collateral posted and the repurchase price of the securities that the borrower failed to return (further reduced by any excess margin of collateral maintained). Borrower default indemnifications 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 borrower default indemnifications 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 Agent 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 borrower default indemnification 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.

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[28] *See* footnote 17 and accompanying text.

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.[29] 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.[30] If the FDIC determines to transfer the securities borrowing agreement to a "bridge financial company," that company will assume the borrower's obligations under the QFC.[31] Through discussions with the Federal Reserve throughout the rulemaking process, the RMA Committee 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 event 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 borrower default indemnification. 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 borrower default indemnifications 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), 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 borrower default indemnification is not increased when the cash collateral is reinvested. Moreover, borrower default indemnification 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

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

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

31 Dodd-Frank Act § 210(c)(9).

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.