

CONTENTS

Executive Summary	1
Managing Major Financial Defaults	3
Dodd-Frank, Rules and Amendments	4
European Crisis Management	8
The Financial Stability Board	9
Certainty and Liquidity in Securities Lending	11

Securities Lending, Crisis Management and the Orderly Liquidation Authority

In the aftermath of the financial crisis, regulators are working to prevent another financial disaster similar to Bear Stearns or Lehman Brothers. In the US and Europe, one answer has been to begin to create orderly unwind processes that allow both regulators and the markets to understand what will happen in the event a major institution is near default. International organizations are looking at cross-border resolution capabilities given the interconnectedness of the global financial system. This report evaluates recent government efforts and their potential impacts on beneficial owners in the securities lending market.

Executive Summary

- Dodd-Frank’s Orderly Liquidation Authority sets forth a new set of rules for how securities lending transactions will be dealt with in the event of a default of a major financial institution, most likely a large Systemically Important Financial Institution (SIFI). These changes may provide some improvements but a number of uncertainties remain.
- European authorities are moving forward with their versions of crisis management, although their resolutions to date remain largely principal-based instead of presenting the concrete steps that regulators would take to wind down a bankrupt firm. While Europe is moving in the right direction, regulators looking for a unified solution may be overtaken by member-states who act according to their own dictates.
- The Financial Stability Board has emerged as an important international body in setting economic and financial policy. Several recent white papers from this organization focus on cross-border cooperation in the event of a financial failure. Recommendations from the Financial Stability Board are likely to be adopted by many G20 and emerging economies.
- Current efforts towards creating more stable liquidation or resolution regimes are ongoing and represent changes for the securities lending industry. While much regulation stills need to be written, the potential for improvement and increased clarity has been highlighted by the ongoing administration of Lehman Brothers Holdings.

Managing Major Financial Defaults

Financial history is strewn with the demise of major firms at inopportune times. The most recent of these disasters was the forced sale of Bear Stearns and the subsequent collapse of Lehman Brothers during the credit crisis of 2008; these events were by far among the most significant financial failures of the last 25 years. In Bear Stearns' case, its purchase by JP Morgan allowed all outstanding Bear Stearns contracts to continue without default or need for renegotiation. For Lehman however, claims and litigation continue into 2012 as shareholders and creditors work to retrieve some fraction of what they owned or were owed.

Regulators in both the US and Europe recognize that the current process for liquidations of major financial institutions has been flawed. In the US, the response has been to expand the powers of the Federal Deposit Insurance Corporation (FDIC) beyond banks, allowing it to manage the failure of a wider array of SIFIs in times of crisis. Authorities in Europe are in the process of establishing a European Union-wide crisis management directive that provides authorization to member-states to liquidate a failing financial entity in a controlled manner, although their task is complicated by the multiple regulatory regimes and agencies operating in each member-state.

The US, UK, France, Germany and other G20 member countries support the work of the Financial Stability Board (FSB), which seeks to coordinate globally how regulators would manage the collapse of an important financial institution, and how difficult issues like the hierarchy of creditor claims would be managed across national regulatory regimes. While the FSB may be seen as duplicating some of the provisions of Dodd-Frank and European regulators, it is setting an international framework that other countries can follow.

A cornerstone of the US, EU and FSB proposals is defining institutions whose failure could destabilize or damage the global economy. These institutions must create a living will that can be executed as needed through government intervention. Using an orderly unwind process, government authorities can salvage what institutional value remains of a failing or bankrupt organization and ensure that shareholders rather than taxpayers carry any losses. As institutions begin to write their living wills and regulators develop multi-lateral liquidation procedures, their combined efforts are intended to add more stability and rational expectations to what has hitherto been the highly disruptive event of a major financial failure.

Securities lending will be impacted by these new resolution authorities. While the extent of the changes are still not fully clear, some may represent an improvement over the existing process. Recent settlements on securities lending transactions for Lehman Brothers, four years after the firm's failure, illustrate the potential benefits of a well-defined resolution regime. For beneficial owners, new regulations will serve to reduce fears of counterparty defaults arising from bankruptcy and give more comfort to the overall stability of the financial system.

Dodd-Frank, Rules and Amendments

As part of the largest restructuring of the financial services industry in the last 70 years, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) has created a new Orderly Liquidation Authority (OLA). This is one of the major initiatives of the Act and signals a new willingness for the government to pre-emptively intervene in the financial services sector. Its impacts will be far ranging. Since Dodd-Frank's passage in July 2010, OLA has been a central subject of conversation as the FDIC works to implement its requirements and industry participants both contribute to the conversation and look to understand how OLA will affect themselves and their counterparties.

OLA is designed to facilitate the liquidation or sale of "failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard."¹ This is the US government's way of avoiding another AIG, Bear Stearns or Lehman Brothers, where the government is either forced to intervene or let a major firm fail resulting in uncertain or chaotic market conditions.

Dodd-Frank gives new authority to the FDIC to take over a failing financial company. This authority mirrors the power the FDIC has to act with failing banks, but expands the agency's remit to encompass a much broader array of financial entities including derivatives clearing firms and central credit counterparties. The FDIC can also recommend to state insurance regulators that these agencies wind down insurance companies under their regulatory jurisdiction. In order for OLA to apply and for the FDIC to become the receiver of a failing financial company, the Secretary of the Treasury and certain federal regulatory authorities must make a systemic risk determination and approve the use of the authority.

OLA has specific requirements and must function by specified rules; many of which are still to be refined by the FDIC regulation process. To start, OLA applies to certain financial companies incorporated or organized under US federal or state law for which a systemic risk determination has been made. This will most likely include the larger SIFIs, although in an emergency a financial company can be brought under OLA even though it was not previously considered systemically important. Broker-dealer subsidiaries of banking organizations may also be covered. However, for any broker-dealer that is a member of the Securities Investor Protection Corporation (SIPC) and is registered with the Securities and Exchange Commission, the FDIC must appoint SIPC as trustee. That broker-dealer will be liquidated under the provisions of the Securities Investor Protection Act (SIPA) with one important exception. All qualified financial contracts to which the broker-dealer is a party are removed from the SIPA proceeding and are dealt with by the FDIC under the provisions of OLA. Securities lending and repurchase contracts along with most other counterparty based instruments are considered qualified financial contracts and, as a result, would be subject to the provisions of OLA. Insurance companies and insured depository institutions are subject to their state or federal regulators. However, a holding company with insurance company subsidiaries could fall under OLA.

While the Bankruptcy Code is still preferred to OLA for winding down a non-bank financial institution, if other options present greater systematic risks, the FDIC is now permitted to prepare for and manage a controlled wind-down of a failing institution using the following steps:

1. Dodd-Frank Act, Section 204(a).

- i. Conduct advance resolution planning for SIFIs based on their living wills. The FDIC recognizes the signal that this planning might send to the market and, to avoid the appearance of targeting one or more firms for takeover, intends to have an ongoing presence in many of the large SIFIs.
- ii. Be an immediate source of liquidity for an orderly liquidation, which allows continuation of essential functions and maintains asset values. It is expected that the FDIC will initially rely on government funding, subject to certain limitations based on the value of the entity's assets, to meet liquidity demands but will be the first creditor for an expected sale of all or part of the failed institution.²
- iii. Make advance dividends and prompt distributions to creditors based upon expected recoveries. Creditors and shareholders will not need to wait for their money back in order of priority.
- iv. Continue key, systemically important operations, including through the formation of one or more bridge financial companies. This ensures that obligations under contracts transferred to bridge entities will continue to be met in the normal course of business.
- v. Transfer qualified financial contracts as defined by Dodd-Frank with a given counterparty to another entity (such as a bridge financial company) and avoid their immediate termination and liquidation to preserve value and promote stability.³ A one business day stay will be imposed on termination and netting rights under qualified financial contracts while the FDIC determines which contracts to transfer. The FDIC also has the authority to repudiate certain contracts or leave them in the failing entity.
- vi. Under Dodd-Frank, the government is not required to wait until an institution has failed to appoint the FDIC to take over a financial company. The FDIC's mandate is to insure "the ability to continue key operations, services, and transactions that will maximize the value of the firm's assets and operations and avoid a disorderly collapse in the marketplace."⁴ If the FDIC and the Federal Reserve Board determine that failure on some or more obligations or critical market functions is imminent, they can request the Secretary of the Treasury to appoint the FDIC as receiver. Institutions are allowed a one-time appeal of this decision, although it is expected that in the extreme case of an AIG or Lehman Brothers collapse that such appeals would not be granted. It is thought that due to the preference of using the Bankruptcy Code, the Secretary of the Treasury will be very conservative in making the decision that OLA should be utilized.

While all covered financial companies are potentially subject to OLA, as a practical matter, it is likely that only the largest SIFIs would be administered under this new resolution authority. The final decisions on which non-bank institutions to designate as SIFIs are still pending.

2. Dodd-Frank section 204(d) allows the FDIC to borrow from the Department of the Treasury to maintain the operations and liquidity of a new bridge company. By law however, the Treasury must be repaid this money through either the proceeds of asset sales or an assessment on the financial services industry.

3. The FDIC's responsibilities are summarized in The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act, FDIC. Available at http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf.

4. The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act, FDIC. Available at http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf.

The Financial Stability Board has released a list of 29 global banks, including eight US-based banks, which are systemically important and required to maintain additional capital buffers. It is also expected that certain asset managers, the largest insurance companies, certain clearing firms and selected other companies or subsidiaries with important financial services arms may be designated as SIFIs, requiring them to write living wills and be evaluated by their regulators.

As mentioned above, securities lending transactions are included in the definition of a qualified financial contract. Dodd-Frank defines a qualified financial contract as “any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement.”⁵ Qualified financial contracts are subject to OLA whether they are part of a bank holding company or a broker-dealer. Conversations about OLA to date have included the idea that viable qualified financial contracts would be transferred to the federally funded “bridge” entity and continued without interruption. These contracts would be maintained by the bridge entity until they could be unwound in an orderly manner or transferred to a third-party purchaser.

Given the FDIC’s mandate to minimize taxpayer losses, whether a securities lending contract is transferred to the bridge company could be in large part dependent on the level of collateralization. All qualified financial contracts for a single counterparty will either be transferred to the bridge company or remain in the insolvent entity. Overcollateralized securities loans would most likely be transferred to the bridge entity unless the counterparty had certain other contracts that were problematic. However, in the event that a counterparty’s loan transactions were undercollateralized by an unknown but sufficient amount, this transaction could cause the FDIC to decide not to transfer the qualified financial contracts for that counterparty to the bridge entity. The industry continues to have discussions with the FDIC in order to get more clarity around exactly how decisions to transfer qualified financial contracts will be made. Although there have historically been few losses in securities lending owing to counterparty defaults, the potential to have some assurance that valid and properly collateralized securities loans would be transferred to a bridge company would lend stability to both the markets and lending operations.

Although loan obligations may be protected in the long run, OLA imposes a one business day stay on the exercise of termination or netting rights under qualified financial contracts that arise solely as a result of the financial condition of the company or the fact that the FDIC has been appointed as a receiver. The FDIC expects that most OLA takeovers would occur on a Friday, giving the weekend to sort out the disposition of assets and allow for business as usual by 5pm (EST) on the following Monday. Whether terminations for other reasons such as a technical default resulting from a failure to meet a margin call would be permissible during the stay period remains unclear and is the subject of discussions between industry groups and the FDIC. While the period of the stay is small, it is still important and must be evaluated in the course of conducting actual and potential loans with counterparties.

5. Dodd-Frank Act, Section 210(c)(8)(D)(i).

The new OLA stay marks a change from how securities loans are dealt with in the bankruptcy of a broker-dealer that is a member of SIPC. In a SIPA proceeding, loans collateralized by cash are not subject to a stay. For loans collateralized by securities collateral, the OLA stay is likely an improvement over SIPA rules that could impose stays on terminations of five days or, in the case of Lehman Brothers, significantly longer. At the same time, new questions are raised whether all securities lending counterparties would be grouped by holding company or whether each subsidiary would be considered a separate legal entity. When evaluating solvent transactions on a counterparty basis, regulators may assess securities loans by each underlying lender as opposed to the agent who made the loan.

In spite of the unknowns, OLA appears to be an area of Dodd-Frank that offers some benefits to financial markets including securities lending. While exact details remain to be seen, the following are now clear:

- Securities loans are considered qualified financial contracts regardless of collateral type along with defined rights for holders of those contracts.
- There is a reasonable probability that overcollateralized qualified financial contracts would be transferred to a solvent bridge company.
- The orderly unwind process of OLA provides some assurance to the financial markets that securities lending contracts will be maintained with a government established bridge company or another creditworthy counterparty.
- The one day stay applies to all loans regardless of collateral and is an improvement over current SIPA proceedings for loans collateralized by securities.

The FDIC rulemaking process with respect to OLA continues and there are a significant amount of regulations still to be written. Those regulations will need to be evaluated as they are produced in order to determine the full impact of the OLA provisions. In addition, how those regulations are implemented by the FDIC will also have an impact. Still, the significant power granted to the FDIC under OLA and the fact that this will be an administrative rather than a judicial process places a premium on obtaining answers that are favorable to securities lending.

European Crisis Management

Regulators in Europe continue to work out the possible details of their own version of the Orderly Liquidation Authority, driven by the European Commission's DG Internal Markets and Services, Financial Stability Unit. The general objective of the European plan is almost identical to the US outlook: avoid a highly disruptive default in the financial sector by ensuring an orderly resolution of an institution's affairs assisted by government intervention. The EU goes further than the US in positing seven principals for crisis management resolution:⁶

1. Put prevention and preparation first
2. Provide credible resolution tools
3. Enable fast and decisive action
4. Reduce moral hazard
5. Contribute to a smooth resolution of cross-border groups
6. Ensure legal certainty
7. Limit distortions of competition

Like the US, the EU believes that shareholders, not taxpayers, should bear the burden of resolving a failed financial institution. This appears to be a generally accepted principal of orderly liquidation plans worldwide with special levies or taxes envisioned on the financial sector specifically to manage potential failures. The latest EU release on crisis management, a consultation paper on the technical details of orderly defaults, moves in this direction.⁷

However, for details on how these principals get translated into action, such as the US Secretary of the Treasury officially granting liquidation authority to the FDIC, each EU member-state would either need to provide its own plans or the European Commission would need to move from generalities to more specifics. The UK, Ireland, Netherlands and Denmark have already drafted their own recommendations for managing crises, although these are not yet at the point where they could be immediately translated into an expected action, and still leaves 23 countries to go. As one example, the UK's Independent Commission on Banking produced a recommendation in September 2011 for crisis management, however, the recommendations were still largely principal-based rather than oriented towards actions. Translating well-meaning principals into concrete action steps is the next challenge for European regulators.

An additional difficulty for European regulators is establishing crisis management resolution rules in the middle of a current financial crisis. While the latest pan-European consultation document was issued in January 2011, more recent threats to European finances have forced ad-hoc actions by national regulators that may ultimately affect the final outcome of European crisis management in the financial sector.

6. *Communication on a new framework for crisis management in the financial sector, European Commission, October 2010. Available at http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf.*

7. *Consultation on technical details of a possible European crisis management framework, European Commission, January 2011. Available at http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.*

The Financial Stability Board

Since 1999, the Financial Stability Board and its predecessor the Financial Stability Forum has been a key organizing body among G20 countries for promoting financial and economic policy. In November 2010, the FSB entered the conversation on orderly liquidations with the release of its white paper on reducing the moral hazard of SIFIs.⁸ This report was followed in July 2011 and October 2011 by the FSB's recommendations for resolving globally systematically important financial institutions.⁹ Most recently on November 4, 2011, the FSB released their list of global SIFIs.¹⁰

The importance of the Financial Stability Board is that much like its sister organization, the Basel Committee on Banking Supervision, it sets model recommendations for countries around the world to follow. As a country-neutral organization, national regulators can support its recommendations without being seen as copying one country or another. As a result, it is important to carefully watch the international standards that the FSB is promoting as they are likely to appear across national regulations worldwide in the future.

The Financial Stability Board's comments appear both ahead and behind Dodd-Frank and European actions. The July 2011 report promotes several existing key US and European ideas, including instituting responsible arrangements for the orderly liquidation of SIFIs and mandating that institutions have a living will, or in the FSB's language, a Recovery and Resolution Plan. It also adds new ones including the specific ways that international regulators should interact with one another and how SIFIs should be monitored.

The FSB raised a new and important question in July 2011 concerning the orderly liquidation of global bank SIFIs: whether international regulations on the hierarchy of creditor rights and rankings will be a significant impediment towards international harmonization of liquidation rules. The FSB notes that the ability of creditors to understand their rights determines their levels of confidence in an institution. If international regulators disagree on the fundamental hierarchy of how monies should be returned in the case of a default or liquidation, creditors at multiple levels will be unsuccessful in resolving their claims in an orderly fashion. This would leave the markets with no better resolution than if a SIFI had gone bankrupt without government intervention.

Creating international standards on the hierarchy of creditor obligations is a critical matter for resolving any SIFI liquidation; while regulators agree that creditors should absorb losses and regain their assets in order of seniority, there is not always agreement on what that seniority represents. The FSB has reached out to the international community for comment on how and where these difficulties exist and how they could be resolved. In the event that no international standard exists, global regulators have the option of establishing credit seniority on a case-by-case basis, although that will be a laborious process given the number of SIFIs and regulators involved.

8. *Reducing the moral hazard posed by systematically important institutions*, available at http://www.financialstabilityboard.org/publications/r_101111a.pdf.

9. *Effective Resolution of Systematically Important Institutions*, available at http://www.financialstabilityboard.org/publications/r_110719.pdf, and *Key Attributes of Effective Resolution Regimes for Financial Institutions*, available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

10. *FSB announces policy measures to address systematically important financial institutions (SIFIs) and names initial group of global SIFIs*, http://www.financialstabilityboard.org/press/pr_111104cc.pdf.

In their October 2011 report, the FSB provided further guidance on what makes an effective resolution regime including adding on to the European Union's recommended principals. The new FSB guidance reads very similar to Dodd-Frank, suggesting that the Dodd-Frank model could be broadly adopted in the international community over the coming years. From a practical perspective, the most important contribution of the FSB in the October 2011 document concerns more specifics on cross-border legal frameworks and cooperation between regulators. Further details are discussed in an Annex to that document covering each area of necessary coordination between international authorities.

In both July and October 2011 the FSB addressed what temporary stays of financial contracts look like in practice. While Dodd-Frank has specified many but not all of these rules and the FDIC has presented what a stay in contract termination would look like in practice, the FSB is still seeking public comments that would more clearly define what a stay of early termination rights would look like including possible exemptions and cross-border applications. In their October 2011 report, the FSB mentioned that a temporary stay should be strictly limited in time and be imposed with clear rules and expectations on how long it will last. An Annex to that report presents further structure. A missing piece of the FSB conversation is still how regulators will determine which contracts will be transferred to a bridge company and which will stay in the insolvent entity. These will be critical questions for regulators to resolve globally.

The Financial Stability Board is an important organization in financial affairs today. While it may follow rather than lead on certain key issues, its final recommendations will likely be adopted by many countries that have not yet thought through a proactive stance on the orderly liquidation of significant financial institutions, including many countries in the developing world. Given the interconnectedness of global financial institutions today, the FSB's final recommendations take on more importance than its lack of a clear regulatory mandate may imply.

Certainty and Liquidity in Securities Lending

In financial markets, certainty breeds confidence and trust; this in turn encourages liquidity in securities lending as much as other products. Efforts by global regulators to introduce more certainty into the resolution of failing or bankrupt financial institutions gives greater confidence to securities lending participants that their contracts will be honored and cash or securities returned in the event of a counterparty failure.

Compared to today's bankruptcy rules, new regulatory initiatives offer several direct benefits:

- A clear definition of securities loans as qualified financial contracts, which places them alongside repurchase agreements, securities contracts, forward contracts, commodity contracts and swap agreements.
- An understanding that authorities have the right to take over a failing institution before bankruptcy occurs, to separate good assets from bad, and to manage those assets for the greatest benefit of shareholders and creditors.
- A reasonable expectation that fully collateralized securities loans would be transferred to the bridge entity.

While difficult situations may continue to arise, particularly for undercollateralized securities loans that may prevent transfer to a bridge entity, the likelihood is that crisis resolution regimes worldwide will benefit the securities lending market. Regulators are working to present transparent resolution processes for failed institutions. The more that this can occur, the more likely that market participants will extend credit to counterparties and generate both market liquidity and returns.

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