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Regulatory Change in Securities Lending: An Update for Clients

An array of proposed legislation and recommendations including Basel III, Dodd-Frank and European Commission rules on short selling will ultimately provide new mandates for securities lending market participants at all stages of the transaction. In the meanwhile however, beneficial asset holders and securities lending agents are working to assess the new environment as regulatory concepts become formalized and specific rules are adopted.

Executive Summary

- Dodd-Frank's Orderly Liquidation Authority, credit limits on counterparties, capital rules and short sale disclosure studies have a potentially major impact on securities lending market participants. The Volcker Rule calls into question the ability of agent lenders to manage certain unregistered cash collateral reinvestment pools.
- European Commission proposals on regulating short selling, the Alternative Investment Fund Managers Directive and the coordination of European tax rates would, if carried out in their current form, dramatically affect the securities lending industry. Borrower demand could also be reduced by the ability of European regulators to intervene in financial markets to temporarily reduce or eliminate short selling.
- Globally, requirements for hedge fund disclosure of short positions would very likely decrease short selling and hence the demand for securities loans. Regulators are discussing many proposed rules now.
- Basel III brings into question for the first time the value of indemnification that banks provide their securities lending clients, and encourages banks to consider Central Credit Counterparties for trading OTC derivatives as well as other bilaterally traded products. Basel III may also encourage more acceptance of non-cash collateral to manage balance sheets.
- The Financial Stability Board has begun to review the shadow banking industry with potential implications for repo, securities lending and money market funds. Any changes or increased regulation in this area could impact cash collateral reinvestment portfolios for securities loans.

Financial Regulations and Securities Lending After the Crisis

Three years after the credit crisis of 2008, financial markets continue to be impacted by new proposals for regulating short selling, derivatives and related market activities. In some cases the desires of regulators to maintain fair and orderly markets would create only minor adjustments for the securities lending industry. In others, regulations could affect major change including limiting the ability of securities lenders to select the most credit-worthy counterparties and potentially discouraging short sellers from engaging in their currently common market activity. While nearly all regulations that may affect securities lending remain undefined at a practical level, it is now possible to evaluate the major proposals and ideas to watch in the coming twelve to eighteen months.

Dodd-Frank and several different European rules figure prominently in the new regulatory landscape. Dodd-Frank is the major US regulation affecting a wide variety of financial services including trading, over-the-counter derivatives, credit cards and mortgages. While the initial Dodd-Frank Act contained general ideas and direction, rule-makings are starting to better define how this legislation will shape the securities lending market. European Commission proposals on short selling, the Alternative Investment Fund Managers Directive, and studies by the Financial Stability Board on the shadow banking industry will also play major roles in the evolution of lending markets.

In the background of these regional rules stands Basel III, now finding its way into national banking regulations. Basel III capital rules, including potential further enhancements by local jurisdictions, will put substantial pressure on banks to reduce their risks and leverage across multiple business activities by mandating adherence to new ratios for risk management. While Securities Finance Transactions are specifically exempt from several of Basel III's new rules, there remain potential impacts on indemnification and the use of Central Credit Counterparties across a variety of product types.

Much of the uncertainty surrounding regulations in securities lending is due to the myriad of linkages that exist between different parts of financial markets. For example, bans on uncovered short sales that require pre-borrows might increase demand for securities lending, but how much would these bans discourage short selling as costs increase? Would more transparency in reporting short sales discourage market participation? Would further dampeners on bank risk ultimately affect indemnification as new accounting rules are introduced for liabilities? And how will overlapping Basel III and Dodd-Frank capital rules interact with each other? While these questions remain unanswered today, assessing and understanding multiple scenarios across jurisdictions is an important task for securities lending market participants. Changes may occur quickly, and regulation intended for one purpose could spill into securities lending with unintended consequences.

Dodd-Frank, Rules and Amendments

The Dodd-Frank Wall Street Reform and Consumer Protection Act, better known simply as Dodd-Frank, has become one of the most complex financial reforms of the last fifty years. Several of its many initiatives have been delayed due to the complexity of writing new rules and the difficulty of establishing basic definitions for financial products such as swaps. Although much could change before final rules are established, the following provisions of Dodd-Frank are foreseen as having an impact on the securities lending market.

SEC Authority

The SEC has authority over securities lending as noted in Section 984 of Dodd-Frank. However, one year after the signing of the bill, the SEC has made no clear indication of how it intends to regulate securities lending or what data must be provided to ensure supervision. Ultimately the SEC will provide substantial direction on the reporting and transparency required from securities lending in US markets.

Orderly Liquidation Authority

Dodd-Frank provides the FDIC with a new "Orderly Liquidation Authority." The FDIC could take one of two actions in an orderly liquidation with adverse consequences for the securities lending industry.

First, the FDIC could separate "good" assets into a bridge company while leaving behind "bad" assets in the original structure. Securities loans held with the "good" assets should continue in the normal course of business with a bridge company established by the federal government or otherwise transferred to a going concern. Loans with the "bad" assets would need to be promptly closed out. However, an exact division of "good" and "bad" assets cannot be guaranteed. Second, if the FDIC were to order a liquidation then all assets and contracts would be frozen for 24 hours (or over a weekend), and no action could be taken with respect to insolvency but loans could be recalled or closed out in the normal course of business.

The FDIC orderly liquidation process as it stands leaves significant levels of uncertainty in the case of an FDIC takeover of an insolvent entity. Although banks are required to write "living wills" that show how their assets should be managed, this does not mean that every direction will be followed in practice.

The Volcker Rule

Although initially intended to cover proprietary trading desks within banks, one implication of the Volcker Rule is that agent lenders may be prohibited from operating certain types of unregistered cash collateral reinvestment pools. Assets currently invested though an unregistered pool structure would need to move to separately managed accounts or to mutual fund or other permitted commingled fund structures.

Central Credit Counterparties (CCPs) for OTC Derivatives

A growth in CCP usage for OTC derivatives creates an increased demand for treasuries to post as collateral. As many US institutions including insurance companies and corporations lack sufficient treasury holdings today, they will lend out corporate bonds and equities in exchange for treasuries in the securities lending market in a "collateral transformation,"

"collateral conversion" or "collateral upgrade" trade. Holders of treasuries will likely see increased demand for their securities. In Europe, insurance companies hold sufficient government debt but see these holdings as vital for meeting their Solvency II, CCP and collateral obligations; they are looking to balance their lending and collateral needs for optimal efficiency.

Short-selling Disclosure

In both Sections 929x and 417, Dodd-Frank addresses the idea of disclosure of short-selling positions on a monthly basis. Section 929x mandates the aggregate disclosure of short sale information to public markets, although these data would not disclose who sold short which quantity of shares. Section 417 goes further by mandating that the SEC division of Risk, Strategy and Financial Innovation study the potential impact of mandating public disclosure of short sales by CUSIP, in aggregate, to regulatory authorities or to the general public. For hedge funds, this would amount to a new disclosure in Form 13-F. For mutual funds, the same disclosure could be made in Form NQ. While the mandated study is currently underway, the likely impact of any public disclosure of short selling at the firm and CUSIP level could result in a reduction of market liquidity.

Additional Capital and Leverage Requirements

Section 171 of the Dodd-Frank Act including the "Collins Amendment" mandates that federal banking authorities propose additional capital requirements (i) for banks that engage in derivatives, repo and securities lending activities, and (ii) for excessive concentrations in market share or asset types, that could disrupt the market if that bank were to fail. The Collins Amendment has set these capital requirements at a minimum of what they were under Basel I, effectively removing any benefits of new rules in Basel II and Basel III and allowing only increases in capital. Discussions are underway for what additional capital requirements might be required.

A similar need for capital management is found in Dodd-Frank Section 165, although here the directions are more specific. Large banks are required to keep their debt to equity ratio at a maximum of 15:1, down from the 25:1 or 30:1 found in 2007 and 2008. Off-balance sheet holdings are required to be included in this calculation. Banks are also prevented from having a credit exposure to any one Significant Financial Institution counterparty of more than 25% of their capital and surplus at the bank holding company level including affiliates.

Lastly, a combination of Sections 165, 610 and 611 ensure that the total exposure of one institution to another will be no more than 25% of a bank's outstanding capital plus surplus. Taking multiple business lines into consideration, this may result in some counterparties becoming ineligible for securities loans if for example their bilateral derivatives exposures become large. While this aspect of the rule may be mitigated by holding cash and treasuries as collateral, if not it will cause constraints in lending counterparties for agent lenders.

As can be readily observed, the impacts of Dodd-Frank may reach far and wide into the securities lending market. However, there also remains substantial time for regulations to change in ways that would cause few negative impacts and several potentially positive repercussions.

The European Approach to Market Regulation

European Commission regulators have taken a very aggressive approach to managing markets although their proposals are not always welcome by Europe's member-states. A September 20, 2010 discussion document from the European Commission proposed that all short sales should be monitored, reported and disclosed in a timely fashion for equity and debt trades.[1] It also advocated a ban on naked CDS trades and the use of pre-borrows for short sales, meaning that every time a short seller in equities or bonds wanted to take action, they must first reserve the security for borrow.

Previous rules were also moving in the direction of a more activist and intrusive regulatory regime. After two years of negotiation, the Commission passed in November 2010 the Alternative Investment Fund Managers Directive, intended to regulate and promote transparency in the hedge fund and private equity markets. European regulators continue to pursue tax harmonization, or equal corporate withholding taxes across the European Union, although this is contrary to the desires of most European member-states who prefer a softer version of tax coordination between individual countries. Taken together, new European rules, proposals and intentions could substantially dampen market liquidity by reducing the availability and incentive for short selling and securities lending across a variety of markets.

European Short-Sale Proposals

The newest European short sale proposals, including a May 2011 press release for revisions, recommend:

- Flagging short selling activity on European financial markets, including OTC markets for corporate and sovereign debt. This would allow for private or public reporting of short selling positions. Such transparency would likely discourage short sellers who would prefer to remain anonymous and result in fewer securities loans.
- The ability of European regulators to intervene in a standardized manner to eliminate or reduce short selling in times of stress. This would legitimize the elimination of short selling during market crises or when regulators deemed that short selling was detrimental to a market's health. This could again decrease borrower demand as short sellers may be concerned about the consistency of market rules.
- Having a "reasonable expectation" of the ability to borrow a stock or bond prior to a short sale. This is a more permissive position than what the European Commission initially proposed, which required obtaining a securities loan within one day of a short sale. Either way, there would be an increased demand for securities loans based on the need to identify borrow opportunities. Costs for borrowers would also increase leading to potentially less demand.

The proposals from the European Commission are the most restrictive yet to emerge from the financial crisis of 2008, and go further than recommendations from both the International Organization of Securities Commissions (IOSCO) and the Committee of

1 Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps, September 15, 2010, http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf.

European Securities Regulators (CESR).[2] While these organizations support further transparency and disclosure in short selling, they also balance this need with maintaining market liquidity and keeping costs manageable for both investors and intermediaries.

As in other recent cases of European financial regulation, the proponents of more restrictive regimes and government intervention are supported by EU member-states France and Germany. On the other hand, the UK, the member-state with the largest banking and alternatives investment industry in Europe, along with Poland and Denmark, believes that the European Commission proposal goes too far. These are fundamental issues of market regulation and speak to the continuing philosophical divide between European Union members.

While it is unlikely that the European Commission proposals will be enacted in their current state, some of their provisions could have unintended consequences for the securities lending market. To start, penalties for settlement failures could cause securities lending agents to hold back inventory. Securities loans that did go out would be more expensive for end-borrowers, as every intended short sale may be required to reserve or identify specific shares before the sale could be made; this would be the case regardless of whether the sale ultimately went through or not. In fixed income, banning uncovered short sales or requiring a viable pre-borrow opportunity could result in dramatically lower liquidity and much higher costs for sovereign and corporate debt issuers. There is little doubt that these proposals would substantially affect liquidity across product types in European financial markets.

The Alternative Investment Fund Managers Directive (AIFM)

The Alternative Investment Fund Managers Directive, approved in November 2010 and set to become law in 2013, brings with it the expectation of further disclosures of short selling activity. AIFM Article 21, Section 2 mandates that hedge funds shall periodically report on their use of short selling to member-state authorities. Along with the AIFM, the Committee of European Securities Regulators has proposed that hedge funds be required to publicly disclose individual net short positions above 0.5% of issued share capital. This is a very low threshold as far as hedge funds are concerned. European central regulators clearly believe that short selling is a source of market risk; this idea appears on multiple charts and comments throughout the AIFM document.

In response to new disclosure rules and recommendations, hedge fund associations have produced studies showing that public short sale disclosures will damage market liquidity and increase the cost of trading. While partisan, these studies contain some important points: the most widely distributed of these, a February 2010 Oliver Wyman report sponsored by the Managed Funds Association, shows that public short sale disclosures have negative impacts for the health of Europe's equity markets. Hedge funds are however open to the idea of private short sale disclosures to regulators.

2 "Regulation of Short Selling Final Report: Technical Committee of the International Organization of Securities Commissions," June 2009, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD292.pdf.
"Model for a Pan-European Disclosure Regime," CESR, March 2010, http://www.cesr.eu/data/document/10_088.pdf.

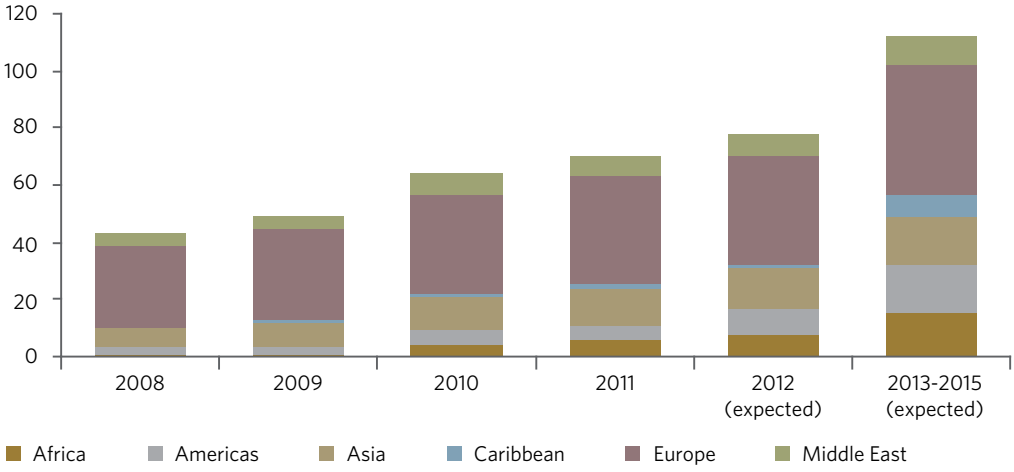
The Bank for International Settlements and the Financial Stability Board

The Bank for International Settlements (BIS), the world's bank for settling the payments of central banks worldwide, has driven a substantial amount of financial regulation for the last fifteen years. The last three years however have seen a flurry of new activity as regulators have reacted to the global credit crisis. Among its many activities, the BIS sponsors the Basel Committee on Banking Supervision, responsible for writing Basel rules on bank capital and risk management, and hosts the Financial Stability Board, an association of G20 country finance secretaries and treasurers that coordinates substantial global policy initiatives.

Basel III, Capital and Leverage

In December 2010 the Basel Committee on Banking Supervision released Basel III, a substantial change to capital requirements and risk management in the banking industry. Created largely in response to the credit crisis of 2008, Basel III is the next iteration of a capital and risk management framework, including Basel I and Basel II, that recommends what types of and how much capital banks should hold, what accounting treatment that capital should receive and how it should be reported. The Basel recommendations also indicate how banks should disclose information to regulators and the public, and what sorts of risk management fail-safes they should have internally. Basel II recommendations have become a globally accepted standard for bank regulation (see Exhibit 1). While not binding regulation, versions of Basel III will be codified by individual countries over the next several years.

Exhibit 1: Adoption of Basel II by Region



Source: 2010 Financial Stability Institute Survey on the Implementation of the New Capital Adequacy Framework

Basel III takes the well-known three pillars of Basel II, Minimum Capital Requirements, Supervisory Review and Market Discipline, and adds three new ratios in order to reduce risk. The first of these is the Liquidity Coverage Ratio, which tracks the amount of liquidity a bank has on hand to meet its funding needs in a 30-day period. The second, the Net Stable Funding Ratio, covers similar data over one year. Lastly, the Leverage Ratio takes a different approach to keeping leverage in check by looking at current assets and exposures on and off a bank's balance sheet.

The Leverage Ratio speaks to how banks account for indemnification and could have implications for how securities lending programs are run or the cost of these programs. The intention of the Leverage Ratio is to constrain leverage in the banking industry. Instead of calculated leverage of 25% or 30%, the Leverage Ratio would impose a top leverage limit of 3% on banks as defined by total adjusted assets as compared against Tier 1 capital.[3] While the US has always had a Leverage Ratio, the new limit is much lower than what banks have seen previously. The Leverage Ratio is a new introduction for European banks.

In securities lending, indemnities can be treated as a loan on a bank's balance sheet; if a counterparty were to fail and collateral found insufficient, the bank would be responsible for compensating its client directly. This exposes the bank to some degree of risk, although indemnity clauses are rarely used due to overcollateralization of securities loans. Regulators have not yet determined how to account for indemnification; their final decisions could have ramifications throughout the global securities lending industry.

The Liquidity Ratio, to be phased in starting from 2015, has an unintended side effect on some cash collateral management reinvestment portfolios particularly in the US. By mandating that banks reduce their short-term liquidity, the Liquidity Ratio inadvertently reduces the amount of repo contracts available for purchase by cash managers, particularly at month and quarter end. For repo-only collateral investors, this will result in a reduction of securities loans outstanding at the same time that banks call in their contracts. These investors may see the benefits of taking additional non-cash collateral as a way to manage their collateral exposures. The introduction of a new FDIC fee has also reduced the incentives for banks to issue repos while reducing returns for investors.

Basel III strongly promotes the use of Central Credit Counterparties by allowing a capital charge of just 2% for trades on these entities. Compared to a weighting of between 0.7% and 10% for bilateral trades, this could improve or worsen a bank's capital position depending on the credit rating of the counterparty. Currently 14 CCPs are operating globally for OTC derivatives, only two of which clear more than two products (see Exhibit 2). Although capital rules for trading on a CCP are attractive, this diversity in counterparties presents multiple challenges including the need to maintain collateral with each institution. It is important to note that CCPs do not eliminate risk; they merely spread it around among more underlying counterparties.

3 "The role of valuation and leverage in procyclicality," Committee on the Global Financial System, CGFS Papers No. 34, April 2009 (citing Bankscope data), http://www.bis.org/publ/cgfs34.pdf.

Exhibit 2: Central Counterparties for OTC Derivatives

Platform (Domicile)	Interest Rate Swaps	Credit Default Swaps	Foreign Exchange	Equities	Other
CME Clearing (US)		X			X
BM&FBovespa(Brazil)	X		X	X	X
Eurex Clearing AG (Germany)	X	X		X	X
Euronext/Life BClear (UK)				X	X
ICE Clear Canada (Canada)					X
ICE Clear Europe (UK)		X			X
ICE Trust (US)		X			
LCH.Cleamet (UK)	X				X
LCH.Cleamet SA (France)		X			
IDCG international Derivatives Clearinghouse (US)	X				
NASDAQ OMX Stockholm AB (Sweden)					X
NYSE Portfolio Clearing	X				X
NOS Clearing (Norway)					X
SGX AsiaClear (Singapore)					X

Source: "Making Over-The-Counter Derivatives Safer: The Role of Central Counterparties," Global Financial Stability Report, International Monetary Fund, April 2010; Finadium analysis

Regulators have just begun to mention requiring CCPs for securities lending transactions, and the facilities already exist in the US, Europe, Latin America and several Asian countries. In Europe, regulators have discussed the idea of moving all securities loans onto a CCP. However, this is largely impractical; adding the cost of a CCP onto a general collateral trade at current borrowing levels would make those loans uneconomical for the lender. Market participants do not expect these conversations to advance at this time.

The Shadow Banking Industry

A recent focus of the Financial Stability Board (FSB) is on the shadow banking industry, estimated by the New York Federal Reserve Bank at US$15 trillion as compared to US$13 trillion for the traditional banking system. As generally defined by both the Fed and the FSB, the shadow banking system entails "credit intermediation involving entities and activities outside the regular banking system." Repo is noted as a specific example of shadow banking; securities loans could conceivably be included as well. In addition, certain money market investment products such as Special Purpose Vehicles or structured products can also be considered part of the shadow banking industry. The FSB report follows a similar study by the Federal Reserve on shadow banking produced in July 2009.

The FSB is currently concerned with further framing the definition of shadow banking and in proposing rules to regulate its activities, noting that shadow banking can build up unmonitored leverage and can lead to regulatory arbitrage with traditional banking activities. In an April 12, 2011 release, the FSB narrowed its focus by recommending that regulators pinpoint areas of the shadow banking industry where transformations in maturity or liquidity, flawed credit risk transfer or a hidden build-up of leverage can create undue risk. However, the FSB also notes that data for monitoring shadow banking activities are limited; Flow of Funds data comes closest although methodologies and details vary substantially by country.

Conclusions for Beneficial Asset Holders

A review of financial history shows that the pendulum of regulation swings towards conservatism and reverses towards liberalism depending on markets, popular opinion and political trends. The pendulum has now swung towards conservatism and is likely to remain there for some time to come. While the exact impacts to securities lending are still unknown, current proposals and ideas suggest that changes to industry practices and greater transparency for market participants are not far off.

As securities lending has become accepted as an investment product and not a back-office process, asset holders have become more aware of the importance of maintaining appropriate supervision for this activity. The current regulatory environment supports this thesis; asset holders with interests in securities lending would be well served by paying close attention to regulatory initiatives in jurisdictions where they hold securities. While agent lenders and consultants will strive to keep their clients educated, each individual situation requires its own analysis, risk management and decision-making.

Dodd-Frank is likely to create change in securities lending. As just one example, the number of eligible counterparties for lending agents may shrink if other areas of a bank have additional exposure to that counterparty, notably for OTC derivatives trading. Across the board banks will need to hold more capital with resulting uncertainties for lending activity, at least until further rules are clarified. While the demand for treasuries will likely increase due to the need for high quality collateral by entities trading OTC derivatives, potential hedge fund short sale disclosures may put downward pressure on the lending markets. How Dodd-Frank will ultimately unfold remains to be seen.

If European Commission regulars proceed unopposed on short selling disclosure, it is likely that short selling volumes will decline in European markets. This will not only reduce the volume of securities loans but will also damage liquidity in European markets. Due to the extreme differences between member-states on the matter, little will be known for some months until finance ministers and national regulators work through details of the proposals and negotiate a middle ground. Tax coordination is likely to continue albeit at a slow pace.

Basel III recommendations on bank capital and leverage mean that beneficial asset holders should consider the value of indemnification and the impact that CCPs may have on their securities lending programs. If indemnification is viewed as vital for continuing in securities lending, asset holders should think about what they might be willing to pay if costs increase. Asset holders may also want to keep abreast of CCP conversations that would affect the amount and cost of securities that can be put out on loan due to these new Central Credit Counterparties. Driven by similar forces as Dodd-Frank, holders of government securities may want to evaluate increasing their lending activity as demand for CCP-eligible collateral increases.

The securities lending market continues to offer substantial rewards for market participants, albeit not without risk. As with any investment product, the best investor is an educated investor.

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