

# Securities Lending - Impact of Regulatory Initiatives on Borrower Default Indemnification

For many years, beneficial owners, ranging from mutual funds to both public and private pension plans, have relied on bank securities lending agents to enable them to obtain incremental revenue from their securities holdings in a very safe manner. To provide additional comfort as to the safety of the transactions and to demonstrate confidence in their risk management systems, banks have long provided borrower default indemnification as part of their securities lending services. This protection is also sometimes referred to as a securities replacement guarantee. Generally, indemnification protects beneficial owners against losses in the event that a borrower fails to return the loaned securities. Under the typical borrower default indemnification provision, the lending agent agrees to purchase replacement securities for the beneficial owner using the proceeds of collateral posted by the borrower and, to the extent that the value realized on the collateral is insufficient to purchase the replacement securities, the agent bank agrees to make up the difference. Borrower default indemnification has become customary in the industry, and indeed in many cases lending clients are required by applicable law or policy to demand this protection from their lending agents.

## Key Points:

- Despite the customary, low risk nature of this longstanding practice, borrower default indemnification is likely to come under increasing stress due to the torrent of new rules promulgated since 2008 in the wake of the global financial crisis.
- Very few regulatory changes are specifically directed at agency securities lending, however, many of the new proposed rules indirectly affect agency lending as a result of the borrower default indemnification provided by agent banks to their clients under the typical agency lending agreement.
- Borrower default indemnification is treated under certain of these proposed regulatory initiatives as a direct credit exposure of the agent bank to the borrower of securities and, in some instances, to the issuers of collateral securities.

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## Key Points: continued

- Proposed regulations implementing Section 165(e) of the Dodd-Frank Act limit the amount of indemnification exposure that agent banks may have to counterparties and collateral issuers. If implemented in its current form, this rule could make borrower default indemnification a limited resource. Specifically, it is estimated that the Section 165(e) proposals could cause securities on loan at U.S. agent banks to decrease by up to 30% to 50% from already reduced post-financial crisis levels, representing \$4 to \$6 billion in total lost revenues.
- On June 12, 2012, U.S. banking regulators released three joint notices of proposed rulemaking (“Capital NPRs”) containing proposals to implement the international capital standards commonly called “Basel III,” as well as a final joint market risk capital rule implementing the international standards referred to as “Basel II.5,” each in a manner aligning with Dodd-Frank Act requirements such as the Collins Amendment. These changes to the U.S. regulatory capital regime will increase the capital costs associated with providing borrower default indemnifications.
- It remains uncertain as to how borrower default indemnifications will be treated for purposes of calculating a bank’s leverage ratio. The Capital NPRs added a new supplemental leverage ratio to address off-balance sheet items but specifically excluded securities finance transactions. US banking regulators indicated that they would address securities lending indemnification at a later date once there is international consensus. Depending on the methodology ultimately selected, inclusion of off-balance sheet indemnifications in the leverage ratio could severely limit agent banks’ ability to provide this protection.
- Other regulatory changes such as the Orderly Liquidation Authority under the Dodd-Frank Act and potential new liquidity rules under Basel III create uncertainty and risk for agent banks with respect to the application of these rules to borrower default indemnification.

## Summary

Indemnified agency securities lending still serves a vital role by generating income for beneficial owners and supporting financial market liquidity. Nevertheless, although the outcome of many of the regulatory regime changes discussed in this article remains uncertain, the overarching theme to the proposals is a tightening of restrictions affecting agent banks’ indemnified securities lending programs. Whether these restrictions take the form of capital charges, liquidity requirements, counterparty concentration limits or outright prohibitions, agent banks will need to align the scope and breadth of indemnified lending activities with a new regulatory environment. Indemnified lending will certainly be more costly for agent banks to provide under the new regulations, but, more importantly, new counterparty concentration limits may effectively make borrower default indemnification a limited resource, forcing agent banks to optimize the use of indemnification at a client or transaction level.

## What Happens Next?

As the foregoing evidences, many aspects of Dodd-Frank are likely to impair the ability of custody banks to continue to provide their historical indemnification. Still, it is worth highlighting again that, despite it now being more than two years since Dodd-Frank's enactment, none of the regulatory initiatives discussed in this article are complete.

- The Section 165(e) counterparty limits and the Volcker Rule are still in proposed form with their comment periods closed. The Volcker Rule is rumored to be finalized by year end, but no certain date has been set for either of those rules to be completed.
- The Agencies recently extended the comment period for the US Capital Proposal until October 22, so the planned January 1 effective date of portions of those rules now seems unlikely, particularly with Europe recently stating that implementation of CRD IV (the European version of Basel III) will be delayed beyond that date.
- The OCC published the revised national bank lending limits as an interim rule (date of the final rule uncertain), and the FDIC continues to slowly publish proposed and final rules for OLA, with much more guidance about the statutory framework still expected.
- The agent banks are hoping that the various agencies have time to fully consider their comments about the undue individual and cumulative burden of the proposals, and modulate the final rules more appropriately. However, there can be no certainty that industry comment and meetings will have a meaningful impact on the process, and if the final rules are anything like the proposals lending clients may need to adjust to an environment with much less borrower default indemnification.

## Detailed Discussion

For several decades, agency securities lending transactions have been viewed by regulators as, comparatively low-risk, customary bank activities at some of the largest banks in the world. Until recently, indemnified agency securities lending activities enjoyed very few regulatory burdens due to the fact that they were fully collateralized, usually by cash, U.S. Treasuries or other readily marketable securities. Since the financial crisis, however, regulatory bodies have been revising the banking regulatory framework in a manner that, directly or indirectly, may place significant constraints on agent lenders' indemnified agency securities lending practices. More specifically, treatment of borrower default indemnification has been and will continue to be impacted by changes to domestic and international capital and liquidity rules, as well as by a number of other rules under the behemoth Dodd-Frank Act. These and other new and proposed regulations seek to address perceived concerns through a combination of charges, limitations and prohibitions. This report evaluates a number of these efforts that potentially will impact the ability of agent banks to provide borrower default indemnification to beneficial owners in the securities lending market.

In this article, we first describe the historical regulatory regime for context and then analyze several of these recent and proposed changes and their possible impact on borrower default indemnification. Many of these rules, including the capital requirements stemming from Basel III and most regulations necessitated by Dodd-Frank, are still very much under development; thus, banks are currently operating without complete information as to how their agency lending programs will be fully affected by the changes. Banks and

their trade groups, however, have been and continue to be very actively involved in the regulatory development process. By commenting on proposed regulations and meeting with regulators, these institutions are seeking to promote understanding of indemnified agency lending programs. They are also trying to ensure that new regulations are workable and consistent with current safe and sound industry practice and that any burdens imposed on indemnified lending programs do not substantially outweigh the actual risks involved. Nevertheless, it already is safe to assume that indemnified agency securities lending programs could be impacted to a material extent as the rules are finalized.

### **Historical Regulatory Treatment of Indemnified Agency Securities Lending Programs**

The basic underlying securities lending transaction creates no risk of loss to an agent bank's own capital - the agent bank merely facilitates a loan between the beneficial owner and the borrower of the securities. Indeed, even the secondary transaction whereby the agent bank or other custodian reinvests cash collateral typically is at the risk of the beneficial owner. The only risk to bank capital under an agency securities lending transaction instead stems from borrower default indemnification, which agent banks have provided for decades in the vast majority of securities lending transactions as a matter of standard market practice. Agent banks rely on a variety of market, regulatory and transactional factors to mitigate the risk of loss arising from borrower default indemnification. The most important of these are: the use of highly developed risk mitigation techniques; high quality collateral (e.g., cash, U.S. Treasuries, foreign government debt or other liquid securities); requiring margins that result in over-collateralization; and marking the loan and collateral to market on a daily basis.

Historically, because indemnification is an off-balance sheet item, U.S. agent banks incurred no leverage capital charge to operate their indemnified agency lending programs. In addition, the typical collateralization of the underlying securities loans by an excess margin of cash or U.S. Treasuries translated to a zero percent risk capital charge under the current U.S. capital regime, and also generally resulted in the indemnified lending program being exempt from applicable lending limits. With U.S. regulatory agency approval, a number of agent banks also have had the option to use internal Value at Risk (VaR) modeling methods as an alternative to standardized models-based approaches to comply with capital rules in respect of their indemnified lending transactions. VaR recognizes the limited capital risk involved in these over-collateralized transactions, especially where the securities lent are highly correlated to the securities received as collateral. Thus, the use of VaR-based models has resulted in capital charges for agent lenders that more closely align with the low risk associated with indemnified agency lending transactions. Finally, prudential, liquidity and counterparty limits generally did not inhibit indemnified lending given the sophisticated bank risk mitigation systems and the secure nature of the collateral involved.

### **Dodd-Frank Act Section 165(e) - Counterparty Concentration Limits**

Sections 165 and 166 of the Dodd-Frank Act, commonly called the "prudential standards" sections of the statute, contain a number of measures designed to address perceived weaknesses in the financial industry and regulatory framework thought to have exacerbated the most recent crisis. One concern of banking regulators is that, while bank-level exposure to any counterparty is subject to lending limits, the aggregate exposure of consolidated banking organizations (e.g., at the holding company level) historically has been subject only to prudential regulation rather than strict numerical limits. Another concern relates to limiting the interconnectivity of systemically important financial institutions (SIFIs).

To address these concerns, Section 165(e) of the Dodd-Frank Act caps the net credit exposure that a “covered company” may have to any counterparty on a fully consolidated basis. A covered company includes U.S. bank holding companies with over \$50 billion in total consolidated assets. This encompasses all of the major U.S. agent lending banks. The Federal Reserve proposed rules implementing these credit exposure limits in early January, and comments were due April 30. The Federal Reserve has indicated that these rules might be finalized this Fall.

If implemented as proposed, these exposure limits will impact all securities lending programs. The statute sets a general aggregate limit on the net credit exposure that a covered company (agent bank) may have to any consolidated counterparty (the borrower of the securities). That limit is, at most, 25 percent of the consolidated capital stock and surplus of the agent bank. The proposed rules set an even lower net credit exposure limit for transactions between a “major” agent bank and a “major” counterparty. Major agent banks and major counterparties include SIFIs and banking organizations with consolidated assets greater than \$500 billion. This lower net exposure limit is 10 percent of the consolidated capital stock and surplus of the major agent bank. To determine “aggregate net credit exposure” between an agent bank and a borrower, the net credit exposure for every credit transaction between the agent bank and any of its affiliates and the borrower and any of its affiliates is calculated and the results are aggregated as of close of business each day.

Of particular importance to indemnified agency lending programs is the fact that, credit transactions subject to the above limits include, “any securities lending or securities borrowing transaction with the counterparty.” Agent banks only enter into lending transactions with borrower counterparties on behalf of their beneficial owner clients. Accordingly, they are acting as an agent and are not a principal in the transaction. The proposed rules do not specifically address indemnified agency lending. However the Federal Reserve has made it clear in meetings with the industry that agency lending transactions in which the agent bank provides borrower default indemnification to its lending clients will be treated as a direct credit exposure of the agent bank to the borrower of the securities thereby making it the functional equivalent of a principal securities lending transaction between the agent bank and the borrower under the rules. As a result, indemnified agency lending transactions likely will be subject to these rules and will need to be included in an agent bank’s calculation of its consolidated net credit exposure limit to the borrower.

Under the proposed rules, the gross credit exposure for a securities lending transaction is calculated as the market value of the securities on loan plus an add-on (called a “haircut”) determined based on the type of securities on loan. The Agent bank then has the choice to apply or not to apply the collateral received to reduce the gross exposure. If the agent bank elects to apply the collateral, then the market value of the collateral is adjusted downward by a haircut applicable to that type of collateral. This reduced collateral amount is then subtracted from the gross credit exposure (the inflated value of the securities on loan) to determine the agent bank’s net credit exposure to the borrower for that transaction.

Once the agent bank applies the reduced collateral amount to calculate its net credit exposure to the borrower, then under the proposed rules, it also has an unsecured credit exposure as a result of the same transaction to the issuer of the collateral. The exposure

to the collateral issuer is generally equal to the amount the agent bank deducted from its gross credit exposure to the borrower. The agent bank’s credit exposure to the collateral issuer is subject to the percentage limitations described above. As a result, agent banks are not only limited as to their credit exposure to the securities borrowers, but also to the issuers of collateral. If the agent bank chooses to insure or hedge any of this credit exposure, it results only in shifting the exposure to the insurer or hedge provider which exposure is also subject to the same limits.

The proposed haircuts are absolute—i.e., no credit is given for correlation between the values of the securities on loan and the collateral received. Both equity loans and equity collateral generally are given a 15% haircut. Cash on deposit applied as collateral is given a zero haircut. Exposures to sovereign entities are given a range of haircuts depending on the maturity and OECD country risk classification (CRC) of the sovereign. Exposures to the U.S. government are exempted from the limits, but not exposures to other sovereigns. Exposure limits to a sovereign country include exposure to any of its agencies, instrumentalities and political subdivisions. In addition, where the currency of the securities on loan does not match the currency of the securities received as collateral, an additional 8% “haircut” is applied to the transaction. The table below represents a reproduction of the haircut provisions from the proposed regulations.

### Haircuts

Sovereign Entities		
	Residual maturity	Haircut without currency mismatch <sup>207</sup>
OECD Country Risk Classification <sup>208</sup> 0-1	≤1 year	0.005
	>1 year, ≤ 5 years	0.02
	> 5 years	0.04
OECD Country Risk Classification 2-3	≤1 year	0.01
	>1 year, ≤ 5 years	0.03
	>5 years	0.06
Corporate and Municipal Bonds that are Bank Eligible Investments		
	Residual maturity for debt securities	Haircut without currency mismatch
All	≤1 year	0.02
All	>1 year, ≤5 years	0.06
All	>5 years	0.12

Other Eligible Collateral	
	Haircut without currency mismatch
Main index <sup>209</sup> equities (including convertible bonds)	0.15
Other publicly traded equities (including convertible bonds)	0.25
Mutual funds	Highest haircut applicable to any security in which the fund can invest
Cash collateral held	0

*207 In cases where the currency denomination of the collateral differs from the currency denomination of the credit transaction, an addition 8 percent haircut will apply.*

*208 OECD Country Risk Classification means the country risk classification as defined in Article 25 of the OECD's February 2011 Arrangement on Officially Supported Export Credits Arrangement.*

*209 Main index means the Standard & Poor's 500 Index, the FTSE All-World Index, and any other index for which the covered company can demonstrate to the satisfaction of the Federal Reserve that the equities represented in the index have comparable liquidity, depth of market, and size of bid-ask spreads as equities in the Standard & Poor's 500 Index and FTSE All-World Index.*

Below are examples of how the rules as proposed would apply to specific loan transactions. The examples are: (1) equity securities on loan against equity collateral and (2) U.S. Treasuries on loan against German Bunds as collateral.

### 1. Equity Securities on Loan / Equity Securities as Collateral

In this example, the agent bank lends main index equity securities with a market value of \$100 on behalf of its beneficial owner client to a borrower. The borrower provides \$108 in main index equity collateral. The currency of the securities on loan and the collateral is the same. This example assumes that the equity securities provided as collateral are from a single issuer.

The collateral haircut applied to main index equities is 15%.

- Agent Bank's Credit Exposure to the Borrower
  - Gross Exposure =  $\$100 + \$100 \times 15\% = \$115$
  - Net Exposure =  $\$115 - \$108 \times 85\% = \$23.20$
- Agent Bank's Credit Exposure to the Issuer of Equity Securities Collateral
  - Gross Exposure =  $\$115 - \$23.2 = \$91.80$

## 2. U.S. Treasuries on Loan / German Bunds as Collateral

In this example, the agent bank lends 10-year U.S. Treasuries with a market value of **\$100** on behalf of its beneficial owner client to a borrower. The borrower provides **\$105** in 10-year German Bund collateral. The collateral haircut applied to an exposure to an OECD sovereign with a country risk classification of 0-1 (including the U.S. and Germany) with a maturity of greater than 5 years is 4%. There is an additional 8% haircut since there is a currency mismatch between the loan and collateral securities.

- Agent Bank's Credit Exposure to the Borrower
  - Gross Exposure =  $\$100 + \$100 \times 4\% = \$104$
  - Net Exposure =  $\$104 - \$105 \times 88\% = \$11.60$
- Agent Bank's Credit Exposure to Germany
  - Gross Exposure =  $\$104 - \$11.60 = \$92.40$

If implemented as currently proposed, these credit exposure limits could potentially limit agent banks' ability to provide their indemnified agent lending services in two major respects. First, on the securities loan side, the calculation methods prescribed in the proposed rules will severely overstate net credit exposure to borrowers because, among other reasons, they do not take into account any correlations between the securities on loan and collateral provided or benefits of portfolio diversification in general. This could mean that agent banks may hit their respective aggregate net credit exposure limits to certain highly active securities borrowers, particularly if such borrowers also engage in other credit transactions with affiliates or divisions of those banks. Second, on the collateral side, due to the notional shifting requirement described above, agent banks run the risk of hitting their exposure limits to certain foreign sovereigns that are the most popular issuers of non-cash collateral. Thus, banks are not rewarded, but rather penalized, for risk-mitigating activities.

A number of interested parties have raised these and other concerns with the Federal Reserve in meetings and comment letters. BNY Mellon participated in a number of industry group comment letters, including the letter submitted by the Securities Lending Division of the RMA, which focused on aspects of the proposed rules that affect agency securities lending. Many of the comment letters include proposals for revising the acceptable methodologies to calculate net credit exposure for securities financing transactions to take into account correlations among securities as well as currencies, and exempting obligations of certain high credit quality foreign sovereigns from the exposure limits, just as U.S. obligations are exempt from the limits under the proposed rules.

### Proposed Changes to U.S. Capital Rules

The U.S. agencies' joint Capital NPRs, if adopted as proposed, would over time replace the U.S. banking book capital regime, and consistent with Basel III, substantially increase capital and procedural requirements with respect to banking institutions subject to the framework. More specifically, these and other changes demanded by Basel III will place stress on indemnified securities lending programs in two ways: (1) by increasing capital demands on banking organizations generally, and (2) by imposing particular additional

capital charges on counterparty-based activities like indemnified securities lending. As for the first, more general stress, the Basel III changes principally result in higher capital ratio requirements for banks. In addition to the already higher limits of capital that the Capital NPRs would require, the largest global banks (G-SIBs), which include most large securities lending agent banks, will be further impacted by higher surcharges under Basel III. These additional charges are also expected to be implemented (and potentially exacerbated) under the prudential rules imposed by Section 165 of the Dodd-Frank Act. According to a report published by Fitch Ratings on May 17, the 29 identified G-SIBs will need to raise an additional 23% more capital, or \$566 billion, over current reserve levels in order to satisfy new capital requirements under the Capital NPRs and Basel III. The Clearing House estimated in a study published in the fall of 2011 that the cumulative impact of the Basel III minimum capital requirement and G-SIB surcharges would decrease return on equity at the largest global banks by up to 4.9 percentage points. Further increasing this general stress is the fact that fewer bank-issued instruments constitute “capital” under the new capital framework. As to U.S. banks in particular, these higher general capital requirements may be hardened and amplified by the “Collins Amendment” in Section 171 of the Dodd-Frank Act, which requires the largest covered banking institutions to use the higher of the generally applicable capital charge (i.e., that is applicable to all U.S. banks) and the charge applicable under the advanced approaches.

As to the second component of capital stress, Basel III, as reflected in the Capital NPRs, places particular emphasis on activities resulting in counterparty credit risk, including securities finance, and contains several changes that specifically impact indemnified agency lending programs. The Capital NPRs, like Basel III, include both a generally applicable “standardized” method to calculate risk-weighted capital as well as an “advanced approach” applicable to the largest or most internationally active institutions (including the major U.S. agent banks). However, the Collins Amendment, as implemented in the Capital NPRs, requires the largest institutions to calculate capital charges under both the standardized and the advanced approach and use the higher of the two as the applicable capital charge. Although, the determination of which method is controlling is done on an aggregate basis, it appears that the method that would produce the largest capital charge for indemnified securities lending transactions would be the charge calculated under the “standardized” method. This method employs a collateral haircut approach similar to that under the proposed Section 165(e) rules discussed above for securities finance transactions and other counterparty transactions, as opposed to the simple VaR or other internal models that would reflect correlations. The standardized approach also would, to some extent, negate the value of netting arrangements. These changes increase the denominator in the required regulatory capital ratios and thereby will significantly increase capital required to provide borrower default indemnification.

Potentially adding further stress to banks that use VaR-based internal models to calculate regulatory capital, a Basel Committee trading book review issued in May proposes even more radical adjustments to market risk modeling requirements. Building on concepts introduced in Basel II.5, the consultative document proposes a move from VaR-based modeling methods to “expected shortfall,” which purportedly better captures so-called “tail risk” that statistically outlying scenarios will occur in times of stress. Although the new proposals only affect trading book modeling requirements, the conclusions stemming from the study conceivably could affect banks’ abilities to use VaR-based methodologies to calculate banking book capital in the future.

## Leverage Ratio

The leverage ratio is intended to ensure banks maintain a base level of liquidity. The traditional leverage ratio is determined by placing Tier 1 capital in the numerator, and on-balance sheet assets (not risk-weighted) in the denominator. In the U.S. system, for a bank to be “well-capitalized” it must have a leverage ratio of at least 5%.

Although U.S. regulators have imposed some sort of leverage ratio requirement on banks since the early 1980s, regulators from most peer countries (including European countries) did not require banks to calculate a leverage ratio prior to the Basel III accords. Basel III, however, introduced a generally applicable “traditional” leverage ratio, and also creates a “supplemental” leverage ratio, including off-balance sheet assets, as a “backstop” to the risk-based capital requirements. The Capital NPRs contain some significant changes to the required leverage ratios for banks based on new requirements under Basel III.

In general, the Capital NPRs propose to extend the current 4% leverage ratio requirement of Tier 1 capital to average consolidated on-balance sheet assets (minus amounts deducted from Tier 1 capital) to all banking organizations (including highly-rated banking organizations, which are currently subject to a 3% leverage ratio requirement). To be “well-capitalized,” a bank must continue to maintain a 5% leverage ratio. Banking institutions subject to the “advanced approaches” capital methodologies would also be subject to a “supplementary leverage ratio” based on the more stringent Basel III formulation that also takes into account certain off-balance sheet assets, with a minimum ratio requirement of 3% (the “well-capitalized” requirement does not include the supplemental leverage ratio). The leverage ratios would be calculated using the proposed new definition of Tier 1 capital.

The new “supplementary leverage ratio” is not yet fully developed, and in particular its treatment of borrower default indemnification provided in agency lending transactions is still under consideration by international regulators. For this reason, the joint agencies have proposed under the Capital NPRs to measure exposure under repo-style transactions (including securities lending transactions) as the value of such transactions carried as an asset on the balance sheet, consistent with the measure of exposure under such transactions used in the agencies’ current leverage measure. However, they will consider modifying this approach in the future based on the results of ongoing observations by the Basel Committee and further international discussions.

BNY Mellon and other agent banks have met with regulators to assert that indemnification should be included in the supplementary leverage ratio, if at all, only to the extent that the indemnification exposure exceeds the collateral coverage (the “current exposure”). The regulators have expressed some support for the current exposure approach, but as indicated above, the ultimate result is not certain. If current exposure is the final approach, the supplementary leverage ratio should have little impact on securities lending programs. If, on the other hand, the full amount of the indemnification exposure were to be included in the supplementary leverage ratio, it could substantially curtail indemnification programs.

Although the new leverage ratio requirements are not effective until 2018, banks must begin reporting for the new requirements under the proposed rules beginning January 1, 2015.

## **Dodd-Frank Act Section 619 - The Volcker Rule**

The Volcker Rule of Dodd-Frank and its proposed implementing regulations have drawn the ire of a wide range of critics, from domestic banks to foreign governments. Congress intended the provision to restrict banks from investing their own funds in speculative trading activity, putting banks' own capital at risk and resulting in potential conflicts of interest between the banks and their clients. The inter-agency proposed rules, however, are extremely far-reaching in geography and breadth, and commenters have argued that they capture a number of transactions that do not properly fit within Congress' intent and had nothing to do with the financial crisis.

Of particular relevance to indemnified securities lending transactions is the current proposed rule that implements the statutory provision of the Volcker Rule commonly called "Super 23A." The proposed rules provide that a banking entity that serves, directly or indirectly, as the investment manager, investment advisor, or sponsor to a covered fund, or that organizes and offers a covered fund cannot enter into a covered transaction with the covered fund. A covered fund is any fund that is exempt from investment company registration under Section 3(c)(1) or Section (7) of the Investment Company Act of 1940. A covered transaction is a transaction described in section 23A of the Federal Reserve Act (12 U.S.C. 371c) relating to transactions between a banking entity and any of its affiliates. Covered transactions include, among other things, loans or extensions of credit to, and guarantees on behalf of, affiliates of a member bank of the Federal Reserve System.

If the proposed rules are implemented as drafted, and the banking agencies consider borrower default indemnification to be "covered transactions," agent banks may need to qualify for an exception from Super 23A in order to continue providing borrower default indemnification to clients that are covered funds (whether such funds are sponsored by banks under the "customer fund" exemption to the Volcker Rule or are advised or managed by the agent banks). Again, although borrower default indemnification does not appear to pose the "bail out" risks that Super 23A was intended to address, we do not know whether agencies will interpret this requirement to prohibit agent banks' provision of borrower default indemnification to lending clients that are covered funds.

Finally, the overbroad definition of covered fund as drafted under the proposed rules actually captures the structure of most vehicles through which agent banks invest pooled cash collateral on behalf of and for the benefit of their lending clients. As a result, agent banks may be prohibited from providing basic custodial type services for these funds such as intra-day overdraft protection. It remains to be seen whether the final rule will clearly exempt these types of fiduciary funds.

Since the statutory effective date of the Volcker Rule is July 21, 2012 and the final implementing regulations have not yet been adopted, the joint agencies have clarified that entities covered by the Volcker Rule would have an additional two year period, or until July 21, 2014, to fully conform to the final rule, unless that period is further extended by regulators. It has been reported that the joint agencies are expected to promulgate a final rule implementing the Volcker Rule by this fall, and possibly as early as the summer. On April 26, 22 U.S. senators published a letter urging the regulators to implement the Volcker Rule "without delay." However, it is not certain whether the agencies will address the issues discussed above in the final rule in a manner that would allow agent banks to continue providing their borrower default indemnification and collateral investment services as currently provided.

## **Additional Regulatory Developments**

### **A. Basel III - Liquidity**

Basel III also introduces two new liquidity ratios that banks must maintain under a globally standardized liquidity regime. The first, the Liquidity Coverage Ratio (LCR), requires banks to hold enough cash or liquid assets on reserve to cover expected outflows over a 30-day "acute stress scenario." The LCR is meant to address sudden liquidity deficiencies present in the Lehman bankruptcy. The second, the Net Stable Funding Ratio (NSFR), is intended to promote longer-term stability over a one-year time horizon. The NSFR seeks to incentivize banks to fund their activities with more stable sources of funding by requiring that banks must hold U.S. Treasuries or other highly liquid securities against certain types of transactions. Basel III indicates that liquidity may need to be held against certain off-balance sheet obligations. It is still unclear if liquidity will need to be held to support borrower default indemnifications. The joint Capital NPRs discussed in Section IV do not address the liquidity changes imposed by Basel III. Regulators have, however, recently indicated that changes to the international standards would expand the range of assets that may be applied to banks' liquidity requirements. The impact of the new liquidity ratios will not be known until implementing rules are published and finalized. Nevertheless, to the extent new liquidity rules will increase the need to hold Treasuries and other liquid securities to support activities like indemnified securities lending, these new rules could impose further costs to providing borrower default indemnification by materially impairing a bank's net interest margin.

### **B. Dodd-Frank Act Title II - Orderly Liquidation Authority Procedures**

As discussed at length in the last article in the Thought Leadership Series, "Securities Lending, Crisis Management and the Orderly Liquidation Authority," Dodd-Frank's Orderly Liquidation Authority (OLA) sets out new rules for how qualified financial contracts (QFCs), which include securities financing arrangements, may be affected in the event of a default of a major broker-dealer or other financial institution. Specifically, as explained in greater detail in our OLA article, it appears the FDIC's intent is that all QFCs between a large failed financial institution and a single counterparty will either be transferred to a federally-funded "bridge" company and continued without interruption or loss, or remain in the insolvent entity and likely receive less than full value. It is likely that over-collateralized securities loans will be considered "viable" and transferred to the bridge company unless the counterparty had certain other contracts with the failing institution that were considered problematic, such as an under-collateralized derivative portfolio.

The proposed OLA regime raises two issues for banks engaged in indemnified agency securities lending, one capital intensive and more procedural. First, the FDIC's apparent broad interpretation of the one-business day stay required by the statute could potentially expose the agent bank to a one business day mark-to-market risk as the values of securities on loan and collateral fluctuate. Specifically, the statutory procedures prohibit termination of a QFC for one business day in the event of insolvency of the borrower. The FDIC has interpreted this to include a failure by the borrower to fund its mark-to-market collateral requirements. This may cause particular concern in the case where a broker-dealer fails to fund its collateral requirements on a Friday for securities on loan. Under the FDIC's current interpretation, the agent bank would not be able to take action to terminate the loan and liquidate the collateral until late in the day on the following Monday.

Second, there is a lack of clarity as to whether the “counterparty” to the covered borrower under the procedures is the indemnifying agent bank that facilitated the loan, or the beneficial owner of the securities. If the “counterparty” in an agency securities lending transaction is the agent bank, this would make the mechanics of OLA procedures easier and more cost-effective for agent banks. If, however, the ultimate securities lender is considered the “counterparty” (an outcome which the FDIC has indicated appears more likely), banks will need to deal with transactions between the failed broker-dealer and each of the banks’ lending clients separately under OLA. This results in uncertainty and creates risk for the agent bank because it could have many indemnified securities loans outstanding with one borrower but with multiple lending clients, some of which may be transferred to a bridge and some of which may not.

Unless and until the FDIC provides greater clarity (in a manner favorable to agent banks) as to how solvent qualified financial contracts will be affected in the event of an OLA proceeding for a large broker-dealer, agent banks will need to evaluate the risks posed by this uncertainty in the course of facilitating loans between large broker-dealers and beneficial owner counterparties. In any event, because the implementation of the OLA procedures remains uncertain in many respects, agent banks must prepare for bankruptcy procedures of major broker-dealer counterparties under both OLA and the Securities Investor Protection Act (SIPA). On a positive note, although there remain uncertainties under the statute, the changes may provide some improved stability in the event of a major broker-dealer default when compared to the provisions of SIPA.

### **C. Dodd-Frank Act Section 610 – Lending Limits**

As stated above, the consolidated concentration limits of Dodd-Frank 165(e) were developed in part because lending limits only applied to bank-level lending exposures. These bank-level limits themselves will be amended, however, by Section 610 of the Dodd-Frank Act. Section 610 for the first time expressly includes securities lending and borrowing transactions as well as derivative transactions in the definition of “loans and extensions of credit” covered by the lending limits for national banks, which comprise many of the large U.S. agent banks that operate securities lending programs. The OCC has proposed an interim final rule implementing this provision; however, it is not completely clear how the proposal applies to borrower default indemnification. Assuming indemnified agency lending would be treated in the same manner as principal securities lending, an agent bank may use either an approved internal models-based approach or a standardized “non-model method” to calculate credit exposure arising under the transaction for purposes of the limits. To the extent cash is taken as collateral, treatment of indemnified securities lending programs may not be affected depending on the approach taken. As the industry migrates to other types of collateral, however, the amendments to the lending limits may pose more issues for these programs at national banks, as well as at banks chartered in the many states that largely adopt OCC limitations in their own state laws. The interim final rule is effective July 21, 2012, with a temporary exception for extensions of credit arising from derivative or securities financing transactions until January 1, 2013.

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1 In this article, the “Dodd-Frank Act” refers to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

2 Risk Management Association (“RMA”) Comment letter, at p. 7 (Apr. 30, 2012).

3 In this article, the “Capital NPRs” refers to the Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action; Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule, each available at <http://www.federalreserve.gov/aboutthefed/boardmeetings/20120607openmaterials.htm>.

4 In this article, “Basel III” refers to the framework developed in Basel Committee on Banking Supervision (“BCBS”), Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (December 2010, rev. June 2011), available at [www.bis.org/publ/bcbs189.pdf](http://www.bis.org/publ/bcbs189.pdf); and BCBS, Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring (Dec. 2010), available at <http://www.bis.org/publ/bcbs188.pdf>.

5 In this article, the final joint market risk capital rule refers to Risk-Based Capital Guidelines: Market Risk, available at [http://www.federalreserve.gov/aboutthefed/boardmeetings/market\\_risk\\_capital\\_final\\_FR\\_draft\\_20120607.pdf](http://www.federalreserve.gov/aboutthefed/boardmeetings/market_risk_capital_final_FR_draft_20120607.pdf). “Basel II.5” refers to the framework developed in the following publications: BCBS and International Organization of Securities Commissions, The Application of Basel II to Trading Activities and the Treatment of Double Default Effects (April 2005), available at <http://www.bis.org/publ/bcbs111.pdf>; BCBS, Enhancements to the Basel II Framework (July 2009), available at <http://www.bis.org/publ/bcbs157.pdf>; BCBS, Revisions to the Basel II Market Risk Framework (July 2009), available at <http://www.bis.org/publ/bcbs158.pdf>; BCBS, Guidelines for Computing Capital for Incremental Risk in the Trading Book (July 2009), available at <http://www.bis.org/publ/bcbs159.pdf>; and BCBS, Changes to the Revisions to the Basel II Market Risk Framework (June 2010), available at <http://www.bis.org/press/p100618/annex.pdf>.

6 Dodd-Frank Act, Section 171.

7 The Clearing House Association L.L.C., “How much capital is enough?”: Capital Levels and G-SIB Capital Surcharges (September 26, 2011).

8 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (Nov. 7, 2011), §\_\_16(a)(1).

9 Finadium and BNY Mellon, 1st Quarter, 2012, available at <http://www.bnymellon.com/foresight/pdf/securitieslending-0112.pdf> (the “OLA article”).

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