COMMITTEE ON SECURITIES LENDING

September 20, 2013

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: ***Revised Basel III leverage ratio framework and disclosure requirements.***

Dear Sir or Madam:

The Committee on Securities Lending of the Risk Management Association (the “RMA”) appreciates the opportunity to provide comments to the Basel Committee on Banking Supervision (the "Committee"), with respect to the Consultative Document entitled *Revised Basel III leverage ratio framework and disclosure requirements* (the "Consultation").[1] We understand and accept the core rationales of the Consultation; the need to ensure that banking organizations possess the necessary loss absorbency to withstand potential losses, particularly during periods of market stress. The RMA believes that such a regulatory focus is not only appropriate given the financial crisis, but also necessary to ensure financial stability. We believe that a meaningful backstop leverage ratio is fundamental to sound capital management and believe the adoption of the supplemental leverage ratio (the “SLR”) will strengthen the risk-based approach of the broader Basel III Accord.

Though we support the general aims of the Committee’s work, we believe that certain clarifications concerning the treatment of agent securities lending transactions are necessary. Specifically, while we support the Committee’s acknowledgment that agent securities lending transactions do not create leverage for the agent bank and, therefore, warrant current exposure treatment, we are concerned that the relevant paragraphs outlining the treatment of exposures arising from the provision of an agent lender indemnification or guarantee require clarification to fully effectuate the treatment the Committee proposes. Our recommendations are set forth in Part III below.

Our comments are organized into three parts. Part I focuses on the agent securities lending market and the types of transactions our members intermediate. Included is a general discussion of how cash collateral is managed in accordance with client guidelines and why the

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

singular treatment of agent lending exposures outlined in the Consultation is warranted. Part II focuses on the different species of indemnification provisions that agent lenders provide and sets out why these should be included within the current exposure treatment for agent securities lending. Part III explains the minor clarifications that we believe are necessary to ensure the SLR framework appropriately captures the nuances of agent-intermediated securities lending transactions.

Part I: Agent securities lending services are critical to the financial markets.

Securities lending plays a critical role in the efficient functioning of financial markets. It helps facilitate the timely settlement of securities transactions, as well as the conduct of both market making and hedging activities. In addition, securities lending provides important benefits to institutional investors, such as retirement plans and mutual funds, by enabling the generation of low-risk, incremental returns on investment portfolios. These returns are used to enhance investment performance and offset administrative and other portfolio costs.
All of these benefits cannot flow to market participants if the banks charged with intermediating lending and borrowing are unnecessarily constrained.

Agent Banks act as intermediaries in securities lending programs by facilitating loans on behalf of securities lenders to qualified borrowers. Securities are generally lent pursuant to a (i) securities lending authorization agreement between the securities lender and the agent bank, and (ii) securities borrowing agreement between the borrower and the agent bank. Under these agreements, the borrower provides collateral to the securities lender (and generally, via its agent bank) in excess of the value of the loaned securities, usually by 2% to 10% depending upon the characteristics of the loaned securities and the collateral. The loan is then marked to market daily to ensure that the collateral consistently meets the requisite excess value.

The benefits of securities lending are well known not only to the markets, but also to the supervisory community. Time and again global regulators, including the Committee itself, have described the benefits of securities lending. The Committee has stated that securities lending markets are a "vital component of … domestic and international financial markets, providing liquidity and greater flexibility to securities, cash and derivatives markets," and the Financial Stability Board (the "FSB") has found that agent lenders play an important role by helping beneficial owners access "economies of scale, securities lending expertise and systems . . . specialized market knowledge and better access to borrowers."[2] Recently, the Federal Reserve Bank of New York (the "FRBNY") studied the repo and securities lending markets and determined that the services RMA members provide are necessary for both fixed income and equity markets.[3] Moreover, the FRBNY noted that securities lending is especially important to create liquidity in markets for sovereign bonds, providing broad benefits concerning price discovery, efficiency and market liquidity.

Supervisors recognize that securities lending increases global market liquidity and enhances price discovery. For these reasons, it was appropriate that the Committee applied a different treatment to exposures arising from the provision of an agent indemnification from that

[2] *See* BCBS, *Securities lending transactions: market development and implications* (July 1999), *available at* http://www.bis.org/publ/cpss32.htm; FSB, *Securities Lending and Repos: Market Overview and Financial Stability Issues* 20-21 (Apr. 27, 2012), *available at* http://www.financialstabilityboard.org/publications/r_120427.pdf.

[3] Federal Reserve Bank of New York – Staff Reports – Repo and Securities Lending (January 2012).

for principal exposure. To implement the treatment set out in the Consultation, we recommend the Committee adopt the technical clarifications discussed in Part III below.

A. The provision of an agent indemnification or guaranty does not create leverage for the agent lender.

The provision of securities replacement guarantees or indemnification for borrower defaults by agent lenders is standard market practice. Securities lending agreements typically provide that lending clients are indemnified by the agent banks for any shortfall in collateral in the event of a borrower default. Securities lending is often viewed by lending clients as a lower-risk investment strategy complimentary to other asset servicing relationships, such as custody, due to the over-collateralization of loans and borrower default indemnification. The securities replacement guarantee provides both protection to the clients' own programs and a validation of the strength of their agent lenders' risk management systems.

Beyond market strategy considerations, the agent indemnification is a legal requirement for many securities lending clients. Many lending clients are required under applicable law to receive borrower default indemnification by an agent bank in their securities lending program under defined circumstances.[4] This is especially true in the context of ERISA plans; certain states and municipalities also require indemnification from the lending agent, either by statute or by policy, as a condition to their funds' participation in securities lending.[5] In addition, the Securities and Markets Stakeholder Group of the European Securities and Markets Authority ("ESMA") has recommended that the securities lending agent be required to indemnify Exchange Traded Funds and other UCITS (Undertaking for Collective Investment in Transferable Securities) funds that loan securities.[6]

The necessity of providing indemnifications to lending clients by agent lenders makes it critical for the Committee to ensure its current exposure plan captures all aspects of agent-intermediated securities lending transactions, including the technical details and scope of a typical indemnification provision. Such an approach would maintain proper delineation between agent and principal securities lending activities.

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[4] *See* Prohibited Transaction Exemption (PTE) 2006-16, Class Exemption To Permit Certain Loans of Securities by Employee Benefit Plans, 71 Fed. Reg. 63,786 (Oct. 31, 2006) (requiring in the case of securities lending transactions involving (i) certain types of foreign banks or broker-dealers as borrowers or (ii) certain types of collateral, including U.S. and non-U.S. securities, defined in the exemption as "Foreign Collateral," that a U.S. bank or broker-dealer "Lending Fiduciary" indemnify the lending plan for borrower default).

[5] *See*, *e.g.*, Texas Government Code § 825.303(b)(3) (stating that in order for a bank to be eligible to lend securities on behalf of a Texas Public Fund, the bank must "execute an indemnification agreement satisfactory in form and content to the retirement system fully indemnifying the retirement system against loss resulting from borrower default).

[6] *See* European Securities and Markets Authority, *Consultation paper: ESMA's guidelines on ETFs and other UCITS issues, ESMA/2012/44* 42, 68, 75 (Jan. 30, 2012), *available at* http://www.esma.europa.eu/consultation/ Consultation-ESMA-guidelines-regulatory-framework-ETFs-and-other-UCITS-issues.

B. The Consultation's proposed treatment of securities lending exposures is directionally correct and aligned with historical loss data.

The historical loss record associated with the provision of indemnifications and guarantees to lending clients by agent lenders supports that such product offerings are not a means for injecting additional leverage into the financial system and are lower risk financial products. A recent internal RMA survey indicates that most firms with large agency securities lending operations have never experienced a loss due to the provision of indemnifications. Further, across the totality of our members involved in agency lending, no firm's data indicated anything more than a few *de minimis* losses. This data set included the financial crisis and RMA member close-outs involving Lehman Brothers and AIG.

Part II: The use of a current exposure method is appropriate for agent securities lending transactions

Providing indemnities or guaranties to securities lending customers does not create any ability for agent banks to lever up their balance sheets. The securities replacement guarantees provided in connection with agency securities lending transactions do not result in risky off-balance sheet exposure for agent banks. An agent bank's exposure arising from a securities replacement guarantee is the difference, if any, between the mark-to-market amount of the collateral posted and the repurchase price of the securities that the borrower failed to return, with the risks being further reduced by any excess margin of collateral held. The likelihood of this exposure resulting in material losses to agent banks is low since the borrower's obligation to return loaned securities is typically secured by an excess amount (generally 102% to 105%, and sometimes up to 110%) of cash or liquid securities collateral (often high-quality sovereign debt). Loaned securities and non-cash collateral are marked to market daily. In the event of a borrower default, the agent bank would first look to the marked to market collateral posted, substantially reducing any risk of loss to the bank.[7]

The concept of "right-way" credit risk also applies to many securities lending transactions. For example, in the case of a loan of equity securities against cash or sovereign collateral, an agent bank's liability under a securities replacement guarantee is contingent upon both of the following market events happening concurrently: (i) the default of a borrower (typically a major broker-dealer) and (ii) a rally in the equity market that leads to the value of securities on loan appreciating beyond the level of collateralization related to the prior day's marking to market. Such a confluence of events has proven highly unlikely.

Part III: Suggested Technical Clarifications

A. Control Issue

Paragraph 39 and related footnote 23 could be read to limit the ability of a bank to use the current exposure treatment in standard agent lending transactions. This is due to the Consultation's lack of clarity concerning bank's management of received collateral. We respectfully request that the Committee clarify that an agent bank will not be deemed to own or control cash collateral when it acts as an investment manager on behalf of a client. The receipt, holding and/or investment of cash collateral are core agent lender services provided by many

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[7] As discussed previously, an informal survey of RMA members involved in the drafting of this letter indicates that many members with the largest securities lending operations have never experienced any losses as a result of borrower-default indemnification, and that none has incurred material losses as a result of the indemnification.

agent banks. All of this investment management activity takes place either in accordance with specific client guidelines or, in a commingled fund, in accordance with fund guidelines that have been agreed to by the client either contractually or by disclosure.

The reinvestment activity may occur in a client separate account, in a commingled fund such as a joint account, a collective trust fund, a money market fund registered with the SEC or under UCITS. Multiple clients' cash may be commingled, including cash not derived from securities lending activities, but the cash is not commingled with the bank's own assets. When securities are accepted as collateral, multiple clients' collateral may be commingled in a single custodial account but as with cash collateral, would not be commingled with the bank's own assets. This reinvestment occurs, however, at the client's discretion and according to their direction. Moreover, the client has the cash reinvestment risk, which is clearly spelled out in the underlying agreement.

In addition to the limitations on the lending agent's discretion throughout the cash reinvestment process, it is also important to note that reinvestment does not result in cash being leveraged by the agent bank. All reinvestment activities are conducted on behalf of the particular fund or of the commingled fund in which the client invests. Agent lenders (and lenders themselves) are prohibited from re-hypothecating collateral; nor is collateral used in a principal capacity.

The RMA requests formal clarification that the receipt, holding and/or investment of cash collateral on behalf of lending clients, a fundamental aspect of many agent-intermediated securities lending programs, does not alter the proposed current exposure treatment for agent banks. Such clarification would be consistent with footnote 23 of the Consultation, which suggests that a bank does not lose the exception treatment of Paragraph 38 when it manages collateral on the account of a customer or borrower.

B. Limitation of Exposure to Value Difference

In addition to the provision of an indemnification or guaranty, agent lenders provide a host of additional services ancillary to their intermediation role. There are various miscellaneous processing or transaction costs that are generally covered by standard agent lending indemnifications. We believe Paragraph 39 should be revised to clarify that costs incidental to an agent-intermediated transaction may be covered by a qualifying indemnifications.

For example, as part of the overall servicing of a transaction, agents typically process substitute payments for clients. Substitute payments are merely the outgrowth of contractual obligations between the beneficial owner of a security and a borrower designed to ensure the owner retains the economic value of securities lent. The agent lender, on behalf of the borrower, provisionally credits substitute payments to the owner-lender. This standard agency function does result in a temporary, *de minimis* exposure, but only for the time between the agent lender's forwarding of the funds and the borrower's processing of the dividend. The RMA is concerned that the language in Paragraph 39 limiting a qualifying indemnification to the difference between the value of the security lent and the value of collateral provided by a borrower may exclude the provision of substitute payments or related contractual provisions concerning transaction costs.

We respectfully request that the Committee clarify that if, in addition to a guarantee to a customer or counterparty for any difference between the value of the security or cash the customer has lent and the value of collateral the borrower has provided, an agent bank in an SFT assumes supplemental or contractual obligations in respect of the transaction, he agent will have the ability to calculate its exposure measure by applying only section (ii) of paragraph 35, so long as the agent bank is not, as a result, further economically exposed to potential losses in the value of the collateral that the borrower has provided. This clarity is necessary to allow agent banks, in their capacity as service providers to their customers, to offer customary operational protections that have never been interpreted as subject to capital charges. These customary protections do not subject the agent bank to economic exposure to the underlying security or cash in the transaction and do not cause additional leverage in the banking sector nor do they create an opportunity for the agent bank to rehypothecate the collateral or subject the bank to collateral reinvestment risk, which the leverage ratio was designed to mitigate.

To the extent the Committee declines to extend the current exposure treatment to ancillary and limited contractual obligations beyond the underlying securities lending transaction, we request that the current exposure measure be retained for the actual indemnification, with the additional contractual obligations treated separately.

C. Indemnified Repo

The extension of the agent indemnification to the repurchase leg of certain securities lending transactions is a fairly common practice for many agent banks. When the cash collateral reinvestment involves a repurchase transaction, the cash collateral of the original lending transaction may be subject to a separate contractual counterparty default indemnification provision**.** That indemnification generally covers the difference between the cash investment and the value of collateral of the indemnified repurchase transaction. The transaction is procedurally identical to the underlying securities lending agreement and does not present any opportunity for additional leverage by an agent lender. Rather, in the event of a default, the agent lender is responsible for providing the lending client the difference between the repurchase counterparty's collateral and the cash investment amount.

We respectfully ask the Committee to clarify that such a transaction, which is an outgrowth of an agent-intermediated securities lending trade with similar indemnification standards, does not result in the loss of the current exposure treatment

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We encourage the Committee to consider the comments and recommendations we have set forth in this letter. If desired by the Committee, the RMA would be pleased to discuss this letter in further detail, and stands ready to assist the Committee in any way as it formulates the SLR.

Sincerely,

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