February 1, 2006

MEMORANDUM TO: The Board of Directors

FROM: Christopher J. Spoth, Acting Director
Division of Supervision and Consumer Protection

SUBJECT: Final Rule Amending the Securities Borrowing Rule in Appendix C to Part 325 (Market Risk Capital Rule)

SUMMARY

The Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) issued an interim final rule on December 5, 2000, that provides substantial risk-based capital relief for cash collateral posted in connection with certain securities borrowing transactions for banks subject to the Market Risk Capital Rule, (12 CFR Part 325, Appendix C). We recommend that the interim final rule should be modified to expand the scope of the capital relief to cover securities borrowing transactions that are unconditionally cancelable or overnight, or that may be netted and closed out in the event of default, including counterparty insolvency. The rule would be issued as a final interagency rule with the FRB and the OCC and published in the Federal Register. The final rule more closely aligns the capital requirements with the risks present in these transactions.

The FDIC supervises two banks that, while eligible for the capital treatment in the final rule, have not engaged in a significant amount of securities borrowing transactions.

RECOMMENDATION

DSC recommends that the Board approve this final rule, to be effective upon its publication in the Federal Register.

Concur:

Douglas H. Jones
Acting General Counsel

DISCUSSION

Appendix C to Part 325 of the FDIC's regulations sets forth risk-based capital requirements for banks with significant exposures to market risk. These rules ensure that banks subject to Appendix C maintain adequate capital to support the risks arising from such exposures. Appendix C applies only to insured state nonmember banks whose trading activity equals (on a worldwide consolidated basis): (i) 10 percent or more of its total assets, or (ii) $1 billion or more in trading activity.

On December 5, 2000, the FRB, the OCC and the FDIC (collectively, the Agencies) jointly issued an interim final rule amending the Agencies' Market Risk Capital Rules to revise the capital treatment for certain securities borrowing transactions (Securities Borrowing Rule). For FDIC-supervised institutions, the Securities Borrowing Rule revised the risk-based capital treatment under Appendix C on cash collateral posted in connection with certain securities borrowing transactions. In a typical securities borrowing transaction, a party (such as a bank) needing to borrow securities obtains the securities from a securities lender and posts collateral in the form of cash or highly marketable securities with the securities lender in an amount that fully covers the value of the securities borrowed plus an additional margin. The purpose of the rule was to amend Appendix C to reflect the low level of risk associated with such transactions, subject to certain criteria. Prior to this amendment, cash collateral posted in connection with securities borrowing transactions was subject to a 100% risk-weight under Appendix C. Following this amendment, banks engaged in securities borrowing transactions and subject to Appendix C were able to obtain a more favorable capital treatment for certain securities borrowing transactions (i.e., to assign the covered amount of qualifying transactions to the 0% risk weight category).

Under the interim final rule, a securities borrowing transaction must meet four criteria to qualify for the reduced capital treatment. These criteria are:

(i) The transaction is based on securities includable in the trading book that are liquid and readily marketable,
(ii) The transaction is marked to market daily,
(iii) The transaction is subject to daily margin maintenance requirements,

(iv) The transaction is a securities contract for the purposes of section 555 of the Bankruptcy Code (11 U.S.C. 555), a qualified financial contract for the purposes of section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions for the purposes of sections 401--407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401--4407), or the Board's Regulation EE (12 CFR Part 231).

When the interim final rule was promulgated, the Agencies sought public comment on all aspects of the Securities Borrowing Rule.

The FDIC received four comments on the Securities Borrowing Rule. One banking organization stated that the fourth criterion was unnecessary and should be deleted.[1] This banking organization recommended that instead of this requirement, the Agencies merely require that the pledge of the borrowed securities be legally enforceable in the event of counterparty failure. It suggested that a bank meeting this legal enforceability standard would be able to recover the full value of the collateral.

Recently, the Agencies have learned that the current scope of the Securities Borrowing Rule as constructed excludes various types of low risk transactions, because in various instances the counterparties in such transactions are not subject to the U.S. Bankruptcy Code, the FDI Act, or FDICIA (e.g., foreign companies, insurance companies and pension funds).

On November 17, 2005, the FRB hosted an industry forum to solicit comments from banks currently subject to the Market Risk Capital Rule to discuss possible amendments to the Securities Borrowing Rule that would remedy the eligibility issues with the interim rule. At the forum, several industry representatives confirmed that most of the counterparties that lend securities in conjunction with securities borrowing transactions are not subject to the U.S. Bankruptcy Code, the FDI Act, or FDICIA. Consequently, cash posted as collateral in connection with securities borrowing transactions involving such counterparties is subject to a 100% risk-weight under the Market Risk Capital Rule, despite the low risk associated with such securities borrowing transactions. In contrast,

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[1] See letter from First Union Corporation to the Agencies, dated January 19, 2001.

U.S. broker dealers are not required to hold capital against similar types of securities borrowing transactions.

In response to the issues raised at the industry forum and the comments received on the Securities Borrowing Rule, staff from the Agencies recommend that a final rule be issued that would permit additional securities borrowing transactions to qualify for favorable capital treatment under the Securities Borrowing Rule. In addition to those securities borrowing transactions that meet the rule under the current fourth criterion, the final rule would create an alternative criterion to provide favorable capital treatment to certain securities borrowing transactions where the securities borrowing agreement includes the right by the bank to close out the transactions on a net basis provided that: (i) upon an event of default, including the insolvency of a counterparty, the bank's right to close out the transactions will not be stayed under applicable law, or (ii) the transactions are unconditionally cancelable or conducted on an overnight basis. Under this alternative fourth criterion, banks would be required to conduct sufficient legal review to conclude with a well-founded basis that: (i) the bank may close-out and net the transaction promptly in the event of counterparty default and (ii) the securities borrowing agreement is legal, valid, binding, and enforceable under the applicable law.

The final rule would not amend the first three criteria in the current Securities Borrowing Rule. Therefore, all securities borrowing transactions would be required to meet these three criteria.

Thus, the final rule would cover certain securities borrowing transactions with foreign companies, insurance companies, and pension funds that meet the first three criteria in the current Securities Borrowing Rule and that are unconditionally cancelable or conducted on an overnight basis. As noted above, these transactions are not covered by the current Securities Borrowing Rule, because such foreign companies, insurance companies, and pension funds are not subject to the U.S. Bankruptcy Code, the FDI Act, or FDICIA. For such transactions, there is a risk that in the event of default, the counterparty may enter into insolvency proceedings before the bank can liquidate the

collateral and close out the transaction. However, the final rule includes prudential safeguards that are considered sufficient to qualify such securities borrowing transactions for favorable capital treatment given the low risk nature of these transactions, as reflected in the industry's experience since the issuance of the interim final rule.

The FDIC would publish this final rule in the Federal Register as a joint rulemaking with the FRB and the OCC. The FRB believes that issuing a notice of proposed rulemaking or a new interim final rule would create unnecessary delays in providing this favorable capital treatment for certain securities borrowing transactions and that there is a sufficient basis in the comments on the interim final rule to view this amendment as a natural outgrowth of the comments received on that rule. The FDIC's Legal Division concurs with the FRB's conclusion that despite the length of time since the issuance of the interim final rule, the promulgation of a final rule for this amendment to the Securities Borrowing Rule is legally permissible.

The effective date for the final rule would be the date of the rule's publication in the Federal Register. Under the Administrative Procedure Act, there must be a 30-day delay between the publication date for a final rule and the rule's effective date. However, there is an exception from that 30-day period for "good cause found." In this rulemaking, the Agencies are concerned that it is contrary to the public interest for U.S. banking organizations to be held to less favorable capital treatment for certain securities borrowing transactions than similar transactions conducted by foreign competitors and other types of domestic financial services firms.