

Securities Lending Alert

A report
for clients
and friends
of the firm

May 2003

Fed Modifies Capital Charges For Certain Indemnified Securities Lending Programs

Recently, the Board of Governors of the Federal Reserve System (the "Fed"), at the request of State Street Bank and Trust Company, approved an exception to its risk-based capital guidelines for indemnified securities lending. The exception applies to securities lending agency transactions collateralized by cash where the agent bank indemnifies its client against both (i) the risk that, in the event of default by the securities borrower, the amount of cash collateral is insufficient to repurchase the amount of securities lent and (ii) the reinvestment risk associated with lending the cash collateral in a transaction fully collateralized by securities (typically, a reverse repurchase transaction involving government or corporate securities).

Under the existing risk-based capital guidelines, the first indemnification would receive the risk-weight of the securities borrowing counterparty because of the bank's indemnification of the client's reinvestment risk on the cash collateral. The second indemnification would receive the lower of the risk weight of the reverse repurchase counterparty or the collateral (unless fully collateralized by OECD government securities, which would qualify for a zero percent risk weight).

State Street noted that the Fed's capital charges placed it at a competitive disadvantage with securities lending activities of European agents because most European regulators allow a zero percent risk weight for both indemnifications. The Fed agreed that existing capital charges are significantly out of proportion to the risk and provided relief.

Under the Fed's new framework, a bank will not use the notional amount of underlying transactions that are subject to client indemnifications as the "expo-

sure amount" for risk-based capital purposes. Rather, a bank must determine an "unsecured loan equivalent amount" for each counterparty, and this amount will be assigned the risk weight appropriate to such counterparty.

To determine the "unsecured loan equivalent," the bank adds its current exposure to the counterparty and its potential future exposure ("PFE") to the counterparty. Current exposure is the sum of the market values of all securities lent to the counterparty and cash invested with the counterparty through repo under the bank's indemnified arrangements, less the sum of all securities and cash received from the counterparty as collateral under the indemnified arrangements. PFE is intended to pick up market volatilities of the securities lent and the securities received in a reverse repo (from investment of the cash collateral) as well as foreign exchange rate volatility associated with any cash or securities denominated in other than U.S. dollars. For State Street, the Fed required use of value-at-risk (VaR) modeling. State Street was required to calculate VaR using a five-day holding period and a 99th percentile one-tailed confidence interval based on market price data over a one-year historical observation. Data was required to be updated at least quarterly. For each counterparty, the unsecured loan equivalent amount was required to be calculated daily.

To qualify for the favorable capital treatment, the indemnified securities lending and repo transactions are required, upon the occurrence of an event of default such as insolvency or bankruptcy of the counterparty, to be subject to a bilateral netting agreement allowing all securities loan and repo transactions to be closed out, liquidated, and all gains and losses netted and set off against one another so that only a single net amount is owed by one party to the other.

The Fed stated that the revised capital treatment was not inconsistent with the current Basel capital framework and was generally in line with ongoing efforts to revise the Basel Accord. It noted that the capital treatment made available to State Street would be made available to similarly situated institutions upon request and approval by the Fed.

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Client Alert

Proskauer's Corporate Law Department includes over 140 attorneys with significant and diverse corporate law experience. The following individual serves as a contact person and would welcome any questions you might have.

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