

# Securities Lending Alert

A report  
for clients  
and friends  
of the firm July 2002

## Capital Risk-Weighting Developments

Effective July 1, 2002, the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of Thrift Supervision ("OTS") amended their respective risk-based capital standards for banks, bank holding companies and savings associations with regard to the risk-weighting of claims on, and claims guaranteed by, qualifying securities firms. This has relevance to banks which effect securities loans and repos as principal, and to banks which, as securities lending agent, indemnify their customers against borrower default.

For securities firms incorporated in the OECD-based group of countries, "qualifying securities firms" are defined as those securities firms that a banking organization is able to demonstrate are subject to consolidated supervision and regulation (covering their direct and indirect subsidiaries but not necessarily their parent organization) comparable to that imposed on banks in OECD banking countries. Such regulation must include risk-based capital requirements comparable to those applied to banks under the Basel Accord. For securities firms incorporated in the United States, "qualifying securities firms" are those securities firms that are broker-dealers registered with the SEC and in compliance with the SEC's net capital rule. The U.S. regulators determined that net capital monitoring of counterparties should not be burdensome for banking organizations because securities firms not in compliance with the net capital rule must immediately cease conducting business as broker-dealers, which would usually be well-known in the United States. Absent information to the contrary, banking organizations could rely on annual reports or other confirmations of compliance provided by securities firms.

In respect of securities lending/borrowing and repo/reverse repo transactions with qualifying securities firms, which are collateralized by marketable securities other than cash or securities issued or guaranteed by the United States (including U.S. government agencies) or other OECD central governments, the risk-weighting is 20%. In relevant part, the amended statutes provide that the 20% risk-weighting is applicable to:

Certain collateralized claims on qualifying securities firms in the United States or other members of the OECD-based group of countries, without regard to satisfaction of the rating standard [one of the three highest investment-grade rating categories from a nationally recognized statistical rating organization applicable to the securities firms or a parent guarantor], provided that the claim arises under a contract that:

- (a) Is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed under standard industry documentation;
- (b) Is collateralized by liquid and readily marketable debt or equity securities;
- (c) Is marked to market daily;
- (d) Is subject to a daily margin maintenance requirement under the standard industry documentation; and
- (e) Can be liquidated, terminated, or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or avoided, under applicable law of the relevant jurisdiction.

Clause (e) is satisfied because a claim is exempt from the automatic stay in bankruptcy in the United States if it arises under (i) a securities contract or repurchase agreement subject to Section 555 or 559 of the Bankruptcy Code, (ii) a qualified financial contract under Section 11(e)(8) of the Federal Deposit Insurance Act, (iii) a netting contract between financial institutions under Sections 401-407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 or (iv) Regulation EE of the FRB.

In addition, the FDIC and the OTS amended their risk-based capital standards to harmonize with existing rules of the FRB and the OCC to permit a zero percent risk-weighting for certain claims on qualifying securities firms (including repo and securities lending/borrowing transactions) that are fully collateralized by cash on deposit in the lending institution or by securities issued or guaranteed by the United States (including U.S. government agencies) or other OECD central governments, and that are marked to market daily.

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NEWARK PARIS

### 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.

**Charles E. Dropkin**  
212.969.3535 - [cdropkin@proskauer.com](mailto:cdropkin@proskauer.com)

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1585 Broadway  
New York, NY 10036-8299  
212.969.3000

2049 Century Park East  
32nd Floor  
Los Angeles, CA 90067-3206  
310.557.2900

2255 Glades Road  
Suite 340 West  
Boca Raton, FL 33431-7383  
561.241.7400

1233 Twentieth Street NW  
Suite 800  
Washington, DC 20036-2396  
202.416.6800

One Newark Center  
18<sup>th</sup> Floor  
Newark, NJ 07102-5211  
973.274.3200

68, rue du Faubourg Saint-  
Honoré  
75008 Paris, France  
331.53.05.60.00

You can also visit our Website at [www.proskauer.com](http://www.proskauer.com)

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