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Client Alert

A report for clients and friends of the firm

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FEDERAL BANK REGULATORS ISSUE FINAL RULE ON RISK WEIGHTING OF CASH COLLATERALIZED SECURITIES BORROWINGS

Effective February 22, 2006, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation issued a final rule to address risk-based capital treatment for cash collateral that is posted by a banking organization in connection with securities borrowing transactions. The final rule, which makes permanent and expands the scope of an interim rule issued in 2000, excludes from risk-weighted assets those receivables arising from the posting of cash collateral in securities borrowing transactions to the extent such receivables are collateralized by the market value of the securities borrowed. Since securities borrowings are typically over-collateralized, the extent of the excess collateral cushion (the difference between the amount of cash collateral posted in support of the securities borrowing and the value of the securities borrowed) would be assigned to the risk weight appropriate to the bank as securities borrower. Thus, for example, to the extent that cash collateral posted is equal to 102% of the value of the borrowed securities, only 2% of the cash collateral would be subject to risk weighting and capital set-aside.

Securities borrowings which are collateralized by securities (other than cash) would continue to be not subject to risk weighting and capital set-aside. Although the regulators acknowledged this lack of consistency in treatment between cash and securities collateralized securities borrowings, the regulators felt that the benefit of mandating consistency would be outweighed by the extra burden that would be imposed on banks.

To avail itself of the final rule, banking organizations must have adopted the market risk rule for assessing capital adequacy for trading positions and have satisfied the following conditions:

1. The borrowed securities includable in the trading book must be liquid and readily marketable,

2. The transaction must be marked to market daily and subject to daily margin maintenance requirements, and

3. The securities borrowing transaction must be a "securities contract" under the US Bankruptcy Code, a "qualified financial contract" under the Federal Deposit Insurance Act or a "netting contract between or among financial institutions" under the Federal Deposit Insurance Corporation Improvement Act or Regulation EE of the Federal Reserve Board; or the bank shall have determined that it has a legally enforceable agreement to terminate and close out all transactions upon counterparty insolvency or the transaction is, by its terms, terminable on demand with like rights of close-out.

The regulators noted that the treatment set forth in the final rule for securities borrowing could result in lower capital charges than that contained in the Basel II framework.

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