BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: **Securities Lending**

To: Chief Executive Officers of All National Banks, Deputy Comptrollers (District) and All Examining Personnel

PURPOSE

The Comptroller of the Currency has approved a new uniform policy for supervising national banks which are lending securities. The Federal Financial Institutions Examination Council (FFIEC) recently endorsed the same supervisory policy. Adoption of the policy by the FFIEC is intended to achieve uniform and effective supervision by financial institutions participating in securities lending.

BACKGROUND

The policy is directed toward national banks that are lending securities from their own investment or trading accounts or from safekeeping, trust or pension accounts of their customers. The securities loaned may be corporate equity or debt obligations or U.S. government and federal agency securities. Because securities brokers and dealers are the primary borrowers of securities, bankruptcies of several brokers have heightened regulatory sensitivity to the potential for problems in this area.

GUIDELINES

This policy focuses on prudent controls for securities lending. It is intended to provide guidance to national banks operating securities lending programs as well as examiners reviewing the activity. The areas of supervisory concern addressed in the guidelines include: recordkeeping, credit analysis and approval of borrowers, credit and concentration limits, collateral management, regulatory reporting and the necessity for written policies and procedures.

The examination of the securities lending activity will center on the adequacy of supervision, including written policies and procedures, internal controls and audit coverage.

The statement of the uniform supervisory policy as endorsed by the Comptroller of the Currency is attached.

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ORIGINATING OFFICE

If questions arise regarding this circular, contact the Investment Securities Division, (202) 447-1901, Washington, D.C. 20219.

H. Joe Selby
Acting Comptroller of the Currency

Attachment

Federal Financial Institutions Examination Council
Supervisory Policy

SECURITIES LENDING

PURPOSE

Financial institutions are lending securities with increasing frequency. In some instances a financial institution may lend its own investment or trading account securities. More and more often, however, financial institutions lend customers' securities held in custody, safekeeping, trust or pension accounts. Not all institutions that lend securities or plan to do so have relevant experience. Because the securities available for lending often greatly exceed the demand for them, inexperienced lenders may be tempted to ignore commonly recognized safeguards. Bankruptcies of broker/dealers has heightened regulatory sensitivity to the potential for problems in this area. Accordingly, we are providing the following discussion of guidelines and regulatory concerns.

SECURITIES LENDING MARKET

Securities brokers and commercial banks are the primary borrowers of securities. They borrow securities to cover securities fails (securities sold but not available for delivery), short sales, and option and arbitrage positions. Securities lending, which used to involve principally corporate equities and debt obligations, increasingly involves loans of large blocks of U.S. government and federal agency securities.

Securities lending is conducted through open-ended "loan" agreements, which may be terminated on short notice by the lender or borrower. [1] The objective of such lending is to receive a safe return in addition to the normal interest or dividends. Securities loans are generally collateralized

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[1] Repurchase agreements, generally used by owners of securities as financing vehicles are, in certain respects, closely analogous to securities lending. Repurchase agreements however, are not the direct focus of these Guidelines. A typical repurchase agreement has the following distinguishing characteristics:

- The sale and repurchase (loan) of U.S government or federal agency securities.
- Cash is received by the seller (lender) and the party supplying the funds receives the collateral margin.
- The agreement is for a fixed period of time.
- A fee is negotiated and established for the transaction at the outset and no rebate is given to the borrower from interest earned on the investment of cash collateral.
- The confirmation received by the financial institution from a borrower broker/dealer classifies the transaction as a repurchase agreement.

by U.S. government or federal agency securities, cash, or letters of credit. [2]At the outset, each loan is collateralized at a predetermined margin. If the market value of the collateral falls below an acceptable level during the time a loan is outstanding, a margin call is made by the lender institution. If a loan becomes over-collateralized because of appreciation of collateral or market depreciation of a loaned security, the borrower usually has the opportunity to request the return of any excessive margin.

When a securities loan is terminated, the securities are returned to the lender and the collateral to the borrower. Fees received on securities loans are divided between the lender institution and the customer account that owns the securities. In situations involving cash collateral, part of interest earned on the temporary investment of cash is returned to the borrower and the remainder is divided between the lender institution and the customer account that owns the securities.

DEFINITIONS OF CAPACITY

Securities lending may be done in various capacities and with differing associated liabilities. It is important that all parties involved understand in what capacity the lender institution is acting. For the purposes of these Guidelines, the relevant capacities are:

Principal: A lender institution offering securities from its own account is acting as principal. A lender institution offering customers' securities on an undisclosed basis is also considered to be acting as principal.

Agent: A lender institution offering securities on behalf of a customer-owner is acting as an agent. For the lender institution to be considered a bona fide or "fully disclosed" agent, it must disclose the names of the borrowers to the customer-owners (or give notice that names are available upon request), and must disclose the names of the customer-owner to borrowers (or give notice that names are available upon request). In all cases the agent's compensation for handling the transaction should be disclosed to the customer-owner. Undisclosed agency transactions, i.e. "blind brokerage" transactions in which participants cannot determine the identity of the contraparty, are treated as if the lender institution were the principal. (See definition above.)

Directed Agent: A lender institution which lends securities at the direction of the customer-owner is acting as a directed agent. The customer directs the lender institution in all aspects of the transaction, including to whom the securities are loaned, the terms of the transaction (rebate rate and maturity/call provisions on the loan), acceptable collateral, investment of any cash collateral, and collateral delivery.

[2] Broker-dealers borrowing securities are subject to the restrictions of the Federal Reserve's Regulation T (12 CFR 220.16), which specifies acceptable borrowing purposes and types of collateral.

Fiduciary: A lender institution which exercises discretion in offering securities on behalf of and for the benefit of customer-owners is acting as a fiduciary. For purposes of these Guidelines, the underlying relationship may be as agent, trustee, or custodian.

Finder: A finder brings together a borrower and a lender of securities for a fee. Finders do not take possession of the securities or collateral. Delivery of securities and collateral is direct between the borrower and the lender and the finder does not become involved. The finder is simply a fully disclosed intermediary.

GUIDELINES

All financial institutions that participate in securities lending should establish written policies and procedures governing these activities. At a minimum, policies and procedures should cover each of the topics in these Guidelines.

Recordkeeping

Before establishing a securities lending program, a financial institution must establish an adequate recordkeeping system. At a minimum, the system should produce daily reports showing which securities are available for lending, and which are currently lent, outstanding loans by borrower, outstanding loans by account, new loans, returns of loaned securities, and transactions by account. These records should be updated as often as necessary to ensure that the lender institution fully accounts for all outstanding loans, that adequate collateral is required and maintained, and that policies and concentration limits are being followed.

Administrative Procedures

All securities lent and all securities standing as collateral must be marked to market daily. Procedures must ensure that any necessary calls for additional margin are made on a timely basis.

In addition, written procedures should outline how to choose the customer account that will be the source of lent securities when they are held in more than one account. Possible methods include: loan volume analysis, automated queue, a lottery, or some combination of those. Securities loans should be fairly allocated among all accounts participating in a securities lending program.

Internal controls should include operating procedures designed to segregate duties and timely management reporting systems. Periodic internal audits should assess the accuracy of accounting records, the timeliness of management reports, and the lender institution's overall compliance with established policies and procedures.

Credit Analysis and Approval of Borrowers

In spite of strict standards of collateralization, securities lending activities involve risk of loss. Such risks may arise from malfeasance or failure of the borrowing firm or institution. Therefore, a duly established management or supervisory committee of the lender institution should formally approve, in advance, transactions with any borrower.

Credit and limit approvals should be based upon a credit analysis of the borrower. Review should be performed before establishing such a relationship and reviews should be conducted at regular intervals thereafter. Credit reviews should include an analysis of the borrower's financial statement, and should consider capitalization, management, earnings, business reputation, and any other factors that appear relevant. Analyses should be performed in an independent department of the lender institution, by persons who routinely perform credit analyses. Analyses performed solely by the person(s) managing the securities lending program are not sufficient.

Credit and Concentration Limits

After the initial credit analysis, management of the lender institution should establish an individual credit limit for the borrower. That limit should be based on the market value of the securities to be borrowed, and should take into account possible temporary (overnight) exposures resulting from a decline in collateral values or from occasional inadvertent delays in transferring collateral. Credit and concentration limits should take into account other extensions of credit by the lender institution to the same borrower or related interests. Such information, if provided to a bank trust department conducting a securities lending program, would not be considered material inside information and therefore, not violate "Chinese Wall" policies designed to protect against the misuse of material inside information. Violation of securities laws would arise only if material inside information were used in connection with the purchase or sale of securities.

Procedures should be established to ensure that credit and concentration limits are not exceeded without proper authorization from management.

When a lender institution is lending its own securities as principal, statutory lending limits may apply. For national banks, the limitations in 12 USC 84 apply. For state-chartered institutions, state law and applicable federal law must be considered. Certain exceptions may exist for loans that are fully secured by obligations of the United States government and federal agencies.

Collateral Management

Securities borrowers generally pledge and maintain collateral [3] at a level equal to at least 100 percent of the value of the securities borrowed. [4] The minimum amount of excess collateral, or

[3] Under the Federal Reserve Board's Regulation T (12 CFR 220.16) applicable to broker/dealers, the only acceptable collateral is as follows: cash, securities issued or guaranteed by the United States or its agencies, negotiable bank certificates of deposit and bankers acceptances issued by banking institutions in the United States and payable in the United States, or irrevocable letters of credit issued by a bank insured by the Federal Deposit Insurance corporation or a foreign bank that has filed an agreement with the Board on Form FR T2.

[4] Employee Benefit plans subject to the Employee Retirement Income Security Act are specifically required to collateralize securities loans at a minimum of 100 percent of the market value of loaned securities (see section concerning Employee Benefit plans).

margin acceptable to the lender institution should relate to price volatility of the loaned securities and the collateral (if other than cash) [5]. Generally, the minimum initial collateral on securities loans is at least 102 percent of the market value of the lent securities plus, for debt securities, any accrued interest.

Collateral must be maintained at the agreed margin. A Daily "mark-to-market" or valuation procedure must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should take into account the value of accrued interest on debt securities.

Securities should not be lent unless collateral has been received or will be received simultaneously with the loan. As a minimum step toward perfecting the lender's interest, collateral should be delivered directly to the lender institution or an independent third party trustee.

Cash as Collateral

When cash is used as collateral, the lender institution is responsible for making it income productive. Lenders should establish written guidelines for selecting investments for cash collateral. Generally, a lender institution will invest cash collateral in repurchase agreements, master notes, a short term investment fund (STIF), U.S. or Eurodollar certificates of deposits, commercial paper or some other type of money market instrument. If the lender institution is acting in any capacity other than as principal, the written agreement authorizing the lending relationship should specify how cash collateral is to be invested.

Investing cash collateral in liabilities of the lender institution or its holding company would be an improper conflict of interest unless that strategy was specifically authorized in writing by the owner of the lent securities. Written authorizations for participating accounts are further discussed later in these Guidelines.

Letters of Credit as Collateral

Since May 1982, letters of credit have been permitted as collateral in certain securities lending transactions outlined in Federal Reserve Regulation T. If a lender institution plans to accept letters of credit as collateral, it should establish guidelines for their use. Those guidelines should require a credit analysis of the banks issuing the letter of credit before securities are lent against that collateral. Analyses must be periodically updated and reevaluated. The lender institution should also establish concentration limits for the banks issuing letters of credit and procedures should ensure they are not exceeded. In establishing concentration limits on letters of credit accepted as collateral, the lender institution's total outstanding credit exposures from the issuing bank should be considered.

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[5] The level of margin should be dictated by level of risk being underwritten by the securities lender. Factors to be considered in determining whether to require margin above the recommended minimum include: the type of collateral, the maturity of collateral and lent securities, the term of the securities loan, and the costs which may be incurred when liquidating collateral and replacing loaned securities.

Written Agreements

Securities should be lent only pursuant to a written agreement between the lender institution and the owner of the securities specifically authorizing the institution to offer the securities for loan. The agreement should outline the lender institution's authority to reinvest cash collateral (if any) and responsibilities with regard to custody and valuation of collateral. In addition, the agreement should detail the fee or compensation that will go to the owner of the securities in the form of a fee schedule or other specific provision. Other items which should be covered in the agreement have been discussed earlier in these Guidelines.

A lender institution must also have written agreements with the parties who wish to borrow securities. These agreements should specify the duties and responsibilities of each party. A written agreement may detail: acceptable types of collateral (including letters of credit); standards for collateral custody and control, collateral valuation and initial margin, accrued interest, marking to market, and margin calls; methods for transmitting coupon or dividend payments received if a security is on loan on a payment date; conditions which will trigger the termination of a loan (including events of default); and acceptable methods of delivery for loaned securities and collateral.

Use of Finders

Some lender institutions may use a finder to place securities, and some financial institutions may act as finders. A finder brings together a borrower and a lender for a fee. Finders should not take possession of securities or collateral. The delivery of securities loaned and collateral should be direct between the borrower and the lender. A finder should not be involved in the delivery process.

The finder should act only as a fully disclosed intermediary. The lender institution must always know the name and financial condition of the borrower of any securities it lends. If the lender institution does not have that information it and its customers are exposed to unnecessary risks.

Written policies should be in place concerning the use of finders in a securities lending program. These policies should cover the circumstances in which a finder will be used, which party pays the fee (borrower or lender), and which finders the lender institution will use.

Employee Benefit Plans

The Department of Labor has issued two class exemptions which deal with securities lending programs for employee benefit plans covered by the Employee Retirement Income Security Act (ERISA) -- Prohibited Transaction Exemption 8-16 (46 FR 7527 (January 23, 1981) and correction published at 46 FR 10570 (February 3, 1981)), and Prohibited Transaction Exemption 82-63 (47 FR 14804 (April 6, 1982)). The exemptions authorize transactions which might otherwise constitute unintended "prohibited transactions" under ERISA. Any institution engaged in lending of securities for an employee benefit plan subject to ERISA should take all steps necessary to design and maintain its program to conform with these exemptions.

Prohibited Transaction Exemption 81-6 permits the lending of securities owned by employee benefit plans to persons who could be "parties in interest" with respect to such plans, provided certain conditions specified in the exemption are met. Under those conditions neither the borrower nor an affiliate of the borrower can have discretionary control over the investment of plan assets, or offer investment advice concerning the assets, and the loan must be made pursuant to a written agreement. The exemption also establishes a minimum acceptable level for collateral based on the market value of the loaned securities.

Prohibited Transaction Exemption 82-63 permits compensation of a fiduciary for services rendered in connection with loans of plan assets that are securities. The exemption details certain conditions which must be met.

Indemnification

Certain lender institutions offer participating accounts indemnification against losses in connection with securities lending programs. Such indemnifications may cover a variety of occurrences including all financial loss, losses from a borrower default, or losses from collateral default. Lender institutions that offer such indemnification should obtain a legal opinion from counsel concerning the legality of their specific form of indemnification under federal and/or state law.

A lender institution which offers an indemnity to its customers may, in light of other related factors, be assuming the benefits and, more importantly, the liabilities of a principal. Therefore, lender institutions offering indemnification should also obtain written opinions from their accountants concerning the proper financial statement disclosure of their actual or contingent liabilities.

Regulatory Reporting

Commercial banks conducting securities borrowing and lending transactions with securities owned by the lender institution (portfolio securities) should report the transactions according to the Instructions for the consolidated Reports of Condition and Income. Transactions involving the borrowing and lending of securities for the lender institution's own account are, for official reporting purposes, contingent obligations and, except for those transactions collateralized by cash, should be reported gross in Report of Condition schedule RC-L, "Commitments and Contingencies," as "Securities Borrowed" and/or "Securities lent." Securities borrowed or lent against cash collateral should not be reported in Schedule RC-L. Cash collateral received by a bank will be reported as a deposit in Schedule RC-E. If a bank borrows securities and pledges cash as collateral, the cash is to be reported as a balance due from a depository institution or alternatively as an "Other Asset" (Schedule RC-F) if the cash collateral is pledged to someone other than a depository institution.

When the lender institution is acting as a fully disclosed agent, securities lending activities need not be reported on the Report of condition. However, lending institutions offering indemnification against loss to its customer-owners should report the associated contingent liability gross in schedule RC-L as "Other significant commitments and contingencies."

Institutions subject to regulation by the Federal Home Loan Bank Board when lending their own securities should report the transactions as U.S. Government and Agency securities (Line A37O) on the Quarterly Financial Report.

Institutions subject to Regulation by the Federal Home Loan Bank Board
The Federal Home Loan Bank board has developed specific rules and regulations addressing securities lending for the institutions it regulates. An association lending its own securities is directed to 12 CFR 545.49 and memorandum R 48 and T 34-5 for additional guidance.

Questions
Questions concerning securities lending should be sent, in writing, to the lender institution's primary federal regulator.

National banks should contact the Comptroller of the Currency, Investment Securities Division, Washington, D.C. 20219, (202)447- 1901.

State Federal Reserve member banks should contact the Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation, Washington, D.C. 20551.

State non-member banks should contact the Federal Deposit Insurance Corporation, Division of Banking Supervision, Washington, D.C. 20429.

Federally insured savings and loan associations should contact the Federal Home Loan Bank Board, the Corporate and Securities Division, Office of the General Counsel or the Associate Director for Policy Development, Office of Examinations and Supervision, Washington, D.C. 20552.