Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

September 18, 2008

Interpretive Letter #1105
December 2008

Dear **[ ]**:

This is in response to your letter dated May 7, 2007 concerning the risk-based capital treatment for certain securities lending transactions conducted by **[ ]** (the Bank). The Bank is seeking approval to use the alternative approach described in the Office of the Comptroller of the Currency's Interpretative Letter #1066 (OCC Letter #1066) to calculate the risk-based capital requirements for those transactions. The Office of the Comptroller of the Currency (OCC) approves the use of the alternative approach for the securities lending transactions described in this letter, subject to the bank satisfying the conditions outlined below.

Description of the Transactions

The Bank enters into three types of securities lending transactions and is requesting approval to use the alternative approach to calculate risk-based capital for each type. The first type of transaction is identical to the transaction described in OCC Letter #1066 and consists of two components. First, the Bank, acting as agent for a customer, lends the customer's security to a counterparty and receives cash collateral in return. The security is marked to market daily, and the counterparty must maintain a positive margin of cash collateral at all times. The Bank indemnifies the customer against the risk of loss from a default of the counterparty. Such a loss could occur if the counterparty failed to post additional collateral upon the increase in the market value of the security. In such an event, the Bank would immediately terminate the transaction and use the cash collateral to replace the security. The Bank's loss is limited to the difference between the market value of the security and the cash collateral received. In the second component of the transaction, the Bank reinvests the cash collateral received on behalf of the customer in a reverse repurchase agreement or similar transaction. The counterparty in this second component posts collateral in the form of OECD government and U.S. Government-sponsored agency securities or liquid and readily marketable corporate debt and equity securities.

The security received as collateral in the second component is marked to market daily, and the counterparty must maintain a positive margin of collateral. As in the first component, the Bank indemnifies the customer against the risk of loss arising from a default by the counterparty of the second component. Such a loss could occur if the counterparty fails to post additional collateral upon the decrease in the market value of the security posted as collateral. The Bank then would terminate the transaction and sell the security to replace the customer's cash. The Bank's loss is limited to the difference between the cash lent to the counterparty and the market value of the security.

In the second type of securities lending transaction, the Bank, acting as agent for a customer, lends the customer's security to a counterparty and receives liquid securities as collateral. The security collateral may be an instrument that a bank could hold as an investment under 12 CFR 1 (bank-eligible investment) or an instrument that a bank would not be permitted to hold as an investment under 12 CFR 1 (bank-ineligible investment). As in the first type of transaction described above, the Bank indemnifies the customer against the risk of loss from a default of the counterparty. Such a loss could occur if the counterparty failed to post additional collateral upon the increase in the market value of the borrowed security. The Bank would immediately terminate the transaction, sell the security collateral, and use the proceeds to replace the borrowed security. The Bank's loss is limited to the difference between the market value of the security lent and the security collateral received.

In the third transaction type, the Bank plans to engage in conduit securities lending transactions where the Bank would act as an intermediary or "conduit lender" in such riskless principal transactions. In such a transaction, the Bank borrows the security as principal from the customer and on-lends the same security as principal to the ultimate security borrower. The collateral received by the Bank from the ultimate security borrower is passed through to the security lender. The Bank's loss exposure in acting as a conduit is limited to the difference between the market value of the securities lent and the market value of collateral pledged. The OCC approved the Bank's request to engage in this activity in OCC Interpretative Letter #1026 dated April 27, 2005.

Current Risk-Based Capital Treatment

Under the OCC's current risk-based capital rules, an indemnification issued in connection with a securities lending transaction is an off-balance sheet guarantee that is subject to risk-based capital charges. (12 CFR Part 3, Appendix A § 3(b)(1)(v) and corresponding footnote 15). In the first type of transaction, the Bank has indemnified the customer for both the risk of loss from the default of the counterparty and the reinvestment risk associated with the cash collateral. The Bank cannot consider the first component of the transaction collateralized by cash as it has been lent to the counterparty in the second component of the transaction, and thus is not in the control of the Bank. (12 CFR Part 3, Appendix A § 3(a)(1)(viii)(C)). The first component of the transaction would be considered a loan to the security borrower and receive a risk weight appropriate for the borrower. The second component of the transaction is considered a loan of the cash collateral from the first component. The security collateral received in connection with the second component could be recognized for risk-based capital purposes if it met the conditions of 12 CFR Part 3, Appendix A § 3(a)(1)(viii), 12 CFR Part 3, Appendix A § 3(a)(2)(iv) or 12 CFR Part 3, Appendix A § 3(a)(2)(viii). If not, the Bank would assign the risk weight appropriate for the counterparty in the second component.

In the second type of transaction, the Bank could recognize the security collateral received from the security borrower as collateral against the indemnification for risk-based capital purposes if the security met the conditions of 12 CFR Part 3, Appendix A § 3(a)(1)(viii), 12 CFR Part 3, Appendix A § 3(a)(2)(iv) or 12 CFR Part 3, Appendix A § 3(a)(2)(viii). If not, the Bank would assign the risk weight appropriate for the borrower of the security to the indemnity.

In a conduit securities lending transaction, the Bank acts as both a security borrower and a security lender. The current risk-based capital treatment for a securities borrowing transaction follows the accounting treatment of the transaction. If the Bank posts cash collateral, the cash collateral is reported as an account receivable on the Bank's balance sheet. Under the current risk-based capital rules, the Bank may consider that account receivable as collateralized by the borrowed security and hold capital only for the portion of the receivable that exceeds the marked-to-market value of the security collateral if the transaction meets the conditions of 12 CFR 3 Part 3, Appendix B §3(a)(1)(ii). If the Bank posts a security as collateral for the securities borrowing transaction, there is no risk-based capital requirement on that component of the conduit securities transaction. When the Bank lends that borrowed security, the risk-based capital treatment is the same as a securities lending transaction where the Bank acts as agent and provides an indemnification.

Alternative Risk-Based Capital Approach – the VAR Approach

The Bank is requesting approval for an alternative approach to determining the risk-based capital requirement for three types of securities lending transactions. In the proposed alternative approach, the risk-based capital charge would be based on a measure of economic exposure that takes into account the market value and price volatilities of collateral received and securities lent. The Bank would calculate an unsecured loan equivalent amount for all of its credit risk exposures to a counterparty arising from the securities lending transaction. The Bank would determine the loan equivalent amount as the sum of the current exposure and the potential future exposure (PFE) to the counterparty. The Bank would calculate its current exposure as the sum of the market value of all securities and cash lent to a counterparty in the securities lending transactions less the sum of all securities and cash received from the counterparty as collateral under those transactions. The PFE would be calculated daily using a value-at-risk (VAR) model that incorporates the market volatilities of the securities lent and the securities received as well as any foreign exchange rate volatilities associated with any cash or securities lent or received. The VAR model will assume a five-day holding period and use a 99 percent one-tailed confidence level. By using a VAR model, the Bank would be able to take into account correlations in market price volatilities of the instruments lent and received as collateral. The Bank would calculate its current exposure and VAR model estimate of PFE separately for each of its counterparties. The VAR approach would be applied to all components of the securities lending transactions described above where the Bank acts either as agent or conduit lender.

The OCC previously approved the VAR approach described above only for securities lending transactions where the bank received cash collateral and then reinvested that collateral (Interpretative Letter #1066). The VAR approach was to be applied to both components of the transaction – the lending of the security and the reinvestment of the cash collateral. The OCC believes that the VAR approach described above is also appropriate for a securities lending transaction where the bank receives security collateral. The two components of the cash collateral securities lending transaction are economically equivalent to a securities transaction where the counterparty provides collateral in the form of a liquid and marketable security. In addition, in a securities lending transaction with security collateral, the Bank acting as agent generally has less operational risk as there is only one component to the transaction and thus only one counterparty and contractual agreement to manage.

For a conduit securities lending transaction, the bank enters into a securities borrowing transaction and a securities lending transaction. The two transactions are conducted with different counterparties, with each counterparty posing a risk of default to the Bank. The VAR approach would be applied to both transactions.

The OCC believes that the VAR methodology is a more risk sensitive approach for the securities lending and conduit securities lending transactions described in this letter than the approach of 12 CFR Part 3, Appendix A and Appendix B. The amount of credit risk exposure to the counterparties is driven by the market risk associated with the securities lent, borrowed and received as collateral. Therefore, the OCC believes it is appropriate to use an approach based on the methodology used for determining risk-based capital for a bank's trading book described in 12 CFR Part 3 Appendix B to determine the PFE for these transactions. The PFE in conjunction with the current exposure results in a loan or credit equivalent amount to which the Bank would assign the risk weight appropriate for the counterparty. Under the reservation of authority in 12 CFR § 3.4(b), on a case-by-case basis, the OCC may look to the substance of a transaction and assign a credit equivalent amount to an asset or off-balance sheet transaction that more appropriately reflects the risks of that transaction. The OCC approves the use of the VAR methodology as described in Interpretative Letter #1066 for the transactions described herein, subject to the conditions described below.

Conditions of the VAR-Based Approach

Only the securities lending and conduit securities lending transactions described in this letter are eligible for the risk-based capital treatment described above. In order to qualify for the risk-based capital treatment described above, transactions must meet the following conditions:

1. The transactions are fully collateralized;

2. Any securities borrowed, lent or taken as collateral are eligible for inclusion in the trading book and are liquid and readily marketable;

3. Any securities borrowed, lent or taken as collateral are marked-to-market daily; and,

4. The transactions are subject to daily margin maintenance requirements.

Additionally, the transactions must be executed under a bilateral netting agreement, or an equivalent arrangement. These arrangements must:

1. Provide the non-defaulting party the right to terminate and close-out promptly all transactions under the agreement upon an event of default, including in the event of insolvency or bankruptcy of the counterparty;

2. Provide for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under the agreement so that a single net amount is owed by one party to the other;

3. Allow for the prompt liquidation or setoff of collateral upon the occurrence of an event of default;

4. Be, together with the rights arising from the provisions required in (1) to (3) above, conducted under documentation that is legally binding on all parties and legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of the counterparty's insolvency or bankruptcy; and,

5. Be conducted under documentation for which the bank has completed sufficient legal review to verify it meets provision (4) above and for which the bank has a well-founded legal basis for reaching this conclusion.

In addition to the criteria described above for the securities lending and conduit securities lending transactions eligible for the VAR-based capital treatment, the Bank's VAR model must satisfy certain conditions. The VAR model must be run daily to calculate the capital requirement and must meet all the qualitative and quantitative requirements outlined in 12 CFR Part 3, Appendix B § 4(b); 12 CFR Part 3, Appendix B § 4(c), and 12 CFR Part 3, Appendix B § 4(d) except that a 5-day holding period may be assumed instead of the 10-day holding period specified in Appendix B. The OCC believes a shorter assumed holding period is appropriate for the transactions described in this letter because the transactions must satisfy the risk mitigating conditions described above while transactions subject to 12 CFR Part 3 Appendix B do not have similar conditions.

The VAR model will be subject to supervisory review and acceptance before the Bank may use it to determine its risk-based capital requirements for these transactions. As part of that review, the OCC will evaluate the Bank's compliance with the requirements of 12 CFR Part 3, Appendix B identified above and the model validation guidance outlined in OCC Bulletin 2000-16. The Bank may not use its VAR model for the risk-based capital calculation for the transactions described in this letter until the OCC Examiner-in-Charge has determined that the model and the Bank's risk management of the business are satisfactory.

The Bank must conduct regular and rigorous backtesting procedures to ensure the validity of the VAR model output along with the volatility and correlation factors the Bank uses and the stability of these factors over time. In addition, the Bank must conduct independent reviews of its VAR model at least annually. The Bank should take immediate action to correct any weaknesses in the model revealed by its backtesting or annual review. The Bank will be subject to ongoing supervisory review of its model and backtesting procedures and results. If the Bank fails to take action to improve its model in response to any findings of material deficiencies, the OCC may require the Bank to hold additional capital or recalculate its capital requirement using the treatment described in 12 CFR Part 3, Appendix A.

Conclusion

Use of the VAR approach to calculate risk-based capital for securities lending and conduit securities lending transactions described in this letter is dependent on a determination by the OCC Examiner-in-Charge that the VAR model and the Bank's risk management practices are in compliance with the conditions detailed in this letter. This approval and the activities and communications by OCC employees in connection with the bank's request do not constitute a contract, express or implied, or any other obligation binding upon the OCC, and do not affect the ability of the OCC to exercise its supervisory, regulatory and examination authorities under applicable law and regulations. Consequently, if in the future a change to the OCC's regulations results in a different approach to the calculation of risk-based capital charges for the transactions described in this letter, the Bank would be subject to those revised regulations, notwithstanding this letter. Additionally, when the Bank adopts the Advanced Capital Adequacy Framework (Basel II) described in 12 CFR Part, Appendix C, the Bank will be subject to the approaches prescribed in that regulation, notwithstanding this letter.

The OCC's determination is specifically conditioned on compliance by the Bank with all the commitments and representations it made in connection with its request, as well as the conditions imposed in this letter. This determination is based on the specific facts and circumstances of the agency securities lending program and conduit securities lending program described in your correspondence and this letter. Any material change in those facts and circumstances or any failure by the Bank to observe any of its commitments or representations may result in a different view or in a revocation of the exception. Please be advised that the conditions of this approval are conditions "imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. § 1818 and, as such, are enforceable under 12 U.S.C. § 1818.

If you have further questions, please do not hesitate to contact the **[ ]**, Examiner-in-Charge on **[ ]**, **[ ]** on **[ ]**, or Margot Schwadron in the Capital Policy Division on 202-874-6022.

Sincerely,

Signed

Amrit Sekhon
Director, Capital Policy