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M E M O R A N D U M

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To Our Clients and Friends

Re: Risk-Based Capital Treatment of Cash Collateral in Securities Transactions

The Federal Reserve Board has issued a final rule which reduces the risk-based capital treatment of cash collateral posted in securities borrowing transactions. The rule makes permanent the interim rule issued by the agencies in 2000. The other banking agencies are expected to issue similar guidance in the near future.

When engaging in securities activities, banking organizations may borrow securities to cover short sales, securities fails and for other purposes. Under risk-based capital requirements, cash collateral posted by a banking organization with the securities lender is treated like a loan to the securities lender, and the securities borrower, the banking organization, is required to hold capital against the full amount of the collateral posted. However, if the securities borrower posts collateral in the form of securities rather than cash, no capital charge is imposed. To correct this inconsistent treatment, the agencies adopted an interim rule that excluded cash collateralized securities borrowing transactions from the risk-based capital requirements, subject to certain requirements.

Under the final rule, banking organizations subject to the market-risk rule for assessing capital adequacy for trading positions may exclude from their risk-weighted assets a securities lender's obligation to return the cash to the extent the lender's obligation is collateralized by the market value of the securities borrowed, and provided that the transaction is:

- based on securities includable in the trading account that are liquid and readily marketable
- marked to market daily
- subject to daily margining requirement, and

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- a securities contract for purposes of the Bankruptcy Code, a qualified financial contract under the Federal Deposit Insurance Act, or a netting contract between financial institutions for the purposes of the Federal Deposit Insurance Corporation Improvement Act or Regulation EE.

The rule also provides that if the last requirement is not met, a banking organization may conduct a legal review to determine if certain criteria set out in the rule are met in order to qualify the transaction for favorable treatment.

The rule takes effect upon approval of the Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation and publication in the Federal Register. Banks would be permitted to apply the rule to their fourth quarter 2005 regulatory reports.

A copy of the rule can be found on our web site at http://www.schwartzandballen.com/whats_new.html.

If you have any questions, please call Gilbert Schwartz, Robert Ballen, Tom Fox or Heidi Wicker at (202) 776-0700.