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# Guideline

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**Subject :**    **Securities Lending**

**No :**            **B-4**

**Date:**   **September 1996**

This guideline sets out prudential considerations relating to the lending of securities by federally regulated banks, authorized foreign banks in respect of their business in Canada (foreign bank branches - FBBs), trust and loan companies and cooperative credit associations ("financial institutions").

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## **Introduction**

Traditionally, security loans have been short-term transactions designed to assist the liquidity of securities markets by enabling dealers/brokers to cover failed deliveries or short sales. However, some security loans may also have been undertaken for longer terms in which liquidity is a secondary consideration. Financial institutions should be fully cognizant of the additional risks stemming from such longer-term transactions and should ensure that they have the systems and controls in place to identify and control these risks.

Financial institutions should ensure that securities lending activities are conducted in a safe and prudent manner and they should seek appropriate professional advice to ensure that controls and procedures are comprehensive and sound.

## **Collateral**

Financial institutions should at all times hold adequate collateral to protect themselves against the risks associated with securities lending.

The amount of collateral taken for securities lending should reflect best practices in local markets. In Canada, the current market practice is to obtain collateral of at least 102 per cent of the market value of the securities lent. Management is expected to ensure that the margin of collateral in excess of market value of securities lent is appropriate at all times. This margin should provide adequate protection against volatility and liquidity problems that may arise for securities lent and for securities held as collateral. Both loaned and collateral securities should be "marked to market" at least daily. Shortfalls in the amount of collateral should be rectified immediately.

A financial institution's policy on acceptable collateral should be consistent with the financial institution's overall investment policies as established by the board of directors. Accordingly, financial institutions should only take securities as collateral that are acceptable as a direct investment.

For securities lending within North America, eligible collateral should be readily marketable and would normally be restricted to the following assets, denominated in Canadian or U.S. dollars:

- cash;
- widely-traded debt instruments having a rating of single A (or the equivalent) or higher from a recognized, widely followed North American credit rating agency;
- commercial paper rated A-1 or R-1 or the equivalent by a recognized, widely followed North American credit rating agency;
- acceptances of banks and trust and loan companies whose short-term deposits are rated A-1 or R-1 or the equivalent by a recognized, widely followed North American credit rating agency; and
- high quality common and preferred shares.

Eligible collateral also includes:

- unconditional, irrevocable letters of credit that comply with the standards of the International Chamber of Commerce and which are issued by banks and trust and loan companies whose short-term deposits are rated A-1 or R-1 or the equivalent by a recognized, widely followed North American credit rating agency; and
- unconditional and irrevocable guarantees of banks and trust and loan companies whose short-term deposits are rated A-1 or R-1 or the equivalent by a recognized, widely followed North American credit rating agency.

Convertible preferred shares and convertible debt instruments may be taken as collateral when they are immediately convertible into the underlying security lent.

Securities lending activities in Organization for Economic Co-operation and Development (OECD) countries other than Canada and the U.S. should be in accordance with the above criteria, but financial institutions may also accept collateral denominated in the currency of the country in which the lending occurs, and debt instruments issued by that country's central government.

## Controls and Records

Financial institutions should ensure that they have appropriate internal controls, procedures and records in place. Controls should include a list of approved borrowers, consistent with the financial institution's lending policies, that are based on generally accepted credit worthiness standards with specified lending limits for each borrower. The list should be:

- available at all times to the personnel responsible for administering the securities lending program; and
- reviewed regularly by appropriate senior management.

The financial institution's board of directors (or a committee designated by the board and reporting to the board)<sup>1</sup> should, at least annually, review and approve:

- the general credit worthiness standards used in establishing the list of approved borrowers which should be consistent with the financial institution's overall lending policies as established by the board; and
- overall and individual securities lending limits. These limits should take into account other exposures established by the board.

External or internal auditors should verify at appropriate intervals:

- that the list of borrowers conforms to the criteria established by the board (or a committee designated by the board and reporting to the board);
- that securities accepted as collateral are consistent with the overall investment policies established by the board of directors; and
- the existence of securities lent and taken as collateral.

A designated senior manager of the financial institution should receive regular, comprehensive and timely reports summarizing the financial institution's securities lending activities to allow the manager to judge whether the activities are being properly administered.

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<sup>1</sup> In the case of an FBB, the role of the Board shall be discharged by a senior officer or committee of the authorized foreign bank that has been delegated responsibility for the Canadian operations and that has the authority to approve the policies developed to comply with OSFI guidelines.

### **Use of an Agent**

A financial institution may employ an agent for the administration of its securities lending program. The financial institution's board of directors (or a committee designated by the board and reporting to the board) should approve the choice of an agent. The agent selected should be an institution that can demonstrate an ability to perform the required duties in a competent and responsible manner. Administrative and reporting arrangements satisfactory to the financial institution should be clearly set out and agreed to in writing.

### **Other Considerations**

A financial institution should enter into a legally binding master agreement with each borrower establishing the basis for all security loans between the two parties. When an agent is involved, there should be a master agreement between the financial institution and agent as well as a master agreement between borrower and agent. The agreement(s) should set out the rights and obligations of all parties including the right to immediate set-off for the financial institution (or agent acting for the financial institution) in the event of the borrower's failure to return the securities as specified in contractual arrangements.

Financial institutions should ensure that they are in compliance with applicable *Protection of Assets Regulations*.

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