



SECTION: Investment of Pension Funds

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TITLE: Letters of Credit As Collateral In Securities Lending -
O. Reg. 708/87 ss. 73(b)

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Letters of Credit

The issue has arisen as to whether letters of credit are satisfactory as collateral in securities lending.

The use of letters of credit is not currently permitted as collateral in securities loans. Subsection 73(b) of the Regulation to the *Pension Benefits Act*, 1987 (the "PBA") specifies that the investments of a pension fund may be lent provided that:

"the loans are secured by cash or readily marketable investments having a market value of at least 105 percent of the loan and maintained no less frequently than weekly to ensure a market value of the collateral of at least 105 per cent of the outstanding market value of loaned assets."

As justification for the use of letters of credit as collateral, the view has been expressed that an irrevocable letter of credit is money or money's worth put at risk forthwith. However, the use of letters of credit presents many difficulties; for instance:

- they are difficult to segregate;
- they are not divisible like blocks of securities;
- they expire; and
- they have varying revocation clauses.

As a result of these limitations, banks have not accepted letters of credit as collateral from brokers. Furthermore, for these and other reasons pertaining to capitalization rules, the Toronto Stock Exchange (the "TSE") has not allowed members to use letters of credit as acceptable collateral.

The PCO has been asked to consider recommending to the Government that the Regulation be amended to permit the use of letters of credit in securities lending, provided that industry participants can agree on a set of uniform practices that embrace a number of conditions for letters of credit:

- 1) letters of credit will adhere to a standard format;
- 2) they will be issued by a Schedule "A" Canadian chartered bank;
- 3) they will be irrevocable; and
- 4) they will not contain any conditions that would delay or render uncertain the realization thereon by a pension plan.

A universal standard for letters of credit presents the advantage that the letter of credit format could be approved by the PCO on a one-time basis.

However, the PCO has serious concerns that the greater flexibility presumed to be given to securities loan transactions by the use of letters of credit may be outweighed by the number and nature of inherent technical problems. Administrators who propose to use letters of credit must possess levels of knowledge and competence compatible with the standard of prudence stipulated in the PBA, 1987.

The matter of securities lending gives rise to another caution - the issue of borrowing. Brokers and dealers lend each other securities in accordance with TSE rules.

These deals are effectively cross-borrowings. Since the Regulation to the PBA, 1987 precludes pension funds from borrowing, **pension funds which lend securities according to TSE rules are in contravention of the Regulation.**

Comments concerning the above may be addressed to Jules Huot, Senior Policy Analyst at 416-314-0613.