LEGAL LENDING LIMIT TREATMENT OF DERIVATIVE TRANSACTIONS
PURSUANT TO LSA-R.S. 6:415
LOUISIANA OFFICE OF FINANCIAL INSTITUTIONS (OFI)
OFI Advisory Opinion No.10
November 1, 2013

BACKGROUND

As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), states were required to modify their legal lending limit statutes to take into consideration credit exposure to derivative transactions in order for their institutions to engage in such activities. LSA-R.S. 6:415 (Loans; other credit exposure; derivative transactions; restrictions; penalties) was amended during the 2012 Regular Legislative Session to provide a definition of derivative transactions consistent with Dodd-Frank.

SB 164/Act 30/Effective Date: 5-4-12 (click to view entire Act)

Section 610 of Dodd-Frank mandated that national bank lending limits must include "any credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction **{collectively known as "securities financing transactions"}** between the national banking association and the person." Effective January 21, 2013, Section 611 of the Dodd-Frank Act prohibits state chartered banks from engaging in derivative transactions unless "the law with respect to lending limits of the State in which the insured State bank is chartered takes into consideration credit exposure to derivative transactions." On June 25, 2013, the Office of the Comptroller of the Currency (OCC) released its final rule implementing Dodd-Frank related mandates for national banks and federal thrifts and extended the effective date to October 1, 2013.

PURPOSE

Currently, LSA-R.S. 6:415, does not contain specific guidance relating to how a state-chartered bank should value its credit exposure to another person/party arising from derivative and/or securities financing transactions for the purpose of applying the applicable lending limit. As a result, state-chartered banks engaging in these types of transactions are unable to properly report their credit exposure at this time. This Advisory Opinion provides methods of valuing a bank's exposure to derivatives and certain securities financing transactions.

We recognize that derivatives can be a very useful risk management tool that enables banks (large and small) to hedge against potential losses from unpredictable changes in interest and exchange rates, commodity prices, and other financial measures. Since these tools are regularly utilized by state-chartered institutions, further clarification is needed for the proper reporting of such credit exposure in determining compliance with LSA-R.S. 6:415. Refer to chart on page 6.

As with traditional loans and extensions of credit, safety and soundness considerations would apply. Similar to loans and extensions of credit, examiners will assess the "quality" of a derivative and/or securities financing transaction during the examination process. If necessary, such transactions are subject to "adverse classification." Management and the Board of Directors should formulate and implement a formal policy before engaging in such activities in order to avoid any unnecessary exposure.

INTENT

Pursuant to LSA-R.S. 6:121(A), the Commissioner is issuing this Advisory Opinion intended to provide clarification concerning the methods detailed in the Office of the Comptroller of the Currency (OCC) Lending Limits Final Rule (Rule) effective October 1, 2013, for banks and savings associations calculating the amount of credit exposure arising from derivative and other securities financing transactions. The Rule implements Section 610 of the Dodd-Frank Act, which expands the statutory definition of "loans and extensions of credit" for the purpose of lending limits.

ANALYSIS

The OCC Rule contains the following methods for calculating the amount of credit exposure: the Model Method, the Current Exposure Method (CEM), and the Conversion Factor Matrix Method (CFMM). For state-chartered institutions, interest rate swap contracts account for the vast majority of derivative products reported on the Call Report Schedule RC-L. Institutions that wish to use the Model Method are required to receive approval prior to implementing.

Interagency Guidance on Correspondent Concentration Risk (CCR), which was issued in 2010, notes that an institution's relationship with a correspondent may result in credit (asset) and funding (liability) concentrations. In addressing the calculation of these concentrations, the CCR guidance states the following: "When identifying credit and funding concentrations for risk management purposes, institutions should calculate both gross and net exposures to the correspondent on a standalone basis and on a correspondent organization-wide basis as part of their prudent risk management practices. Exposures are reduced to net positions to the extent that the transactions are secured by the net realizable proceeds from readily marketable collateral or are covered by valid and enforceable netting agreements." The OCC Rule also discusses netting under a qualifying master agreement.

The CEM and CFMM appear to be the two options that would best suit state-chartered banks given the type of products engaged in and their size and complexity. While both methods arrive at the amount of credit exposure for such transactions, the CEM provides a more refined calculation as it allows for a more risk-sensitive method than that provided by the CFMM. Both methods are detailed below.

Current Exposure Method

Credit Exposure = current exposure (Mark-to-Market (MTM) or zero) + (notional amount x conversion factor)

Maturity	Interest Rate	Foreign Exchange Rate & Gold	Credit (investment grade reference obligor)	Credit (noninvestment grade reference obligor)	Equity	Precious metals (except gold)	Other
1 yr or less	0.00	0.01	0.05	0.10	0.06	0.07	0.10
>1 yr to 5 yrs	0.005	0.05	0.05	0.10	0.08	0.07	0.12
>5 yrs	0.015	0.075	0.05	0.10	0.10	0.08	0.15

Under the Rule, credit exposure under the CEM is determined by adding the current exposure (the greater of zero or the MTM value) of the derivative transaction to the product of the notional amount of the transaction and a conversion factor based on product type and determined by a look-up table outlined in the Rule. The CEM provides a more refined analysis of credit exposure through its familiarity to both industry and regulators as an available measure of derivative exposure under current regulatory capital rules, both Basel I and II, and would be retained under the Standardized and Advances Approaches Basel III related proposals. Under this method, the reported credit exposure would be added to any other obligation to the entity in order to determine compliance the LSA-R.S. 6:415. Individual contracts and their terms should be carefully analyzed by each institution to determine whether they are secured or unsecured pursuant to the statute.

- **Example:** Bank A enters a five-year interest rate swap with a notional value of $100,000 and a MTM of zero at execution. The swap is not collateralized and is not subject to a qualifying master netting agreement. At execution, Bank A's credit exposure is $0 or ($0+ ($100,000 x 0.00)). In year two, Bank A makes a loan to its counterparty on the interest rate swap. At this time, assume the MTM of the swap is $2,000. Bank A's credit exposure arising from the swap is $2,500 or ($2,000 + ($100,000 x 0.005)). If the MTM of the swap in year two is negative $1,000, Bank A's credit exposure arising from the swap would be $500 or ($0 + ($100,000 x 0.005)). If the MTM of the swap in year five is $10,000, Bank A's lending limit exposure for the swap would be $10,500 ($10,000 + ($100,000 x 0.005).

Conversion Factor Matrix Method

Credit Exposure = Notional Amount x Conversion Factor in look-up table

Original Maturity	Interest Rate	Foreign exchange rate and gold	Equity	Other (includes commodities and precious metals except gold
1 year or less	0.015	0.015	0.20	0.06
Over 1 to 3 years	0.03	0.03	0.20	0.18
Over 3 to 5 years	0.06	0.06	0.20	0.30
Over 5 to 10 years	0.12	0.12	0.20	0.60
Over 10 years	0.30	0.30	0.20	1.00

Under this method, credit exposure will equal and remain fixed at an amount equal to the notional amount of the derivative transaction multiplied by the conversion factor listed in the look-up table. The CFMM is similar to the method for calculating credit exposure arising from a derivative transaction in the risk-based capital rules, except the exposure amount will remain fixed under the former. This is achieved by removing the "current credit exposure" component of the formula in the risk-based capital rules (which can fluctuate over time) and by adjusting the values in the CFMM to reflect the absence of the "current credit exposure" component. As with the CEM, the reported credit exposure would be added to any other obligation to the entity in order to determine compliance the LSA-R.S. 6:415. Individual contracts and their terms should be carefully analyzed by each institution to determine whether they are secured or unsecured pursuant to the statute.

- **Example:** The bank has an interest rate swap used to hedge the balance sheet. The notional amount of the swap is $1,000,000 with an original maturity of 2 years. The MTM value is $10,000. What is the credit exposure? $1,000,000 x 0.03 = $30,000 potential credit exposure

The OCC Rule also provides for the calculation of credit exposure related to Security Financing Transactions (as defined). For a majority of Louisiana institutions, credit exposure will be best calculated by utilizing the Non-Model Method, including haircuts associated on securities as determined by the look-up table included in the rule.

Securities Financing Transaction means a repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction. The OCC's final rule specifically exempts securities financing transactions relating to Type I securities (U.S. or state government obligations, etc.) from the lending limit calculations. For other securities financing transactions, consistent with 12 CFR 32, institutions can choose to measure credit exposure by the following methods:

- Locking in the attributable exposure based on the type of the transaction
- Using a regulator-approved internal model
- As added by the OCC's final rule, using the *Basel Collateral Haircut Method*. This last method applies standard supervisory haircuts (the percentage reduction of the amount that will be repaid to creditors) for measuring counterparty credit risk for such transactions under the capital rules' Basel II Advanced Internal Ratings-Based Approach or the Basel III Advanced Approaches

It should be noted that the Rule allows institutions to utilize different valuation methods for different types of transactions in certain instances. In addition, the Rule provided clarification of nonconforming status for transactions valued with non-model and model methods. Under this clarification, credit exposure arising from a derivative transaction or securities financing transaction and determined by a model or non-model method, will not be deemed a violation of the lending limit statute or regulation and will be treated as nonconforming if the extension of credit was within the institution's legal lending limit at execution and is no longer in conformity because the exposure has increased since execution. Once a transaction becomes nonconforming, the Rule requires the institution to use "reasonable efforts" to bring it into conformity with the lending limit unless doing so would be inconsistent with safety and soundness.

Refer to the link below to access the OCC Final Rule, including further detail regarding the above mentioned items.
http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-102a.pdf

CONCLUSION

A state-chartered bank will be allowed to engage in derivative and certain securities financing transactions in accordance with the provisions of this Advisory Opinion. If a state-chartered bank wishes to use another method for calculating the credit exposure arising from a derivative or securities financing transaction not covered by this Advisory Opinion, such a request can be made to this Office for approval pursuant to LSA-R.S. 6:242(D), which allows parity with national banks. Such requests will be considered provided they comply with all applicable state and federal laws, rules, and regulations, and such use is consistent with safe and sound banking practices. A state-chartered thrift will be allowed to engage in such activities to the same extent as a state-chartered bank pursuant to LSA-R.S. 6:1136, and such use is consistent with safe and sound banking practices.*****

John Ducrest, Commissioner
Louisiana Office of Financial Institutions
Effective Date: November 1, 2013

****See definitions on Page 5.***

DEFINITIONS

Counterparty – A legal entity, an incorporated entity, or collection of entities to which an exposure to a financial transaction exist.

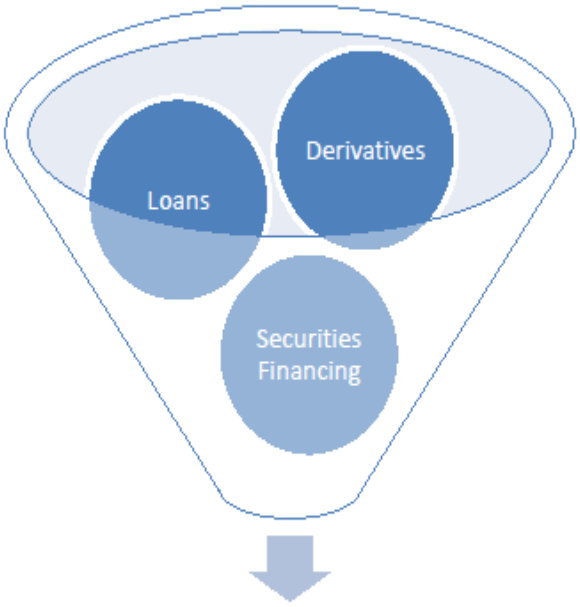
Credit exposure – The amount of loss associated with a counterparty default.

Derivative transaction – Pursuant to the OCC's Interim Final Rule to implement Section 610 of Dodd-Frank, a "derivative transaction" shall include any transaction that is a contract, agreement, swap, warrant, note or option that is based, in whole or in part, on the value of, any interest in, any quantitative measure of, or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets.

Securities financing transaction – Pursuant to LSA-R.S. 6:415(D), a "securities financing transaction" includes a repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction. Consistent with 12 CFR 32, credit exposure related to certain government securities, listed below, are not to be included in determining compliance with this Advisory Opinion:
(a) Obligations of the US Government;
(b) Obligations issued, insured, or guaranteed by a department or an agency of the US Government, if the obligation, insurance, or guarantee commits the full faith and credit of the US for the repayment of the obligation;
(c) Obligations issued by a department or agency of the US Government, or an agency or political subdivision of a State, that represent an interest in a loan or a pool of loans made to third parties, if the full faith and credit of the US Government has been validly pledged for the full and timely payment of interest on, and principal of, the loans in the event of non-payment by the third party obligor(s); and
(d) General obligations of a State or any political subdivision thereof; and municipal bonds if the bank is well capitalized as defined in applicable state or federal law.

In addition, a bank does not have to include intraday credit exposures arising from a derivative transaction or securities financing transaction in its lending limit determination.

Aggregating Credit Exposures



Aggregate credit exposure to a single counterparty

Exposures

- Loans: $1,000,000
- Derivatives: $30,000
- Reverse Repo: $20,000
- Aggregate: $1,050,000

Have you exceeded your legal lending limit?
