DEPARTMENT OF STATE

OFFICE OF THE STATE BANKING COMMISSIONER

Statutory Authority: 5 Delaware Code, Sections 121(b) and 977 (5 **Del.C.** §121(b) & 977)

PROPOSED

PUBLIC NOTICE

905 Loan Limitations: Credit Exposure to Derivative Transactions

Summary

The State Bank Commissioner proposes to adopt new Regulation 905, “Loan Limitations: Credit Exposure to Derivative Transactions”. This proposed new Regulation sets forth the rules for calculating the credit exposure arising from a derivative transaction entered into by a bank for purposes of determining the bank’s loan limitations pursuant to Section 909 of Title 5 of the Delaware Code.

Section 611 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (Dodd-Frank Act), requires state law lending limits to take into consideration credit exposure to derivative transactions in order for FDIC-insured state banks to be permitted to engage in derivative transactions. Dodd-Frank Act Section 610 imposed a similar requirement on national banks, and the United States Office of the Comptroller of the Currency (OCC) complied by issuing an interim final rule in June, 2012. Proposed Regulation 905 is based on the OCC's rule so that the requirements for state banks will be the same as those for national banks.

The State Bank Commissioner would adopt the proposed new Regulation 905 on or after December 3, 2012. Other regulations issued by the State Bank Commissioner are not affected by this proposal. The State Bank Commissioner is issuing this regulation in accordance with Title 5 of the Delaware Code.

Comments

A copy of the proposed new regulation is published in the Delaware Register of Regulations. A copy is also on file in the Office of the State Bank Commissioner, 555 E. Loockerman Street, Suite 210, Dover, DE 19901 and is available for inspection during regular office hours. Copies are available upon request.

Interested parties are invited to comment or submit written suggestions, data, briefs or other materials to the Office of the State Bank Commissioner as to whether this proposed new regulation should be adopted, rejected or modified. Written materials submitted will be available for inspection at the above address. Comments must be received at or before the public hearing scheduled for 10:00 a.m. December 3, 2012.

Public Hearing

A public hearing on the proposed new Regulation will be held in the offices of the State Bank Commissioner, 555 E. Loockerman Street; Dover, Delaware, 19901 on Monday, December 3, 2012, commencing at 10:00 a.m. This notice is issued pursuant to the requirements of Subchapter III of Chapter 11 and Chapter 101 of Title 29 of the Delaware Code.

905 Loan Limitations: Credit Exposure to Derivative Transactions

1.0 Purpose

This regulation sets forth the rules for calculating the credit exposure arising from a derivative transaction entered into by a bank for purposes of determining the bank’s loan limitations pursuant to Section 909 of Title 5 of the **Delaware Code**.

2.0 Definitions

The following words and terms, when used in this regulation, shall have the following meaning unless the context clearly indicates otherwise:

“Borrower” means a person who is named as a borrower or debtor in a loan or extension of credit, including a person to whom a bank has credit exposure arising from a derivative transaction.

“**Contractual commitment to advance funds**”:

a. Includes a bank’s obligation to:

1. Make payment (directly or indirectly) to a third person contingent upon default by a customer of the bank in performing an obligation and to make such payment in keeping with the agreed upon terms of the customer’s contract with the third person, or to make payments upon some other stated condition;

2. Guarantee or act as surety for the benefit of a person;
3. Advance funds under a qualifying commitment to lend, as defined for a national bank in 12 C.F.R. 32.2(t); and
4. Advance funds under a standby letter of credit as defined in 12 C.F.R. 32.2(dd), a put, or other similar arrangement.

b. The term does not include commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw on the issuer, that do not guarantee payment, and that do not provide for payment in the event of a default by a third party.

"Credit derivative" means a financial contract executed under standard industry credit derivative documentation that allows one party (the protection purchaser) to transfer the credit risk of one or more exposures (reference exposure) to another party (the protection provider).

"Derivative transaction" includes 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, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets.

"Effective margining arrangement" means a master legal agreement governing derivative transactions between a bank and a counterparty that requires the counterparty to post, on a daily basis, variation margin to fully collateralize that amount of the bank's net credit exposure to the counterparty that exceeds $1 million created by the derivative transactions covered by the agreement.

"Eligible credit derivative" means a single-name credit derivative or a standard, non-tranched index credit derivative provided that:

a. The derivative contract meets the requirements of an eligible guarantee, as defined in this regulation, and has been confirmed by the protection purchaser and the protection provider;
b. Any assignment of the derivative contract has been confirmed by all relevant parties;
c. If the credit derivative is a credit default swap, the derivative contract includes the following credit events:
   1. Failure to pay any amount due under the terms of the reference exposure, subject to any applicable minimal payment threshold that is consistent with standard market practice and with a grace period that is closely in line with the grace period of the reference exposure; and
   2. Bankruptcy, insolvency, or inability of the obligor on the reference exposure to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due and similar events;
d. The terms and conditions dictating the manner in which the derivative contract is to be settled are incorporated into the contract;
e. If the derivative contract allows for cash settlement, the contract incorporates a robust valuation process to estimate loss with respect to the derivative reliably and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;
f. If the derivative contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract provides that any required consent to transfer may not be unreasonably withheld; and
g. If the credit derivative is a credit default swap, the derivative contract clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event.

"Eligible guarantee" means a guarantee that:

a. Is written and unconditional
b. Covers all or a pro rata portion of all contractual payments of the obligor on the reference exposure;
c. Gives the beneficiary a direct claim against the protection provider;
d. Is not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;
e. Is legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced;
f. Requires the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligor on the reference exposure in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment;
g. Does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure; and

h. Is not provided by an affiliate of the bank, unless the affiliate is an insured depository institution, bank, securities broker or dealer, or insurance company that:

   1. Does not control the bank; and
   2. Is subject to consolidated supervision and regulation comparable to that imposed on U.S. depository institutions, securities broker-dealers, or insurance companies (as the case may be).

"Eligible protection provider" means:

a. A sovereign entity (a central government, including the U.S. government; an agency; department; ministry; or central bank);

b. The Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, or a multilateral development bank;

c. A Federal Home Loan Bank;

d. The Federal Agricultural Mortgage Corporation;

e. A depository institution, as defined in section 3 of the Federal Deposit Insurance Act, 12 U.S.C. 1813(c);

f. A bank holding company, as defined in section 2 of the Bank Holding Company Act, as amended, 12 U.S.C. 1841;

g. A savings and loan holding company, as defined in section 10 of the Home Owners' Loan Act, 12 U.S.C. 1467a;

h. A securities broker or dealer registered with the SEC under the Securities Exchange Act of 1934, 15 U.S.C. 78o et seq.;

i. An insurance company that is subject to the supervision of a State insurance regulator;

j. A foreign banking organization;

k. A non-U.S.-based securities firm or a non-U.S.-based insurance company that is subject to consolidated supervision and regulation comparable to that imposed on U.S. depository institutions, securities broker-dealers, or insurance companies; and

l. A qualifying central counterparty.

"Loans and extensions of credit"

a. Loans or extensions of credit, for purposes of Section 909 of Title 5 of the **Delaware Code** include any credit exposure, as determined pursuant to Section 3.0 of this regulation, arising from a derivative transaction, and also include a contractual commitment to advance funds.

b. The following items do not constitute loans or extensions of credit for purposes of Section 909 of Title 5 of the **Delaware Code** and this regulation:

   1. Additional funds advanced for the benefit of a borrower by a bank for payment of taxes, insurance, utilities, security, and maintenance and operating expenses necessary to preserve the value of real property securing the loan, consistent with safe and sound banking practices, but only if the advance is for the protection of the bank's interest in the collateral, and provided that such amounts must be treated as an extension of credit if a new loan or extension of credit is made to the borrower;
   2. Accrued and discounted interest on an existing loan or extension of credit, including interest that has been capitalized from prior notes and interest that has been advanced under terms and conditions of a loan agreement;
   3. Financed sales of a bank's own assets, including Other Real Estate Owned, if the financing does not put the bank in a worse position than when the bank held title to the assets;
   4. A renewal or restructuring of a loan as a new "loan or extension of credit," following the exercise by a bank of reasonable efforts, consistent with safe and sound banking practices, to bring the loan into conformance with the lending limit, unless new funds are advanced by the bank to the borrower (except as permitted for national banks by 12 C.F.R. § 32.3(b)(5)), or a new borrower replaces the original borrower, or unless the Commissioner or the appropriate Federal banking agency determine that a renewal or restructuring was undertaken as a means to evade the bank's lending limit;
   5. Amounts paid against uncollected funds in the normal process of collection; and
   6. A. That portion of a loan or extension of credit sold as a participation by a bank on a nonrecourse basis, provided that the participation results in a pro rata sharing of credit risk proportionate to the respective interests of the originating and participating lenders. Where a participation agreement provides that repayment must be applied first to the portions sold, a pro rata sharing will be deemed to exist only if the agreement also provides that, in the event of a default or comparable event defined in the agreement, participants must share in all

subsequent repayments and collections in proportion to their percentage participation at the time of the occurrence of the event.

B. When an originating bank funds the entire loan, it must receive funding from the participants before the close of business of its next business day. If the participating portions are not received within that period, then the portions funded will be treated as a loan by the originating bank to the borrower. If the portions so attributed to the borrower exceed the originating bank's lending limit, the loan may be treated as nonconforming subject to Section 5.0 of this regulation, rather than a violation, if:

i. The originating bank had a valid and unconditional participation agreement with a participant or participants that was sufficient to reduce the loan to within the originating bank's lending limit;

ii. The participant reconfirmed its participation and the originating bank had no knowledge of any information that would permit the participant to withhold its participation; and

iii. The participation was to be funded by close of business of the originating bank's next business day.

"Qualifying master netting agreement" means any written, legally enforceable bilateral agreement, provided that:

a. The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including bankruptcy, insolvency, or similar proceeding, of the counterparty;

b. The agreement provides the bank the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of bankruptcy, insolvency, or similar proceeding, of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions;

c. The bank has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that:

1. The agreement meets the requirements of paragraph (b) of this definition; and

2. In the event of a legal challenge (including one resulting from default or from bankruptcy, insolvency, or similar proceeding) the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions;

d. The bank establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of this definition; and

e. The agreement does not contain a walkaway clause (that is, a provision that permits a non-defaulting counterparty to make a lower payment than it would make otherwise under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement).

3.0 Credit Exposure to Derivative Transactions.

3.1 *Derivative transactions*. For purposes of Section 909 of Title 5 of the **Delaware Code**, derivative transactions entered into by a bank shall be included for purposes of determining the bank's loan limitations.

3.2 *Non-credit derivatives*. Subject to Subsections 3.3 and 3.4 of this section, a bank shall calculate the credit exposure to a counterparty arising from a derivative transaction by one of the following methods. Subject to Subsection 3.4 of this section, a bank shall use the same method for calculating counterparty credit exposure arising from all of its derivative transactions.

3.2.1 *Internal Model Method*.

3.2.1.1 *Credit exposure*. The credit exposure of a derivative transaction under the Internal Model Method shall equal the sum of the current credit exposure of the derivative transaction and the potential future credit exposure of the derivative transaction.

3.2.1.2 *Calculation of current credit exposure*. A bank shall determine its current credit exposure by the mark-to-market value of the derivative contract. If the mark-to-market value is positive, then the current credit exposure equals that mark-to-market value. If the mark to market value is zero or negative, than the current credit exposure is zero.

3.2.1.3 *Calculation of potential future credit exposure*. A bank shall calculate its potential future credit exposure by using an internal model that has been approved by the Commissioner and the appropriate Federal banking agency for purposes of Section 909 of Title 5 of the Delaware Code, or any other appropriate model approved by the Commissioner and the appropriate Federal banking agency.

3.2.1.4 *Net credit exposure*. A bank that calculates its credit exposure by using the Internal Model Method pursuant to this paragraph may net credit exposures of derivative transactions arising under the same qualifying master netting agreement.

3.2.2 *Conversion Factor Matrix Method*. The credit exposure arising from a derivative transaction under the Conversion Factor Matrix Method shall equal and remain fixed at the potential future credit exposure of the derivative transaction as determined at the execution of the transaction by reference to Table 1 below.

Table 1—Conversion Factor Matrix for Calculating Potential Future Credit Exposure.[1]

Original maturity[2]	**Interest Rate**	**Foreign exchange rate and gold**	**Equity**	**Other[3] (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

[1] For an OTC derivative contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the derivative contract.

[2] For an OTC derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005.

[3] Transactions not explicitly covered by any other column in the Table are to be treated as "Other."

3.2.3 *Remaining Maturity Method*. The credit exposure arising from a derivative transaction under the Remaining Maturity Method shall equal the greater of zero or the sum of the current mark-to-market value of the derivative transaction added to the product of the notional amount of the transaction, the remaining maturity in years of the transaction, and a fixed multiplicative factor determined by reference to Table 2, below.

Table 2—Remaining Maturity Factor for Calculating Credit Exposure

	Interest Rate	**Foreign exchange rate and gold**	**Equity**	**Other[4] (includes commodities and precious metals except gold)**
Multiplicative Factor	1.5%	1.5%	6%	6%

[4] Transactions not explicitly covered by any other column in the Table are to be treated as "Other."

3.3 *Credit Derivatives*.

3.3.1 Notwithstanding Subsection 3.2 of this section, a bank that uses the Conversion Factor Matrix Method or Remaining Maturity Method, or that uses the Internal Model Method without entering an effective margining arrangement, as defined in Section 2.0 of this regulation, shall calculate the counterparty credit exposure arising from credit derivatives entered by the bank by adding the net notional value of all protection purchased from the counterparty on each reference entity.

3.3.2 A bank shall calculate the credit exposure to a reference entity arising from credit derivatives entered by the bank by adding the notional value of all protection sold on the reference entity. However, the bank may reduce its exposure to a reference entity by the amount of any eligible credit derivative purchased on that reference entity from an eligible protection provider.

3.4 *Mandatory use of a certain method*. The Commissioner or the appropriate Federal banking agency may require a bank to use the Internal Model Method set forth in Subsection 3.2.1, the Conversion Factor Matrix Method set forth in Subsection 3.2.2, or the Remaining Maturity Method set forth in Subsection 3.2.3 to calculate the credit exposure of derivative transactions, upon finding that such method is necessary to promote the safety and soundness of the bank.

4.0 Intraday credit exposures

Intraday credit exposures arising from a derivative transaction are not subject to the lending limits of Section 909 of Title 5 of the Delaware Code or this regulation.

5.0 Nonconforming Loans and Extensions of Credit

A loan or extension of credit, within the bank's legal lending limit when made, will not be deemed a violation, but will be treated as nonconforming, if the loan or extension of credit is no longer in conformity with the bank's lending limit because, in the case of a credit exposure arising from a derivative transaction identified in Section 3.0 of this regulation and measured by the Internal Model Method specified in Section 3.2.1 of this regulation, the credit exposure, subject to the lending limits of Section 909 of Title 5 of the **Delaware Code** or this regulation, increases after execution of the transaction. A bank must use reasonable efforts to bring a loan or extension of credit that is nonconforming as a result of this section into conformity with the bank's lending limit unless to do so would be inconsistent with safe and sound banking practices.

16 DE Reg. 523 (11/01/12) (Prop.)