



American
Bankers
Association

Derivatives & Legal Lending Limits Industry Perspectives

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Swaps Regulation: New Regulatory Framework

- The Dodd-Frank Act (Dodd-Frank) mandates:
 - Central clearing
 - Exchange trading
 - Transaction reporting
 - Registration and regulation of swap dealers and major swap participants
 - Capital and margin for uncleared swaps
- Purpose:
 - Intended to reduce counterparty risk
 - Increase market transparency

Swaps Regulation: New Regulatory Framework (cont.)

Swaps markets were largely unregulated

- Transactions generally done over-the-counter (OTC) rather than on an exchange
- In the future, cleared swaps will have to be exchange traded

How central clearing works:

- (1) Rather than one contract between two parties, the transaction is split into two contracts with a clearinghouse in between the parties; and
- (2) Clearinghouses manage default risk primarily by requiring members to post cash or U.S. Treasury securities as collateral, including initial and daily mark-to-market margin.

Swaps Regulation: Rulemaking

CFTC and SEC have rapidly proposed dozens of rules

- Had a one year statutory deadline to finalize these groundbreaking rules
- Extending timeline to ensure appropriate opportunity for public notice and comment
- Roundtable discussions, thousands of comment letters, and hundreds of meetings
- “Substantially complete mosaic” of proposals
 - Continuing to accept comments as public analyzes the framework
 - SEC has still not issued its proposal on margin and capital for uncleared swaps
- Implementation schedule under consideration

Pending Swaps Legislation

- Nearly a dozen pending bills in House Agriculture and Financial Services Committees on a range of topics:
 - Swap dealer definition
 - End user clearing exemption
 - Margin exemption for end users
 - Exempt inter-affiliate swaps
 - Refine swap execution facility (SEF) definition
 - Business conduct for special entities
 - International jurisdiction
 - Revise pushout provision
- Senate also remains interested
- Even if not enacted, legislation will likely influence rulemaking



Swaps Regulation: Impact

- Rulemaking in Overdrive
 - Thousands of pages of rule proposals
 - Aggressive statutory timeline
 - CFTC starting to finalize rules
 - Jurisdiction for interest rate swaps
- Implementation phasing/sequencing
 - Goal is successfully functioning swaps market
- Business impact:
 - Reduce counterparty risk
 - Transparency



Dodd-Frank Act Sections 610 and 611

Dodd-Frank Sections 610 and 611

- Lending limits applicable to credit exposure
 - Includes: derivative transactions, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing transactions
- Derivatives:
 - Contract, agreement, swap, warrant, note, or option
 - Based on value of, interest in, or any quantitative measure or the occurrence of any event
 - Commodities, securities, currencies, interest or other rates, indices, or other assets

Sections 610 and 611: Effective Dates


- Section 610 applicable to national banks
 - Effective July 2012
- Section 611 applicable to FDIC-insured state banks
 - May engage in derivative transactions only if lending limits state where chartered take into account credit exposure
 - Effective date is January 2013

Enacted State Legislation

- MA: “amount bank reasonably determines” would be loss from default on that date
 - Take into account netting, collateral arrangements, and any guarantees or other credit enhancements
 - May elect method permitted by primary federal regulator
- NY: Bill summary indicates flexibility in existing lending limit statute to determine credit exposure
 - Provides superintendant authority determine manner and extent of credit exposure – certainty with regard to Section 611
 - May do by order or regulation, but not required to do either
- Bills pending in GA, CT, KS, KY, MN, NE, UT, VT



Credit Exposure



Other Dodd-Frank Provisions: Derivatives Credit Exposure

- **Affiliate Transactions (Section 608)**
 - Amends Federal Reserve Act Section 23A restrictions on transactions with affiliates
 - Effective date: July 2012
- **Lending Limits to Insiders (Section 614)**
 - Amends Federal Reserve Act limit on extension of credit to executive officers, directors, and principal shareholders of member banks
 - Effective date: July 2012

Section 165: Enhanced Supervision

- Federal Reserve required to establish prudential supervision standards for large, interconnected financial institutions
 - BHCs with \$50+ billion in assets
 - Nonbanks financial companies
- Single counterparty aggregate net credit exposure limit:
 - Maximum 25% of regulatory capital
 - Maximum 10% for major companies, incl. BHCs with \$500+ billion
 - Includes loans, deposits, lines of credit, derivatives counterparty credit exposure, etc.

Section 165: Enhanced Supervision (cont.)

- Rulemaking required
 - Open comment period – deadline extended
 - Industry comments on proposal under consideration
- Transition period: 3 years after enactment
 - Possible two year extension
- Federal Reserve has never had legal lending limits
- “More stringent” – heightened supervision



Section 165: Resolution Plan

- Resolution plan and credit exposure report requirements
 - Credit exposure report with respect to other large, interconnected financial institutions
 - Both to and from the other institution
 - Fed. and FDIC required to issue joint rules within 18 months after enactment
 - Postponed finalizing



Proposed Margin Requirements

- Clearinghouses take on risk from both counterparties
 - Type of risk exposure, but don't use term credit exposure
 - Initial margin -- collateral requirement
 - Variation margin calculated daily
- Uncleared swaps
 - Higher than clearinghouse requirements
 - Purpose: offset greater risk to market and participant

Proposed Margin Requirements (cont.)

- Banks
 - One-way risk rather than two-way risk
 - Clearinghouse stands in between counterparties
 - Credit risk decision -- may be uncollateralized
 - Swap is small part of lending relationship
 - Subject to capital and other regulatory requirements
 - Lending limits don't have margin requirement
- Many state chartered banks may not face clearinghouse
 - Small notional amounts
 - Need to customize



Lending Limits Generally

- Limit on exposure to individual or entity
 - Specified percentage of capital or reserves
 - National banks: 15% for unsecured credit and 25% secured
 - Total “outstanding at one time”
 - Readily marketable collateral
- Measure loans and extensions of credit against established limit
 - Prevention of undue concentrations of credit risk
 - Manage drawn exposure – advances of funds and obligation to repay
 - Actual exposure for bank
 - Amount owed on particular date



Lending Limit Adjustments

- Collateral
 - Any collateral is not exposure and should be exempt from measurement
 - Cash and cash equivalent collateral
 - Readily marketable collateral
- Netting arrangements reduce exposure
- Derivative exposure
 - No cash outlay that must be returned to bank
 - Does not easily fit lending limit framework



Credit Exposure – Sections 610 and 611

- Dodd-Frank purposefully used “credit exposure”
 - Not “credit exposure and potential future exposure”
 - Not “potential future credit exposure”
- Monitor within established credit limits
 - Default risk rather than credit risk
 - Replacement in current market if terminate and not paid
 - Terminate on specific date
- Accurate reflection of current risk is MTM



Why MTM?

- MTM:
 - Models all different – range of practices
 - Market's expectation includes counterparty risk assessment for life of contract
 - May rely on estimates from bank, dealers, 3rd parties, Bloomberg
 - Transparency initiative
- Unlikely to trigger lending limit
- Options for reducing credit exposure:
 - Collateral margining arrangements
 - Loan repayment
 - Unwinding or transferring derivatives
 - No new trade if will exceed

Why MTM? (cont.)

- Community bank access to swaps market:
 - Smaller notional amounts and need to customize
 - Through dealer or back-to-back with intermediary
- Lending limit monitoring
 - MTM simple measurement
 - Appropriate and consistent for banks of all sizes
 - Easier to examine and supervise
 - Loan date report – snapshot on given date