Bulletin B-12-1

TO: **All Tennessee State-Chartered Banks and Savings Banks**

SUBJECT: **Public Chapter 634-Amendment to T.C.A. 45-2-1102-Lending Limit/Derivatives**

DATE: **December 17, 2012**

The federal Dodd-Frank Act, specifically in Section 611 amending 12 U.S.C. Sec 1828, provides in pertinent part that, effective January 2013, an insured state bank may engage in derivative transactions "only if 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." Public Chapter 634 of the Acts of 2012, amends T.C.A. Sec. 45-2-1102, Tennessee's lending limit statute, by adding a new subsection (d) requiring that Tennessee's lending limit provision takes into consideration credit exposure arising from derivative transactions. A copy is attached. Public Chapter 634 takes effect January 1, 2013, and this bulletin is intended to provide guidance regarding its implementation.

A bank shall calculate credit exposure to a derivative transaction according to the following guidance for non-credit derivatives and credit derivatives, respectively. This derivative exposure should be combined with related credit exposure to calculate total exposure to a person, firm or corporation in assessing compliance with T.C.A. Sec. 45-2-1102. Definitions are provided towards the end of this bulletin.

NON-CREDIT DERIVATIVES

The bank shall calculate the credit exposure to a counterparty arising from a derivative transaction by one of the following methods for all non-credit derivatives. The bank shall use the same method for calculating counterparty credit exposure arising from all of its non-credit derivative transactions. The Department may require a bank to use the Conversion Factor Matrix Method or the Remaining Maturity Method to calculate the credit exposure of derivative transactions if it finds that such method is necessary to promote the safety and soundness of the bank.

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.................	.015	.015	.20	.06
Over 1 to 3 years...........	.03	.03	.20	.18
Over 3 to 5 years...........	.06	.06	0.20	0.30
Over 5 to 10 years.........	.12	.12	0.20	.60
Over ten years..............	.30	.30	.20	1.0

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.

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[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 Original 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."

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%

CREDIT DERIVATIVES

Counterparty Risk - For credit derivatives, a bank 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.

Reference Entity Risk - 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.

DEFINITIONS

Credit derivative - 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).

Counterparty - the other party that participates in a financial transaction.

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.

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

(1) The derivative contract has been confirmed by the protection purchaser and the protection provider;
(2) Any assignment of the derivative contract has been confirmed by all relevant parties;
(3) If the credit derivative is a credit default swap, the derivative contract includes the following credit events:

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

(i) 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

(ii) 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;

(4) The terms and conditions dictating the manner in which the derivative contract is to be settled are incorporated into the contract;

(5) 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;

(6) 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

(7) 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 protection provider:

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

(2) The Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, or a multilateral development bank;

(3) A Federal Home Loan Bank;

(4) The Federal Agricultural Mortgage Corporation;

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

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

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

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

(9) An insurance company that is subject to the supervision of a State insurance regulator;

(10) A foreign banking organization;

(11) 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

(12) A qualifying central counterparty.

Reference Entity - the entity upon which the counterparties in the transaction are taking a position.

If you have questions regarding this bulletin, please contact Financial Analyst Philip Ruffin at (615) 741-4791.

Greg Gonzales
Commissioner

State of Tennessee

PUBLIC CHAPTER NO. 634

SENATE BILL NO. 2216

By Norris, Johnson

Substituted for: House Bill No. 2354

By McCormick, Kevin Brooks, McManus

AN ACT to amend Tennessee Code Annotated, Title 45, Chapter 2, relative to the regulation of state banks.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF TENNESSEE:

SECTION 1. Tennessee Code Annotated, Section 45-2-1102, is amended by adding as a new subsection (d) the following:

> (d)(1) The loan limit applicable to any one (1) person under this section shall take into consideration credit exposure arising from derivative transactions between the state bank and the person.
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> (2) For purposes of subdivision (d)(1), the term "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 (1) or more commodities, securities, currencies, interest or other rates, indices, or other assets.

SECTION 2. For the purpose of promulgating rules and regulations, this act shall take effect upon becoming a law, the public welfare requiring it. For all other purposes, this act shall take effect January 1, 2013, the public welfare requiring it.

SENATE BILL NO. 2216

PASSED: March 15, 2012

RON RAMSEY
SPEAKER OF THE SENATE

BETH HARWELL, *SPEAKER*
HOUSE OF REPRESENTATIVES

APPROVED this 30th day of March 2012

BILL HASLAM, *GOVERNOR*