Bulletin B-14-1

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

SUBJECT: **Pledging Collateral for Hedging in Interest Rate Swap Transactions**

DATE: **January 15, 2014**

This Bulletin is being issued to permit state-chartered banks to pledge bank assets to secure counterparty exposure in interest rate swap transactions. It is intended that this Bulletin will encourage and facilitate prudent risk mitigation strategies, and will help ensure that state-chartered banks are not at a competitive disadvantage vis-à-vis national banks in their ability to engage in interest rate swap transactions.

This Bulletin is being issued under the Commissioner's authority in Tennessee Code Annotated ("Tenn. Code Ann."), Sections 45-2-601 and 45-2-611. Tenn. Code Ann. Section 45-2-611 pertains to pledging of bank assets and, while it does not specifically address interest rate swap transactions, subsection (a)(4) permits pledging "for other purposes that are approved by the commissioner." Tenn. Code Ann. Section 45-2-601, the wildcard statute, provides that "any state bank may exercise any power or engage in any activity that it could exercise or engage in if it were a national bank located in Tennessee, subject to regulation by the commissioner for the purpose of maintaining the state bank's safety and soundness."

The Department recognizes that many Tennessee state-chartered banks engage in derivatives transactions, especially interest rate swap transactions. In recognition of this, the Department recently issued Bulletin B-12-1, which provides guidance to banks in calculating exposure from derivatives transactions for lending limit purposes. Consideration of this exposure is a new lending limit requirement, effective January 1, 2013, which was implemented in response to Section 611 of the federal Dodd-Frank Act.

The Department has considered the issue of pledging assets in conjunction with interest rate swap transactions, and has arrived at several conclusions. First, it appears that state-chartered banks are engaging in interest rate swap transactions with various counterparties as a tool to manage interest rate risk. Second, it appears that it has become a customary industry practice for counterparties in such transactions to require a pledge of assets as collateral to secure the counterparties' exposure. Third, national banks have been pledging bank assets to secure counterparty exposure in customer-driven swap transactions, apparently without affecting their ability to operate in a safe and sound manner. And, lastly, it appears that pledging assets to secure counterparties' exposure in interest rate swap transactions is widely viewed as contributing to the safety and soundness of the financial system as a whole.

In consideration of the above, the Department will permit a state-chartered bank to pledge assets to secure counterparty exposure in interest rate swap transactions. Bank management should review the following factors prior to entering into an interest rate swap transaction requiring collateralization:

(1) The overall condition of the institution;
(2) Whether the Bank has demonstrated that it has the requisite knowledge and expertise to effectively analyze and engage in such transactions;
(3) Whether the Bank's Board of Directors has considered and adopted specific written policies and procedures governing interest rate swap transactions, addressing, but not limited to:
  a. Consideration of derivatives exposure for lending limit purposes;
  b. The purposes of swap transactions (for example, speculation is an impermissible purpose);
  c. The standards for selecting and procuring swaps;
  d. Risk limits; and
  e. Requirements for review and recordkeeping of such transactions.

This bulletin only addresses interest rate swap transactions; however, the Department may allow the pledging of bank assets to facilitate other legally permissible derivatives transactions when it is safe and sound to do so. If a state-chartered bank seeks to pledge assets in another type of derivatives transaction, management should first contact the Department.

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

Greg Gonzales
Commissioner