

OCC Revises Lending Limit Rules to Implement Dodd-Frank Provides Methods for Calculating “Credit Exposure” Arising From Derivative and Securities Financing Transactions

The OCC has issued an [interim final rule](#) to implement Section 610 of the Dodd-Frank Act, which expands the statutory definition of “loans and extensions of credit” for purposes of the lending limits that apply to national banks and federal and state-chartered savings associations (collectively, “**banks**”). Section 610 revises the definition of “loans and extensions of credit” to include credit exposures arising from repurchase agreements, reverse repurchase agreements, securities lending transactions and securities borrowing transactions (collectively, “**securities financing transactions**”) and from derivative transactions.

The interim final rule introduces a number of alternative methods for banks to calculate credit exposures arising from these types of transactions, which range in complexity to accommodate banks of different profiles. It remains to be seen whether the Federal Reserve Board will adopt similar methods for purposes of implementing the Dodd-Frank Act’s amendments to Section 23A of the Federal Reserve Act, which will become effective on July 21, 2012. Among other things, the Dodd-Frank Act expands the definition of “covered transaction” in Section 23A to include derivative and securities lending or borrowing transactions with an affiliate, to the extent they give rise to “credit exposure” to the affiliate.

The effective date of the OCC’s interim final rule is July 21, 2012, which coincides with the effective date of Section 610 of the Dodd-Frank Act. However, banks have until **January 1, 2013** to comply with the rule’s requirements relating to derivative and securities financing transactions. It remains to be seen whether the Federal Reserve Board will take similar action to allow affected institutions time to comply with the Dodd-Frank Act’s amendments to Section 23A.

Using examples, the remainder of this client newsflash describes the interim final rule’s methods for calculating “credit exposure” arising from derivative and securities financing transactions.

Background on Bank Lending Limits

The statutory provisions governing lending limits generally provide that the total “loans and extensions of credit” by a national bank to a person outstanding at one time may not exceed 15 percent of the unimpaired capital and unimpaired surplus of the bank if the loan is not fully secured, plus an additional 10 percent of unimpaired capital and unimpaired surplus if the loan is fully secured (for an aggregate total of 25 percent). The Home Owners’ Loan Act (“**HOLA**”) provides that the lending limits applicable to national banks generally apply to federal and state-chartered savings associations in the same manner and to the same extent as they apply to national banks, subject to certain statutory exceptions. In addition to its provisions relating to credit exposures arising from derivative and securities financing transactions, the OCC’s interim final rule also consolidates the lending limits rules applicable to national banks and savings associations and removes the OCC’s separate rules governing lending limits for savings associations.

OCC Introduces Alternative Methods for Calculating “Credit Exposure”

Although Section 610 of the Dodd-Frank Act expands the definition of “loans and extensions of credit” in the lending limits statute to include credit exposures arising from derivative and securities financing transactions, it does not define “credit exposure” or provide guidance on how to measure fluctuating credit exposures arising from such transactions as a result of market movements. The OCC’s interim final rule is intended to provide certainty regarding the methodology for calculating “credit exposure” for purposes of the lending limits. The rule generally permits banks to choose from three alternative methods for

calculating “credit exposure” arising from derivative transactions (other than credit derivatives, which are subject to special rules) and two alternative methods for calculating “credit exposure” arising from securities financing transactions.¹ However, the OCC notes that it may require a bank to use a specific method if “necessary to promote the safety and soundness of the bank.” Consistent with the existing lending limits rules, a bank is required to calculate its lending limit quarterly or on the date on which there is a change in the bank’s capital category, although the OCC may require more frequent calculations.

Methods for Calculating Credit Exposure Arising From Derivative Transactions

The interim final rule provides three methods for calculating credit exposure arising from derivative transactions *other than* credit derivatives, and contains a special set of rules with respect to credit derivatives. Generally, once a bank selects a method, it must use the same method for calculating counterparty credit exposure arising from all of its derivative transactions.²

Key Definitions. The interim final rule defines “derivative transaction” to 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, 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. The rule incorporates the definition of “credit derivative” contained in the OCC’s advanced approaches capital rules, which defines credit derivative as “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).”

Methods for Non-Credit Derivatives

1. Internal Model Method

$$\text{Credit Exposure} = \text{Current credit exposure} + \text{Potential future credit exposure}$$

This method is only available to a bank that calculates potential future credit exposure arising from its derivative transactions using an internal model that has been approved for purposes of the federal banking agencies’ advanced approaches capital rules (which apply to the largest and most internationally active U.S. banking organizations) or any other appropriate model approved by the relevant federal banking agency.

Under the Internal Model Method, “current credit exposure” equals the greater of the mark-to-market value of the derivative transaction or zero. Generally, the mark-to-market value of a derivative is zero at time of execution and subsequently may be positive or negative, depending on whether a bank is in the money or out of the money. “Potential future credit exposure” is determined using the bank’s approved internal model. In addition, a bank may net credit exposures of derivative transactions arising under the same qualifying master netting agreement.³

¹ The OCC noted that its approach to implementing Section 610 has been informed by proposals to implement other provisions of the Dodd-Frank Act raising similar issues and comments received by other agencies in connection with such rulemakings, including the Federal Reserve Board’s proposal to implement Section 165(e) of the Dodd-Frank Act (single counterparty credit exposures of large bank holding companies and systemically important nonbank financial companies).

² The interim final rule does not address the applicability of the lending limit rules to a bank’s contingent obligation under derivative clearinghouse rules to advance funds to a clearinghouse guaranty fund. The OCC seeks comments on this issue.

³ The interim final rule incorporates the definition of “qualifying master netting agreement” contained in the OCC’s advanced approaches capital rules.

2. Conversion Factor Matrix Method

Credit Exposure = Notional amount x Conversion factor in look-up table

Under this method, which is available to all banks, credit exposure will equal and *remain fixed* at an amount equal to the notional amount of the derivative transaction multiplied by the conversion factor set forth in a look-up table (“**Conversion Factor Matrix**”). The Conversion Factor Matrix Method is similar to the method for calculating credit exposure arising from a derivative transaction in the federal banking agencies’ 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 Conversion Factor Matrix to reflect the absence of the “current credit exposure” component. The Conversion Factor Matrix Method in the interim final rules does not appear to take into account the effect of netting.

Conversion Factor Matrix for Calculating Potential Future Credit Exposure⁴

Original maturity ⁵	Interest Rate	Foreign exchange rate and gold	Equity	Other ⁶ (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

3. Remaining Maturity Method

Credit Exposure is the greater of:

(a) Zero; or

(b) Current mark-to-market value + (notional amount x remaining maturity x fixed multiplier)

Under this method, which is available to all banks, credit exposure is determined by adding the current mark-to-market value of the derivative transaction to the product of the notional amount of the transaction, the remaining maturity of the transaction (in years) and a fixed multiplier based on product type and determined by a look-up table. All else being equal, as the remaining maturity on a derivative transaction

⁴ 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.

⁵ 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.

⁶ Transactions not explicitly covered by any other column in the table are to be treated as “Other.”

decreases, credit exposure calculated under the Remaining Maturity Method also decreases. This method also incorporates the fact that a negative mark-to-market value can offset the positive contribution from the remaining maturity portion of the formula, though the overall calculation has a floor of zero. The Remaining Maturity Method does not appear to take into account the effect of netting.

- **Example.** Bank A enters a five-year interest rate swap with a notional value of \$100,000 and a mark-to-market value (“MTM”) of zero at execution. At execution, Bank A’s credit exposure is \$7,500 ($\$0 + (\$100,000 \times 5 \times 1.5\%)$). 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 \$1,000. Bank A’s credit exposure arising from the swap is \$5,500 ($\$1,000 + (\$100,000 \times 3 \times 1.5\%)$). If the MTM of the swap in year two is negative \$1,000, Bank A’s credit exposure arising from the swap would be \$3,500 ($-\$1,000 + (\$100,000 \times 3 \times 1.5\%)$). If the MTM of the swap in year two is negative \$10,000, Bank A’s lending limit exposure for the swap would be zero ($-\$10,000 + (\$100,000 \times 3 \times 1.5\%) = -\$5,500$, which is less than zero); zero being the floor for credit exposure calculated using the Remaining Maturity Method.

Remaining Maturity Factor for Calculating Credit Exposure

	Interest Rate	Foreign exchange rate and gold	Equity	Other ⁷ (includes commodities and precious metals except gold)
Fixed Multiplier	1.5%	1.5%	6%	6%

Special Rules for Credit Derivatives

Calculating Counterparty Credit Exposure to Protection Seller. Under the interim final rule, a bank that uses the Conversion Factor Matrix Method or Remaining Maturity Method, or that uses the Internal Model Method *without* entering into an “effective margining arrangement,”⁸ must calculate the **counterparty credit exposure** arising from credit derivatives with a counterparty by adding the net notional value of all protection **purchased** from the counterparty on each reference entity.

- **Example.** Bank A buys and sells credit protection from and to Bank B on Firms X, Y and Z. Assume there is an effective margining arrangement between the banks. Banks A and B will use their approved internal models to determine their counterparty credit exposures arising from these credit default swaps.
- **Example.** Bank A buys and sells credit protection from and to Bank B on Firms X, Y and Z. Assume no effective margining arrangement exists between the two banks. Bank A’s net notional protection *purchased* from Bank B is \$50 for Firm X and \$100 for Firm Y. Bank A’s net protection sold to Bank B is \$35 for Firm Z. Under the interim final rule, the counterparty credit exposure of Bank A to Bank B is \$150 (sum of the notional value of all protection *purchased* from Bank B).

Calculating Credit Exposure to Reference Entity. A bank must calculate the **credit exposure to a reference entity** arising from credit derivatives relating to a reference entity by adding the notional value of all protection **sold** on the reference entity. However, the bank may reduce its exposure to a reference

⁷ Transactions not explicitly covered by any other column in the table are to be treated as “Other.”

⁸ Under the interim final rule, “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.

entity by the amount of any “eligible credit derivative” purchased on that reference entity from an “eligible protection provider,”⁹ as such terms are defined in the interim final rule.

- **Example.** Bank C buys and sells credit protection on Firms X, Y and Z. Bank C’s notional protection sold is \$100 for Firm X, \$200 for Firm Y and \$300 for Firm Z. Under the interim final rule, the credit exposure of Bank C to Firm X is \$100, to Firm Y is \$200 and to Firm Z is \$300. However, if Bank C purchases protection on Firm Z from an “eligible protection provider” in the amount of \$25 via an “eligible credit derivative,” Bank C can reduce its \$300 lending limit exposure to Firm Z to \$275.

Methods for Calculating Credit Exposure Arising From Securities Financing Transactions

The interim final rule provides two methods for calculating credit exposure arising from securities financing transactions. Generally, a bank must use the same method for calculating credit exposure arising from all of its securities financing transactions.

Internal Model Method

Under this method, a bank may calculate credit exposure arising from a securities financing transaction by using an internal model that has been approved for purposes of the federal banking agencies’ advanced approaches capital rules, or any other appropriate model approved by the relevant federal banking agency.

Non-Model Method

The specific method for calculating credit exposure under the Non-Model Method for each type of securities financing transaction is set forth below.

1. Repurchase Agreement

$$\text{Credit Exposure} = \text{Market value of securities transferred} - \text{Cash received}$$

The credit exposure arising from a repurchase agreement is equal to and **remains fixed** at the market value at execution of the transaction of the securities transferred to the other party less cash received.

- **Example.** Bank A executes a repo in which it borrows \$100, pledging securities worth \$102. Credit exposure is \$2 (\$102 - \$100), the market value at execution of the securities transferred less cash received.

2. Securities Lending

a) Cash Collateral Transactions

$$\text{Credit Exposure} = \text{Market value of securities transferred} - \text{Cash received}$$

⁹ Under the interim final rule, “eligible protection provider” includes: a sovereign entity (a central government, including the U.S. government; an agency; department; ministry; or central bank); a depository institution; a bank holding company; a savings and loan holding company; an SEC-registered broker-dealer; an insurance company that is subject to the supervision of a state insurance regulator; a foreign banking organization; 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 a qualifying central counterparty.

The credit exposure arising from a securities lending transaction where the collateral is cash is equal to and **remains fixed** at the market value at execution of the transaction of securities transferred less cash received.

- **Example.** Bank A lends a \$102 security (par value of \$100) and receives \$100 in cash collateral. Credit exposure is \$2 ($\$102 - \100), the market value at execution of securities transferred less cash received.

b) Non-cash Collateral Transactions

Credit Exposure = Higher of 2 collateral haircuts x Higher of 2 securities' par values

The credit exposure arising from a securities lending transaction where the collateral is other securities is equal to and **remains fixed** at the product of: (i) the higher of the two collateral haircuts associated with the two securities, as determined by the collateral haircuts tables (below), and (ii) the higher of the two par values of the securities.

- **Example.** Bank A lends a \$100 par value security (fair value \$101) and receives another security as collateral. The collateral has a \$100 par value (and \$102 fair value). The collateral haircuts associated with the loaned and borrowed securities are 2% and 4% respectively. Credit exposure is \$4 ($4\% \times \100), the product of the higher of the two collateral haircuts and the higher of the two par values (here the par values were the same).

3. Reverse Repurchase Agreements

Credit Exposure = Collateral haircut x Cash transferred

The credit exposure arising from a reverse repurchase agreement is equal to and **remains fixed** at the product of the haircut associated with the collateral received, as determined by the collateral haircuts tables, and the amount of cash transferred.

- **Example.** Bank A lends \$100 secured by securities worth \$102 that have a collateral haircut of 4%. Credit exposure is \$4 ($4\% \times \100), the product of the haircut associated with the collateral received and the amount of cash transferred.

4. Securities Borrowing

a) Cash collateral transactions

Credit Exposure = Collateral haircut x Cash transferred

The credit exposure arising from a securities borrowing transaction where the collateral is cash is equal to and **remains fixed** at the product of the haircut associated with the collateral received, as determined by the collateral haircuts tables, and the amount of cash transferred to the other party.

- **Example.** Bank A borrows a \$100 par value security that has a fair value of \$102. Bank A pledges \$100 in cash. The collateral haircut associated with the security is 4%. The credit exposure is \$4 ($4\% \times \100), the product of the haircut associated with the collateral received and the amount of cash transferred.

b) Non-cash collateral transactions

Credit Exposure = Higher of 2 collateral haircuts x Higher of 2 securities' par values

The credit exposure arising from a securities borrowing transaction where the collateral is other securities is equal to and **remains fixed** at the product of: (i) the higher of the two collateral haircuts associated with the two securities, as determined by the collateral haircuts tables, and (ii) the higher of the two par values of the securities.

- **Example.** Bank A borrows a \$100 par value security (with fair value \$101) and pledges a security with a par value of \$100. The fair value of the security pledged is \$102. The collateral haircut associated with the borrowed security is 2% and the collateral haircut associated with the pledged security is 4%. The credit exposure is \$4 (4% x \$100), the product of the higher of the two collateral haircuts and the higher of the two par values (here the par values were the same).

Collateral Haircuts Tables

Sovereign Entities	Residual maturity	Haircut without currency mismatch ¹⁰
<i>OECD Country Risk Classification¹¹ 0-1</i>	≤ 1 year	0.005
	>1 year, ≤ 5 years	0.02
	> 5 years	0.04
<i>OECD Country Risk Classification 2-3</i>	≤ 1 year	0.01
	>1 year, ≤ 5 years	0.03
	> 5 years	0.06

Corporate and Municipal Bonds that are Bank-Eligible Investments	Residual maturity for debt securities	Haircut without currency mismatch
<i>All</i>	≤ 1 year	0.02
<i>All</i>	>1 year, ≤ 5 years	0.06
<i>All</i>	> 5 years	0.12

Other Eligible Collateral	Haircut
<i>Main index¹² equities (including convertible bonds)</i>	0.15
<i>Other publicly traded equities (including convertible bonds)</i>	0.25
<i>Mutual funds</i>	Highest haircut applicable to any security in which the fund can invest
<i>Cash collateral held</i>	0

¹⁰ In cases where the currency denomination of the collateral differs from the currency denomination of the credit transaction, an additional 8 percent haircut will apply.

¹¹ OECD Country Risk Classification means the country risk classification as defined in Article 25 of the OECD's February 2011 Arrangement on Officially Supported Export Credits Arrangement.

¹² Main index means the Standard & Poor's 500 Index, the FTSE All-World Index, and any other index for which the covered company can demonstrate to the satisfaction of the Federal Reserve that the equities represented in the index have comparable liquidity, depth of market, and size of bid-ask spreads as equities in the Standard & Poor's 500 Index and FTSE All-World Index.

Credit Exposures arising from Transactions Financing Certain Government Securities

The interim final rule excepts from the lending limit credit exposures arising from securities financing transactions in which the securities being financed are certain government securities, specifically, Type I securities¹³ in the case of national banks, and the securities listed in Sections 5(c)(1)(C), (D), (E), and (F) of HOLA and general obligations of a state or subdivision as listed in Section 5(c)(1)(H) of HOLA,¹⁴ in the case of savings associations.

Exception for Intraday Credit Exposures

The interim final rule excepts from the lending limits for banks intraday credit exposures arising from a derivative transaction or securities financing transaction. According to the OCC, this exception is intended to minimize the impact of the interim final rule on the payment and settlement of financial transactions and is consistent with the current application of national bank lending limits.

Nonconforming Loans and Extensions of Credit

The interim final rule provides that a credit exposure arising from a derivative transaction or securities financing transaction and determined by the Internal Model Method will not be deemed a violation of the lending limits rules and will be treated as “nonconforming” if the transaction was within the bank’s lending limit at execution but is no longer in conformity because the exposure has increased since execution. Under the applicable provision in the interim final rule, a bank must use reasonable efforts to bring the nonconforming transaction into conformity with its lending limit unless to do so would be inconsistent with safe and sound banking practices.

Effective Date and Comment Period

The interim final rule becomes effective on July 21, 2012. However, as noted above, the interim final rule contains a temporary exception from the lending limit rules for credit exposures arising from derivative transactions or securities financing transactions until January 1, 2013. Comments on the interim final rule must be received by August 6, 2012. If any amendments are required in light of the comments received, the OCC stated that it will issue a final rule “as expeditiously as possible” and will adjust the compliance date if and as necessary.

¹³ For national banks, a Type I security means: (i) obligations of the United States; (ii) obligations issued, insured, or guaranteed by a department or an agency of the United States government, if the obligation, insurance, or guarantee commits the full faith and credit of the United States for the repayment of the obligation; (iii) obligations issued by a department or agency of the United States, or an agency or political subdivision of a state of the United States, that represent an interest in a loan or a pool of loans made to third parties, if the full faith and credit of the United States 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); (iv) general obligations of a state of the United States or any political subdivision thereof; and municipal bonds if the national bank is well-capitalized; (v) obligations authorized under 12 U.S.C. 24 (Seventh) as permissible for a national bank to deal in, underwrite, purchase, and sell for the bank’s own account, including qualified Canadian government obligations; and (vi) other securities the OCC determines to be eligible as Type I securities under 12 U.S.C. 24 (Seventh).

¹⁴ For federal savings associations, these investments include: (i) obligations of, or fully guaranteed as to principal and interest by, the United States; (ii) investments in securities of the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Government National Mortgage Association, or any agency of the United States; and (iii) investments in obligations issued by any state or political subdivision thereof.

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