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Alert Memo

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OCC Revises Lending Limits Rule to Include Derivatives and Securities Financing Transactions

On June 20, 2012, the Office of the Comptroller of the Currency (the "OCC") issued an interim final rule (the "Rule")[1] that implements Section 610 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 610 expanded the range of transactions subject to lending limits applicable to national banks under the National Bank Act to include credit exposures arising from derivative transactions, as well as from repurchase and reverse repurchase agreements and securities lending and borrowing transactions ("Securities Financing Transactions"). The Rule also makes a number of technical changes that expand the scope of the current rule's exclusion for loans to affiliates and subsidiaries of a bank and consolidate the lending limits rules applicable to savings associations with those applicable to national banks.

The changes made to implement Section 610 could have significant implications for many financial institutions if the Rule is finalized in its current form. The Rule does not exempt or provide a different approach for calculating exposure to clearinghouses and central counterparties ("CCPs"), as the industry had hoped for in light of domestic and international mandates to move towards the standardization and clearing of derivatives. Left unchanged, this treatment for CCPs could significantly constrain bank derivatives activities. The Rule may also have profound effects on dealer banks, in particular their ability to face other dealers. In addition, there are significant inconsistencies between the Rule and other regulatory requirements, including risk-based capital rules, the proposed margin and capital rules for swaps, and other rules requiring the calculation of credit exposure for these types of transactions. This lack of harmonization could pose significant challenges for financial institutions.

The Rule will become effective on July 21, 2012, the effective date of Section 610 of the Dodd-Frank Act; however, the Rule temporarily exempts derivative transactions and Securities Financing Transactions from the lending limits until January 1, 2013. The OCC has requested comments by August 6, 2012.

[1] 77 Fed. Reg. 37,265 (June 21, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-06-21/pdf/2012-15004.pdf.

I. Background and Scope

The National Bank Act, as implemented by the OCC's lending limits rule, requires that national banks limit their outstanding loans and credit exposure to a single counterparty to 15% of a bank's unimpaired capital and unimpaired surplus, plus up to an additional 10% (for a total credit exposure limit of 25%) of a bank's unimpaired capital and unimpaired surplus if the exposure exceeding 15% is fully secured by readily marketable collateral.[2] The Home Owners' Loan Act applies national bank lending limits to state and federally chartered savings associations, subject to certain statutory exemptions. Once effective, the Rule will require national banks and savings associations to include credit exposures from derivative transactions and Securities Financing Transactions in their calculations of these limits.[3]

State-chartered banks are typically subject to lending limits under state law. Although Section 610 and the Rule do not by their terms apply to state-chartered banks, beginning January 21, 2013, Section 611 of the Dodd-Frank Act will prohibit FDIC-insured state-chartered banks from engaging in derivative transactions unless the chartering state takes into consideration credit exposure to derivative transactions in its lending limits laws.

This memorandum first discusses the key considerations raised by the Rule, and then provides more detail on how a bank would calculate its credit exposure from derivative transactions and Securities Financing Transactions under the Rule.

II. Key Considerations

- *Clearinghouses and Central Counterparties.* The Rule does not contain any exemptions for the measurement of a bank's exposure to a clearinghouse or CCP, nor does it discuss the possibility of differential treatment for such exposures.[4] Given the Dodd-Frank Act's mandatory clearing requirements for certain derivatives—and analogous non-U.S. rules—this could significantly constrain

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2 See 12 U.S.C. § 84; 12 C.F.R. Part 32.

3 For ease of reference, this memorandum uses the terms "bank" or "banks" to refer to national banks and savings associations subject to the Rule unless the context requires otherwise.

4 In Question 15 of the preamble to the Rule, the OCC focuses on a more specific issue in the context of CCPs, stating that the Rule does not address whether the lending limits should apply to a bank's contingent obligation to advance funds to a derivative clearinghouse guaranty fund. This suggests that the OCC may consider funds currently advanced to such a guaranty fund, and other current or potential future exposures to a clearinghouse or CCP, to be subject to the lending limits, and is questioning only whether to also apply the Rule to any "contingent" future obligation to advance additional funds. In the Proposed SIFI Rule (defined below), the Federal Reserve suggested that initial margin, excess variation margin and contributions to a guaranty fund should be considered credit exposure to the CCP.

derivatives activities by banks as their exposure becomes more concentrated at a limited number of CCPs.

The Federal Reserve's proposed rule to implement Section 165 of the Dodd-Frank Act (the "Proposed SIFI Rule")—which would limit single counterparty credit exposure for large bank holding companies and systemically important nonbank financial companies—also did not propose a specific solution to the problem of credit exposure to CCPs. However, the Federal Reserve did request comment on the "competing policy concerns in considering whether to limit a covered company's exposure to central counterparties."[5] The industry had hoped for some recognition from the regulatory agencies that a separate limitation framework should be created for exposure to CCPs (to permit banks to continue to provide liquidity in a market subject to mandatory clearing).

- *Impact on Dealer Banks*. Banks that operate as market makers or dealers in derivatives, or that play similar roles with respect to Securities Financing Transactions, may find their operations significantly affected by the Rule. Although the lending limit thresholds may be high enough not to interfere with a dealer bank's transactions with its customers, the limits could impair a dealer bank's ability to manage its risks through offsetting trades in the interdealer market, where a small number of institutions are readily available to take both sides of trades and provide the majority of the liquidity in the market. Further, concentrated derivatives exposure to this limited number of other dealer institutions could "crowd out" a bank's ability to provide other forms of financing to such institutions.

- *Impact on Nondealer Banks*. Although the Rule is likely to have a much greater effect on dealer banks, it also could raise the costs of hedging and risk mitigation for many nondealer banks. Smaller banks that engage in derivative transactions or Securities Financing Transactions to only a limited extent may find it more efficient to maintain a relationship with only one or a few dealer banks. Capping the amount of credit protection that a bank can purchase from any one counterparty may force these smaller banks to establish new relationships with additional dealers, which could increase costs and decrease operational efficiencies.

- *Harmonization of Exposure Limits.* The OCC's approach to calculating credit exposure from derivatives transactions and Securities Financing Transactions differs from the approach proposed by the Federal Reserve for the calculation of

[5] Section 165 of the Dodd-Frank Act requires the Federal Reserve to impose enhanced prudential standards, including concentration limits, on large bank holding companies and certain systemically important nonbank financial companies. The Federal Reserve proposed rules to implement Section 165 in January 2012. See 77 Fed. Reg. 594 (Jan. 5, 2012).

single counterparty concentration limits in the Proposed SIFI Rule. For example, the OCC's Rule permits a variety of methods for calculating credit exposure, including an internal model approach, while the Federal Reserve's Proposed SIFI Rule contains only a single method based on the current exposure method under the Federal Reserve's risk-based capital rules. The capital rules' current exposure method calculates exposure as the current mark-to market ("MTM") value of a derivative (a measure of the derivative's current credit exposure) plus an estimate of potential future exposure ("PFE") equal to a fixed percentage of the notional amount of the derivative.[6]

The industry has criticized the Proposed SIFI Rule specifically on this point, arguing that internal models developed under the capital rules should be permitted as tools to measure credit exposure and that the current exposure methodology (in addition to other features of the Proposed SIFI Rule) would significantly overstate the true credit exposure of an institution. To the extent that the Rule (unlike the Proposed SIFI Rule) permits the industry to use internal models, it may alleviate concerns about the potential to overestimate credit exposures, although not the underlying complications that arise from subjecting new classes of transactions to the lending limits pursuant to Section 610 of the Dodd-Frank Act.

Inconsistencies between the Rule and the Proposed SIFI Rule, and with other regulations that require the measurement of credit exposure, are likely to complicate the industry's attempts to integrate credit exposures from derivatives and Securities Financing Transactions into their compliance systems. The OCC indicated in the preamble to the Rule that it took into account the proposals and comments received on other, related rulemakings, including the Proposed SIFI Rule, which may suggest some willingness on the part of the federal banking regulators to harmonize their requirements to the extent possible.

- *Implications for the Federal Reserve's Regulation W.* The Federal Reserve has not yet proposed rules to implement Section 608 of the Dodd-Frank Act, which, among other things, will subject derivative transactions and Securities Financing Transactions to the limitations on bank transactions with affiliates in Section 23A of the Federal Reserve Act. The OCC's approach to calculating credit exposures in the Rule is one possible approach the Federal Reserve could take, but there is

[6] The percentage of notional value to include as a measure of PFE is derived from a look-up table similar to that used in the OCC's Conversion Factor Matrix Method, which is described in greater detail below. See our alert memo, entitled "The Federal Reserve Board's Heightened Prudential Requirements for Systemically Important Financial Institutions: Initial Framework, but More Detail to Follow" (Jan. 24, 2012), for further discussion of the single counterparty credit exposure limits in the Proposed SIFI Rule, *available at* http://www.cgsh.com/federal_reserve_boards_heightened_prudential_requirements/.

no indication yet whether the Federal Reserve will adopt the OCC's approach or propose a different one. The methodology chosen may affect the relative size of credit exposures under interaffiliate derivative transactions, and therefore the degree to which such transactions will be restricted or curtailed. Significant curtailment of interaffiliate transactions would likely hinder the ability of banking institutions to engage in efficient enterprise-wide risk management.

Section 608, like Section 610, takes effect on July 21, 2012, and therefore some action by the Federal Reserve is expected in the next several weeks. That action, which could be a proposed or interim final rule or simply a type of no-action announcement, may also provide some indication of the level of harmonization the industry should expect among the various rules on counterparty exposures.

- *"Effective Margining Arrangements" for Credit Derivatives*. The $1 million threshold for posting variation margin in the Rule's definition of an "effective margining arrangement"[7] is not fully consistent with either current market practice or the OCC's proposed swap margin and capital requirements under Title VII of the Dodd-Frank Act.[8] As a result, many banks may not be able to rely on internal models to calculate counterparty credit exposure from credit derivatives, especially with respect to pre-existing derivatives contracts.

- *Application of the OCC's Combination Rules*. The Rule does not discuss the application of the combination rules in the lending limits rule (the "Combination Rules")[9] to derivative transactions or Securities Financing Transactions, although the OCC does ask whether any changes or adjustments to the Combination Rules might be necessary given the expanded scope of lending limits under the Rule. Under the Combination Rules, an extension of credit may be attributed to another person or persons, in addition to the direct counterparty, if (i) the proceeds of the extension of credit are used for the direct benefit of the other person (other than in a bona fide arm's length transaction where the proceeds are used to acquire

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7 See infra, note 14.

8 Under current market practices, negotiated thresholds for variation margin often exceed $1 million, and some derivatives contracts rely on alternative methods of collateralizing credit exposure (for example, non-financial end users without the liquidity to post variation margin often instead grant a security interest in non-financial assets). Likewise, the OCC's proposed swap margin requirements would in some cases allow thresholds significantly higher than $1 million. See 76 Fed. Reg. 27,564 (May 11, 2011), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-10432.pdf. See also our alert memo, entitled "Prudential Regulators Propose Swap Margin and Capital Requirements" (Apr. 14, 2011), for further discussion of margin and capital requirements applicable to swap dealers, security-based swap dealers, major swap participants and security-based swap participants that are banks or otherwise subject to oversight by the OCC or other banking regulators. http://www.cgsh.com/prudential_regulators_propose_swap_margin_and_capital_requirements.

9 See 12 C.F.R. § 32.5.

property, goods or services), or (ii) if a common enterprise is deemed to exist among the direct counterparty and other persons.

The direct benefit test in particular can raise significant challenges in the context of attributing loans, guarantees and other traditional extensions of credit—it likely will be far more complicated in the context of derivative transactions and Securities Financing Transactions. For example, it is unclear how the Combination Rules might be applied to the sets of independent but related transactions that arise regularly in the derivatives and securities financing markets, such as a bank providing one side of a counterparty's back-to-back swap, a bank executing a trade settled through a CCP, or a Securities Financing Transaction in which the transferred or loaned securities are used to collateralize a contract with a third party.

- *Timing of Calculations.* Currently, the OCC's lending limits rule requires banks to calculate compliance with their lending limits once per quarter, or whenever there is a change in a bank's capital category for purposes of the OCC's prompt corrective action rules, unless the OCC determines that a bank should calculate compliance with its lending limits more frequently. The Dodd-Frank Act and the Rule now apply the lending limits rule to transactions that, for banks using the Internal Model Methods or the Remaining Maturity Method, may fluctuate in value on a daily basis (in contrast to most transactions previously subject to the lending limit rules). The OCC did not state whether it would require that banks engaged in significant derivatives and/or securities financing activities calculate compliance with the lending limits more frequently than quarterly. In the Proposed SIFI Rule, the Federal Reserve proposed requiring daily calculation of single counterparty credit limits so as to monitor compliance.

- *State-Chartered Banks*. State banks face an even less certain regulatory environment than do national banks and savings associations with respect to the application of lending limits to derivative transactions. As noted above, beginning January 21, 2013, Section 611 of the Dodd-Frank Act will prohibit FDIC-insured state banks from engaging in derivative transactions unless "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."[10]

[10] One interesting question raised by Section 611 is whether its requirement that the law of a state take credit exposure to derivative transactions into consideration would be satisfied by an action taken by a state administrative or regulatory body, rather than a state legislature. State banks are more likely to obtain timely action from their state regulators than their state legislatures. Some states have already taken the position that legislation requiring the inclusion of derivatives credit exposure in a state's legal lending limits can empower a state regulatory agency to make a final determination on how such credit exposure should be calculated. Other state regulatory agencies have been awaiting guidance from the OCC to have a model for implementation at the state level.

Although several states have acted, it is impossible to predict at this time whether, and in what manner, other chartering states will implement laws to satisfy the requirements of Section 611. If they do not, then absent some form of regulatory relief, some state-chartered banks may be prohibited from engaging in any derivative transactions—even transactions that would not ordinarily be subject to lending limits, such as transactions fully secured by U.S. treasuries, interaffiliate derivative transactions subject to Regulation W, and possibly even transactions that would be used by a state bank for risk-mitigating purposes.

- *Branches and Agencies of Foreign Banking Organizations.* The federally licensed branches and agencies of foreign banking organizations will be subject to the Rule to the same extent as any national bank (although the capital and surplus used to determine the constraints imposed by the Rule would be the capital and surplus of the foreign bank that operates the branch or agency). In addition, Section 611 of the Dodd-Frank Act by its terms applies only to insured state banks, and therefore should have no effect on state-licensed uninsured branches and agencies. Pursuant to the International Banking Act, state branches and agencies are subject to the same lending limit rules that are applicable to federal branches and agencies, unless the state's rules are "more stringent." Therefore the OCC's Rule may also apply to state branches and agencies depending upon how the states act.

III. Calculation of Credit Exposure

The Rule gives banks a choice between using internally developed models for calculating credit exposures and using a simpler, alternative method. The OCC expects that large banks, in particular those that engage in complex or significant volumes of derivatives transactions or Securities Financing Transactions, are likely to use internal models for calculating credit exposure. Although such models must be approved by the bank's primary Federal banking regulator, they are likely to provide more flexibility and a better dynamic measure of credit exposure than the alternative methods provided in the Rule.

The alternative methods are intended to relieve banks that make more limited use of derivatives and securities financing from the burden of developing statistical models to estimate their credit exposure. Instead, these methods rely on fixed haircuts and conversion factors to calculate the approximate credit exposure of a transaction, sacrificing accuracy and flexibility for simplicity.

The OCC (or the FDIC, in the case of state-chartered savings associations) may mandate that a bank use a particular method if necessary to promote the safety and soundness of the institution. In all instances, once a bank has chosen the method it will use to determine its credit exposure arising out of derivative transactions or Securities Financing

Transactions, it must use the same method to calculate its exposure to all transactions in each category.

A. Derivative Transactions

The Rule provides that, for non-credit derivative transactions, a bank may choose one of three models for calculating credit exposure, each of which is explained in further detail below: (1) the Internal Model Method, (2) the Conversion Factor Matrix Method, or (3) the Remaining Maturity Method. Each of these methods employs one or both of the two components that the OCC has determined typically constitute the credit exposure arising from a derivative transaction—the current credit exposure, which under the Rule is deemed to equal the MTM value of the derivative contract, and the PFE. Credit derivatives are subject to a special set of rules requiring calculation of a bank's credit exposure to each seller of credit protection to the bank and to each reference entity on which the bank sells protection.

1. Non-Credit Derivatives

(a) Internal Model Method. This method permits a bank to select an internal model that it determines to be most appropriate to estimate its credit exposure from derivative transactions and that has been approved by the OCC (or the FDIC, in the case of state-chartered savings associations).[11] The model's estimates must include both the current credit exposure of a transaction (equal to its MTM value) and the estimated PFE of the transaction. The current credit exposure of a transaction cannot fall below zero—if the MTM value of a transaction

[11] As an alternative to a model specifically approved for purposes of the Rule, a bank may use a model that was previously approved under Section 53 of the advanced approaches appendices in the Federal banking agencies' risk-based capital rules, which set forth the requirements for internal models used to calculate equity exposures for purposes of risk-based capital rules. See, e.g., 12 C.F.R. Part 3, Appendix C. The OCC did not indicate why it chose the capital rules governing models for equity exposures, rather than those for over-the-counter ("OTC") derivatives.

Furthermore, in the context of risk-based capital calculations, although many large institutions were permitted by the Federal banking regulators to undertake a "parallel run" of the advanced approaches together with the Basel I approach, no bank was ever given permission to exit the parallel run and use only the advanced approaches methods. Consequently, it is not clear whether banks have already had internal models fully approved by the OCC or another Federal banking regulator, or whether banks will be required to seek such approval (or at least further clarity) before the Rule's January 1, 2013 effective date. Complicating matters further, the Federal banking agencies recently proposed significant and comprehensive changes to the risk-based capital framework for banks to bring the United States in line with the Basel III accord. The Joint Notice of Proposed Rulemakings regarding Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action; the Advanced Approaches Risk-Based Capital Rule and Market Risk Capital Rule; and the Standardized Approach for Risk-Weighted Assets are available at http://www.federalreserve.gov/newsevents/press/bcreg/20120607a.htm.

is negative, its current credit exposure is zero, and its total credit exposure will equal its estimated PFE. A bank that uses this method may reduce its exposure to a borrower by netting the credit exposure of transactions that arise under a single qualifying master netting agreement.[12]

(b) Conversion Factor Matrix Method. Under this method, credit exposure is calculated as equal to the PFE of the transaction at the time of execution. The PFE is determined by multiplying the derivative's notional value by a conversion factor established based on the type of derivative (e.g., interest rate swap, foreign exchange, equity, other) and its original maturity. Once determined pursuant to this method, a transaction's credit exposure for purposes of the Rule will remain unchanged for the duration of the transaction. Only the PFE is used under this method, and the MTM value of the transaction does not figure into the exposure calculation either at the inception of the transaction or if the MTM value changes over the tenor of the transaction. Furthermore, netting across transactions with the same counterparty does not seem to be permitted under this method. The Rule sets forth the conversion factors for this method in a simple table, reproduced below:[13]

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	.20	.30
Over 5 to 10 years	.12	.12	.20	.60
Over ten years	.30	.30	.20	1.0

[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

12 The Rule adopts the definition of "qualifying master netting agreement" used in the OCC's advanced approaches capital rule to determine whether a set of OTC derivatives contracts is eligible for netting. See 12 C.F.R. Part 3, Appendix C, § 2.

13 The conversion factors to be used in the Conversion Factor Matrix Method are higher than those set forth in the Proposed SIFI Rule and the risk-based capital rules, because the conversion factors under the Rule have been adjusted to reflect the absence of the current MTM value component that is separately counted in the other rules.

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.''

(c) Remaining Maturity Method. This method measures credit exposure by reference both to current MTM value and to the remaining maturity of the transaction. Under the Remaining Maturity Method, credit exposure is calculated as the sum of the current MTM value plus the product of a fixed multiplicative factor, the notional amount of the transaction and the remaining maturity of the transaction. The OCC noted that, while this method may be more burdensome to calculate than the Conversion Factor Matrix Method, it has the advantage that the calculated credit exposure may decrease as the derivative transaction's remaining maturity decreases (depending on changes in the MTM value), thus permitting a bank to take on additional credit exposures to that counterparty over time. It also takes into account fluctuations in current MTM value, which can either reduce or increase a bank's credit exposure (i.e., under this method, if MTM value is negative, it can offset some or all of the projected PFE of a transaction, but the Rule provides that the total credit exposure can never fall below zero). This method also does not seem to permit netting across transactions with the same counterparty. The multiplicative factors, which vary depending upon the asset underlying the derivative transaction, are set forth in a simple table, reproduced below:

TABLE 2—REMAINING MATURITY FACTOR FOR CALCULATING CREDIT EXPOSURE [1]				
	Interest rate	Foreign exchange rate and gold	Equity	Other [1] (includes commodities and precious metals except gold)
Multiplicative Factor	1.5%	1.5%	6%	6%
[1] Transactions not explicitly covered by any other column in the Table are to be treated as ''Other.''				

2. Credit Derivatives.

(a) Counterparty exposure. Unless a bank uses the Internal Model Method with an "effective margining arrangement",[14] it must use a special method for calculating a bank's credit exposure from credit

[14] "Effective margining arrangement" is defined to mean "a master legal agreement governing derivative transactions between a bank or a savings association 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." Note that, for purposes of the Rule, an effective margining arrangement does not require the agreement to include initial margin or other independent amounts.

derivatives to counterparties. Credit exposure is calculated as the sum of the "net" notional value of all credit protection purchased from a counterparty, for each reference entity. The net notional value is to be calculated by netting any protection sold by the bank on the same reference entity to the same counterparty. By using a transaction's notional value as the base for this calculation, the Rule does not take into account a more sophisticated analysis of the probability of required payment by the counterparty based on the probability of default of the reference entity, as internal models would.

(b) Reference entity exposure. Although Section 610 requires only the calculation of credit exposure to counterparties, the OCC has included in the Rule a requirement that banks apply the lending limits to exposures to the reference entities of credit derivatives as well. Credit exposure is calculated as the sum of the notional value of all credit protection sold by the bank on a particular reference entity, although such exposure may be partially or fully offset by protection purchased on the reference entity in the form of an "eligible credit derivative" that meets certain criteria.[15] Because the Rule requires use of the full notional amount of the credit derivative, it equates the credit derivative to a guarantee or letter of credit, each of which is counted toward the lending limits even when not drawn.

B. Securities Financing Transactions

The Rule permits banks to calculate their credit exposure arising out of Securities Financing Transactions using one of two methods: the Internal Model Method or the Non-Model Method.[16]

1. Internal Model Method. As with the Internal Model Method for derivative transactions, this method permits a bank to use an internal model that has been approved by the OCC (or the FDIC, in the case of state-chartered savings associations) to estimate its credit exposure from Securities Financing Transactions.[17]

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[15] In Question 8 of the Rule, the OCC asks whether protection purchased in the form of eligible credit derivatives should be permitted to reduce other forms of exposure under the lending limits rule, such as exposure from loans.

[16] The Rule did not provide guidance on whether guarantees of Securities Financing Transactions (or of derivatives), such as those provided by custodians in their agency securities lending programs, should be subject to one of these methods of calculation as well.

[17] As with the Internal Model Method for derivatives, a bank may, as an alternative to a model specifically approved for purposes of the Rule, use a model that was previously approved for purposes of the Federal

2. Non-Model Method. As with the non-model methods for calculating credit exposures from derivative transactions, the calculations for credit exposure from Securities Financing Transactions under the Non-Model Method provide a simpler approach intended to relieve less complex institutions of the burden of implementing statistical models for their credit exposures. The form of the calculation is a function of the type of transaction for which the exposure is being calculated, and in many cases relies on specified haircuts set forth in a table, reproduced below. Under the Non-Model Method, a bank's credit exposure from a transaction is determined and fixed at the time of execution, and does not change for the duration of the transaction.

   (a) Securities Financing Transactions involving cash collateral

      (i) *Repurchase Agreements and Securities Lending Transactions*: Credit exposure is calculated as the market value at execution of the transferred securities less the amount of cash received.

      (ii) *Reverse Repurchase Agreements and Securities Borrowing Transactions*: Credit exposure is calculated as the product of the prescribed collateral haircut and the amount of transferred cash.

   (b) Securities lending and borrowing transactions involving non-cash collateral

      (i) For both securities lending and securities borrowing transactions where the collateral involved is other securities, credit exposure is calculated as the product of the higher of the two prescribed haircuts associated with the securities exchanged and the higher of the two par values of the securities. For example, if a bank lends $100 par value of corporate debt securities to a borrower and takes $105 par value of U.S. treasuries with the same residual maturity in return, the haircut used would be that assigned to the corporate debt securities, and the credit exposure would be that haircut multiplied by $105, the higher of the two par values.

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banking agencies' risk-based capital rules, in this case under Section 32(d) of the advanced approaches appendices, which set forth the requirements for internal models used to calculate exposure from repo-style transactions, among others. See, e.g., 12 C.F.R. Part 3, Appendix C. See also note 12, above.

TABLE 3—COLLATERAL HAIRCUTS		
	Residual maturity	Haircut without currency mismatch[1]
SOVEREIGN ENTITIES		
OECD Country Risk Classification[2] 0–1	≤ 1 year	.005
	>1 year, ≤ 5 years	.02
	5 years	.04
OECD Country Risk Classification 2–3	≤ 1 year	.01
	>1 year, ≤ 5 years	.03
	5 years	.06
CORPORATE AND MUNICIPAL BONDS THAT ARE BANK-ELIGIBLE INVESTMENTS		
	Residual maturity for debt securities	Haircut without currency mismatch
All	≤ 1 year	.02
All	>1 year, ≤ 5 years	.06
All	> 5 years	.12
OTHER ELIGIBLE COLLATERAL		
Main index[3] equities (including convertible bonds)		0.15
Other publicly traded equities (including convertible bonds)		0.25
Mutual funds		Highest haircut applicable to any security in which the fund can invest
Cash collateral held		0

[1] In cases where the currency denomination of the collateral differs from the currency denomination of the credit transaction, an addition 8 percent haircut will apply.

[2] 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.

[3] 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.

C. New Exceptions to the Lending Limits Rule

1. Certain Transactions Involving Type I Securities. The Rule will not require banks to include credit exposures for Securities Financing Transactions that finance Type I securities—i.e., U.S. government, U.S. municipal and certain other securities—in their lending limit calculations.[18] In explaining this exemption, the OCC noted that banks are already permitted to invest freely in Type I securities without limit, and further suggested that the exemption

[18] See 12 C.F.R. § 1.2(j).

should reduce the burden of the Rule on community and midsized banks, which the OCC believes make relatively little use of Securities Financing Transactions that do not involve Type I securities. Reverse repurchase agreements involving Type I securities were already exempted from the lending limit requirements as equivalent to a loan secured by Type I collateral. The lending limits rule's current exclusion for loans and extensions of credit fully secured by U.S. government bonds and other similar obligations fully guaranteed by the United States would also apply to derivative transactions and Securities Financing Transactions.[19]

2. Intraday Credit Exposures. The Rule excludes intraday credit exposures arising from derivative transactions or Securities Financing Transactions from the calculation of lending limits. The OCC commented that this exemption is intended to "help minimize the impact on the payment and settlement of financial transactions." Without such an exemption, the Rule could have significantly disruptive effects on parts of the financial system's infrastructure that involve large intraday credit exposures, such as the tri-party repo market.

3. Nonconforming Loans and Extensions of Credit. Under the current lending limits rule, a loan that was within the lending limits when made, but then later exceeds those limits (because, for example, the bank's capital has declined or the collateral securing the loan has dropped in value) is treated as nonconforming. Rather than being deemed in violation of the lending limits rule, the lending bank is given the opportunity to bring a nonconforming loan back into conformance in a manner consistent with safety and soundness. Since the Rule introduces dynamic formulas for the calculation of credit exposure under derivative transactions and Securities Financing Transactions, an exposure could now exceed the lending limits for reasons other than those set forth in the current lending limits rule, such as through changes in the valuation of the transaction itself.

   (a) The OCC, therefore, has added a specific provision to ensure that credit exposures arising out of derivative transactions and Securities Financing Transactions that are calculated using one of the dynamic methods—the Internal Model Method—will also be treated as nonconforming rather than in violation of the lending limits if an

[19] Transactions in which a bank receives cash collateral may be exempt under the existing lending limits rule if the cash is held in a segregated deposit account, and as described above, repurchase agreements and securities lending transactions in which a bank receives cash may effectively be exempt, since the amount of cash received is deducted from the market value of the securities at the time of execution.

increase in the credit exposure calculation after execution of the transaction causes the bank to exceed its limit to that counterparty.

(b) The Rule, however, seems not to have provided the same relief for a bank using the Remaining Maturity Method, in the event that an increase in the current MTM value of a derivative transaction post-execution increases the bank's credit exposure to a counterparty as calculated under that method. The OCC does not provide an explanation for this omission.

(c) In contrast, derivative exposures determined under the Conversion Factor Matrix Method and Securities Financing Transaction exposures determined under the Non-Model Method remain fixed at the inception of the transaction and would not be subject to the changes in exposure amount that may cause an exposure to become nonconforming.

(d) The Rule also includes revisions to the nonconforming loans provisions to make clear that credit exposures from derivatives and Securities Financing Transactions (regardless of the method of calculation used) will generally be treated as equivalent to loans if they become nonconforming for another reason, such as a drop in the bank's capital.

IV. Effective and Compliance Dates

The Rule becomes effective in interim final form on July 21, 2012, the date that Section 610 becomes effective; however, the OCC provided a temporary exception with respect to the transactions covered by Section 610 until January 1, 2013. This exception is intended to give banks time to implement procedures to allow them to comply with the expanded scope of the lending limits rules. However, especially in light of the issues and complexities described above, the intersection of the Rule with other related rulemakings, the time it will take for the OCC to finalize the Rule, and the systems requirements for banks to achieve compliance with the Rule, we expect that the industry will advocate for a significantly longer period to come into compliance with a final rule. The OCC indicated that it may use its existing safety and soundness authority to address credit exposures that present concentration risks in the interim.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Banking and Financial Institutions" in the Practices Section of our website at http://www.cgsh.com.

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