STATE OF MICHIGAN
DEPARTMENT OF LICENSING AND REGULATORY AFFAIRS
OFFICE OF FINANCIAL AND INSURANCE REGULATION

Before the Commissioner of the Office of Financial and Insurance Regulation

In the Matter of:

Order No.: 12-023-BT

Request by Citizens Bank to Pledge Assets to Counterparties in Interest Rate Swap Transactions

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Issued and Entered,
This 3rd day of May, 2012,
by R. Kevin Clinton,
Commissioner

ORDER AUTHORIZING STATE CHARTERED BANKS TO PLEDGE ASSETS TO COUNTERPARTIES IN INTEREST RATE SWAP TRANSACTIONS

I
BACKGROUND

Citizens Bank, a state chartered bank headquartered in Flint, Michigan, engages in interest rate swap transactions with various counterparties as a means of offsetting swaps it enters into with commercial loan customers and as tool to manage its interest rate risk. As a condition to many of these interest rate swap agreements, it has become customary for counterparties to require a pledge of assets as collateral to secure the counterparties' exposure in these swap transactions. There appears to be confusion in the counterparty community as to whether or not state chartered banks have the authority under the Michigan Banking Code of 1999, MCL 487.11101 *et seq.* (Code) to engage in the pledging of assets as collateral security in these swap transactions.

As a result, Citizens Bank requests the Commissioner of the Office of Financial and Insurance Regulation (Commissioner) issue an order affirmatively authorizing Citizens Bank to pledge assets as collateral security in connection with interest rate swap transactions.

II
ISSUE

The principal issue is whether a bank subject to the Code may pledge assets as collateral security in connection with interest rate swap transactions.

III
ANALYSIS

The Code sets forth the powers that state chartered banks may exercise. The Code neither expressly authorizes nor specifically prohibits state chartered banks from pledging assets as collateral security in an interest rate swap transaction. Section 4108 of the Code, MCL 487.14108, allows state chartered banks to pledge assets of the bank in certain enumerated circumstances, however, they do not expressly encompass the activity at issue here: namely the pledging of assets to a counterparty as collateral security for the counterparty's exposure in an interest rate swap transaction.

In addition to specifically enumerated bank powers, the Code grants permissive statutory authority to the Commissioner to authorize additional powers. Section 4101(3) of the Code, MCL 487.14101(3), permits state chartered banks to exercise powers authorized by the Commissioner by order or declaratory ruling. Section 2204 of the Code, MCL 487.12204, permits the Commissioner to authorize state chartered banks to exercise powers not specifically enumerated in the Code:

> (1) The commissioner may issue declaratory rulings in accordance with the administrative procedures act of 1969, or issue orders on applications by 1 or more banks to exercise powers not specifically authorized by this act that will authorize banks to exercise powers appropriate and necessary to compete with other providers of financial services. MCL 487.12204(1).

The section continues and sets forth criteria the Commissioner must consider when exercising discretion in authorizing new powers for state chartered banks:

> (2) In the exercise of the discretion permitted by this section, the commissioner shall consider the ability of banks to exercise any additional power in a safe and sound manner, the authority of depository institutions operating under state or federal law or regulation, the powers of other competing entities providing financial services, and any specific limitations on bank powers contained in this act or in any other law of this state. The commissioner shall give notice, at least quarterly, to all banks of declaratory rulings, orders, or determinations issued during the preceding quarter under this section. MCL 487.12204(2) (emphasis added).

Addressing the criteria in the order presented in Section 2204(2), the Commissioner finds as follows with respect to the additional power requested by Citizens Bank – authorizing state chartered banks to pledge assets to counterparties as collateral security for the counterparties' exposure in interest rate swap transactions:

1. Approval of the request and expressly authorizing the requested additional power will not negatively impact a state chartered bank's ability to operate in a safe and sound manner. State chartered banks have prudently engaged in interest rate swap transactions for many years and these transaction can serve as an important risk mitigate when employed within a sound and comprehensive risk management structure. The National Bank Act contains no provision comparable to Section 4108 of the Code, and national banks have exercised the authority to pledge assets in connection with interest rate swap transactions for many years with no apparent threat to safety and soundness inherent in the power itself. Further, pledging

assets as collateral security in connection with a counterparty's exposure in interest rate swap transactions is widely viewed as a measure that enhances the safety and soundness of the financial system as a whole.

2. Other competing providers of financial services, including national banks, may pledge assets to counterparties in interest rate swap transactions. It has become customary in the industry for counterparties to require pledging of assets as collateral to secure the counterparties' exposure under interest rate swap transactions.
3. The pledging of assets as collateral security in connection with interest rate swap transactions is allowed and is acknowledged as a prudent counterparty risk management practice for other providers of financial services, including national banks. Pledging of assets in connection interest rate swap transaction facilitates a bank's continued ability to offer interest rate swap services to its customers and to engage in such swap activity to manage interest rate risk
4. Although the pledging of assets as collateral security in connection with interest rate swap transactions is not expressly authorized by the Code, the Code does not specifically prohibit state chartered banks from engaging in the activity.

Based on the foregoing, the Commissioner finds that pledging of assets as collateral to secure a counterparty's exposure in interest rate swap agreements is not expressly prohibited by the Code; that competing providers of financial services, including national banks, presently have authority to pledge assets as collateral in interest rate swap transactions, thereby placing state chartered banks at a distinct competitive disadvantage; that this authority is appropriate and necessary to enable state chartered banks, including Citizens Bank, to compete with other

providers of financial services; that a bank may exercise this additional power in a safe and sound manner; and that this determination is otherwise consistent with the Commissioner's charge as delineated in Section 2102 of the Code, "to maximize the capacity of banks to offer convenient and efficient financial services, to promote economic development, and to ensure that banks remain competitive with other types of financial service providers."

IV
ORDER

Therefore, it is **ORDERED** that Citizens Bank's request for additional powers is granted and that Citizens Bank is expressly authorized to pledge assets to counterparties as collateral to secure the counterparties' exposure in interest rate swap transactions pursuant to Section 2204 of the Code.

It is further **ORDERED** that state chartered banks are expressly authorized to pledge assets to counterparties to secure the counterparties' exposure in interest rate swap transactions pursuant to Section 2204 of the Code.

This determination does not exempt state chartered banks, including Citizens Bank, from any other requirement in the Code or state law that may otherwise apply to the exercise of this additional power.

R. Kevin Clinton,
Commissioner