

**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.: 13-005-BT

**Lending Limits:
Consideration of Credit Exposure
to Derivative Transactions**

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Issued and Entered,
This 17th day of January, 2013,
by R. Kevin Clinton,
Commissioner

**ORDER ADOPTING CONSIDERATION OF CREDIT EXPOSURE TO DERIVATIVE
TRANSACTIONS IN LENDING LIMITS**

**I
BACKGROUND**

Section 611 of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), Pub. L. 111-203, which takes effect January 21, 2013, amends Section 18 of the Federal Deposit Insurance Act and prohibits state chartered 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.” 12 U.S.C. 1828(y).

Section 610 of Dodd-Frank defines a derivative transaction as follows:

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. 12 U.S.C. 84(b)(3)

II ANALYSIS

Michigan's lending limit law is set forth in Section 4202 of the Banking Code of 1999 (Code), MCL 487.14202, and provides, in pertinent part, as follows:

(1) *Except as otherwise provided in this section or by order or declaratory ruling of the commissioner*, the total loans and extensions of credit and leases by a bank to a person at no time shall exceed 15% of the capital and surplus of the bank, except that upon approval by 2/3 vote of its board of directors the limit may be increased to not to exceed 25% of the capital and surplus of the bank. (Emphasis added).

The lending limit applies only to "loans and extensions of credit" and "leases", and the lending limit is expressly conditioned by the phrase "except as otherwise provided ... by order or declaratory ruling of the commissioner".

The phrase "loan and extension of credit" is defined in Section 1202(j) of the Code, MCL 487.11202(j), which provides as follows:

(j) "Loan and extension of credit" or "loan or extension of credit" includes all direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person. *To the extent specified by the commissioner*, loan and extension of credit or loan or extension of credit includes any liability of a bank to advance funds to or on behalf of a person under a contractual commitment. The term does not include investment securities held by a bank under section 4301. (Emphasis added).

Derivatives are not loans and, therefore, not a direct advance of funds to a person made based on an obligation of that person to repay the funds or repayable from collateral. However, a derivative transaction can result in the counterparty's obligation to pay the bank. The counterparty's obligation to pay the bank constitutes an indirect extension of credit. While the definition of "loan and extension of credit" does not expressly include derivative transactions, the nature of a derivative transaction is such that it can create a credit exposure, i.e., risk of loss,

to a bank similar to that created by originating a loan or other extension of credit. If a counterparty to a bank's derivative transaction were unable to fulfill its obligations when due, the bank would suffer a loss – just as a bank suffers a loss when a borrower is unable to pay.

Sections 4202 and 1202(j) of the Code clearly contemplate further refinement, clarification, or interpretation of those statutory provisions by the Commissioner through the issuance of order or declaratory ruling.

Further, Section 1102 of the Code, MCL 487.12102, directs the Commissioner as follows:

This act shall be implemented by the commissioner 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.

Finally, consideration must be given to the state policy concerning regulation and supervision of banks as provided in Section 1102 of the Code, MCL 487.11102:

It is the policy of this state that the business of all banking organizations shall be supervised and regulated in a manner that insures the safe and sound conduct of business, to conserve their assets, promote competition among banking organizations, to maintain public confidence in the business, and to protect the public interest and the interests of depositors, creditors, and shareholders.

To comply with the requirements of Section 611 of Dodd-Frank and in order to preserve Michigan state chartered banks' authority to engage in derivative transactions and thereby remain competitive with other types of financial service providers, the Commissioner finds it necessary and appropriate to issue this Order.

III ORDER

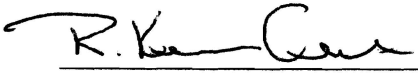
Therefore, it is **ORDERED** that the definition “loan and extension of credit” for purposes of Section 4202 of the Banking Code of 1999, MCL 487.14202, shall include any credit exposure arising from a derivative transaction. For purposes of this definition, “derivative transaction” shall include any 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.

It is further **ORDERED** that “credit exposure” to a counterparty in connection with derivative transactions shall be determined based on an amount that the bank reasonably determines pursuant to a methodology acceptable to the Office of Financial and Insurance Regulation (OFIR) under the terms of the derivative or otherwise would be its loss were the counterparty to default on the date of determination, taking into account any netting and collateral arrangements and any guarantees or other credit enhancements; provided, however, that the bank may elect to determine credit exposure on the basis of such other method of determining credit exposure as may permitted by OFIR. Further, OFIR may require the use of a specific method to determine the credit exposure of derivative transactions if it finds that such method is necessary to promote the safety and soundness of a bank.

It is further **ORDERED**, pursuant to Section 4202(1) of the Code, MCL 487.14202(1), to permit banks a sufficient period of time to comply with this Order, that the requirements of this

Order shall not apply to the credit exposure arising from a derivative transaction until January 1, 2014.

Nothing in this Order shall limit OFIR's ability to address credit exposures that present undue concentrations on a case-by-case basis through its safety and soundness supervisory program, or to implement further safeguards pursuant to the Code, and as authorized by law.



R. Kevin Clinton,
Commissioner