BEFORE THE DEPARTMENT OF ADMINISTRATION
OF THE STATE OF MONTANA

In the matter of the adoption of NEW RULES I, II, III, IV, and V pertaining to derivatives transactions and securities financing transactions and the amendment of ARM 2.59.108 pertaining to lending limits	)	NOTICE OF PROPOSED ADOPTION AND AMENDMENT NO PUBLIC HEARING CONTEMPLATED

TO: All Concerned Persons

1. On March 3, 2014, the Department of Administration proposes to adopt and amend the above-stated rules.

2. The Department of Administration will make reasonable accommodations for persons with disabilities who wish to participate in this rulemaking process or need an alternative accessible format of this notice. If you require an accommodation, contact Department of Administration no later than 5:00 p.m. on February 24, 2014, to advise us of the nature of the accommodation that you need. Please contact Wayne Johnston, Department of Administration, P.O. Box 200546, Helena, Montana 50620-0546; telephone (406) 841-2920; fax (406) 841-2930; TDD (406) 444-1421; or e-mail banking@mt.gov.

3. The rules as proposed to be adopted provide as follows:

<u>GENERAL STATEMENT OF REASONABLE NECESSITY</u>: The proposed rules in this notice were adapted from the Conference of State Bank Supervisors' (CSBS) Model Rules for state regulators' implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L.111-203, H.R. 4173 of 2010 (Dodd-Frank Act) requirements that are applicable to state banks. The CSBS Model Rules, in turn, were adapted from the federal Office of the Comptroller of the Currency (OCC) rules implementing the provisions of the Dodd-Frank Act as applied to national banks. Given that these model rules have been thoroughly vetted, the department saw no need to draft its own rules except that New Rule II is unique to Montana.

<u>NEW RULE I DEFINITIONS APPLICABLE TO DERIVATIVE TRANSACTIONS AND SECURITIES FINANCING TRANSACTIONS</u> (1) "Bank" or "state bank" has the same meaning as "eligible state bank" in (10).

(2) "Borrower" means:

(a) a person who is named as a borrower or debtor in a loan or extension of credit;

(b) a person to whom a bank has credit exposure arising from a derivative transaction or securities financing transaction entered by the bank; or

(c) any other person, including a drawer, endorser, or guarantor, who is deemed to be a borrower under the direct benefit or common enterprise tests in 12

CFR 32.5 and ARM 2.59.108.

(3) "Contractual commitment to advance funds" means:

(a) a bank's obligation to:

(i) make payment directly or indirectly to a third person contingent upon default by a customer of the bank in performing an obligation and to make such payment in keeping with the agreed-upon terms of the customer's contract with the third person, or to make payments upon some other stated condition;

(ii) guarantee or act as surety for the benefit of a person;

(iii) advance funds under a qualifying commitment to lend, as defined in 12 CFR 32.2(t); or

(iv) advance funds under a standby letter of credit, as defined in 12 CFR 32.2(dd) and 12 CFR 208.24, a put, or other similar arrangement.

(b) The term does not include commercial letters of credit and similar instruments:

(i) under which the issuing bank expects the beneficiary to draw on the issuer;

(ii) that do not guarantee payment; and

(iii) that do not provide payment if a third party defaults.

(4) "Credit derivative" means 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 to another party (the protection provider).

(5) "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. The term includes a securities financing transaction.

(6) "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 $25 million created by the derivative transactions covered by the agreement.

(7) "Eligible credit derivative" means a single-name credit derivative or a standard, non-tranched index credit derivative provided that:

(a) the derivative contract meets the requirements of an eligible guarantee as defined in (8) and has been confirmed by the protection purchaser and the protection provider;

(b) any assignment of the derivative contract has been confirmed by all relevant parties;

(c) if the credit derivative is a credit default swap, the derivative contract includes the following credit events:

(i) failure to pay any amount due under the terms of the reference exposure, subject to any applicable minimal payment threshold that is consistent with standard market practice and with a grace period that is closely in line with the grace period of the reference exposure; and

(ii) bankruptcy, insolvency, or inability of the obligor on the reference exposure to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and similar events;

(d) the terms and conditions dictating the manner in which the derivative contract is to be settled are incorporated into the contract;

(e) if the derivative contract allows for cash settlement, the contract incorporates a robust valuation process to reliably estimate loss with respect to the derivative and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;

(f) if the derivative contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract provide that any required consent to transfer may not be unreasonably withheld; and

(g) if the credit derivative is a credit default swap, the derivative contract:

(i) identifies the parties responsible for determining whether a credit event has occurred;

(ii) specifies that the determination is not the sole responsibility of the protection provider; and

(iii) gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event.

(8) "Eligible guarantee" means a guarantee that:

(a) is written and unconditional;

(b) covers all or a pro rata portion of all contractual payments of the obligor on the reference exposure;

(c) gives the beneficiary a direct claim against the protection provider;

(d) is not unilaterally cancelable by the protection provider for reasons other than the beneficiary's breach of contract;

(e) is legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced;

(f) requires the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligor on the reference exposure in a timely manner without the beneficiary first having to take legal action to pursue the obligor for payment;

(g) does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure; and

(h) is not provided by an affiliate of the bank, unless the affiliate is an insured depository institution, bank, securities broker or dealer, or insurance company that:

(i) does not control the bank; and

(ii) is subject to consolidated supervision and regulation comparable to that imposed on U.S. depository institutions, securities broker-dealers, or insurance companies as applicable.

(9) "Eligible protection provider" means:

(a) a sovereign entity (a central government, including the U.S. government, an agency, department, ministry, or central bank);

(b) the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, or a multilateral development bank;

(c) a federal home loan bank;

(d) the Federal Agricultural Mortgage Corporation;

(e) a depository institution, as defined in section 3 of the Federal Deposit Insurance Act, 12 USC 1813(c);

(f) a bank holding company, as defined in section 2 of the Bank Holding Company Act, as amended, 12 USC 1841;

(g) a savings and loan holding company, as defined in section 10 of the Home Owners' Loan Act, 12 USC 1467a;

(h) a securities broker or dealer registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934, 15 USC 78o, et seq.;

(i) an insurance company that is subject to the supervision of a state insurance regulator;

(j) a foreign banking organization;

(k) 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

(l) a qualifying central counterparty.

(10) "Eligible state bank" means a bank organized under Montana laws that:

(a) is well-capitalized as defined in the prompt corrective action rules applicable to the bank; and

(b) has a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System in connection with the bank's most recent examination or subsequent review.

(11) "Loans," "extensions of credit," or "obligations" have the meaning in 32-1-432, MCA, and any credit exposure determined under [NEW RULE V] arising from a derivative transaction or a securities financing transaction.

(a) The terms include:

(i) a contractual commitment to advance funds;

(ii) a maker or endorser's obligation arising from a bank's discount of commercial paper;

(iii) a bank's purchase of third-party paper subject to an agreement that the seller will repurchase the paper upon default or at the end of a stated period. The amount of the bank's loan is the total unpaid balance of the paper owned by the bank less any applicable dealer reserves retained by the bank and held by the bank as collateral security. Where the seller's obligation to repurchase is limited, the bank's loan is measured by the total amount of the paper the seller may ultimately be obligated to repurchase. A bank's purchase of third-party paper without direct or indirect recourse to the seller is not a loan or extension of credit to the seller;

(iv) an overdraft, whether or not prearranged, but not an intraday overdraft for which payment is received before the close of business of the bank that makes the funds available;

(v) the sale of federal funds with a maturity of more than one business day, but not federal funds with a maturity of one day or less or federal funds sold under a continuing contract;

(vi) loans or extensions of credit that have been charged off on the books of the bank in whole or in part unless the loan or extension of credit is:

(A) unenforceable by reason of discharge in bankruptcy;
(B) no longer legally enforceable because of expiration of the statute of limitations or a judicial decision; or
(C) no longer legally enforceable for other reasons provided that the bank maintains sufficient records to demonstrate that the loan is unenforceable; and
(vii) a bank's purchase of securities subject to an agreement that the seller will repurchase the securities at the end of a stated period, but does not include a bank's purchase of Type I securities, as defined in (15), subject to a repurchase agreement, where the purchasing bank has assured control over or has established its rights to the Type I securities as collateral.
(b) The terms do not include:
(i) additional funds advanced for a borrower's benefit by a bank for payment of taxes, insurance, utilities, security, and maintenance and operating expenses necessary to preserve the value of real property securing the loan, consistent with safe and sound banking practices, but only if the advance is for the protection of the bank's interest in the collateral, and provided that such amounts must be treated as an extension of credit if a new loan or extension of credit is made to the borrower;
(ii) accrued and discounted interest on an existing loan or extension of credit, including interest that has been capitalized from prior notes and interest that has been advanced under terms and conditions of a loan agreement;
(iii) financed sales of a bank's own assets, including other real estate owned, if the financing does not put the bank in a worse position than when the bank held title to the assets;
(iv) a renewal or restructuring of a loan as a new "loan or extension of credit," following the exercise by a bank of reasonable efforts, consistent with safe and sound banking practices, to bring the loan into conformance with the lending limit, unless new funds are advanced by the bank to the borrower (except in circumstances permitted under 12 CFR 32.3(b)(5)), a new borrower replaces the original borrower, or unless the department singly or in collaboration with the appropriate federal banking agency determines that a renewal or restructuring was undertaken as a means to evade the bank's lending limit;
(v) amounts paid against uncollected funds in the normal process of collection;
(vi) with regard to participations:
(A) that portion of a loan or extension of credit sold as a participation by a bank on a nonrecourse basis, provided that the participation results in a pro rata sharing of credit risk proportionate to the respective interests of the originating and participating lenders. Where a participation agreement provides that repayment must be applied first to the portions sold, a pro rata sharing will be deemed to exist only if the agreement also provides that, in the event of a default or comparable event defined in the agreement, participants shall share in all subsequent repayments and collections in proportion to their percentage participation at the time of the occurrence of the event;
(B) when an originating bank funds the entire loan, it must receive funding from the participants before the close of business of its next business day. If the participating portions are not received within that period, then the portions funded will be treated as a loan by the originating bank to the borrower. If the portions so

attributed to the borrower exceed the originating bank's lending limit, the loan may be treated as nonconforming subject to the circumstances included in 12 CFR 32.2(q)(2)(vi)(B) rather than a violation if:

(I) the originating bank had a valid and unconditional participation agreement with one or more participants that was sufficient to reduce the loan to within the originating bank's lending limit;

(II) the participant reconfirmed its participation and the originating bank had no knowledge of information that would permit the participant to withhold its participation; and

(III) the participation was to be funded by close of business of the originating bank's next business day.

(12) "Qualifying central counterparty" has the same meaning as the term has in 12 CFR Part 3, Appendix C, Section 2.

(13) "Qualifying master netting agreement" means any written, legally enforceable bilateral agreement, provided that:

(a) the agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default, including bankruptcy, insolvency, or similar proceeding of the counterparty;

(b) the agreement provides the bank the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default of the counterparty, including upon an event of bankruptcy, insolvency, or similar proceeding, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions;

(c) the bank has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient documentation of that legal review) that:

(i) the agreement meets the requirements of (13)(b); and

(ii) in the event of a legal challenge (including one resulting from default or from bankruptcy, insolvency, or similar proceedings), the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions;

(d) the bank establishes and maintains procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of this definition; and

(e) the agreement does not contain a walkaway clause (that is, a provision that permits a nondefaulting counterparty to make a lower payment than it would make otherwise under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement).

(14) "Securities financing transaction" means a repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction.

(15) "Type I securities" means:

(a) obligations of the United States;

(b) 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;

(c) obligations issued by a department or agency of the United States government 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 have been validly pledged for the full and timely payment of interest on, and principal of, the loans in the event of nonpayment by the third party obligor(s); and

(d) general obligations of a state of the United States or any political subdivision thereof; and

(e) municipal bonds if the bank is well capitalized.

AUTH: 32-1-432, MCA
IMP: 32-1-432, MCA

STATEMENT OF REASONABLE NECESSITY: Terms commonly used in reference to derivative transactions and securities financing transactions are specialized. For clarity purposes, the department believes it is necessary and advisable to include the specialized terms in a separate definition rule rather than to include them in a rule with other definitions that have more general applicability. The definitions in this rule are patterned after the derivative transaction and securities financing transaction rules adopted by the OCC at 12 CFR Part 32 applicable to national banks, and after the model derivative transaction rules developed by the CSBS. Uniformity in the use and definitions of terms related to derivative transactions promotes effective communication between and among banks, bank regulatory agencies, and bank examiners.

The department is not proposing to adapt and adopt one of the OCC's exclusions from the definition of loans and extensions of credit in (11)(b). The OCC regulation, 12 CFR 32.2(q)(2)(vii), states that for lending limit purposes, the term "loan or extension of credit" does not include that portion of one or more loans or extensions of credit, not to exceed 10 percent of capital and surplus, with respect to which the national bank or savings association has purchased protection in the form of a single-name credit derivative that meets the requirements of 12 CFR 32.2(m)(1) through (7) from an eligible protection provider if the reference obligor is the same legal entity as the borrower in the loan or extension of credit and the maturity of the protection purchased equals or exceeds the maturity of the loan or extension of credit. The department considered adapting the OCC regulation recited above to more closely conform to Montana law concerning capital for lending limit purposes even though use of the federal regulation could be used in this context without adaptation. The department elected instead to propose omission of the OCC exclusion altogether because it believes that the exclusion of any portion of total credit exposure from credit derivatives for purposes of the lending limit is inconsistent with bank safety and soundness principles.

NEW RULE II ELIGIBLE STATE BANK'S PERMISSIBLE DERIVATIVE TRANSACTIONS (1) An eligible state bank as defined in [NEW RULE I] may engage in any derivative transaction if the bank has a written policy approved by its board of directors that:

(a) identifies the types of derivative transactions in which the bank is authorized to engage;

(b) establishes an exposure limit for each type of authorized derivative transaction and an aggregate exposure limit for all of the bank's authorized derivative transactions expressed in relation to the bank's lending limit;

(c) is consistent with bank safety and soundness principles; and

(d) requires the designation of an employee to be in charge of the bank's derivatives program who:

(i) has demonstrable expertise and understanding of derivative transactions; and

(ii) is responsible for periodic testing of the model(s) used to measure credit exposure against actual outcomes.

AUTH: 32-1-432, MCA
IMP: 32-1-432, MCA

<u>STATEMENT OF REASONABLE NECESSITY</u>: The threshold eligibility criteria for banks to enter into derivative transactions are contained in the definition of the term "eligible state bank" in [NEW RULE I]. The definition differs from the OCC's threshold eligibility criteria in that the definition in [NEW RULE I (10)(b)] is based only on the bank's composite rating and not on the rating of any particular CAMELS component(s), i.e., capital, asset quality, management, earnings, liquidity, or sensitivity to market risks. That distinction was made because the department deems the composite rating to be a better benchmark for eligibility than are ratings assigned to individual CAMELS components.

The department believes that it is the management prerogative of an eligible state bank's board of directors to establish the parameters of the bank's derivatives program including identifying the types of derivative transactions that the bank is willing to authorize. The department further believes that part of the exercise of that prerogative must include setting a credit exposure tolerance for the bank consistent with safety and soundness principles. In the past, derivative transactions have not been routinely engaged in by a majority of banks organized under the laws of this state. The department believes that it is necessary for the bank to designate an employee with demonstrable expertise to be in charge of its derivatives program to guard against the bank relying too heavily on the expertise of third-party vendors or contract program administrators in derogation of the bank's own ultimate responsibility for the program and for the safety and soundness of the bank.

<u>NEW RULE III LENDING LIMITS APPLICABLE TO DERIVATIVE TRANSACTIONS</u> (1) For purposes of 32-1-432, MCA, derivative transactions and securities financing transactions must be included in the calculation of lending limits.

(2) The calculation of credit exposure arising from derivative transactions and securities financing transactions for lending limit purposes under 32-1-432, MCA, must be determined pursuant to Appendix A to [NEW RULE V].

(3) Loans not subject to lending limits of 32-1-432, MCA, and this regulation are:

(a) credit exposures arising from transactions financing certain government securities. Credit exposures arising from securities financing transactions in which the securities financed are Type I securities, as defined in [NEW RULE I] and 12 CFR 1.2(j);

(b) intraday credit exposures arising from derivative transactions or securities financing transactions; and

(c) other exceptions as applicable.

AUTH: 32-1-432, MCA
IMP: 32-1-432, MCA

STATEMENT OF REASONABLE NECESSITY: This rule is necessary to clarify that the rules proposed in this notice all pertain to derivative transactions and securities financing transactions by summarizing the basic premises underlying the rules: that credit exposures arising from derivative transactions and securities financing transactions must be included in the calculation of lending limits; that there are limited exemptions; and that credit exposure arising from derivative transactions and securities financing transactions must be measured/quantified using approved models specified in NEW RULE V and Appendix A.

Derivative transactions and securities financing transactions are not "loans or extensions of credit" as that term has traditionally been defined and understood in the banking industry. The number of banks that enter into over-the-counter (OTC) and other derivative transactions and securities financing transactions has grown substantially over the years as has the aggregate credit exposure of all banks arising from the transactions. As a result of the 2008 financial crisis, Congress enacted the Dodd-Frank Act. Included in the Dodd-Frank Act were laws to bring derivatives markets and OTC derivatives transactions under closer bank management and regulatory scrutiny consistent with bank safety and soundness principles. Requiring the credit exposures to be included in the calculation of lending limits ensures appropriate transparency, recognition, and consistent treatment among banks and regulators of the credit exposures arising from these transactions.

Section 611 of the Dodd-Frank Act, as amended, prohibits a state-chartered bank from entering into derivative transactions after October 1, 2013, unless the lending limit laws of the chartering state take into consideration credit exposure arising from derivative transactions. The department's bill in response to the Dodd-Frank Act provisions concerning derivatives and securities financing transactions (SB 61) was passed by the 2013 Legislature and signed into law by the Governor effective March 29, 2013. These rules are intended to implement SB 61, 2013 LAWS.

Section 610 of the Dodd-Frank Act contains requirements for inclusion of credit exposures arising from derivative transactions in the determination of national banks' lending limits. In addition, Section 610 contains requirements pertaining to inclusion of credit exposures of national banks arising from securities financing transactions in lending limit calculations. The securities financing provision is not included in Section 611 applicable to state-chartered banks. The department proposes to adopt and apply those additional requirements pertaining to securities financing transactions to banks organized under Montana laws to maintain competitive parity between the federal and state charters and because the credit exposures arising from securities financing transactions are as much a bank obligation as are exposures arising from derivative transactions. Both can affect the bank's safety and soundness if large losses occur with respect to the transactions.

Stifling business innovation and decision making is not the department's purpose or legislative mandate. These rules allow banks to engage in derivative transactions and securities financing transactions under the parameters set by their boards of directors as well as by the department through these rules. The objective of the rules is to assure that the resulting credit exposures are transparent and properly measured and managed. Treatment of the credit exposures in the context of lending limit determinations under the requirements of the Dodd-Frank Act is intended to help assure responsible use of derivative transactions and securities financing transactions for sound business purposes including, but not limited to, hedging interest rate risk.

NEW RULE IV NONCONFORMING LOANS AND EXTENSIONS OF CREDIT (1) A loan or extension of credit within a bank's legal lending limit when made will not be deemed a violation but will be treated as nonconforming if the loan or extension of credit is no longer in conformity with the bank's lending limit because:

(a) the bank's capital has declined, borrowers have subsequently merged or formed a common enterprise, lenders have merged, or the lending limit or capital rules changed;

(b) collateral securing the loan to satisfy the requirements of a lending limit exception has declined in value; or

(c) in the case of a credit exposure arising from a derivative transaction or a securities financing transaction and measured by either the Current Exposure Method or the Basel Collateral Haircut Method specified in [NEW RULE V and Appendix A], the credit exposure subject to the lending limits of 32-1-432, MCA, or this rule increases after execution of the transaction.

(2) A bank shall use reasonable efforts to bring a loan or extension of credit that is nonconforming as a result of (1)(a) or (1)(c) into conformity with the bank's lending limit unless to do so would be inconsistent with safe and sound banking practices.

(3) A bank shall bring a loan that is nonconforming as a result of circumstances described in (1)(b) into conformity with the bank's lending limit within 30 calendar days, except when judicial proceedings, regulatory actions or other extraordinary circumstances beyond the bank's control prevent it from taking action.

AUTH: 32-1-432, MCA
IMP: 32-1-432, MCA

STATEMENT OF REASONABLE NECESSITY: This rule is necessary to put banks on notice of the level of regulatory response that can be expected concerning lending limit irregularities. The rule distinguishes between a loan or extension of credit that flatly violates a lending limit and a loan or extension of credit that, in the circumstances described in (1)(a), (1)(b), and (1)(c), warrants a designation of "nonconforming." The distinction could conceivably make a difference in a bank's

CAMELS ratings in the appropriate circumstance. The dual corrective action requirements in (2) and (3) are intended to be proportionate to the seriousness of the circumstance that triggered the "nonconforming" designation. The practice of distinguishing violations from nonconformance is already familiar to banks with respect to traditional loans or extensions of credit. This rule introduces a circumstance that would warrant a "nonconforming" treatment when a lending limit irregularity arises from increases in a bank's credit exposure during the term of a derivative transaction or securities financing transaction so long as the credit exposure was properly measured using authorized methods and models in the first instance.

NEW RULE V CREDIT EXPOSURE ARISING FROM DERIVATIVES AND SECURITIES FINANCING TRANSACTIONS (1) For purposes of determining a bank's lending limit under 32-1-432, MCA, the bank's credit exposure arising from a derivatives transaction or a securities financing transaction entered by a bank must be calculated in accordance with the methods and models contained in Appendix A which is adopted and incorporated by reference. Appendix A may be found on the department's web site at http://banking.mt.gov/bank.mcpx.

AUTH: 32-1-432, 32-1-433, MCA
IMP: 32-1-432, 32-1-433, MCA

NOTE: Appendix A is included here for ease of use by the public.

Appendix A to [New Rule V]

Methods and Models for Calculating Credit Exposure from Derivatives or Securities Financing Transactions

(1) **Derivative Transactions**

(a) **Non-credit derivatives:** A bank shall calculate the credit exposure to a counterparty arising from a derivative transaction by one of the following methods:

(i) **Conversion Factor Matrix Method.** The credit exposure arising from a derivative transaction under the Conversion Factor Matrix Method shall equal and remain fixed at the potential future credit exposure of the derivative transaction which shall equal the product of the notional amount of the derivative transaction and a fixed multiplicative factor determined by reference to Table 1.

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 10 years	.30	.30	.20	1.0

[1] For an over-the-counter (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 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 Table 1 are to be treated as "Other."

(ii) **Current Exposure Method.** The credit exposure arising from a derivative transaction (other than a credit derivative transaction) under the Current Exposure Method shall be calculated pursuant to 12 CFR part 3, Appendix C, Sections 32(c)(5), (6), and (7); 12 CFR part 167, Appendix C, Sections 32(c)(5), (6), and (7); or 12 CFR part 390, subpart Z, Appendix A, Sections 32(c)(5), (6), and (7), as appropriate.

(b) **Credit Derivatives**

(i) **Counterparty Exposure.** Notwithstanding (2)(a), a bank that uses the Conversion Factor Matrix Method or Current Exposure Method without entering into an effective margining arrangement as defined in [NEW RULE I] must calculate the counterparty credit exposure arising from the credit derivatives entered by the bank by adding the net notional value of all protection purchased from the counterparty on each reference entity.

(ii) **Reference Entity Exposure.** A bank must calculate the credit exposure to a reference entity arising from credit derivatives entered by the bank by adding the net notional value of all protection sold on the reference entity. However, the bank may reduce its exposure to a reference entity by the amount of any eligible credit derivative purchased on that reference entity from an eligible protection provider.

(c) **Special Rule for Central Counterparties.** In addition to amounts calculated under previous sections of this rule, the measure of counterparty exposure to a central counterparty must include the sum of the initial margin posted by the bank plus any contributions made by it to a guaranty fund at the time such contribution is made.

(d) **Mandatory or Alternative Method.** The department may, in its discretion, require or permit a bank to use a specific method or methods set forth in this rule to calculate the credit exposure arising from all derivative transactions or any specific derivative transaction or type or category of derivative transactions if it finds, in its discretion, that such method is consistent with the safety and soundness of the bank.

(2) **Securities Financing Transactions**

(a) **Calculation Methods.** In general, a bank must calculate the credit exposure arising from a securities financing transaction by one of the methods in this section appropriate to the transaction. Except as provided by (2)(d), a bank must use the same method for calculating credit exposure arising from all of its securities financing transactions.

(b) **Basic Method.** A bank may calculate the credit exposure of a securities financing transaction as follows:

(i) **Repurchase Agreement.** The credit exposure arising from a repurchase agreement shall equal and remain fixed at the market value at execution of the transaction of the securities transferred to the other party less cash received.

(ii) **Securities Lending Transaction**

(A) **Cash Collateral Transactions.** The credit exposure arising from a securities lending transaction where the collateral is cash shall equal and remain fixed at the market value at execution of the transaction of securities transferred less cash received.

(B) **Non-cash Collateral Transactions.** The credit exposure arising from a securities lending transaction where the collateral is other securities shall equal and remain fixed as the product of the higher of the two haircuts associated with the two securities, as determined in Table 2 below, and the higher of the two par values of the securities. Where more than one security is provided as collateral, the applicable haircut is the higher of the haircut associated with the security lent and the notional-weighted average of the haircuts associated with the securities provided as collateral.

(iii) **Reverse Repurchase Agreement.** The credit exposure arising from a reverse repurchase agreement shall equal and remain fixed as the product of the haircut associated with the collateral received, as determined in Table 2 below, and the amount of cash transferred.

(iv) **Securities Borrowing Transaction**

(A) **Cash Collateral Transactions.** The credit exposure arising from a securities borrowed transaction where the collateral is cash shall equal and remain fixed as the product of the haircut on the collateral received, as determined in Table 2 below, and the amount of cash transferred to the other party.

(B) **Non-Cash Collateral Transactions.** The credit exposure arising from a securities borrowed transaction where the collateral is other securities shall equal and remain fixed as the product of the higher of the two haircuts associated with the two securities, as determined in Table 2 below, and the higher of the two par values of the securities. Where more than one security is provided as collateral, the applicable haircut is the higher of the haircut associated with the security lent and the notional-weighted average of the haircuts associated with the securities provided as collateral.

Table 2 – Collateral Haircuts

Sovereign Entities

	Residual Maturity	Haircut without currency mismatch[1]
OECD Country Risk Classification[2] 0-1	≤ 1 year > 1 year, ≤ 5 years > 5 years	0.005 0.02 0.04
OECD Country Risk Classification 2-3	≤ 1 year >1 year, ≤ 5 years > 5 years	0.01 0.03 0.06

Corporate and Municipal Bonds That Are Bank-Eligible Investments

	Residual Maturity	Haircut without currency mismatch
All	≤ 1 year	0.02
All	> 1 year, ≤ 5 years	0.06
All	> 5 years	0.12

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 additional 8% haircut will apply.

[2] Organization for Economic Cooperation and Development (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 Credit 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) **Basel Collateral Haircut Method.** A bank may calculate the credit exposure of a securities financing transaction pursuant to 12 CFR part 3, Appendix C, Sections 32(b)(2)(i) and (ii); 12 CFR part 167, Appendix C, Sections 32(b)(2)(i) and (ii); or 12 CFR part 390, subpart Z, Appendix A, Sections 32(b)(2)(i) and (ii), as appropriate.

(d) **Mandatory or Alternative Method.** The department may, in its discretion, require or permit a bank to use a specific method or methods set forth in (2) to calculate the credit exposure arising from all securities financing transactions or any specific, or category of, securities financing transactions if it finds, in its discretion, that such method is consistent with the safety and soundness of the bank.

(3) Banks that hold government securities in a fiduciary capacity for customers in conjunction with a repurchase agreement must comply with FDIC regulations, 12 CFR Part 344, including but not limited to recordkeeping, confirmations, and having written policies and procedures. Custodial holdings of government securities are subject to examination by the department for compliance with fiduciary requirements. Banks must adopt policies applying to custodial holdings of government securities all of the requirements imposed by their appropriate federal regulator that are applicable to government securities held in a fiduciary capacity.

STATEMENT OF REASONABLE NECESSITY: The department deems it necessary and consistent with bank safety and soundness principles to establish permissible models or methods for measuring credit exposure arising from derivative transactions and securities financing transactions and require that the same model be used for all derivative transactions except as provided in (2)(d) of Appendix A. The department deems consistency in measuring credit exposure key to a bank's awareness of its aggregate exposure and to its effective management of the credit exposures. The models and methods give banks the means of measuring credit exposure for purposes of lending limit determinations and benchmarks for comparing actual outcomes against model-based projected outcomes pertaining to derivative transactions and securities financing transactions.

Requiring use of the specific models and methods specified in Appendix A is necessary to enable the department to more easily review a bank's determination of its derivative transaction and securities financing transaction credit exposures and verify whether the bank is in compliance with lending limits. The department believes that required use of the Appendix A models and methods coupled with the definition of "eligible bank" in NEW RULE I will provide a good foundation for responsible use of derivative and securities financing transactions.

Section (3) of Appendix A is not a CSBS model rule provision and is not patterned after OCC regulation. With respect to (3), the U.S. Treasury Department, which is responsible for implementing and enforcing the Government Securities Act (GSA) of 1986, as amended, determined that the rules and standards of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the former Office of Thrift Supervision governing the holding of government securities in a fiduciary capacity by the depository institutions subject to the GSA, are adequate. Accordingly, the depository institutions are exempt from Title 17 CFR Part 450 regarding their holdings of government securities in a fiduciary capacity and holdings of government securities in a custodial capacity provided that: (i) the institution has adopted policies and procedures applying to the custodial holdings all the requirements imposed by the institution's appropriate regulatory agency that are applicable to government securities held in a fiduciary capacity, and (ii) the custodial holdings are subject to examination by the appropriate regulatory agency for compliance with fiduciary requirements. Section (3) of Appendix A is intended to assure continued exemption of banks organized under Montana laws from the regulatory oversight of the U.S. Treasury Department under Title 17 CFR Part 450 with respect to holdings of government securities in a fiduciary or a custodial capacity by making the same standards applicable to the banks under these rules and the regulatory oversight of the department.

4. The rule as proposed to be amended provides as follows, new matter underlined, deleted matter interlined:

2.59.108 LIMITATIONS ON LOANS (1) In the context of this rule, the following definitions apply:

(a) remains the same, but is renumbered (f).

(b) through (b)(ii) remain the same.

(iii) undisbursed portions of credit card plans; and

(iv) through (c)(i)(A) remain the same.

(B) the expected source of repayment for each loan or extension of credit is the same for two or more of the persons, and those persons lack another source of income from which the loans or extensions of credit, together with the person's other liabilities, may be fully repaid~~.~~; and

(ii) through (B) remain the same.

~~(d) "Control" means the following:~~

~~(i) the ownership, control or ability to vote 25% or more of a corporation's outstanding voting stock.~~

~~(ii) the ability to control, in any manner, the election of a majority of a corporation's directors;~~

~~(iii) the power to exercise a controlling influence over the management or policies of a corporation.~~

~~(e)~~(d) "Direct benefit" means that t~~T~~he proceeds of a loan or extension of credit to a person will be deemed to be used ~~for the "direct benefit"~~ to the advantage of another person and the amount of the loan will be attributed to the other person when the proceeds, or assets purchased with the proceeds, are transferred to the other person. For the purpose of this definition, when the proceeds are used to acquire property, goods, or services through a bona fide arm's length transaction, a direct benefit will not have occurred with regard to the seller of the property, goods, or services.

(e)(i) remains the same, but is renumbered (a).

~~(f)~~(e) "Loan or extension of credit" includes, but is not limited to:

(i) direct loans, whether on the bank's books or charged off the bank's books, subject to the exclusions in (3)(a) ~~below,~~;

(ii) loans, extensions of credit, or participation in loans or extensions of credit sold with recourse to or guaranteed by the bank~~,~~;

(iii) letters of credit, other than standby letters of credit~~,~~;

(iv) overdrafts, excluding intraday overdrafts for which the bank receives payment prior to its close of business~~.~~; and

(v) any credit exposure of a bank to a counterparty arising from a derivative transaction or a securities financing transaction as defined in [NEW RULE I].

(2) For lending limit purposes~~, loans or extensions of credit will be combined as follows~~:

(a) remains the same.

(i) proceeds of a loan or extension of credit are to be used for the direct benefit of the other person~~,~~; or

(ii) a common enterprise is deemed to exist between the persons, to the extent that loan proceeds are used for the benefit of the common enterprise and repayment is dependent upon the common enterprise~~.~~;

(b) a loan or extension of credit guaranteed by a person shall be aggregated with the person's other loans and extensions of credit only to the extent that the person receives direct benefit from the loan~~.~~; and

(c) through (3)(a) remain the same.

(i) the loan, extension of credit, or the portion of the loan or extension of credit sold as a participation is sold without recourse to the selling bank~~,~~; and

(ii) through (b)(ii) remain the same.

(iii) no longer legally enforceable for other reasons, provided that the bank maintains sufficient records to demonstrate that the loan is unenforceable~~.~~;

(c) credit exposures arising from securities financing transactions in which the securities financed are Type I securities, as defined in 12 CFR 1.2(j);

(d) intraday credit exposures arising from a derivative transaction; and

~~(c)~~(e) all other loans or portions of loans specifically exempted by provisions of 32-1-432, MCA, or other applicable laws.

AUTH: 32-1-432, MCA
IMP: 32-1-432, MCA

STATEMENT OF REASONABLE NECESSITY: Definitions of terms relating specifically to derivative transactions and securities financing transactions were purposely included in NEW RULE I rather than incorporated into this rule, which contains terms having more general applicability to traditional loans and extensions of credit. The department believes, however, that this rule must be amended to incorporate certain basic information relating to credit exposures arising from derivative transactions and securities financing transactions for lending limit purposes to avoid ambiguity and the appearance of conflict between statutes, rules, and definitions. Derivative transactions are not actually loans or extensions of credit in the traditional sense at all. By passing the Dodd-Frank Act, Congress determined that the best way and place to take credit exposures arising from derivative transactions and securities financing transactions into account for bank safety and soundness purposes was to treat them as if they were loans and extensions of credit in the lending limit context. Lending limits as calculated in reference to credit exposures arising from traditional loans and extensions of credit were already familiar to banks and regulators alike. Essentially, the Dodd-Frank Act created something of a legal fiction to accomplish the objective of bringing transparency and uniformity to the regulatory treatment of derivative transactions and securities financing transactions for bank safety and soundness purposes.

The definition of "control" in (1)(d) is being deleted because the term is defined in 32-1-109, MCA. In this case, it is not necessary or appropriate to duplicate a statute in rule. The definition of "loan or extension of credit" is being amended to include credit exposure arising from a derivative transaction or securities financing transaction in (1)(d)(v). Inclusion of credit exposures arising from derivative transactions and securities financing transactions in the definition is necessary in order to implement 32-1-432, MCA, as amended by SB 61 in the 2013 legislative session. That bill was necessitated by the Dodd-Frank Act, Sec. 611 which, as amended, stated that after October 1, 2013, a state-chartered bank may not engage in derivative transactions as defined in 12 USC 84(b)(3) unless the lending limit law in the state in which the bank is organized takes into consideration credit exposures arising from derivative transactions. In addition, Sec. 610 of the Dodd-Frank Act required that national banks also take into consideration credit exposures arising from securities financing transactions (i.e., repurchase agreements, reverse repurchase agreements, securities lending transactions, or securities borrowing transactions) for lending limit purposes. The Dodd-Frank Act left it up to state bank regulators to decide whether to include credit exposures arising from securities financing transactions in state-bank lending limits. The department proposes to do so in (1)(d)(v). Montana state-chartered banks enter into securities financing transactions regularly. The department believes that taking all credit exposures into account for lending limit purposes is consistent with bank safety and soundness principles.

The department proposes to amend (3) to add subsection(c), which omits from lending limit calculations credit exposures arising from securities financing transactions involving government securities known as "Type 1 securities." Bank safety and soundness principles are not comprised by doing so and that treatment is also consistent with the way government securities collateralizing regular loans and extensions of credit are treated for lending limit purposes under 32-1-432(1)(c), MCA. In addition, (3)(d) is being added to omit intraday credit exposures arising from derivative transactions and securities financing transactions because the exposures resolve by close of business. That treatment is also consistent with the treatment of intraday overdrafts in (1)(d)(iv) of this rule.

All proposed amendments to this rule are consistent with OCC derivatives rules, CSBS Model Derivatives Rules, and NEW RULES I through IV. The rule is also being amended to bring the formatting into compliance with current standards.

5. Concerned persons may submit their data, views, or arguments concerning the proposed action in writing to Lorraine A. Schneider, Legal Counsel, Division of Banking and Financial Institutions, P.O. Box 200546, Helena, Montana 59620-0546; faxed to the office at (406) 841-2930; or e-mailed to banking@mt.gov, and must be received no later than 5:00 p.m., February 28, 2014.

6. If persons who are directly affected by the proposed action wish to express their data, views, or arguments orally or in writing at a public hearing, they must make written request for a hearing and submit the request along with any written comments to the person listed in 5 above no later than 5:00 p.m., February 28, 2014.

7. If the agency receives requests for a public hearing on the proposed action from either 10 percent or 25, whichever is less, of the persons directly affected by the proposed action; from the appropriate administrative rule review committee of the Legislature; from a governmental subdivision or agency; or from an association having not less than 25 members who will be directly affected, a hearing will be held at a later date. Notice of the hearing will be published in the Montana Administrative Register. Ten percent of those directly affected has been determined to be six persons based on 57 existing state-chartered banks.

8. The Division of Banking and Financial Institutions maintains a list of interested persons who wish to receive notices of rulemaking actions proposed by this division. Persons who wish to have their name added to the mailing list shall make a written request that includes the name and mailing address and e-mail address of the person to receive notices and specifies that the person wishes to receive notices regarding division rulemaking actions. Notices will be sent by e-mail unless a mailing preference is noted in the request. Such written requests may be mailed or delivered to Wayne Johnston, Division of Banking and Financial Institutions, 301 S. Park, Ste. 316, P.O. Box 200546, Helena, Montana 59620-0546; faxed to the office at (406) 841-2930; e-mailed to banking@mt.gov; or may be made by completing a request form at any rules hearing held by the department.

9. An electronic copy of this proposal notice is available through the department's web site at http://doa.mt.gov/administrativerules.mcpx. The department strives to make the electronic copy of this notice conform to the official version of the notice, as printed in the Montana Administrative Register, but advises all concerned persons that in the event of a discrepancy between the official printed text of the notice and the electronic version of the notice, only the official printed text will be considered. In addition, although the department works to keep its web site accessible at all times, concerned persons should be aware that the web site may be unavailable during some periods, due to system maintenance or technical problems.

10. The bill sponsor contact requirements of 2-4-302, MCA, apply and have been fulfilled. The primary bill sponsor was contacted by mail on April 4, 2013, and by telephone and e-mail on April 11, 2013.

11. The department has determined that under 2-4-111, MCA, the proposed new rules and rule amendment will not significantly and directly affect small businesses.

By: /s/ Sheila Hogan
Sheila Hogan, Director
Department of Administration

By: /s/ Michael P. Manion
Michael P. Manion, Rule Reviewer
Department of Administration

Certified to the Secretary of State January 21, 2014.