

**STATE OF NEBRASKA**  
**Department of Banking & Finance**

|  |                                 |  |
|--|---------------------------------|--|
| IN THE MATTER OF:  | )<br>)<br>)<br>)<br>)<br>)<br>) | ORDER ADOPTING<br>CONSIDERATION GIVEN TO<br>CREDIT EXPOSURE<br>ARISING FROM DERIVATIVE<br>AND SECURITIES FINANCING<br>TRANSACTIONS |
| Lending Limits Involving Derivatives<br>and Securities Financing |                                 |  |

The Nebraska Department of Banking and Finance (“DEPARTMENT”) is responsible for the administration and enforcement of the Nebraska Banking Act, Neb. Rev. Stat. §§ 8-101 to 8-1,140 (Reissue 2007; Cum. Supp. 2010; Supp. 2011; LB 963, 2012) (“the Act”).

The Dodd-Frank Wall Street Reform and Consumer Protection Act provides that it shall be illegal for a Federal Deposit Insurance Corporation (“FDIC”) insured state-chartered bank to enter into new derivative transactions after January 21, 2013, unless the laws of the state in which the bank is chartered address credit exposure created by derivative transactions.

Section 8-141(5) of the Act authorizes the Director of the DEPARTMENT to determine the manner and extent to which credit exposure resulting from derivative transactions, repurchase agreements, reverse repurchase agreements, securities lending transactions, and securities borrowing transactions shall be taken into account for purposes of determining compliance with lending limits.

The Director has concluded that the determination of the eligibility of banks to participate in derivative transactions, the determination of eligible derivatives and protection providers, the adoption of methods for calculating the credit exposure arising from derivative and securities transactions, and the manner and extent to which credit exposure shall be taken

into account in determining compliance with loan limits, is necessary and appropriate to comply with Section 8-141(5) and, more generally, the Act.

IT IS THEREFORE ORDERED as follows:

I. **Definitions.** The definitions adopted for purposes of Section 8-141(5) and this Order, are set forth in Appendix A of this Order.

II. **Eligible Banks.** For a bank to be eligible to enter into derivative transactions, the bank must be well capitalized as defined in the prompt corrective action rules applicable to the institution.

III. **Eligible Credit Derivatives.** A bank may only enter into a credit derivative that is a single-name credit derivative or a standard, non-tranched index credit derivative, provided it meets the definition of eligible credit derivative found in Appendix A of this Order.

IV. **Eligible Protection Providers.** A bank may enter into transactions with eligible protection providers, as defined in Appendix A of this Order.

V. **Calculation of Credit Exposure.** The calculation of the credit exposure resulting from derivative transactions and securities financing transactions, for the purpose of determining the bank's lending limit, shall be made by the appropriate method found in Appendix B of this Order.

VI. **Loans Not Subject to Lending Limits.** The following loans or extensions of credit are not subject to the lending limits of Section 8-141(5):

1. Credit exposures arising from transactions financing Type I securities as defined in Appendix A of this Order;
2. Intraday credit exposures; and

3. Contracts which enable a flow of individual bank-originated one-to-four family real estate loans to be sold into the secondary market.

VII. **Nonconforming Loan.** A loan or extension of credit that is a credit exposure arising from a derivative transaction which was entered into prior to the effective date of this Order and which was within a bank's legal lending limit when made but is no longer in conformity with the bank's lending limit under this Order, will not be deemed a violation but will be treated as nonconforming.

VIII. Nothing in this Order shall limit the DEPARTMENT's ability to implement further safeguards pursuant to the Act, and as authorized by law.

IX. A copy of this Order shall be made publicly available on the DEPARTMENT's website.

X. This Order shall remain in effect until subsequently modified or vacated by Order of the Director.

The effective date of this Order shall be January 21, 2013.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2012.

**STATE OF NEBRASKA  
DEPARTMENT OF BANKING AND FINANCE**

By: \_\_\_\_\_  
John Munn, Director

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## APPENDIX A

### DEFINITIONS

For purposes of Section 8-141(5) and this Order, the following definitions are adopted:

1. **Borrower** means a person who is named as a borrower or debtor in a loan or extension of credit; a person to whom a bank has credit exposure arising from a derivative transaction or a securities financing transaction, entered into by the bank; or any other person, including a drawer, endorser, or guarantor, who is a direct or indirect borrower.
2. **Credit Derivative** means a financial contract that allows one party (the protection purchaser) to transfer the credit risk of one or more credit exposures (reference exposure) to another party (the protection provider).
3. **Derivative Transaction** means any 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.
4. **Eligible Credit Derivative** means a single-name credit derivative or a standard, non-tranched index credit derivative, provided that:
  - a. The derivative contract is an eligible guarantee 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 addresses 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 of settlement of the derivative contract are included in the contract;
- e. If the derivative contract allows for cash settlement, the contract incorporates a valuation process sufficient to estimate loss with respect to the derivative and specifies a 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 provides 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 clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event.

5. **Eligible Guarantee.** An eligible guarantee means a contract 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 breach of the contract by the beneficiary;
- 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 the case may be).

6. **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 the Federal Deposit Insurance Act;
- f. A bank holding company, as defined in the Nebraska Bank Holding Company Act of 1995;
- g. A savings and loan holding company, as defined in the Home Owners' Loan Act;
- h. A securities broker-dealer registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 or registered by the DEPARTMENT;
- i. An insurance company that is subject to the supervision of a State insurance regulator;
- j. A foreign banking organization as defined in 12 CFR § 211.2;
- 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; or
- l. A qualifying central counterparty, as defined in the Federal Deposit Insurance Act.

7. **Loan and Extension of Credit** means a bank's direct or indirect advance of funds to or on behalf of a borrower based on an obligation of the borrower to repay the funds or

being repayable from specific property pledged by or on behalf of the borrower; and any credit exposure arising from a derivative transaction or a securities financing transaction, and includes a bank's purchase of securities subject to an agreement that the seller will repurchase the securities at the end of a stated period. This does not include a bank's purchase of Type I securities which are subject to a repurchase agreement, where the purchasing bank has assured control over the Type I securities as collateral.

8. **Securities Financing Transaction** means a repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction.

9. **Single-Name Derivative** means a credit derivative that has a single obligor.

10. **Type I Securities** are as defined in 12 CFR § 1.12(j).

Effective Date: 01-21-2013

## APPENDIX B

### CALCULATION OF CREDIT EXPOSURE

I. **Calculation of Credit Exposure: Non-Credit Derivative Transactions.** A bank shall calculate the credit exposure to a counterparty arising from a non-credit derivative transaction, for purposes of determining compliance with the bank's lending limit, by one of the two following methods. Subject to Section IV of this Appendix B, a bank shall use the same method for calculating counterparty credit exposure arising from all of its derivative transactions.

1. **Conversion Factor Matrix Method.** Credit exposure calculated with the Conversion Factor Matrix Method shall equal and remain fixed at the potential future credit exposure of the derivative transaction as determined at the execution of the transaction, using Table 1 in Appendix C of this Order.

2. **Remaining Maturity Method.** Credit exposure calculated with the Remaining Maturity Method shall equal the greater of zero, or the sum of the current mark-to-market value of the derivative transaction plus the product of the notional amount of the transaction, the remaining maturity in years of the transaction, and the factor determined by Table 2 in Appendix C of this Order.

II. **Calculation of Credit Exposure: Credit Derivative Transactions.** A bank shall calculate credit exposure arising from a credit derivative transaction, for purposes of determining compliance with the bank's lending limit as follows:

1. A bank shall calculate the counterparty credit exposure arising from credit derivative entered by the bank by adding the net notional value of all protection purchased on the reference entity.

2. Credit exposure to a reference entity shall equal the notional value of all protection sold on the reference entity.

3. A bank may reduce its credit exposure to a reference entity by the amount of any eligible credit derivative purchased on that entity from an eligible protection provider.

**III. Calculation of Credit Exposure; Securities Financing Transactions.** Calculation of credit exposure arising from a securities financing transaction for purposes of determining compliance with the bank's lending limit shall be made as follows:

1. **Repurchase Agreement.** 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.

2. **Reverse Repurchase Agreements.** Credit exposure arising from a reverse repurchase agreement shall equal, and remain fixed at, the product of the haircut associated with the collateral received, as determined by Table 3 in Appendix C of this Order, and the amount of cash transferred.

3. **Securities Lending; Cash Collateral Transactions.** 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.

4. **Securities Lending; Non-cash Collateral Transactions.** Credit exposure arising from a securities lending transaction where the collateral is other securities shall equal, and remain fixed at, the product of the higher of the two haircuts associated with the two securities, as determined by Table 3 in Appendix C of this Order, and the higher of the two par values of the securities.

5. **Securities Borrowing; Cash Collateral Transactions.** Credit exposure arising from a securities borrowed transaction where the collateral is cash shall equal, and remain fixed at, the product of the haircut on the collateral received, as determined by Table 3 in Appendix C of this Order, and the amount of cash transferred to the other party.

6. **Securities Borrowing; Non-cash Collateral Transactions.** Credit exposure arising from a securities borrowed transaction where the collateral is other securities shall equal, and remain fixed at, the product of the higher of the two haircuts associated with the two securities, as determined by Table 3 in Appendix C of this Order, and the higher of the two par values of the securities.

IV. **Mandatory Methods.** Notwithstanding Sections I, II, and III of this Appendix B, the DEPARTMENT or the bank's primary federal regulator may require a bank to use a specific method to calculate credit exposure resulting from derivative transactions and securities financing transactions.

Effective Date: 01-21-2013

**APPENDIX C**

**TABLES USED IN THE CALCULATION OF CREDIT EXPOSURE FROM  
NON-CREDIT DERIVATIVES**

**Table 1—Conversion Factors Matrix for Calculating Potential Future Credit Exposure.<sup>1</sup>**

| <b>Original maturity<sup>2</sup></b> | <b>Interest rate factor</b> | <b>Foreign exchange rate and gold factor</b> | <b>Equity factor</b> | <b>Other factor<sup>3</sup><br/>(includes commodities and precious metals except gold)</b> |
|--------------------------------------|-----------------------------|--|----------------------|--|
| 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                  | 1.00   |

<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> Transactions not explicitly covered by any other column in the Table are to be treated as "Other."

**Table 2—Remaining Maturity Factors for Calculating Credit Exposure**

|                       | <b>Interest rate factor</b> | <b>Foreign exchange rate and gold factor</b> | <b>Equity factor</b> | <b>Other factor<sup>1</sup><br/>(includes commodities and precious metals except gold)</b> |
|-----------------------|-----------------------------|--|----------------------|--|
| Multiplicative Factor | .015                        | .015   | .06                  | .06  |

<sup>1</sup> Transactions not explicitly covered by any other column in the Table are to be treated as "Other."

**TABLE 3—Collateral Haircuts**

**Sovereign Entities**

| <b>Sovereign Entity</b>                                | <b>Residual Maturity</b>  | <b>Haircut Without Currency Mismatch<sup>1</sup></b> |
|--|---------------------------|--|
| OECD Country Risk Classification <sup>2</sup> 0-1..... | ≤ 1 year .....            | .....005   |
|  | > 1 year, ≤ 5 years.....  | .....020   |
|  | > 5 years .....           | .....040   |
| OECD Country Risk Classification 2-3.....              | ≤ 1 year .....            | .....010   |
|  | > 1 year, ≤ 5 years ..... | .....030   |
|  | > 5 years .....           | .....060   |

**Corporate and Municipal Bonds That Are Bank-Eligible Investments**

| <b>Bond</b> | <b>Residual Maturity for Debt Securities</b> | <b>Haircut Without Currency Mismatch</b> |
|-------------|--|--|
| All.....    | ≤ 1 year .....                               | .....02                                  |
| All.....    | > 1 year, ≤ 5 years .....                    | .....06                                  |
| All.....    | > 5 years .....                              | .....12                                  |

**Other Eligible Collateral**

| <b>Collateral</b>   | <b>Haircut</b>   |
|---|--|
| Main index <sup>3</sup> equities (including convertible bonds)..... | .....015   |
| Other publicly traded equities (including convertible bonds).....   | .....025   |
| Mutual funds.....   | .....Highest haircut applicable to any security in which the fund can invest |
| Cash collateral held.....   | .....0   |

<sup>1</sup> In cases where the currency denomination of the collateral differs from the currency denomination of the credit transaction, an additional 8 percent haircut will apply.

<sup>2</sup> 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.

<sup>3</sup> 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.

Effective Date: 01-21-2013