

MAINE BUREAU OF FINANCIAL INSTITUTIONS
SUPERINTENDENT'S
NOTICE TO INTERESTED PARTIES

Please find attached the Bureau's newly adopted Regulation 28: Loans to One Borrower Limitations, together with the Basis Statement, the Summary of Comments and the Bureau's responses to those comments. No substantive changes were made from the proposed rule. Pursuant to its effective date, Maine banks are not required to employ the rules for calculating credit exposures in section 8 of the rule until April 1, 2013.

/s/ Lloyd P. LaFountain III
Superintendent
Gardiner, Maine
December 19, 2012

NOTICE OF AGENCY RULE-MAKING ADOPTION

AGENCY: Bureau of Financial Institutions, Department of Professional and Financial Regulation

CHAPTER NUMBER AND TITLE: Chapter 128: Loans to One Borrower Limitations

ADOPTED RULE NUMBER: 20xx.xxx

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SECRETARY OF STATE)

CONCISE SUMMARY

9-B MRS §439-A establishes the basis for determining the legal lending limits for financial institutions, including their subsidiaries, organized under the laws of this State. The lending limit law prohibits loans or extensions of credit at any one time to an individual borrower in excess of 20% of the financial institution's total capital. In addition, this statute authorizes the Superintendent to adopt rules to define or further define terms used in the statute and to establish limits or requirements other than those specified in the statute. This regulation protects the safety and soundness of financial institutions by preventing excessive loans to one person while promoting diversification of loans and equitable access to financial institution services.

This promulgation repeals and replaces existing Regulation 28. Its purpose is to establish guidelines for the administration of lending limits and to accommodate recent federal requirements pertaining to such limits found in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 111 PL 203 ("Dodd-Frank Act"). Effective January 21, 2013, section 611 of the Dodd-Frank Act will prohibit state-chartered financial institutions from engaging in derivative transactions unless state lending limit laws take into consideration credit exposure to derivative transactions. Prior to this promulgation, Maine's lending limit law did not provide guidance for measuring credit exposure arising from derivative transactions. This promulgation addresses the Dodd-Frank Act requirements by providing methods for taking into consideration credit exposure to derivative transactions for Maine's financial institutions. This promulgation is based on the new interim final regulation that was issued by the Office of the Comptroller of the Currency (OCC) in response to the Dodd-Frank Act. This new interim final regulation, which amends 12 CFR Part 32, may be found at 77 FR 37265. Pursuant to this interim final regulation, national banks must also evaluate credit exposure to derivatives transactions when calculating lending limits to a single borrower.

Credit unions have lending limit requirements other than those found in the regulation.

EFFECTIVE DATE:

January 21, 2013. Until April 1, 2013, Maine banks engaging in derivative transactions must document that they have taken into consideration credit exposure to derivative transactions when evaluating loans to one borrower, taking into account whether credit exposure from derivative transactions adversely impacts safety and soundness of their institution. During this period, Maine banks are not required to employ the rules for calculating credit exposures from derivative transactions as set forth in section 8 of the regulation. Beginning April 1, 2013, Maine banks will be required to employ the rules for calculating credit exposures from derivative transactions as set forth in section 8 of the regulation.

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02 DEPARTMENT OF PROFESSIONAL AND FINANCIAL REGULATION
029 BUREAU OF FINANCIAL INSTITUTIONS
CHAPTER 128 LOANS TO ONE BORROWER LIMITATIONS (REG. 28)

SECTION 1. PURPOSE

9-B MRSA §439-A establishes the basis for determining the legal lending limits for financial institutions, including their subsidiaries, organized under the laws of this State. The lending limit law prohibits loans or extensions of credit at any one time to an individual borrower in excess of 20% of the financial institution’s total capital. In addition, this statute authorizes the Superintendent to adopt rules to define or further define terms used in the statute and to establish limits or requirements other than those specified in the statute. This regulation protects the safety and soundness of financial institutions by preventing excessive loans to one person while promoting diversification of loans and equitable access to financial institution services.

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SECTION 2. AUTHORITY

Title 9-B MRS §215 authorizes the Superintendent to implement by rule any provisions of law relating to the supervision of financial institutions.

Title 9-B MRS §439-A(5) authorizes the Superintendent to adopt rules to carry out purposes of the Banking Code's lending limit law, including rules to define or further define terms used in the section and to establish limits or requirements other than those specified in the section if the Superintendent determines that such action is necessary for the protection of depositors, investors or the public.

SECTION 3. DEFINITIONS

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 financial institution has credit exposure arising from a derivative transaction entered by the financial institution; or any other person, including a drawer, endorser, or guarantor, who is deemed to be a borrower under the "direct benefit" or the "common enterprise" tests set forth in section 6 of this regulation.
2. "Contractual commitment to advance funds":
 - A. Includes a financial institution's obligation to:
 - (1) Make payment (directly or indirectly) to a third person contingent upon default by a customer of the financial institution 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;
 - (2) Guarantee or act as surety for the benefit of a person;
 - (3) Advance funds under a qualifying commitment to lend, that is, a legally binding written commitment to lend that, when combined with all other outstanding loans and qualifying commitments to a borrower, is within the financial institution's lending limit when entered into, and has not be disqualified; and

- (4) Advance funds under a standby letter of credit as defined in subsection 3(13) of this regulation, a put, or other similar arrangement.
 - B. The term does not include commercial letters of credit and similar instruments where the issuing financial institution expects the beneficiary to draw on the issuer, that do not guarantee payment, and that do not provide for payment in the event of a default by a third party.
- 3. "Control" is presumed to exist when a person directly or indirectly, or acting through or together with one or more persons:
 - A. Owns, controls, or has the power to vote 25 percent or more of any class of voting securities of another person;
 - B. Controls, in any manner, the election of a majority of the directors, trustees, or other persons exercising similar functions of another person; or
 - C. Has the power to exercise a controlling influence over the management or policies of another person.
- 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 (reference exposure) 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.
- 6. "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 subsection 3(7) of this regulation 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:
 - (1) 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
 - (2) 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 estimate loss with respect to the derivative reliably 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 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.

7. "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 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 actions 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 financial institution, unless the affiliate is an insured depository institution, bank, securities broker or dealer, or insurance company that:
 - (1) Does not control the financial institution; and
 - (2) 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).
8. "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 U.S.C. §1813(c);
- F. A bank holding company, as defined in section 2 of the Bank Holding Company Act, as amended, 12 U.S.C. §1841;
- G. A savings and loan holding company, as defined in section 10 of the Home Owners' Loan Act, 12 U.S.C. §1467a;
- H. A securities broker or dealer registered with the SEC under the Securities Exchange Act of 1934, 15 U.S.C. §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, for example, a clearing house that:
 - (1) Facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts;
 - (2) Requires all participants in its arrangements to be fully collateralized on a daily basis; and

- (3) The bank demonstrates to the satisfaction of the Bureau that it is in sound financial condition and is subject to effective oversight by a national supervisory authority.
9. "Financial institution" has the same meaning that is set forth in 9-B MRSA §131(17).
10. "Loans or extensions of credit" has the same meaning that is set forth in 9-B MRSA §439-A(1)(A)

A. "Loans or extensions of credit" include:

- (1) Any credit exposure, as determined pursuant to section 8 of this regulation, arising from a derivative transaction;
- (2) A contractual commitment to advance funds;
- (3) An overdraft, whether or not prearranged, but not an intraday overdraft for which payment is received before the close of business of the financial institution that makes the funds available;
- (4) 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; and
- (5) Loans or extensions of credit that have been charged off on the books of the financial institution in whole or in part, unless the loan or extension of credit:
 - (a) Is unenforceable by reason of discharge in bankruptcy;
 - (b) Is no longer legally enforceable because of expiration of the statute of limitations or a judicial decision; or
 - (c) Is no longer legally enforceable for other reasons, provided that the financial institution maintains sufficient records to demonstrate that the loan is unenforceable.

B. In addition to the exclusions from limitations found in 9-B MRSA §439-A(3), the following items do not constitute "loans or extensions of credit" for purposes of this regulation:

- (1) Additional funds advanced for the benefit of a borrower by a financial institution 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 financial institution'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;
- (2) 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;
 - (3) Financed sales of a financial institution's own assets, including Other Real Estate Owned, if the financing does not put the financial institution in a worse position than when the financial institution held title to the assets;
 - (4) A renewal or restructuring of a loan as a new "loan or extension of credit," following the exercise by a financial institution 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 financial institution to the borrower, or a new borrower replaces the original borrower, or unless the Bureau determines that a renewal or restructuring was undertaken as a means to evade the financial institution's lending limit;
 - (5) Amounts paid against uncollected funds in the normal process of collection;
 - (6)
 - (a) That portion of a loan or extension of credit sold as a participation by a financial institution 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 must 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 financial institution 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 financial institution to the borrower. If the portions so attributed to the borrower exceed the originating financial institution's lending limit, the loan may be treated as nonconforming subject to section 7 of this regulation, rather than a violation, if:

- (i) The originating financial institution had a valid and unconditional participation agreement with a participant or participants that was sufficient to reduce the loan to within the originating financial institution's lending limit;
 - (ii) The participant reconfirmed its participation and the originating financial institution had no knowledge of any 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 financial institution's next business day; and
- (7) Intraday credit exposures arising from a derivative transaction.

11. "Perpetual preferred stock" means preferred stock that does not have a stated maturity date and cannot be redeemed at the option of the holder.
12. "Person" has the meaning as defined in 9-B MRSA §131(30).
13. "Standby letter of credit" is any letter of credit, or similar arrangement, however named or described, which represents an obligation to the beneficiary on the part of the issuer:
 - A. To repay money borrowed by or advanced to or for the account of the account party;

- B. To make payment on account of any indebtedness undertaken by the account party; or
 - C. To make payment on account of any default by the account party in the performance of an obligation.
14. "Subsidiary" has the meaning as defined in 9-B MRSA §131(39-A). A "service corporation," as defined in 9-B MRSA §131(37), is a "subsidiary" for the purposes of this regulation.
15. "Total capital and surplus" means:
- A. A financial institution's Tier 1 and Tier 2 capital calculated under the risk-based capital standards applicable to the institution as reported in the financial institution's Consolidated Reports of Condition and Income (Call Report); plus
 - B. The balance of a financial institution's allowance for loan and lease losses not included in the financial institution's Tier 2 capital, for purposes of the calculation of risk-based capital described in paragraph (A) of this subsection, as reported in the financial institution's Call Report.

SECTION 4. LENDING LIMITS

Except as provided in 9-B MRSA §439-A and this regulation, a financial institution and/or its subsidiaries may not make loans or extensions of credit outstanding at one time to a borrower in excess of 20% of its total capital and surplus.

SECTION 5. CALCULATION DATE OF LENDING LIMITS

1. Calculation date. For purposes of determining compliance with this regulation, a financial institution shall determine its lending limit on the last day of the preceding calendar quarter, unless otherwise directed by the Superintendent.

2. Effective date. A financial institution's lending limit calculated in accordance with subsection (1) of this section will be effective as of the earlier of the date on which the financial institution's Consolidated Reports of Condition and Income (Call Report) is submitted or the date the Call Report is required to be submitted.

SECTION 6. COMBINATION RULES

1. General rule. Loans or extensions of credit to one borrower will be attributed to another person and each person will be deemed a borrower:
 - A. When proceeds of a loan or extension of credit are to be used for the direct benefit of the other person, to the extent of the proceeds so used; or
 - B. When a common enterprise is deemed to exist between the persons.
2. Direct benefit. The proceeds of a loan or extension of credit to a borrower will be deemed to be used for the direct benefit of another person and will be attributed to the other person when the proceeds, or assets purchased with the proceeds, are transferred to another person, other than in a bona fide arm's length transaction where the proceeds are used to acquire property, goods, or services.
3. Common enterprise. A common enterprise will be deemed to exist and loans to separate borrowers will be aggregated:
 - A. When the expected source of repayment for each loan or extension of credit is the same for each borrower and neither borrower has another source of income from which the loan (together with the borrower's other obligations) may be fully repaid. An employer will not be treated as a source of repayment under this section because of wages and salaries paid to an employee, unless the standards of paragraph 3(B) of this section are met;
 - B. When loans or extensions of credit are made:

- (1) To borrowers who are related directly or indirectly through common control, including where one borrower is directly or indirectly controlled by another borrower; and
 - (2) Substantial financial interdependence exists between or among the borrowers. Substantial financial interdependence is deemed to exist when 50 percent or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other borrower. Gross receipts and expenditures include gross revenues/expenses, intercompany loans, dividends, capital contributions, and similar receipts or payments;
 - C. When separate persons borrow from a financial institution to acquire a business enterprise of which those borrowers will own more than 50 percent of the voting securities or voting interests, in which case a common enterprise is deemed to exist between the borrowers for purposes of combining the acquisition loans;
 - D. When the Bureau determines, based upon an evaluation of the facts and circumstances of particular transactions, that a common enterprise exists.
4. Loans to corporations. For purposes of this regulation and 9-B MRSA §439-A, a corporation is a "subsidiary" of any person who directly or indirectly owns or beneficially owns more than 50% of the voting stock of the corporation. Loans or extensions of credit to a person and its subsidiary or to subsidiaries of one person need not be combined where the financial institution has determined that the person and subsidiaries involved are not engaged in a "common enterprise" as that term is defined in subsection 3 of this section. Notwithstanding the foregoing sentence, loans or extensions of credit by a financial institution to a "corporate group" (defined as a person and all of its subsidiaries) may not exceed 50% of the financial institution's total capital and surplus.
 5. Loans to partnerships, joint ventures, and associations.

- A. Loans or extensions of credit to a partnership, joint venture, or association shall, for purposes of this regulation, be considered loans or extensions of credit to each member of such partnership, joint venture, or association.
- B. Paragraph (5)(A) of this section is not applicable to limited partners in limited partnerships or to members of joint ventures or associations if such partners or members, by the terms of the partnership or membership agreement are not to be held liable for the debts or actions of the partnership, joint venture, or association. However, the rules set forth in subsections 6(1), (2) and (3) of this regulation are applicable to such partners or members.
- C. Loans or extensions of credit to members of a partnership, joint venture, or association shall, for purposes of this regulation, be attributed to the partnership, joint venture, or association where one or more of the tests set forth in subsections 6(2) and 6(3) of this regulation is satisfied with respect to one or more such members. However, loans to members of a partnership, joint venture, or association will not be attributed to other members of the partnership, joint venture, or association under this regulation unless one or more of the tests set forth in subsections 6(2) and (3) of this regulation is satisfied with respect to such members.
- D. The tests set forth in subsections 6(2) and (3) of this regulation shall be deemed satisfied when loans or extensions of credit are made to members of a partnership, joint venture, or association for purposes of purchasing an interest in such partnership, joint venture, or association.

SECTION 7: NONCONFORMING LOANS AND EXTENSIONS OF CREDIT

- 1. A loan or extension of credit, within a financial institution'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 financial institution's lending limit because:
 - A. The financial institution's capital has declined, borrowers have subsequently merged or formed a common enterprise, lenders

have merged, or the lending limit or capital rules have changed;

- B. Collateral securing the loan to satisfy the requirements of a lending limit exception has declined in value.
2. A financial institution must use reasonable efforts to bring a loan or extension of credit that is nonconforming as a result of paragraph 1(A) of this section into conformity with the financial institution's lending limit unless to do so would be inconsistent with safe and sound banking practices.
 3. A financial institution must bring a loan that is nonconforming as a result of circumstances described in paragraph 1(B) of this section into conformity with the financial institution's lending limit within 30 calendar days, except when judicial proceedings, regulatory actions or other extraordinary circumstances beyond the financial institution's control prevent it from taking action.

SECTION 8: CREDIT EXPOSURE ARISING FROM DERIVATIVE TRANSACTIONS

1. Scope. This section sets forth the rules for calculating the credit exposure arising from a derivative transaction entered into by a financial institution for purposes of determining the financial institution's lending limit pursuant to this regulation.
2. Derivative transactions
 - A. Non-Credit Derivatives. Subject to paragraph 2(B) of this section, a financial institution shall calculate the credit exposure to a counterparty arising from a derivative transaction by one of the following methods. A financial institution shall use the same method for calculating counterparty credit exposure arising from all of its derivative transactions.
 - (1) 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 as determined at the execution of the transaction by reference to Table 1 below.

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	0.20	0.30
Over 5 to 10 years.....	.12	.12	0.20	.60
Over ten years.....	.30	.30	.20	1.0

¹ For an OTC derivative contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the derivative contract.

² For an OTC derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005.

³ Transactions not explicitly covered by any other column in the Table are to be treated as “Other.”

- (2) Remaining Maturity Method. The credit exposure arising from a derivative transaction under the Remaining Maturity Method shall equal the greater of zero or the sum of the current mark-to-market value of the derivative transaction added to the product of the notional amount of the transaction, the remaining maturity in years of the transaction, and a fixed multiplicative factor determined by reference to Table 2, below.

TABLE 2—REMAINING MATURITY FACTOR FOR CALCULATING CREDIT EXPOSURE

	Interest Rate	Foreign exchange rate and gold	Equity	Other ^[4] (includes commodities and precious metals except gold)
Multiplicative Factor	1.5%	1.5%	6%	6%

B. Credit Derivatives

- (1) Notwithstanding paragraph 2(A) of this section, a financial institution that uses the Conversion Factor Matrix Method or Remaining Maturity Method shall calculate the counterparty credit exposure arising from credit derivatives entered by the financial institution by adding the net notional value of all protection purchased from the counterparty on each reference entity.
- (2) A financial institution shall calculate the credit exposure to a reference entity arising from credit derivatives entered by the financial institution by adding the notional value of all protection sold on the reference entity. However, the financial institution 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.

SECTION 9: AUTHORITY OF THE SUPERINTENDENT

⁴ Transactions not explicitly covered by any other column in the Table are to be treated as “Other.”

The Superintendent may require a financial institution to use the Conversion Factor Matrix Method or the Remaining Maturity Method to calculate the credit exposure of derivative transactions if the Superintendent finds that such method is necessary to promote the safety and soundness of the financial institution.

SECTION 10: EFFECTIVE DATE: January 21, 2013. Until April 1, 2013, Maine banks engaging in derivative transactions must document that they have taken into consideration credit exposure to derivative transactions when evaluating loans to one borrower, taking into account whether credit exposure from derivative transactions adversely impacts safety and soundness of their institution. During this period, Maine banks are not required to employ the rules for calculating credit exposures from derivative transactions as set forth in section 8 of the regulation. Beginning April 1, 2013, Maine banks will be required to employ the rules for calculating credit exposures from derivative transactions as set forth in section 8 of the regulation.

BASIS STATEMENT^[5]

Derivative transactions, when used appropriately, are a valuable tool for financial institutions. Derivative transactions can range from relatively simple to extremely complex. The following general descriptions are for the limited purpose of aiding the reader in understanding the intent of this regulation.

A derivative transaction is a financial 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. Derivative transactions include interest rate derivative contracts, credit derivatives, and any other instrument that poses similar counterparty credit risks.

Derivatives are risk-shifting devices. For example, to mitigate risks that occur from ordinary lending activities, smaller financial institutions typically use and rely almost exclusively on derivatives known as "swaps," a simultaneous buying and selling of the same security or obligation. In a low interest rate environment, most borrowers desire fixed rate loans. Most financial institutions

prefer making floating rate loans to better match the inevitable changes in interest rates they pay for deposits and wholesale loans that serve as the funding source for customer loans. To allow the borrower to pay a fixed rate, a financial institution can enter into an interest rate swap with a counterparty and swap its fixed rate loan payment stream for a floating rate payment stream based on an identical principal amount, as a hedge to better control fluctuations in its borrowing costs. These derivative activities can be highly useful in managing or hedging existing risk in a financial institution's loan or investment portfolio.

The Dodd-Frank Act provisions require state-chartered financial institutions to identify and manage the risks being assumed in derivative transactions. Part of the risk identification and management process is determining the potential monetary exposure of the parties under the terms of the derivative instrument. This regulation requires state-chartered financial institutions to make determinations at loan inception of potential credit exposure from a derivative transaction in a manner similar to that required of their federally-chartered counterparts.

Dodd-Frank Requirements

On June 20, 2012, the Office of the Comptroller of the Currency (the OCC) released its interim final regulation for nationally-chartered financial institutions to implement section 610 of the Dodd-Frank Act. Published in the June 21, 2012 edition of the Federal Register (77 FR 37265). This regulation sets out procedures and methodologies for calculating the credit exposure under these newly-covered transactions. In order to reduce the practical burden of these calculations, particularly for smaller financial institutions, the OCC provided different options for measuring credit exposures in new 12 CFR §32.9. These alternatives appear to implement the statutory changes, consistent with safety and soundness and the goals of the statute, in a manner that seeks to reduce unnecessary new regulatory burden. This regulation adopts the derivative evaluation methods used by the OCC, except for the Internal Model Method.

Description of this regulation

The credit exposure arising from a derivative transaction is commonly viewed as the sum of the current credit exposure on the contract or portfolio plus some measure of potential future exposure (PFE). Under section 8 of this regulation, the current credit exposure is determined by the mark-to-market value (MTM) of the derivative contract. The current MTM is generally zero at execution of the contract. Subsequent to the execution of the contract, if the MTM value is positive, then the current credit exposure equals that MTM value. If the MTM value is zero or negative, then the current credit exposure is zero.

PFE, on the other hand, recognizes the possibility that the MTM amount may increase over time, based upon changes in market factors. The PFE, when added to the MTM amount, can be viewed as the anticipated ceiling of credit exposure at the execution of a derivative transaction.

Section 8 of this regulation provides two methods for calculating credit exposure of derivative transactions other than credit derivatives. Unless required to use a specific method by the Superintendent pursuant section 9 of this regulation, a financial institution may choose which of these methods it will use. However, a financial institution must use the same method for calculating credit exposure arising from all derivative transactions.

Method One: A financial institution may choose to measure the credit exposure arising from a derivative transaction under the "conversion factor matrix method." Under this method, the credit exposure will equal and remain fixed at the PFE of the derivative transaction, as determined at execution of the transaction by reference to a simple look-up table (Table 1 in the section 8 of this regulation).

While the simplicity and stability of the "conversion factor matrix method" will make it easy to apply, actual credit exposure can arise during the life of a derivative contract that is not captured under this method. The Bureau believes that the potentially unmeasured risks can be addressed in the supervisory process by examiners appropriately responding to unsafe and unsound concentrations, and that the certainty and simplicity of allowing non-complex financial institutions to "lock in" the attributable exposure at the execution of the contract balances the possible risks.

Method Two: A financial institution may choose to measure the credit exposure arising from a derivative transaction under the "remaining maturity method." This measurement of the credit exposure incorporates both the current MTM and the transaction's remaining maturity (measured in years) as well as a fixed add-on for each year of the transaction's remaining life. Specifically, this method measures credit exposure by adding the current MTM value of the transaction to the product of the notional amount of the transaction, the remaining maturity of the transaction, and a fixed multiplicative factor. These multiplicative factors differ based on product type and are determined by a look-up table (Table 2 in section 8 of this regulation).

The credit exposure calculated under the remaining maturity method accounts for the diminishing maturity of the transaction as well as the current MTM of the transaction. A financial institution may find that any additional burden involved with determining the MTM under this optional method is balanced by the fact that, depending on the MTM, as the maturity decreases, the credit exposure also decreases, thereby permitting additional extensions of credit under the lending limit.

In the case of credit derivatives, in which a financial institution buys or sells credit protection against loss on a third-party reference entity, a special rule would apply as set forth in section 8 of this regulation. Specifically, a financial institution that uses the "conversion factor matrix" method or "remaining maturity method" calculates the counterparty credit exposure arising from credit derivatives by adding the net notional value of all protection purchased from the counterparty on each reference entity. For example, financial institution A buys and sells credit protection from and to financial institution B on Firms X, Y and Z. Financial institution A's net notional protection purchased from financial institution B is \$50 for Firm X and \$100 for Firm Y. Financial institution A's net protection sold to financial institution B is \$35 for Firm Z. The lending limit exposure of financial institution A to financial institution B is \$150.

In addition, a financial institution would calculate the credit exposure to a reference entity arising from credit derivatives by adding the notional value of all protection sold on the reference entity. For example, financial institution C buys and sells credit protection on Firms 1, 2 and 3. Financial institution C's notional protection sold is \$100 for Firm 1, \$200 for Firm 2 and \$300 for Firm 3. The lending limit exposure of financial institution C to Firm 1 is \$100, to Firm 2 is \$200 and to Firm 3 is \$300.

However, the financial institution may reduce its exposure to a reference entity by the amount of any "eligible credit derivative," defined in section 3 of this regulation, purchased on that reference entity from an "eligible protection provider," also defined in section 3 of this regulation. In the last example, if financial institution C purchases protection on Firm 3 from an eligible protection provider in the amount of \$25 via an eligible credit derivative, financial institution C can reduce its \$300 lending limit exposure to Firm 3 to \$275.

COMMENTS AND THE BUREAU'S RESPONSES

The Bureau received one comment letter from the Maine Bankers' Association (MBA). In a letter dated November 19, 2012, Kathy Keneborus, Director of Government Relations and Compliance for the MBA, provided the following comments:

1. Given the Bureau's current safety and soundness authority, the need by Maine banks to develop systems and compliance programs to comply with the regulation, and the possibility that the Office of the Comptroller's (OCC) interim final regulation may change, the MBA urged the Bureau to extend the compliance date of the regulation to October 1, 2013, the same date requested by the American Bankers' Association, The Clearing House, and The Financial Services Roundtable, in their joint letter to the OCC dated August 6, 2012.

Bureau's response: The Bureau notes that on November 14, 2012, the OCC issued a Notice of Compliance Extension wherein it provided notice to extend from January 1, 2013, to April 1, 2013, the temporary exception for the application of its lending limits regulation, 12 CFR 32, to certain credit exposures arising from derivative and securities financing transactions.

The Bureau also notes that, pursuant to section 611 of the Dodd-Frank Act, commencing January 21, 2013, state-chartered banks may engage in derivative transactions only if the law with respect to lending limits of the State in which the state bank is chartered takes into consideration credit exposure to derivative transactions.

The Bureau has therefore amended the effective date of the regulation in the following manner. The effective date of the regulation will be January 21, 2013 in order to comply with section 611 of the Dodd-Frank Act. However, between January 21, 2013 and April 1, 2013, the mandatory compliance date of the final OCC regulation, this regulation will require only that Maine banks "take into consideration" credit exposure to derivative transactions when evaluating loans to one borrower, taking into account whether credit exposure from derivative transactions adversely impacts the safety and soundness of their institution, without mandating that Maine banks use the methods set forth in section 8 of the regulation. Beginning April 1, 2013, Maine banks will be required to follow the methods set forth in section 8 of the regulation for determining credit exposure to derivative transactions. In amending the effective date in this manner, the Bureau seeks to, in effect, align the mandatory compliance date in its regulation with that of its federal counterpart, 12 CFR Part 32, while also adhering to the deadline imposed by the Dodd-Frank Act.

2. The MBA notes that the Bureau has proposed adopting the OCC definition of "eligible protection provider" in section 3(8) of the regulation and seeks clarification as to why a "mutual holding company" is not included in this definition.

Bureau's response: The definition of an "eligible protection provider" in the regulation includes a "bank holding company" as defined in section 2 of the Bank Holding Company Act, 12 USC 1841 and a "savings and loan holding company" as defined in section 10 of the Home Owners' Loan Act, 12 USC 1467a. The Bureau will interpret the broadly defined terms "bank holding company" and "savings and loan holding company" to include a "mutual holding company" and, therefore, a "mutual holding company" will be considered an "eligible protection provider" under the regulation.

3. The MBA requests clarification that U.S. Agency step bonds are not derivatives for the purposes of this regulation.

Bureau's response: The Bureau confirms that U.S. Agency step bonds are generally not derivatives for the purposes of this regulation. However, it is conceivable that certain types of step bonds may contain attributes that fit the definition of a derivative and, therefore, could require evaluation for credit exposure. The Bureau intends to evaluate step bonds in a manner consistent with federal banking regulators.

4. The MBA requests that the "direct benefit test" set forth in the proposed regulation should be limited by its terms to situations of evasion, noting that tracing the proceeds of a loan and determining for whose benefit the loan is made can be difficult, especially so, in the context of derivative transactions.

Bureau's response: The Bureau notes that this request has also been made by the American Bankers' Association, The Clearing House and The Financial Services Roundtable in their letter to the OCC dated August 6, 2012. The Bureau further notes that the OCC has not responded to this industry request.

In light of the fact that the OCC regulation has not yet adopted a more limited approach to the "direct benefit test" nor is the Bureau aware of how the OCC will respond to this request, and, further, in light of the impending deadline imposed by section 611 of the Dodd-Frank Act as noted above, the Bureau is not inclined to amend the "direct benefit test" in such a way as to limit its scope to situations of evasion at this time. The Bureau's aims in this rulemaking include complying with the Dodd-Frank Act and generally maintaining consistency between state and federal law. If and when the OCC amends its "direct benefit test," the Bureau will consider doing likewise.

5. The MBA requests that the Bureau include the internal model method as an option for calculating credit exposure arising from derivative transactions, noting that the internal model method is included in the OCC interim final regulation and that this would allow a Maine bank to develop such a model as a "fail-safe" if necessary.

Bureau's response: In an effort to simplify implementation of the regulation, and the evaluation of compliance with the regulation, the internal model method was not included. Internal model methods are highly technical and are not expected to be used outside of larger banking organizations. The Bureau is not aware of any Maine-chartered banks currently using an internal model method. However, going forward, should Maine banks express a concerted interest to employ an internal model method, use of such a method becomes more widespread by national banks and other state banks, and should state resources allow, the Bureau will consider amending the regulation to include use of an internal model method. Finally, the Bureau notes that the regulation does not prohibit

Maine banks from employing an internal model method for their own use in addition to the methods prescribed in section 8 of the regulation.

6. The MBA notes that the regulation requires a bank to choose a single method that it will use to calculate credit exposure for all types of derivative transactions. It requests that the regulation should be amended so as to allow banks to use more than one method across derivative activities.

Bureau's response: The Bureau notes that the OCC interim final regulation does not allow national banks or savings associations to use different methods depending upon the type of derivative transaction. As set forth in 77 FR 37265 at 37268, "a national bank or savings association must use the same method for calculating credit exposures arising from all derivative transactions." The Bureau is therefore inclined not to amend the regulation to allow Maine banks to use more than one method across derivative activities. Should the OCC amend its regulation to allow banks to use more than one method across derivative activities, the Bureau will consider doing likewise.

7. The MBA requests clarification that the Superintendent's authority to require a Maine bank to use a particular method in section 8 of the regulation should apply to the bank prospectively only, not retroactively. The MBA further requests that mandated use of a particular method should be phased in over a period of time and that factors in exercising the Superintendent's authority could be included in published guidance.

Bureau's response: The Bureau agrees that the Superintendent's authority to require a Maine bank to use a particular method applies prospectively only, not retroactively. The Bureau is presently of the view that the timing for a Maine bank to adopt a particular method pursuant to the Superintendent's authority (whether phased-in or otherwise) should be left on a case-by-case basis. Finally, the Bureau does not believe that formal guidelines describing how a Maine bank may change methods are necessary. The Bureau will review any changes in methods as part of its examination process, and Maine banks may consult with the Bureau regarding contemplated changes in methods.

FISCAL IMPACT STATEMENT

This regulation does not impose any cost on municipalities or counties.

PRIMARY SOURCES OF INFORMATION RELIED UPON

The Bureau relies upon the following primary sources of information in developing this regulation: The Federal Deposit Insurance Act, 12 USC §1828, as amended by section 611 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 111 PL 203; and 12 CFR Part 32 (OCC Lending Limits regulation).

[1] For an OTC derivative contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the derivative contract.

[2] For an OTC derivative contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity equals the time until the next reset date. For an interest rate derivative contract with a remaining maturity of greater than one year that meets these criteria, the minimum conversion factor is 0.005.

[3] Transactions not explicitly covered by any other column in the Table are to be treated as "Other."

[4] Transactions not explicitly covered by any other column in the Table are to be treated as "Other."

[5] The OCC's comments on the interim final regulation on lending limits for certain credit exposures to derivatives and securities financing transactions published on June 21, 2012 have been used as the primary source for this discussion.