

**WEST VIRGINIA  
SECRETARY OF STATE  
NATALIE E. TENNANT  
ADMINISTRATIVE LAW DIVISION**

Form #2

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OFFICE WEST VIRGINIA  
SECRETARY OF STATE

**NOTICE OF A COMMENT PERIOD ON A PROPOSED RULE**

AGENCY: W.Va. Division of Financial Institutions TITLE NUMBER: 106

RULE TYPE: Interpretive CITE AUTHORITY: W.Va. Code 31A-2-4(c)(11)

AMENDMENT TO AN EXISTING RULE: YES  NO

IF YES, SERIES NUMBER OF RULE BEING AMENDED: \_\_\_\_\_

TITLE OF RULE BEING AMENDED: \_\_\_\_\_

IF NO, SERIES NUMBER OF RULE BEING PROPOSED: 20

TITLE OF RULE BEING PROPOSED: Treatment of Derivative Transactions Under Legal Lending Limits

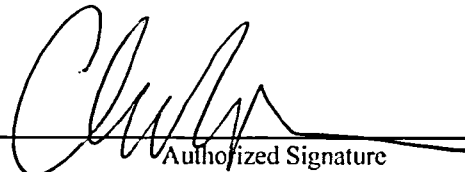
IN LIEU OF A PUBLIC HEARING, A COMMENT PERIOD HAS BEEN ESTABLISHED DURING WHICH ANY INTERESTED PERSON MAY SEND COMMENTS CONCERNING THESE PROPOSED RULES. THIS COMMENT PERIOD WILL END ON December 10, 2012 AT 4:30 p.m. ONLY WRITTEN COMMENTS WILL BE ACCEPTED AND ARE TO BE MAILED TO THE FOLLOWING ADDRESS:

W.Va. Division of Financial Institutions

900 Pennsylvania Ave., Suite 306  
Charleston, WV 25302-3542

ATTN: Robert J. Lamont

THE ISSUES TO BE HEARD SHALL BE LIMITED TO THIS PROPOSED RULE.

  
Authorized Signature

ATTACH A **BRIEF** SUMMARY OF YOUR PROPOSAL

**Proposed Title 106, Series 20, Interpretive Rule**  
**Treatment of Derivative Transactions Under Legal lending Limits**

**STATEMENT OF CIRCUMSTANCES WHICH REQUIRE THIS RULE**

Effective January 21, 2013, Section 611 of the Dodd-Frank Act prohibits state chartered banks from engaging in derivative transactions unless “the law with respect to lending limits of the State in which the insured bank is chartered takes into consideration credit exposure to derivative transactions.” 12 U.S.C. 1828(y). The West Virginia law on legal lending limits, W.Va. Code §31A-4-26(a), has a very broad definition of “loans and extensions of credit” which includes “obligations”. Similarly, the legislative rule pertaining to the legal lending limit, 106 CSR Series 9, contains a broad definition of a “contractual commitment to advance funds”. West Virginia banks have engaged in derivative transactions, usually to hedge interest rate risk, without negative impact on the soundness of the institution. This Rule is intended to set forth the formal interpretation of the Division of Financial Institution that both the state law and the legislative rules relating to legal lending limits are sufficiently broad to permit state chartered institutions to engage in derivative transactions.

**Proposed Title 106, Series 20, Interpretive Rule  
Treatment of Derivative Transactions Under Legal Lending Limits**

**SUMMARY OF THE PROPOSED RULE**

The proposed rule sets forth the interpretation of the Division of Financial Institutions regarding the applicability of both the state law and the legislative rule on legal lending limits to derivative transactions. It is intended to provide guidance to banks chartered in this State as to the acceptable methods they may use for calculating credit exposure from derivative transactions and restricts use of an internal model method to only those models that have been pre-approved by both the Division and the bank's primary federal regulator. It also clarifies that derivative transactions are financially related activities and, as such, subject to the provisions of the West Virginia bank parity law.

TITLE 106  
INTERPRETIVE RULE  
COMMISSIONER OF FINANCIAL INSTITUTIONS  
WEST VIRGINIA  
SECRETARY OF STATE

SERIES 20  
TREATMENT OF DERIVATIVE TRANSACTIONS UNDER  
LEGAL LENDING LIMITS

**§106-20-1. General.**

1.1 Scope. -- This rule provides guidance to West Virginia state-chartered banking institutions as to how the Division of Financial Institutions will treat derivative transactions under the legal lending limits set forth by W.Va. Code §31A-4-26(a) and the legislative rule pertaining to the legal lending limit, Title 106, Series 9.

1.2 Authority. -- W.Va. Code §31A-2-4(c)(11)

1.3 Filing Date. --

1.4 Effective Date. --

**§106-20-2. Definitions.**

2.1 "Bank" means a federally insured depository institution chartered under the laws of West Virginia.

2.2 "Derivative transaction" means an obligation, created by 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.

2.3 "Loans and extensions of credit" are defined in the state law with respect to legal lending limits, at W.Va. Code §31A-4-26(a)(3), as "all direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person and to the extent specified by the Commissioner of Banking, the terms also include any liability of a state-chartered banking institution to advance funds to or on behalf of a person pursuant to a contractual commitment".

2.4 A "Contractual Commitment to Advance Funds" has been defined broadly in the Legislative Rule Pertaining to the Legal Lending Limit, 106 CSR, Series 9, Section 2.1 as "(a) an obligation on the part of the bank to make payments (directly or indirectly) to a designated third party contingent upon a default by the bank's customer in the performance of an obligation under

the terms of that customer's contract with the third party or (b) an obligation to guarantee or stand as surety for the benefit of a third party. The term includes, but is not limited to, 'Standby Letters of Credit', guarantees, puts and other similar arrangements."

2.5 "Credit derivative" means a financial contract executed under standard industry credit derivative documentation that allows one party (the bank or protection purchaser) to transfer the credit risk of one or more exposures (reference exposure) to another party (the protection provider).

2.6 "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 \$1 million created by the derivative transactions covered by the agreement.

### **§106-20-3. Purpose of legal lending limits law and regulations.**

3.1 The purpose of the state legal lending limits law and regulations, W.Va. Code §31A-4-26(a), and 106 CSR Series 9 respectively, is to protect a bank from the credit risks associated with over-exposure to a single person, entity, or affiliated group of persons or entities through loans, extensions of credit, or other contractual commitments or obligations with that person, entity or affiliated group.

### **§106-20-4. Applicability of legal lending limits to derivative transactions.**

4.1 The state legal lending limits law and its applicable regulations apply to derivative transactions entered into by banks because those transactions are obligations that require a bank to commit funds, by contract, agreement, swap or otherwise. Failure to properly limit the use of derivative transactions by a bank would pose a safety and soundness risk to the institution. Therefore, for purposes of the state legal lending limits law and regulations, derivative transactions shall always be included in the calculation of lending limits.

### **§106-20-5. Acceptable methods for calculating credit exposure from derivative transactions.**

5.1 Banks may elect to use one of three methods to calculate their credit exposure for derivative transactions: the Conversion Factor Matrix Method; the Remaining Maturity Method; or an Internal Model Method.

5.2 The Division of Financial Institutions encourages banks to use either the Conversion Factor Matrix Method or the Remaining Maturity Method since they provide a simpler method for calculating credit exposures.

5.3 A bank may only use the Internal Model Method to calculate credit exposure to derivative transactions after obtaining the prior approval to use that model from both its primary federal regulator and the Division of Financial Institutions.

5.4 A bank must declare and document at the origination of a derivative transaction which of the permitted methods it will use to determine potential future exposure of the derivative. The bank may not change the method used to calculate potential future exposure during the life of that derivative. Furthermore, for each type of derivative, a bank must use the same method to calculate potential future exposure for that type.

5.5 If the derivative transaction is a credit derivative and the bank has not established an effective margining arrangement, the bank must calculate its credit exposure to a counterparty by adding the net notional value of all protection purchased from the counterparty on each reference entity.

**§106-20-6. Applicability of the West Virginia bank parity law to derivative transactions.**

6.1 West Virginia Code §31A-8C-1, *et seq.*, allows banks, upon the prior approval of the Commissioner of Financial Institutions, to engage in or offer any “financially related” activities, products or services that are offered or engaged in by national banks, federal thrifts, credit unions, or any state bank chartered in a state other than West Virginia.

6.2 Engaging in a derivative transaction is a “financially related” activity as that term is defined in W.Va. Code §31A-8C-1.

6.3 Banks may engage in derivative transactions using the laws or regulations applicable to national banks, federal thrifts, credit unions or state banks chartered in a state other than West Virginia terms and conditions only if they have obtained the prior approval of the Commissioner of Financial Institutions.

**FISCAL NOTE FOR PROPOSED RULES**

Rule Title: Treatment of Derivative Transactions Under Legal Lending Limits

Type of Rule:  Legislative  Interpretive  Procedural

Agency: W.Va. Division of Financial Institutions

Address: 900 Pennsylvania Ave., Suite 306  
Charleston, WV 25302-3542  
ATTN: Robert J. Lamont

Phone Number: 304.558.2294 Email: blamont@wvdob.org

**Fiscal Note Summary**

Summarize in a clear and concise manner what impact this measure will have on costs and revenues of state government.

This Interpretive Rule will have no impact on either the costs or revenues of state government generally or of the Division of Financial Institutions in particular.

**Fiscal Note Detail**

Show over-all effect in Item 1 and 2 and, in Item 3, give an explanation of Breakdown by fiscal year, including long-range effect.

FISCAL YEAR			
Effect of Proposal	Current Increase/Decrease (use "--")	Next Increase/Decrease (use "--")	Fiscal Year (Upon Full Implementation)
<b>1. Estimated Total Cost</b>	0.00	0.00	0.00
Personal Services	0.00	0.00	0.00
Current Expenses	0.00	0.00	0.00
Repairs & Alterations	0.00	0.00	0.00
Assets	0.00	0.00	0.00
Other	0.00	0.00	0.00
<b>2. Estimated Total Revenues</b>	0.00	0.00	0.00

Rule Title: \_\_\_\_\_

Rule Title: \_\_\_\_\_

**3. Explanation of above estimates (including long-range effect):**

Please include any increase or decrease in fees in your estimated total revenues.

Series 20 is an Interpretive Rule setting forth the formal interpretation of the Division of Financial Institutions that both the state law and the legislative rules relating to legal lending limits are sufficiently broad to permit state chartered institutions to engage in derivative transactions. West Virginia state-chartered banks have engaged in such transactions in the past and the Division anticipates that they will continue to do so in the future. The Division is confident that this Rule will have no impact on revenues.

**MEMORANDUM**

Please identify any areas of vagueness, technical defects, reasons the proposed rule would not have a fiscal impact, and/or any special issues not captured elsewhere on this form.

None.

Date: October 22, 2012

Signature of Agency Head or Authorized Representative

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