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

Form #5

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OFFICE OF WEST VIRGINIA SECRETARY OF STATE

NOTICE OF AGENCY ADOPTION OF A PROCEDURAL OR INTERPRETIVE RULE OR A LEGISLATIVE RULE EXEMPT FROM LEGISLATIVE REVIEW

AGENCY: West Virginia Division of Financial Institutions TITLE NUMBER: 106

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

RULE TYPE: PROCEDURAL _____ INTERPRETIVE X

EXEMPT LEGISLATIVE RULE _____

CITE STATUTE(s) GRANTING EXEMPTION FROM LEGISLATIVE REVIEW

_____

AMENDMENT TO AN EXISTING RULE: YES ____ NO X

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

_____

THE ABOVE RULE IS HEREBY ADOPTED AND FILED WITH THE SECRETARY OF STATE. THE EFFECTIVE DATE OF THIS RULE IS ~~January~~ FEBRUARY 2, 2013

Authorized Signature

106CSR20

TITLE 106
INTERPRETIVE RULE
COMMISSIONER OF FINANCIAL INSTITUTIONS

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. - January 3, 2013

1.4 Effective Date. - February 2, 2013

§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. These methods are interpreted by the Division to be the same as those contained in 12 C.F.R. Part 32.

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 unless it requests and receives prior written permission from the Division.

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.

106CSR20

TITLE 106
INTERPRETIVE RULE
COMMISSIONER OF FINANCIAL INSTITUTIONS

SERIES 20
TREATMENT OF DERIVATIVE TRANSACTIONS UNDER
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December 10, 2012

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West Virginia Division of Financial Institutions
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Charleston, West Virginia 25302-3542

VIA HAND DELIVERY AND E-MAIL

Re: Treatment of Derivative Transactions under Legal Lending Limits

Dear Mr. Lamont:

The Community Bankers of West Virginia and the West Virginia Bankers Association (the "Associations") appreciate the opportunity to comment on the proposed rule submitted by the Division of Financial Institutions relating to the treatment of derivative transactions under the West Virginia legal lending limit statute (the "Proposed Rule").

The Associations and their members support a strong and effective regulatory system, and a fundamental element of that system is appropriately designed rules to limit risk concentrations, including exposures of a bank to a single counterparty in derivative transactions. The Associations acknowledge and appreciate the Division of Financial Institutions efforts to develop a rule that accomplishes this regulatory objective while allowing banks flexibility in implementation. This flexibility not only enables banks to avoid undue regulatory burden by providing optional approaches to calculating credit exposure, it also promotes important safety and soundness principles at West Virginia banks.

Consistent with these goals, the Associations request that the Division of Financial Institutions reconsider the requirement under the Proposed Rule that for each type of derivative, a bank must use the same method to calculate potential future exposure for that type. The Associations believe banks should be permitted to apply different calculation methods based on a particular transaction. For example, legitimate business reasons exist for a bank that enters into a derivative transaction to hedge against interest rate risk to choose among the acceptable methods for calculating risk exposure set forth in the Proposed Rule, including whether the derivative instrument has short or long term features. This added flexibility would be appropriately limited by the requirement that a bank may not change the method used to calculate potential future exposure during the life of a particular derivative. Accordingly, the Associations respectfully request that the last sentence in Section 5.4 be deleted in the final rule.

For these reasons, the Associations support the proposed rule as drafted and will not be submitting substantive comments at this time. Should you have any questions, please do not hesitate to contact me.

Respectfully submitted,

Sandra M. Murphy
Counsel to and on behalf of
West Virginia Bankers Association and
Community Bankers of West Virginia

SMM/jam

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bcc: Donna Tanner
Joe Ellison

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Earl Ray Tomblin
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December 18, 2012

Sandra M. Murphy, Esq.
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Re: Treatment of Derivative Transactions under Legal Lending Limits

Dear Ms. Murphy:

Thank you for your December 10, 2012 comments on behalf of the Community Bankers of West Virginia and the West Virginia Bankers Association (the "Associations") regarding the Division of Financial Institution's proposed Interpretive Rule, Title 106 Series 20, Treatment of Derivative Transactions under Legal Lending Limits. We appreciate your statement that the Associations support the proposed rule as drafted and would have no substantive comments.

Your letter did contain a suggestion that the last sentence of Section 5.4 be deleted. That sentence provides that a bank must use the same method for calculating credit exposure for each type of derivative transaction. The suggestion states that there may be legitimate business reasons for a bank to elect to use one method for valuing one particular derivative transaction that is a hedge against interest rate risk and then decide to use a different method for a subsequent derivative transaction that is also intended to be a hedge against interest rate risk.

The purpose of the last sentence of Section 5.4 was to promote consistency and prevent a bank from "shopping" for the most favorable method to measure exposure. The Division also believes that encouraging a variety of methods to measure credit exposure could complicate the job of our field examiners if exposures for one type of derivative transaction are measured in different ways at different times.

Nevertheless, the Division recognizes that there may be value in providing banks with sufficient flexibility in the conduct of derivative transactions. Therefore, in lieu of removing the last sentence in its entirety, the Division has decided to add a phrase at the end of that sentence which provides an option for a bank to obtain the prior written approval of the Division for using a

different valuation method. We hope that this will provide the flexibility a bank may need when faced with what it believes to be a legitimate business reason to use a different method at a particular time for the same type of derivative.

Sincerely,

Robert J. Lamont
General Counsel

REASONS FOR AMENDMENTS TO INTERPRETIVE RULE TITLE 106 SERIES 20 TREATMENT OF DERIVATIVE TRANSACTIONS UNDER LEGAL LENDING LIMITS

The Division of Financial Institutions made two amendments to its proposed Interpretive Rule, Title 106 CSR Series 20 following the comment period.

The first amendment is at the last sentence of subsection 5.4. The Division added the final phrase which allows a bank to obtain the written permission of the Division to change that bank's method for calculating credit exposure for a particular type of derivative. The Division received only one comment during the comment period. That comment requested that the entire last sentence of subsection 5.4 be deleted so that a bank would have the flexibility to make changes in the methods by which it would calculate credit exposure for derivative types. As outlined in its response to the comment, the Division believes that the change it made affords a bank sufficient flexibility in the event it has a legitimate business reason to use a different method.

The second amendment is at subsection 5.1. On its own initiative, the Division has elected to add the last sentence to that subsection thereby clarifying that the three acceptable methods for calculating credit exposure are to be interpreted as the same as those contained in the Office of the Comptroller of the Currency's rule at 12 C.F.R. Part 32.

Neither of the changes made after the comment period change the nature of the proposed rule or alter the calculations in the Fiscal Note previously filed.