January 11, 2013

TO THE CHIEF EXECUTIVE OFFICER OF THE BANK ADDRESSED

Re: Lending Limits Applicable to Credit Exposure on Derivative Transactions
        Banking Letter #49

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 State bank is chartered takes into consideration credit exposure to derivative transactions."

The Division of Banking has determined that the language in Wisconsin's lending limit statutes, by incorporating the use of the terms "liabilities" and "extension of credit" are broad enough to include derivatives. This interpretation is consistent with the treatment of derivatives in *Banking Letter #48* relating to the pledging of assets.

Under Dodd-Frank, a 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."

Effective January 21, 2013, the Division of Banking will consider the credit exposure of derivative transactions when computing lending limits under the provisions of ss. 214.54 and 221.0320, Wis. Stats.

The potential future credit exposure arising from a derivative transaction shall be determined for legal lending purposes. The potential future credit exposure is calculated using the Remaining Maturity Method.

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 1, below.

Division of Banking

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TABLE 1—REMAINING MATURITY FACTOR FOR CALCULATING CREDIT EXPOSURE

	Interest rate	Foreign exchange rate and gold	Equity	Other[1] (includes commodities and precious metals except gold)
Multiplicative Factor	1.5%	1.5%	6%	6%

EXAMPLE

A bank enters into a five year swap for $10,000,000 on LIBOR on 1/1/20xx, agreeing to pay a floating rate three month LIBOR in exchange for receipt of a 2.00% fixed rate. On 1/1/20xx +3 years the fixed portion of the LIBOR is valued at 0.50% and the bank has a positive market value of $250,000 (the counterparty would owe the bank if the swap was terminated).

The calculation of the future credit exposure would be
$250,000 (market value owed the bank) + ($10,000,000 (notional value) * 2 (remaining maturity in years) * 0.015 (multiplicative factor)) = $550,000 (future credit exposure)

Sincerely,
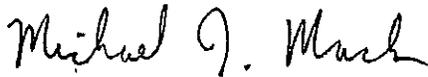
Michael J. Mach
Administrator
Division of Banking

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