ALABAMA STATE BANKING DEPARTMENT **October 19, 2012**

Proposed Regulation No. 14 – Credit Exposure Limits

ACTION: **Notice of Extension of Comment Period on Proposed Rulemaking – Amendments to the Alabama Banking Board Regulation No. 14 – Credit Exposure Limits**

SUMMARY: On August 24, 2012, the Superintendent of Banks solicited comments on proposed amendments to the existing Regulation No. 14 which implements the lending and credit exposure limits contained in §5-5A-22 of the Alabama Banking Code ("§5-5A-22"). Those comments were due on or before October 15, 2012. Many thoughtful and constructive comments were received by the Superintendent during that comment period; however, Superintendent of Banks John D. Harrison wishes to provide interested parties more time in which to submit additional comments on the proposed Regulation No. 14. Consequently, the Superintendent has extended the comment period to November 9, 2012. Additional comments should be submitted on or before November 9, 2012.

The following is a link to the original Notice of Proposed Rulemaking that describes the proposed amendments to Regulation 14 and to a summary of the issues and questions raised during the initial comment period through October 15, 2012:

http://www.banking.alabama.gov/Regulations_Banking_Proposed2.aspx

DATES: Comments must be received on or before November 9, 2012.

ADDRESS: Comments may be submitted through the Alabama Banking Department website at www.banking.alabama.gov. There are links for comments on specific proposed regulations on the home page. Alternatively, comments may be e-mailed directly to comments.reg14@banking.alabama.gov. Comments may also be mailed to John D. Harrison, Superintendent of Banks, State of Alabama, State Banking Department, Post Office Box 4600, Montgomery, AL 36103 or faxed to John D. Harrison, Superintendent of Banks at 334-242-3500.

FOR FURTHER INFORMATION CONTACT: Deputy Superintendent Trabo Reed at 334-242-3452 or by e-mail at Trabo.reed@banking.alabama.gov.

ALABAMA STATE BANKING DEPARTMENT **August 24, 2012**

Proposed Regulation No. 14 – Credit Exposure Limits

ACTION: **Notice of Proposed Rulemaking – Amendments to the Alabama Banking Board Regulation No. 14 – Credit Exposure Limits**

SUMMARY: The Superintendent of Banks solicits comments on proposed amendments to the existing Regulation No. 14 which implements the lending and credit exposure limits contained in §5-5A-22 of the Alabama Banking Code ("§5-5A-22"). Broadly, the proposed amendments:

1. Add, pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the 2011 amendments to §5-5A-22, procedures and methods for calculating the counterparty credit exposure limits related to derivatives and securities financing transactions;
2. Add explicit emphasis that debts of an associated group of borrowers may require aggregation for legal lending limit purposes;
3. Add general guidance and examples on the lending limits and procedures for aggregation of debts for legal lending limit purposes; and
4. Add information on the interaction of the State lending limits with the lending limits for insiders contained in Federal Reserve Board Regulation O.

DATES: Comments must be received on or before October 15, 2012.

ADDRESS: Comments may be submitted through the Alabama Banking Department website at www.banking.alabama.gov. There are links for comments on specific proposed regulations on the home page. Alternatively, comments may be e-mailed directly to comments.reg14@banking.alabama.gov. Comments may also be mailed to John D. Harrison, Superintendent of Banks, State of Alabama, State Banking Department, Post Office Box 4600, Montgomery, AL 36103 or faxed to John D. Harrison, Superintendent of Banks at 334-242-3500.

FOR FURTHER INFORMATION CONTACT: Deputy Superintendent Trabo Reed at 334-242-3452 or by e-mail at Trabo.reed@banking.alabama.gov.

I. Background

Whereas, Section 5-2A-9 of the Alabama Banking Code specifies the procedures for adoption, amendment, or repeal of any regulation promulgated by the Superintendent of Banks, with the concurrence of the State Banking Board, pursuant to Section 5-2A-8; this notice of intended action to amend the Alabama State Banking Department Regulation No. 14 ("Regulation 14") is hereby provided.

The current regulation expands on and offers additional guidance on the lending limits contained in §5-5A-22 of the Alabama Banking Code ("§5-5A-22"). The amendments to the current regulation, generally:

Add, pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and the 2011 amendments to §5-5A-22, procedures and methods for calculating the counterparty credit exposure limits related to derivatives and securities financing transactions;

Add explicit emphasis that debts of an associated group of borrowers may require aggregation for legal lending limit purposes;

Add general guidance and examples on the lending limits and procedures for aggregation of debts for legal lending limit purposes; and

Add information on the interaction of the State lending limits with the lending limits for insiders contained in Federal Reserve Board Regulation O.

<u>Derivatives and Securities Financing Transactions</u>

The amendments to §5-5A-22 dealing with counterparty credit risk limits relating to derivatives and securities financing transactions were required by Dodd-Frank Section 611, CONSISTENT TREATMENT OF DERIVATIVE TRANSACTIONS IN LENDING LIMITS, which states:

'(a) AMENDMENT.—Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) is amended by adding at the end the following:

''(y) STATE LENDING LIMIT TREATMENT OF DERIVATIVES TRANSACTIONS.— An insured State bank may engage in a derivative transaction, as defined in section 5200(b)(3) of the Revised Statutes of the United States (12 U.S.C. 84(b)(3)), only if 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.''.

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect 18 months after the transfer date.'

As a result of this language in Dodd-Frank, amendments were made to §5-5A-22 that were signed into law by Governor Bentley on June 9, 2011, so that Alabama, State-chartered banks could continue to engage in derivative transactions after the date specified in Dodd-Frank.

Without the amendments to §5-5A-22, Alabama, State-chartered banks could not engage in derivative transactions effective January 21, 2013. The proposed amendments to Regulation 14, provide the rules as to how the limits on derivative transactions should be measured. The Superintendent considers it important to provide this extra detail in a revised Regulation 14, to offer clear guidance on the application of the §5-5A-22 limits to derivatives and securities financing transactions in a manner which is reasonably consistent with the rules that have been put forth by the Office of the Comptroller of the Currency ("OCC") for national banks. (See Press Release and Interim Final Rule at http://www.occ.gov/news-issuances/news-releases/2012/nr-occ-2012-92.html.)

Aggregation of Loans and Credit Exposures – Associated Groups of Borrowers

Since Regulation 14 was last amended in 1998, examiners have encountered situations where confusion on the part of bankers about the rules and processes for aggregation of loans has resulted in violations of the Regulation's limits. The proposed Regulation adds clarifying language and examples of situations, based upon real-life situations, to attempt to avoid such confusion about debt aggregation, particularly among groups of associated borrowers. The proposed changes do not alter the existing Regulation's requirements, but add explanation of and put in writing long-held interpretations of the Department as to how the lending limits should be applied. The Superintendent believes that it is important to provide this expanded explanation and clarification of these long-held interpretations in the Regulation itself to serve as guidance to Alabama, State-chartered banks and avoid potential violations in the future.

Interaction of Alabama State Lending Limits and Federal Reserve Board Regulation O Limits

The Superintendent believes that it is important to provide the information on the interaction of State Lending Limits and Federal Reserve Board Regulation O Limits applicable to insider loans. Due to provisions of Regulation O, there has been some confusion as to how these limits interact. By including the information in this Regulation, we are attempting to inform all Alabama, State-chartered banks. Again, the information provided represents a long-held position of this Department in which the Federal Reserve has, in the past, concurred. The Department sought and obtained confirmation of this interpretation from the Federal Reserve as early as April, 2000 and has consistently used this interpretation regarding the interaction of the Limits.

II. Proposed Changes

The following discussion covers what the Department believes are the major, substantive provisions, changes and additions to the Regulation. It does not cover all, word-for-word changes. If a commenter is interested in looking at such word-for-word changes, it is recommended that they obtain a copy of the current Regulation No. 14 at:

http://www.bank.state.al.us/pdfs/Regulations/Banking/Reg_14.pdf

Page 1, Paragraph 3 – Lending Limits - Terminology

In this paragraph, the terminology of the current regulation is changed from dealing solely with loans and borrowers to "loans and credit exposures" as well as "borrowers and counterparties." This is due to the inclusion in the Regulation of credit exposures to counterparties on derivatives and securities financing transactions. These changes in terminology are applied consistently throughout the proposed Regulation.

Page 1, Paragraph 4 – Approval Requirements

This paragraph also makes clear the long-held Department position that any loan or credit exposure which is made to a borrower with debts that exceed, or causes the total debts of a borrower or counterparty to exceed, 10 percent of the total capital base of the bank must receive advance approval by the Board, a committee thereof, or a loan or other committee. The Department has, in the past, encountered confusion among bankers that such approval was required only for individual loans that exceeded 10 percent of the total capital base.

This paragraph makes clear, consistent with the 2011 amendments to §5-5A-22, that advance approval is required. The current Regulation 14 was written before advance approval was required by the Code Section, and this change to the Regulation makes it consistent with the law.

Page 2 – Sections 1-4 - Capital Definition and Calculation, Exposure Limits and Collateralization

The Department does not believe that substantive changes were made to these Sections of the current Regulation.

Page 3 – Section 5 - Exceptions to Limits on Exposure – Bank Deposits

The substantive change to this page, by footnote 2, adds the explanation of the long-held Department position that the amount of loans secured by own-bank deposits may be deducted for lending limit calculations, but loans secured by other-bank deposits may not qualify as an exception.

Page 3 – Section 5 e. - Exceptions to Limits on Exposure – Derivatives and Securities Financing Transactions

This Section specifically excludes credit exposures on derivatives and securities financing transactions from being considered as exceptions to the 20 percent of capital secured lending limit even when such credit exposures are collateralized by cash or cash equivalents.

Page 4 – Section 6 - Footnote 3 – Definition of Affected Personnel

This footnote makes clear that all affected personnel including lenders, loan committee members, and investment personnel and committee members who deal with extensions of credit and their approvals and entering into derivatives positions and securities financing transactions and their approvals must be informed of the lending limits on, at least, a quarterly basis.

Page 4 – Section 8 a. – Loans and Extensions of Credit - Renewals

Footnote 4, to this Section, refers the reader to Appendix 2 for the limits governing insider loans. Emphasis has been added to the definition of “extension of credit” to highlight the inclusion of renewals. The definition of “extension of credit” itself is not changed.

Page 5 – Section 8 b. – Loans and Extensions of Credit - Participations

Language is added to this Section that, if a bank chooses to reduce the aggregate credit exposure to a borrower by entering into an agreement to participate a credit to another bank, it must close and fund the participation on the same business day that the loan is closed. Further, the added language requires that the participation agreement must qualify for sales treatment under FASB Statement No. 166 in order for the participated amount to be deducted for legal lending limit purposes.

Page 5 – Section 8 c. i – Loans and Extensions of Credit – Loans to Borrower's Spouse

This Section is in the current regulation, but only says that for a borrower's spouse's loans to not be aggregated with the borrower's loans, "each spouse has a separate net worth and such net worth of each is not dependent on decisions made or actions taken by the other." The changes to this wording make clear the long-held Department position that, to avoid aggregation of the debts, each spouse must have a separate net worth and repayment capacity, and the loans were not made for the direct benefit of the other spouse.

Page 5 – Section 8 c. ii – Loans and Extensions of Credit – Aggregation of Loans to Associates or Controlled Companies

Through the proposed Regulation, a substantive change is made to the current Regulation which in its 1998 adoption contained a dropped word that caused some confusion in interpretation of this Section. The Department has long maintained the position reflected in the proposed Regulation. The current Regulation states: "Loans made to or for the tangible economic benefit of a borrower and the borrower's associates or controlled companies which are substantially dependent upon the same source for repayment or which were made for the same ultimate purpose will be aggregated and treated as one loan for legal lending limit purposes." The proposed regulation adds a missing "or" after controlled companies so that this Section now reads: "Loans made to or for the tangible economic benefit of a borrower and the borrower's associates or controlled companies or which are substantially dependent upon the same source for repayment or which were made for the same ultimate purpose will be aggregated and treated as one loan for legal lending limit purposes." This eliminates the confusion where tangible economic benefit was required in all cases for aggregation. It makes clear that aggregation will occur when there is tangible economic benefit or dependence on the same repayment source or common purpose of the loans.

Page 6 – Section 8 c. iii. - viii. – Loans and Extensions of Credit

The Department does not believe that substantive changes were made to these Sections of the current Regulation.

Page 6 – Section 9 – Credit Exposure from Derivatives and Securities Financing Transactions

This entire Section 9 and related appendices are added as a result of requirements of Dodd-Frank that States must consider these credit exposures in their lending limits in order for their banks to engage in such transactions effective January 21, 2013. As noted previously, §5-5A-22 of the Alabama Banking Code (which this Regulation implements) was amended in 2011 to comply with this Dodd-Frank requirement. The changes made to §5-5A-22 included the definitions of derivatives and securities financing transactions that were contained in Section 610 of Dodd-Frank. Consequently, the proposed changes to Regulation 14, use the same definitions.

Because the definitions adopted for "derivative transactions" in the 2011 amendments to §5-5A-22, mirror the definitions specified in Section 610 of Dodd-Frank; transactions engaged in by community banks, such as interest rate hedges and swaps, will be impacted by the proposed changes to Regulation 14 along with the more complex derivative transactions that may be engaged in by the largest, Alabama, State-chartered banks.

Page 7 – Section 9 a. – Credit Exposure from Derivatives and Securities Financing Transactions – Non-Credit Derivative Transactions

The procedures for calculating the aggregate credit exposure from derivatives and securities financing transactions are divided into three broad categories in the proposed Regulation: a. Credit exposure arising from non-credit derivative transactions and b. Credit Derivatives, and c. Securities Financing Transactions. Calculation of credit exposures arising from non-credit derivative transactions are covered in Section 9 a.

Non-credit derivative transactions may include items such as: forward, futures, options, warrants, swaps, caps, or floors which are not based upon the occurrence of any credit event such as a default or downgrade and which are not intended as a hedge or insurance against credit risk.

The counterparty credit exposure from non-credit derivative transactions may be measured for specific types of non-credit derivatives by using one of three methods: an internal model method, a conversion factor matrix method, or a remaining maturity method. These methods generally correspond to methods allowed under the rules established for national banks by the OCC. It is assumed that larger banks may be willing and able to devote the expertise, time and resources into maintaining approved, internal models for measuring credit exposures, but the internal model method is available under the proposed Regulation to all banks willing to do so. Alternatively, the conversion factor matrix and remaining maturity methods are allowed for any bank wishing to use a simpler method for calculating credit exposures.

<u>Page 7 – Section 9 a. i. – Credit Exposure from Derivatives and Securities Financing Transactions – Non-Credit Derivative Transactions – Internal Model Method</u>

This Section specifies the manner in which current, potential future, and net credit exposures on non-credit derivatives may be calculated using an internal model. This Section requires that, before any internal model is used by a bank, the bank must receive prior approval from the Superintendent of Banks <u>and</u> the bank's primary federal regulator. This Section also specifies under what circumstances a bank using an internal model method may consider its credit exposure secured. Generally, the position will only be considered secured when the bank receives cash or cash equivalents, and the bank maintains control over the collateral.

<u>Page 7 – Section 9 a. ii. – Credit Exposure from Derivatives and Securities Financing Transactions – Non-Credit Derivative Transactions – Conversion Factor Matrix Method</u>

This Section states that a bank calculating credit exposure using the Conversion Factor Matrix Method shall, at execution of the derivative transaction, calculate the credit exposure as the potential future credit exposure using the Conversion Factor Matrix contained in Appendix 3 of the proposed Regulation. The potential future exposure will be the notional value at origination multiplied by the conversion factor from the Appendix 3 matrix.

<u>Page 8 – Section 9 a. iii. – Credit Exposure from Derivatives and Securities Financing Transactions – Non-Credit Derivative Transactions – Remaining Maturity Method</u>

This Section states that a bank calculating credit exposure using the Remaining Maturity Method shall calculate the exposure as the greater of zero <u>or</u> the current mark-to-market value <u>plus</u> the product of: the notional amount of the transaction, the remaining maturity of the transaction in years, and the appropriate fixed multiplier factor from the table located in Appendix 4 of the proposed Regulation.

Page 8 – Section 9 a. iv. – Credit Exposure from Derivatives and Securities Financing Transactions – Non-Credit Derivative Transactions – Unsecured Status

This Section states that banks electing to use the Conversion Factor Matrix Method or the Remaining Maturity Method for calculating their credit exposures on non-credit derivative transactions must consider their exposures to be unsecured for purposes of the limits of the proposed Regulation.

Page 8 – Section 9 a. v. – Credit Exposure from Derivatives and Securities Financing Transactions – Non-Credit Derivative Transactions – Election of Method

This Section requires banks to declare and document their election of method of measuring credit exposure at the origination of a non-credit derivative transaction. It prohibits a bank from changing its method of calculating credit exposure during the life of the derivative. The proposed Section also requires banks to use the same method for calculating credit exposures for all derivatives of a given type. It should be noted that "type" as intended in the proposed Regulation refers to broad types or categories of derivative transactions such as interest rate swaps or hedges. It does not, for example, refer to transactions having differing specific terms such as swaps with differing indices. Once a method has been elected for a given type of derivative, a bank must obtain the written approval of the Superintendent to change the method used for that derivative type.

Page 8 – Section 9 b. – Credit Exposure from Derivatives and Securities Financing Transactions – Credit Derivatives

Credit derivatives, including items such as credit default swaps, are derivatives based upon the occurrence of any credit event such as a default or downgrade or are derivatives intended as a hedge or insurance against credit risk.

This Section requires the credit exposure on credit derivatives to be calculated as the notional value of protection sold on a reference entity <u>less</u> the amount of any <u>eligible</u> credit derivative purchased on the reference entity from an <u>Eligible Protection Provider</u>.

Eligible Protection Providers are defined in Section 9 b. i. The definitions of Eligible Protection Providers generally correspond to those maintained by the OCC for national banks; however, it should be noted that in the proposed Regulation's reference to sovereign entities, in Section 9 b. i. 1., a qualification is included that obligations of the sovereign entity must be considered investment quality. It appears that no such qualification exists in the OCC definitions.

<u>Page 9 – Section 9 c. – Credit Exposure from Derivatives and Securities Financing Transactions – Securities Financing Transactions</u>

Securities financing transactions include transactions such as repurchase and reverse repurchase agreements and securities lending and borrowing transactions. For measuring credit exposure for the credit exposure limits on securities financing transactions, banks may elect to use an internal model method or one of the non-model methods for specific types of transactions. A bank may not elect to use the internal model method for some types of securities financing transactions and one of the non-model methods for other types of transactions.

<u>Page 9 – Section 9 c. 1. – Credit Exposure from Derivatives and Securities Financing Transactions – Securities Financing Transactions – Internal Model Method</u>

To use the internal model method, a bank must receive the prior written approval of the Superintendent and its primary federal regulator.

<u>Pages 9 and 10 – Section 9 c. 2. – Credit Exposure from Derivatives and Securities Financing Transactions – Securities Financing Transactions – Non-Model Methods</u>

Non-model methods of calculating credit exposures are specified for the following specific types of securities financing transactions: repurchase agreements, securities lending, reverse repurchase agreements, and securities borrowing transactions. For securities lending and borrowing transactions that are non-cash collateral transactions, the credit exposures must be calculated by reference to collateral haircuts contained in Appendix 5 of the proposed Regulation.

Page 10 – Section 9 c. 3. – Credit Exposure from Derivatives and Securities Financing Transactions – Securities Financing Transactions – Collateralization

This Section states that only securities financing transactions that are secured by cash or cash equivalents over which the bank maintains control may be considered to be secured for purposes of the credit exposure limits of the proposed Regulation.

Page 10 – Section 9 c. 4. – Credit Exposure from Derivatives and Securities Financing Transactions – Securities Financing Transactions – Election of Methods

This Section requires banks to declare and document at origination of a securities financing transaction which method (internal model or non-model) it will use. The method elected at origination must be used for the life of a specific securities financing transaction.

Pages 11-18 – Appendix 1 – Guidance and Examples of Application of Legal Lending Limits – Examples 1-7

Guidance and examples are provided, based on real-life situations where the Department's examiners have encountered confusion, concerning instances where debts should be aggregated for purposes of the lending limits. No new aggregation rules are provided in the examples which merely illustrate long-held interpretations of the Department.

Pages 19-20 - Appendix 2 – Calculation of Lending Limits for Insider Loans: State Banking Board Regulation 14 and Federal Reserve Board Regulation O

As noted previously, the information contained in this appendix represents no new position of the Department. It is provided in the proposed Regulation to make the information available to all Alabama, State-chartered banks on the long-held Department position regarding the interaction of the State and federal regulations.

Pages 21-23 - Appendices 3, 4, and 5 – Conversion Factor Matrix, Remaining Maturity Factor and Collateral Haircuts

Each of these appendices are referred to in Section 9 of the proposed Regulation for banks electing to use different methods of calculating credit exposures on derivatives and securities financing transactions.

III. Effective Date

The proposed changes to Regulation No. 14 shall become effective January 1, 2013. Prior to such changes becoming effective, however, the Superintendent shall have fully considered all comments received on or before October 15, 2012, and obtained the concurrence of the Alabama State Banking Board.

Proposed Regulation No. 14
Credit Exposure Limits

WHEREAS, Section 5-2A-8 of the Alabama Banking Code provides that the Superintendent of Banks may, with the concurrence of a majority of the members of the State Banking Board, promulgate reasonable rules and regulations,

AND WHEREAS, The Superintendent of Banks, with the concurrence of a majority of the members of the State Banking Board, recognizes the need and desirability for rules and regulations pertaining to maximum legal lending limits allowable under Section 5-5A-22 of the Alabama Banking Code,

NOW THEREFORE, be it known that the Superintendent, with the concurrence of the State Banking Board, does hereby promulgate the following regulation. Section 5-5A-22 of the Alabama Banking Code prohibits banks from making loans and having credit exposures to any one borrower or counterparty which, when combined with all other loans and credit exposures to such borrower or counterparty, would cause total loans and credit exposures to that borrower or counterparty to exceed:

> Ten percent of the capital base of the bank, if such loans and credit exposures are unsecured, or
>
> Twenty percent of the capital base of the bank if loans and credit exposures in excess of 10 percent of capital are fully secured.

Section 5-5A-22 further requires that all loans and credit exposures to a borrower or counterparty whose total loans and credit exposures exceed or, by virtue of the entering into the loan or credit exposure, would exceed 10 percent of the capital base of the bank be approved in advance by the bank's board of directors, a committee of the board of directors, or a loan, investment, or other committee. Such approval must be recorded in the minutes of the board or committee. If such loans and credit exposures are approved by a committee, the committee must have at least three (3) members to be considered valid for this purpose. Whenever a loan officer, committee member, or committee learns that a loan or loans or credit exposures have been made in excess of the Section 5-5A-22 limits, the officer, committee member, or committee must report the violation to the full board at the next regularly scheduled board meeting. Upon the Superintendent learning through an examination that loans or credit exposures have been made in excess of the Section 5-5A-22 limits, he or she may require the bank to adopt such approval practices as he or she deems necessary to prevent future violations of the limits. Failure of the bank to implement such required approval practices will be deemed a violation of this regulation.

This regulation must be applied in conjunction with (not in place of) the provisions of Section 5-5A-22.

1) **DEFINITION OF CAPITAL** - The total capital base for lending limits contained in §5-5A-22 of the Alabama Banking Code includes: capital stock, surplus, undivided profits, subordinated capital notes or debentures, and the allowance for loan and lease losses. Reserves for contingencies that are not set aside to cover any specific expected losses may also be included. Specific contingency reserves and unrealized gains or losses on debt securities available for sale are not to be included.

2) **CALCULATION OF CAPITAL** - The total capital base for computing the maximum lending limit shall be the amounts shown for capital stock, surplus, undivided profits, subordinated capital notes and debentures, and the allowance for loan and lease losses reflected on the bank's most recent quarterly Report of Condition (Call Report). Specific contingency reserves and unrealized gains or losses on debt securities available for sale are not to be included.

3) **LIMITS ON EXPOSURE** - If any loan, credit exposure, or aggregate of loans and credit exposures exceeds 10 percent of the total capital base, such excess must be fully secured by good collateral or other ample security. All subsequent loans and credit exposures shall likewise be fully secured by good collateral or other ample security. A maximum of 20 percent of the total capital base may be loaned or extended (exposed) to one individual borrower or counterparty or one associated group of borrowers or counterparties where all in excess of 10 percent is fully secured as defined above[1].

4) **COLLATERIZATION OF EXPOSURE** - A loan or credit exposure may be purported to be secured but, for lending limit purposes, may, in the opinion of the Superintendent, be considered unsecured. Such a case could come about where the stated collateral is so poor as to have little value, where the lien on the collateral is not perfected within a reasonable time, or where a combination of factors including, but not limited to, missing documentation of the bank's lien position, amount of collateral, location of collateral, or condition of collateral casts substantial doubt on the collateral's existence or value. In such cases, the Superintendent shall provide the bank a period of time, determined by the Superintendent, to correct the documentation deficiencies, prove the value of the

[1] Rules for aggregation of loans and credit exposures for individuals, groups of associated individuals, and their related entities per this regulation and §5-5A-22 must be followed when applying the limits on credit exposure.

collateral, obtain additional collateral, or otherwise correct the violation before imposing the penalties prescribed by §5-5A-22.

5) **EXCEPTIONS TO LIMITS ON EXPOSURE** - There are certain instances when loans or credit exposures to one borrower or counterparty or one associated group of borrowers or counterparties may exceed 20 percent of the total capital base. Exceptions provided for in this regulation are in addition to the exceptions specified by §5-5A-22(d)(1)-(4). The exceptions detailed here are granted pursuant to §5-5A-22(d)(5) that lists as exceptions "such other loans, liabilities or transactions as shall from time to time be established by regulations of the State Banking Department." Such exceptions are primarily dependent on the loans' collateral and the controls over that collateral. There would be such a large number of different types of collateral that it would be impossible to list them all. The following requirements, however, have to be met for any such loan or credit exposure to conform to this section and be considered an exception:
    a. The collateral must be cash or equivalent to cash or have a readily established market value and be a product for which there is a ready sale in the open market. There must be no question regarding the market value. If the condition or grade of the collateral is questionable, it will not be acceptable as collateral in this instance.
    b. The collateral must be assigned to the bank in such a manner that in the event of default the bank can take possession and title at its discretion. Also, the collateral must be in possession of or under absolute control of the bank at all times[2].
    c. In the event that the market value of the collateral declines, additional collateral must be provided immediately or the loan reduced appropriately so that, at all times, the loans are fully secured with the market value of collateral at least equal to the amount of the loan or credit exposure.
    d. Such loans or credit exposures must be approved in advance by the bank's board of directors, a committee of the board of directors, or a loan, investment, or other committee. Such approval must be recorded in the minutes of the board or committee.
    e. Credit exposures on derivatives and securities financing transactions, however, do not qualify as exceptions to exceed the twenty percent limit on secured transactions even with cash or cash equivalent collateral.

[2] In the case of loans secured by pledged certificates of deposit or other cash deposits qualifying as deductions or exceptions to the amount of loans aggregated for lending limit purposes, to be considered under the absolute control of the lending bank at all times, such deposits must be in the lending bank. Pledged deposits in a bank other than the lending bank are not considered to be under the absolute control of the lending bank, and the loans to which such other bank deposits are pledged are not excluded from the lending limit calculations.

6) **REPORTING OF LIMITS ON EXPOSURE** - Management of the bank is responsible for providing the secured and unsecured lending limits to the board of directors (and/or committee responsible for approving loans and credit exposures to a borrower or counterparty whose total loans and credit exposures exceed or, by virtue of the entering into the loan or credit exposure, would exceed 10 percent of the total capital base of the bank). At a minimum, the limits should be reported to the board or committee quarterly at the first meeting following the due date for submission of the bank's call report. A notation of the lending limits should be entered in the minutes of the board or committee at which they are reported or otherwise documented in a manner satisfactory to the Superintendent. Management is also responsible for informing all personnel[3] affected by the lending limits.

7) **RESPONSIBILITY OF DIRECTORS, MANAGEMENT, AND OFFICERS** - Management's responsibility to inform the board and affected personnel does not, however, relieve directors and officers of their duty to ascertain the limits prior to making loans or creating credit exposure from derivatives, securities financing, or other transactions.

8) LOANS AND EXTENSIONS OF CREDIT

a. For legal lending purposes, the definition of a loan shall be the same as the definition of an extension of credit contained in §215.3 of Federal Reserve Board Regulation O[4]. This definition includes, but is not limited to:
    i. An advance by means of an overdraft, cash item, or otherwise,
    ii. Issuance of a standby letter of credit (or similar arrangement regardless of name or description),
    iii. Granting (by an executed note or written, loan agreement) of a line of credit, draw note, or other commitment on the part of a bank to extend credit,
    iv. Making a direct loan or acceptance of paper sold under guaranty, repurchase agreement, or other recourse arrangement,
    v. **Making or renewal** of any loan, line of credit, or extension of credit.

b. The amount of the loan for the purpose of legal lending limits shall be the principal balance of the loan (or the total amount of a line of credit, draw note,

[3] Affected personnel includes all loan officers and committee members responsible for approving extensions of credit as well as all investment personnel and committee members responsible for approving the entering into of derivative positions and transactions.

[4] Lending limits do not by themselves govern limits on extending credit to insiders, directors, or executive officers. Refer to Appendix 2 for the interaction between State Banking Board Regulation 14 and Federal Reserve Board Regulation 0.

or other commitment) including any fees and charges added to the principal balance of the loan, but shall not include interest collected and not earned that is added to the loan or interest accrued and not collected that is not added to the loan. Interest capitalized by adding back to the note shall be included. If a bank chooses to participate all or part of a loan to another bank to comply with lending limits, the participation documents must be executed on the same business day as the loan documents in order for the full amount of the loan to not be considered for lending limits. Furthermore, if the terms of the participation agreement fail to qualify for sales treatment as defined by FASB Statement No. 166, Accounting for Transfers of Financial Assets, the total amount of the loan should be included when determining compliance with lending limits. For a line of credit, draw note, or other commitment on the part of the bank to extend credit, the total amount of such line including the maximum amount drawn and available to be drawn shall be included.

c. The purpose of statutory loan limits is to prevent one borrower or a relatively small and economically related group from borrowing an unduly large portion of the bank's capital. In order to have diversification by spreading loans out among a relatively large number of creditworthy borrowers who are not economically related, all direct or indirect loans to borrowers, their partnerships, firms, limited liability companies, corporations, or unincorporated associations must be aggregated and regarded as single loans. The procedures to be used in determining which loans to aggregate shall include the following:
    i. Direct or indirect loans to a borrower's spouse will be aggregated and treated as one loan to the borrower unless the lender can prove to the satisfaction of the Superintendent that each spouse has a separate net worth and repayment capacity and such net worth and repayment capacity of each is not dependent on decisions made or actions taken by the other and such loans were not made for the direct benefit of the other spouse.
    ii. Loans made to or for the tangible economic benefit of a borrower and the borrower's associates or controlled companies or which are substantially dependent upon the same source for repayment or which were made for the same ultimate purpose will be aggregated and treated as one loan for legal lending limit purposes.
        1. Associates means members of a partnership or unincorporated group of individuals or companies allied to own or control business ventures or entities.

2. Controlled company means one which a borrower or associated group of borrowers directly or indirectly through immediate family members or associates effectively manages or controls.

iii. If an individual borrower owns 35 percent or more of a corporation or limited liability company by stock ownership or otherwise, the direct or indirect loans to this company and to the borrower would be treated as one loan to the borrower.

iv. If an individual borrower owns less than 35 percent of a corporation or limited liability company, the direct or indirect loans to the company and to the borrower will be aggregated and treated as one loan to the borrower to the extent that the borrower guarantees or is otherwise legally liable for the loans to the company.

v. If an individual borrower owns less than 35 percent of a corporation or limited liability company, but in the opinion of the Superintendent effectively manages the company, and the borrower's presence or managerial ability are vitally necessary for the continued successful operation of the company, then direct or indirect loans to the company would be aggregated with direct or indirect loans to the borrower.

vi. If an individual borrower is a general partner, the direct and indirect loans to the partnership and to the general partner will be aggregated and treated as one loan to the general partner.

vii. If an individual borrower is a limited partner, the direct and indirect loans to the partnership and to the limited partner will be aggregated and treated as one loan to the limited partner to the extent that the limited partner guarantees or is otherwise legally liable for the loans to the partnership.

viii. When, in the opinion of the Superintendent, an individual borrower or company or an associated group of borrowers appears to be fully responsible for the debt service on paper that is purported to be "without recourse" through the practice of paying off delinquent paper or other indications of responsibility, then the amount of such paper will be aggregated and treated as one loan to the individual or company.

9) **CREDIT EXPOSURE FROM DERIVATIVES AND SECURITIES FINANCING TRANSACTIONS** - For legal lending purposes, all credit exposures to a person or counterparty arising from extensions of credit, a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction between the bank and the person or counterparty

shall be aggregated. The term derivative transaction shall include any transaction that is a contract, agreement, swap, cap, floor, future, forward, 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, and that are either over-the-counter (OTC) or settled through a Centralized Clearing House.

a. Credit exposure arising from non-credit derivative transactions
    i. Internal Model Method – The credit exposure of a derivative transaction under the internal model method shall equal the sum of the current credit exposure of the derivative transaction and the potential future credit exposure of the derivative transaction.
        1. Calculation of current credit exposure – A bank shall determine its current credit exposure by the mark-to-market value of the derivative contract. If the mark-to-market value is positive, then the current credit exposure equals that mark-to-market value. If the mark-to-market value is zero or negative, then the current credit exposure is zero.
        2. Calculation of potential future credit exposure – A bank shall calculate its potential future credit exposure by using an internal model. To use the internal model method, the bank must receive prior written approval from the Superintendent of Banks and its primary Federal regulator.
        3. Net Credit Exposure – A bank that calculates its credit exposure by using the Internal Model Method pursuant to this paragraph may net credit exposures bilaterally of derivative transactions arising under the same qualifying master netting agreement contained in industry standard contracts.
        4. Collateralization – A bank that calculates its credit exposure by using the Internal Model Method pursuant to this paragraph may consider their derivative positions collateralized if the bank receives cash or cash equivalents, and if the bank maintains control over the collateral.
    ii. Conversion Factor Matrix Method – The credit exposure arising from a derivative transaction under the Conversion Factor Matrix Model 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 the Conversion Factor Matrix located in Appendix 3.

Potential future exposure is equal to the notional value at origination multiplied by the Conversion Factor.

iii. 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 the Remaining Maturity Factor table located in Appendix 4.

iv. Banks that elect to calculate their potential future exposures using the Conversion Factor Matrix Method and the Remaining Maturity Method shall consider their exposures unsecured for legal lending limits.

v. A bank must declare and document at the origination of a derivative which of the permitted methods it shall use to determine potential future exposure of the derivative. The bank shall not change the method used to calculate potential future exposure during the life of the derivative. Furthermore, for each type of derivative, a bank must use the same method to calculate potential future exposure for that type. A bank must receive prior written approval of the Superintendent of Banks before changing the method used to calculate potential future exposure for a type of derivative. Once a derivative has been purchased, the method used to calculate the potential future exposure shall not change.

b. Credit Derivatives – A bank shall calculate the credit exposure to a reference entity arising from credit derivatives entered by the bank by adding the notional value of all protection sold on the reference entity. The bank 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.

i. An Eligible Protection Provider means:

1. A sovereign entity whose debt or other obligations are considered to be investment quality per Alabama State Banking Board Regulation No. 1 – Investment Securities (a central government, including the U.S. government; an agency; department; ministry; or central bank);
2. The Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, or a multilateral development bank;
3. A Federal Home Loan Bank;
4. The Federal Agricultural Mortgage Corporation;

5. A qualified central counterparty or clearing house.

c. Securities Financing Transactions – A bank shall calculate the credit exposure arising from a securities financing transaction by one of the following methods. A bank shall use the same method for calculating credit exposure arising from all of its securities financing transactions.

    1. Internal Model Method – A bank shall calculate its potential future credit exposure by using an internal model. To use the internal model method, the bank must receive prior written approval from the Superintendent of Banks and its primary Federal regulator.
    2. Non-Model Method – A bank may calculate the credit exposure of a securities financing transaction as follows:
        a. Repurchase Agreement – The credit exposure arising from a repurchase agreement shall equal and remain fixed at the market value at the execution of the transaction of the securities transferred to the other party less cash received.
        b. Securities Lending
            i. Cash Collateral Transactions – The 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 the securities transferred less cash received.
            ii. Non-Cash Collateral Transactions – The credit exposure arising from a securities lending transaction where the collateral is other securities shall equal and remain fixed as the product of the higher of the two haircuts associated with the two securities, as determined by the table of collateral haircuts located in Appendix 5, and the higher of the two par values.
        c. Reverse Repurchase Agreements – The credit exposure arising from a reverse repurchase agreement shall equal and remain fixed as the product of the haircut associated with the collateral received, as determined by the table of collateral haircuts located in Appendix 5, and the amount of cash transferred.

d. Securities Borrowing
    i. Cash Collateral Transactions – The credit exposure arising from a securities borrowed transaction where the collateral is cash shall equal and remain fixed as the product of the haircut on the collateral received, as determined by the table of collateral haircuts located in Appendix 5, and the amount of cash transferred to the other party.
    ii. Non-Cash Collateral Transactions – The credit exposure arising from a securities borrowed transaction where the collateral is other securities shall equal and remain fixed as the product of the higher of the two haircuts associated with the two securities, as determined by the table of collateral haircuts located in Appendix 5, and the higher of the two par values of the securities.

3. Securities Financing Transactions, which are collateralized with cash or cash equivalents, shall consider the potential future exposures secured for legal lending limit purposes if the bank has control of the collateral.
4. A bank must declare and document at the origination of a securities financing transaction which of the permitted methods it shall use to determine potential future exposure of the transaction. The bank shall not change the method used to calculate potential future exposure during the life of the transaction.

This regulation is proposed to be effective January 1, 2013.

Appendix 1 – Guidance and Examples of Application of Legal Lending Limits

General Guidance on Credit Exposure Limits and Debt Aggregation

As stated in this Regulation, the purpose of statutory loan limits is to prevent one borrower or a relatively small and economically related group from borrowing an unduly large portion of the bank's capital. Legal limits on credit exposures are in place for the worst-case scenario of default to prevent losses to one borrower and their related interests or group of associated borrowers from putting banks in unsafe and unsound conditions through loss of capital. Consequently, when banks determine concentrations of credit risk and aggregation of credit exposures for legal limit purposes, the banks should start from the perspective of asking: Are the credit exposures so related that they would all be impaired or in default in the event of a default on one or more of the other loans or exposures? Generally, the Alabama State Banking Department has followed the principal that if a borrower, related entities, or group of borrowers made the decision to borrow a large portion of the capital of a bank, they will also together control the decision whether the related loans are repaid or are defaulted upon through diversion of cash flows.

This Regulation and Alabama Banking Code §5-5A-22 require diversification of credit risk through banks spreading loans out among a relatively large number of creditworthy borrowers who are not economically related. The Code section and this Regulation require procedures and processes where all direct or indirect loans to borrowers, their partnerships, firms, limited liability companies, corporations, or unincorporated associations must be aggregated and regarded as single loans. This Regulation focuses on individual borrowers, their related companies, and associated groups of individual borrowers and their related companies.

There are rules in place in this Regulation dealing with aggregation of debts to individual borrowers and groups of associated borrowers. Some of the rules, dealing with percentage ownership of businesses, guarantees, and liability of partners deal with principles of legal liability for debts. An analysis of aggregation of debts cannot stop there. This regulation requires that banks also look at additional factors such as:

1. What borrowers, groups of borrowers, or entities would benefit from the extension of credit? Common benefit requires aggregation.
2. What borrowers, groups of borrowers or entities are responsible for repayment or serve as the repayment source for the extension of credit? Common repayment sources or responsibility requires aggregation.
3. For what purpose were loans to borrowers, groups of borrowers, or entities made? Common purpose requires aggregation.
4. Is there common control among borrowers, groups of borrowers, or entities? Common control requires aggregation.

Examples

The following examples illustrate many of the points above and particular provisions of this regulation and §5-5A-22. These examples are provided for illustrative purposes only and are designed to recreate common misinterpretations by bank management of when loans should be aggregated for State lending limit purposes.

EXAMPLE 1 – Definition of a Loan, Standby Letters of Credit (Sections 8.a., 8.c.iii., 8.c.iv.)

As of December 31, 2011, Bank A had advanced $2,500,000 in outstanding indebtedness to Corporation A in the form of a $2,200,000 commercial real estate loan secured by a first real estate mortgage on 50 residential lots with a market value of $3,000,000; and two outstanding unsecured, standby letters of credit issued on behalf of Corporation A totaling $300,000. On January 31, 2012, Bank A made a $700,000 loan to Borrower B to purchase a vacation home. The loan is secured by a first real estate mortgage on the vacation home which has a current market value of $1,000,000. Borrower B owns 100% of the common stock of Corporation A and provides an unlimited continuing guaranty on the existing $2,500,000 of indebtedness previously advanced. On January 31, 2012, the secured (20 percent) State lending limit was calculated at $3,000,000 based on the most recent quarterly Report of Condition (Call Report).

As a result of the $700,000 loan advanced to Borrower B, the aggregate indebtedness of Borrower B totaled $3,200,000, and exceeded the $3,000,000 secured lending limit based on Regulation 14 definitions and aggregation requirements. Regulation 14 states, in part, that if a borrower owns 35% or more of a corporation or limited liability company by stock ownership or otherwise, the direct or indirect loans to this company and to the borrower would be treated as one loan to the borrower. Also, the definition of a loan includes the issuance of standby letters of credit. In this example, Bank A failed to aggregate the two standby letters of credit outstanding when calculating the secured State lending limits. Therefore, the $700,000 loan to Borrower B was made in violation of State lending limits.

EXAMPLE 2 – Execution of Participations, Amount of Loan (Section 8.b.)

On October 30, 2011, Bank A extended a $5,000,000 closed-end acquisition and construction loan, to be fully funded through draws during construction phase, to Limited Liability Company A to purchase land and construct a hotel and related amenities. Collateral for the loan consists of a first real estate mortgage and security agreement on the land and proposed hotel, amenities, and personal property with an "as completed" market value of $7,500,000. Bank A's secured State lending limit was $4,000,000 based on calculations using the most recent quarterly Call Report. A review of internal loan approval documents indicated that Bank A had an informal agreement with Participant Bank B to fund all advances after Bank A's drawn or funded loan balance reached $3,500,000 up to a maximum amount of $1,500,000; however, a formal, executed Participation Agreement was not entered into between Bank A and Participant Bank B until June 30, 2012. Regulation 14 states, in part, that for a line of credit, draw note, or other commitment on the part of the bank to extend credit, the total amount of such line including the maximum amount drawn and available to be drawn shall be included. Since the total loan commitment of $5,000,000 to Limited Liability Company A exceeded Bank A's State lending limit at origination on October 30, 2011, and Bank A failed to simultaneously execute a formal Participation Agreement with Participant Bank B for the overage, the loan was made in violation of State lending limits. Also, as it relates to participation loans, if the terms of the participation agreement fail to qualify for sales treatment as defined by FASB Statement

No. 166, *Accounting for Transfers of Financial Assets*, the total amount of the loan should be included when determining compliance with State lending limits.

EXAMPLE 3 – Collateral Values (Section 4.)

On May 1, 2012, Bank A extended a $1,250,000 term loan to Borrower A secured by an assignment of Borrower A's 50% membership interest in XYZ, LLC. Internal loan approval documents reported a collateral value of $1,500,000 based on 50% of the book value of XYZ, LLC's Members' Capital accounts as of March 31, 2012. Bank A's unsecured (10%) and secured (20%) State lending limits were $1,000,000 and $2,000,000, respectively, based on the most recent quarterly Call Report. Internal loan documents also indicated that XYZ, LLC is a single asset entity formed in 2007 to develop a 40-unit condominium project, and 20-units remained unsold. File information further indicated that a loan secured by the remaining condominium units from Bank B to XYZ, LLC was in default and judicial foreclosure proceedings were pending prior to the May 1, 2012 advance. Given the pending foreclosure of XYZ, LLC's primary assets, the 50% membership interest assigned as collateral appears to have little to no value. For lending limit purposes, the loan is considered unsecured and, therefore, exceeded the unsecured State lending limit at origination.

Regulation 14 states, in part, that, in such cases, the Superintendent shall provide the bank a period of time, determined by the Superintendent, to prove the value of the collateral, obtain additional collateral, or otherwise correct the violation before imposing the penalties prescribed by §5-5A -22.

EXAMPLE 4 – Common Purpose, Benefit, and Source of Repayment (Section 8.c.ii.)

On April 15, 2011, Bank A granted the renewal of a $2,450,000 acquisition and development loan to Limited Liability Company A for one year with interest payable quarterly and all principal due on April 15, 2012. Collateral consisted of 18 developed residential lots and 20 acres of excess land with a combined "as is" market value of $2,800,000. Bank records indicated that the LLC has four members with each holding a 25% ownership interest in the LLC. Also, each member provides a limited guaranty of $750,000 for the loan. An internal guarantor analysis indicated that the guarantors have minimal capacity to repay the loan from personal resources.

On September 1, 2011, Bank A made an unsecured, $150,000 single payment loan to Limited Liability Company B for working capital purposes. The primary source of repayment is excess proceeds from the sale of the real estate securing the loan to Limited Liability Company A above. Limited Liability Company B consists of the same members and ownership interests as outlined above for Limited Liability Company A, and each member provides a limited guaranty of $50,000. As of September 1, 2011, the secured State lending limit was $2,500,000 based on the most recent quarterly Call Report. Based on internal loan approval documents, the loans to Limited Liability Company A and B (totaling $2,600,000) were not aggregated by Bank A for State lending limit purposes. However, bank records indicated that the $150,000 in loan proceeds to Limited Liability Company B were used to make delinquent interest payments on the $2,450,000 loan to Limited Liability Company A and to pay-off mechanic liens attached to the underlying real estate.

For State lending limit purposes, the two loans should be aggregated as the $150,000 loan to Limited Liability Company B was made for the tangible economic benefit of Limited Liability Company A and its common members and is substantially dependent upon the same source of repayment. Therefore, the $150,000 loan to Limited Liability Company B was made in violation of State lending limits. Regulation 14 states, in part, that loans made to or for the tangible economic benefit of a borrower and the borrower's associates or controlled companies or which are substantially dependent upon the same source for repayment or which were made for the same ultimate purpose will be aggregated and treated as one loan for legal lending limit purposes.

<u>EXAMPLE 5 – Renewal and Additional Advance (Section 8.a.v.); Declining Capital Base (Section 2.); Responsibility for Informing (Sections 6. and 7.)</u>

On December 31, 2010, Bank A advanced funds to Corporation Z for the purposes of working capital and was collateralized by 10 acres of land plus improvements which consist of a 35,000 square foot manufacturing facility. The note was set to mature on March 15, 2012. The loan received all the proper approvals and was well within the 20% secured limits as stated in Regulation 14 at the time of origination. Over the following year, the bank's capital began to erode due to substantial loan losses unrelated to the subject borrower. On March 1, 2012, the bank's loan officer sent a loan renewal package to the Board for approval, which included a request for renewal for an additional two years plus a request for additional funds to renovate the office and purchase new equipment. Since the loan had been paying as agreed and the new financials showed no reason to turn down the request, the Board approved the loan with the additional advance. That same day, the new loan with additional funds was made. Since the loan had been reviewed for legal limit purposes in 2010, it was not reviewed again because the loan had subsequently paid down and remained below the lending limit calculated at the time of the loan's origination. In addition, the additional advance with the new loan did not exceed the original loan amount made in 2010. However, since the bank's capital had dropped significantly in 2011, the new loan was in excess of the bank's 20% limitation based on a calculation using the most recent December 31, 2011 Call Report. Regulation 14 defines a loan, in part, as a making or renewal of any loan, line of credit, or extension of credit. Regulation 14 also states, in part, that the capital base for computing the maximum lending limit shall be the amounts shown for the required capital accounts (not detailed) including the allowance for loan and lease losses reflected on the bank's most recent quarterly Report of Condition (Call Report). Since the loan was a renewal which is treated as a new extension of credit, the bank is in violation of Regulation 14.

EXAMPLE 6 – Tangible Economic Benefit (Section 8.c.ii.), Other Indications of Responsibility (Section 8.c.viii.)

As of July 1, 2011, Borrower A and his wholly-owned companies were indebted to the bank in an aggregate amount of $4,500,000. On that date, the bank's applicable legal lending limit was $12,000,000. During a subsequent examination, bank documentation indicated several loans in the names of other borrowers (who were investors in Borrower A's projects or employees of Borrower A's companies) were being serviced with deposits or checks from one or more of Borrower A's companies. Consequently, the presumption is that these loans were made for the tangible economic benefit of Borrower A, and Borrower A is fully responsible for debt service on all the loans which were serviced through deposits or checks from Borrower A's companies. Therefore, all of the loans should be aggregated for legal lending limit purposes.

The aggregate balance of these loans was $14,500,000 as of the examination date; however, nine loans totaling $6,000,000 were originated or renewed while the aggregate indebtedness was above the applicable legal lending limit. Renewals are considered extensions of credit just like newly originated loans. Therefore, these nine loans were originated or renewed in violation of Section 5-5A-22 of the Alabama Banking Code and Alabama Banking Board Regulation No. 14.

EXAMPLE 7 – Associates and Same Source of Repayment (Section 8.c.ii.)

Borrower A is an LLC involved in residential real estate development and owned by Guarantors 1 and 2, both of whom fully guarantee the debt of Borrower A. Borrower B is an individual who is an associate of Guarantor 1 through his 25 percent ownership of an LLC that is 75 percent owned by a wholly-owned LLC of Guarantor 1. On April 30, 2007, the aggregate indebtedness of Borrower A was $840,000. On that same date, the bank extended a loan to Borrower B in the amount of $1,700,000 for the purpose of purchasing acreage in the residential development of Borrower A, with the purchase being made from Guarantor 1 individually. The source of repayment of this loan was ultimately the sale of the real estate, which was substantially the same as debt in the name of Borrower A. Bank management contends that the loan was originated based on Borrower B's individual financial strength; however, no comprehensive analysis of his repayment ability was performed nor did management even order a credit report on the Borrower B. At this time, the applicable legal lending limit of the bank was $1,818,000.

Given that Guarantor 1 and Borrower B are associates due to their business relationship and that the source of repayment for all the loans is essentially the same (sale of real estate in the development), the debt of both Borrower A (fully guaranteed by Guarantor 1) and Borrower B should be aggregated for legal lending limit purposes. Therefore, the loan to Borrower B was originated in violation of Section 5-5A-22 of the Alabama Banking Code and Alabama Banking Board Regulation No. 14.

Subsequently, the bank renewed three loans to Borrower A totaling $150,000, while the aggregate indebtedness remained above the legal lending limit. Since a renewal is considered an extension of credit just like a new loan, these three loans were renewed in violation of the law and regulation as well.

Appendix 2 – Calculation of Lending Limits for Insider Loans: State Banking Board Regulation 14 and Federal Reserve Board Regulation O

LEGAL LENDING LIMIT (State)

Unsecured loans to any person (direct or indirect) cannot exceed 10 percent of total capital and reserves as reported in the most recent Call Report.

$20,000,000	Capital
+ 400,000	Allowance for Loan and Lease Losses
20,400,000	Total Capital and Reserves
X 10%	
$ 2,040,000	**Unsecured Limit**

AND

Total loans secured and unsecured to any one person (direct or indirect) cannot exceed 20 percent of the capital and reserves of the bank; however, loans in excess of 10 percent must be fully secured.

All loans to a borrower or counterparty whose total loans exceed or, by virtue of the entering into the loan, would exceed 10 percent of the total capital and reserves of the bank require authorization or approval by the Board of Directors of the bank, or a committee thereof, or a loan committee, with such authorization or approval recorded in the minutes of the meeting.

$20,000,000	Capital
+ 400,000	Allowance for Loan and Lease Losses
20,400,000	Total Capital and Reserves
X 20%	
$ 4,080,000*	**Secured Limit**

*10 percent of $2,040,000 must be fully secured.

REGULATION O LIMITS (Federal Reserve)

For insider debt, the lending limits and Regulation O limits must be considered together. Generally, for any single limit, the most conservative of the two must be used as shown in the example below[5].

When an insider's aggregate debt exceeds the higher of $25,000 or 5 percent of capital and surplus, or when any extension of credit exceeds $500,000, each extension of credit must be approved in advance by a majority of the board of directors. As defined by Regulation O, an extension of credit is a making or renewal of any loan, a granting of a line of credit, or an extension of credit in any manner whatsoever. Additional Regulation O restrictions apply to executive officers.

For an insider, the 20 percent legal lending limit still applies, but because of Regulation O restrictions, any loan amounts in excess of 15 percent of capital and reserves must be secured by "listed" collateral such as stocks and bonds. Real estate, equipment, etc. could collateralize the 5 percent that can be supported by "normal" collateral. The reference to "listed" collateral for the next 5 percent (up to 20 percent) refers to listed stocks, U.S. Government bonds, etc. for which there is a functioning market and continuously available market quotes.

TIER DESCRIPTION	CAPITAL TOTAL	PERCENT (%)	LIMIT	TOTAL OF TIERS
Unsecured Limitation	$20,400,000	10	$2,040,000	$2,040,000
Limit of Debt Supported by "Normal Collateral"	$20,400,000	5	$1,020,000	$3,060,000
Limit of Debt Supported by "Listed Collateral"	$20,400,000	5	$1,020,000	$4,080,000

[5] Section 215.2(i) of Regulation O states in part: "Where State law establishes a lending limit for a State member bank that is lower than the amount permitted in section 5200 of the Revised Statutes, the lending limit established by applicable State laws shall be the lending limit for the State member bank." This requirement also applies to State, nonmember banks per Section 18(j)(2) of the Federal Deposit Insurance Act.

Appendix 3

Conversion Factor Matrix for Calculating Potential Future Credit Exposure[6]

Original Maturity[7]	**Interest Rate**	**Foreign Exchange and Gold**	**Equity**	**Other[8] (includes commodities and precious metals except gold)**
1 year or less	0.015	0.015	0.20	0.06
Over 1 to 3 years	0.03	0.03	0.20	0.18
Over 3 to 5 years	0.06	0.06	0.20	0.30
Over 5 to 10 years	0.12	0.12	0.20	0.60
Over 10 years	0.30	0.30	0.20	1.00

[6] 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.

[7] 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.

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

Appendix 4

Remaining Maturity Factor for Calculating Credit Exposure

	Interest Rate	Foreign Exchange and Gold	Equity	Other[9] (includes commodities and precious metals except gold)
Multiplicative Factor	0.015	0.015	0.06	0.06

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

Appendix 5 – Collateral Haircuts

Sovereign Entities

	Residual Maturity	Haircut without Currency Mismatch[10]
OECD Country Risk Classification[11] 0-1	**1 year or less** **Over 1 year to 5 years** **Over 5 years**	0.005 0.02 0.04
OECD Country Risk Classification 2-3	**1 year or less** **Over 1 year to 5 years** **Over 5 years**	0.01 0.03 0.06

Corporate and Municipal Bonds that are Bank-Eligible Investments

Residual Maturity for Debt Securities	Haircut without Currency Mismatch
1 year or less	0.02
Over 1 year to 5 years	0.06
Over 5 years	0.12

Other Eligible Collateral

Main Index[12] equities (including convertible bonds)	0.15
Other publicly traded equities (including convertible bonds)	0.25
Mutual Funds	Highest haircut applicable to any security in which the fund can invest
Cash collateral held	0

[10] 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.

[11] 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.

[12] Main index means the Standard and 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 Alabama Banking Department and the bank's appropriate Federal Regulator that the equities represented in the index have comparable liquidity, depth of market, and size of bid-ask spreads as equities in the Standard and Poor's 500 Index and FTSE All-World Index.