ALABAMA STATE BANKING DEPARTMENT **December 17, 2012**

Regulation No. 14 – Credit Exposure Limits

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

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SUMMARY: The Superintendent of Banks, with the concurrence of the State Banking Board assembled on December 7, 2012, has amended 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 final 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 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.

EFFECTIVE DATE: January 1, 2013

FOR FURTHER INFORMATION CONTACT: Deputy Superintendent Trabo Reed by telephone at 334-242-3452, by mail at State of Alabama, State Banking Department, Post Office Box 4600, Montgomery, AL 36103 or by e-mail at Trabo.reed@banking.alabama.gov.

SUPPLEMENTARY INFORMATION:

I. Background

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. Subsequently, the Superintendent extended the comment period to November 9, 2012.

Many thoughtful and constructive comments were received by the Superintendent during the comment period, and many of the comments and suggestions for improvement in the proposal have been adopted in the final Regulation No. 14. In the following section of this Notice, the comments and the responses to those comments are discussed.

The final 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 final Regulation No. 14, generally:

Adds, 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;

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

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

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

II. Comments and Response

Derivatives and Securities Financing Transactions

Clearing House Exposure

- We received a comment that the proposed rule could cause a bank to be limited on its clearing of derivatives transactions through clearing houses if the bank enters into derivatives transactions that are cleared through one or two clearing houses.

We did not make an exception to the limits for clearing houses based on the still-evolving status of clearing house use for derivatives transactions. We will continue to evaluate the credit exposure limits based on noted concentrations of clearing house use in the future.

Collateralization of Derivatives and Securities Financing Transactions

- Comments questioned the fact that, in the proposed regulation, derivatives and securities financing transactions would be treated differently, regardless of the type of collateral pledged, from loans as far as being considered secured or being eligible to be considered as exceptions to the lending limits. There was also inconsistency in the proposed treatment of collateral between the internal model, conversion factor matrix, and remaining maturity methods.

  These inconsistencies have been eliminated in the final regulation. Derivatives and securities financing transactions are treated the same as loans. If they are adequately collateralized, they may be considered secured for purposes of the credit exposure limits. If the collateral securing a derivatives or securities financing transaction qualifies as an exception to the lending limits, then the transaction may be considered as an exception.

Definitions (relating to Derivatives and Securities Financing Transactions)

- We received a request that a definition for "Counterparty" be included.

  We have included a definition of Counterparty in the final regulation.

- We also received a comment that commercial banks should not be excluded from the definition of Qualified Central Counterparty for derivatives and securities financing transactions that may be guaranteed by Qualified Central Counterparties with the amount of such guarantees being excluded from the calculated credit exposure.

  We determined that guarantees of other commercial banks are not sufficiently higher credit quality to be excluded from the credit exposure limits. Consequently, we did not include commercial banks as Qualified Central Counterparties. We also expanded the requirement that any of the other Qualified Central Counterparties must be considered "investment quality" per Alabama State Banking Board Regulation No. 1.

Examples

- We received a request that we include examples of calculation of credit exposures for derivatives and securities financing transactions; however, we determined that if there are significant calculation issues going forward, we will provide examples in separate guidance issued at a later date.

Internal Models

- We received questions and comments regarding validation and approval of internal models including the timing of federal approvals of the models.

  In addressing the requirement that an internal model be approved by the Superintendent and the bank's primary federal regulator, we determined that this due approval requirement could result in delays in the approval of specific models. The final regulation only requires that the Superintendent approve use of an internal model. It does not require approval of a specific model; however, the validation of the model and appropriate controls and backups will be reviewed and addressed through the examination and supervisory process.

Credit Exposure Limits on Loans – Associated Borrower Groups and Aggregation Rules

General Comments

- We received comments from one commenter that indicated the proposed regulation blurs the line of statutory lending limits and expands too broadly upon what the commenter perceived were provisions of Alabama Banking Code Section 5-5A-22 that limit aggregation of debts to situations where a person has 35 percent control of a business entity. This commenter also felt that the proposed regulation expanded upon the requirements of the existing Regulation No. 14.

  We did not alter the proposed regulation in response to the above comments because we do not believe that the proposed regulation expands upon either the existing Regulation No. 14, or the requirements of Section 5-5A-22. The positions in the proposed and final regulation are consistent with long-standing interpretations of the law and the department's practice in enforcing the law and the existing regulation.

  We have held this position because the requirements of Section 5-5A-22 are affirmative and not prohibitive. For example, Section 5-5A-22(c)(2)c. states *"In*

*computing the total liabilities of any partnership or unincorporated association to a bank, there **shall** be included all liabilities of its individual members to such bank, loans made for the benefit of such partnership or unincorporated association or any member thereof, and any loan made to, or for the benefit of, any corporation of which any member owns 35 percent or more of the capital."*

This Section does not say that you **shall not** aggregate debts to business entities of which an individual person owns less than 35 percent but is a member of an unincorporated association that collectively owns more than 35 percent regardless of other factors such as common benefit, common repayment source, common purpose, or common control. Consequently, in the final Regulation No. 14 we have again emphasized that the analysis of whether debts should be aggregated should not begin with nor be isolated to the ownership percentages of individual members of a group of business associates.

- The commenter also suggested that the definitions of "unincorporated associations" and "associates" contained in the proposed regulation expanded upon the existing regulation. The definition of "associate," however, is retained verbatim from the existing regulation

  In the final Regulation No. 14, an unincorporated association is a group of individual associates. Associates are defined as "members of a partnership or unincorporated group of individuals or companies allied to own or control business ventures or entities." This definition maintains the Department's long-standing position that, when looking at aggregation of debts, the first step should be to look at individuals and groups of individuals who are economically related i.e., in business together.

<u>Aggregation of Credit Exposures</u>

- We received comments that the aggregation rules and the examples that were provided in the proposed regulation were complex.

  We concurred with those comments. Consequently, we included in Appendix 1 of the final Regulation No. 14 a step-by-step process to look at the aggregation of credit exposures. We also have issued the examples to a separate document (*SBD Opinion 2012–01 – Credit Exposure Limits*) containing guidance on reviewing the examples using the step-by-step process outlined in Appendix 1 of the final Regulation No. 14. The step-by-step process is essentially the process that examiners use in looking at aggregation of credit exposures. By including it in Appendix 1, we hope to provide a useful tool for bankers.

- We also received several questions asking whether loans to unrelated individuals that may be dependent upon the same repayment source (such as employees of a local hospital or chicken producers that sell to the same chicken plant) would be aggregated for legal credit exposure limits because of the repayment source.

  We have made clear (through the footnote in Appendix 1) that, in the absence of other factors requiring aggregation; these unrelated individuals who are not in business together would not be considered "associates," and their loans would not be aggregated.

- It was also pointed out to use that the proposed regulation did not contain a definition of "tangible economic benefit."

  We have included a definition in the final Regulation No. 14 in a Definitions section that will hopefully make the regulation less confusing.

- We also received a request that after-the-fact aggregation determinations for extensions of credit not be considered violations of the regulation.

  We did not choose to address this request because we believe that it is incumbent upon banks to properly aggregate debts and comply with the law and regulation when an extension of credit is made. We also believed that this could open a loophole that would make the Regulation difficult to enforce.

Loan Renewals and Participations

- We received the question as to whether a renewal of a loan without an additional advance would require a new determination of the renewed loans' compliance with the credit exposure limits.

  This question is addressed in the final Regulation No. 14 by its retention of the Federal Reserve Board definition of "extension of credit" to include renewals whether or not new funds are advanced.

- As far as the exclusion of participations sold from the amounts to be considered for credit exposure limits, the notice of proposed rulemaking included a statement 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. We received a number of comments questioning whether banks should actually be required to receive funds from the participant bank on the same business day. We also received questions as to whether assignments or syndications of loans could be excluded.

We have modified the language in the final Regulation No. 14 that requires only that the assignment or participation documents establishing the assignee's or participant's firm legal commitment to fund be executed prior to or on the same business day as the loan documents. We did not directly address syndications; however, any binding legal agreement that is executed on the same day that the loan is closed and that constitutes a "true sale" for Call Report purposes would generally apply.

Exceptions to Credit Exposure LImits

- We had a number of questions regarding what types of loans and collateral qualifies as an exception to the credit exposure limits. One question asked for a definition of what collateral constitutes a "product for which there is a ready sale in the open market."

  In response, we have modified the language to state: "*The collateral must be cash or equivalent to cash or have a readily established market value as determined by reliable and continuously available price quotations. There must be no question regarding the market value.*"

- We also received questions regarding the meaning of a bank taking possession and title at its discretion.

  We have not modified the language of the final Regulation No. 14 to address this; however, the meaning is that the bank does not have to go through legal or other repossession/collection proceedings to take possession of the collateral.

- A question was also asked about the result of a customer being unable to make good deterioration in collateral values where the loan was originally considered to be an exception.

  We did not specifically address this in the final Regulation No. 14, but the result would be that the loan would no longer be considered an exception. The question as to whether it should have ever qualified as an exception would depend upon whether the collateral shortfall could have reasonably been foreseen.

- We received a comment that the proposed regulation should expand upon acceptable means of collateral control to include the use of bailees, collateral agents and other methods permitted under the Uniform Commercial Code.

  We did not specifically address each of these means of collateral control, but instead have retained the general description of qualifying collateral and controls for

exceptions. Such means of collateral control have qualified in the past; however, we have tried to avoid placing an exhaustive list in the final Regulation No. 14. It is common practice for banks to call the Department to discuss whether a particular loan would qualify as an exception, and we encourage bankers to continue to do so regarding specific loans and means of collateral control.

- We received a comment that loans secured by certificates of deposit in a bank other than the lending bank should qualify as exceptions to the credit exposure limits.

  We did not address this request because we would not, in the regulation, contradict Alabama Banking Code Section 5-5A-22(d)(3)d. which states that loans to the extent secured by "*At least a like amount of cash or deposits held by the lending bank.*" shall be excluded. We have also noted issues in the past with banks maintaining inadequate control over certificates of deposit pledged to another bank.

III. Final Regulation

The final regulation is attached to this Notice. Copies of this Notice and the final Regulation No. 14 should be distributed to all board members, committee members, and affected personnel. 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 derivatives positions and securities financing transactions. Additional copies may be obtained by contacting the Alabama State Banking Department at the address, e-mail address or telephone number provided on page 1 of this notice. Copies may also be obtained from the Alabama State Banking Department website at www.banking.alabama.gov

Regulation No. 14
Credit Exposure Limits[1]

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 Credit Exposure 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 in official meeting assembled on December 7, 2012, does hereby promulgate the following regulation which amends and supersedes the previous Regulation No. 14 that was effective October 1, 1998.

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

1) **DEFINITIONS**

a. ASSOCIATES - Associates means members of a partnership or unincorporated group of individuals or companies allied to own or control business ventures or entities.
b. CAPITAL BASE - The total Capital Base for Credit Exposure Limits contained in §5-5A-22 of the Alabama Banking Code includes: capital stock, surplus, undivided profits, subordinated capital notes and 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. The total Capital Base for computing the maximum Credit Exposure Limits shall be the amounts reflected on the bank's most recent quarterly Report of Condition ("Call Report").

[1] Because of the addition of limits on credit exposure from Derivative Transactions and securities financing transactions to the prior limits that applied only to loans or extensions of credit, the terminology used in this regulation refers to "Credit Exposure Limits," which is a term adopted to apply to the limits contained in this Regulation No. 14 and those in Alabama Banking Code §5-5A-22 that have previously been referred to as "legal lending limits."

c. CONTROLLED COMPANY - Controlled Company means any corporation, partnership, trust (business or otherwise), association, joint venture, pool syndicate, sole proprietorship, unincorporated organization, or any other form of business entity not specifically listed herein which a Person or associated group of Persons, directly or indirectly, through immediate family members or Associates, effectively manages or controls.

d. COUNTERPARTY - Counterparty refers to the opposing entity or individual, including financial intermediaries, exchanges, and clearing houses, that facilitate the execution of a Derivative contract or securities financing transaction.

e. DERIVATIVE TRANSACTION - 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), settled or cleared through a Centralized Clearing House, or are exchange traded.

f. ELIGIBLE PROTECTION PROVIDER - An Eligible Protection Provider means any of the following whose debt or other obligations are considered to be investment quality per Alabama State Banking Board Regulation No. 1 – Investment Securities:

   i. A sovereign entity (a central government, including the U.S. government; an agency; department; ministry; or central bank);
   ii. The Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, or a multilateral development bank;
   iii. A Federal Home Loan Bank;
   iv. The Federal Agricultural Mortgage Corporation; and
   v. A qualified central counterparty or clearing house.

g. LOANS AND EXTENSIONS OF CREDIT -

   i. For Credit Exposure Limit 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. The terms "loan" and "extension of credit" are used interchangeably within this regulation. This definition includes, but is not limited to:
      1. An advance by means of an overdraft, cash item, or otherwise;
      2. Issuance of a standby letter of credit (or similar arrangement regardless of name or description);

3. 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;
4. Making a direct loan or acceptance of paper sold under guaranty, repurchase agreement, or other recourse arrangement; and
5. **Making or renewal** of any loan, line of credit, or extension of credit.

ii. The amount of the loan for the purpose of Credit Exposure Limits shall be the principal balance of the loan (or the total amount of a line of credit, draw note, 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. 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. If a bank chooses to assign or participate all or part of a loan to another bank to comply with Credit Exposure Limits, the assignment or participation documents establishing the assignee or participating bank's firm legal commitment to fund the assigned or participated amount must be executed prior to or on the same business day as the loan documents in order for the full amount of the loan to not be considered for Credit Exposure 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 Credit Exposure Limits.

h. PERSON - For purposes of this regulation, the term Person collectively refers to an individual, as specified in this regulation an individual's spouse, a business entity, or a business venture and their controlled companies. The term also refers to a group of Associates and the associated group's controlled companies.

i. TANGIBLE ECONOMIC BENEFIT - A Person receives Tangible Economic Benefit when the proceeds of an extension of credit are transferred to that Person or the Person receives a direct or indirect economic benefit from the extension of credit. An exception to this definition would occur only where the Person receives benefit from an arms-length transaction to finance the bona fide purchase of property from the Person by an otherwise unrelated third party who is not an immediate family member or Associate of the Person and where no

common repayment source or other factors requiring aggregation of the extension of credit exist.

2) **LIMITS ON EXPOSURE** - Section 5-5A-22 of the Alabama Banking Code prohibits banks from making loans and having credit exposures to any Person which, when combined with all other loans and credit exposures to such Person, would cause total loans and credit exposures to that Person 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.

    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[2]. 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 Person where all amounts in excess of 10 percent are fully secured as defined above[3].

3) **COLLATERALIZATION OF EXPOSURE** - A loan or credit exposure may be purported to be secured but, for Credit Exposure 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 collateral, obtain additional collateral, or otherwise correct the violation before imposing the penalties prescribed by §5-5A-22.

[2] State Credit Exposure Limits do not, by themselves, govern limits on extending credit to insiders, directors, or executive officers. Refer to Appendix 2 for the interaction between Alabama State Banking Board Regulation No. 14 and Federal Reserve Board Regulation 0.

[3] Rules for aggregation of loans and credit exposures for Persons and their controlled companies per this regulation and Alabama Banking Code §5-5A-22 must be followed when applying the Credit Exposure Limits on credit exposure.

4) **EXCEPTIONS TO LIMITS ON EXPOSURE** - There are certain instances when loans or credit exposures to one Person 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 as determined by reliable and continuously available price quotations. 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, or under absolute control, of the bank at all times[4].
   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.

[4] 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 Credit Exposure Limit purposes, to be considered under the absolute control of the lending bank at all times, such deposits must be in the lending bank as required by Alabama Banking Code §5-5A-22(d)(3)d. 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 Credit Exposure Limit calculations.

5) **APPROVAL AND REPORTING REQUIREMENTS** -

a. REPORTING OF CREDIT EXPOSURE LIMITS - Management of the bank is responsible for providing the secured and unsecured Credit Exposure Limits to the board of directors and/or committee responsible for approving loans and credit exposures to a Person 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 Credit Exposure 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 Credit Exposure 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[5] affected by the Credit Exposure Limits. Management's responsibility to inform the board and affected personnel does not, however, relieve directors and officers of their duty to ascertain the Credit Exposure Limits prior to making loans or creating credit exposure from Derivatives, securities financing, or other transactions.

b. APPROVAL REQUIREMENTS - Section 5-5A-22 requires that all loans and credit exposures to a Person 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. Upon the Superintendent learning through an examination that loans or credit exposures have been made in excess of the Section 5-5A-22 limits, the Superintendent may require the bank to adopt such approval practices as the Superintendent deems necessary to prevent future violations of the Credit Exposure Limits. Failure of the bank to implement such required approval practices will be deemed a violation of this regulation. In order for loans or credit exposures to be considered as exceptions under Section 4 of this regulation, 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,

[5] 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 derivatives positions and securities financing transactions.

investment, or other committee, and such approval must be recorded in the minutes of the board or committee.

c. REPORTING OF VIOLATIONS - 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.

6) **REQUIREMENTS FOR AGGREGATION OF LOANS AND CREDIT EXPOSURES** -

a. For Credit Exposure Limit purposes, all credit exposures to a Person[6] arising from extensions of credit, Derivative Transactions, repurchase agreements, reverse repurchase agreements, securities lending transactions, or securities borrowing transactions between the bank and the Person shall be aggregated.

b. Relating to extensions of credit, 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 Persons, 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. Loans made to or for the Tangible Economic Benefit[7] of a Person and the Person'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 Credit Exposure Limit purposes.

   ii. Direct or indirect loans to a Person's spouse will be aggregated and treated as one loan to the Person unless the lender can prove to the

[6] When considering each of the requirements for aggregation contained in Section 6 of this regulation, the definition of Person contained in Section 1 h. of this regulation should be used with reference also being made to the definitions of Associate, Controlled Company and Counterparty contained in Sections 1 a., 1 c., and 1 d. The definition of Person states "For purposes of this regulation, the term Person collectively refers to an individual, as specified in this regulation an individual's spouse, a business entity, or a business venture and their controlled companies. The term also refers to a group of Associates and the associated group's controlled companies." Consequently, when considering whether extensions of credit and credit exposures should be aggregated, debts of associated groups of individuals, companies, and their controlled companies should be looked at as well as debts of single individuals, their family members, and their controlled companies.

[7] Refer to the definition of Tangible Economic Benefit contained in Section 1 i. of this regulation.

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.

iii. If a Person 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 Person would be treated as one loan to the Person.

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

v. If a Person 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 Person'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 Person.

vi. If a Person 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 a Person 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, a Person appears to be fully responsible for the debt service on loans that are purported to be "without recourse" through the practice of paying off delinquent loans or other indications of responsibility, then the amount of such loans will be aggregated and treated as one loan to the Person.

7) **CREDIT EXPOSURE FROM DERIVATIVES AND SECURITIES FINANCING TRANSACTIONS**[8] - For Credit Exposure Limit purposes, all credit exposures to a Person or Counterparty arising from an extension of credit, 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. Relating to the measurement of credit exposures from Derivatives and securities financing transactions, the following procedures shall apply.

a. CREDIT EXPOSURE ARISING FROM NON-CREDIT DERIVATIVE TRANSACTIONS -

For purposes of Credit Exposure Limits, a bank may, subject to the following requirements and conditions, elect to use the Internal Model Method, the Conversion Factor Matrix Method, or the Remaining Maturity Method to measure the credit exposures relating to 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 electing to use the Internal Model Method for non-credit Derivative Transactions 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 electing to use the Internal Model Method for non-credit Derivative Transactions shall calculate its potential future credit exposure by using an internal model. However, to use the Internal Model Method, the bank must receive the prior written approval of the Superintendent of Banks. The model implementation, the modeling process, and the reliance upon model results shall comply with Federal Reserve SR Letter 11-7, Supervisory Guidance

[8] Banks having significant derivatives portfolios, and those using derivatives that are more complex, should refer to and, where applicable, follow the Interagency Supervisory Guidance on Counterparty Credit Risk Management contained in FDIC FIL-53-2011 and FRB SR 11-10 issued July 5, 2011. This Guidance is targeted to the largest dealer banking organizations and other banks with significant or complex derivatives portfolios. It does not apply to banks with limited derivatives exposures, particularly noncomplex exposures that are typical for community banks. Banks should consult with their primary federal regulator if they have questions regarding the applicability of the Guidance to their derivatives activities.

on Model Risk Management, issued April 4, 2011, or other subsequent guidance.

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.

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 table 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. A bank must declare and document at the origination of a Derivative Transaction 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[9], 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 Transactions entered into 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

[9] Type of derivative refers to the type of contract or transaction as well as the purpose, such as balance sheet hedging or client accommodation.

credit derivative purchased on that reference entity from an Eligible Protection Provider.

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.

   i. Internal Model Method - A bank electing to use the Internal Model Method for securities financing transactions shall calculate its potential future credit exposure by using an internal model. However, to use the Internal Model Method, the bank must receive the prior written approval of the Superintendent of Banks. The model implementation, the modeling process, and the reliance upon model results shall comply with Federal Reserve Board SR Letter 11-7, Supervisory Guidance on Model Risk Management, issued April 4, 2011, or other subsequent guidance.

   ii. Non-Model Method - A bank not electing to use the Internal Model Method shall calculate the credit exposure of securities financing transactions as follows:

      1. 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.
      2. Securities Lending -
         a) 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.
         b) 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.
      3. Reverse Repurchase Agreement - 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.

4. Securities Borrowing -
    a) 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.
    b) 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.

iii. 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.

d. <u>COLLATERALIZATION OF DERIVATIVES AND SECURITIES FINANCING TRANSACTIONS</u> - A bank that calculates its credit exposure for Derivatives Transactions and securities financing transactions may consider its derivative and securities financing positions collateralized if the bank receives cash or cash equivalents, and if the bank maintains control over the collateral.

This regulation is effective January 1, 2013.

Appendix 1 – 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. Credit Exposure 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 Credit Exposure 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.

Regulation No. 14 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 Regulation No. 14 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. Regulation No. 14 focuses on individual borrowers, their related companies, and associated groups of individual borrowers and their related companies.

There are rules in place in Regulation No. 14 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 and standards for presumption of control. An analysis of aggregation of debts should not begin there and cannot stop there. Regulation No. 14 requires that banks first 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[10].

[10] The question has been asked whether the debts of a large group of otherwise unrelated borrowers, such as employees of a local hospital or poultry farmers who sell to the same poultry companies should be aggregated for Credit Exposure Limit purposes because of an apparent common repayment source. These loans may represent a concentration, but the answer to these questions, for Credit Exposure Limit purposes, is normally no. These individuals are not Associates that are economically related; i.e., they are not in business together. In the cases of these loans, there is no common benefit, no common purpose, and no common control. The related repayment source is substitutable. Employees of the hospital can take employment elsewhere. Poultry farmers can sell their product to another poultry company. As an example, these cases are different from the case of a small group of borrowers that are in the real estate development business together, where the repayment source is actually the sale of the bank's collateral, where common control is frequently exercised over a number of projects and the cash

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.

In general, when determining the application of Credit Exposure Limits to extensions of credit and the aggregation of those extensions of credit, the Alabama State Banking Department recommends use of the following process for determining compliance with the Credit Exposure Limits.

Process for Determining Application of Credit Exposure Limits to Credit Exposures

1. Determine the borrower or group of borrowers whose debts should be looked at to determine if they should be aggregated. This is perhaps the most important step in the process. Individuals, the individuals' family members, and groups of associated individuals that are in business together, as well as their businesses should be looked at to see whether debts owed by any to the bank should be aggregated. [Refer to Regulation No. 14, Section 6 b. that states that debts of one borrower, or a relatively small and economically related group, including all direct or indirect loans to Persons, their partnerships, firms, limited liability companies, corporations, or unincorporated associations must be aggregated and regarded as single loans. Particular attention should be given to Section 6 b. (i. and ii.) as well as the definitions of Person, Associate, Controlled Company and Counterparty 1 a., 1 c., 1 d. and 1 h. of Regulation No. 14.]

2. Determine the debts of each borrower or the group of borrowers that need to be aggregated by looking at:
    a. Common benefit from the loans,
    b. Common repayment sources for the loans,
    c. Common purpose for the loans,
    d. Common control among the entities receiving the loans, and
    e. Aggregation rules of §5-5A-22(c)(2)(a.-f.) and of Regulation No. 14, Section 6 b. (i.-viii.).

3. Determine the proper amount of each loan to be counted for Credit Exposure Limit purposes (e.g., full amount of line of credit vs. amount drawn) and calculate the secured and unsecured totals of the aggregated loans (Refer to Regulation No. 14, Sections 1 g., 2, and 3).

4. Deduct any loans that are exceptions to being counted for aggregation per §5-5A-22(d)(1)-(4) or Regulation No. 14, Section 4 (e.g., loans secured by own-bank CDs).

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flows therefrom, where there is frequently common benefit, and the individuals are commonly responsible to varying degrees for repayment.

5. Check the total of unsecured loans against the bank's 10% unsecured Credit Exposure Limit. (Refer to Section 5-5A-22 Sections (a) and (c)(1) and Regulation No. 14, Sections 1 b., 2, and 3.)

6. Check the total of secured and unsecured loans against the bank's 20% total unsecured and secured limit. (Refer to Section 5-5A-22 Sections (a) and (c)(1) and Regulation No. 14, Sections 1 b. and 2. In the case of an extension of credit to an insider to which Federal Reserve Board Regulation O would apply, refer to Regulation No. 14, Appendix 2 – Calculation of Credit Exposure Limits for Insider Loans: Alabama State Banking Board Regulation No. 14 and Federal Reserve Board Regulation O.)

Appendix 2 – Calculation of Credit Exposure Limits for Insider Loans: Alabama State Banking Board Regulation No. 14 and Federal Reserve Board Regulation O

CREDIT EXPOSURE 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 Person 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, or $2,040,000, must be fully secured.

REGULATION O LIMITS (Federal Reserve)

For insider debt, the State Credit Exposure 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[11].

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 State Credit Exposure 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

[11] 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[12]

Original Maturity[13]	Interest Rate	Foreign Exchange and Gold	Equity	Other[14] (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

[12] 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.

[13] 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.

[14] 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[15] (includes commodities and precious metals except gold)
Multiplicative Factor	0.015	0.015	0.06	0.06

[15] 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[16]
OECD Country Risk Classification[17] 0-1	**1 year or less**	0.005
	Over 1 year to 5 years	0.02
	Over 5 years	0.04
OECD Country Risk Classification 2-3	**1 year or less**	0.01
	Over 1 year to 5 years	0.03
	Over 5 years	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[18] 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

[16] 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.

[17] 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.

[18] 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 State 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.