Superintendent Guidance
SG-2012-02
January 23, 2012

Seeking Superintendent Approval to Pledge Collateral for Hedging

TO: STATE CHARTERED BANKS

Effective July 1, 2010, subject to the approval of the Superintendent, state banks may pledge assets to secure transactions to hedge risks associated with interest rate exposure. See Iowa Code § 524.814(2). Hedging risks associated with interest rate exposure will typically involve use of instruments such as interest rate swaps (swaps). Swaps are complex financial transactions. As a result, a bank seeking approval to pledge assets as part of a hedging strategy must demonstrate to the Superintendent that it has the requisite knowledge and sophistication to effectively analyze and manage swaps. The bank's Board of Directors should consider any plan to engage in swap activities and should adopt specific written policies and procedures governing swap activities. The bank's request for Superintendent approval shall include a complete description of the hedging strategy the bank intends to employ. The bank must also include a copy of the interest rate swap policy adopted by the bank's Board of Directors.

We recommend the Board consider covering the following subjects in its policy. It may be appropriate to address other areas as well.

Policy Objectives

The policy should include policy objectives specific enough to outline permissible swap strategies and their relationships to other banking activities.

Analysis and Management of Swap Transactions

The policy should include a description of the types of instruments the Board authorizes bank management to purchase. The policy should include an evaluation methodology for analyzing new and existing swaps. Bank management should conduct a thorough analysis of the swap, including projections of the impact the hedge will have on the bank's net interest margin during the term of the swap. And, the bank should shock-test the interest rates during the term of the hedge to assess the bank's risks. The bank should not rely on the counterparty's opinion or recommendation regarding the effectiveness of the hedge.

Counterparty Credit Risk

The policy should address standards designed to protect the bank from counterparty credit risk. Such standards may include strategies such as limiting the bank to use only highly rated counterparties, requiring collateralization in the event of a counterparty downgrade, termination thresholds, and plans to avoid excessive concentration of exposure to a single counterparty or guarantor. The policy should also establish gross dollar limits and exposure limits for swaps and limits per counterparty. Swap exposures to any single counterparty should not exceed 15% of the Bank's aggregate capital.

Selecting and Procuring Swaps

The policy should include standards for selecting and procuring swaps, such as underwriter and counterparty selection. It may also address the methodology the Board wishes the bank to use when procuring swaps, such as via competitive bid or negotiation.

Form of Agreement

The policy should address necessary features of the swap agreement, such as authorizing use of a standardized form such as the International Swap and Derivatives Association, Inc. "ISDA" Master Agreement.

Periodic Review and Reporting

The Board of Directors, a duly authorized committee thereof, or the bank's internal auditors should review all outstanding swap positions periodically and ensure that swap exposure limits established by the Board are not exceeded. Appropriate committee minutes should document in detail how the swap positions taken contribute to attaining the bank's stated objectives. Recordkeeping systems must be sufficiently detailed to permit internal auditors and examiners to determine whether operating personnel have acted in accordance with authorized objectives. If these activities are not conducted by the full Board, the Board should receive regular reports regarding these activities.

Prohibited Use of Swaps

The policy should address circumstances where swap use is prohibited. For example, the bank should not use a swap contract for purely speculative purposes.

Accounting and Call Reporting

The bank should have appropriate written accounting procedures and Call Report procedures in place before entering into swap transactions. And, the Board should consider whether the bank's external audit program should be expanded to include an audit of this area.

Sincerely,

James M. Schipper
Superintendent of Banking