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Superintendent Guidance  
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## State Bank Exposure to Derivatives

TO: STATE CHARTERED BANKS

Section 611 of the Dodd-Frank Act permits a state chartered bank to engage in derivative transactions *only if* the state lending limit law takes credit exposure to derivatives transactions into consideration. 12 U.S.C. § 1828(y). This provision of the Dodd-Frank Act is effective January 21, 2013. For the purposes of this requirement, a derivative transaction “includes any transaction that is a contract, agreement, swap, warrant, note, or option that is based, in whole or in part, on the value of any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets.” 12 U.S.C. § 84(b)(3). “Derivatives” do not include repurchase agreements, reverse repurchase agreements, securities lending transactions, or securities borrowing transactions.<sup>1</sup> Contracts that enable a flow of individual bank-originated one-to-four family real estate loans to be sold in the secondary market are also not “derivatives” subject to the lending limit.

We have reviewed Iowa’s lending limit law, Iowa Code § 524.904, and concluded it “takes into consideration credit exposure to derivative transactions” as required by section 611 of the Dodd-Frank Act. As a result, we conclude Iowa state-chartered banks may continue to use derivatives transactions, provided they comply with all applicable requirements and use is consistent with safe and sound banking practices.

Iowa’s lending limit law, Iowa Code § 524.904(1), provides:

1. For purposes of this section, “*loans and extensions of credit*” means a state bank’s direct or indirect advance of funds to a borrower based on an obligation of that borrower to repay the funds or repayable from specific property pledged by the borrower and shall include:

...

k. All other loans and extensions of credit to one borrower of the state bank not otherwise excluded by subsection 7, whether directly or indirectly, primarily or secondarily.

(Underlining added.)

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<sup>1</sup>Section 610 of the Dodd-Frank Act addressed national banks’ use of derivatives transactions. Section 610 is broader than the section applicable to state banks. In addition to derivatives, national banks must also include credit exposures to a person arising out of repurchase agreements, reverse repurchase agreements, securities lending transactions, or securities borrowing transactions in their lending limit calculations. This Superintendent Guidance does not address repurchase agreements, reverse repurchase agreements, securities lending transactions, or securities borrowing transactions.

Derivatives are not loans and, therefore, are not a direct advance of funds based on an obligation of the borrower to repay the funds or repayable from collateral. But, a derivative transaction can result in the counterparty's obligation to pay the bank. If a bank's counterparty to a derivative transaction were unable to pay when its obligation comes due, the bank would suffer a loss – just as the bank suffers a loss when a traditional borrower is unable to pay. Therefore, the bank counterparty's obligation to pay constitutes an indirect or secondary extension of credit and is subject to Iowa's lending limit laws, including the limits set forth in subsection 524.904(2).

The Banking Division is in the process of promulgating administrative rules that will address how a bank using derivatives should calculate its credit exposure to derivatives transactions. Once those rules are effective, a state bank using derivatives should comply with the rules to ensure any derivatives it uses are within the bank's lending limit.

#### Other Considerations

Derivatives are complex financial transactions and should only be used by banks that have the requisite knowledge and sophistication to effectively analyze and manage derivatives. We also would expect to see Iowa state-chartered banks using derivatives to use them simply to hedge interest rate and balance sheet risk, not as a profit seeking activity. Relatively conservative, plain vanilla derivatives, such as interest rate swaps would be appropriate for a state bank to use, provided it has the necessary level of expertise. A state bank should not use a derivative for purely speculative purposes.

A state bank's use of derivatives remains subject to all other applicable laws. For example, if the terms of the derivative transaction require the bank to pledge collateral, the bank must obtain the Superintendent's approval to pledge assets pursuant to Iowa Code § 524.814(2). Superintendent Guidance SG-2012-02, dated January 23, 2012, addresses the process for obtaining Superintendent approval to pledge collateral under § 524.814(2).<sup>2</sup>

Safety and soundness considerations also continue to apply. Like traditional extensions of credit, examiners may assess the quality of a derivative and may adversely classify it. Examiners also retain the authority to address credit exposures that present undue concentrations on a case-by-case basis using the Banking Division's existing safety and soundness authorities.

The Board of Directors of any bank using derivatives should consider the bank's plan to engage in derivatives activities and adopt a policy addressing its use of derivatives. We recommend the Board consider including the subjects described in Superintendent Guidance SG-2012-02 in its policy. It may be appropriate to address other areas as well.

Finally, a bank using derivatives should review the financial position of any counterparty to whom the bank is exposed as a result of its derivatives activity on at least an annual basis.

Sincerely,



James M. Schipper  
Superintendent of Banking

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<sup>2</sup>SG-2012-02 is available on the Banking Division's website <http://www.idob.state.ia.us/> under "Banking/Superintendent Guidances."