

MAINE BUREAU OF FINANCIAL INSTITUTIONS
SUPERINTENDENT'S
NOTICE TO INTERESTED PARTIES

Please find below (1) the Bureau of Financial Institution's Notice of Agency Rule-making Proposal, (2) a Basis Statement providing background information to the proposal, (3) the Bureau's proposed repeal and replacement of Chapter 128 (Regulation 28) – Loans to One Borrower, and (4) the Small Business Impact Statement. The comment deadline is November 19, 2012.

/s/ Lloyd P. LaFountain III
Superintendent of Financial Institutions
Gardiner, Maine
October 12, 2012

NOTICE OF AGENCY RULEMAKING
02 DEPARTMENT OF PROFESSIONAL AND FINANCIAL REGULATION
029 BUREAU OF FINANCIAL INSTITUTIONS
CHAPTER 128 LOANS TO ONE BORROWER LIMITATIONS (REG. 28)

SECTION 1. PURPOSE

9-B MRSA §439-A establishes the basis for determining the legal lending limits for financial institutions, including their subsidiaries, organized under the laws of this State. The lending limit law prohibits loans or extensions of credit at any one time to an individual borrower in excess of 20% of the financial institution's total capital. In addition, this statute authorizes the Superintendent to adopt rules to define or further define terms used in the statute and to establish limits or requirements other than those specified in the statute. This regulation protects the safety and soundness of financial institutions by preventing excessive loans to one person while promoting diversification of loans and equitable access to financial institution services.

This promulgation repeals and replaces existing Regulation 28. Its purpose is to establish guidelines for the administration of lending limits and to accommodate recent federal requirements pertaining to such limits found in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 111 PL 203 ("Dodd-Frank Act"). Effective January 21, 2013, section 611 of the

Dodd-Frank Act will prohibit state-chartered financial institutions from engaging in derivative transactions unless state lending limit laws take into consideration credit exposure to derivative transactions. Prior to this promulgation, Maine's lending limit law did not provide guidance for measuring credit exposure arising from derivative transactions. This promulgation addresses the Dodd-Frank Act requirements by providing methods for taking into consideration credit exposure to derivative transactions for Maine's financial institutions. This promulgation is based on the new interim final rule that was issued by the Office of the Comptroller of the Currency (OCC) in response to the Dodd-Frank Act. This new interim final rule, which amends 12 CFR Part 32, may be found at 77 FR 37265. Pursuant to this interim final rule, national banks must also evaluate credit exposure to derivatives transactions when calculating lending limits to a single borrower.

Credit unions have lending limit requirements other than those found in the regulation.

SECTION 2. AUTHORITY

Title 9-B MRS §215 authorizes the Superintendent to implement by rule any provisions of law relating to the supervision of financial institutions.

Title 9-B MRS §439-A(5) authorizes the Superintendent to adopt rules to carry out purposes of the Banking Code's lending limit law, including rules to define or further define terms used in the section and to establish limits or requirements other than those specified in the section if the Superintendent determines that such action is necessary for the protection of depositors, investors or the public.

SECTION 3. DEFINITIONS

1. "Borrower" means a person who is named as a borrower or debtor in a loan or extension of credit; a person to whom a financial institution has credit exposure arising from a derivative transaction entered by the financial institution; or any other person, including a drawer, endorser, or guarantor, who is deemed to be a borrower under the "direct benefit" or the "common enterprise" tests set forth in section 6 of this regulation.

2. "Contractual commitment to advance funds":
 - A. Includes a financial institution's obligation to:
 - (1) Make payment (directly or indirectly) to a third person contingent upon default by a customer of the financial institution in performing an obligation and to make such payment in keeping with the agreed upon terms of the customer's contract with the third person, or to make payments upon some other stated condition;
 - (2) Guarantee or act as surety for the benefit of a person;
 - (3) Advance funds under a qualifying commitment to lend, that is, a legally binding written commitment to lend that, when combined with all other outstanding loans and qualifying commitments to a borrower, is within the financial institution's lending limit when entered into, and has not be disqualified; and
 - (4) Advance funds under a standby letter of credit as defined in subsection 3(13) of this regulation, a put, or other similar arrangement.
 - B. The term does not include commercial letters of credit and similar instruments where the issuing financial institution expects the beneficiary to draw on the issuer, that do not guarantee payment, and that do not provide for payment in the event of a default by a third party.
3. "Control" is presumed to exist when a person directly or indirectly, or acting through or together with one or more persons:
 - A. Owns, controls, or has the power to vote 25 percent or more of any class of voting securities of another person;
 - B. Controls, in any manner, the election of a majority of the directors, trustees, or other persons exercising similar functions of another person; or
 - C. Has the power to exercise a controlling influence over the management or policies of another person.
4. "Credit derivative" means a financial contract executed under standard industry credit derivative documentation that allows one party (the protection purchaser) to transfer the credit risk of one or

more exposures (reference exposure) to another party (the protection provider).

5. "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.
6. "Eligible credit derivative" means a single-name credit derivative or a standard, non-tranched index credit derivative provided that:
 - A. The derivative contract meets the requirements of an eligible guarantee, as defined in subsection 3(7) of this regulation and has been confirmed by the protection purchaser and the protection provider;
 - B. Any assignment of the derivative contract has been confirmed by all relevant parties;
 - C. If the credit derivative is a credit default swap, the derivative contract includes the following credit events:
 - (1) Failure to pay any amount due under the terms of the reference exposure, subject to any applicable minimal payment threshold that is consistent with standard market practice and with a grace period that is closely in line with the grace period of the reference exposure; and
 - (2) Bankruptcy, insolvency, or inability of the obligor on the reference exposure to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due and similar events;
 - D. The terms and conditions dictating the manner in which the derivative contract is to be settled are incorporated into the contract;

- E. If the derivative contract allows for cash settlement, the contract incorporates a robust valuation process to estimate loss with respect to the derivative reliably and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;
 - F. If the derivative contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract provides that any required consent to transfer may not be unreasonably withheld; and
 - G. If the credit derivative is a credit default swap, the derivative contract clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event.
7. "Eligible guarantee" means a guarantee that:
- A. Is written and unconditional;
 - B. Covers all or a pro rata portion of all contractual payments of the obligor on the reference exposure;
 - C. Gives the beneficiary a direct claim against the protection provider;
 - D. Is not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;
 - E. Is legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced;
 - F. Requires the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligor on the reference exposure in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment;

- G. Does not increase the beneficiary's cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure; and
 - H. Is not provided by an affiliate of the financial institution, unless the affiliate is an insured depository institution, bank, securities broker or dealer, or insurance company that:
 - (1) Does not control the financial institution; and
 - (2) Is subject to consolidated supervision and regulation comparable to that imposed on U.S. depository institutions, securities broker-dealers, or insurance companies (as the case may be).
8. "Eligible protection provider" means:
- A. A sovereign entity (a central government, including the U.S. government; an agency; department; ministry; or central bank);
 - B. The Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, or a multilateral development bank;
 - C. A Federal Home Loan Bank;
 - D. The Federal Agricultural Mortgage Corporation;
 - E. A depository institution, as defined in section 3 of the Federal Deposit Insurance Act, 12 U.S.C. §1813(c);
 - F. A bank holding company, as defined in section 2 of the Bank Holding Company Act, as amended, 12 U.S.C. §1841;
 - G. A savings and loan holding company, as defined in section 10 of the Home Owners' Loan Act, 12 U.S.C. §1467a;
 - H. A securities broker or dealer registered with the SEC under the Securities Exchange Act of 1934, 15 U.S.C. §78o et seq.;

- I. An insurance company that is subject to the supervision of a State insurance regulator;
 - J. A foreign banking organization;
 - K. A non-U.S.-based securities firm or a non-U.S.-based insurance company that is subject to consolidated supervision and regulation comparable to that imposed on U.S. depository institutions, securities broker-dealers, or insurance companies; and
 - L. A qualifying central counterparty, for example, a clearing house that:
 - (1) Facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts;
 - (2) Requires all participants in its arrangements to be fully collateralized on a daily basis; and
 - (3) The bank demonstrates to the satisfaction of the Bureau that it is in sound financial condition and is subject to effective oversight by a national supervisory authority.
9. "Financial institution" has the same meaning that is set forth in 9-B MRSA §131(17).
10. "Loans or extensions of credit" has the same meaning that is set forth in 9-B MRSA §439-A(1)(A)
- A. "Loans or extensions of credit" include:
- (1) Any credit exposure, as determined pursuant to section 8 of this regulation, arising from a derivative transaction;
 - (2) A contractual commitment to advance funds;
 - (3) An overdraft, whether or not prearranged, but not an intraday overdraft for which payment is received before the close of business of the financial institution that makes the funds available;
 - (4) The sale of Federal funds with a maturity of more than one business day, but not Federal funds with a maturity

of one day or less or Federal funds sold under a continuing contract; and

- (5) Loans or extensions of credit that have been charged off on the books of the financial institution in whole or in part, unless the loan or extension of credit:
 - (a) Is unenforceable by reason of discharge in bankruptcy;
 - (b) Is no longer legally enforceable because of expiration of the statute of limitations or a judicial decision; or
 - (c) Is no longer legally enforceable for other reasons, provided that the financial institution maintains sufficient records to demonstrate that the loan is unenforceable.

B. In addition to the exclusions from limitations found in 9-B MRSA §439-A(3), the following items do not constitute "loans or extensions of credit" for purposes of this regulation:

- (1) Additional funds advanced for the benefit of a borrower by a financial institution for payment of taxes, insurance, utilities, security, and maintenance and operating expenses necessary to preserve the value of real property securing the loan, consistent with safe and sound banking practices, but only if the advance is for the protection of the financial institution's interest in the collateral, and provided that such amounts must be treated as an extension of credit if a new loan or extension of credit is made to the borrower;
- (2) Accrued and discounted interest on an existing loan or extension of credit, including interest that has been capitalized from prior notes and interest that has been advanced under terms and conditions of a loan agreement;
- (3) Financed sales of a financial institution's own assets, including Other Real Estate Owned, if the financing does not put the financial institution in a worse position than when the financial institution held title to the assets;
- (4) A renewal or restructuring of a loan as a new "loan or extension of credit," following the exercise by a financial institution of reasonable efforts, consistent with safe and sound banking practices, to bring the loan into conformance with the lending limit, unless new funds are advanced by the financial institution to the borrower, or a new borrower replaces the original borrower, or unless the Bureau determines that a renewal or restructuring

was undertaken as a means to evade the financial institution's lending limit;

(5) Amounts paid against uncollected funds in the normal process of collection;

(6) (a) That portion of a loan or extension of credit sold as a participation by a financial institution on a nonrecourse basis, provided that the participation results in a pro rata sharing of credit risk proportionate to the respective interests of the originating and participating lenders. Where a participation agreement provides that repayment must be applied first to the portions sold, a pro rata sharing will be deemed to exist only if the agreement also provides that, in the event of a default or comparable event defined in the agreement, participants must share in all subsequent repayments and collections in proportion to their percentage participation at the time of the occurrence of the event.

(b) When an originating financial institution funds the entire loan, it must receive funding from the participants before the close of business of its next business day. If the participating portions are not received within that period, then the portions funded will be treated as a loan by the originating financial institution to the borrower. If the portions so attributed to the borrower exceed the originating financial institution's lending limit, the loan may be treated as nonconforming subject to section 7 of this regulation, rather than a violation, if:

(i) The originating financial institution had a valid and unconditional participation agreement with a participant or participants that was sufficient to reduce the loan to within the originating financial institution's lending limit;

(ii) The participant reconfirmed its participation and the originating financial institution had no knowledge of any information that would permit the participant to withhold its participation; and

(iii) The participation was to be funded by close of business of the originating financial institution's next business day; and

- (7) Intraday credit exposures arising from a derivative transaction.
11. "Perpetual preferred stock" means preferred stock that does not have a stated maturity date and cannot be redeemed at the option of the holder.
 12. "Person" has the meaning as defined in 9-B MRSA §131(30).
 13. "Standby letter of credit" is any letter of credit, or similar arrangement, however named or described, which represents an obligation to the beneficiary on the part of the issuer:
 - A. To repay money borrowed by or advanced to or for the account of the account party;
 - B. To make payment on account of any indebtedness undertaken by the account party; or
 - C. To make payment on account of any default by the account party in the performance of an obligation.
 14. "Subsidiary" has the meaning as defined in 9-B MRSA §131(39-A). A "service corporation," as defined in 9-B MRSA §131(37), is a "subsidiary" for the purposes of this regulation.
 15. "Total capital and surplus" means:
 - A. A financial institution's Tier 1 and Tier 2 capital calculated under the risk-based capital standards applicable to the institution as reported in the financial institution's Consolidated Reports of Condition and Income (Call Report); plus

- B. The balance of a financial institution's allowance for loan and lease losses not included in the financial institution's Tier 2 capital, for purposes of the calculation of risk-based capital described in paragraph (A) of this subsection, as reported in the financial institution's Call Report.

SECTION 4. LENDING LIMITS

Except as provided in 9-B MRSA §439-A and this regulation, a financial institution and/or its subsidiaries may not make loans or extensions of credit outstanding at one time to a borrower in excess of 20% of its total capital and surplus.

SECTION 5. CALCULATION DATE OF LENDING LIMITS

- 1. Calculation date. For purposes of determining compliance with this regulation, a financial institution shall determine its lending limit on the last day of the preceding calendar quarter, unless otherwise directed by the Superintendent.
- 2. Effective date. A financial institution's lending limit calculated in accordance with subsection (1) of this section will be effective as of the earlier of the date on which the financial institution's Consolidated Reports of Condition and Income (Call Report) is submitted or the date the Call Report is required to be submitted.

SECTION 6. COMBINATION RULES

- 1. General rule. Loans or extensions of credit to one borrower will be attributed to another person and each person will be deemed a borrower:
 - A. When proceeds of a loan or extension of credit are to be used for the direct benefit of the other person, to the extent of the proceeds so used; or
 - B. When a common enterprise is deemed to exist between the persons.

2. Direct benefit. The proceeds of a loan or extension of credit to a borrower will be deemed to be used for the direct benefit of another person and will be attributed to the other person when the proceeds, or assets purchased with the proceeds, are transferred to another person, other than in a bona fide arm's length transaction where the proceeds are used to acquire property, goods, or services.
3. Common enterprise. A common enterprise will be deemed to exist and loans to separate borrowers will be aggregated:
 - A. When the expected source of repayment for each loan or extension of credit is the same for each borrower and neither borrower has another source of income from which the loan (together with the borrower's other obligations) may be fully repaid. An employer will not be treated as a source of repayment under this section because of wages and salaries paid to an employee, unless the standards of paragraph 3(B) of this section are met;
 - B. When loans or extensions of credit are made:
 - (1) To borrowers who are related directly or indirectly through common control, including where one borrower is directly or indirectly controlled by another borrower; and
 - (2) Substantial financial interdependence exists between or among the borrowers. Substantial financial interdependence is deemed to exist when 50 percent or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other borrower. Gross receipts and expenditures include gross revenues/expenses, intercompany loans, dividends, capital contributions, and similar receipts or payments;
 - C. When separate persons borrow from a financial institution to acquire a business enterprise of which those borrowers will own more than 50 percent of the voting securities or voting interests, in which case a common enterprise is deemed to exist between the borrowers for purposes of combining the acquisition loans;

- D. When the Bureau determines, based upon an evaluation of the facts and circumstances of particular transactions, that a common enterprise exists.
4. Loans to corporations. For purposes of this regulation and 9-B MRSA §439-A, a corporation is a "subsidiary" of any person who directly or indirectly owns or beneficially owns more than 50% of the voting stock of the corporation. Loans or extensions of credit to a person and its subsidiary or to subsidiaries of one person need not be combined where the financial institution has determined that the person and subsidiaries involved are not engaged in a "common enterprise" as that term is defined in subsection 3 of this section. Notwithstanding the foregoing sentence, loans or extensions of credit by a financial institution to a "corporate group" (defined as a person and all of its subsidiaries) may not exceed 50% of the financial institution's total capital and surplus.
5. Loans to partnerships, joint ventures, and associations.
- A. Loans or extensions of credit to a partnership, joint venture, or association shall, for purposes of this regulation, be considered loans or extensions of credit to each member of such partnership, joint venture, or association.
 - B. Paragraph (5)(A) of this section is not applicable to limited partners in limited partnerships or to members of joint ventures or associations if such partners or members, by the terms of the partnership or membership agreement are not to be held liable for the debts or actions of the partnership, joint venture, or association. However, the rules set forth in subsections 6(1), (2) and (3) of this regulation are applicable to such partners or members.
 - C. Loans or extensions of credit to members of a partnership, joint venture, or association shall, for purposes of this regulation, be attributed to the partnership, joint venture, or association where one or more of the tests set forth in subsections 6(2) and 6(3) of this regulation is satisfied with respect to one or more such members. However, loans to members of a partnership, joint venture, or association will not be attributed to other members of the partnership, joint venture, or association under this regulation unless one or more of the tests set forth in

subsections 6(2) and (3) of this regulation is satisfied with respect to such members.

- D. The tests set forth in subsections 6(2) and (3) of this regulation shall be deemed satisfied when loans or extensions of credit are made to members of a partnership, joint venture, or association for purposes of purchasing an interest in such partnership, joint venture, or association.

SECTION 7: NONCONFORMING LOANS AND EXTENSIONS OF CREDIT

1. A loan or extension of credit, within a financial institution's legal lending limit when made, will not be deemed a violation but will be treated as nonconforming if the loan or extension of credit is no longer in conformity with the financial institution's lending limit because:
 - A. The financial institution's capital has declined, borrowers have subsequently merged or formed a common enterprise, lenders have merged, or the lending limit or capital rules have changed;
 - B. Collateral securing the loan to satisfy the requirements of a lending limit exception has declined in value.
2. A financial institution must use reasonable efforts to bring a loan or extension of credit that is nonconforming as a result of paragraph 1(A) of this section into conformity with the financial institution's lending limit unless to do so would be inconsistent with safe and sound banking practices.
3. A financial institution must bring a loan that is nonconforming as a result of circumstances described in paragraph 1(B) of this section into conformity with the financial institution's lending limit within 30 calendar days, except when judicial proceedings, regulatory actions or other extraordinary circumstances beyond the financial institution's control prevent it from taking action.

SECTION 8: CREDIT EXPOSURE ARISING FROM DERIVATIVE TRANSACTIONS

1. Scope. This section sets forth the rules for calculating the credit exposure arising from a derivative transaction entered into by a financial institution for purposes of determining the financial institution’s lending limit pursuant to this regulation.
2. Derivative transactions
 - A. Non-Credit Derivatives. Subject to paragraph 2(B) of this section, a financial institution shall calculate the credit exposure to a counterparty arising from a derivative transaction by one of the following methods. A financial institution shall use the same method for calculating counterparty credit exposure arising from all of its derivative transactions.
 - (1) Conversion Factor Matrix Method. The credit exposure arising from a derivative transaction under the Conversion Factor Matrix Method 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 Table 1 below.

TABLE 1—CONVERSION FACTOR MATRIX FOR CALCULATING POTENTIAL FUTURE CREDIT EXPOSURE.^[1]

Original maturity ^[2]	Interest Rate	Foreign exchange rate and gold	Equity	Other ^[3] (includes commodities and precious metals except gold)
1 year or less.....	.015	.015	.20	.06
Over 1 to 3 years.....	.03	.03	.20	.18
Over 3 to 5 years.....	.06	.06	0.20	0.30
Over 5 to 10 years.....	.12	.12	0.20	.60
Over ten years.....	.30	.30	.20	1.0

¹ 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.

² 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.

³ Transactions not explicitly covered by any other column in the Table are to be treated as “Other.”

- (2) 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 Table 2, below.

TABLE 2—REMAINING MATURITY FACTOR FOR CALCULATING CREDIT EXPOSURE

	Interest Rate	Foreign exchange rate and gold	Equity	Other ^[4] (includes commodities and precious metals except gold)
Multiplicative Factor	1.5%	1.5%	6%	6%

B. Credit Derivatives

- (1) Notwithstanding paragraph 2(A) of this section, a financial institution that uses the Conversion Factor Matrix Method or Remaining Maturity Method shall calculate the counterparty credit exposure arising from credit derivatives entered by the financial institution by adding the net notional value of all protection purchased from the counterparty on each reference entity.
- (2) A financial institution shall calculate the credit exposure to a reference entity arising from credit derivatives entered by the financial institution by adding the notional value of all protection sold on the reference entity. However, the financial institution 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.

SECTION 9: AUTHORITY OF THE SUPERINTENDENT

⁴ Transactions not explicitly covered by any other column in the Table are to be treated as “Other.”

The Superintendent may require a financial institution to use the Conversion Factor Matrix Method or the Remaining Maturity Method to calculate the credit exposure of derivative transactions if the Superintendent finds that such method is necessary to promote the safety and soundness of the financial institution.

SECTION 10: EFFECTIVE DATE: January 1, 2013

FISCAL IMPACT STATEMENT

This proposed regulation does not impose any cost on municipalities or counties.

PRIMARY SOURCES OF INFORMATION RELIED UPON

The Bureau relies upon the following primary sources of information in developing the proposed rule: The Federal Deposit Insurance Act, 12 USC §1828, as amended by section 611 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 111 PL 203; and 12 CFR Part 32 (OCC Lending Limits regulation).

[1] 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.

[2] 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.

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

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

MAINE BUREAU OF FINANCIAL INSTITUTIONS

BASIS STATEMENT RELATING TO THE PROPOSED REPEAL AND REPLACEMENT OF REGULATION 28^[1]

Derivative transactions, when used appropriately, are a valuable tool for financial institutions. Derivative transactions can range from relatively simple to extremely complex. The following general descriptions are for the limited purpose of aiding the reader in understanding the intent of the proposed regulation.

A derivative transaction is a financial 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. Derivative contracts include interest rate derivative contracts, credit derivatives, and any other instrument that poses similar counterparty credit risks.

Derivatives are risk-shifting devices. For example, to mitigate risks that occur from ordinary lending activities, smaller financial institutions typically use and rely almost exclusively on derivatives known as "swaps," a simultaneous buying and selling of the same security or obligation. In a low interest rate environment, most borrowers desire fixed rate loans. Most financial institutions prefer making floating rate loans to better match the inevitable changes in interest rates they pay for deposits and wholesale loans that serve as the funding source for customer loans. To allow the borrower to pay a fixed rate, a financial institution can enter into an interest rate swap with a counterparty and swap its fixed rate loan payment stream for a floating rate payment stream based on an identical principal amount, as a hedge to better control fluctuations in its borrowing costs. These derivative activities can be highly useful in managing or hedging existing risk in a financial institution's loan or investment portfolio.

The Dodd-Frank Act provisions require state-chartered financial institutions to identify and manage the risks being assumed in derivative transactions. Part of the risk identification and management process is determining the potential monetary exposure of the parties under the terms of the derivative instrument. This proposed regulation will require state-chartered financial institutions to make determinations at loan inception of potential credit exposure from a derivative transaction in a manner similar to that required of their federally-chartered counterparts.

Dodd-Frank Requirements

On June 20, 2012, the Office of the Comptroller of the Currency (the OCC) released its interim final regulation for nationally-chartered financial institutions

to implement Section 610 of the Dodd-Frank Act. Published in the June 21, 2012 edition of the Federal Register (77 Fed. Reg. 37265). The regulation sets out procedures and methodologies for calculating the credit exposure under these newly-covered transactions. In order to reduce the practical burden of these calculations, particularly for smaller financial institutions, the OCC provided different options for measuring credit exposures in new 12 CFR §32.9. These alternatives appear to implement the statutory changes, consistent with safety and soundness and the goals of the statute, in a manner that seeks to reduce unnecessary new regulatory burden. The Bureau's regulation adopts the derivative evaluation methods used by the OCC, except for the Internal Model Method.

The effective date for Section 611 of Dodd-Frank is January 21, 2013. The OCC interim final rule may be amended prior to that date. Interested parties should therefore be made aware that the Bureau may amend the proposed regulation prior to adoption to incorporate amendments similar to those that may be made by the OCC. Such amendments will serve to align state and federal law thereby streamlining regulation and reducing regulatory burdens.

Description of the Proposed Regulation

The credit exposure arising from a derivative transaction is commonly viewed as the sum of the current credit exposure on the contract or portfolio plus some measure of potential future exposure (PFE). Under Section 8 of the proposed regulation, the current credit exposure is determined by the mark-to-market value (MTM) of the derivative contract. The current MTM is generally zero at execution of the contract. Subsequent to the execution of the contract, if the MTM value is positive, then the current credit exposure equals that MTM value. If the MTM value is zero or negative, then the current credit exposure is zero.

PFE, on the other hand, recognizes the possibility that the MTM amount may increase over time, based upon changes in market factors. The PFE, when added to the MTM amount, can be viewed as the anticipated ceiling of credit exposure at the execution of a derivative transaction.

Section 8 of the proposed regulation provides two methods for calculating credit exposure of derivative transactions other than credit derivatives. Unless required to use a specific method by the Superintendent pursuant Section 9 of the proposed regulation, a financial institution may choose which of these methods it will use. However, a financial institution must use the same method for calculating credit exposure arising from all derivative transactions.

Method One: A financial institution may choose to measure the credit exposure arising from a derivative transaction under the "conversion factor matrix method." Under this method, the credit exposure will equal and remain fixed at the PFE of the derivative transaction, as determined at execution of the

transaction by reference to a simple look-up table (Table 1 in the Section 8 of the proposed regulation).

While the simplicity and stability of the "conversion factor matrix method" will make it easy to apply, actual credit exposure can arise during the life of a derivative contract that is not captured under this method. The Bureau believes that the potentially unmeasured risks can be addressed in the supervisory process by examiners appropriately responding to unsafe and unsound concentrations, and that the certainty and simplicity of allowing non-complex financial institutions to "lock in" the attributable exposure at the execution of the contract balances the possible risks.

Method Two: A financial institution may choose to measure the credit exposure arising from a derivative transaction under the "remaining maturity method." This measurement of the credit exposure incorporates both the current MTM and the transaction's remaining maturity (measured in years) as well as a fixed add-on for each year of the transaction's remaining life. Specifically, this method measures credit exposure by adding the current MTM value of the transaction to the product of the notional amount of the transaction, the remaining maturity of the transaction, and a fixed multiplicative factor. These multiplicative factors differ based on product type and are determined by a look-up table (Table 2 in Section 8 of the proposed regulation).

The credit exposure calculated under the remaining maturity method accounts for the diminishing maturity of the transaction as well as the current MTM of the transaction. A financial institution may find that any additional burden involved with determining the MTM under this optional method is balanced by the fact that, depending on the MTM, as the maturity decreases, the credit exposure also decreases, thereby permitting additional extensions of credit under the lending limit.

In the case of credit derivatives, in which a financial institution buys or sells credit protection against loss on a third-party reference entity, a special rule would apply as set forth in Section 8 of the proposed regulation. Specifically, a financial institution that uses the "conversion factor matrix" method or "remaining maturity method" calculates the counterparty credit exposure arising from credit derivatives by adding the net notional value of all protection purchased from the counterparty on each reference entity. For example, financial institution A buys and sells credit protection from and to financial institution B on Firms X, Y and Z. Financial institution A's net notional protection purchased from financial institution B is \$50 for Firm X and \$100 for Firm Y. Financial institution A's net protection sold to financial institution B is \$35 for Firm Z. The lending limit exposure of financial institution A to financial institution B is \$150.

In addition, a financial institution would calculate the credit exposure to a reference entity arising from credit derivatives by adding the notional value of all

protection sold on the reference entity. For example, financial institution C buys and sells credit protection on Firms 1, 2 and 3. Financial institution C's notional protection sold is \$100 for Firm 1, \$200 for Firm 2 and \$300 for Firm 3. The lending limit exposure of financial institution C to Firm 1 is \$100, to Firm 2 is \$200 and to Firm 3 is \$300.

However, the financial institution may reduce its exposure to a reference entity by the amount of any "eligible credit derivative," defined in Section 3 of the proposed regulation, purchased on that reference entity from an "eligible protection provider," also defined in Section 3 of the proposed regulation. In the last example, if financial institution C purchases protection on Firm 3 from an eligible protection provider in the amount of \$25 via an eligible credit derivative, financial institution C can reduce its \$300 lending limit exposure to Firm 3 to \$275.

[1] The OCC's comments on the interim final rule on lending limits for certain credit exposures to derivatives and securities financing transactions published on June 21, 2012 have been used as the primary source for this discussion.

NOTICE OF AGENCY RULE-MAKING PROPOSAL

AGENCY: Department of Professional and Financial Regulation – Bureau of Financial Institutions

CHAPTER NUMBER AND TITLE: Chapter 128: Loans to One Borrower Limitations

PROPOSED RULE NUMBER (*leave blank; assigned by Secretary of State*):

CONTACT PERSON FOR THIS FILING: Christian D. Van Dyck, Attorney, Bureau of Financial Institutions; email: Christian.d.vandyck@Maine.gov; tel: (207) 624-8574.

CONTACT PERSON FOR SMALL BUSINESS INFORMATION (if different): N/A.

PUBLIC HEARING (if any): None proposed by the Bureau. If 5 or more interested persons request a hearing, they may submit their request electronically to Christian D. Van Dyck at Christian.d.vandyck@Maine.gov on or before the comment deadline.

COMMENT DEADLINE: November 19, 2012. Data, views or arguments may be submitted to the Bureau for consideration (whether or not a hearing is held) by submitting them electronically to Christian D. Van Dyck at Christian.d.vandyck@Maine.gov or in writing to the Bureau of Financial Institutions, 36 State House Station, Augusta, ME 04333-00336 on or before the comment deadline.

BRIEF SUMMARY OF THE PROPOSED RULE AND WHERE COPY OF THE PROPOSED RULE MAY BE FOUND TOGETHER WITH BACKGROUND STATEMENT:

This promulgation repeals and replaces existing Regulation 28. Its purpose is to establish guidelines for the administration of lending limits and to accommodate recent federal requirements pertaining to such limits found in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 111 PL 203 ("Dodd-Frank Act"). Effective January 21, 2013, section 611 of the Dodd-Frank Act will prohibit state-chartered financial institutions from engaging in derivative transactions unless state lending limit laws take into consideration credit exposure to derivative transactions. Prior to this promulgation, Maine's lending limit law did not provide guidance for measuring credit exposure arising from derivative transactions. This promulgation addresses the Dodd-Frank Act requirements by providing methods for taking into consideration credit exposure to derivative transactions for Maine's financial institutions. This promulgation is based on the new interim final rule that was issued by the Office of the Comptroller of the Currency (OCC) in response to the Dodd-Frank Act. This new interim final rule, which amends 12 CFR Part 32, may be found at 77 FR 37265. Pursuant to this interim final rule, national banks must also evaluate credit exposure to derivatives transactions when calculating lending limits to a single borrower.

The proposed rule and background statement may be found at: www.maine.gov/pfr/financialinstitutions.

IMPACT ON MUNICIPALITIES OR COUNTIES (if any): N/A.

STATUTORY AUTHORITY FOR THIS RULE:

Title 9-B MRS §215 authorizes the Superintendent to implement by rule any provisions of law relating to the supervision of financial institutions.

Title 9-B MRS §439-A(5) authorizes the Superintendent to adopt rules to carry out purposes of the Banking Code's lending limit law, including rules to define or further define terms used in the section and to establish limits or requirements other than those specified in the section if the Superintendent determines that such action is necessary for the protection of depositors, investors or the public.

SUBSTANTIVE STATE OR FEDERAL LAW BEING IMPLEMENTED (if different): 9-B, MRS, s. 439-A, The Federal Deposit Insurance Act, 12 USC 1828, as amended by section 611 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 111 PL 203; and 12 CFR Part 32 (Interim final OCC Lending Limits regulation, implemented in part).

E-MAIL FOR OVERALL AGENCY RULE-MAKING LIAISON:

Christian.d.vandyck@Maine.gov.

NAME, ADDRESS AND TELEPHONE NUMBER OF STAFF PERSON RESPONSIBLE FOR PROVIDING ADDITIONAL INFORMATION OR A PRINTED VERSION OF THE PROPOSED RULE:

Attorney Christian D. Van Dyck

Maine Bureau of Financial Institutions

36 State House Station

Augusta, ME 04333-0036

(207) 624-8574

STATEMENT OF IMPACT ON SMALL BUSINESS MAY BE FOUND AT:
www.Maine.gov/pfr/financialinstitutions.

* *Check one of the following two boxes.*

The above summary is for use in both the newspaper and website notices.

The above summary is for the newspaper notice only. A more detailed summary / basis statement is attached.

Please approve bottom portion of this form and assign appropriate AdvantageME number.

APPROVED FOR PAYMENT _____ DATE: _____

(authorized signature)

FUND	AGENCY AMOUNT	ORG	APP	JOB	OBJT
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MAPA-3 revised 9-09: additional summary information for web

Notice of Agency Rule-making Proposal

DETAILED BASIS STATEMENT / SUMMARY:

029 BUREAU OF FINANCIAL
INSTITUTIONS
CHAPTER 128 (REGULATION 28)

PROPOSED REPEAL AND REPLACEMENT OF THE LOANS TO ONE
BORROWER LIMITATIONS RULE
STATEMENT OF IMPACT ON SMALL BUSINESS

Prepared pursuant to 5 MRSA §8052, sub-§5-A

- A. Identification of the types and an estimate of the number of the small businesses subject to the proposed partial repeal of Chapter 550 (Bureau of Consumer Credit Protection) and Chapter 144 (Bureau of Financial Institutions):

There is only one Maine-chartered financial institution that meets the definition of a small business.

- B. Projected Reporting, record-keeping and other administrative costs required for compliance with the proposed partial repeal of Chapter 128 (Bureau of Financial Institutions), including the type of professional skill necessary for preparation of the report or record:

This proposed rule is permissive because it will allow Maine-chartered financial institutions to engage in derivative activities. To the extent that they decide to do so, they will be required to adhere to methods for determining credit exposures arising from these derivative transactions. These methods are the same as those found in federal regulation. Like their federal counterparts, Maine financial institutions will need to verify with the Maine Bureau of Financial Institutions through record-keeping that they are adhering to these methods.

- C. Brief statement of the probable impact on affected small businesses:

This proposed rule will allow Maine-chartered financial institutions to engage in derivative transactions putting them on an equal footing with their federal counterparts.

- D. Description of any less intrusive or less costly, reasonable alternative methods of achieving the purposes of the proposed partial repeal of Chapter

550 (Bureau of Consumer Credit Protection) and Chapter 144 (Bureau of Financial Institutions):

None.