INTERPRETIVE LETTER 13-01 (February 13, 2013)

STATE CHARTERED BANKS ARE AUTHORIZED TO PARTICIPATE IN DERIVATIVE TRANSACTIONS

This letter[1] is in response to your inquiries requesting the Illinois Department of Financial and Professional Regulation, Division of Banking ("Department") to opine on whether the Illinois Banking Act ("Act") provides the authority for state chartered banks to participate in derivative transactions pursuant to section 611 of the Dodd-Frank Act.

As you know, effective January 21, 2013, Section 611 of the Dodd-Frank Act prohibits state chartered banks from engaging in derivative transactions unless the law of the State in which the insured state bank is chartered takes into consideration credit exposure to derivative transactions with respect to lending limits.[2] The Department has conducted a review of the Act and concluded that the Act meets this requirement.[3] The following is an Interpretive Letter that explains the two separate provisions in the Act that authorize a state bank's participation in derivative transactions.

First, authority for a state bank to participate in a derivative transaction can be found in section 32 of the Act, under which state banks are required to take into consideration credit exposure to derivative transactions. Section 32 states, in part:

> The liabilities outstanding at one time to a state bank of a person for money borrowed, including the liabilities of a partnership or joint venture in the liabilities of the several members thereof, shall not exceed 25% of the amount of the unimpaired capital and unimpaired surplus of the bank.

The authority is drawn from the definition of the words "money borrowed" as used in section 32. According to Black's Law Dictionary, to borrow money is to receive it from another and promise to repay or return its equivalent; in a broad sense, it means to contract for the use of money. [Blacks Law Dictionary 5th ed. 1979]. In a typical derivative transaction, parties contractually agree to exchange payments based on the change in the value or performance of an index or asset. The change in the underlying index or asset then is multiplied typically by an agreed upon amount, commonly referred to as the notional amount, to determine the total that one party must pay to the other. The liability or credit exposure created by the transaction is "money borrowed", and has historically been, as it is today, accounted for by application of section 32.

The Act also considers credit exposure from derivative transactions in a second manner, by way of reference. Section 5(11) of the Act is a parity statute and is a dynamic regulatory provision—the application of which is intended to be fluid.[4] By the statute's operation, a state bank may receive powers that are identical to powers that have been granted to national banks. A state bank that proposes to engage in any act that is permitted to national banks can utilize the statute. In typical cases, a state bank may utilize section 5(11) through its own election without first seeking the Department's approval. When this happens, the relevant federal law, including the grant of authority and any related restrictions, is referenced by the application of section 5(11).

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[1] This letter supplements and replaces the Department's letter issued on January 17, 2013.
[2] Subsequently codified at 12 U.S.C. § 1828y (2011).
[3] 205 ILCS 5/1 *et seq*.
[4] 205 ILCS 5/5(11).

The Illinois Banking Act, through section 5(11), incorporates provisions that consider derivative transactions in the context of lending limits.[5] The referenced federal law that establishes the definitive terms, including the restrictions and limitations, can be found at 12 U.S.C. 84 and 12 CFR part 32. These three laws meet and form the rules that fulfill the purpose of Section 611, which also includes the regulatory decision reached by the Office of the Comptroller of the Currency providing a temporary exception from the application of the derivatives lending limits rule until July 1, 2013.[6]

Two general matters are worth emphasizing. First, whenever section 5(11) is used to alter or otherwise avoid the constructs of the lending limits imposed by section 32 of the Act, a state chartered bank must be able to identify the specific law or laws that bear on its transactions. Second, a state bank that utilizes section 5(11) is bound by lending limits that are expressly informed by federal law.

A state bank that chooses to engage in derivative transactions must adhere to safety and soundness principles. The Department retains full authority to address credit exposures that present undue concentrations on a case by case basis through existing safety and soundness authorities.

[5] Basic lending limit provisions can be found at 205 ILCS 5/32.
[6] 12 CFR 32.1(d).