Frequently Asked Questions regarding the Order titled: *Adopting Consideration Given to Credit Exposure Arising from Derivatives and Securities Financing Transactions, which is effective January 21, 2013.*

1. **What is the purpose of the Department Order regarding Derivatives?**

   Answer: The Department Order allows banks to enter into derivative transactions, which are both credit and non-credit derivatives. Congress, through the Dodd Frank 2010 Act, mandated that statutory changes be made at the state level or banks would be prohibited from entering into derivative transactions after January 21, 2013. The Order determines the manner and extent to which credit exposure from derivative transactions is taken into account with regard to lending limits.

2. **What is a derivative?**

   Answer: A derivative is a risk shifting devise that utilizes a contract between two parties. The derivative contract specifies conditions (such as the dates, resulting values of the underlying variables, and notional amounts) under which payments are to be made between the parties. Derivatives can be useful tools for banks to effectively manage risk and on a very broad measure are either described as credit or non-credit derivatives.

3. **What is a credit derivative?**

   Answer: Credit derivatives are contracts related to credit risk. Common types of contracts considered credit derivatives include, but are not limited to, credit default swaps and total return swaps.

4. **What is a non-credit derivative?**

   Answer: Non-credit derivatives are derivative contracts regarding performance at a point in time unrelated to specific credit risk. Non-credit derivative transactions may include forwards, futures, options, caps, or floors, which are not based upon the occurrence of a credit event such as a default or down grade.

5. Can all banks participate in derivative activities?

Answer: A bank may participate in derivative activities if it is well capitalized as defined in prompt corrective action rules.

6. Is the Department's Order on derivatives applicable to every bank?

Answer: If a bank enters into derivative transactions, the Department's Order is relevant. Refer to the flow chart found at the end of this document for more detail.

7. How do derivatives impact on the calculation of the lending limit (exposure limit) for a specific entity?

Answer: Credit exposure resulting from a derivative transaction is calculated using methods found in the Order. The calculated credit exposure is added to the amounts actually advanced to an entity in determining compliance with the bank's legal lending limit.

8. Are derivatives useful to a bank?

Answer: Derivatives can be effective at managing risk. Banks can gain certainty by locking in an interest rate or use swaps as useful tools to manage risk. Derivatives can be risky if sound risk management policies, procedures, and goals are not in place. If used in a speculative manner, derivatives increase risk.

9. What are the typical types of derivatives used by banks?

Answer: Banks that are engaged in derivative transactions are most commonly using plain vanilla Interest Rate Swaps (IRS). However, some institutions engage in very advanced derivative activities. Interest rate swaps provide banks flexibility in managing their interest rate risk; however, drastic interest rate movements can still result in an institution suffering substantial losses. Historically, interest rate swaps represent approximately 80% of all derivatives contracts.

10. If a bank's credit exposure from derivative transactions is determined to be over the bank's legal lending limit on January 23, 2013, will the bank be in violation?

Answer: Per the Order, the derivative transactions will be treated as non-conforming; however, they will not be cited as violations of law.

11. Can a bank switch between methods used to calculate credit risk?

Answer: With the prior written approval of the Director, a bank may change its method of calculating counterparty credit exposure.

12. Is the exposure to government sponsored entities unlimited?

Answer: Nebraska law provides exclusions for lending limit consideration when the borrower or counter party is backed by the full faith and credit of the US Government.

Proposed – FAQ's are periodically updated based upon questions and responses from the industry.