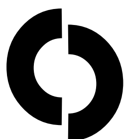

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

February 10, 2005

Interpretive Letter #1018
March 2005
12 USC 24(7)

Re: Equity Derivatives Hedging

Dear **[ ]**:

This is in response to your inquiry regarding whether **[ ]** (the "Bank") may enter into derivatives transactions with certain of its affiliates and subsidiaries that mirror the affiliates' and subsidiaries' transactions with their customers, and may hedge the risks of those transactions in the same manner as it hedges the risks of its existing derivatives business. The transactions would be permissible for the Bank to conduct directly, and the mirror transactions enable the Bank to centrally and more efficiently manage the risks of such transactions conducted by the Bank and certain of its affiliates and subsidiaries. For the reasons set forth below, we conclude that these activities, as described herein, are permissible for the Bank, provided the Bank's Examiner-in-Charge ("EIC") has no supervisory objection.

A. Background

The Bank has a well-established equity derivatives business involving transactions conducted directly with Bank customers for the customers' own business purposes. The Bank hedges the risks arising from those activities through equity derivatives transactions and physical positions in equity securities, based upon prior authorization.[1]

The Bank now proposes to enter into derivatives transactions with affiliates or subsidiaries that mirror the affiliates' and subsidiaries' transactions with their customers.[2] The Bank will only mirror equity transactions with subsidiaries and affiliates that are customer-driven[3] and bank

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[1] *See* Interpretive Letter No. 892 (Sept. 13, 2000).

[2] Some customers conduct transactions with subsidiaries and affiliates of the Bank, rather than the Bank itself, due to foreign legal and regulatory requirements or because the customers prefer to do so because they have existing business relationships with the subsidiaries and affiliates. The customers may include other financial institutions, public and private investment companies, corporations, private banking clients, other high net worth individual customers, and retail customers purchasing equity-linked securities. The Bank will conduct all equity derivatives transactions governed by the Commodity Exchange Act (7 U.S.C. §§ 1 *et seq.*) in conformity with that Act.

[3] A customer-driven transaction is one entered into for another party's valid and independent business purpose. *See* Interpretive Letter No. 892, *supra*.

permissible.[4] The Bank will hedge the risks of those derivatives transactions with subsidiaries and affiliates in the same manner as it hedges its existing equity derivatives business (through derivative and physical equity positions) and subject to the same risk management systems and controls. Due to regulatory considerations, the Bank will not conduct mirror transactions with affiliates or subsidiaries that are U.S. registered securities broker-dealers. The Bank represents that these transactions will accomplish a centralization of risk management of equity derivatives transactions that will be cost effective and will reduce the operational risks that are present when those activities are dispersed across numerous subsidiaries and affiliates across varying geographies within the same organization.

The Bank's fees for the transactions with its subsidiaries and affiliates will be the same as the fees the Bank charges for transactions with other customers, and the transaction fees will be determined using the same processes and systems. However, because the subsidiary or affiliate will retain the credit risk that a customer may default, and because the subsidiary or affiliate is the counterparty and the subsidiary or affiliate will provide collateral that covers the mark-to-market amount for the derivatives transaction, the Bank will not charge a fee for credit risk. The Bank represents that all of the transactions with its affiliates will be conducted on market terms pursuant to section 23B of the Federal Reserve Act.[5]

The Bank will hedge the subsidiary-affiliate transactions on the public trading desk side of the Bank, which has in place Chinese walls to prevent this desk from receiving material nonpublic information from the parts of the Bank with access to such information.

B. Discussion

National banks may engage in customer-driven equity derivatives transactions, including cash-settled options, forwards, and swaps, as part of a financial intermediation business.[6] National banks also may hedge risks arising from those permissible banking activities. Because equity holdings provide cost-effective hedges for risks arising from permissible equity derivatives transactions, the OCC has found banks may hold equities to manage those risks, if appropriate risk management processes are established.[7]

Through the derivatives and hedging activities, national banks serve as financial intermediaries, a traditional and permissible banking function.[8] Financial intermediation includes, for example,

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[4] The Bank's proposed equity derivatives transactions involve swaps, forwards, options, and equity-linked notes, all of which the OCC has affirmed are bank permissible transactions. *See* Interpretive Letter No. 949 (Sept. 19, 2002).

[5] 12 U.S.C. 371c-1.

[6] *See* Interpretive Letter No. 949, *supra.*

[7] *See* Interpretive Letter 892, *supra*.

[8] National banks may use a variety of cash-settled derivatives for financial intermediation purposes. *See* Interpretive Letter No. 949, *supra*. National banks may engage in interest rate, currency, and commodity price index swaps and caps. *See, e.g.,* No-Objection Letter No. 87-5 (July 20, 1987) and Interpretive Letter No. 462

engaging in swap transactions and assuming offsetting swap positions and hedges. In assuming an offsetting swap or hedge, a bank protects itself against risks arising from an established, permissible banking activity and acts as a financial intermediary by interposing itself between customers initiating swaps and customers providing offsetting cash flows or returns. Thus, hedging can be an integral part of financial intermediation services permissible for national banks.[9]

The major difference between the activities previously authorized for the Bank and the Bank's current proposal is that in the former the Bank entered into derivatives transactions directly with its own customers, while here the Bank will enter into derivatives transactions with a subsidiary or an affiliate that mirror that entity's customer transactions, and then hedge the risks of the equity derivatives transactions by holding a limited amount of equity securities. Through the proposed derivatives and hedging activities, the Bank will serve as a financial intermediary, a traditional and permissible banking function. In so doing, the Bank will assume derivatives risks similar to those arising from its existing business and hedge those risks using the same hedging methods. The Bank will only enter into transactions with subsidiaries and affiliates that are the types of derivatives transactions permissible for the Bank, and that the Bank could enter into with unrelated third parties under U.S. laws. The Bank will act as a risk manager, by hedging the risks of its derivatives transactions with its subsidiaries and affiliates in the same manner as it hedges its existing equity derivatives business (through derivatives and physical equity positions) and subject to the same risk management systems and controls. Through these activities, the Bank will serve as a financial intermediary, effectively interposing itself between customers of the subsidiary or affiliate initiating equity derivatives transactions and third party customers providing offsetting cash flows. Thus, the proposed centralized risk management activities rely upon the same core competencies developed by the Bank in managing its own risks as financial intermediary and, for that reason, are a logical outgrowth of those activities and are part of the business of banking.

The Bank will obtain financial and operational advantages through the proposed centralization of risk management for derivatives transactions based on U.S. equities within the Bank's holding company organization. The arrangement will enable the Bank to receive additional revenues and

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(Dec. 19, 1988). National banks also may engage in transactions involving interest rate, basis rate, currency, currency coupon, and cash-settled commodity and equity swaps, swaptions, captions, and other option-like products, forward rate agreements, rate locks and spread locks. *See, e.g.,* Interpretive Letter No. 725 (May 10, 1996), Interpretive Letter No. 652 (Sept. 13, 1994), and No-Objection Letter No. 90-1 (Feb. 16, 1990). Swap and funds intermediation activities are part of the business of banking. *See* Interpretive Letter No. 937 (June 27, 2002) and Interpretive Letter No. 892, *supra*.

[9] The General Accounting Office ("GAO") reviewed and affirmed the OCC's determination in Interpretive Letter 892, *supra*, in a report issued in August 2001. GAO Report 01-945 (Aug. 16, 2001). In its report, the GAO stated that it agreed with the OCC's conclusion that national banks, subject to supervisory approval, have authority under the National Bank Act to own corporate stock to hedge their customer-driven equity derivative transactions. The GAO found that the OCC had reasonably determined that dealing in equity derivatives and managing the risks of that activity are part of the business of banking. The GAO also found that the OCC had reasonably concluded that equity hedging is incidental to the business of banking. Finally, the GAO concluded that 12 U.S.C. 24 (Seventh) does not prohibit national banks from owning stocks for incidental purposes.

profits generated by the fees the Bank will charge the subsidiaries and affiliates that originate the transactions. Further, the arrangement permits the Bank and its holding company to select the most efficient and cost effective means for managing risks arising from equity derivatives transactions throughout their organization.

The OCC previously has recognized that banking organizations should be able to exercise their business judgment in deciding which entities within the organization are the most efficient for conducting their activities.[10] Specifically, the Bank may conduct permissible U.S. equity derivatives activities through operating subsidiaries, including Edge corporations.[11] Operating subsidiaries, including Edge corporations, are structures through which national banks are specifically authorized to conduct their business.[12] The activities of operating subsidiaries and Edge corporation subsidiaries are consolidated with the Bank for financial reporting purposes. Accordingly, the decision whether to conduct an activity directly in the bank itself or through a subsidiary or Edge corporation is fundamentally a business decision that may be influenced by customer needs, internal efficiencies or risk management objectives. Thus, the Bank may conduct U.S. equity derivative transactions through such subsidiaries that would be permissible for the Bank to conduct directly. The Bank also may internally transfer the risks arising from those transactions through mirror transactions between the Bank and such subsidiaries, in order to more efficiently manage risks arising from those transactions, using the same hedging methods applied generally to its derivatives business.

OCC precedents also recognize that it may be advantageous for a national bank to centralize risk management of activities conducted by the bank and its subsidiaries and/or affiliates. For example, national banks may self insure risks arising from their own activities and may provide insurance coverage for activities of bank affiliates.[13] National banks also may provide credit-related insurance coverage for loans they or their affiliates extend to customers.[14] Through these

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[10] *See, e.g.,* Interpretive Letter No. 845 (Oct. 20, 1998) (for efficiency reasons, national bank may use operating subsidiary to self-insure business risks of bank and its bank affiliates) and Interpretive Letter No. 398 (Sept. 28, 1987) (for efficiency reasons a national bank may centralize its internal security in an operating subsidiary that would also provide such services to nonbank affiliates within holding company system).

[11] An Edge corporation is a corporation organized under Section 25A of the Federal Reserve Act, 12 U.S.C. 611-631, through which a national bank may engage in international operations.

[12] *See, e.g.,* 69 Fed. Reg. 1895, 1900 (Jan. 13, 2004) and Corporate Decision No. 2000-07 (May 10, 2000).

[13] In Corporate Decision 99-03 (Dec. 21, 1998), several affiliated banks proposed transferring banking risks to a central national bank subsidiary that would manage the risks by providing insurance coverage. The OCC determined that inherent in the power of national banks to carry on a "business" under 12 U.S.C. 24(Seventh) is the authority to assume risks associated with operating a bank and the ability to manage those risks to the bank's best advantage. *See also* CRA Decision 125 (Dec. 21, 2004) (excess lines insurance coverages are within the types of insurance coverages a national bank subsidiary may provide for its parent bank and bank affiliates).

[14] A national bank may provide mortgage insurance on loans originated, purchased, or serviced by the bank, its subsidiaries or its affiliates. *See* Corporate Decision No. 99-02 (Dec. 11, 1998). National banks may underwrite credit life and credit health, accident, disability and/or involuntary unemployment insurance written in connection with loans extended by a bank and affiliated and unaffiliated lenders. *See* Corporate Decision No. 2001-10 (April

activities, the banks assume credit-related risks arising from permissible banking activities of affiliates and centrally manage those risks.

Similarly, the Bank may centrally manage risks arising from U.S. equity derivatives transactions of affiliates and subsidiaries that are permissible for the Bank. Affiliates and subsidiaries of the Bank are engaged in a variety of customer-driven derivatives transactions as part of a financial intermediation business. The Bank may conduct those types of transactions directly with customers and also may assume the risks of those transactions by entering into transactions with affiliates and subsidiaries that mirror their transactions with customers. Further, the Bank may hedge risks arising from those transactions using the same risk management tools applied to its own equity derivatives business. The hedges used by the Bank to manage resulting risks will be identical to those currently used by the Bank for its existing hedging activities and subject to the same risk management controls. By assuming a centralized risk management function, the Bank enhances the efficiency of its own risk management functions and also benefits from the compensation it receives for its role with respect to transactions of subsidiaries and affiliates.

Safety and Soundness

The proposed activity must be conducted in a safe and sound manner. As indicated above, the Bank represents that all of the transactions with its affiliates will be conducted on market terms pursuant to section 23B of the Federal Reserve Act, and that collateral will be posted by the affiliates to cover the mark-to-market amount that would be owed to the Bank under derivatives transactions to isolate the Bank from credit risks in the transactions with the affiliates.

In addition, the Bank must establish to the satisfaction of the Bank's EIC that the Bank has an adequate and effective risk measurement and management program for the expanded activities. As detailed in the OCC handbook, *Risk Management of Financial Derivatives,*[15] and OCC Banking Circular 277,[16] an effective risk measurement and management process includes board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as effective risk control function that oversees and ensures the appropriateness of the risk management process.

In addition to a risk management program, the Bank's process must include an independent compliance monitoring program to ensure ongoing compliance with the specific commitments made by the Bank, including its commitment to conduct its financial intermediation activities in

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23,2001), Corporate Decision No. 2000-16 (Aug. 29, 2000), and Corporate Decision Nos. 98-31 (May 26, 1998) and 98-28 (May 11, 1998).

[15] January 1997.

[16] October 27, 1993.

equities as a customer-driven, and non-proprietary trading business.[17] The Bank must have an adequate and effective compliance monitoring program that includes policies, training, independent surveillance and well-defined exception approval and reporting procedures.

The OCC will make these determinations through the Bank's EIC, and the Bank may not commence the proposed activities unless and until its EIC has determined that he has no supervisory objection to the expanded activities, as described herein.

3. Conclusion

Based upon a review of the information you provided, including the representations and commitments made in your letters to the OCC, and for the reasons discussed above, we conclude that the Bank may enter into the proposed mirror transactions with subsidiaries and affiliates and may hold limited amounts of equity securities to hedge the risks arising from those transactions. This conclusion is subject to the condition that the Bank will have an appropriate risk management process in place, satisfactory to the Bank's EIC, for its expanded activities. Accordingly, the Bank may not commence the proposed activity unless and until its EIC has determined that he has no supervisory objection to the expansion of the Bank's activities, as described herein.

Sincerely,

/s/ *Daniel P. Stipano*

Daniel P. Stipano
Acting Chief Counsel

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[17] The OCC has long considered safety and soundness issues when determining whether an activity is part of, or incidental to the business of banking. *See e.g.*, Interpretive Letter 892, *supra* (national bank may engage in equity hedging activities only if it has an appropriate risk management process in place); Banking Bulletin 96-5 (Sept. 20, 1996) (replaced by Bulletin 2000-23 (July 20, 2000)) (national bank's purchase of life insurance is incidental to banking if it is convenient or useful in connection with the conduct of the bank's business and consistent with safe and sound banking practices); Interpretive Letter No. 684 (Aug. 4, 1995) (commodity hedging is a permissible banking activity provided the activity is conducted in accordance with safe and sound banking practices); Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A. to Offer the Chase Market Index Investment Deposit Account (Aug. 8, 1988) (national banks have the authority to establish the amount of the payments to be made and received under their deposit and loan contracts and may determine the amount of those payments by reference to any index or standard as long as the bank complies with safe and sound banking principles and, in the case of loans, with state usury laws); Interpretive Letter No. 376 (Oct. 22, 1986) (indemnification from losses resulting from participation in the bank's fiduciary securities lending program is a permissible incidental activity provided the indemnification is consistent with OCC guidance and safety and soundness); Interpretive Letter No. 274 (Dec. 2, 1983) (a national bank's authority to lease its office space provides the authority for it to establish appropriate lease terms if consistent with safe and sound banking practices).