Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

April 6, 2005

Interpretive Letter #1025
April 2005
12 USC 24(7)

Re: Authority of a National Bank to Engage in
Financial Intermediation Transactions Involving Electricity

Dear **[ ]**:

This responds to your request that the Office of the Comptroller of the Currency ("OCC") confirm the opinion of **[ ]** (the "Bank") that it is permissible for the Bank to engage in customer-driven electricity derivative transactions[1] and hedges, settled in cash and by transitory title transfer,[2] as activities part of, or incidental to, bank permissible financial intermediation transactions. For the reasons discussed below and subject to the limitations described herein, the proposed transactions are permissible for the Bank.

I. Background

The Bank currently engages in a variety of customer-driven financial intermediation transactions involving exchanges of payments based on interest rates, and the value of equities and certain commodities. The Bank's financial intermediation derivative transactions involve a wide range of energy-related commodities, including natural gas and oil. These transactions provide risk management tools to meet customers' financial needs. For example, oil and gas derivatives offer users and producers protection against increases and decreases in the price of oil or gas.

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[1] For the purposes of this letter, the term "electricity derivative transactions" includes cash-settled electricity-linked transactions of every type -- including derivative products such as futures, forwards, options, swaps, caps, floors, and collars, and options thereon -- in which a portion of the return (including interest and/or principal and/or payment streams) is linked to the price of electricity.

[2] The term "transitory title transfer" means accepting and instantaneously relinquishing title to the commodity, as a party in a "chain of title" transfer.

The Bank is seeking authority to engage in customer-driven electricity derivative transactions and hedges to assist customers in meeting their legitimate financial and risk management needs. Under the Bank's proposal, it will settle all of its customer-driven electricity derivative transactions and hedges in cash or by transitory title transfers. Representative examples of cash-settled electricity derivative transactions include swaps, options, and forwards contracts like those previously described in OCC Interpretive Letter No. 937 (June 27, 2002). Electricity derivative contracts that settle by transitory title transfer are similar to these cash-settled contracts, the primary difference being the method of settlement.[3] The Bank does not intend to receive or deliver actual electricity in connection with its proposed electricity derivatives business. The Bank represents that it will engage in transitory title transfers solely for the accommodation of customers or for its own risk management purposes that arise from customer related trading activities.

In anticipation of obtaining OCC approval of the Bank's proposal, the Bank will seek to obtain an order from the Federal Energy Regulatory Commission ("FERC") granting it authority to act as a power marketer, thus enabling the Bank to engage in transitory title transfers in electricity in interstate commerce at market-based rates.[4] The Bank will also file an application with each relevant independent system operator for authority to trade power in that network.

The Bank proposes to engage in cash-settled electricity derivatives transactions with any entity that qualifies as an "eligible contract participant," as defined in the Commodity Futures Modernization Act, and that otherwise meets the standards set forth in the Bank's Corporate Appropriateness Policy for Over-the-Counter Foreign Exchange, Derivatives, and Structured Securities Transactions with Clients.

The Bank's customers for electricity derivative transactions involving transitory title transfers will be "wholesale" market participants regulated by FERC, including power generators or distributors, industrial and corporate consumers, traders and marketers of electricity, many of which are already customers of the Bank in different risk management products. The Bank will not market these transactions to "retail" customers or undertake any transaction that would require a license or authorization from any state public utilities department or commission with jurisdiction over the retail electricity market in a particular state, absent further review by the OCC.

The Bank will manage the market risks in its electricity derivative transactions on a "portfolio basis," and will hedge the resulting net risk exposures. Because the market risk exposures

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[3] OCC Interpretive Letter No. 962, n. 3 (April 21, 2003). The Bank expects that less than 20% of the Bank's total volume of energy derivative transactions will result in transitory title transfers. The Bank must consult with its examiner-in-charge ("EIC") and address any supervisory concerns raised before exceeding the 20% of total volume limit.

[4] FERC asserts jurisdiction over entities such as the Bank that engage in transitory title transfers. *See* e.g., *Bank of America, N.A.,* 101 FERC ¶ 61,098 (Oct. 30, 2002). Financial institutions that participate in electricity derivative markets —including Bank of America, N.A. and affiliates of Credit Suisse First Boston, Goldman Sachs & Co., Merrill Lynch & Co., Morgan Stanley & Co. and UBS —have received FERC approval to operate as power marketers authorized to sell electricity in interstate commerce at market-based rates.

arising from transactions with customers may offset each other, the Bank will not need to hedge each transaction individually. The Bank will use both cash-settled hedges and those that involve transitory title transfers. There will normally be some market risk that will not be hedged and this residual exposure will be subject to risk management limits as discussed below. The Bank represents that residual market risk arising from this activity at all times will be *de minimis* relative to the Bank's earnings and capital and will be consistent with a customer-driven business strategy.

The Bank's desire to expand its financial intermediation activities to include electricity derivative transactions is driven by developments in the market that introduce opportunities, and increase demand for, financial intermediation. Deregulation of the power market has introduced variable pricing for electricity where fixed pricing was once the norm, affecting producers as well as consumers. This has presented risks to the participants in the electricity market similar to risks presented by fluctuations in interest rates, natural gas, or equity prices. Additionally, the departure from the market of merchant energy trading companies has reduced the number of trading intermediaries. If not effectively managed, electricity prices can introduce volatility to a customer's earnings and performance. Presently, power generators and distributors face substantial electricity price risks. Institutional and corporate customers (such as chemical companies, refineries and heavy manufacturers) are similarly exposed to price risk. The Bank has existing relationships with many of these types of customers and can assist them with the management of their energy and power risks.

The Bank maintains that transitory title transfers are an important component of the Bank's proposed financial intermediation services in the electricity derivatives business. Absent the ability to offer transitory title transfer transactions as part of this business, the Bank believes its ability to address its customers' financial, risk management and liquidity needs will be incomplete. The Bank states that its customers expect the Bank to be able to accommodate all of their needs including participating in markets that settle electricity derivative contracts by transitory title transfers if those markets present the most effective liquidity and risk management solutions.[5]

The Bank has expertise in conducting energy derivative transactions. Consistent with this expertise, the Bank has well-established policies, procedures and controls that apply to its customer-driven commodities businesses. For example, the Bank: (i) hedges the price risk arising from commodity derivatives on a portfolio basis and values transactions using data sets and models implemented in accordance with prudent banking standards; (ii) records credit exposure against customer credit limits; (iii) documents cash-settled customer transactions using the ISDA Master Agreement, with appropriate confirmations;[6] and (iv) uses operations systems

[5] In certain electricity derivatives markets, contracts do not specifically provide for assignment, termination, or offset prior to delivery. Instead, participants in these markets settle electricity derivative contracts through transitory title transfers. Financial intermediaries in these markets enter into back-to-back contracts providing for the receipt and immediate transfer of title to electricity.

[6] We would expect the Bank to document all electricity transitory title transfer transactions with appropriately comparable confirmations.

that permit booking and settlement of commodity derivatives transactions. The Bank represents that it will conduct its activities in customer-driven electricity derivatives consistent with the same policies, procedures and controls it applies to its existing energy commodity derivatives business.

The Bank commits that before engaging in electricity derivative transactions that it will adopt and implement all necessary policies, procedures and controls to assure that: (i) its electricity derivative business is customer-driven and meets all required regulatory standards for conducting a customer-driven derivative business, and (ii) the Bank has in place all appropriate mechanisms to identify, monitor, limit and control the risks inherent in conducting this business so that it complies with all applicable OCC guidance and requirements.[7]

To manage the risks in its electricity derivatives business, the Bank represents it will implement those policies, procedures and controls set forth in OCC guidance, *e.g.*, *OCC Derivatives Handbook* and BC-277, to assure the ongoing function and maintenance of an effective risk management process. The Bank specifically acknowledges that, as contemplated by the *OCC Derivatives Handbook* and BC-277, an effective risk management process includes appropriate oversight and supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification, measurement and management information systems, and effective risk control functions that oversee and ensure the continuing appropriateness of the risk management process.

In implementing those policies, procedures, and controls, the Bank commits to conducting a full evaluation of: (i) pricing, hedging (including portfolio hedging), processing, recordkeeping, documentation, accounting, "back office" and risk management; (ii) the development of adequate knowledge, staff, oversight management and technology (including contingency planning) to accommodate the activity; (iii) the implementation of appropriate controls (discussed above); (iv) the establishment, implementation and monitoring of appropriate risk management limits with respect to various types of risks —such as market risk, credit risk, and liquidity risk —associated with electricity derivatives and transitory title transfers;[8] and (v) Compliance Department training of personnel and development of a supervisory framework designed to ensure compliance with policies and procedures, including trading practices. Such a framework will strictly prohibit manipulative practices of any kind, including patterns of trading related to so-called "round tripping" of electricity derivatives transactions and will promote compliance with FERC and other relevant regulatory requirements.[9] Risk Control, Operations,

[7] *See, e.g.,* OCC Handbook: *Risk Management of Financial Derivatives* (January 1997) ("*OCC Derivatives Handbook*"); OCC Banking Circular No. 277 (October 27, 1991) ("BC-277"); OCC Bulletin 94-31 (May 10, 1994).

[8] For example, in the context of market and related risks of electricity derivatives, the Bank will specifically address such matters as price volatility and concentration of market participants on a geographic and power exchange/power pool/individual customer basis. In the context of options, it will specifically address all of those characteristics identified in the *OCC Derivatives Handbook* (*e.g.,* at 20-21 and Appendix B) as primary component measures of option sensitivity.

[9] To illustrate, the head of the electricity derivatives desk will be provided with a "best practices" policy that describes the responsibilities of the position in monitoring transactions for market manipulation, including round-

Accounting, Legal, Compliance, Audit and Senior and Line Management will all be involved in assuring that the risks undertaken by the Bank are comparable to, and are addressed in ways comparable to those applicable to, the Bank's existing energy-based commodity derivative products and business.

The Bank commits that it will conduct the proposed electricity derivatives transactions consistent with the policies, procedures and controls it applies to its existing customer-driven commodity derivatives business. The Bank further commits to the same principles set forth in OCC Interpretive Letter No. 962 that: (i) it will not run a proprietary book in electricity and electricity derivative transactions; (ii) any trading in electricity derivatives will be done with customers (defined above), and exclusively to hedge residual open positions related to customer transactions (or incurred in anticipation of customer transactions); and (iii) its electricity derivatives business will be conducted in a safe and sound manner and consistent with prudential risk management practices as prescribed in the *OCC Derivatives Handbook* and BC-277.

Furthermore, the Bank represents that complex structured transactions involving electricity derivatives will be subject to appropriate review and oversight of the Bank's risk management approval process to ensure that such transactions conform to the Bank's standards of appropriateness and integrity for complex structured transactions. In this risk management approval process, committees that are independent of the sponsoring business will review complex structured transactions for risks, including credit risk, market risk, operations risk, legal risk and reputation risk. In the normal course of risk management, the Bank typically will evaluate the purpose of transactions to assess whether the client has attempted to achieve a financial statement objective that could be construed as materially misrepresenting its financial condition, even if in conformance with generally accepted accounting principles ("GAAP"). In any instance where it is determined that a proposed transaction may result in materially misleading financial statements, the Bank will decline the transaction, condition approval upon the counterparty making express disclosures regarding the nature and financial impact of the transaction on the counterparty's financial position, or take other steps to assure that the Bank's role is appropriate. The Bank will also have an appropriate process for verifying customers have satisfied any conditions the Bank establishes concerning disclosures. As part of the process to determine the appropriateness of a transaction, the Bank may seek representations and warranties from the counterparty to the complex structured transaction stating the purpose of the transaction, how the counterparty will account for the transaction, and that the counterparty will account for the transaction in accordance with GAAP, consistently applied.

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tripping. This individual will receive daily position and activity reports to review and monitor consistent with the best practices policy. The Bank's Compliance Division will also receive and review position and activity reports on a daily basis, test for proprietary trading, test the appropriateness of derivative transactions and hedges, and review documentary support on a quarterly basis. Bank employees involved in this business will be subject to applicable "Standards of Professional Conduct" and will be required to attend compliance training. Furthermore, the Bank's Legal Department will provide guidance to the Compliance Department to ensure FERC rules and regulations as prescribed by the National Power Act are understood and that appropriate compliance policies and procedures are developed and implemented.

II. Discussion

In OCC Interpretive Letter No. 937, the OCC determined that national banks may engage in customer-driven, cash-settled electricity derivative transactions and hedges as part of bank permissible financial intermediation activities. Subsequently, in OCC Interpretive Letter 962, the OCC concluded that a national bank could engage in transitory title transfers as an activity incidental or "convenient and useful" to a national bank's permissible financial intermediation business in electricity. These permissibility determinations were conditioned on the national bank having established, to the satisfaction of its EIC, an appropriate risk measurement and management process for the activities.[10]

The activities proposed here are similarly permissible for the Bank, if the Bank can demonstrate to the satisfaction of the EIC that the Bank has established an appropriate risk measurement and management process for these activities. As detailed further in the *OCC Derivatives Handbook* and BC-277, 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 an effective risk control function that oversees and ensures the appropriateness of the risk management process. Risk control processes will need to become increasingly sophisticated as this business activity grows in size and complexity, and the Bank's risk management approval process must subject complex structured electricity derivative transactions to appropriate review and oversight, as described above, to ensure that these transactions conform to the Bank's standards of appropriateness and integrity for complex structured transactions.

The Bank's processes also must include an independent compliance monitoring program to ensure ongoing compliance with the specific commitments made by the Bank in its proposal, including the commitment to continue to conduct its financial intermediation activities in electricity as a customer-driven and non-proprietary trading business. The compliance monitoring program should also ensure that the Bank has a supervisory framework that protects against manipulative practices of any kind, including "round tripping," and promotes compliance with FERC and other regulatory requirements. An adequate and effective compliance monitoring program will include 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 expressed no supervisory objection.

[10] This process is necessary for the Bank to achieve its customer risk management objectives in a safe and sound manner and, thus, must be established before the OCC can conclude that the activities are permissible for the Bank.

III. Conclusion

The Bank may engage in electricity derivative transactions and hedges, settled in cash and by transitory title transfer, as part of, or incidental to, its existing financial intermediation business in energy-related commodities derivatives, provided the Bank has established appropriate risk measurement and management processes for these activities, as described herein, to which the EIC expresses no supervisory objection.

I trust this is responsive to your inquiry. If you have additional questions, please do not hesitate to contact Tena M. Alexander, Special Counsel, Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

-signed-

Daniel P. Stipano
Acting Chief Counsel