Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

June 14, 2005

Interpretive Letter #1033
July 2005
12 USC 24(7)

Re: Offering Equity Index Swaps and Holding Baskets of Securities for Hedging Purposes

Dear **[ ]**:

This letter confirms that **[ ]** (the "Bank") may, with the approval of the Bank's examiner-in-charge ("EIC"), engage in customer-driven equity index derivatives transactions and may use baskets of securities to hedge its risk exposures to the index swaps where the baskets do not exactly match the underlying index, but are designed to replicate the sector and industry weightings and general risks of the index.

I. Background

The Bank currently offers equity derivatives to customers as a financial intermediary and hedges those derivatives with equity derivatives or holdings of individual stocks. The Bank would like to expand its program to include equity index swaps that provide customers economic returns similar to investments in equity index portfolios and to hedge its exposures from the program by holding baskets of securities that closely replicate the performance of the equity index swaps.

The Bank has seen a growing use of index swaps by customers to provide them with economic results similar to investments in index portfolios without the costs of ownership. In a long index swap, the customer pays the Bank LIBOR plus a spread and any depreciation on the underlying equity. In return, the customer receives the appreciation plus any dividends on the underlying equity. Index swaps often reference the S&P 500 but with a growing frequency also refer to the Russell 1000 and Russell 3000 and many subsets of these indices.

The Bank proposes to hedge its obligations under the equity index swaps with a basket of securities that does not exactly match the underlying index, but is designed to replicate the sector and industry weightings and general risks of the index. The Bank believes that these baskets offer practical and economic advantages over other hedging options.

The Bank states that maintaining stock holdings that precisely match all the index holdings can be unnecessarily costly, particularly for smaller holdings. Also, the Bank is restricted from buying and selling certain stocks that are included in indices, such as stock of affiliates or stock of companies involved in the Bank's management and advisory work.

The Bank proposes to design baskets of securities to hedge its risk exposures in a manner that provides tax advantages under the Internal Revenue Code (the "Code"). Under sections 243 through 246 of the Code, in certain circumstances, the Bank may be entitled to exclude from taxation 70% of the dividends received from other U.S. corporations. However, under IRS rules applicable to hedges, the "dividends received" deduction (the "DRD") is reduced or disallowed if the hedge portfolio and index portfolio overlap by more than 70 percent.[1]

The Bank expects that complying with the DRD rules will result in a relatively small tracking error (less than 1 percent based on several probable scenarios) between the basket of securities and the index the basket hedges. Although the basket will hold less than 70 percent of the securities in an index, the basket will be weighted to closely track the performance of the index.

The Bank believes the DRD tax benefits will exceed any losses resulting from the tracking error. The Bank also believes it must conduct hedging activities in conformance with the DRD rules in order to provide competitive pricing for its index swaps products. It hedges these customer trades by trading in the futures market on the underlying index or by trading the stocks that underlie the index. As with any derivative product, hedging strategies are used to dramatically reduce the risks associated with these positions, but some small and measurable amount of basis risk remains. The Bank believes it can best deal with this basis risk from the customer activity by using customized stock baskets to hedge index swaps. These customized baskets are designed to match the sector and industry weightings and general risks of the underlying indices.

Using proprietary software, the Bank can create customized baskets that effectively hedge equity indices without replicating the index exactly.

II. Legal Analysis

You have asked if the Bank may engage in customer-driven equity index derivatives transactions and whether the Bank may design baskets of securities to hedge its risk exposures to the index swaps where the baskets do not exactly match the underlying index, but are designed to replicate the sector and industry weightings and general risks of the index. This activity is permissible provided it has the approval of the Bank's EIC.

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[1] The bank has obtained an opinion of tax counsel that it should not be precluded from taking the DRD. The OCC takes no position on the tax aspects of the proposed transaction.

A. Equity Index Swaps

National banks may engage in customer-driven derivatives transactions, including equity swaps, as financial intermediaries.[2] In 1994, the OCC addressed the legal permissibility of national banks engaging in swap activities tied to equities and equity indices.[3] The OCC recognized that swap contracts are, in some respects, direct descendants of traditional deposit contracts because payments under the contracts are similar to the receipt of deposits and the payment of interest on deposits.[4] Based, in part, on that line of authority, the OCC concluded that national banks may make payments to, or receive payments from, equity and equity index swap customers in the event of a gain or loss in a designated equity or equity index. The OCC further recognized that equity and equity index swap activities are permissible for national banks as a financial intermediation activity.[5] In such arrangements, national banks act as financial intermediaries between customers that want to manage risks resulting from the variations in a particular equity or equity index. Customers do not deal directly with one another, but instead make payments through the intermediary bank.

Banks, through their equity derivative transactions, are better able to meet customer needs by offering financial instruments that serve important risk management and other financial functions. National banks have benefited from equity derivative transactions that enable them to diversify, expand their customer base, and increase revenues.[6] Equity derivative transactions pose risks similar to those inherent in other types of banking activities that national banks are familiar with and manage, *e.g.*, interest rate, liquidity, credit, and compliance risks.

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[2] OCC Interpretive Letter No. 935 (May 14, 2002) and OCC Interpretive Letter No. 892 (September 13, 2000).

[3] OCC Interpretive Letter No. 652 (September 13, 1994). The OCC has recognized the ability of banks to engage in swap products for a number of years. In the 1980's the OCC opined on the permissibility of national banks engaging in interest rate, currency, and commodity price index swaps and caps. OCC No-Objection Letter No. 87-5 (July 20, 1987); OCC Interpretive Letter No. 462 (December 19, 1988); OCC Letter from J. Michael Shepherd, Senior Deputy Comptroller, Corporate and Economic Programs (July 7, 1988) (unpublished). Later, in the 1990's, the OCC recognized that national banks may advise, structure, arrange, and execute transactions, as agent or principal, in connection with interest rate, basis rate, currency, currency coupon, and cash-settled commodity swaps; swaptions, captions, and other option-like products; forward rate agreements, rate locks and spread locks, as well as similar products that national banks are permitted to originate and trade in and in which they may make markets. OCC Interpretive Letter No. 725 (May 10, 1996); OCC Letter from Jimmy F. Barton, Deputy Comptroller Multinational Banking, to Carl Howard, Associate General Counsel, Citibank, N.A. (May 13, 1992) (unpublished); OCC Letter from Horace G. Sneed, Senior Attorney, Legal Advisory Services Division (March 2, 1992) (unpublished); OCC No-Objection Letter No. 90-1 (February 16, 1990).

[4] OCC Interpretive Letter No. 652, *supra.*

[5] OCC Interpretive Letter No. 652, *supra.* That Interpretive Letter pre-dated *NationsBank of North Carolina v. Variable Annuity Life Insurance Co., 513 U.S. 251 (1995)* and characterized swaps as a financial intermediary activity incidental to a bank's express power to engage in deposit and lending activities under 12 U.S.C. § 24(Seventh). Upon re-examination, the OCC since has concluded that swap and funds intermediation activities are part of the business of banking. Letter from Ellen Broadman, Director, Securities and Corporate Practices Division, OCC, to Barbara Moheit, Regional Counsel, FDIC (October 29, 1998) (unpublished).

[6] OCC Bank Derivatives Report, Second Quarter (2000).

We conclude that the Bank may engage in customer-driven equity index derivatives transactions, with the approval of the Bank's EIC.

B. Hedging Equity Index Swaps with Securities Baskets

The OCC has determined that it is legally permissible for a national bank to purchase and hold equity securities that banks do not generally have authority to purchase to hedge customer-driven, bank permissible equity derivative transactions.[7] A national bank may hold these securities to hedge bank permissible equity derivative transactions if the activities comply with the standards set forth below, which include obtaining the approval of its EIC. Before establishing an equity hedging program, a national bank must provide written documentation to its EIC that evidences compliance with the following standards, and must obtain the EIC's approval. The documentation should establish to the satisfaction of the EIC that:

1. The Bank will hold the securities solely to hedge risks arising from bank permissible derivative transactions originated by customers for the customers' valid and independent business purposes;
2. The Bank will not hold the securities for speculative purposes;
3. The securities will offer a cost-effective means to hedge risks arising from permissible banking activities;
4. The Bank will not take anticipatory, or maintain residual positions in the non-qualifying securities except as necessary for the orderly establishment or unwinding of a hedging position.
5. The Bank will not acquire equity securities for hedging purposes that constitute more than 5% of a class of securities of any issuer; and
6. The Bank will have an appropriate risk management process in place, satisfactory to the EIC, for its hedging activities.[8]

National banks may hedge risks arising from bank permissible equity derivative transactions with either long or short positions in an equity or equity index.[9] A national bank can protect itself against changes in the value of the security underlying an equity derivative transaction by taking an offsetting (long or short, as appropriate) position in that equity or index. A national bank also may cross-hedge its equity derivatives where consistent with the bank's OCC approved hedging risk management process.[10] While the baskets created by the Bank to hedge its equity index swap activities do not exactly match the applicable underlying index, we find that the extent of the mismatch is so slight as to still fall within the scope and rationale of the

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[7] *See* OCC Interpretive Letter No. 935 (May 14, 2002) and OCC Interpretive Letter No. 892 (September 13, 2000).

[8] As detailed further in the Comptroller's Handbook, *Risk Management of Financial Derivatives*, (January 1997) and OCC Banking Circular 277 (October 27, 1993), an effective risk management process will include board of directors supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification, measurement and management information systems, as well as effective risk control functions that oversee and ensure the continuing appropriateness of the risk management process.

[9] See OCC Interpretive Letter No. 892 *supra*.

[10] OCC Interpretive Letter No. 935 *supra*. A cross-hedge is based on the premise that, although certain securities are not the same, the securities are similar and their price movements strongly correlate.

OCC precedents cited in support of bank hedging activities. The baskets will be designed and weighted to closely track the performance of the applicable index, *i.e.*, less than 1% deviation under several probable scenarios. Thus, the likely potential mismatch is *de minimis*. Based on this authority, we conclude a national bank may purchase a basket of equities that closely tracks but does not exactly replicate the performance of an equity index, with the approval of the Bank's EIC.

III. Conclusion

We conclude, that the Bank, with the approval of the Bank's EIC, may engage in customer-driven equity index derivatives transactions and may use baskets of securities to hedge its risk exposures to the index swaps where the baskets do not exactly match the underlying index, but are designed to replicate the sector and industry weightings and general risks of the index.

If you have additional questions, please do not hesitate to contact Eugene H. Cantor, Counsel, Securities & Corporate Practices Division at 202-874-5202.

Sincerely,

signed

Daniel P. Stipano
Acting Chief Counsel