Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

April 26, 2006

Interpretive Letter #1060
May 2006

Subject: Portfolio-hedged Coal Derivative Transactions

Dear **[ ]**:

[ ]. (“Bank”) is seeking confirmation from the Office of the Comptroller of the Currency (“OCC”) that it is permissible for the Bank to engage in customer-driven[1] coal derivative transactions[2] that settle in cash *or* by transitory title transfer and that are hedged on a portfolio basis with derivative and spot transactions[3] that settle in cash *or* by transitory title transfer. Previously, the Bank received authority to enter into customer-driven, cash-settled coal derivative transactions and simultaneously enter into perfectly matched offsetting derivative transactions.[4] Under its current proposal, rather than simultaneously entering into a perfectly matched offsetting transaction, the Bank will hedge coal derivative transactions on a portfolio basis with exchange-traded and over-the-counter (“OTC”) cash-settled derivative transactions, in the same manner as the Bank currently hedges its crude oil, natural gas and electricity derivatives.[5] The Bank will also enter into transitory title transfers to settle and hedge coal derivative transactions as permitted for the Bank in OCC Interpretive Letter No.

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[1] A “customer-driven” transaction is one entered into for a customer’s valid and independent business purpose. *See* OCC Interpretive Letter No. 892 (September 13, 2000).

[2] A coal derivative is a financial instrument used to manage the price exposure to the coal markets. The Bank is currently authorized to engage in customer-driven, perfectly matched coal derivative transactions such as swaps, options, forwards, caps, floors, collars and futures, where payments are based on coal prices and indices. OCC Interpretive Letter No. 1039 (September 13, 2005).

[3] A spot transaction is a cash sale for the immediate delivery of the commodities. *See, e.g., OCC Handbook: Foreign Exchange* (March 1990).

[4] OCC Interpretive Letter No. 1039, *supra.*

[5] *See, e.g.,* OCC Interpretive Letter No. 1025 (April 6, 2005).

1025, in the context of electricity derivative transactions.[6] For the reasons discussed below, we conclude that the Bank may engage in the proposed transactions, provided the Bank's examiner-in-charge ("EIC") is satisfied that the Bank has adequate risk management and measurement systems and controls to conduct the activities on a safe and sound basis.

I. Background

The Bank currently engages in a variety of financial intermediation transactions involving a wide range of energy-related commodities. The Bank recently received authority to engage in customer-driven,[7] perfectly matched, cash-settled coal derivative transactions.[8] The Bank now wishes to engage in customer-driven, coal derivative transactions that settle in cash or by transitory title transfer and hedge the transactions on a portfolio basis with derivative and spot transactions that settle in cash or by transitory title transfer (coal-linked transactions).

Presently, the Bank enters into a coal derivative transaction and simultaneously enters into a perfectly matched offsetting derivative transaction. Under the Bank's proposal, it will enter into coal derivative transactions and hedge the transactions, on a portfolio basis, with cash-settled, exchange-traded and OTC coal derivative transactions and transitory title transfers, based on the aggregate unmatched position in the portfolio. To the extent that the Bank determines that a strong correlation exists between coal derivative contracts and other commodity derivatives or the value of other commodities, the Bank may use such interrelated contracts and take transitory title to such commodities in its overall portfolio management (*i.e.*, cross-hedging). The Bank may use only derivative contracts on commodities for cross-hedging purposes that the OCC approved for hedging in OCC Interpretive Letter No. 1039 or other relevant OCC precedent. Similarly, the Bank will use only those commodities for cross-hedging that the OCC has approved for hedging by transitory title transfer in OCC precedent.[9] As new derivative transactions are added to the coal derivative transaction portfolios resulting in changes to the unmatched position, the Bank will adjust its hedging position to manage its aggregate exposure to market risk (*i.e.*, the risk to earnings or capital arising from changes in the value of portfolios of coal derivative transactions). The purpose of the proposed hedges, similar to the transactions addressed in OCC Interpretive Letter No. 1039, is to offset market risk from its coal derivative transactions.

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[6] *Id.*

[7] The Bank's customers for this purpose include coal producers (*e.g*. mining companies), coal users (*e.g*. utilities and other power generators) and other financial intermediaries.

[8] *Id.*

[9] *See, e.g.*, OCC Interpretive Letter No. 1025, *supra* (transitory title transfer of electricity derivatives permitted for hedging purposes).

The Bank believes that the expansion of the Bank's energy-related businesses to include the proposed coal-linked transactions is a natural extension of the Bank's existing financial intermediation activities and will benefit customers as well as the Bank. The major difference between the financial intermediation activities the OCC recently approved for the Bank involving coal derivatives and the proposed activity, is that here the Bank will manage risks arising from derivatives transactions on a portfolio basis rather than on a perfectly matched basis. When transactions are perfectly matched, the primary risk to the Bank is counterparty credit risk (*i.e.*, the risk that a counterparty will not make payments according to the terms of the transaction). In contrast, portfolio-hedging may expose the Bank to market and basis risk (*i.e.*, the risk that the price fluctuations of the hedging instruments will not exactly match price fluctuations of the underlying transactions), however, these risks will be subject to risk management limits. And, to the extent there is any legal risk in coal-linked transactions, indemnification provisions in the relevant documentation discussed below will mitigate this risk.

The Bank represents that portfolio-hedging is a more cost effective means of managing risks arising from permissible derivative activities than perfectly matching transactions because it reduces transactional costs and operational risks (*i.e.*, the risk of incurring financial loss due to human or technical errors). Coal portfolios will naturally contain offsetting transactions. Thus, the Bank need only hedge the net residual risk position in each portfolio when it engages in portfolio-hedging. With perfectly matched transactions, the Bank must offset each coal transaction that it enters into and pay the costs associated with executing each of these trades. Because the Bank must execute a greater number of transactions to perfectly match transactions than it would if it were portfolio-hedging, there is also greater opportunity for back office error and reconcilement issues in perfectly matched trades.

Periodically the Bank may hedge coal derivative portfolios by using hedging instruments that result in basis risk. Such mismatches, and thus the resulting basis risk, tend to become more pronounced progressively during the life of the transactions, thus making accurate hedging essential. In some instances, cash-settled transactions may provide less than completely accurate hedges. The Bank believes that the ability to engage in transitory title transfers involving coal will enable the Bank to more accurately and precisely hedge its proposed coal derivative transactions and substantially reduce its basis risk in portfolio-hedged coal derivative transactions. For coal-linked transactions that involve transitory title transfer, the Bank represents that it will execute an offsetting transaction for settlement at the same delivery point on the same settlement day as the original transaction.[10] Ownership and control of, and title to, the coal will pass instantaneously from the Bank's upstream counterparty through the Bank to its downstream counterparty at the delivery point. The last buyer in the chain will provide the transport vehicles to the delivery point, and the initial seller will load the vehicle. The Bank will not be the initial seller or the end-buyer in the chain. The Bank represents that it will engage in

[10] A time lag may exist between the original transaction and the offsetting transaction. The existence and duration of that time lag will be a function of market conditions and customer interest. Notwithstanding any time lag, the Bank represents that it will always have an offsetting transaction in place by the settlement date to make certain that the Bank never will take physical possession of coal. The Bank will hedge market risk created by the time lag through the futures or over-the-counter markets.

the proposed title transfer transactions solely for the accommodation of customers or for its own risk management purposes.

The Bank plans to mitigate any potential legal risks from engaging in transitory title transfers of coal by including indemnification provisions in its coal documentation, a customary industry practice. Under the indemnification provisions, the Bank will be indemnified from legal claims when it is the buyer and will be the indemnifying party for legal claims when it is the seller. Any legal claim the Bank may face as a seller will be a claim that the Bank has as a buyer under the matching indemnification provisions. Consequently, such legal claims should be resolved by the initial seller and the ultimate buyer because the indemnification provisions effectively pass claims up and down through the chain of intermediary titleholders to the initial seller and ultimate buyer.[11]

The Bank states that its ability to engage in the proposed activities will enable the Bank to compete more effectively with other intermediaries, meet customer demand, operate more efficiently and profitably, and diversify its business risks. For example, the Bank represents that expansion of its existing energy derivatives business will enable the Bank to compete with other market intermediaries that can make coal products available to customers, particularly those market intermediaries that give customers the option of engaging in coal-linked transactions that settle by transitory title transfer. Moreover, the Bank states that the ability to offer these products will enable the Bank to meet the growing demand for these products by customers such as mining companies and electricity generators. In addition, the Bank believes that by offering customers a broader range of risk management products that more effectively address their individual risk management needs, the Bank will have the ability to attract a broader customer base. Finally, the Bank represents that by participating in a broader range of markets and expanding its customer base, it may diversify and reduce credit and other risks arising from its energy derivatives business. Accordingly, the Bank believes the proposed transactions will enable it to meet customer demand and operate its energy derivatives business more competitively, efficiently, and profitably.

In sum, the Bank contends that the proposed transactions pose risks similar in nature to those inherent in perfectly matched, cash-settled coal derivative transactions and in its portfolio-hedged oil, gas and electricity derivative transactions (*e.g.,* credit, market and legal risks), which it has demonstrated the ability to successfully manage and control. The Bank maintains that the proposed transitory title transfers do not pose risks different from the transitory title activities the

[11] The Bank will retain the right to have a representative present at the delivery point during the weighing, sampling and analysis of the coal. The Bank represents that while most market participants retain this right, they do not exercise this right. If the Bank decides to exercise this right, the Bank will use consultants whom it has retained to confirm the specifications of coal at the relevant delivery point. If the Bank does not exercise this right, such representatives will not be able to confirm the specifications of the coal until after title has transferred and the seller provides the analysis report, which will ultimately be provided to the end-buyers. If the coal does not meet the required specifications, the end-buyer has the right to reject the coal, at which point title should revert back through the chain instantaneously to the initial seller. The initial seller is then responsible for transporting the rejected coal to another location and providing substitute coal at the buyer's request. In most cases, the end-buyer will accept non-conforming shipments with price adjustments rather than reject the coal.

OCC addressed in OCC Interpretive Letter No. 1025 in the context of electricity derivative transactions. Further, because the coal-linked transitory title transfer transactions will not entail the physical possession of commodities, the Bank represents that these transactions will not involve the customary activities relating to, or risks attendant to, commodity ownership (*e.g.*, storage costs, insurance, and environmental protection). The Bank maintains that while coal-linked transitory title transfer transactions will require the Bank to perform obligations such as sending loading instructions to the previous seller and analysis results to the next buyer[12] as well as making payment transfers, these functions are similar to those regularly performed by national banks in their role as financial intermediaries.

The Bank states that its proposal to engage in coal-linked transactions does not envision the use of special purpose entities ("SPEs"). However, should the Bank determine that the use of SPEs may be appropriate in connection with coal-linked transactions, the Bank represents that the transactions will undergo a thorough internal due diligence and review prior to execution. The Bank further represents that such transactions would conform to the Bank's SPE Policy.

The Bank commits that the proposed coal-linked transactions will be conducted in accordance with all the risk management processes and procedures currently in place for the Bank's energy-related derivatives business.[13]

II. Discussion

For the reasons and subject to the conditions described below, the Bank may engage in customer-driven coal derivative transactions that settle in cash and hedge these transactions on a portfolio basis with cash-settled coal derivatives, and also may engage in transitory title transfers of coal in connection with settling and hedging coal-linked transactions. These activities are permissible for the Bank provided the Bank has established an appropriate risk measurement and management process for these derivative and hedging activities that is satisfactory to the Bank's EIC. This process is necessary for the Bank to achieve its customer risk management objectives

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[12] The Bank represents that a seller is typically required to provide a shipping notice to the buyer within 48 hours of loading the coal or prior to arrival of the vessel, barge, truck or train at the destination following loading of a shipment (whichever comes first). The shipping notice includes the vessel's name or train, barge or truck number, source from which supplied, tonnage shipped, shipping date, destination, time loading commenced and finished, and the results of a coal analysis showing that the coal meets the specifications set forth in the appropriate coal documentation. The Bank states that the initial seller generally sends the shipping notice to the first buyer in the chain. The buyer then has the obligation to send the results to the next buyer. The Bank represents that about 50% of the time, the initial seller will agree to send the analysis results directly to the ultimate buyer; however, this results only out of a courtesy agreement between parties. The shipping notice is tantamount to an instrument evidencing title.

[13] The Bank may execute coal hedging transactions with its unrated affiliate, JPMorgan Ventures Energy Corporation, if the Bank decides that such a hedge is the most effective one available. In such case, the Bank represents that it will comply with the requirements of section 23A and 23B of the Federal Reserve Act, the Federal Reserve Board's Regulation W and the Bank's section 23A and 23B and Regulation W policy.

in a safe and sound manner and thus must be established before the OCC can determine that the proposed activities are permissible.

A. National Bank may engage in Customer-driven, Portfolio-hedged Coal-linked Transactions.

The OCC has previously determined that the Bank may engage in perfectly matched cash-settled coal derivatives as a financial intermediary under 12 U.S.C. § 24(Seventh).[14] The Bank now proposes to portfolio-hedge these derivatives with derivatives that settle in cash or by transitory title transfer. The ability to engage in these transactions will increase the Bank's hedging options and its ability to control risks in its energy-related derivatives business. The difference between the activities previously approved for the Bank and those for which approval is sought here is that rather than simultaneously entering into coal-linked transactions with perfectly matched offsetting transactions, the Bank will enter into coal derivative transactions with customers and manage the transactions on a portfolio basis with exchange-traded and OTC cash-settled derivative transactions, in the same manner as the Bank currently manages its crude oil, natural gas and electricity derivatives. The Bank will also settle coal derivative transactions by transitory title transfer and hedge these transactions with derivative transactions and spot transactions that settle by transitory title transfer, in a manner previously addressed for the Bank in OCC Interpretive Letter No. 1025 in the context of electricity derivative transactions.

The expansion of the Bank's derivatives business to include the proposed transactions is a natural extension of the Bank's existing financial intermediation activities. The OCC has previously addressed the permissibility of portfolio-hedging and transactions that settle in cash or by transitory title where the bank takes title to the commodity in a "chain of title" and relinquishes title instantaneously under Section 24(Seventh).[15] Portfolio-hedging is a more cost effective means of managing risks arising from permissible derivative activities than perfectly matching transactions because it reduces transactional costs and operational risks. Portfolio-hedging and transitory title transfer activities allow banks to compete more effectively, meet customer demand, and operate more efficiently and profitably. Transitory title transfers also enable banks to participate in markets using this form of settlement and provide customers a broader range of sophisticated risk management tools to address their financial, risk management, and liquidity needs. In conducting transitory title transfers in connection with a permissible derivatives business, banks act as financial intermediaries, ultimately exchanging payments between counterparties managing financial risks or otherwise meeting financial needs.[16] While a time lag may exist between the original transaction and the offsetting transitory title transfer transaction, the Bank represents that it will always have an offsetting transaction in place by the settlement date to make certain that the Bank never will take physical

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[14] OCC Interpretive Letter No. 1039, *supra.*

[15] *See* OCC Interpretive Letter No. 1025, *supra*; OCC Interpretive Letter No. 962 (April 21, 2003); OCC Interpretive Letter No. 632 (June 30, 1993); OCC Interpretive Letter (March 2, 1992).

[16] *See, e.g., OCC* Interpretive Letter No. 1025, *supra.*

possession of coal. Executing transactions and hedging in this manner is consistent with a portfolio-hedged financial intermediation business.

The OCC finds the risks to which the Bank is exposed under this proposal are similar in nature to other energy-related derivative transactions where the Bank has a demonstrated ability to manage and control such risks. Accordingly, the Bank may act as a financial intermediary in customer-driven, portfolio-hedged coal derivative transactions that settle in cash or by transitory title transfer, and hedge these transactions with coal derivative and spot transactions that settle in cash or by transitory title transfer, subject to satisfying the safety and soundness factors discussed below.

B. The Portfolio-hedged Coal-linked Transactions must be Conducted in a Safe and Sound Manner.

For the Bank to permissibly engage in the proposed activities, the Bank's risk measurement and management capabilities must be of appropriate sophistication to ensure that the activity can be conducted in a safe and sound manner and in accordance with applicable law. Consequently, in order for the OCC to conclude that this activity is permissible for the Bank, the Bank must demonstrate to the satisfaction of its EIC that the Bank has established an appropriate risk measurement and management process for its proposed activity. As detailed further in the *OCC Handbook: Risk Management of Financial Derivatives*[17] and Banking Circular 277,[18] 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. The Bank's risk control processes should include the Bank's compliance with accounting and reporting as stipulated by the instructions for the Consolidated Reports of Condition and Income and generally accepted accounting principles.

In implementing these policies, procedures, and controls, the Bank shall commit 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; (iv) the establishment, implementation and monitoring of appropriate risk management limits with respect to various types of risks —such as credit, market and basis risk —associated with coal derivatives and transitory title transfers of coal; and (v) Compliance Department training of personnel and development of a supervisory framework designed to ensure compliance with policies and procedures, including trading practices. Risk Control, Operations, 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 commodity derivative products and business.

[17] *OCC Handbook*: *Risk Management of Financial Derivatives* (January 1997).

[18] OCC Banking Circular No. 277 (October 27, 1993).

In addition to a satisfactory 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 in its proposal, including the commitment to continue to conduct its financial intermediation activities involving coal derivatives 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. An adequate and effective compliance-monitoring program will include policies, training, independent surveillance and well-defined exception approval and reporting procedures.

Should the Bank determine that the use of SPEs is appropriate in connection with coal-linked transactions, the Bank must satisfy its EIC of the adequacy of the Bank’s SPE policies for such transactions prior to using SPEs.

III. Conclusion

We conclude that the Bank may engage in the transactions it proposes, provided the Bank’s EIC is satisfied that the Bank has adequate risk management and measurement systems and controls to conduct the activities on a safe and sound basis. Our conclusions herein are specifically based on the Bank’s representations and written submissions describing the facts and circumstances of the subject transactions. Any change in the facts or circumstances could result in different conclusions. If you have any questions please contact Tena M. Alexander, Special Counsel, Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

Signed

Julie L. Williams
First Senior Deputy Comptroller
and Chief Counsel