



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

September 13, 2005

**Interpretive Letter #1039
September 2005**

Subject: Customer-driven, Perfectly Matched, Cash-settled 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 enter into customer-driven, perfectly matched, cash-settled derivative transactions on certain commodities and related indices. For the reasons discussed below, we conclude that the Bank may engage in the transactions it proposes, 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.

Background

The Bank proposes to act as a financial intermediary in customer-driven,¹ perfectly matched, cash-settled derivative transactions with market participants and offsetting mirror transactions with its unrated affiliate, [] (“*OpSub*”).² The commodities and indices that will serve as reference assets under the Bank’s request are: crude oil, natural gas, heating oil, natural gasoline, gasoline, unleaded gas, gasoil, diesel, jet fuel, jet-

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 [*OpSub*] is an indirect subsidiary of the bank’s holding company, [*BHC*]. The Bank represents that [*OpSub*] is subject to the Federal Reserve Board’s Regulation Y, 12 C.F.R. Part 225, and will engage only in activities authorized by that regulation. [*OpSub*] is not rated by any credit rating agency. The Bank states that [*OpSub*]’s business strategy is to enter into commodity and commodity derivatives transactions, including cash-settled, over-the-counter derivative transactions. The Bank represents that this strategy has been approved within [*BHC*] and is permissible under Regulation Y.

kerosene, residual fuel oil, naphtha, ethane, propane, butane, isobutene, crack spreads, lightends, liquefied petroleum gases, natural gas liquids, distillates, oil products, coal, emissions allowances, benzene, dairy, cattle, wheat, corn, soybeans, soybean meal, soybean oil, cocoa, coffee, cotton, orange juice, sugar, paper, rubber, steel, aluminum, zinc, lead, nickel, tin, cobalt, iridium, rhodium, freight, high density polyethylene (plastic), ethanol, methanol, newsprint, paper (linerboard), pulp (kraft), and recovered paper (old newsprint).

The Bank proposes to enter into the transactions with [**OpSub**] in two contexts.³ First, the Bank proposes to enter into these transactions under a so-called “prime brokerage” agreement with [**OpSub**] similar to prime brokerage agreements that the Bank has executed with nonaffiliated third parties. Under the agreement, [**OpSub**] will negotiate transactions with Bank pre-approved counterparties. If [**OpSub**] and a third party agree on the terms of the transaction, the Bank will execute the transaction with the counterparty and concurrently enter into a perfectly matched transaction with [**OpSub**].

The second context arises when the Bank identifies a transaction it would like to enter into with a customer and decides that the best hedge available would be a perfectly matched transaction with [**OpSub**]. The Bank will negotiate the type, size and price of the transaction with the customer, and if it reaches agreement with the customer, the Bank concurrently will execute the offsetting, perfectly matched transaction with [**OpSub**].

The Bank’s transactions with [**OpSub**] will match all the economic terms of the transactions between the Bank and the market participants (*e.g.*, commodity, amount and maturity). The arrangements will be financial arrangements only. All of the transactions will settle in cash. Neither the Bank, [**OpSub**] nor the market participants will at any time be required to take title to the commodities underlying the derivative transactions. The Bank represents that the terms and circumstances of all transactions between [**OpSub**] and the Bank will be at least as favorable to the Bank as those prevailing at the time for comparable transactions between the Bank and similarly situated counterparties or will be such that the Bank, in good faith, would offer to, or that would apply to, such entities.

The Bank believes that by engaging in the proposed transactions it will be exposed to credit risk with respect to [**OpSub**] and the other market participant counterparties. To manage the credit risk arising from its transactions with [**OpSub**], an ISDA Master Agreement and Credit Support Annex (“CSA”) will govern each derivative transaction executed between the Bank and [**OpSub**]. The terms of the CSA with [**OpSub**] will be as stringent on [**OpSub**] as CSAs the Bank enters into with comparable third parties. The Bank will either have or obtain standard ISDA Master Agreements and CSAs with its other counterparties.

The Bank will be compensated for its credit risk in the pricing on all of the proposed transactions, the terms of which it represents will be consistent with arms-length terms and based upon market conditions at the time of each transaction. The Bank will also provide operational and administrative services to [**OpSub**], paid for by [**OpSub**] under the terms of an agency

³ The Bank also proposes to act as financial intermediary in customer-driven, perfectly matched derivative transactions where [**OpSub**] is not a counterparty.

agreement between the parties. The [*OpSub*] service agreement will be at least as favorable to the Bank as its service agreements with its other comparable third parties.

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.

Discussion

The proposed activities are consistent with OCC precedent finding national banks may engage in customer-driven commodity derivative transactions as financial intermediaries under 12 U.S.C. § 24(Seventh).⁴ National banks may enter into derivative transactions and may hedge risks arising from these permissible banking activities as part of the business of banking.⁵ In assuming an offsetting derivative 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 providing offsetting cash flows or returns. Permissible financial intermediation transactions include cash-settled options, forwards, and swaps.⁶

In OCC No-Objection Letter 87-5,⁷ the OCC recognized that a national bank could engage in perfectly matched, cash-settled, derivative contracts based on the rise or fall in the price of designated price indices (specifically, swaps based on oil price indices).⁸ The bank entered into these transactions only on a matched basis, such that the bank would be matched as to index, amount, and maturity on each side of the transaction. Because the transactions were matched, the only risk to the bank was its credit risk with respect to the counterparties to these transactions, as is the case here.

The difference between the activities in OCC No-Objection Letter 87-5 and the Bank's proposal is the use of an affiliate for one leg of the transaction and the expansion of the list of commodities and related indices that the Bank may use as reference assets in these transactions. Based on the facts presented, these differences do not alter the nature of the proposed activities as financial intermediation. Indeed, the OCC has recognized that national banks may enter into derivatives transactions with affiliates that mirror the affiliates' transactions with customers, and may hedge resulting risks, in the banks' role as financial intermediaries.⁹ Further, the OCC has

⁴ OCC Interpretive Letter No. 1018 (February 10, 2005); OCC Interpretive Letter No. 937 (June 27, 2002); OCC No-Objection Letter No. 87-5 (July 20, 1987).

⁵ OCC Interpretive Letter No. 892, *supra*.

⁶ OCC Interpretive Letter No. 937 (June 27, 2002).

⁷ OCC No-Objection Letter No. 87-5, *supra*.

⁸ *Id.*

⁹ OCC Interpretive Letter No. 1018, *supra*; OCC Interpretive Letter No. 892, *supra*.

already determined national banks may engage in derivative transactions on any commodity where the use of the commodity will not result in any substantive change in the type or nature of the financial intermediation activity but only in its underlying basis (*i.e.*, the particular commodity or related index used as the reference asset).¹⁰ Accordingly, the Bank may act as a financial intermediary in customer-driven, perfectly matched, cash-settled, derivative transactions on the listed commodities and related indices where its EIC is satisfied the Bank has adequate risk management systems and controls to conduct the activities on a safe and sound basis.

Safety and Soundness Requirements and EIC No Objection

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*¹¹ and Banking Circular 277,¹² 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.

The Bank may not commence the proposed activity unless and until its EIC concludes that the foregoing standards are met and expresses no supervisory objection. Provided these standards are met, the Bank may commence the proposed activities on the commodities and related indices addressed by the EIC.

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. Any change in this information could lead to

¹⁰ OCC Interpretive Letter 937 (June 27, 2002).

¹¹ OCC Handbook: *Risk Management of Financial Derivatives* (January 1997).

¹² OCC Banking Circular No. 277 (October 27, 1993).

a different conclusion. If you have any questions concerning this letter, please contact Tena M. Alexander, Special Counsel, Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

/s/

Julie L. Williams
First Senior Deputy Comptroller
and Chief Counsel