



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1071
October 2006
12 USC 84
12 USC 24(7)
12 CFR 32

September 6, 2006

Subject: [] (“Bank”) Permissible Electricity Derivatives Activities; Proposed Membership in Independent Systems Operators (“ISOs”)¹ and Regional Transmission Organizations (“RTOs”)² to Execute Transactions

Dear []:

This is in reference to your request for confirmation that the Bank may participate as a member in several regional ISOs and RTOs in order to execute electricity derivatives transactions that the OCC previously has found to be permissible for the Bank. For the reasons discussed below, we conclude that the Bank may join the proposed ISOs and RTOs. The Bank’s exposures are subject to the limitations set forth in 12 U.S.C. § 84 and 12 C.F.R. Part 32 and any additional limitations imposed by the Bank’s examiner-in-charge (“EIC”) based on safety or soundness considerations. Moreover, before such a membership is activated, the Bank must notify its EIC, in writing, of the proposed activities and must receive written notification of the EIC’s supervisory non-objection, based on the EIC’s evaluation of the adequacy of the Bank’s risk measurement and management systems and controls to enable the Bank to engage in the proposed activities on a safe and sound basis, and the EIC’s evaluation of any other supervisory considerations relevant to the particular proposal.

¹ An ISO is an organization that has been granted authority to operate, in a nondiscriminatory manner, the transmission assets of participating transmission owners in a fixed geographic area. ISOs also run organized spot markets for electricity. See *2004 Statement of the Markets Report*, FERC Office of Market Oversight and Investigations (June 2005) (“*Markets Report*”), <http://www.ferc.gov/EventCalendar/Files/20050615093455-06-15-05-som2004.pdf>.

² An RTO is an organization with a role similar to that of an ISO but covering a larger geographical scale and involving both the operation and planning of a transmission system. RTOs also run organized spot markets for electricity. *Id.* The Federal Energy Regulatory Commission (“FERC”) has promoted the voluntary formation of RTOs to promote efficiency in wholesale electricity markets and the lowest price possible for reliable service. See FERC Order No. 2000, 89 FERC ¶ 61,285 (Dec. 20, 1999). For ease of reference, RTOs and ISOs will hereinafter be referred to collectively as “ISOs”.

Background

National banks may engage in certain customer-driven commodity derivatives transactions, including options, forwards and swaps, and offsetting hedge transactions, as part of the business of banking.³ These derivative transactions are financial arrangements involving exchanges of payments, with the bank acting as a financial intermediary between customers, a traditional and permissible banking function.⁴ For example, a bank may engage in a commodity swap transaction involving the exchange of fixed payments for payments based on the value of a commodity, and then assume an offsetting swap position or hedge. In assuming an offsetting swap, a bank acts as a financial intermediary by interposing itself between customers initiating swaps and counterparties providing offsetting cash flows or returns. These derivative transactions assist bank customers in managing financial risks or meeting other financial needs. For example, commodity derivative transactions can offer users and producers of a commodity protection against increases and decreases in the price of the commodity.

In the exercise of this authority, national banks also may engage in certain commodity derivative transactions and hedges that are settled by transitory title transfers where the bank takes title to the commodity in a “chain of title” and relinquishes title instantaneously.⁵ The transitory title transfers 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. Further, the transitory title transfers allow banks to compete more effectively and operate more efficiently and profitably. Transitory title transfer capability also increases banks’ hedging options and ability to control risks in their derivatives business. 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.⁶

Banks have long-served as financial intermediaries between customers, most traditionally by taking deposits and making loans, to facilitate the flow of funds in the economy and meet various

³ OCC Interpretive Letter No. 1025 (Apr. 6, 2005) (“IL No. 1025”), OCC Interpretive Letter No. 962 (Apr. 21, 2003) (“IL No. 962”), and OCC Interpretive Letter No. 937 (June 27, 2002) (“IL No. 937”).

⁴ IL No.1025, *supra*, IL No. 962, *supra*, IL No. 937, *supra*, OCC Interpretive Letter No. 892 (Sept. 13, 2000), OCC Interpretive Letter No. 725 (May 10, 1996), OCC Interpretive Letter No. 652 (Sept. 13, 1994), OCC No-Objection Letter No. 90-1 (Feb. 16, 1990), OCC Interpretive Letter No. 462 (Dec. 19, 1988), and OCC No-Objection Letter No. 87-5 (July 20, 1987).

⁵ IL No.1025, *supra*, IL No. 962, *supra*, and OCC Interpretive Letter No. 684 (Aug. 4, 1995) (“IL No. 684”).

⁶ *See, e.g.*, IL No. 962, *supra*. Engaging in transitory title transfers subjects bank to risks similar in nature to those inherent in cash-settled derivatives conducted pursuant to demonstrated risk management procedures, systems and controls to appropriately manage and control such risks. Transitory title transfer transactions as proposed by the Bank would not involve taking physical possession of commodities, and thus do not involve the activities that are customarily associated with commodity ownership. While transitory title transfer transactions may require the introduction of some new operational processes (*e.g.*, scheduling receipt and delivery), the majority of operational functions, such as passing notices, document transfers, and payments, are similar to those regularly performed by national banks in their role as financial intermediaries.

financial needs of customers. The derivative transactions that the OCC has found permissible for national banks over the past thirty years are a modern form of financial intermediation. Through these exchanges of payments, banks facilitate the flow of funds within our economy and serve important financial risk management and other financial needs of bank customers.

Deregulation of the power markets, which has introduced variable pricing for electricity where fixed pricing was once the norm, has affected producers as well as customers, and provided a new opportunity for banks to perform this role. Variable pricing presents risks to the participants in electricity markets similar to risks presented by fluctuations in interest rates, or natural gas or equity prices. The Bank has relationships with power generators, distributors, and institutional and corporate customers exposed to price risk in electricity markets and previously sought confirmation from the OCC that it could assist such firms in managing these financial risks through electricity derivative products. The Bank maintained that using transitory title transfers to do so would be an important component of its proposed financial intermediation services in the electricity derivatives business. Absent these transactions, the Bank believed its ability to address customers' financial, risk management and liquidity needs would be incomplete since title transfers can present the most effective liquidity and risk management solutions for customers.⁷

In IL No. 1025, the OCC permitted the Bank to expand its existing financial intermediation activities to include electricity derivatives transactions and hedges, settled in cash and by transitory title transfer.⁸ The Bank now seeks to become an active member of several regional ISOs in order to execute those permissible electricity derivative transactions in certain regions.⁹

ISOs are federally regulated regional nonprofit organizations that coordinate, control and monitor the operation of the electrical power system.¹⁰ ISOs also operate day-ahead and real-time clearing markets for electric power and related products.¹¹ In the real-time market, market participants that fail to supply or receive scheduled energy may be charged or credited a real-time market clearing price, which is in effect a financial settlement of a physical power

⁷ The Bank obtained an order from FERC granting it authority to act as a power marketer, so that the Bank could engage in transitory title transfers in electricity in connection with its financial intermediation business. *See Declaratory Order* (Dec. 19, 2002) (Docket Nos. EL02-130-000 and EC02-120-000). FERC asserts jurisdiction over entities such as the Bank that engage in transitory title transfers in the electricity markets. *See Bank of America, N.A.*, 101 FERC ¶ 61,098 (Oct. 30, 2002). *See also Electric: How to Get Market-based Rate Approval*, FERC, <http://www.ferc.gov/industries/electric/gen-info/pm-over.asp>.

⁸ *See* IL No. 1025, *supra*.

⁹ The Bank is an inactive member of PJM Interconnection ("PJM"), ISO-New England and the Electric Reliability Connection of Texas ("ERCOT") and has applied for membership in New York ISO, Midwest ISO, California ISO, and the Southwest Power Pool. Several of these entities are RTOs, but are referred to herein as ISOs for ease of reference.

¹⁰ *See FERC Glossary*, <http://www.ferc.gov/help/glossary.asp#P>. ISOs, with the exception of ERCOT, are regulated by FERC.

¹¹ *See Markets Report*, *supra*.

obligation.¹² Many ISOs also operate day-ahead power markets, designed to provide price certainty to market participants in advance of real-time operations.¹³ Some ISOs also operate regional capacity¹⁴ markets, financial transmission rights¹⁵ markets, and markets for some ancillary services.

Bank Membership in ISO

The Bank represents that ISO membership is required for the Bank, as a FERC authorized power marketer, to participate in physically settled and ISO-administered markets. In addition, the Bank views membership in an ISO as the most effective, and in some cases the only, way for the Bank to enter into or to hedge cash-settled electricity derivative transactions, because ISOs provide liquidity necessary for cash-settled transactions not readily available elsewhere in the market. As a result, the Bank contends that ISO membership is convenient or useful to its permissible financial intermediation business in electricity derivatives.

Mutualized Default Risk

ISOs typically are nonprofit entities that administer markets on behalf of market participants and, in this capacity, serve as the clearing firm to every transaction. As a result, ISO members are exposed to the credit risk of other members.¹⁶ This mutualization of risk means that the Bank, as an ISO member, could be allocated a portion of the losses arising from the default of another ISO member. Typically, these losses are distributed to non-defaulting members on a pro rata basis, based on the ratio of individual member activity to total market activity for a defined period of time (*e.g.*, two months).¹⁷ Losses are not allocated to non-defaulting members unless and until the ISO exercises its rights of set-off against the defaulting member and draws on all available working capital and collateral of the defaulting member. Any remaining losses will be allocated to non-defaulting members according to the loss or default allocation assessment formula.

¹² The real-time market settles and determines the price for one-hour periods or less during the day of delivery. *Id.*

¹³ The day-ahead markets are forward markets for electricity to be supplied the following day. This market closes with acceptance by the ISO, power exchange or scheduling coordinator of the final day-ahead schedule. *Id.*

¹⁴ Capacity markets are designed to allow companies with an obligation to deliver electricity to customers to competitively procure contracts with power plant owners to have their units up and running and able to produce additional energy. *Id.*

¹⁵ Financial transmission rights (also known as congestion revenue rights) are financial contracts that protect the holder from an increase in cost due to congestion of the power transmission system and resulting in price differentials within the transmission system. *See FERC Glossary, supra.*

¹⁶ *See* “Policy Statement on Credit-Related Issues for Electric OATT Transmission Providers, Independent System Operators and Regional Transmission Organizations” (“*FERC Policy Statement*”), 109 FERC 61,186 (Nov. 19, 2004).

¹⁷ *Id.*

For example, in the event of a member's default, PJM (an ISO the Bank proposes to join) will set off amounts due to a defaulting member by PJM.¹⁸ If the default remains, PJM will draw upon the defaulting member's credit support (collateral).

If the default still remains, PJM will allocate the remaining amounts to PJM members according to its default allocation assessment formula.¹⁹ The default allocation assessment first allocates 10% of the default amount to all non-defaulting PJM members (capped at \$10,000 per member, per calendar year). The remaining 90% of the default amount is allocated according to each member's gross activity for the entire month of the default and the two previous months. As is the case with regard to other ISOs, PJM's loss allocation assessment formula does not place a cap on non-defaulting members' potential liability; however, the risk mitigation factors described below and the limits on advances to ISO's under 12 U.S.C. § 84 and 12 C.F.R. Part 32 serve to limit the Bank's advances to an ISO.

Risk Mitigation Factors

ISOs take a number of steps to mitigate the risk of a default allocation assessment, including the following:

Credit, Collateral and Netting Requirements. ISOs require, as a condition for membership, that members meet and maintain certain creditworthiness standards to ensure that members have the financial ability to meet their payment obligations in the ISO markets.²⁰ ISO members must meet and maintain certain credit criteria to qualify for unsecured credit or provide credit support (collateral) to the ISO.²¹ For example, members of PJM with investment grade ratings may be granted unsecured credit based on a percentage of the member's tangible net worth.²² If PJM determines that a member is not eligible for a line of unsecured credit, it requires the member to provide financial securities in the form of a cash deposit or letter of credit, equal to that entity's highest two consecutive months of historical activity. Member obligations may not exceed 85% of the unsecured or secured credit established with PJM at any time and a member's total net obligation to PJM through settlement should not exceed its working credit limit.

In the event of a default by a member with posted collateral, the ISO will use the collateral to cover losses, thereby reducing the exposure to non-defaulting members. Where a defaulting ISO

¹⁸ See *Amended and Restated Operating Agreement of PJM Interconnection, L.L.C.*, section 15.1.13 (Jan. 1, 2005) <http://www.pjm.com/documents/downloads/agreements/oa.pdf>.

¹⁹ *Id.* at § 15.2.2.

²⁰ FERC has encouraged the development of creditworthiness and collateral requirements by ISOs and RTOs to reduce members' credit exposure from defaulting members. See *FERC Policy Statement, supra*.

²¹ *Id.*

²² PJM has a detailed process to evaluate a member's creditworthiness. See "Overview of PJM Credit Policy and Credit Requirements" (March 18, 2005), <http://www.pjm.com/documents/downloads/agreements/pjm-credit-overview.pdf>.

member owes payments to and is owed payments from the ISO, during individual settlement periods, most ISOs are allowed to net these two payment obligations.²³ This ability to net payments to and from the ISO reduces the risk of credit loss in the event of a default by a member that is owed money by the ISO.²⁴

Credit Monitoring and Analysis. ISOs also engage in credit monitoring and analysis to evaluate the credit exposure from each member. For example, PJM provides monthly credit exposure reports that include detailed information on the amount of money owed to PJM by its members, the amount of collateral on hand, and the amount of money owed to the members that can be netted against the members' obligations. Members can determine their maximum hypothetical exposure for the prior month based upon the information contained in the report.

Settlement Periods. The settlement period used by ISOs also is an important element in determining credit risk exposure.²⁵ The size of credit risk is largely a function of the length of time between the completion of the various parts of electricity transactions. The risk of default begins at the time the product or service is committed for delivery and continues until the account payable is ultimately extinguished. Thus, the shorter the settlement period the lower the credit risk. Some ISOs have shortened the settlement period for electricity transactions to reduce the credit risk. For example, ISO-NE has implemented a weekly billing period and a shortened settlement cycle in its hourly markets.²⁶ These actions are predicted to reduce both the amount of collateral required from market participants and the ISO's exposure to default by market participants. Settlement cycles in other ISOs are as high as 90 days. FERC has asked these ISOs to initiate processes to shorten settlement periods.²⁷ In addition to the steps ISOs take to mitigate the risk of a member's default,²⁸ there are regulatory controls and physical constraints on the market that serve to limit default risk.

Regulatory Controls. ISOs are regulated by FERC and FERC approves the "tariffs" that govern the operations of ISOs.²⁹ These tariffs typically include numerous safeguards to ensure competitive markets, including price caps on certain products.³⁰

²³ See *FERC Policy Statement, supra*.

²⁴ FERC has asked ISOs to adopt three basic types of netting: (1) netting accounts payable and accounts receivable within one product class (e.g., energy); (2) netting accounts payable and accounts receivable across products (e.g. energy and ICAP); and (3) netting internal bilateral energy contracts. *Id.*

²⁵ *Id.*

²⁶ See *New England Power Pool*, 107 FERC ¶ 61,201.

²⁷ See *FERC Policy Statement, supra*.

²⁸ In addition to the risk mitigants discussed above, FERC has asked ISOs to consider other means, such as obtaining credit insurance, that they believe would be cost-effective measures to reduce the mutualized default risk. *Id.*

²⁹ ISOs and RTOs are required to file open access transmission tariffs with FERC for approval. See *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities: Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, 61 Fed. Reg. 21,540 (May

Physical Constraints. The physical constraints of the electricity generation, transmission, and distribution systems, as well as the level of electricity demand, act to limit the amount of activity in the physical electricity markets. This, in turn, limits the amount of credit exposure from those activities.

Bank Risk Mitigation. The Bank will assess and evaluate the default allocation procedures, liability calculations and available risk mitigants for each ISO to determine its potential credit risk.³¹

Discussion

In our opinion, the Bank may become a member of an ISO for the purpose of executing its permissible electricity derivatives transactions. The Bank's exposures are subject to the limitations set forth in 12 U.S.C. § 84 and 12 C.F.R. Part 32 and any additional limitations imposed by the Bank's EIC based on safety or soundness considerations. Before such a membership is activated, however, the Bank must notify its examiner-in-charge ("EIC"), in writing, of the proposed activities and must receive written notification of the EIC's supervisory non-objection, based on the EIC's evaluation of the adequacy of the Bank's risk measurement and management systems and controls to enable the Bank to engage in the proposed activities on a safe and sound basis, and the EIC's evaluation of any other supervisory considerations relevant to the particular proposal.

A. Membership in an ISO to conduct bank permissible commodity derivative transactions is incidental to engaging in electricity derivative transactions.

A national bank may engage in activities pursuant to 12 U.S.C. § 24(Seventh) if the activities are part of or incidental to the business of banking.³² Incidental activities are activities that are permissible for national banks, not because they are part of the powers expressly authorized for

10, 1996) ("*FERC Order No. 888*"). See, e.g., *Order Accepting Tariff Provisions for PJM Interconnection, L.L.C.*, 112 FERC 61,264 (2005); *Midwest Independent Transmission System Operator, Inc.*, 100-FERC ¶ 61,144 (2002); *ISO New England, et al.*, 106 FERC ¶ 61,280 (2004).

³⁰ See *FERC Policy Statement* and *FERC Order No. 888* (capping the price for reassigned capacity), *both supra*.

³¹ Because default allocation formulas are based in part on a non-defaulting member's market activity at the time of another member's default, the Bank has indicated that it may also reduce its exposure to future defaults by reducing its market activity in the ISO or by terminating its membership. This will not eliminate its exposure to the default that has already occurred, or to defaults that occur for some period of time in the future, however.

³² Section 24(Seventh) expressly provides that national banks shall have the power: "To exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes." The Supreme Court held that this authority is a broad grant of power to engage in the business of banking, including, but not limited to, the five powers expressly granted in 12 U.S.C. § 24(Seventh) and in the business of banking as a whole. *NationsBank of North Carolina v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995).

banks or the “business of banking,” but rather because they are “convenient” or “useful” to those activities.³³

In considering whether an activity is “convenient” or “useful” and therefore incidental to the business of banking, the OCC has considered whether the activity facilitates the operations of the bank as a banking enterprise, enhances the efficiency or quality of the content or delivery of banking services or products, optimizes the use and value of a bank’s facilities and competencies, or enables a bank to avoid economic waste in its banking franchise.³⁴

The OCC has previously concluded that the Bank may engage in customer-driven electricity derivative transactions and hedges, settled in cash and by transitory title transfer, as activities part of or incidental to bank permissible financial intermediation transactions. In order to execute those permissible transactions, the Bank has, or will seek to, become a member of several regional ISOs. The Bank represents that ISO membership is required for physically settled electricity derivative transactions, including those settled by transitory title transfer, and can be the most effective, and in some cases the only, way for the Bank to enter into or hedge cash-settled transactions.

Based on these representations, the Bank’s participation in the ISO clearly is convenient and useful to the Bank’s financial intermediation business in electricity and therefore incidental to the business of banking. The Bank’s ISO membership will facilitate the operations of the Bank as a financial intermediary and will enhance the efficiency of the delivery of electricity derivatives products to its customers.

B. The obligation to advance funds to cover a portion of the losses arising from the default of other ISO members is a permissible guaranty.

As a member of an ISO, the Bank could be required to cover a portion of the losses arising from the default of another ISO member. This obligation is in the nature of a guaranty. Under 12 C.F.R. § 7.1017, a national bank is permitted to guarantee the obligations of another party if the bank has a substantial interest of its own in the transaction. This regulation provides, in part:

A national bank may lend its credit, bind itself as a surety to indemnify another, or otherwise become a guarantor . . . if:

- (a) The bank has a substantial interest in the performance of the transaction involved

12 C.F.R. § 7.1017.

³³ See *Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 431-32 (1st Cir. 1972) (“*Arnold Tours*”).

³⁴ See, e.g., OCC Interpretive Letter No. 845 (Oct. 20, 1998) (“IL No. 845”) (national bank may establish an operating subsidiary to serve as a captive insurance company for the purpose of providing insurance coverage on the business risks of the parent bank and its affiliates).

A nexus between a bank permissible transaction and a guaranty may provide the “substantial interest” for the bank.³⁵ For example, the interest of a national bank in assuring the performance of a co-fiduciary constitutes a sufficient interest to justify the issuance of a guaranty.³⁶

Here, the Bank clearly has a substantial interest in agreeing to cover a portion of the losses of defaulting ISO members, where such an obligation is an integral part of ISO membership. The Bank seeks ISO membership to effectively and efficiently execute its electricity derivatives transactions. The Bank must agree to cover a portion of the losses of defaulting ISO members as a condition of that membership. We have concluded that ISO membership is incidental to the Bank’s electricity derivatives activities. As a result, the Bank’s attendant obligation as an ISO member also is incidental to the Bank’s electricity derivative activities. Accordingly, the Bank’s obligation as an ISO member to cover a portion of the losses of defaulting ISO members is a permissible guaranty.

This conclusion is consistent with decisions the OCC has reached regarding similar membership arrangements. The OCC has long permitted national banks (or their operating subsidiaries) to be members of securities and commodity exchanges and clearinghouses and assume liability as members in order to conduct bank permissible activities. As long ago as 1975, the OCC approved membership by a national bank operating subsidiary in commodity and mercantile exchanges that carried the possibility of liability for defaults of other exchange members.³⁷ The OCC found this potential liability to be a permissible guaranty because the subsidiary had a substantial interest in being a member of the exchanges.

In 1986, the OCC approved the acquisition by a national bank of an operating subsidiary that was a member of the clearing corporations or associations of several securities and options exchanges.³⁸ For each of these entities, the operating subsidiary was required to make deposits to a guaranty fund that would be used to satisfy the outstanding obligations of any member that was unable to satisfy its debts. The OCC found that the subsidiary had a substantial interest in satisfying the guaranty fund requirement in order to retain its ability to provide clearing services to its customers.

³⁵ See, e.g., OCC Interpretive Letter No. 929 (Feb. 11, 2002) (“IL No. 929”) (bank’s provision of a default fund contribution/guaranty was incidental to the business of bank’s clearing and execution activities and satisfied substantial interest needed for issuance of a guaranty); OCC Interpretive Letter No. 542 (Feb. 6, 1991) (guaranteeing loans of a foreign bank subsidiary fell within a guaranty issued for the bank’s own benefit, and thus viewed as incidental to the business of banking); OCC Interpretive Letter No. 376 (Oct. 25, 1986) (“IL No. 376”) (national bank’s guarantee of third party securities borrowers’ conduct was incidental to the bank’s securities lending program and constituted a sufficient substantial interest).

³⁶ See IL No. 376, *supra*, OCC Interpretive Letter No. 121 (Sept. 19, 1979), and OCC Interpretive Letter No. 57 (Oct. 5, 1978).

³⁷ Letter of J.T. Watson, Deputy Comptroller of the Currency (July 11, 1975) (unpublished).

³⁸ OCC Interpretive Letter No. 380 (Dec. 29, 1986).

In 2002, the OCC found that it was permissible for the foreign branch of a national bank to become a member of a securities clearinghouse in order to engage in permissible securities activities.³⁹ Members in the clearinghouse were required to contribute to a default fund to cover losses caused by any defaulting member of the group. The OCC found that contributing to the default fund in order to guarantee the national bank's own obligations as well as those of other clearinghouse members was consistent with the "substantial interest" requirement of 12 C.F.R. 7.1017.

The OCC also confirmed that national banks may participate as netting members in the loss allocation system of a government securities clearinghouse.⁴⁰ Clearinghouse members were required to maintain deposits in a clearing fund account that could be used in the event of the member's default. Any losses remaining after applying the deposit and netting the member's security positions could be allocated to nondefaulting members. In that event, a nondefaulting member could pay the amount of the loss or terminate its membership. If a netting member terminated its membership, its loss allocation liability was limited to its clearing fund deposit. As a result, a member could limit its liability to its required fund deposit. The OCC determined that a member's obligation to cover a portion of the losses of defaulting members was a permissible guaranty.

Recently, the OCC has permitted a national bank to assume potential liability as a participant in a group self-insurance program that provided worker's compensation insurance to members of the group.⁴¹ Under the program, members were required to contribute insurance premiums to establish a reserve fund that would be used to pay claims against any member of the group. In the event the reserve funds were insufficient to cover member obligations, each member would be subject to an additional assessment in order to fund the shortage. The OCC concluded that the program included enough safeguards that the possibility that any member would be required to fund the shortage was *de minimis*.⁴²

In the present case, there are numerous safeguards and controls in place to limit the risk of liability to the Bank from member defaults. As described above, ISO credit policies limit the exposure members have to non-defaulting members by imposing credit limits and collateral requirements based on each member's creditworthiness. Similarly, the physical constraints in the ISO markets limit the potential exposure of ISO members because loss allocation formulas are typically based, in part, on the amount of business in a three-month period. In this case, all

³⁹ IL No. 929, *supra*.

⁴⁰ OCC Interpretive Letter No. 1014 (Jan. 10, 2005) ("IL No. 1014").

⁴¹ OCC Interpretive Letter No. 1022 (Feb. 15, 2005).

⁴² The OCC found the decision in *Merchants v. Wehrmann*, 202 U.S. 295 (1906) ("*Wehrmann*") inapplicable to the proposed activities because existing safeguards were expected to limit the bank's liabilities under the group self-insurance program to *de minimis* amounts. In *Wehrmann*, the Supreme Court held that a national bank was not authorized to participate as a general partner in a partnership that was engaged in activities the Supreme Court found impermissible for national banks and that exposed the bank to potentially unlimited liabilities from those partnership activities.

advances by the Bank to an ISO arising from defaults of ISO members also would be limited, pursuant to 12 U.S.C. § 84 and 12 C.F.R. Part 32.⁴³ As described below, the Bank would establish risk management systems and controls to estimate and maintain their potential liabilities within these limitations. Accordingly, based on all the foregoing, we conclude that the Bank may join the proposed ISOs with the attendant obligations of ISO membership.

C. Membership in an ISO must be conducted in a safe and sound manner.

The Bank must have adequate risk measurement and management systems and controls to participate in the ISOs on a safe and sound basis. Specifically, the Bank may not participate as a member of an ISO unless and until it has received written notification of the EIC's supervisory non-objection. As discussed above, all advances by the Bank to an individual ISO arising from defaults of ISO members are subject to limits pursuant to 12 U.S.C. § 84 and 12 C.F.R. Part 32. However, the EIC will establish a lower limit, based on safety and soundness considerations. If at any time, the Bank's analysis indicates that its potential liabilities from defaults of ISO members would result in advances to an ISO that exceed limits under 12 U.S.C. § 84 and 12 C.F.R. Part 32, or lower limits established by the Bank's EIC, the Bank must adjust its activities such that its estimated potential liabilities fall below the limits.

To participate in the ISO's on a safe and sound basis, the Bank must:

- Conduct a formal written risk assessment of credit risk measurement and management practices for each ISO the Bank joins as a member. At a minimum, this risk assessment should determine:
 - potential liability to the Bank from membership in each ISO; and
 - the degree of reliance the Bank can place on ISO credit risk management practices to minimize or mitigate liability from other member obligations to the ISO.
- Obtain accurate and timely management information from each ISO to periodically assess and monitor, based upon the Bank's activity and default allocation rules, potential liability from the Bank's membership in the ISO. As part of this process, the Bank should review the membership of each exchange, and changes in member activity, on a periodic basis to assess how its contingent risk exposure is changing.

⁴³ As discussed above, the Bank assumes an obligation as an ISO member to advance funds to the ISO in certain circumstances in order to cover a portion of the losses arising from the default of another ISO member. In the event that the Bank advances funds, the ISO must repay the Bank upon recovery of funds from the defaulting member. Under the general lending limit, 12 U.S.C. § 84 and 12 C.F.R. Part 32, a national bank's loans and extensions of credit to one borrower are limited to 15 percent of the bank's capital and surplus. A loan is defined as an advance of funds based on an obligation of the borrower to repay or repayable from property pledged. Accordingly, all advances by the Bank to the ISO that arise from the default of ISO members (including subsequent defaults that may result if other ISO members are unable to meet their payment obligations under a default allocation assessment) cannot, as a matter of law, exceed in the aggregate 15 percent of the Bank's capital and surplus.

- Develop contingency strategies to mitigate risk to each ISO, and establish risk triggers and an approval process for executing contingency risk mitigation strategies. The contingency risk mitigation strategies should include internal limits when the Bank must adjust its activities to avoid exceeding limits on advances of funds to an ISO arising from defaults of ISO members. The contingency risk mitigation strategies also should include notification to the Bank's EIC if at any time the cumulative payments under its contingent obligation to an individual ISO approach those limitations.

In addition, the Bank should establish a compliance program to ensure these supervisory conditions are adhered to on an ongoing basis.

Conclusion

The Bank may participate as a member in the proposed ISOs for the purpose of executing its permissible electricity derivatives transactions, subject to the limitations set forth in 12 U.S.C. § 84 and 12 C.F.R. Part 32 and any additional limitations imposed by the Bank's EIC based on safety or soundness considerations. Before such a membership is activated, however, the Bank must notify its examiner-in-charge ("EIC"), in writing, of the proposed activities and must receive written notification of the EIC's supervisory non-objection, based on the EIC's evaluation of the adequacy of the Bank's risk measurement and management systems and controls to enable the Bank to engage in the proposed activities on a safe and sound basis, and the EIC's evaluation of any other supervisory considerations relevant to the particular proposal. Our conclusions herein are specifically based on the Bank's representations and written submissions describing the facts and circumstances of the subject transactions. A material change in the facts may result in a different conclusion. If you have any questions concerning this letter, please contact Beth Kirby, Special Counsel, Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

/s/

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel