



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

October 15, 2007

Interpretive Letter #1089
November 2007

Re: Property Index Derivative Transactions

Dear []:

This responds to your request that the Office of the Comptroller of the Currency (“OCC”) confirm that it is permissible for [] (“Bank”) to engage in customer-driven,¹ perfectly matched, cash-settled derivative transactions on property indices. For the reasons discussed below, based on the facts and representations provided by the Bank, we believe that the proposed activities are permissible for the Bank. Before the Bank may engage in the transactions, 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 no-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.

Background

The OCC has permitted national banks, including the Bank, to act as a financial intermediary in customer-driven, perfectly matched, cash-settled derivative transactions on commodities and indices as part of its financial intermediation business.² Perfectly matched derivative

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 See, e.g., OCC Interpretive Letter No. 1065 (July 24, 2006); OCC Interpretive Letter No. 1059 (April 13, 2006); and OCC Interpretive Letter No. 1039 (September 13, 2005).

transactions are financial arrangements involving exchanges of payments, with the Bank acting as a financial intermediary between customers, a traditional banking function. In these transactions the Bank first negotiates the type, size, and price of the transaction with the customer. Then, if the Bank reaches agreement with the customer, the Bank concurrently will execute an offsetting, perfectly matched transaction with a counterparty. The Bank's transactions with a counterparty will match all the economic terms of the transaction between the Bank and its customer (*e.g.*, index, amount, maturity, and underlying reference asset or index). The Bank does not take an ownership interest in any commodity, asset, or instrument underlying, or related to an index referenced in, a perfectly matched financial intermediation derivative transaction. Rather, these financial arrangements settle in cash. These transactions assist customers in managing financial risks associated with a particular commodity, asset, or instrument and meeting other financial needs.

The Bank now proposes to act as a financial intermediary in customer-driven, perfectly matched, cash-settled derivative transactions on property indices as part of its customer-driven financial intermediation business. These indices will include certain Investment Property Databank ("IPD") indices, namely the IPD's UK Property Indices,³ the IPD's French Property Index ("FPI"),⁴ the IPD's Deutscher Immobilien Index ("DIX"),⁵ and any sub-indices of these indices. The Bank's proposed property derivative reference indices will further include the S&P/Case-Shiller® Home Price Indices ("S&P/CSI"),⁶ Radar Logic's Residential Property Index™ ("RPX™"),⁷ the S&P/GRA Commercial Real Estate Indices ("S&P/CREX")⁸, and the National

³ The IPD Annual UK Index is an appraisal -based index of commercial property values in the United Kingdom. The IPD UK Annual Index tracks three market sectors, industrial, retail, and office. The IPD Annual Index is published as an All Property Index that covers all three of these market sectors and as individual sub-indices for each sector. The IPD also publishes its UK Property Indices on a quarterly and monthly basis. *See* www.ipdindex.co.uk and http://www.ipdglobal.com/derivatives/uk_annual.asp.

⁴ The IPD's FPI is an appraisal-based index of property values in France. The FPI tracks four market sectors, retail, office, industrial, and residential. The FPI is published as an All Property index that covers all of these market sectors and as individual sub-indices for each sector. *See* http://64.233.169.104/search?q=cache:EbPAkncqNi4J:www.ipdindex.co.uk/results/indices/france/index_france.asp+IPD+French+Index+sectors&hl=en&ct=clnk&cd=1&gl=us and http://www.ipdindex.co.uk/derivatives/pdf/IPD_Deriv_FR_2007.pdf.

⁵ The IPD's DIX is an appraisal-based index of property values in Germany. The DIX tracks four market sectors, retail, office, industrial, and residential. The DIX is published as an All Property index that covers all of these market sectors and as individual sub-indices for each sector. *See* <http://www.ipdindex.co.uk/derivatives/pdf/German%20Annual%20Index%202007.pdf>.

⁶ The S&P/CSI are based on repeat sales data on U.S. existing single family homes, excluding condominiums, in 20 US Metropolitan Statistical Areas ("MSAs"). *See* http://www2.standardandpoors.com/spf/pdf/index/121906_CaseShiller_NewIndices.pdf; http://www2.standardandpoors.com/spf/pdf/index/SP_Case_Shiller_Home_Price_Indices_Methodology_Web.pdf.

⁷ The RPX™ is based on the sales price per square foot of new and existing residential properties, including condominiums, in 25 US MSAs. *See* <http://www.financialnews-us.com/index.cfm?page=ushome&contentid=2348557800&uid=9407-8208-211617-691738>.

Council of Real Estate Investment Fiduciaries (“NCREIF”) Property Index (“NPI”) and its sub-indices (collectively “NPI Indices”).⁹ In anticipation of customer demand, the Bank also asks whether it may reference other regularly produced broad-based property indices that use appraisal- and sales-based data on foreign and domestic commercial and residential real estate in future property index derivative transactions. Under the proposal, the Bank will offer cash-settled swaps, forwards, and options to customers to assist them in managing financial risks associated with real estate and meeting other financial needs. Customers will include asset managers, insurance companies, pension funds, hedge funds, real estate investment trusts, major global investment banks, and affiliates of the Bank. The Bank’s customer base for these products will not include retail customers. The Bank will not take an ownership interest in real estate in connection with the proposed derivative transactions.

Property index derivative transactions are attractive to customers as a means of managing financial risks associated with real estate or related payment obligations and meeting other financial needs. Property index derivatives can be used by customers to gain or reduce real estate exposure without dealing in physical assets. Customers can also use property index derivatives to diversify their investment portfolios by receiving payments based on the appreciation or depreciation of property as determined by reference to a property index. Moreover, these derivatives can diversify a customer’s financial exposure to real estate markets as a whole or to specific sectors, whereas real estate purchases tend to provide exposure to a single property at time. In addition, customers can benefit from these financial arrangements without the costs and filing requirements associated with purchasing real estate. Property index derivative transactions are cost efficient and can be executed quickly. A property index derivative is simply a contractual payment obligation that involves making payments based on the performance of a property index. Accordingly, the Bank wishes to make these products available to customers as a means of managing their financial risks and meeting other financial needs. Representative examples of the types of transactions that customers wish to undertake are described in detail in OCC Interpretive Letter No. 1081 (May 15, 2007) (“IL No. 1081”).

The Bank will not assume market risk in connection with the proposed transactions since it will perfectly match all of the proposed property index derivative transactions.¹⁰ The Bank will manage legal, compliance, and counterparty credit risk in the transactions, in part, by the use of ISDA documentation, to evidence and govern the transactions. The Bank will further manage credit

⁸ The S&P/CREX indices measure the change in US commercial real estate sales prices by property sector and geographic region. The indices are comprised of ten commercial real estate indices: a national composite, five geographic regions (Desert Mountain West, Mid-Atlantic South, Midwest, Northeast, and Pacific West) and four national property sectors (apartments, office, retail, and warehouse). See http://www2.standardandpoors.com/spf/pdf/index/SP_GRA_Commercial_Real_Estate_Indices_Methodology_Web.pdf.

⁹ NPI is a family of US appraisal-based commercial property indices. NPI includes indices on the national all-property level as well as sub-indices by property type (*e.g.*, apartment, industrial, etc.) and geographic region (*e.g.*, South, West, etc.). See <http://www.ncreif.com/indices/npi.phtml>; http://www.ncreif.com/pdf/Users_Guide_to_NPI.pdf.

¹⁰ The Bank will act as financial intermediary in customer-driven, perfectly matched, cash-settled property index derivative transactions where a counterparty is a Bank affiliate.

risk by subjecting property index derivative counterparties to the Bank's standard credit approval processes. Credit risk will be captured on the Bank's credit systems and limit exceptions will be reported under the Bank's established processes.

The Bank represents that the terms and circumstances of all transactions between the Bank and its affiliates in conducting these transactions 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 states that it will comply with the requirements of sections 23A and 23B of the Federal Reserve Act, Federal Reserve Board's Regulation W, and the Bank's policies designed to ensure compliance with these requirements when engaging in the proposed property index derivative transactions.

Discussion

The proposed derivative transactions are permissible for the Bank under OCC precedent finding national banks may engage in property index derivative transactions as permissible financial intermediation activity under 12 U.S.C § 24(Seventh). In IL No. 1081, the OCC specifically determined that a national bank may engage in customer-driven, perfectly matched, cash-settled derivative transactions on IPD UK Indices and the S&P/CSI as bank permissible financial intermediation transactions. The indices at issue in IL No. 1081 are similar to the indices at issue here. The NPI Indices, like the IPD UK Indices, are appraisal-based indices of commercial property values. The NPI Indices rely on US commercial property appraisal data, whereas the UK IPD indices rely on UK property appraisal data. Similar to the IPD UK Indices, the IPD's FPI and DIX indices are based on appraisals of foreign properties from any of three commercial real estate sectors although, unlike the IPD UK Indices, the FPI and DIX indices may also use residential real estate data. The S&P/CREX, like the S&P/SCI, uses sales data on property located in the US, with the former using commercial sales data and the latter using residential sales data on existing homes. RPX™ is a residential real estate index like the S&P/SCI, except that RPX™ includes not only sales data on existing homes, but on new home and condominium sales.

In sum, the proposed indices are based on domestic and foreign commercial and residential property valuations or sales, and are similar to the indices previously addressed by the OCC in IL 1081. Accordingly, on the basis of the analysis set forth in detail in IL No. 1081, we conclude that the Bank may act as a financial intermediary in customer-driven, perfectly matched, cash-settled, derivative transactions on the specified property indices. Additionally, the Bank may reference other regularly produced broad-based property indices that use appraisal- and sales-based data on foreign and domestic commercial and residential real estate in property index derivative transactions in response to future customer demand. These perfectly matched transactions are financial arrangements involving exchanges of payments, with the Bank acting as a financial intermediary between customers, a traditional and permissible banking function. As in IL No. 1081, before the Bank may engage in the activities the Bank must provide written notice of the proposed activities to its EIC and must receive written notification of the EIC's supervisory no-objection. The no-objection is 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 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 concerning this letter, 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