Interpretations—April 1 to June 30, 2002

		Page
Interpretive Letters		49

Laws	*Letter No.*	*Page*
12 USC 24(7)	931	54
	932	55
	933	58
	934	62
	935	65
	937	69
Regulations		
12 CFR 1	930	51
12 CFR 7.4002(a) and (b)	932	55
	933	58
	934	62
12 CFR 9.18	936	67
Subjects		
Permissibility of purchasing bonds convertible into equity	930	51
Permissibility of investing in perpetual preferred stock	931	54
Permissibility of non-relationship customer check cashing fees	932	55
Permissibility of non-accountholder check cashing fees	933	58
Permissibility of non-accountholder check cashing fees	934	62
Permissibility of holding securities for hedging purposes	935	65
Permissibility of operations of a collective investment fund	936	67
Permissibility of engaging in financial intermediation transactions	937	69

Interpretive Letters

930—March 11, 2002

12 CFR 1

Subject: Legal Permissibility of Purchasing Bonds Convertible into Equity

Dear [ ]:

This letter addresses whether the *[State1]* federal branch of [ ] (bank) legally purchased bonds convertible into equity. The purchase of the bonds was legally permissible under its Part 1 investment authority if the analysis the branch undertook at the time supported its conclusion that the bonds were the credit equivalent of investment grade and marketable, or if at the time it purchased the bonds, it underwrote them as loans in accordance with the standards of OCC Banking Circular 181.[1] In either case, the branch's examiner-in-charge (EIC) or the appropriate supervisory office must find the branch's conclusion or analysis to be sufficient, as documented by the branch prior to the purchase.

I. Background

In September 2000, the bank and its *[State1]* and *[State2]* federal branches (the branches) engaged in three interrelated transactions: the purchase of bonds convertible into equity, an interest rate swap, and the sale of a call option on the bonds (collectively, the "transactions"). This letter focuses on the bond purchase made by the *[State1]* branch (branch).

A. The Transactions

The transactions comprise a callable asset swap. An asset swap is a synthetic structure that enables an investor to purchase a fixed rate bond and hedge the interest rate risk by swapping the fixed rate payments for floating rate payments using an interest rate swap. The swap converts the asset yield on the bonds from fixed to floating. The sale of the call option enhances the yield. The asset swap is "callable" where, as here, the investor sells call options on the bond and the exercise of the options terminate the swap.

The callable asset swap is described in detail below.

(1) The Bonds

[SPV], a Special Purpose Vehicle, issued $550 million in seven-year Eurobonds, convertible after 12 months, at the option of the purchaser, into 8.708 million shares of *[Co]* stock *("[SPV]* bonds"). The *[SPV]* bonds are Eurodollar bonds quoted daily in the market. The convertible *[SPV]* bonds bear a coupon rate of 4.75 percent. *[Co2]* wholly owns *[SPV]* and guarantees the outstanding principal and accrued interest on the bonds. The bank and the branches purchased $15 million of *[SPV]* bonds. The *[SPV]* bonds have embedded call options that give *[SPV]* the right to call the bonds. The bonds are not rated.

(2) The Interest Rate Swap

Simultaneously with the purchase of the *[SPV]* bonds, the bank and its branches entered into an interest rate swap with *[Co3]*. Under the interest rate swap, the bank and the branches pay *[Co3]* the fixed rate of 4.75 percent, the coupon rate of the bonds, semiannually. In return, *[Co3]* agreed to pay the bank a floating rate of LIBOR[2] plus a spread of 165 basis points, quarterly. The swap terminates in seven years or when the *[SPV]* bonds are called by *[SPV],* or upon *[Co3]'s* exercise of call options it purchased from the bank and the branches (described below). The bank and the branches secured their obligations under the swap by pledging the *[SPV]* bonds to *[Co3].*

(3) The Call Options

The bank and the branches, in connection with the purchase of the *[SPV]* bonds and the interest rate swap, each sold a seven-year call option on the bonds to *[Co3]*. *[Co3]'s* exercise of the options entitles *[Co3]* to purchase all the *[SPV]* bonds purchased by the bank and its branches at a predetermined "strike price." If the *[SPV]* bonds are called, exchanged or redeemed under the terms of the bonds, *[Co3]* is deemed to have exercised its call options and the swap terminates. Under the options' terms,

[1] The OCC requires banks to implement "satisfactory controls" over loans, including: [1] written lending policies and procedures governing those transactions; [2] an independent analysis of credit quality by the purchasing bank; [3] agreement by the obligor to make full credit information available to the selling bank; [4] agreement by the selling bank to provide available information on the obligor to the purchaser; and [5] written documentation of recourse arrangements outlining the rights and obligations of each party. OCC Banking Circular No. 181 (Rev.) (August 2, 1984) (BC–181).

[2] "LIBOR" refers to the London Inter Bank Offered Rate, an interest rate that major international banks charge each other for large loans of dollars outside of the United States.

the bank and its branches are prohibited from converting the *[SPV]* bonds into *[Co]* stock while the transactions remain outstanding.

B. Analysis of the Transactions

As discussed in section II of this letter, a national bank may purchase debt securities as investment securities if the bonds are the credit equivalent of investment grade and marketable. The EIC must be satisfied that the information contained in the credit file demonstrates, at the time of the bond's purchase, appropriate support for the branch to treat the bonds as the credit equivalent of investment grade and marketable.

Here, the bank and the branch analyzed the *[SPV]* bonds in connection with the interest rate asset swap and call option, prior to the purchase of the bonds.[3] The bank and the branch approved the bond purchase based on *[Co2]'s* (the guarantor's) bond guarantee,[4] financial strength, and good market reputation and the convertibility of the *[SPV]* bonds into *[Co]* stock. Based on their financial review, the bank and the branches assigned the transactions an internal rating of 3, equivalent to a long term debt rating of "A," prior to the purchase of the bonds. The bonds were also quoted daily in the market.

II. Applicable Law

A. Permissible Purchases of Debt Securities

National banks may purchase "investment securities" for their own account in an amount that generally may not exceed 10 percent of the bank's capital and surplus.[5] "Investment securities" are "marketable obligations, evidencing the indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures, commonly known as 'investment securities.'" An "investment security" is "a marketable debt obligation that is not predominantly speculative in nature."[6]

To qualify as a Type III security, a bond must be rated investment grade or, if not rated, the credit equivalent of investment grade, and marketable.[7] "Investment grade" means a security that is rated in one of the four highest rating categories by two or more nationally recognized statistical rating organizations (NRSROs) or by one NRSRO if the security is rated only by one NRSRO.[8] A security is the credit equivalent of a security rated investment grade if the bank, after a sufficient analysis, reaches that determination.[9] A debt security is "marketable" if it can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.[10]

A national bank may purchase a debt security as an investment security, even if the security does not qualify as a Type III security, based on the bank's reliable estimates that the obligor will be able to satisfy its obligations under that security.[11] If so, the "reliable estimates" provision allows a bank to invest in a below-investment-grade security or one not determined to be the credit equivalent of investment grade, if the bank satisfies itself that the securities may be sold with reasonable promptness at a price that corresponds reasonably to their fair value.[12] National banks may purchase securities under the "reliable estimates" standard in an aggregate amount no greater than 5 percent of their capital and surplus.[13] This limit applies against all securities in their portfolios acquired on the basis of reliable estimates, rather than on a per-issuer basis.[14]

Banks purchasing securities permitted under Part 1 must adhere to safe and sound banking practices and consider, as appropriate, interest rate, credit, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputation risk the purchases present.[15] Any investments must be appropriate for national banks.[16]

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[3] The bonds are not rated or registered under the federal securities laws. The bank and the branches considered the transactions as "parts of one single transaction." Although the bank and the branches did a formal credit analysis on the issuer, they did not assign a credit rating on the bonds separate and apart from the interest rate swap they entered into with, and the call options they sold to, *[Co3]*. As a general matter, however, debt securities should be assigned their own separate rating.

[4] *[Co2]* provides an irrevocable, unconditional, and unsubordinated guarantee for all amounts payable under the bonds.

[5] 12 USC 24(Seventh). The investment limitations in 12 CFR Part 1 based on the capital stock and surplus of a national bank, when applied to a federal branch or agency, refer to the dollar equivalent of the capital stock and surplus of the foreign bank, and all the business of the foreign bank and federal branches is aggregated in determining compliance with the limitation. *See* 12 USC 3102(b).

[6] 12 CFR 1.2(e). A security is not predominantly speculative in nature if it is rated investment grade. When a security is not rated, the security must be the credit equivalent of a security rated investment grade. *Id.*

[7] *See* 12 CFR 1.2(e) and (f)(2).

[8] *See* 12 CFR 1.2(d) and (h).

[9] *See* OCC Interpretive Letter No. 912 (July 3, 2001), *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–437.

[10] *See* 12 CFR 1.2(f)(4).

[11] *See* 12 CFR 1.3(i)(1).

[12] *Id.*

[13] *See* 12 CFR 1.3(i)(2).

[14] *Id.*

[15] S*ee* 12 CFR 1.5(a).

[16] *Id.*

Alternatively, a national bank may purchase and hold debt securities, including below-investment-grade securities, as loans under its general lending powers, consistent with safety and soundness considerations.[17] National banks that purchase debt securities under their lending authority must comply with the lending limit restrictions in 12 USC 84[18] and generally may not purchase them in an amount exceeding 15 percent of the bank's capital and surplus.[19] Bank purchasers also must adhere to the prudential standards of BC-181, to the extent applicable, including the requirement that they perform an independent credit analysis of the loans to satisfy themselves that the credits meet their own credit standards.[20]

III. Discussion

A. Determination of Credit Equivalent of Investment Grade and Marketable

To qualify as a Type III security, a bond must be rated investment grade or, if not rated, the credit equivalent of investment grade and marketable. The *[SPV]* bonds are not rated. Accordingly, the bank and its branches could only purchase the *[SPV]* bonds as Type III securities, subject to a 10 percent limitation, if, at the time of purchase, they determined the bonds were the credit equivalent of investment grade and marketable. The branch's EIC or supervisory office must find the branch's conclusion or analysis to be sufficient, as documented by the branch at the time of purchase. The subsequent sale of call options on the bonds by the bank and the branches would not affect a determination that the bonds were marketable.

B. The Debt Securities' Conversion Feature is not Prohibited by Part 1

National banks generally may not purchase investment securities that are convertible into equity at the option of the issuer.[21] However, a national bank may acquire convertible debt securities, provided that it disposes of the securities before the date the conversion option comes into effect.[22] A national bank also may purchase debt securities convertible to equity securities at the bank's option where the bank does not exercise the conversion feature.[23]

The branch would not be prohibited from holding the *[SPV]* bonds on the basis of the conversion feature because the conversion feature is in its control. Moreover, because the branch is prohibited from converting the bonds into equities under the callable asset swap, the convertibility of the bonds is not at issue.

C. The Bonds May be Purchased as Loans

The branch may rely on its lending authority to hold the bonds if it underwrote them as loans at the time of purchase, in accordance with the standards of BC-181. The branch's EIC or appropriate supervisory office must find the branch's conclusion or analysis under those standards to be sufficient, as documented by the branch at the time of purchase.

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[17] *See* OCC Interpretive Letter No. 834 (July 8, 1998), *reprinted in* [1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–288; OCC Interpretive Letter No. 833 (July 8, 1998), *reprinted in* [1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–287; OCC Interpretive Letter No. 600 (July 31, 1992), *reprinted in* [1992–1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,427; OCC Interpretive Letter No. 579 (March 24, 1992), *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,349; OCC Interpretive Letter No. 182 (March 10, 1981), *reprinted in* [1981–1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,263.

[18] The lending limits in 12 USC 84 based on the capital stock and surplus of a national bank, when applied to a federal branch or agency, refers to the dollar equivalent of the capital stock and surplus of the foreign bank, and all the business of the foreign bank and federal branches is aggregated in determining compliance with the limitation. *See* 12 USC 3102(b).

[19] *See* OCC Interpretive Letter No. 834, *supra*; OCC Interpretive Letter No. 833, *supra*; OCC Interpretive Letter No. 579, *supra*.

[20] *See* OCC Interpretive Letter No. 663 (June 8, 1995), *reprinted in* [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,611; OCC Interpretive Letter No. 579, *supra*.

[21] *See* 12 CFR 1.6.

[22] OCC Interpretive Letter No. 359 (April 9, 1986), *reprinted in* [1985–1987 Transfer Binder] CCH ¶ 85,529; OCC Investment Securities Letter No. 55 (August 5, 1991), *reprinted in* [1991–1992 Transfer Binder] CCH ¶ 83,328.

[23] If an option is not exercised, there is no conversion and no resultant equity holdings. The OCC similarly has permitted national banks to own real estate as principal in various contexts, notwithstanding the general prohibition in 12 USC 29 against banks owning real property. OCC Corporate Decision No. 99-07 (March 26, 1999) (ownership of real property interests as incidental to permitted financing transactions); OCC Conditional Approval Order No. 295 and OCC Corporate Decision No. 98-17 (March 23, 1998) (same); OCC Interpretive Letter No. 806 (October 17, 1997), *reprinted in* [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,253 (ownership of real property in a net lease transaction that is a loan substitute for Islamic customer); 12 CFR 1.100(b) (municipal leases). In addition, the OCC has permitted national banks to own various types of personal property in order to engage in lease-financing activities. *See* 12 CFR 23.20; *see also,* Letter from Robert Herman, Deputy Comptroller (October 4, 1994) (unpublished) (ownership of an interest in trust that purchased hydrocarbon producer payments in connection with financing transaction). In all these contexts, the prohibitions otherwise applicable to ownership of these assets by a national bank as principal are not applicable because owning the asset is deemed necessary for the national bank to engage in a permissible banking activity or transaction.

IV. Conclusion

The branch's purchase of the bonds was legally permissible under its Part 1 investment authority if the analysis the branch undertook at the time supported its conclusion that the bonds were the credit equivalent of investment grade and marketable, or if at the time it purchased the bonds, it underwrote them as loans in accordance with the standards of BC-181. In either case, the branch's EIC or the appropriate supervisory office must find the branch's conclusion or analysis to be sufficient, as documented by the branch at the time of purchase. The branch must clearly document in its credit files the authority it relies on to make debt acquisitions at the time of purchase.

I trust the foregoing is responsive to your inquiry. If you have additional questions, please do not hesitate to contact Tena M. Alexander, Special Counsel, Securities and Corporate Practices Division at (202) 874-5210.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

931—March 15, 2002

12 USC 24(7)

Re: Purchases of Perpetual Preferred Stock by [ ] (Bank)

Dear [ ]:

This responds to the bank's request that the OCC determine whether a national bank may hold two issues of perpetual preferred stock as investment securities under 12 CFR Part 1. For the reasons described below, we conclude that a national bank may invest in perpetual preferred stock issued by the Federal National Mortgage Association ("Fannie Mae") and by the Federal Home Loan Mortgage Corporation ("Freddie Mac") without limit, subject to safety and soundness considerations.

I. Background

The bank is interested in holding Fannie Mae and Freddie Mac perpetual preferred stock. Both securities are rated A or better by two nationally recognized statistical rating organizations (NRSROs). Both issuers may declare dividends quarterly, out of funds legally available. The holders of both issues do not participate or share in the profits of the issuers. Rather, their return is limited to stated dividends. Both securities are noncumulative. If the issuers do not declare a dividend in a quarter, holders do not have a right to receive that quarter's dividend in the future. Both issues are redeemable by their issuers, starting in 2006, at $50 per share plus accrued dividends for the quarter. Both preferred issues are senior to the issuers' common stock. The issuers may not declare a dividend on common stock in a particular quarter without first paying a dividend on the preferred stock. In the event of a dissolution or liquidation, holders of both issues will receive out of assets available for distribution up to $50 per share plus a pro-rata share of the dividend for the quarter before any distributions to common shareholders. The preferred shares are nonvoting, except that Fannie Mae preferred shareholders may vote on limited matters regarding preferred stock.

II. Discussion

The plain language of section 24(Seventh) authorizes national banks to purchase and hold preferred stock of Freddie Mac and Fannie Mae without quantitative limits.

Section 24(Seventh) permits national banks to hold "mortgages, obligations, or *other securities* which are or ever have been sold by [Freddie Mac] pursuant to section 305 or section 306 of the Federal Home Loan Mortgage Corporation Act" (emphasis added).[1] Section 306(g) of the Federal Home Loan Mortgage Corporation Act empowers Freddie Mac to issue "preferred stock on such terms and conditions as the board of directors shall prescribe."[2] Freddie Mac preferred stock is a "security"[3] that national banks may hold under section 24(Seventh).

Section 24(Seventh) also authorizes banks to purchase and hold Fannie Mae perpetual preferred stock. Section 24(Seventh) permits national banks to hold "obligations, participations, or other instruments of or issued by" Fannie Mae. Since the term "instrument" is commonly defined to include securities,[4] we believe this language affords a basis for national banks to purchase and hold Fannie Mae perpetual preferred stock.

Section 24(Seventh) generally restricts national banks' dealing, underwriting, purchasing, and selling securities.

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[1] Indeed, the OCC previously relied on this same language in section 24(Seventh) in concluding that national banks may purchase and hold preferred stock of Freddie Mac. OCC Interpretive Letter No. 577, *reprinted in* [1991–1992 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 83,347 (April 6, 1992).

[2] 12 USC 1455(f).

[3] OCC Interpretive Letter No. 577, *supra*.

[4] *Black's Law Dictionary,* 5th ed. (West 1979).

Section 24(Seventh) exempts Freddie Mac "securities" and Fannie Mae "instruments" from these restrictions. Thus, banks' holdings of Freddie Mac and Fannie Mae preferred securities are not subject to quantitative limits, other than safety and soundness considerations. Examples of the prudential controls the OCC would expect to see in a bank investing in these instruments include: implementation of appropriate diversification principles, adoption of concentration limits on the securities of any one issuer, and consideration of the impact on the bank's overall interest rate and liquidity risk profiles.

III. Conclusion

Accordingly, a national bank may invest in perpetual preferred stock issued by Fannie Mae and by Freddie Mac. This investment is not subject to quantitative limits on the amount of such stock that the bank may hold, but the amount is subject to safety and soundness considerations, including the prudential controls noted above. If you have any questions, please contact me at (202) 874-5210.

Nancy Worth
Counsel
Securities and Corporate Practices Division

932—August 17, 2001

12 USC 24(7)

12 CFR 7.4002(a) and (b)

Subject: [ ] Non-Relationship Customer Check Cashing Fees

Dear [ ]:

This responds to your letter of July 12, 2001, in which you explain that [ ] (the bank) proposes to commence charging a non-accountholder ("non-relationship customer")[1] a convenience fee for using a bank teller to cash an "on us check," which is a check drawn upon the account of one of the bank's customers. The bank intends to apply this convenience fee with respect to checks drawn on business accounts. This convenience fee is essentially compensating the bank for making cash immediately available to the payee. Otherwise, the payee would have to wait for the check to clear through the payment system.

You request the concurrence of this office that the bank is authorized to charge this fee under section 24(Seventh) of the National Bank Act (12 USC 24(Seventh)) and 12 CFR 7.4002(a).[2] Based on our review of your letter and supporting materials submitted and the relevant procedural considerations set forth in 12 CFR 7.4002(b), we agree that the bank is authorized to charge this convenience fee, in its discretion, pursuant to section 24(Seventh) and section 7.4002(a).[3]

National Bank Charges and Fees Are Authorized Under 12 USC 24(Seventh) and 12 CFR 7.4002

Section 24(Seventh) authorizes a national bank to engage in activities that are part of, or incidental to, the business of banking[4] as well as to engage in certain specified activities listed in the statute. "[N]egotiating . . . drafts" is one of the activities specified in section 24(Seventh). A bank's authority to provide products or services to its customers necessarily encompasses the ability to charge a fee for the product or service.[5]

This ability to charge a fee for the bank's services is expressly reaffirmed in 12 CFR 7.4002(a), which provides:

[1] The bank defines "non-relationship customers" as customers that do not have a mortgage, credit card, other loan, checking account, savings account, or certificate of deposit account with the bank or a loan or other account with an affiliate or subsidiary of the bank.

[2] We note that the authority of the bank and other national banks to charge particular fees is not conditioned on obtaining an individual confirming opinion, since national banks are authorized to charge non-interest fees and charges as an inherent element of their authority to conduct the business of banking.

[3] Your letter noted that the State of Texas has recently enacted legislation that takes effect on September 1, 2001, and that would require banks located in Texas to cash checks drawn on one of the institution's accounts without charging any fee. You have not requested our opinion, and we accordingly express no view, about whether the Texas law you describe or any similar state law would apply to national banks.

[4] The powers clause of section 24(Seventh) provides that a national bank may "exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking . . ." 12 USC′ 24(Seventh). *See NationsBank* v. *Variable Annuity Life Ins. Corp.*, 513 U.S. 251 (1995) (the "business of banking" is not limited to the list of powers enumerated in section 24(Seventh)).

[5] *Cf. Franklin National Bank* v. *New York*, 347 U.S. 373, 377 (1954) (stating, in the context of bank advertising, "We cannot believe that the incidental powers granted to national banks should be construed so narrowly as to preclude the use of advertising in any branch of their authorized business").

(a) *Authority to impose charges and fees*. A national bank may charge its customers non-interest charges and fees, including deposit account service charges.[6]

The bank's authority in this, as in all other, areas must be exercised in a manner that is consistent with safe and sound banking practices. Paragraph (b) of section 7.4002[7] sets out the factors that the bank should consider to ensure that its process for setting its fees and charges is consistent with safety and soundness:

(b) *Considerations*. (1) All charges and fees should be arrived at by each bank on a competitive basis and not on the basis of any agreement, arrangement, undertaking, understanding, or discussion with other banks or their officers.

(2) The establishment of non-interest charges and fees, their amounts, and the method of calculating them are business decisions to be made by each bank, in its discretion, according to sound banking judgment and safe and sound banking principles. A national bank establishes non-interest charges and fees in accordance with safe and sound banking principles if the bank employs a decision-making process through which it considers the following factors, among others:

(i) The cost incurred by the bank in providing the service;

(ii) The deterrence of misuse by customers of banking services;

(iii) The enhancement of the competitive position of the bank in accordance with the bank's business plan and marketing strategy; and

(iv) The maintenance of the safety and soundness of the institution.

If a bank uses a decisionmaking process that takes these factors into consideration, then there is no supervisory impediment to the bank exercising its discretionary authority to charge non-interest fees and charges—such as the non-relationship customer check cashing fees at issue here—pursuant to section 7.4002(a).

The Bank's Consideration of the Section 7.4002(b) Factors

The bank has provided analysis and supporting documentation demonstrating that it has considered each of the four factors listed in section 7.4002(b)(2)(i)–(iv). The materials provided, for which the bank requests confidential treatment,[8] include information on various costs incurred by the bank in cashing checks for non-relationship customers. These include the bank's current losses attributable to non-relationship customer check-cashing, the number of non-relationship checks cashed annually, and the cost per check to process them. The bank notes that in many instances, these costs are projected to increase. The bank has concluded that its proposed non-relationship customer check cashing fee is necessary to help defray these costs.

The bank also has concluded that the convenience fee will help deter misuse because it will reduce check-based fraud. In particular, the bank expects that the fee will serve as an incentive for non-relationship customers to use other payment channels. The bank has described several programs directed toward non-relationship customers that it offers, or is developing, as alternatives to the use by these customers of tellers to cash checks over the counter. These include electronic accounts for cashing federal payments and access to direct deposit payments, which reduce the opportunity for check-based fraud. You have represented that the bank also intends to give written notices to non-relationship customers standing in line to cash payroll checks that they may avoid the proposed fee entirely—and receive the full face value of a check drawn on the bank—by opening an account at the bank or another institution or by electing to use the alternative payment methods offered by the bank.

The bank's submission discusses how charging non-relationship customers this convenience fee relates to its overall business strategy. The bank has provided analysis of the impact that non-relationship check cashing has on the service that the bank provides its account holders. The bank's submission demonstrates that non-relationship

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[6] 12 CFR 7.4002(a). As used in section 7.4002(a), "customer" simply means any party that obtains a product or service from the bank. The OCC recently adopted amendments to section 7.4002 to eliminate certain ambiguities in the text of the regulation. *See* 66 Fed. Reg. 34784 (July 2, 2001). As indicated in the preamble to the final rule, however, these amendments do not affect the substance of the regulation or the way it operates. *Id*. at 34787. Citations to section 7.4002 in this letter are to the regulation as revised. The revisions took effect on August 1, 2001.

[7] 12 CFR 7.4002(b).

[8] The bank's submission includes information that the bank believes to be exempt from disclosure under the Freedom of Information Act (FOIA). 12 USC 552(b). The FOIA exempts matters constituting "trade secrets and commercial or financial information obtained from a person and privileged and confidential."

check cashing, by increasing costs associated with fraud losses and increasing the waiting time in teller lines, has the potential to affect negatively the quality of service the bank provides to its accountholders. The bank's submission shows that deterrence of this potential negative effect was a factor considered by the bank in proposing its non-relationship check cashing fee.

In discussing how the fees would enhance the competitive position of the bank, the bank notes as a threshold matter that superior convenience for its accountholders is a "key competitive ingredient" for the bank. The bank then discusses the impact that these fees will have on the bank's ability to provide superior convenience, through physical and alternative service delivery channels, for both its relationship customers and non-relationship customers. The bank asserts that the proposed non-relationship check cashing fee will promote greater convenience for its customers by allowing the bank to reduce delays in customer service and develop and implement advanced fraud protection systems best suited for the risk of check cashing. Moreover, the bank believes that the fee will enhance its competitive position by creating an incentive for non-accountholders and accountholders to use delivery channels for their banking services that are less costly than the bank's physical banking centers. The bank notes that its proposed fee approximates what a non-relationship customer may pay to use an automated teller machine and is less expensive than what many of its competitors charge for cashing a check presented by a non-accountholder.

Finally, the bank provided analysis on the impact that the fees it charges to access its services have on the bank's safety and soundness, particularly the bank's ability to control costs and increasing exposure to fraud losses. The bank has attempted to avoid misunderstandings with its customers (which could present, among other things, reputation risk to the bank) by disclosing in its deposit agreement that the bank "may" charge a convenience fee for cashing on us checks. The bank also will send a notice to affected customers, 30 days before such a fee goes into effect in a particular state, that the fee will, in fact, be charged.

In addition, as part of its consideration of the safety and soundness implications of initiating a non-relationship customer check cashing convenience fee, the bank analyzed whether the proposed fee would constitute a "wrongful dishonor" of a check or impair the check's negotiability under the Uniform Commercial Code (UCC).

According to the analysis furnished by the bank, whether a customer could challenge the non-relationship check cashing fee as a wrongful dishonor depends on the terms of the deposit agreement between the bank and the customer. *Menicocci* v. *Archer National Bank of Chicago*, 67 Ill. App.3d 388, 391 (1st Dist. 1978) (the terms of a bank's relationship with its customer is governed by the terms of the deposit contract). The deposit agreement for the business accounts to which the bank's proposed non-relationship check cashing fee would apply provides:

> You agree that we may impose additional requirements we deem necessary or desirable on a payee or other holder who presents for cashing an item drawn on your account which is otherwise properly payable, and if that person fails or refuses to satisfy such requirements, our refusal to cash the item will not be considered wrongful. You agree that, subject to applicable law, such requirements may include (but are not necessarily limited to) physical and/or documentary identification, check cashing fees, and requirements that such items may be cashed only at specified locations.

Thus, because the bank's deposit agreement clearly provides for check cashing fees, the bank has concluded that the application of the proposed non-relationship customer check cashing fee would not constitute a wrongful dishonor of a check under the UCC.[9]

The bank also asserts that the application of the proposed non-relationship customer check cashing fee would not impair the negotiability of a check presented for payment. Section 3–104 of the Uniform Commercial Code defines a negotiable instrument as:

> . . . an unconditional promise to pay or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it:
>
> (1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder;
>
> (2) is payable on demand or at a definite time; and
>
> (3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment on money. . . .

The bank asserts that a non-relationship customer check cashing fee does not alter a check's negotiabilty because

[9] *Cf. Your Style Publication, Inc.* v. *Mid Town Bank & Trust Co.*, 501 N.E.2d 805, 810 (Ill. Ct. App. 1986) (defendant banks exceeded their contractual authority because depositor agreements did not clearly provide for check cashing fees and banks' customers would have no reason to believe that their own checks would be subjected to this fee).

the check does not contain on its face an express condition to payment and the fee is not assessed for negotiation of the check. A check is an unconditional promise to pay unless an express condition to payment appears on the face of the check:[10]

> One of the essentials of a negotiable check is that it be payable without condition. This means that a statement must not appear on the check that it is subject to any other order, promise, or condition. There must be no additional order or promise on the check itself; it must merely be an order on a bank for the payment of a sum of money.

Henry J. Bailey and Richard B. Hagedorn, *Brady on Bank Checks*, ¶2.04 (2000)

As explained in the bank's submission, when a bank charges a non-relationship customer check cashing fee, there is no reference to the fee on the face of the check. The fee only applies to over-the-counter check cashings by a non-customer, and is not assessed when the check is deposited or negotiated to another holder. The holder of the check has many choices about how to negotiate the check, and over-the-counter cashing is the only choice under which the fee is assessed. Therefore, the bank concludes that the fee is not assessed for negotiation and does not affect the unconditional nature of the promise to pay.

The bank's conclusion is supported by *Sexton* v. *PNC Bank, N.A.*, 43 UCC Rep.2d 341 (Pa. Ct. Com. Pl. 2000), in which the court found that a similar check cashing fee does not affect the negotiability of checks. In that case, the court found that the fee—

> is not assessed upon the negotiation of a check; it is merely a charge collected by the Bank in exchange for the service of turning a check into cash. A non-customer who deposits a check drawn on PNC into his or her account at another financial institution will receive the full face amount of the check. The same non-customer may also (assuming an agreeable recipient) endorse the check over to another person, who will then receive its full face value upon depositing the check into his (or her) own account, whether at PNC or elsewhere.

Id. at 341. The court went on to conclude:

> Section 3–104 further provides that an order that is payable on demand and drawn on a bank, and that complies with provisions (2) and (3) [thereof] is both a check and a negotiable instrument. Because PNC's $3.00 fee neither alters the payable-on-demand character of checks presented for cashing, nor constitutes an undertaking or instruction by the drawer over and above the promise to pay, the fee does not impair the negotiability of those checks, and its imposition does not violate the law.

Id. at 341.[11]

Conclusion

We therefore conclude that the bank is authorized, under 12 USC 24(Seventh) and 12 CFR 7.4002(a), to charge the non-relationship customer check cashing convenience fee and that the bank's process for considering the establishment of the fee is consistent with the considerations required by section 7.4002(b).

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

933—August 17, 2001

12 USC 24(7)

12 CFR 7.4002(a) and (b)

Subject: Request for Concurrence that [ ] is Authorized to Charge Fees to Cash Checks Drawn on the Bank for Non-Accountholders

Dear [ ]:

This responds to your letter of July 31, 2001, in which you request the concurrence of this office that [ ], a national banking association with its main office in

[10] Section 3–106 of the UCC provides that:

. . . a promise or order is unconditional unless it states

(i) an express condition to payment,

(ii) that the promise or order is subject to or governed by another writing, or

(iii) that rights or obligations with respect to the promise or order are stated in another writing.

[11] *See also Hayes* v. *First Commerce Corp.*, 763 S.2d 733, 43 UCC Rep.2d 335 (La. Ct. App. 2000), in which the court rejected a claim that a check cashing convenience fee constituted misappropriation, finding that the payee had voluntarily chosen to do business with the payor bank and that there is nothing illegal about charging a check cashing fee. In discussing the *Hayes* and *Sexton*, Barkley Clark, a leading commentator on negotiable instruments and bank deposits, stated, "We think both the Louisiana and Pennsylvania decisions hit the target in the middle." Barkley Clark, *Clark's Bank Deposits and Payments Monthly*, Vol. 9, No. 8 (February 2001).

[City, State], and with branch offices in *[State 1, State 2],* and *[State 3]* ("the bank"), is authorized, pursuant to 12 USC 24(Seventh) and 12 CFR 7.4002, to charge non-accountholders convenience fees to cash checks drawn on the bank ("on-us checks").[1] The bank's deposit agreements reserve the right to charge this convenience fee with respect to checks drawn on any deposit accounts. This fee is essentially compensating the bank for making cash immediately available to the payee. Otherwise, the payee would have to wait for the check to clear through the payment system. Based on our review of your letter and supporting materials submitted and the relevant procedural considerations set forth in 12 CFR 7.4002(b), we agree that the bank is authorized to charge this convenience fee, in its discretion, pursuant to section 24(Seventh) and section 7.4002(a).[2]

National Bank Charges and Fees Are Authorized Under 12 USC 24(Seventh) and 12 CFR 7.4002

Section 24(Seventh) authorizes a national bank to engage in activities that are part of, or incidental to, the business of banking[3] as well as to engage in certain specified activities listed in the statute. "[N]egotiating . . . drafts" is one of the activities specified in section 24(Seventh). A bank's authority to provide products or services to its customers necessarily encompasses the ability to charge a fee for the product or service.[4]

This ability to charge a fee for the bank's services is expressly reaffirmed in 12 CFR 7.4002(a), which provides:

> (a) *Authority to impose charges and fees*. A national bank may charge its customers non-interest charges and fees, including deposit account service charges.[5]

The bank's authority in this, as in all other, areas must be exercised in a manner that is consistent with safe and sound banking practices. Paragraph (b) of section 7.4002[6] sets out the factors that the bank should consider to ensure that its process for setting its fees and charges is consistent with safety and soundness:

> (b) *Considerations*. (1) All charges and fees should be arrived at by each bank on a competitive basis and not on the basis of any agreement, arrangement, undertaking, understanding, or discussion with other banks or their officers.
>
> (2) The establishment of non-interest charges and fees, their amounts, and the method of calculating them are business decisions to be made by each bank, in its discretion, according to sound banking judgment and safe and sound banking principles. A national bank establishes non-interest charges and fees in accordance with safe and sound banking principles if the bank employs a decision-making process through which it considers the following factors, among others:
>
> (i) The cost incurred by the bank in providing the service;
>
> (ii) The deterrence of misuse by customers of banking services;
>
> (iii) The enhancement of the competitive position of the bank in accordance with the bank's business plan and marketing strategy; and
>
> (iv) The maintenance of the safety and soundness of the institution.

If a bank uses a decision-making process that takes these factors into consideration, then there is no supervisory impediment to the bank exercising its discretionary

[1] We note that the authority of the bank and other national banks to charge particular fees is not conditioned on obtaining an individual confirming opinion, since national banks are authorized to charge non-interest fees and charges as an inherent element of their authority to conduct the business of banking.

[2] Your letter noted that the State of Texas has recently enacted legislation that takes effect on September 1, 2001, and that would require banks located in Texas to cash checks drawn on one of the institution's accounts without charging any fee. You have not requested our opinion, and we accordingly express no view, about whether the Texas law you describe or any similar state law would apply to national banks.

[3] The powers clause of section 24(Seventh) provides that a national bank may "exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking. . . ." 12 USC ′24(Seventh). *See NationsBank* v. *Variable Annuity Life Ins. Corp.*, 513 U.S. 251 (1995) (the "business of banking" is not limited to the list of powers enumerated in section 24(Seventh)).

[4] *Cf. Franklin National Bank* v. *New York*, 347 U.S. 373, 377 (1954) (stating, in the context of bank advertising, "We cannot believe that the incidental powers granted to national banks should be construed so narrowly as to preclude the use of advertising in any branch of their authorized business").

[5] 12 CFR 7.4002(a). As used in section 7.4002(a), "customer" simply means any party that obtains a product or service from the bank. The OCC recently adopted amendments to section 7.4002 to eliminate certain ambiguities in the text of the regulation. *See* 66 Fed. Reg. 34784 (July 2, 2001). As indicated in the preamble to the final rule, however, these amendments do not affect the substance of the regulation or the way it operates. *Id*. at 34787. Citations to section 7.4002 in this letter are to the regulation as revised. The revisions took effect on August 1, 2001.

[6] 12 CFR 7.4002(b).

authority to charge non-interest fees and charges—such as the on-us check cashing fees at issue here—pursuant to section 7.4002(a).

The Bank's Consideration of the Section 7.4002(b) Factors

The bank has provided analysis and supporting documentation demonstrating that it has considered each of the four factors listed in section 7.4002(b)(2)(i)–(iv). The materials provided, for which the bank has claimed confidential treatment,[7] include information on various costs incurred by the bank in cashing on-us checks. These include personnel, processing, auditing, and overhead expenses as well as losses attributable to on-us check cashing. The bank notes that it can charge accountholders monthly service fees to cover their use of the bank's check cashing services but the only way to charge non-accountholders for their use of such services is to charge a transaction fee at the teller window. The bank states that the only alternatives would be to provide non-accountholders such services at a loss or to increase the service fees paid by accountholders and thereby require them to subsidize non-accountholders.

The bank demonstrates that it faces significantly greater risks—through the practices of drawing checks on insufficient funds and check fraud—in cashing on-us checks for non-accountholders than in accepting such checks for deposit or in paying them upon presentation through the payment system. As the United States District Court for the Northern District of Illinois recently explained (in dismissing a claim that the bank's on-us check cashing fee violated the anti-tying provisions of the Bank Holding Company Act):

> When a non-customer presents a check to be cashed by the drawee bank, the non-customer expects immediate payment in cash. Cash payments are final in the strictest sense. These final transactions pose substantial risk to banks, such as the possibility of overdraft, forgery or fraud. Should one of these occur, the bank is left with no recourse after a final cash transaction.[8]

In contrast, when holders of on-us checks deposit the checks in their bank accounts and the checks are cleared and paid through the payment system, the banks have protections against these risks and can delay or revoke payment.[9] When a bank cashes an on-us check over the counter for a non-accountholder, these protections do not apply. The bank has concluded that its convenience fee is necessary to defray the costs and offset the risks associated with on-us check cashing.[10]

The bank has also concluded that the fee will help deter misuse because it will reduce check-based fraud. In particular, the bank expects that the fee will serve as an incentive for non-accountholders to deposit checks in their bank accounts or, if they do not have bank accounts, to open one either at the bank or elsewhere. The bank's tellers frequently inform people who are cashing payroll checks that they may avoid the proposed fee entirely by opening an account at the bank. We encourage the bank to continue this practice as widely as is practicable.

The bank's submission discusses how charging the fees relates to its overall business strategy. By charging these fees, the bank hopes to shorten teller lines and thereby provide accountholders better service and ensure that its accountholders are not required to subsidize check cashing services for non-accountholders. By doing so, the bank believes its competitive position will be enhanced.

Finally, the bank has provided analysis on the impact that the fees have on the bank's safety and soundness, particularly the bank's ability to recover its costs and cover its risks in providing non-accountholders this service. The fee also serves as an incentive to non-accountholders to present checks for payment through the payment system, which, as discussed above, helps protect the bank from forgery, fraud, and overdrafts. The bank has attempted to avoid misunderstandings with its customers (which could present, among other things, reputation risk to the bank) by disclosing in its deposit agreement that the bank "may charge a person who cashes your check a fee if that person is not a deposit or loan (excluding credit cards) customer of the bank or another [ ] company."

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[7] The bank's submission includes information that the bank believes to be exempt from disclosure under the Freedom of Information Act (FOIA). 12 USC 552(b). The FOIA exempts matters constituting "trade secrets and commercial or financial information obtained from a person and privileged and confidential."

[8] *Batten* v. *Bank One, N.A.*, 2000 WL 1364408 (N.D. Ill. Sept. 15, 2000).

[9] When a check is presented through the payment system, a bank has the right under the Uniform Commercial Code (UCC) to defer deciding whether to make final payment, or to return the item unpaid, until the banking day following the day of presentment. *See* UCC 4–104(a)(10), 4–301(a), 4–301(b), and 4–402(c). Under Regulation CC, a bank need not make funds deposited by means of an on-us check available for withdrawal until the following banking day. 12 CFR 229.10(c)(vi).

[10] *See also Batten* v. *Bank One, N.A.*, 2000 WL at— ("Bank One's practice [of charging non-accountholders a fee for this service] offsets these risks . . . [by generating] funds to cover any losses due to forgery or fraud.").

In addition, as part of its consideration of the safety and soundness implications of initiating an on-us check cashing convenience fee, the bank analyzed whether the proposed fee would constitute a "wrongful dishonor" of a check or impair its negotiability under the Uniform Commercial Code (UCC).

According to the analysis furnished by the bank, whether a customer could challenge the on-us check cashing fee as a wrongful dishonor depends on the terms of the deposit agreement between the bank and the customer. *Menicocci* v. *Archer National Bank of Chicago*, 67 Ill. App.3d 388, 391 (1st Dist. 1978) (the terms of a bank's relationship with its customer is governed by the terms of the deposit contract). As noted above, the deposit agreement for the accounts to which the bank's on-us check cashing fee applies includes a provision that the bank "may charge a person who cashes your check a fee if that person is not a deposit or loan (excluding credit cards) customer of the bank or another [ ] company." Thus, because the bank's deposit agreement clearly provides for check cashing fees, the bank has concluded that the application of the on-us check cashing fee would not constitute a wrongful dishonor of a check under the UCC.[11]

The bank also asserts that the application of the on-us check cashing fee would not impair the negotiability of a check presented for payment. Section 3–104 of the Uniform Commercial Code defines a negotiable instrument as:

> . . . an unconditional promise to pay or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it:
>
> (1) is payable to bearer or to order at the time it is issued or first comes into possession of a holder;
>
> (2) is payable on demand or at a definite time; and
>
> (3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment on money. . . .

The bank asserts that an on-us check cashing fee does not alter a check's negotiability because the check does not contain on its face an express condition to payment and the fee is not assessed for negotiation of the check. A check is an unconditional promise to pay unless an express condition to payment appears on the face of the check:[12]

> One of the essentials of a negotiable check is that it be payable without condition. This means that a statement must not appear on the check that it is subject to any other order, promise, or condition. There must be no additional order or promise on the check itself; it must merely be an order on a bank for the payment of a sum of money.

Henry J. Bailey and Richard B. Hagedorn, *Brady on Bank Checks*, ¶2.04 (2000).

As explained in the bank's submission, when a bank charges an on-us check cashing fee, there is no reference to the fee on the face of the check. The fee only applies to over-the-counter check cashings by a non-customer, and is not assessed when the check is deposited or negotiated to another holder. The holder of the check has many choices about how to negotiate the check, and over-the-counter cashing is the only choice under which the fee is assessed. Therefore, the bank concludes that the fee is not assessed for negotiation and does not affect the unconditional nature of the promise to pay.

The bank's conclusion is supported by *Sexton* v. *PNC Bank, N.A.*, 43 UCC Rep.2d 341 (Pa. Ct. Com. Pl. 2000), in which the court found that an on-us check cashing fee does not affect the negotiability of checks. In that case, the court found that the fee—

> is not assessed upon the negotiation of a check; it is merely a charge collected by the bank in exchange for the service of turning a check into cash. A non-customer who deposits a check drawn on PNC into his or her account at another financial institution will receive the full face amount of the check. The same non-customer may also (assuming an agreeable recipient) endorse the check over to another person, who will then receive its full face value upon depositing the check into his (or her) own account, whether at PNC or elsewhere.

[11] *Cf. Your Style Publication, Inc.* v. *Mid Town Bank & Trust Co.*, 501 N.E.2d 805, 810 (Ill. Ct. App. 1986) (defendant banks exceeded their contractual authority because depositor agreements did not clearly provide for check cashing fees and banks' customers would have no reason to believe that their own checks would be subjected to this fee).

[12] Section 3–106 of the UCC provides that:

> . . . a promise or order is unconditional unless it states
>
> (i) an express condition to payment,
>
> (ii) that the promise or order is subject to or governed by another writing, or
>
> (iii) that rights or obligations with respect to the promise or order are stated in another writing.

Id. at 341. The court went on to conclude:

> Section 3–104 further provides that an order that is payable on demand and drawn on a bank, and that complies with provisions (2) and (3) [thereof] is both a check and a negotiable instrument. Because PNC's $3.00 fee neither alters the payable-on-demand character of checks presented for cashing, nor constitutes an undertaking or instruction by the drawer over and above the promise to pay, the fee does not impair the negotiability of those checks, and its imposition does not violate the law.

Id. at 341.[13]

Conclusion

We therefore conclude that the bank is authorized, under 12 USC 24(Seventh) and 12 CFR 7.4002(a), to charge the convenience fee and that the bank's process for considering the establishment of the fee is consistent with the considerations required by section 7.4002(b).

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

934—August 20, 2001

12 USC 24(7)

12 CFR 7.4002(a) and (b)

Subject: Request for Concurrence that [ ] is Authorized to Charge Fees to Cash Checks Drawn on the Bank for Non-Accountholders

Dear [ ]:

This responds to your letter of August 16, 2001, in which you request the concurrence of this office that [ ] ("the bank") is authorized, pursuant to 12 USC 24(Seventh) and 12 CFR 7.4002, to charge non-accountholders fees to cash checks drawn on the bank ("on-us checks").[1] The bank's deposit agreements reserve the right to charge a convenience fee with respect to checks drawn on all deposit accounts at the bank. This convenience fee is essentially compensating the bank for making cash immediately available to the payee. Otherwise, the payee would have to wait for the check to clear through the payment system. Based on our review of your letter and supporting materials submitted and the relevant procedural considerations set forth in 12 CFR 7.4002(b), we agree that the bank is authorized to charge this convenience fee, in its discretion, pursuant to section 24(Seventh) and section 7.4002(a).[2]

National Bank Charges and Fees Are Authorized Under 12 USC 24(Seventh) and 12 CFR 7.4002

Section 24(Seventh) authorizes a national bank to engage in activities that are part of, or incidental to, the business of banking[3] as well as to engage in certain specified activities listed in the statute. "[N]egotiating . . . drafts" is one of the activities specified in section 24(Seventh). A bank's authority to provide products or services to its customers necessarily encompasses the ability to charge a fee for the product or service.[4]

This ability to charge a fee for the bank's services is expressly reaffirmed in 12 CFR 7.4002(a), which provides:

[13] *See also Hayes* v. *First Commerce Corp.*, 763 S.2d 733, 43 UCC Rep.2d 335 (La. Ct. App. 2000), in which the court rejected a claim that an on-us check cashing fee constituted misappropriation, finding that the payee had voluntarily chosen to do business with the payor bank, and that there is nothing illegal about charging a check cashing fee. In discussing the *Hayes* and *Sexton*, Barkley Clark, a leading commentator on negotiable instruments and bank deposits, stated, "We think both the Louisiana and Pennsylvania decisions hit the target in the middle." Barkley Clark, *Clark's Bank Deposits and Payments Monthly*, Vol. 9, No. 8 (February 2001).

[1] We note that the authority of the bank and other national banks to charge particular fees is not conditioned on obtaining an individual confirming opinion, since national banks are authorized to charge non-interest fees and charges as an inherent element of their authority to conduct the business of banking.

[2] We note that the State of Texas has recently enacted legislation that takes effect on September 1, 2001, and that would require banks located in Texas to cash checks drawn on one of the institution's accounts without charging any fee. You have not requested our opinion, and we accordingly express no view, about whether the Texas law you describe or any similar state law would apply to national banks.

[3] The powers clause of section 24(Seventh) provides that a national bank may "exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking. . . ." 12 USC 24(Seventh). *See NationsBank* v. *Variable Annuity Life Ins. Corp.*, 513 U.S. 251 (1995) (the "business of banking" is not limited to the list of powers enumerated in section 24(Seventh)).

[4] *Cf. Franklin National Bank* v. *New York*, 347 U.S. 373, 377 (1954) (stating, in the context of bank advertising, "We cannot believe that the incidental powers granted to national banks should be construed so narrowly as to preclude the use of advertising in any branch of their authorized business").

(a) *Authority to impose charges and fees*. A national bank may charge its customers non-interest charges and fees, including deposit account service charges.[5]

The bank's authority in this, as in all other, areas must be exercised in a manner that is consistent with safe and sound banking practices. Paragraph (b) of section 7.4002[6] sets out the factors that the bank should consider to ensure that its process for setting its fees and charges is consistent with safety and soundness:

(b) *Considerations*. (1) All charges and fees should be arrived at by each bank on a competitive basis and not on the basis of any agreement, arrangement, undertaking, understanding, or discussion with other banks or their officers.

(2) The establishment of non-interest charges and fees, their amounts, and the method of calculating them are business decisions to be made by each bank, in its discretion, according to sound banking judgment and safe and sound banking principles. A national bank establishes non-interest charges and fees in accordance with safe and sound banking principles if the bank employs a decision-making process through which it considers the following factors, among others:

(i) The cost incurred by the bank in providing the service;

(ii) The deterrence of misuse by customers of banking services;

(iii) The enhancement of the competitive position of the bank in accordance with the bank's business plan and marketing strategy; and

(iv) The maintenance of the safety and soundness of the institution.

If a bank uses a decisionmaking process that takes these factors into consideration, then there is no supervisory impediment to the bank exercising its discretionary authority to charge non-interest fees and charges such as the on-us check cashing fees at issue here pursuant to section 7.4002(a).

The Bank's Consideration of the Section 7.4002(b) Factors

The bank has provided analysis and supporting documentation demonstrating that it has considered each of the four factors listed in section 7.4002(b)(2)(i)–(iv). The bank's submission, for which the bank requests confidential treatment,[7] explains that prior to implementing the fee program, it formed a task force, including a marketing representative and various levels of management from those areas that would be affected by the fee (*e.g*., community banking presidents, a district manager, and a business banking manager). As part of its evaluation, the task force considered the various costs incurred by the bank in cashing on-us checks.

The bank's submission states that the task force considered teller services in evaluating the costs incurred in cashing on-us checks. On paydays, the teller lines in many of the bank's branches are heavily impacted by the employees of the bank's commercial customers who want to cash their payroll checks. According to the bank's submission, the task force believes that this activity negatively affects the ability of those offices to serve their deposit customers expeditiously. The task force therefore concluded that the bank's convenience fee is necessary to offset the negative effects on its services for accountholders that result from on-us check cashing.

The bank's submission also explains that its task force concluded that the fee will help deter misuse because it will serve as an incentive for non-accountholders to deposit checks in their bank accounts or, if they do not have bank accounts, to open one either at the bank or elsewhere. The bank provides notices to non-accountholders, through brochures and lobby posters printed in English and Spanish, that they may avoid the fee by opening an account with the bank.

The bank also states that the task force discussed how charging convenience fees relates to its overall business strategy. The task force considered the practices of other financial institutions regarding the imposition of this type

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[5] 12 CFR 7.4002(a). As used in section 7.4002(a), "customer" simply means any party that obtains a product or service from the bank. The OCC recently adopted amendments to section 7.4002 to eliminate certain ambiguities in the text of the regulation. *See* 66 Fed. Reg. 34784 (July 2, 2001). As indicated in the preamble to the final rule, however, these amendments do not affect the substance of the regulation or the way it operates. *Id*. at 34787. Citations to section 7.4002 in this letter are to the regulation as revised. The revisions took effect on August 1, 2001.

[6] 12 CFR 7.4002(b).

[7] The bank's submission includes information that the bank believes to be exempt from disclosure under the Freedom of Information Act (FOIA). 12 USC 552(b). The FOIA exempts matters constituting "trade secrets and commercial or financial information obtained from a person and privileged and confidential."

of fee and reviewed the fees charged by persons primarily engaged in the check cashing business. The task force concluded that the bank should establish its fees at the low end of that market in order to remain competitive.

Finally, the task force evaluated the impact that the fees have on the bank's safety and soundness. In order to assess possible reputational and litigation risks, the task force considered both the results of internal focus groups (conducted to help gauge the likely reactions of the persons impacted by the fee and the appropriate responses to those risks) and the experiences of an affiliate that had previously implemented a similar fee. The bank has attempted to avoid misunderstandings with its customers (which could present, among other things, reputation risk to the bank) by disclosing in its deposit agreement that the bank "may charge a fee to the person presenting the check. . . ." The bank also sends letters to affected customers in advance of implementing the fee program.

In addition, the bank has analyzed the legal risks (which could raise safety and soundness concerns) arising from whether the proposed fee would constitute a "wrongful dishonor" of a check or impair its negotiability under the Uniform Commercial Code (UCC).

According to the analysis furnished by the bank, whether a customer could challenge the convenience fee as a wrongful dishonor depends on the terms of the deposit agreement between the bank and the customer. *Menicocci v. Archer National Bank of Chicago*, 67 Ill. App.3d 388, 391 (1st Dist. 1978) (the terms of a bank's relationship with its customer is governed by the terms of the deposit contract). The deposit agreement for the accounts to which the bank's fee applies includes a provision that "[i]f a check drawn against your account is presented over the counter for payment by a person who is not a deposit customer of the bank, the bank may charge a fee to the person presenting the check as a condition for payment for the check." Thus, because the bank's deposit agreement clearly provides for check-cashing fees, the bank concluded that the application of the fee would not constitute a wrongful dishonor of a check under the UCC.[8]

The bank asserts that a convenience fee does not alter a check's negotiability, because the check does not contain on its face an express condition to payment and the fee is not assessed for negotiation of the check. A check is an unconditional promise to pay unless an express condition to payment appears on the face of the check:[9]

> One of the essentials of a negotiable check is that it be payable without condition. This means that a statement must not appear on the check that it is subject to any other order, promise, or condition. There must be no additional order or promise on the check itself; it must merely be an order on a bank for the payment of a sum of money.

Henry J. Bailey and Richard B. Hagedorn, *Brady on Bank Checks*, ¶2.04 (2000).

As explained in the bank's submission, when a bank charges a fee for cashing an on-us check, there is no reference to the fee on the face of the check. The fee only applies to over-the-counter check cashings by a non-customer and is not assessed when the check is deposited or negotiated to another holder. The holder of the check has many choices about how to negotiate the check, and over-the-counter cashing is the only choice under which the fee is assessed. Therefore, the bank concludes that the fee is not assessed for negotiation and does not affect the unconditional nature of the promise to pay.

The bank's conclusion is supported by *Sexton* v. *PNC Bank, N.A.*, 43 UCC Rep.2d 341 (Pa. Ct. Com. Pl. 2000), in which the court found that a convenience fee for cashing an on-us check does not affect the negotiability of checks. In that case, the court found that the fee

> is not assessed upon the negotiation of a check; it is merely a charge collected by the bank in exchange for the service of turning a check into cash. A non-customer who deposits a check drawn on PNC into his or her account at another financial institution will receive the full face amount of the check. The same non-customer may also (assuming an agreeable recipient) endorse the check over to another person, who will then receive its full face value upon depositing the check into his (or her) own account, whether at PNC or elsewhere.

[8] *Cf. Your Style Publication, Inc.* v. *Mid Town Bank & Trust Co.*, 501 N.E.2d 805, 810 (Ill. Ct. App. 1986) (defendant banks exceeded their contractual authority because depositor agreements did not clearly provide for check cashing fees and banks' customers would have no reason to believe that their own checks would be subjected to this fee).

[9] Section 3–106 of the UCC provides that:

> . . . a promise or order is unconditional unless it states
> (i) an express condition to payment,
> (ii) that the promise or order is subject to or governed by another writing, or
> (iii) that rights or obligations with respect to the promise or order are stated in another writing.

Id. at 341. The court went on to conclude:

> Section 3–104 further provides that an order that is payable on demand and drawn on a bank, and that complies with provisions (2) and (3) [thereof], is both a check and a negotiable instrument. Because PNC's $3.00 fee neither alters the payable-on-demand character of checks presented for cashing, nor constitutes an undertaking or instruction by the drawer over and above the promise to pay, the fee does not impair the negotiability of those checks, and its imposition does not violate the law.

Id. at 341.[10]

Conclusion

We therefore conclude that the bank is authorized, under 12 USC 24(Seventh) and 12 CFR 7.4002(a), to charge the convenience fee and that the bank's process for considering the establishment of the fee is consistent with the considerations required by section 7.4002(b).

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[10] *See also Hayes* v. *First Commerce Corp.*, 763 S.2d 733, 43 UCC Rep.2d 335 (La. Ct. App. 2000), in which the court rejected a claim that an on-us check cashing fee constituted misappropriation, finding that the payee had voluntarily chosen to do business with the payor bank, and that there is nothing illegal about charging a check cashing fee. In discussing the *Hayes* and *Sexton*, Barkley Clark, a leading commentator on negotiable instruments and bank deposits, stated, "We think both the Louisiana and Pennsylvania decisions hit the target in the middle." Barkley Clark, *Clark's Bank Deposits and Payments Monthly*, Vol. 9, No. 8 (February 2001).

935—May 14, 2002

12 USC 24(7)

Subject: Holding Securities for Hedging Purposes

Dear [ ]:

This letter confirms oral advice provided by OCC legal and supervisory staff concerning the program established by [ ] (the bank) to hedge risks arising from bank permissible, customer-driven derivative transactions. You asked whether the bank can short equities under its hedging program and if the 5 percent limit applies to voting but not nonvoting stock. You also questioned how the bank may settle and terminate its hedges and whether the bank can cross-hedge. You also asked whether the standards applicable to equity hedges apply to commodity and below-investment-grade debt hedges. Our responses are set forth below.

I. Background

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.[1] 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 examiner-in-charge (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 obtain the EIC's approval. The documentation should establish to the satisfaction of the EIC that:

- 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;
- the bank will not hold the securities for speculative purposes;
- the securities will offer a cost-effective means to hedge risks arising from permissible banking activities;
- the bank will not take anticipatory, or maintain residual, positions in the securities except as necessary for the orderly establishment or unwinding of a hedging position;
- the bank will not acquire equity securities for hedging purposes that constitute more than 5 percent of a class of securities of any issuer; and
- the bank has an appropriate risk management process in place, satisfactory to the EIC, for its hedging activities.

Your EIC has approved the bank's hedging program under these standards.

[1] *See* OCC Interpretive Letter No. 892 (September 13, 2000), *reprinted in* [2000–2001 Transfer Binder] Fed. Banking Law Rep. (CCH) ¶ 81–411.

II. Discussion

You have asked a number of questions concerning the bank's hedging program. Our responses to your questions are described below.

A. Shorting Equities

You asked if the bank may short equities for hedging purposes under the EIC's approval of its hedging program. The answer is yes. National banks may hedge risks arising from bank permissible equity derivative transactions with either long or short positions in an equity or basket of equities. 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. So, for example, a national bank may hedge changes in certain equity derivative transactions through delta hedging.[2] Delta is a hedge ratio banks calculate to determine the amount of equity it must be long or short, so that for small changes in the price of an equity, the bank's equity hedge position and its equity derivative contract with a customer will change by equal, and offsetting, amounts.[3] The objective of delta hedging is to have the change in the value of the equity hedge offset the change in value of the customer derivative transaction.

B. Nonvoting Corporate Stock

You inquired whether the 5 percent limit applies to nonvoting corporate stock. The OCC has applied the 5 percent limit only to each separate class of voting shares of a company. A national bank may not acquire securities that, in the aggregate, result in the bank's control of more than 5 percent of the outstanding shares of any class of a company's voting securities. The OCC evaluates a particular bank's hedging program under the criteria described in this letter in order to determine whether the 5 percent limit should also apply to a class of nonvoting securities.

C. Cash- and Physically Settled Hedges

You questioned whether the OCC's approval for hedging permissible equity derivative transactions with equity securities allows the bank to both cash- and physically settle its equity derivative transactions. A national bank with an EIC-approved hedging program may execute cash- and physically settled equity derivative transactions.[4]

D. Hedging Residual Positions

You asked whether the bank may hedge the risks arising from a hedge that remain when a counterparty terminates the underlying hedged transaction. A bank must prudently manage the risk in its equity derivative program and may, in the event of an unforeseen termination of a hedged transaction, hedge exposures from the remaining hedge. We believe that if a national bank holds equities to hedge a bank permissible equity derivative transaction, and a counterparty terminates the initial transaction, the bank must dispose of the equity holdings immediately, except as necessary for the orderly unwinding of the hedge position.[5] During any time required to dispose of the equity holdings, a national bank may enter into an appropriate offsetting equity derivative transaction to hedge the bank's initial hedge transaction, *i.e.,* a reverse hedge. The reverse hedge should terminate as close in time as possible to the disposal of the equity holdings.

E. Physical Commodity Transactions

You inquired whether the standards for examiner review and approval of national bank equity hedge programs apply to commodity hedge programs. No, the standards set forth in OCC Interpretive Letter No. 892 apply to security, but not commodity, hedges. The OCC's process for permitting national banks to hold commodities to hedge derivative transactions is set forth in a number of precedents separate from OCC Interpretive Letter No. 892.[6] Banking Circular 277, for example, describes how national banks may hold commodities as hedges.[7] The analysis governing commodity holdings as hedges is similar in several respects to that underlying the OCC's approval for hedging permissible equity derivative transactions. In both cases, the OCC made clear that

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[2] Delta hedging typically involves equity options. *See* United Stated General Accounting Office (GAO), *Equity Hedging: OCC Needs to Establish Policy on Publishing Interpretive Decisions*, GAO-01-945 (August 2001) at 4, 26.

[3] *See Id.*

[4] The OCC has previously recognized that a national bank may hedge equity derivative transactions with cash-settled hedges. *See* OCC Interpretive Letter No. 652 (September 13, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600.

[5] *See* OCC Interpretive Letter No. 892, *supra.*

[6] *See* OCC Interpretive Letter No. 684 (August 4, 1995), *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,632; OCC Interpretive Letter No. 632 (June 30, 1993), *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,516.

[7] *See* OCC Banking Circular 277 (October 27, 1993) (BC–277). *See also* OCC *Comptroller's Handbook,* "Risk Management of Financial Derivatives" (January 1997 [print version; rev. for Web only, October 2001, available at http://www.occ.treas.gov/handbook/deriv.pdf]).

national banks should not engage in these activities without the prior approval of the OCC. The ability of banks to hold commodities and equities as hedges depends on the existence of customer-driven, bank-permissible derivative transactions. Also, the bank must have acceptable risk monitoring systems to handle the activities in a safe and sound manner. Conversely, commodity hedges differ materially from equity hedges, and therefore the process for engaging in these transactions is different. For example, holding commodities as hedges pose storage (*e.g*., storage tanks, pipelines), transportation (*e.g*., tankers, barges, pipelines), environmental (*e.g*., pollution, fumigation, leakage, contamination), and insurance risks (*e.g*., damage to persons and property, contract breach, spillage) not associated with the physical possession of equities.

F. Cross-Hedges

You questioned whether the bank can hedge equity derivatives with cross-hedges. In limited circumstances, a national bank can cross-hedge its equity derivatives where consistent with the bank's OCC approved hedging risk management process. Generally, an equity hedge is used to protect a position in a security by the purchase or sale of the security. Cross-hedging is the use of one security or a basket of securities to hedge the risk arising from a transaction involving another, different security. 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. Sometimes cross-hedges are used when securities have similar characteristics and there is a deeper, more liquid market for securities other than the security underlying the transaction to be hedged. In some circumstances, cross-hedging may be the most effective risk management tool available to a national bank, enabling it to operate more efficiently, compete more effectively with entities that engage in similar hedging strategies, offer customers the least costly and most attractive products and services, and operate prudently.[8] Bank management must be able to justify its cross-hedge, *i.e*., that the instrument used for cross-hedging provides a reasonable substitute for the security exposure arising from the derivative being hedged. Examiners evaluating the reasonableness of a cross-hedge consider the accuracy of the cross-hedge, its cost-effectiveness, and its liquidity in the market in comparison to the security involved in the initial transaction.

[8] *See* OCC Interpretive Letter No. 892, *supra*.

G. Below-Investment-Grade Bond Hedges

You asked whether the bank may hedge risks arising from permissible derivative activities using bonds that are rated below investment grade. A national bank may hold long or short positions in equity or below-investment-grade debt securities to hedge bank-permissible derivative transactions, if the activities comply with OCC standards *and* the bank obtains the approval of its EIC. The standards set forth in OCC Interpretive Letter No. 892 that apply to hedging with equity securities also apply to hedging with below-investment-grade debt securities. Because a bank's EIC must approve a bank's use of below-investment-grade debt securities for hedging purposes, and such hedging programs must have an appropriate risk management process in place satisfactory to the EIC, the EIC may impose a prudential limit on such holdings. Accordingly, a national bank can use below-investment-grade bonds to hedge the risks arising from permissible derivative transactions if in accordance with its EIC-approved hedging program.

We understand that your EIC has addressed the above issues with the bank. If you have additional questions, please do not hesitate to contact Donald N. Lamson, assistant director, or Tena M. Alexander, special counsel, Securities and Corporate Practices Division at (202) 874-5210.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

936—May 22, 2002

12 CFR 9.18

Re: Proposed Creation of the [ ] Fund

Dear [ ]:

This letter confirms our February 13, 2002, teleconference and responds to your letter dated March 5, 2002, regarding the establishment by [ ] (bank), as trustee, of the [ ] (fund). You have inquired whether the OCC would object to an aspect of the fund's operations under the OCC's rules governing collective investment funds at 12 CFR 9.18. Specifically, you have inquired whether the bank, as trustee, may allow participant withdrawals from the fund at the sole discretion of the bank, or when a participant becomes ineligible to continue as a participant in the fund. Based on your representations, and for the

reasons described below, the OCC does not object to this aspect of the fund's operations under the OCC's rules governing collective investment funds at 12 CFR 9.18.[1]

I. Proposal

The bank seeks to establish the fund for the collective investment of money contributed to the fund by the bank in its capacity as trustee of certain tax-exempt charitable trusts. The bank is forming the fund in order to enable several small trusts for which it serves as trustee to invest in private equity limited partnerships (PELP). However, the trusts cannot invest in the PELP directly because an appropriate private equity investment for these trusts would not satisfy the minimum investment requirement of the limited partnership. The fund will pool the investments of several tax-exempt trusts that are "qualified purchasers,"[2] allowing the fund to satisfy the minimum requirement of the limited partnership.

Under the bank's proposal, fund participants will be unable to make discretionary withdrawals from the fund.[3] Sections 6.2(a), (b), (c), and (e) of the Declaration of Trust provide:

> (a) Unless otherwise limited hereunder, the decision on when to allow, the form of, and the timing of all fund withdrawals shall be within the sole discretion of the trustee;
>
> (b) Participants will not have the right to withdraw from the fund at any particular time or interval;
>
> (c) At the time of the creation of a fund, the trustee does not anticipate allowing any withdrawals from the fund prior to the termination and liquidation of the [private equity investments] of the fund; and
>
> (e) Upon the occurrence of an event that renders a participant ineligible to continue as a participant in the fund,[4] within one year of such event the trustee shall redeem such participant's units in the fund, in kind, with a proportionate share of the [private equity investments] and the other assets of the fund; subject, however, to any liens for incurred and unpaid capital contributions, debts, fees and expenses.

You represented during our February 13, 2002, teleconference that the fund will be valued semi-annually on April 1 and October 1. The bank will use the valuation reports provided by the PELP's general partner to determine the fund's fair value. To comply with 12 CFR 9.18(b)(4)(ii), and as provided in section 5.3(f) of the Declaration of Trust, the bank will determine whether the valuation provided by the PELP's general partner represents the fair value of the fund's assets as of the date of the valuation.

II. Discussion

The OCC's regulation governing collective investment funds does not mandate the frequency of admissions and withdrawals from collective investment funds. The regulation requires that the written plan governing the administration of the collective investment fund include appropriate provisions related to the terms and conditions governing the admission and withdrawal of participating accounts.[5]

In addition, the regulation provides that admissions and withdrawals may only be "on the basis of the valuation described in paragraph (b)(4)." Section 9.18(b)(4), in turn, provides in part that,

> A bank administering a collective investment fund shall determine the value of the fund's assets at least once *every three months.* However, in the case of a fund described in paragraph (a)(2) of this section that is invested primarily in real estate or other assets that are not readily marketable, the bank shall determine the value of the fund's assets *at least once a year.*[6]

[1] We limit our no-objection to the bank's proposal to allow participant withdrawals from the fund at the sole discretion of the bank, or when a participant becomes ineligible to continue as a participant in the fund. We offer no views on whether other aspects of the fund's operations comply with the provisions of 12 CFR 9.18 or with applicable fiduciary law.

[2] While the Investment Company Act of 1940 ("1940 Act") is not applicable to the bank's proposal, the bank represents that if the 1940 Act were applicable to the bank's proposal, the tax-exempt trusts for which the bank is trustee would meet the definition of "qualified purchasers" under section 2(a)(51) of the 1940 Act.

[3] The bank represents that it will provide appropriate disclosures to the board of directors or the trustee(s) of the beneficiaries of each fund participant with respect to the nature of the fund's investments and capital calls, and that fund participants will not have the right to withdraw from the fund at any particular time or time interval.

[4] The bank represents that the only way a participant would cease to be eligible to continue as a participant in the fund would be if the bank was removed, for cause, as trustee of the participating account.

[5] The regulation also provides that certain funds may require a prior notice period of up to one year for withdrawals. 12 CFR 9.18(b)(5)(iii).

[6] 12 CFR 9.18(b)(4)(i). Section 9.18(b)(4) also establishes the method of valuation. In general, bank trustees are required to value fund assets at market value as of the date set for valuation, unless the bank cannot readily ascertain market value, in which case the bank shall use a fair value determined in good faith. *See* 12 CFR 9.18(b)(4)(ii)(A). Different valuation methods apply to short-term investment funds. *See* 12 CFR 9.18(b)(4)(ii)(B).

These provisions require that bank trustees use the valuation derived under section 9.18(b)(4) to determine the amount participants are entitled to when they are admitted to or withdraw from a fund. It does not mandate the frequency of admissions and withdrawals.[7] National banks and institutions that must comply with this regulation to receive favorable tax treatment should have valid reasons for limiting admissions and withdrawals, however. In addition, the admissions and withdrawal policies must be consistent with fiduciary duties.

In this case, the bank does not anticipate allowing any withdrawals from the fund prior to the termination and liquidation of the underlying trust investments because the fund might fail to satisfy the minimum investment requirement of the PELP if the fund permitted discretionary withdrawals from the fund. In addition, you represent that the bank will limit admissions to, and withdrawals from, the fund, because the fund's private equity investments will be in limited partnerships that will be illiquid over their projected 10- to 15-year business cycles. Specifically, the limited partnership interests are not transferable without the permission of the general partner. You have also represented that the amount of the investment that each participating trust will make in the fund will not impair the liquidity of the participating trusts. The fund is designed as, and will be used as, only one part of an overall investment strategy for the participating trusts.

Based on your representations and consistent with applicable law, the bank may permit a participant to withdraw from the fund solely at the bank's discretion, or when a participant becomes ineligible to continue as a participant in the fund.[8]

I trust this is responsive to your inquiry. Please do not hesitate to contact me if you have any questions.

Asa L. Chamberlayne
Counsel
Securities and Corporate Practices Division

[7] OCC Trust Interpretive Letters interpreting the prior version of 12 CFR 9.18 concluded that admissions and withdrawals must occur as frequently as valuations. *See e.g.*, Trust Interpretive Letter No. 13 (February 14, 1986). Upon closer examination of the regulation, however, we have concluded that the regulation does not mandate the frequency of admissions and withdrawals. *See* OCC Interpretive Letter No. 920 (December 6, 2001).

[8] *See* footnote 4, *supra.*

937—June 27, 2002

12 USC 24(7)

Re: Authority of a National Bank to Engage in Financial Intermediation Transactions

Dear [ ]:

This responds to your request that the Office of the Comptroller of the Currency (OCC) confirm the opinion of [ ] (the bank) that it is permissible for the bank to engage in financial intermediation transactions, where the payments between parties are based on the price of electricity.[1] For the reasons discussed below and subject to the limitations described herein, we believe that the proposed transactions are permissible for the bank.

I. Background

The bank currently engages in a variety of financial intermediation transactions involving exchanges of payments based on interest rates, and the value of equities and commodities. The bank's financial intermediation derivative transactions involve a wide range of energy-related commodities, including petroleum, natural gas, and other hydrocarbon products. These transactions provide risk management tools to meet customers' financial needs. For example, oil and gas derivatives offer users and producers protection against increases and decreases in the price of oil or gas.

The bank proposes to add transactions based on the price of electricity to its existing financial intermediation derivatives business. Similar to its existing financial intermediation derivatives business involving energy commodities, the electricity derivative business will be a customer-driven rather than a proprietary trading business. The bank's electricity financial intermediation activities will involve exchanges of payments, similar to other financial intermediary transactions presently engaged in by the bank. The transactions will be cash-settled and the bank will not physically receive or deliver electricity.

The transactions in which the bank proposes to engage will enable customers to meet legitimate financial and

[1] For the purposes of this letter, the term "electricity derivative transactions" includes cash-settled electricity-linked transactions of every type—including derivative products such as futures, forwards, options, swaps, caps, floors, and collars, and options thereon—in which a portion of the return (including interest and/or principal and/or payment streams) is linked to the price of electricity.

risk management needs. Representative examples of these transactions described below, include swaps, options, and forwards contracts. The bank represents that each of these cash-settled transactions is used by market participants (including generators, industrial consumers, and marketers) in their management of price risks in a competitive and deregulated environment.[2]

Example 1: An electricity producer has contracts to provide electricity to manufacturers at market prices over the next two years. The electricity producer wants to receive fixed payments for electricity it produces over that period and obtain protection against price declines.

To eliminate electricity price risk, the producer enters into a cash-settled, electricity derivative swap with the bank. Under the swap, the producer pays the bank the floating market price for a notional amount of electricity over the next two years, and receives a fixed price for the same notional amount of electricity. Alternatively, the producer may achieve the same result through a series of cash-settled forward transactions with the bank. Under the cash-settled, forward transactions, the producer pays the bank the market value of a specified notional amount of electricity at a future date, and receives a fixed price for the same notional amount of electricity.

Example 2: An industrial consumer of electricity wants to fix its cost of electricity over the next two years and protect itself against price increases. The consumer enters into a cash-settled, electricity swap with the bank. Under the swap, the consumer pays the bank a fixed price for a notional amount of electricity over the next two years, and receives the floating market price for the same notional amount of electricity. Alternatively, the consumer may achieve the same result through a series of cash-settled forward transactions with the bank. Under the forward transactions, the customer pays a fixed price for a notional amount of electricity, and the customer receives the market value of the same notional amount of electricity at a future date.

Example 3: An electricity consumer determines it will meet earnings projections only if the cost of a notional amount of electricity is $30 or lower. The consumer wants protection against prices rising over $30 and wants to retain the benefits of prices declining below $30. To achieve this protection, the consumer enters into a cash-settled cap option with the bank that entitles the consumer, for a fee, to receive the difference between $30 and a higher market price for electricity.

As the bank's book of electricity derivative transactions increases, much of the market risk exposures from transactions with customers may offset each other. Consequently, the bank will not need to hedge each transaction individually. It will manage market risks on a "portfolio basis," and hedge the resulting net risk exposures. There will normally be some residual market risk that is left unhedged, which will be subject to risk management limits as discussed below. However, this risk will be *de minimis* relative to the bank's earnings and capital and will be consistent with a customer-driven business strategy. The bank's hedges will include cash-settled electricity swaps, forwards, and options.

The bank represents that deregulation dramatically changed the operation of the power markets. For wholesale market participants, the price of power is a market rate variable that presents a risk profile analogous to that of interest rates, natural gas prices or equity prices. If left unmanaged, power prices can introduce volatility into a customer's earnings. Moreover, as deregulation proceeds, the variety of customers exposed to power prices will broaden. At present, power generators and distributors face substantial electricity price risks. Institutional and corporate consumers (such as chemical companies, refineries, and heavy manufacturers) are also exposed. The bank has well-established relationships with these types of customers.

The bank's proposed financial intermediary initiative relates exclusively to wholesale energy and power markets, and does not in any way relate to a business

[2] In support of the bank's representation, it references the discussion in the *Primer on Electricity Futures and Other Derivatives* (U.S. Department of Energy-funded study by the Environmental Energy Technologies Division of the University of California Ernest Orlando Lawrence Berkeley National Laboratory, January 1998) (referred to as the "Electricity Derivatives Primer") of all three of these instruments and their use in electricity markets, as follows. *Swaps* enable a customer (either a generator or an end-user) to lock in a specific price for the electricity in question, and can be tailored to meet the needs of the buyer and the seller (*e.g.,* delivery points, time periods, etc.). Generators and end-users use both *put-options ("floors")* and *call-options ("caps")*—or a combination of puts and calls *("collars")*—to ensure a particular price range for the electricity in question. Under a *forward contract,* one party is obligated to buy, and the other to sell, a specified quantity of electricity at a fixed price on a given date in the future. At the maturity of a forward contract, the seller will deliver the electricity and the buyer will pay the purchase price. If, at that time, the market price of the electricity is higher than the price specified in the contract, then the buyer will have protected itself from price volatility. Conversely, if the market price is lower than the contract price, then the seller will have benefited from the terms of the contract. The "Electricity Derivatives Primer" emphasizes (at 43) that "[t]hese types of instruments work well because they can be tailored to the unique circumstances of generators, end users, and marketers."

with retail clients or to actual power procurement. Furthermore, because the bank proposes to solely engage in cash-settled electricity derivative transactions, the bank represents it will not be required to register as a power marketer with, or otherwise become subject to the supervision or jurisdiction of, the Federal Energy Regulatory Commission or any regional transmission or other organization which operates as a power exchange or power pool. And, as previously stated, the bank will *not* receive or deliver actual power as a result of any cash-settled electricity derivative transaction that it enters.

The bank believes that financial intermediation activities based on the price of electricity are a natural extension of the bank's existing financial intermediation activities involving energy commodities. The bank states that energy derivative customers have requested that the bank offer electricity derivative transactions for many years. The bank's electricity derivatives business will provide the bank's customers risk management tools in substantively the same manner as the bank provides such tools in connection with its existing petroleum, natural gas, and related derivatives business. Essentially, the bank will offer electricity derivative transactions to customers as an additional means for them to meet their legitimate financial and risk management needs.

The bank has expertise in conducting cash-settled energy commodity derivative transactions. Consistent with this expertise, the bank has well-established policies, procedures, and controls that it applies to its commodity derivatives businesses. For example, the bank: (i) hedges the price risk arising from cash-settled commodity derivatives on a portfolio basis and values transactions using data sets and models implemented in accordance with bank standards; (ii) records credit exposure against customer credit limits; (iii) documents cash-settled customer transactions using the ISDA Master Agreement, with appropriate confirmations; and (iv) uses operations systems that permit booking and settlement of cash-settled commodity derivative transactions. The bank represents that it will conduct the proposed activities in customer-driven, cash-settled electricity derivatives consistent with the same policies, procedures, and controls it applies to its existing energy commodity derivatives business ("Electricity Derivative Product Controls").

The bank commits that it will not commence its new cash-settled electricity derivatives business without first putting in place and implementing all necessary policies, procedures, and controls (including the "Electricity Derivative Product Controls") to assure that (i) its electricity derivative business is customer-driven, cash-settled, and meets all required regulatory standards for conducting a customer-driven derivative business, and (ii) the bank has in place all appropriate mechanisms to identify, monitor, limit, and control the risks inherent in conducting this business so that it complies with all applicable OCC guidance and requirements.[3]

The bank specifically acknowledges that, as contemplated by the OCC "Derivatives" handbook booklet and BC-277, an effective risk management process includes appropriate oversight and supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification, measurement and management information systems, and effective risk control functions that oversee and ensure the continuing appropriateness of the risk management process. To manage the risks in its proposed cash-settled electricity derivatives business, the bank represents it will implement those policies, procedures, and controls set forth in OCC guidance, *e.g.,* OCC "Derivatives" handbook booklet and BC-277, to assure the ongoing function and maintenance of an effective risk management process. In implementing those policies, procedures, and controls, the bank commits 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 (including the "Electricity Derivative Product Controls" discussed above); (iv) the establishment, implementation, and monitoring of appropriate risk management limits with respect to various types of risks—such as market risk, credit risk, and liquidity risk—associated with a customer-driven, cash-settled derivatives activity;[4] and (v) Compliance Department training of personnel and development of a supervisory framework designed to ensure compliance with policies and procedures, including trading practices. Such a framework will strictly prohibit

[3] *See, e.g.*, OCC *Comptroller's Handbook,* "Risk Management of Financial Derivatives" (January 1997 [print version; rev. for Web only, October 2001, available at http://www.occ.treas.gov/handbook/deriv.pdf]) (referred to as the OCC "Derivatives" handbook booklet); OCC Banking Circular No. 277 (October 27, 1993), *reprinted in* CCH Fed. Banking L. Rep. ¶ 62–152 (BC–277); OCC Bulletin 94–31 (May 10, 1994), *reprinted in* CCH Fed. Banking L. Rep. ¶ 62–152.

[4] For example, in the context of market and related risks of electricity derivatives, the bank will specifically address such matters as price volatility and concentration of market participants on a geographic and power exchange/power pool/individual customer basis. In the context of options, it will specifically address all of those characteristics identified in the OCC "Derivatives" handbook booklet (*e.g.*, at 20–21 and Appendix B) as primary component measures of option sensitivity.

manipulative practices of any kind, including patterns of trading related to so-called "round tripping" of electricity derivatives transactions.[5] 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 energy-based derivative products and business.

The bank further commits that: [1] it will *not* engage in any electricity derivatives transactions that might physically settle without the OCC's permission, [2] any trading in derivatives will be limited to cash-settled derivatives and done primarily to hedge residual open positions arising from customer transactions, and [3] its electricity derivative business will be customer driven; it will *not* be operated as a proprietary trading business. Transactions in electricity markets will permit the bank to manage and hedge, within well-controlled limits, the risks arising from valid, customer-driven, derivative transactions.

II. Discussion

In our opinion, the bank may establish a customer-driven, cash-settled electricity derivative business and hedge risks arising from these permissible banking activities, provided the bank has established an appropriate risk measurement and management process for its electricity derivative and hedging activities. This process is necessary for the bank to achieve its customer risk management objectives in a safe and sound manner and, thus, must be established before the OCC can determine that the proposed activities are permissible as part of the business of banking.

A. Financial Intermediation Transactions Involving Commodities are Authorized as Part of the Business of Banking

The OCC has previously concluded in a variety of contexts that national banks may engage in customer-driven, cash-settled financial intermediation transactions they are authorized to conduct as part of the business of banking under 12 USC 24(Seventh). The OCC has recognized, for example, that commodity and commodity index derivatives are a modern form of traditional financial intermediation functions performed by banks and, based in part on that lineage, has concluded that national banks may make payments to, or receive payments from, customers under commodity derivative contracts in the event of a gain or loss in a metal or energy product or index thereon. These derivative transactions thus have been recognized as permissible for national banks as a financial intermediation activity.[6]

In these arrangements, national banks act as financial intermediaries between customers that want to manage risks resulting from the variations in the price of a particular commodity or commodity index. Customers do not deal directly with one another, but instead make payments to the intermediary bank.[7] Under these authorities, the OCC has determined that national banks may engage in matched and unmatched commodity price index swaps and manage and warehouse them on a portfolio basis and originate, trade, and make markets in certain swap products and in other derivative instruments such as futures and options.[8]

Based on similar reasoning, the OCC has permitted national banks to engage in various commodity-linked transactions involving oil, gas, other hydrocarbons, and metals.[9] "Commodity-linked transactions" include making

[5] For example, the head of the electricity derivatives desk will be provided with a "supervisory checklist" that describes the responsibilities of the position in monitoring transactions for market manipulation, including round-tripping. This individual will receive daily position and activity reports to review and monitor consistent with the best practices policy. The bank's Compliance Division will also receive and review on a daily basis, position and activity reports and, on a quarterly basis, will test the appropriateness of derivative transactions and hedges and review documentary support. Bank employees involved in this business will be subject to applicable "Standards of Professional Conduct" and be required to attend annual compliance training.

[6] *See* OCC No-Objection Letter No. 90–1 (February 16, 1990), *reprinted in* [1989–1990 Transfer Binder] Fed. Banking L. Rep. ¶ 83,095 ("*Unmatched Commodity Swap Letter*"); OCC No-Objection Letter No. 87–5 (July 20, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034 ("*Matched Commodity Swap Letter*"). The *Unmatched Commodity Swap Letter* and the Ma*tched Commodity Swap Letter* predate *NationsBank of North Carolina* v. *Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) and characterized the commodity price index swaps as a financial intermediary activity incidental to a bank's express power to engage in deposit and lending activities under 12 USC 24(Seventh). The OCC has since concluded that swap and funds intermediation activities are part of the business of banking. *See* OCC Interpretive Letter No. 892 (September 13, 2000), *reprinted in* [2000–2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–411; OCC Letter from Ellen Broadman, director, Securities and Corporate Practices Division, OCC, to Barbara Moheit, regional counsel, FDIC (October 20, 1998) (unpublished) *("Broadman Letter").*

[7] In the event of a customer default on a commodity swap, the bank makes payments in place of a defaulting customer's obligation. The bank's payment is an advance of funds for which the defaulting customer is obligated to reimburse the bank or is an exercise of a national bank's authority to make loans.

[8] OCC Letter from Jimmy F. Barton, deputy comptroller, Multinational Banking, to Carl Howard, associate general counsel, Citibank, N.A. (May 13, 1992) (unpublished); Unmatched Commodity Swap Letter, supra; Matched Commodity Swap Letter, supra.

[9] *See, e.g.,* OCC Interpretive Letter No. 684 (August 4, 1995), *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,632; OCC Letter from Robert Herman, Deputy Comptroller (October 4, 1994) (unpublished); OCC Interpretive Letter No. 632 (June 30, 1993), *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,516.

loans, taking deposits, and issuing debt instruments having terms related to commodity prices, sales, or indices, or measured in relation to the future; and entering into swaps, forwards, and other transactions relating to commodity prices and indices, or any combination thereof, in order to assist customers of the bank in managing their financial exposures.[10] National banks may also originate, trade, and make markets in swap contracts and related derivative products, including cash-settled commodity swaps, caps, collars, floors, swaptions, captions, and other option-like products, based on their deposit taking, lending, and financial intermediation authority.[11]

Moreover, Congress has recognized the authority of national banks to engage in commodity derivative transactions. Under the Gramm–Leach–Bliley Act,[12] banks may offer "identified banking products" without registration under the Securities Exchange Act of 1934,[13] subject to banking law requirements and supervision. "Identified banking products" include certain swap agreements, defined as "any individually negotiated contract, agreement, warrant, note or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more *commodities,*[14] securities, currencies, interest or other rates, indices, or other assets."[15] The GLBA conference report further observes that these products are among the "activities in which banks have traditionally engaged."[16] Congress' recognition that banks engage in commodity derivative transactions and exemption of these activities from certain securities regulations is consistent with the OCC's longstanding position that national banks have the authority to engage in customer-driven, cash-settled commodity derivative transactions, subject to safety and soundness considerations.

[10] OCC Interpretive Letter No. 632, *supra*.

[11] OCC Letter from Horace Sneed, Senior Attorney, LASD, (March 2, 1992) (unpublished) ("*Commodity Swap Portfolio Letter*").

[12] Pub. L. No. 106–102 (1990) (effective May 12, 2001) (GLBA).

[13] 15 USC 78a *et seq*.

[14] The Commodity Futures Trading Commission has recognized that entities engage in derivative instruments on various commodities, including crude oil, refined oil products, natural gas, metals, and *electricity* (emphasis added). *See, e.g.,* 2000 CFTC Ltr. LEXIS 248 (December 4, 2000).

[15] (emphasis added). See P.L. 106–102, 113 Stat. 1338 (1999), sections 201, 202, 206.

[16] H.R. Rep. No. 106–434 at 163 (1999) (Summary of Title II in Managers' Statement).

B. The Bank's Proposed Cash-Settled Electricity Derivative Business is Functionally Equivalent to other Bank Permissible Commodity Derivative Transactions

Electricity derivative transactions are a natural extension of the bank's existing energy derivative products, *e.g.,* petroleum, natural gas, and other hydrocarbon derivative products. Electricity swaps, forwards and options are the operational, structural, and functional equivalents of commodity derivative transactions the OCC has previously determined are permissible for national banks. Customer-driven, cash-settled commodity swaps, forwards, and options, whether based on metals or energy, including electricity, are privately negotiated contracts between the parties to the transactions. As such, the terms of the swaps, forwards, and options may be individually tailored to the specific risk sensitivities of customers, *e.g.,* limiting exposure to price fluctuations and market uncertainties. And, by entering into a swap, forward, or option contract, the parties agree to make payments based on the performance of a particular commodity or commodity index, whether the commodity at issue is an energy product, such as petroleum, natural gas, a hydrocarbon or electricity, or metal, such as aluminum, lead, nickel, tin, zinc cobalt, iridium, and rhodium.

All of these contracts involve exchanges of payments akin to those that a bank makes and receives in connection with its role as a financial intermediary. Cash-settled electricity swaps are agreements between two counterparties that allow them to exchange fixed or floating payments based on a notional amount of electricity. Banks' authority to enter into cash-settled swaps is well established.[17]

[17] In the 1980s the OCC opined on the permissibility of national banks engaging in interest rate, currency, and commodity price index swaps and caps. *See* Matched Commodity Swap Letter; OCC Interpretive Letter No. 462 (December 19, 1988), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,686; OCC Letter from J. Michael Shepherd, senior deputy comptroller, Corporate and Economic Programs (July 7, 1988) (unpublished). Then, in the 1990s, 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 and equity 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. *See* OCC Interpretive Letter No. 725 (May 10, 1996), *reprinted in* [1995–1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,040; OCC Interpretive Letter No. 652 (September 13, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600; OCC Letter from Jimmy F. Barton, deputy comptroller, Multinational Banking, to Carl Howard, associate general counsel, Citibank, N.A. (May 13, 1992) (unpublished); *Commodity Swap Portfolio Letter*; *Unmatched Commodity Swap Letter, supra.*

Similar exchanges of payments may be achieved using forwards or options. For example, cash-settled electricity and other swaps are basically portfolios of cash-settled forwards. Each forward embedded in a swap transaction is an agreement to exchange payments based on a fixed or floating price at a certain future date. To illustrate, an electricity swap might consist of an exchange of payments based on a notional amount of electricity every month for the next five years. The instrument is a swap because the parties exchange the net of two offsetting payment streams, once a month. The swap is nothing more than a series of 60 separate forward contracts (12 months × 5 years). Although forward contracts may provide for physical delivery, cash-settled forwards are functionally equivalent to cash-settled swaps and permissible under banks' deposit, lending and financial intermediary authorities.

Cash-settled options are similar to those cash-settled contracts, and thus permissible for national banks, in that options permit the holder to decide to execute a transaction in the future with the seller at a price determined today. Cash-settled options also are similar to cash-settled swaps and forwards in that two options—a cap and a floor—can replicate the cash flow of swap transactions. The same legal reasoning that allows national banks to engage in cash-settled electricity swaps applies to cash-settled forwards and options. Expansion of the bank's existing commodity derivatives business to include cash-settled electricity-linked transactions will not effect any substantive change in the *type* or *nature* of the activity conducted, but only in their underlying *basis (i.e.,* the particular commodity in question).

Finally, GLBA supports the permissibility of national banks entering into cash-settled electricity transactions, by not limiting the types of commodity derivative transactions exempt from registration under the 1934 [Securities Exchange] Act. Of course, for any commodity derivative transaction to be permissible for national banks, it must be permissible under national banking law, which requires, as discussed below, the bank to have appropriate risk measurement and management processes in place to conduct the activity.

As described in Section I, the bank's proposal to engage in customer-driven, cash-settled electricity derivative business is intended to build on the bank's existing client product offerings in petroleum, natural gas, and other energy-related financial instruments, and to provide to customers sophisticated risk management tools directly related to the accommodation of customer needs. Bank customers seek a creditworthy, sophisticated, and focused counterparty to assist them in meeting their electricity price management needs and to act as an intermediary in derivative transactions on their behalf. The bank's entry into the electricity derivatives business will provide customers a new, high credit quality counterparty for these transactions that is a trusted and known quantity to them and has significant experience, knowledge, and expertise. The bank's ability to engage in a customer-driven, cash-settled, electricity derivative business will also benefit the bank's customers by reducing customers' financial risks associated with fluctuations in the prices of commodities.[18]

In addition, the bank will benefit from an electricity derivative business that enables it to diversify, expand its customer base, and increase revenues. The bank's proposed cash-settled electricity derivative business will pose risks similar to those inherent in other types of cash-settled electricity derivatives transactions with which it is already familiar and for which it has demonstrated the ability to successfully manage, *e.g.,* counterparty, price, basis, liquidity, credit, and compliance risks.

C. Hedging Risks Arising from Bank Permissible Commodity Derivative Activities Is Integral to Those Permissible Activities

The OCC has long recognized that using derivatives to hedge against the risks associated with bank permissible activities is an integral part of those permissible banking activities.[19] Indeed, the OCC has determined that national banks may hedge bank permissible commodity derivative transactions with other commodity derivatives, such as futures, and swaps and options, and other over-the-counter (OTC) instruments, when conducted in a safe and sound manner as provided in OCC guidance.[20] Hence, as with other commodity derivatives, national banks may hedge bank permissible electricity derivative transactions with

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[18] *See, e.g., Unmatched Commodity Swap Letter.*

[19] Through hedging activities, national banks serve in a financial intermediation capacity. Longstanding OCC precedent recognizes the authority of national banks to act as financial intermediaries, engaging in permissible derivative transactions and assuming offsetting positions or hedges. In so doing, the bank protects itself against risks arising from established, permissible banking activities. As a result of hedging, a bank becomes an intermediary, by interposing itself between customers initiating bank permissible derivative transactions and those providing offsetting returns. Thus, because hedging is an integral part of financial intermediation services, the activity is permissible for national banks. OCC Interpretive Letter No. 896 (August 21, 2000), *reprinted in* [2000–2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–415; *Broadman Letter, supra.*

[20] OCC Interpretive Letter No. 684, *supra*; OCC Interpretive Letter No. 683 (July 28, 1995), *reprinted in* [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,631; OCC Interpretive Letter No. 632, *supra*; *Commodity Swap Portfolio Letter, supra.*

electricity futures, and swaps and options and OTC derivative instruments. Further, the OCC has specifically endorsed the hedging of commodity transactions on a transaction-by-transaction or portfolio basis.[21] The principles that the OCC has articulated in hedging commodity derivatives and related contexts are equally applicable to hedging customer-driven, cash-settled electricity derivative transactions.[22]

D. The Customer-Driven, Cash-Settled Electricity Derivative Transactions and Hedges Must Be Conducted in a Safe and Sound Manner

Engaging in customer-driven, cash-settled derivative transactions and hedges does not automatically qualify the activity as part of the business of banking. The nature of the electricity derivative activity proposed requires sophisticated risk measurement and management capacities on the part of a bank and qualified personnel, in order for the activity to actually function as described and to operate in a safe and sound manner. Thus, in order for the OCC to conclude that this proposed activity is permissible for the bank as "part of the business of banking" the bank must demonstrate to the satisfaction of the OCC that the bank has established an appropriate risk measurement and management process for its electricity derivative activity. As detailed further in the OCC "Derivatives" handbook booklet and BC-277, 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.

In addition to a 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, including its commitment to conduct its financial intermediation activities in electricity as a customer-driven, and non-proprietary trading business.[23] The bank must have an adequate and effective compliance monitoring program that includes policies, training, independent surveillance, and well-defined exception approval and reporting procedures.

The OCC will make these determinations though the bank's examiner-in-charge (EIC), and the bank may not commence the proposed activities unless and until its EIC has concluded that the foregoing standards are met.

III. Conclusion

The bank may conduct the proposed customer-driven, cash-settled electricity derivative business and hedge risks arising from these permissible banking activities as an extension of its existing energy-related commodities derivatives business, provided the bank has established, to the satisfaction of its EIC, an appropriate risk measurement and management process for its electricity derivative and hedging activities.

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First Senior Deputy Comptroller and Chief Counsel

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[21] *See, e.g., Swap Portfolio Letter*, *supra*; *Unmatched Commodity Swap Letter*, supra; *Matched Commodity Swap Letter*, supra.

[22] Indeed, the Federal Reserve Board, in recognizing that "[b]anking organizations have developed a number of commodity . . . linked transactions . . . including commodity-indexed deposits, loans, debt issues, and derivative products, such as *forwards, options,* and *swaps,"* has noted that banks enter "into exchange-traded commodity or stock index futures and options in order to hedge the exposure inherent in these transactions." (emphasis added). 12 CFR 208.128 (repealed so as to broaden the authority of state member banks to engage in derivative transactions without prior Federal Reserve Board approval; *See* 62 Fed. Reg. 15272, 15276 (Mar. 31, 1997) (discussing proposed repeal of section 208.128); *see also* 63 Fed. Reg. 37630 (July 13, 1998)). The OCC recognizes the similarity of different financial instruments, stating, for example, that "[d]espite their difference in form, options, futures and options on futures serve a similar function: enabling banks and investors to hedge against risk of . . . price changes relating to the underlying instruments." OCC Interpretive Letter No. 896, *supra.* In the equity context, the OCC "Derivatives" handbook booklet makes clear (at 71) that banks that enter into swap transactions may hedge these transactions with "futures contracts, options, and similar over-the-counter instruments." *See also* note 3 above.

[23] The OCC has long considered safety and soundness issues when determining whether an activity is part of, or incidental to the business of banking. *See e.g.*, OCC Interpretive Letter No. 892, *supra* (national bank may engage in equity hedging activities only if it has an appropriate risk management process in place); OCC Banking Bulletin 96–5 (September 20, 1996) (replaced by OCC Bulletin 2000–23 (July 20, 2000)) (national bank's purchase of life insurance is incidental to banking if it is convenient or useful in connection with the conduct of the bank's business and consistent with safe and sound banking practices); OCC Interpretive Letter No. 684, *supra* (commodity hedging is a permissible banking activity provided the activity is conducted in accordance with safe and sound banking practices); *Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A. to Offer the Chase Market Index Investment Deposit Account* (August 8, 1988) (national banks have the authority to establish the amount of the payments to be made and received under their deposit and loan contracts and may determine the amount of those payments by reference to any index or standard as long as the bank complies with safe and sound banking principles and, in the case of loans, with state usury laws); OCC Interpretive Letter No. 376 (October 22, 1986) *reprinted in* [1985–1986 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,600 (indemnification from losses resulting from participation in the bank's fiduciary securities lending program is a permissible incidental activity provided the indemnification is consistent with OCC guidance and safety and soundness); OCC Interpretive Letter No. 274 (December 2, 1983) *reprinted in* [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,438 (a national bank's authority to lease its office space provides the authority for it to establish appropriate lease terms if consistent with safe and sound banking practices).