



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 14, 2002

Interpretive Letter #935
June 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% 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

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

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% 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.

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.

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

B. Nonvoting Corporate Stock

You inquired whether the 5% limit applies to nonvoting corporate stock. The OCC has applied the 5% 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% 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% 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 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

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*.

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 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.

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 Handbook for National Bank Examiners, *Risk Management of Financial Derivatives* (January 1997).

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 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 & Corporate Practices Division at (202) 874-5210.

Sincerely,

signed

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel