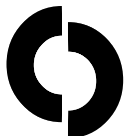

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #961
April 2003
12 U.S.C. 24(7)

March 17, 2003

Subject: Hedging Risks of DPC Stock Holdings

Dear **[ ]**:

This is in response to your letter of March 5, 2002, requesting confirmation that **[ ]** (the "Bank") may buy and sell options on the shares of stock of a company when the Bank has acquired shares of the company in satisfaction of debts previously contracted ("DPC Shares"). The Bank would buy and sell the options to hedge the market risk associated with changes in the value of DPC Shares. For the reasons discussed below and subject to the limitations described herein, we believe that the proposed hedging activity is permissible for the Bank.

Background

In carry out its lending activities, the Bank sometimes receives DPC Shares as part of contractual workout arrangements. The terms of the workout arrangements sometimes restrict the ability of the Bank to dispose of the DPC shares it receives.[1] The Bank believes it would be prudent to hedge the risks of holding DPC Shares against fluctuations in market value. The Bank proposes to use a hedging strategy known as a "butterfly option." Under this hedging strategy, at the time the Bank receives DPC shares, the Bank will (1) buy a "put" option at a strike price lower than the current market price of the DPC Shares and (2) sell a "call" option at a strike price higher than the current market price of the DPC Shares. The Bank's management believes this hedging strategy will reduce market risk.[2]

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[1] The Bank sometimes also may acquire DPC shares that have limited marketability for other reasons. For example, the shares may be thinly traded or their transfer may be restricted under the Federal securities laws.

[2] The amount the Bank receives for selling the call offsets in part the amount the Bank pays for purchasing the put. The butterfly thus allows the Bank to receive protection against market declines at a reduced cost.

The Bank commits that it will use the options solely to hedge risk of DPC Shares and will not engage in speculation. The Bank plans to purchase the butterfly options at the time the Bank acquires the DPC shares and anticipates holding the options without adjustment until it disposes of the DPC shares.[3] The Bank represents that it will not take anticipatory short positions or maintain residual positions in the options that do not operate as a hedge of market exposure in DPC Shares, except as necessary to the orderly taking or unwinding of a hedging position.

Discussion

National banks are authorized to lend under express authorities in the National Bank Act and as part of the business of banking. They may acquire securities, including shares of stock, through foreclosure or otherwise in the ordinary course of collecting a debt previously contracted (DPC). Such securities may be held for up to five years unless the OCC extends the holding period for up to another five years.[4] Hedging risks arising from that permissible banking activity is an essential and integral part of that banking activity. In our opinion, the Bank may buy and sell options as a technique to hedge its market exposures from DPC Shares, provided that the Bank establishes an appropriate risk measurement and management and compliance process to conduct such hedging activities. This process is necessary for the Bank to achieve its risk management objectives in a safe and sound manner and, thus, must be established before the OCC can determine that the proposed activities are convenient and useful in conducting permissible banking activities and thereby permissible as an activity incidental to the business of banking.

A. The National Bank Act ("Act")

A national bank may engage in activities pursuant to 12 U.S.C. § 24(Seventh) if the activities are part of, or incidental to, the business of banking. Section 24(Seventh) expressly provides that national banks shall have the power:

> To exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes.[5]

The Supreme Court has held that this authority is a broad grant of power to engage in the business of banking, including, but not limited to, the five enumerated powers and in the

[3] Should the Bank wish to change its planned procedures for purchasing and holding the options, the Bank should confer with its Examiner in Charge ("EIC") prior to making such a change.

[4] *See* OCC Interpretive Letter No. 643 (July 1, 1992), *reprinted* in [1991-1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,551; OCC Interpretive Letter No. 511 (June 20, 1990), *reprinted* in [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,213.

[5] 12 U.S.C. § 24(Seventh).

business of banking as a whole.[6] National banks also are authorized to engage in an activity that is incidental to the performance of the five enumerated powers *or* incidental to the performance of an activity that is part of the business of banking.[7] Incidental activities are activities that are permissible for national banks, not because they are part of the powers expressly authorized for banks or the "business of banking," but rather because they are "convenient" or "useful" to those activities.[8]

B. Making Loans and Hedging the Associated Risks Are Part of the Business of Banking

Making loans is an express power listed in the National Bank Act and is recognized as a core part of the business of banking.[9] Lending involves risks that banks must manage as part of the business of banking. Banks hedge loans as a means of managing those risks.[10] The OCC has

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[6] *NationsBank of North Carolina v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("*VALIC*"). Judicial cases affirming OCC interpretations establish that an activity is within the scope of the "business of banking" if the activity: [1] is functionally equivalent to or a logical outgrowth of a traditional banking activity; [2] would respond to customer needs or otherwise benefit the bank or its customers; and [3] involves risks similar to those already assumed by banks. *See, e.g., Merchant Bank v. State Bank*, 77 U.S. 604 (1871); *M&M Leasing Corp. v. Seattle First National Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978); *American Insurance Assn. v. Clarke*, 865 F.2d 278, 282 (2d Cir. 1988). In *IAA v. Hawke*, 211 F.3d 638 (D.C. Cir. 2000), the court expressed the position that the "logical outgrowth" rationale needed to be kept within bounds, but endorsed the "functional equivalent" component of the test.

[7] *VALIC, supra,* at 253.

[8] The leading case defining when an activity is authorized as "incidental" under Section 24(Seventh) is *Arnold Tours, Inc. v. Camp,* 472 F.2d 427, 431-32 (1st Cir. 1972). In that decision, the First Circuit held that the term "necessary" in Section 24(Seventh) should be broadly construed to encompass "incidental" activities that are "convenient or useful" to an expressly enumerated power. The Supreme Court later clarified in *VALIC* that these incidental powers include activities that are convenient and useful to the business of banking as well as those that are convenient and useful to the expressly enumerated powers under the National Bank Act. See *VALIC, supra.* Recently, the Ninth Circuit confirmed that these incidental powers should be broadly construed, stating that "[t]he incidental powers of national banks are thus not limited to activities deemed essential to the exercise of enumerated powers but include activities closely related to banking and useful in carrying out the business of banking." *Bank of America v. San Francisco,* 309 F.3d 551, 562 (9th Cir. 2002)

[9] 12 U.S.C. § 24(Seventh). The National Bank Act provides, in pertinent part, that national banks shall have the power "[t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; . . . by loaning money on personal security." *Id.* This power is often referred to generally as a national bank's lending authority.

[10] OCC Interpretive Letter No. 896 (August 21, 2000), *reprinted in* [2000-2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-415 ("*Agricultural Loan Hedge Letter*"). Other banking activities also involve risks that banks must manage as part of the business of banking. *See, e.g.* OCC Interpretive Letter No. 892 (September 13, 2000), *reprinted in* [2000-2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-411 ("*Equity Hedge Letter*") (national bank may hedge risk of derivatives activities by purchasing equity securities); United States General Accounting Office, *Equity Hedging--Report to the Honorable James A. Leach, House of Representatives*, GAO-01-945 (August 2001); *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) ("*MII Deposit*") (national bank may buy and sell futures on the S&P 500 Index to hedge deposits with interest rates tied to the S&P 500 Index).

long recognized that hedging the risks associated with bank permissible lending activities is an integral part of those permissible banking activities. National banks hedge against the risk of loss due to the interest rate fluctuations inherent in their own loan operations.[11] National banks also hedge bank loans to minimize the credit risk in those transactions.[12] As discussed below, hedging these lending risks by buying and selling options on DPC Shares can be part of a bank's permissible lending activities.

C. Buying and Selling Options to Hedge Market Risk on DPC Shares as an Activity that is Incidental to the Business of Banking

Section 24(Seventh) authorizes national banks to engage in "all such incidental powers" as shall be necessary to carry on the "business of banking."[13] An activity is incidental to the business of banking if it is "convenient" or "useful" to an expressly enumerated power or to the business of banking as a whole.[14]

1. Hedging through options can be an effective hedging strategy.

The Bank has demonstrated that the proposed option hedging can be an effective hedging strategy. For example, if the market price of DPC Shares falls, the Bank could exercise its put option and receive cash equal to the strike price of DPC Shares. Thus, the proposed hedging can facilitate and improve the Bank's ability to reduce credit exposures to its borrowers by protecting the value of DPC Shares it receives in a workout.[15]

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[11] Comptroller's Handbook, "Mortgage Banking" (March 1996); OCC Letter to Gregory Crane (October 26, 1976); OCC Letter to Alan E. Rothenberg, Vice President, Bank of America, from Robert Bloom, First Deputy Comptroller (Policy) (October 11, 1976). Similarly, the Department of the Treasury recognizes that interest rate risk of fixed-rate loans can be neutralized by hedging with appropriate interest rate swap, forward, futures, or option contracts. Department of the Treasury, Banking Industry -- Trends and Current Issues: Report titled "Modernizing the Financial System" (November 6, 1995).

[12] OCC Banking Bulletin 96-43: Credit Derivatives, Guidelines for National Banks (August 12, 1996); OCC Interpretive Letter No. 356 (January 7, 1986), *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,526. In addition, national banks may assist customers in hedging their own loans against cash market risks, by obtaining, or by assisting customers in obtaining, hedging instruments. OCC Letter to Jeffrey S. Lillien, The First National Bank of Chicago (June 13, 1986); OCC Letter to Randall R. Kaplan, Caplin & Drysdale from Judith A. Walter, Senior Deputy Comptroller (June 13, 1986); OCC Letter to Thomas N. Rose, Eldredge & Clark, from Michael A. Mancusi, Senior Deputy Comptroller for National Bank Operations (November 5, 1985).

[13] 12 U.S.C. § 24(Seventh).

[14] In considering whether an activity is "convenient" or "useful" and therefore "incidental" to the business of banking, the OCC may consider whether the activity facilitates the operations of the bank as a banking enterprise, enhances the efficiency or quality of the content or delivery of banking services of products, optimizes the use and value of a bank's facilities and competencies, or enables the bank to avoid economic waste in its banking franchise. *See* OCC Interpretive Letter No. 845 (Oct. 20, 1998), *reprinted* in [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,300. *See also* 12 C.F.R. § 7.5001(d).

[15] The OCC also permits national banks to engage in certain activities to preserve the value of their real estate DPC property. For example, national banks can make necessary advances to run a business and thereby preserve its going concern value when the business is acquired to secure or collect debt previously contracted. *See* 12 C.F.R.

2. The proposed equity hedging is similar to activities the OCC has previously approved as convenient and useful to bank permissible activities.

The OCC also has long permitted national banks to use futures, options, and options on futures to manage or "hedge" risks arising from permissible banking activities. The OCC has recognized the permissibility of such activities both for the purpose of providing bank customers with the ability to hedge their own risks and as a means for banks to hedge directly the risks that arise from permissible banking activities.[16] For example, in 2000, the OCC considered a proposal to hedge the risk in a bank's agricultural loans by purchasing cash-settled options on futures on commodities that serve as the primary collateral for the loans. The OCC determined that using options on futures contracts on agricultural commodities to hedge bank permissible lending activities is permissible for national banks.[17] However, the OCC would not permit the bank to engage in the proposed activity until it had an appropriate risk management process in place.[18]

The proposed options hedges are similar to equity hedges the OCC has previously approved for certain national banks as convenient and useful to bank permissible activities. The OCC has determined that, subject to specified conditions and standards, the national banks could purchase and hold equity securities to hedge risks arising from permissible equity derivative transactions.[19] The OCC concluded that the equity hedges provided the national banks in

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§ 34.86; OCC Interpretive Letter No. 576 (March 27, 1992) *reprinted in* [1991-1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,346; OCC Interpretive Letter No. 12 (December 7, 1977) *reprinted in* [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,087.

[16] *See* OCC Interpretive Letter No. 356, *supra* (bank registered as a futures commission merchant could execute customer orders for agricultural and metals futures in connection with its loans to the customers); *MII Deposit*, *supra*, (bank could offer a deposit with a rate of return based in part on the return on a stock index and could hedge the bank's interest rate risk by purchasing futures on that stock index); OCC Interpretive Letter No. 937 (May 14, 2002) *reprinted in* [2001-2002 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,462 (bank could hedge risks arising from intermediation transactions based on electricity prices); OCC No Objection Letter No. 87-5 (July 20, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034 (bank could act as principal in commodity price index swaps with its customers); OCC No Objection Letter 90-1 (February 16, 1990), *reprinted in* [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095 (bank could act as principal in unmatched commodity price index swaps with its customers and hedge its price risk exposure using exchange-traded commodity futures); OCC Letter from Horace G. Sneed, Senior Attorney, Legal Advisory Services Division (March 2, 1992) (unpublished) (bank could manage its commodity index swaps on a portfolio basis and hedge the swaps with swaps, exchange-traded futures or over-the-counter (OTC) options; OCC Interpretive Letter No. 652 (September 13, 1994), reprinted in [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600 (bank could engage in equity and equity derivative swaps and hedge risk using futures contracts, options and similar OTC instruments).

[17] *Agricultural Loan Hedge Letter, supra*.

[18] *Id.*

[19] Similarly, the OCC has determined that national banks may take physical delivery of commodities to hedge bank permissible commodity-linked derivative transactions as a convenient and useful means to manage the risks arising from those permissible banking transactions. OCC Interpretive Letter Nos. 632 and 684, *supra*.

question with a cost-effective, means to hedge risks arising from customer-driven equity derivative transactions and thus were a convenient and useful activity incidental to the business of banking for those banks.[20]

The OCC also has permitted national banks to hedge obligations to make payments on bank permissible employee compensation and benefit plans with incidental life insurance.[21] The OCC later concluded that it was convenient and useful for a national bank to hedge an employee compensation program with bank impermissible insurance company products and investments because the hedge virtually eliminated all the risk arising under the program to the bank.[22]

In each case cited above, the hedging instrument was viewed as an asset held incidental to a permissible banking activity in order to hedge the bank's risks or obligations, rather than as a security held by the bank for investment. The transactions were used to manage risks arising from otherwise bank permissible banking activities and not entered into for speculative purposes. In much the same manner, incidental to the express permissible banking activity of lending, the Bank would buy and sell options on equity securities for the sole purpose of hedging its market risk on DPC Shares. This conclusion is consistent with the foregoing OCC precedents permitting bank-impermissible investments for hedging purposes to manage risks arising from permissible banking activities.

3. The hedging must be conducted in a safe and sound manner.

Buying and selling options for the stated purpose of hedging market exposures on DPC securities does not automatically qualify that activity as an activity that is incidental to banking, however. The nature of the hedging activity proposed requires specialized risk measurement and management capacities on the part of a bank, and qualified personnel, in order for the activity to be conducted so it will actually perform the function of hedging market risks. Thus, in order for the proposed activity to be permissible for the Bank because it is "convenient" or "useful" to conducting authorized banking activities, the Bank must establish an appropriate risk measurement and management process for its DPC Share hedging activity in accordance with applicable requirements contained in the OCC's Derivatives Handbook[23] and OCC Banking

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[20] *See Equity Hedge Letter, supra*. *See also* OCC Interpretive Letter No. 684, *supra* (national banks may take physical delivery of equities and commodities to hedge bank permissible derivative transactions as a convenient and useful means to manage the risks arising from those permissible banking transactions). The General Accounting Office has issued a report agreeing with the OCC's conclusion. United States General Accounting Office, *Equity Hedging--Report to the Honorable James A. Leach, House of Representatives*, GAO-01-945 (August 2001).

[21] OCC Interpretive Letter No. 848 (November 23, 1998), *reprinted in* [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-202; OCC Bulletin 96-51 (September 20, 1996), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 35-491.

[22] OCC Interpretive Letter No. 878 (December 22, 1999), *reprinted in* [1998-1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-373.

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

Circular No. 277.[24] As part of the Bank's risk management process, the Bank's management should:

- document its decisions on hedging DPC Share market exposures;
- develop a clear methodology for determining the amount of market risk from DPC Shares that the Bank needs to hedge; and
- establish objective criteria for the purchase and sale of options sufficient to demonstrate that the options will be used solely to hedge against losses.

In addition, the Bank should develop and implement compliance policies and procedures to ensure that any potential conflicts of interest are appropriately considered and that the hedges will comply with applicable securities laws, including applicable insider trading standards. Because buying and selling options in respect of DPC Shares may raise issues under the federal securities laws, the Bank should consult with competent securities counsel to ensure its activities comply with federal securities laws before entering into such transactions.

Finally, the Bank's audit or another qualified independent control unit should conduct a review to evaluate the adequacy and effectiveness of the Bank's risk and compliance management policies and procedures to ensure that the DPC Share hedging activity is conducted in conformance with the applicable requirements of BC-277 and securities laws.

D. Use of Options to Hedge Banking Risk is not Prohibited Underwriting or Dealing under Section 24(Seventh)

Section 24(Seventh) addresses the ability of a national bank to underwrite or deal in securities. Specifically, Section 24(Seventh) provides that:

> [t]he business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe.

Here, the Bank is not "dealing" in or "underwriting" securities as prohibited by Section 24(Seventh). Although "dealing" and "underwriting" are not defined in Section 24(Seventh),[25]

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[24] October 27, 1993, *reprinted in* [1993-1994 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 62-152, as supplemented by *Supplemental Guidance 1 to BC-277* (January 1997) ("BC-277").

[25] Although the securities laws definitions are not dispositive in determining whether a particular type of securities activity is permitted for banks, these definitions provide a useful starting point for characterizing a bank's securities activities. Under section 3 of the Securities Exchange Act of 1934, a "dealer" is defined as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary

"underwriting" is generally understood as encompassing the purchase of securities from an issuer for distribution and sale to investors.[26] Case law confirms that one cannot be an underwriter in the absence of a public offering.[27]

"Dealing" in securities is generally understood to encompass the purchase of securities as principal for resale to others.[28] Dealing is buying and selling as part of a regular business. A dealer typically maintains an inventory of securities and holds itself out to the public as willing to purchase and sell and continuously quote prices.[29]

Under the above definitions, the Bank's use of options on equity securities for hedging exposures resulting from DPC Shares is not "underwriting" or "dealing." The Bank has committed to sell and purchase debt securities solely for the purpose of hedging. The Bank will not purchase securities from an issuer for sale to investors in connection with a public offering -- essential elements of underwriting. Further, in conducting hedging activities, the Bank will not engage in a regular business of buying and selling equity options in the secondary market, will not publicly offer the equity options from hedging DPC Shares to investors and will not hold itself out as available to buy and sell securities. [30]

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capacity, but not part of a regular business." 15 U.S.C. § 78c(a)(5). Under the Securities Act of 1933, an "underwriter" includes "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security." 15 U.S.C. § 77(b)(a)(11).

[26] OCC Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612; OCC Interpretive Letter No. 329 (March 4, 1985), *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499.

[27] *SIA v. Board of Governors*, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

[28] *See Equity Hedge Letter*, *supra* (banks' purchase of equity securities for hedging customer-driven equity derivative transactions is not "dealing" or "underwriting"). *See also* OCC Interpretive Letter No. 393 (July 5, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,617 (national bank with limited market presence not considered a dealer); Louis Loss, Securities Regulation 2983-84 (3d ed. 1990).

[29] *Citicorp, J.P. Morgan & Co. Inc., Bankers Trust New York Corporation*, 73 Fed. Res. Bull. 473 n.4 (1987); OCC Interpretive Letter No. 684, *supra; Equity Hedging Letter, supra*.

[30] Although securities law is not determinative in interpreting banking law, we note that the Securities and Exchange Commission (SEC) has recognized that entities that purchase and sell securities to hedge their own risks, and that do not hold themselves out as available to buy and sell securities are not dealers under the GSA. *See Fireman's Fund Mortgage Corp.*, 1987 SEC No-Act. LEXIS 2330 (July 20, 1987). *See also Citicorp Homeowners, Inc.*, 1987 SEC No-Act. LEXIS 2596 (Oct. 7, 1987) (involving mortgages and hedging with government securities); *Meridian Mortgage Corp.*, 1987 SEC No-Act. LEXIS 2020 (April 7, 1987) (involving mortgages and hedging with government securities).

Conclusion

The Bank may purchase and sell options on DPC Shares to hedge the risk of holding those shares against fluctuations in market value, provided the Bank has established effective risk measurement and management processes as described in section C. 3., above, to conduct the proposed hedging as described herein.

Sincerely,

/s/ Julie L. Williams

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel