Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #949
12 USC 24(7)
January 2003

September 19, 2002

Kieran J. Fallon, Esq.
Senior Counsel
Board of Governors of the Federal Reserve System
Washington, DC 20551

Re: Authority of National Banks to Engage in Financial Intermediation Transactions involving Equity Options and Forwards

Dear Mr. Fallon:

This is in response to your request that the Office of the Comptroller of the Currency ("OCC") confirm that it is permissible for national banks to engage in cash-settled options and forwards on equity securities (the "Equity Derivatives Transactions").[1] The Equity Derivatives Transactions involve exchanges of payments between a bank and its customers based on changes in the value of equity securities. As discussed below, the OCC views the Equity Derivatives Transactions as permissible if they are part of a bank's customer-driven, non-proprietary financial intermediation business and if the bank has in place an appropriate risk measurement and management process for its derivatives and hedging activities. This risk measurement and management process is necessary for a 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. In the absence of particular facts and supervisory knowledge of an individual institution, the OCC is unable to opine whether particular Equity Derivatives

[1] The owner of an equity option contract has the right to buy or sell a specified equity security or group of securities at a specified price on or before a specified date. The owner of an equity forward contract has the obligation to purchase a specified equity security or group of securities at a specific date in the future. The equity forward contract is purchased by the owner immediately, but the securities are not paid for until some future date. Because the Equity Derivatives Transactions are cash-settled, the counterparties do not actually take or make delivery of the underlying equity securities, but rather take or make cash payments based on the changes in market price of those securities. We understand from you that all the transactions in question would be cash-settled as far as the bank engaging in the activity is concerned. If under the terms of certain contracts the customer is permitted to elect physical settlement, an affiliate of the bank will make or receive physical delivery.

Transactions are permissible.

I. Background

You have indicated that the Board of Governors of the Federal Reserve System has received an application from a state member bank for approval to acquire equity securities solely for the purpose of hedging exposure arising from the Equity Derivatives Transactions. You have asked for this opinion to determine whether engaging in the Equity Derivatives Transactions is permissible for a national bank, and therefore permissible for a state-chartered bank pursuant to 12 U.S.C. § 1831a.[2]

II. Discussion

The Equity Derivatives Transactions may be permissible under 12 U.S.C. § 24(Seventh)[3] as part of a customer-driven, non-proprietary financial intermediation business if a bank has an appropriate risk measurement and management process for its derivatives and hedging activities.

A. Derivatives Transactions May be Permissible as Part of a Financial Intermediation Business

The OCC has concluded that national banks may engage in customer-driven, non-proprietary derivatives transactions involving exchanges of payments as part of a financial intermediation business.[4] Through a derivatives business, a bank may engage in a modern form of the

---

[2] Under 12 U.S.C. § 1831a, an insured state bank may not engage as principal in any type of activity that is not permissible for a national bank, unless (1) the Federal Deposit Insurance Corporation has determined that the activity would pose no significant threat to the appropriate insurance fund and (2) the state bank is, and continues to be, in compliance with applicable capital standards prescribed by the appropriate Federal banking agency.

[3] 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. 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 business of banking as a whole. *NationsBank of North Carolina v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("*VALIC*").

[4] In the 1980's the OCC opined on the permissibility of national banks engaging in interest rate, currency, and commodity price index swaps and caps. *See* 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*"); OCC Interpretive Letter No. 462 (December 19, 1988), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,686; and OCC Letter from J. Michael Shepherd, Senior Deputy Comptroller, Corporate and Economic Programs (July 7, 1988) (unpublished). Then, in the 1990's, 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 Law. 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); OCC Letter from Horace Sneed, Senior Attorney,

traditional financial intermediation functions that banks perform in providing payment, loan and deposit services. In conducting a derivatives business, a bank makes payments to, or receives payments from, customers who want to manage financial risks resulting from the variations in interest rates or prices of commodities or equity securities. Customers do not deal directly with one another in these transactions, but instead make payments to or receive payments from an intermediary bank. Thus, a customer-driven derivatives business may be permissible as a modern form of traditional bank financial intermediation activities involving exchanges of payments with a bank acting as an intermediary between customers and not in a proprietary capacity.

Under this rationale, the OCC has found that national banks, as part of a financial intermediation business, may offer equity and equity index swaps.[5] Equity swaps are agreements between two parties to exchange payments. One party makes a stream of payments based on a short term interest rate index. The other party makes payments tied to the performance of an equity security or equity market index. National banks may hedge risks arising from these transactions either on a matched or portfolio basis and thus act in the traditional role of a financial intermediary exchanging payments with customers on agreed terms.

Cash-settled equity options and forwards may be permissible for national banks under the same rationale provided in OCC precedent addressing equity and equity index swaps.[6] Similar to equity swaps, cash-settled equity options and forwards are privately negotiated contracts between parties that enable customers to manage financial risks relating to price fluctuations in equities and market uncertainties. Similar to swaps, those option and forward products fundamentally involve exchanges of payments based on changes in the value of equities. In fact, comparable payment obligations may be created using equity swaps, options and forwards.[7]

LASD (March 2, 1992)(unpublished); and 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*"). The *Unmatched Commodity Swap Letter* and the *Matched Commodity Swap Letter* predate *VALIC* 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 U.S.C. § 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. 937 (June 27, 2002), *reprinted in* [____-____ Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ _____; OCC Interpretive Letter No. 892 (September 13, 2000), *reprinted in* [2000-2001 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81,411 ("*Equity Hedge Letter*"); OCC Letter from Ellen Broadman, Director, Securities and Corporate Practices Division, OCC, to Barbara Moheit, Regional Counsel, FDIC (October 20, 1998) (unpublished).

[5] *See* OCC Interpretive Letter No. 725, *supra*; and *Equity Hedge Letter*.

[6] *See* OCC Interpretive Letter No. 937, *supra*.

[7] A swap transaction is nothing more than a series of forward contracts. Under a swap, one party owes the other a stream of payments linked to the performance of an equity security (or equity market index) and receives a stream of payments based on a short term interest rate. The payment obligations typically are settled with one party paying the other the difference between these two payment streams. Periodic payments made under a swap agreement can mirror the payment stream on a series of cash-settled forward transactions. Under a cash-settled forward transaction, the parties also exchange the difference between the current market value of the underlying equity and the negotiated contract price for that equity. Cash-settled equity options similarly may generate payment streams comparable to equity and equity index swaps.

Also, through equity option and forward transactions and hedging activities, banks similarly may act in their traditional roles of financial intermediaries exchanging payments with bank customers. Accordingly, national banks have engaged in cash-settled equity options and forwards and the OCC has viewed these transactions as permissible if they are part of a financial intermediation business and an appropriate risk measurement and management process is established.

B. The Activity Must be Conducted in a Safe and Sound Manner

Cash-settled options and forwards on equity securities offered as part of a customer-driven, non-proprietary financial intermediation business do not automatically qualify as an activity that is part of the business of banking. The nature of these derivatives transactions 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 permitted and to operate in a safe and sound manner. Thus, in order for the OCC to conclude that the derivatives transactions are permissible for a national bank as "part of the business of banking," the bank must establish an appropriate risk measurement and management process.[8] As detailed further in the *OCC Derivatives Handbook*[9] and Banking Circular No. 277,[10] an effective risk measurement and management process includes appropriate oversight and 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.

---

[8] In other words, a proposed activity cannot be part of the "business of banking" if the bank in question lacks the capacity to conduct the activity on a safe and sound basis. Courts have long recognized this linkage between qualifying activities and safety and soundness. *See, e.g., First National Bank v. Exchange National Bank*, 92 U.S. 122, 127 (1875); *Merchants National Bank v. Wehrmann*, 202 U.S. 295 (1906). In addition, the OCC considers safety and soundness issues when determining whether an activity is part of, or incidental to the business of banking. *See, e.g.*, *Equity Hedge Letter* (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 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); 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); and 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).

[9] *Risk Management of Financial Derivatives* (January 1997).

[10] OCC Banking Circular No. 277 (October 27, 1993), *reprinted in* 6 CCH Fed. Banking L. Rep. ¶ 62-152 ("BC-277").

In addition to a risk management program, a 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 as a customer-driven, and non-proprietary trading business. 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.

III. Conclusion

The OCC believes that national banks may engage in equity forward and option transactions as part of a customer-driven, non-proprietary financial intermediation business if the banks have in place appropriate risk measurement and management processes for their derivatives and hedging activities. These processes are necessary for the banks to achieve their 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. In the absence of particular facts and supervisory knowledge of an individual institution, we are not able to opine whether particular equity option and forward transactions would be permissible for a particular bank.

Sincerely,

/s/ Julie L. Williams

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel