Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1064
August 2006
12 USC 24(7)

July 13, 2006

Subject: Hedging Customer-Driven Derivative Transactions with Below-Investment Grade Bonds

Dear **[ ]**:

[ ] ("Bank") is seeking confirmation that it may hedge the risks arising from bank permissible, customer-driven[1] derivative transactions using, among other instruments, below-investment grade bonds, and that when the Bank acquires such bonds for this purpose, it is subject to the standards applicable to derivatives hedges and not the limitations in 12 C.F.R. Part 1 applicable to investment securities. For the reasons discussed below, we conclude that the Bank may engage in the hedging transactions in the manner proposed. However, before the Bank commences the proposed activities, the Bank's examiner-in-charge ("EIC") must be satisfied that the Bank has adequate risk management and measurement systems and controls to conduct the activities on a safe and sound basis.

Background

The Bank proposes to act as a financial intermediary in customer-driven derivative transactions, including credit default swaps in various currencies, swaps tied to the CDX.EM index,[2] bond options, credit default swaptions, credit linked notes, cross-currency swaps, baskets, interest rate and cross-currency swaps in various investment and non-investment grade currencies, and

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[1] A customer-driven transaction is one entered into for another party's valid and independent business purpose. *See* OCC Interpretive Letter No. 892 (Sept. 13, 2000) ("IL No. 892").

[2] The CDX.EM index is the Dow Jones CDX Emerging Market Index, which is part of the Dow Jones CDX family of credit derivative indexes. *See* Dow Jones Credit Derivative Indexes, Press Release, *available at* http://indexes.dowjones.com/mdsidx/index.cfm?event=cdxPress.

leveraged notes. The Bank's products relate primarily to countries and currencies in Central and South America, but also to countries in Europe, the Middle East, and Africa.

The Bank's client base for these derivatives products consists of governments, supranational bodies, corporations, and financial institutions both in and outside of the United States. The financial institution segment is widely represented, ranging from insurance companies in North and South America, to European and global hedge funds. Clients for these derivative products may also come from the Bank's private bank or other affiliates. All clients are subject to the Bank's suitability and compliance policies.

The Bank's customers will use the derivatives for a variety of business purposes, including risk management. For example, corporations may use derivatives to manage foreign-exchange risk, or the risk that a change in currency exchange rates will affect business results. A corporation that reports in one currency, *e.g.*, United States Dollars, but receives payments in another currency, *e.g.*, Mexican Pesos, may hedge the foreign-exchange risk through the use of various derivative instruments, including cross-currency swaps. A cross-currency swap involves the exchange of payments denominated in one currency, *e.g.*, United States Dollars, for payments denominated in another, *e.g.*, Mexican Pesos. Payments are based on a notional principal amount the value of which is fixed in exchange rate terms at the swap's inception. If the Bank enters into a cross-currency swap with a customer, the Bank assumes the currency exchange rate risk until it offsets that risk by either entering into an offsetting cross-currency swap or hedging the risk through the use of another financial instrument.

The Bank proposes to hedge certain financial derivative transactions the OCC has previously found permissible by acquiring bonds issued by governmental or corporate entities in Central or South America, Europe, the Middle East, or Africa that are not rated "investment grade." For example, the Bank may purchase below-investment debt in order to hedge a credit-derivative based on the debt of a corporation.

In some cases, the securities purchased for hedging purposes will directly match a customer transaction. In other cases, for risk management or liquidity purposes, the Bank will hedge a transaction with an asset that is of a different type or maturity than the underlying customer transaction. In all cases, the Bank commits to follow procedures to monitor and ensure that the security purchased relates appropriately to the exposure presented by the customer transaction.

The Bank represents that the derivatives activities would be consistent with the Bank's policies and procedures related to the risk management of financial derivatives, along with regulatory requirements applicable to such activities, including OCC Banking Bulletin 96-43: *Credit Derivatives, Guidelines for National Banks* (August 12, 1996); OCC Banking Circular 277: *Risk Management of Financial Derivatives* (October 27, 1993); and the Federal Financial Institutions Examination Council's *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities*, 63 F.R. 20,191 (April 23, 1998). In addition to its overall risk management of financial derivatives, the Bank has tested and implemented particular management and accounting systems that reflect the proposed derivative transactions described above and their associated hedge transactions. Moreover, the Bank will maintain market and credit positions that are essentially flat, with the exception of residual or anticipatory positions arising from the need for the orderly establishment or unwinding of hedge transactions.

Discussion

For the reasons discussed below, and subject to satisfaction of the conditions set forth herein, we conclude that the Bank's acquisition of below-investment grade bonds in order to hedge risks arising from permissible derivative transactions is subject to standards applicable to derivatives activities, as discussed below, and that the limitations of 12 C.F.R. Part 1 applicable to investment securities would not apply. The Bank also may engage in cross-hedging in order to hedge its risks from permissible derivative transactions, as described below.

In longstanding precedent, the OCC has found banks may engage in derivatives transactions[3] with payments based on bank permissible holdings, such as foreign exchange or bank permissible debt securities.[4] Since national banks have legal authority to buy and sell particular assets, the OCC has found that national banks also may enter into derivative transactions involving exchanges of payments tied to changes in the market value of those bank permissible assets.[5] In addition, the OCC has found that national banks, acting as financial intermediaries, may engage in customer-driven derivative transactions with payments tied to a broader range of assets, including below-investment grade debt, and hedge risks arising from those transactions through offsetting derivatives or physical positions in debt securities.[6] For example, under 12 U.S.C. § 24 (Seventh) national banks may engage in perfectly matched, cash-settled, customer-driven derivatives transactions with payments tied to a range of assets.[7] In such transactions,

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[3] The OCC has previously recognized the ability of national banks to provide customers with a wide variety of financial derivatives. *See, e.g.,* OCC Interpretive Letter No. 652 (Sept. 13, 1994) ("IL No. 652") (equity index/derivative swaps) and OCC Letter from Jimmy F. Barton, Deputy Comptroller Multinational Banking, to Carl Howard, Associate General Counsel, Citibank, N.A. (May 13, 1992) (interest rate, basis rate, currency, currency coupon, and cash-settled commodity swaps; caps, collars, floors, swaptions, captions, and other option-like products; forward rate agreements, long rate agreements, rate locks and spread locks, as well as similar products) *available at*, LEXIS, Agency Decisions, OCC Decisions, Letters, Bulletins, Journals & Releases.

[4] *See, e.g.,* OCC Interpretive Letter No. 260 (June 27, 1983) (exchange-traded options on fixed income securities); No Objection Letter No. 86-13 (Aug. 8, 1986) (transactions in futures contracts on United States Treasury securities, mortgage-backed securities guaranteed by the United States government, and other "bank eligible securities"); OCC Interpretive Letter No. 372 (Nov. 7, 1986) (exchange-traded foreign currency options); and OCC Interpretive Letter No. 414 (Feb. 11, 1988) (foreign currency derivatives).

[5] *Id*.

[6] *See, e.g.,* IL No. 892, *supra* (bank may hedge risks from bank permissible, customer-driven equity derivative transactions with equity securities); OCC Interpretive Letter No. 935 (May 14, 2002) ("IL No. 935") (bank may hedge risks from bank permissible, customer-driven derivative activities with below-investment grade bonds); and OCC Interpretive Letter No. 1051 (Feb. 15, 2006) ("IL No. 1051") (bank may hedge and manage the counterparty credit risks and liability exposures arising from contingent credit default swaps with below-investment grade debt).

[7] *See* OCC Interpretive Letter No. 1039 (Sept. 13, 2005) (crude oil, natural gas, heating oil, natural gasoline, gasoline, unleaded gas, gasoil, diesel, jet fuel, jet-kerosene, residual fuel oil, naphtha, ethane, propane, butane, isobutene, crack spreads, lightends, liquefied petroleum gases, natural gas liquids, distillates, oil products, coal, emissions allowances, benzene, dairy, cattle, wheat, corn, soybeans, soybean meal, soybean oil, cocoa, coffee,

banks exchange payments with one customer and then exchange offsetting payments with another counterparty, serving as financial intermediaries facilitating the flow of funds in our economy.

The OCC also has found that national banks may portfolio-hedge their permissible securities derivative transactions using either derivatives that settle in cash or by holding below-investment grade debt securities.[8] It is well established that national banks have authority to manage risks arising from banking activities. Portfolio hedging can provide a more cost effective means of managing risks arising from derivative activities than perfectly matching transactions because it reduces transactional costs and operational risks. Rather than offset each individual derivative transaction, the bank can determine its net positions and hedge only the residual risk in its book of business. In addition, the ability to hold debt securities increases a bank's hedging options and its ability to control risks in its derivatives business, and allows banks to compete more effectively, meet customer demand, and operate more efficiently and profitably.[9]

In engaging in derivative activities and concomitant hedges, banks act as financial intermediaries by exchanging payments with counterparties managing financial risks or otherwise meeting financial needs. Banks have traditionally served as financial intermediaries in taking deposits and making loans. Through permissible derivatives activities, national banks also serve as financial intermediaries exchanging payments with customers to meet customers' financial or risk management needs.

A. Below-Investment Grade Bond Hedges

The OCC has previously determined that a national bank may purchase below-investment grade debt securities in order to hedge customer-driven, bank permissible derivative transactions, provided the bank's EIC is satisfied that the bank has adequate risk management and measurement systems and controls to conduct the activities on a safe and sound basis.[10] In limited circumstances the OCC also has permitted banks to cross-hedge securities derivatives where consistent with a bank's approved hedging risk management processes.[11] Cross-hedging is the use of one security, or a basket or securities, to hedge the risk arising from a transaction involving another, different security.[12] Cross-hedging is premised on the existence of a strong

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cotton, orange juice, sugar, paper, rubber, steel, aluminum, zinc, lead, nickel, tin, cobalt, iridium, rhodium, freight, high density polyethylene (plastic), ethanol, methanol, newsprint, paper (linerboard), pulp (kraft), and recovered paper (old newsprint) derivatives and related indices) and OCC Interpretive Letter No. 1056 (Mar. 29, 2006) (frozen concentrate orange juice, low density polyethylene and polypropylene).

[8] *See* IL No. 892 and IL No. 935, both *supra*.

[9] *See generally* IL No. 892, *supra* (the use of equity holdings, including equities held for hedging purposes, provides substantial financial and operational advantages to banks).

[10] *See* IL No. 935; IL No. 892; and IL No. 1051, all *supra*.

[11] *See* IL No. 935 and IL No. 892, both *supra*.

[12] *See* IL No. 935, *supra*.

correlation between the price movement of different securities. In this case, the Bank may purchase, for hedging purposes, debt securities issued by foreign corporate or governmental entities subject to the standards described below.

Moreover, provided certain conditions are met, below-investment grade bonds purchased for the purpose of hedging risks associated with bank-permissible derivative transactions would not be subject to the provisions of 12 C.F.R. Part 1, which apply to “investment securities.” As discussed below, national banks have several distinct sources of authority to hold debt securities. Each of these authorities has specific limits and standards that apply to the securities held under that authority. Debt securities properly held under one authority need not comply with the limits or standards applicable to another authority.

Under 12 U.S.C. § 24 (Seventh), national banks are specifically authorized to purchase investment securities for their own account subject to limits prescribed in OCC regulations.[13] Purchases of investment securities pursuant to this authority are subject to limits set forth in 12 C.F.R. Part 1. However, the investment securities provisions of Section 24 (Seventh) and Part 1 do not constitute the exclusive source of authority for national banks to hold debt securities. For example, national banks may purchase and hold debt securities pursuant to their lending authority.[14] Moreover, purchases of securities pursuant to these other banking powers, such as lending authority, are not subject to the limits in Part 1. However, national banks purchasing such interests under lending authority must comply with safe and sound lending practices.[15] Such purchases should be based on a complete review of relevant credit information and an informed credit judgment consistent with the acquiring bank’s credit policy, and be subject to appropriate loan administration practices.[16]

Here, the Bank’s authority to hold the debt securities in question is based not on the investment securities authority, but rather on the Bank’s incidental powers under Section 24 (Seventh) to effectively hedge its risks arising under bank permissible derivatives activities.[17] National banks have the authority to engage in the business of banking and in incidental activities that are

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[13] Specifically, the statute provides: “[T]he association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe.”

[14] *See* 12 U.S.C. § 24 (Seventh) and Banking Circular 181 (Rev.), “Purchases of Loans in Whole or in Part-Participations;” *see also* OCC Interpretive Letter No. 600 (July 31, 1992).

[15] *Id.*

[16] *Id.*

[17] Specifically, the statute provides that national banks shall have the authority: “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 this title.”

"useful" or "convenient" to that business.[18] As discussed above, the OCC has found that national banks may engage in a wide variety of customer-driven derivatives transactions as part of the business of banking.[19] Managing the risks arising from permissible banking activities is itself integral to the business of banking. The OCC has previously recognized that, as an activity that is incidental to the business of banking, national banks may hold below-investment grade debt securities in order to hedge risks arising from permissible derivatives activities.[20] Such holdings offer banks cost effective means to manage banking risks and thus are convenient and useful to their banking activities.

The limitations in Part 1, which apply to securities purchased under the Bank's authority to "purchase for its own account investment securities" under Section 24 (Seventh), would not apply to an acquisition of debt securities under the separate incidental authority to hold securities to hedge resulting risks from permissible derivatives activities. When the Bank purchases securities based on its incidental authority to hedge derivatives transactions with below-investment grade debt, these activities are subject to standards specifically applicable to derivatives activities discussed below.[21] As discussed below, however, before the Bank commences the proposed activities, the Bank's EIC must be satisfied that the Bank has adequate risk management and measurement systems and controls to conduct the activities on a safe and sound basis.

B. Safety and Soundness Considerations

For the Bank to permissibly engage in the proposed activities on the basis of its incidental authority to hedge risks arising from otherwise permissible derivatives activities, the Bank's risk measurement and management capabilities must be of appropriate sophistication to ensure that the activity can be conducted in a safe and sound manner, for purposes of hedging and not as a proprietary trading business, and otherwise in accordance with applicable law. Consequently, the Bank must demonstrate to the satisfaction of its EIC that the Bank has established an appropriate risk measurement and management process for the proposed activities.[22] Documentation supplied to the EIC should establish to the satisfaction of the EIC that:

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[18] *See NationsBank of North Carolina v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995); *see also Arnold Tours, Inc. v. Camp*, 472 F.2d 427 (1st Cir. 1972).

[19] *See, e.g.*, IL No. 652, *supra* (equity derivative swaps); OCC Interpretive Letter No. 949 (Sept. 19, 2002) (equity options and forwards); OCC Interpretive Letter No. 962 (Apr. 21, 2003) (electricity derivatives); and OCC Interpretive Letter No. 1040 (Sept. 15, 2005) (emissions derivatives).

[20] IL No. 892, *supra*; OCC Interpretive Letter No. 1033 (June 14, 2005) (hedging equity index derivatives with baskets of securities); *see also* OCC Interpretive Letter No. 1018 (Feb. 10, 2005) (equity hedges on affiliate transactions).

[21] Similarly, Part 1 does not apply to investment grade bonds purchased to hedge permissible derivative transactions.

[22] *See* IL No. 935, *supra* ("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.").

(1) the Bank will hold the securities solely to hedge risks arising from customer-driven bank permissible derivative transactions;
(2) the Bank will not hold the securities for speculative purposes;
(3) the securities will offer a cost-effective means to hedge risks arising from permissible banking activities;
(4) 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; and,
(5) the Bank has an appropriate risk management process place, satisfactory to the EIC, for its hedging activities.

As detailed further in the Comptroller's Handbook: *Risk Management of Financial Derivatives* (January 1997) and OCC Banking Circular 277: *Risk Management of Financial Derivatives* (October 27, 1993), an effective risk 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 effective risk control functions that oversee and ensures the continuing appropriateness of the risk management process. The Bank's risk control processes should include systems to ensure the Bank's compliance with accounting and reporting as stipulated by the instructions for the Consolidated Reports of Condition and Income and generally accepted accounting principles ("GAAP").

Cross-hedging entails basis risk, including the risk that price fluctuations of the hedging instrument will not exactly match the price fluctuations of the underlying transaction.[23] In addition, there can be risks resulting from maturity mismatch, liquidity and credit differences. Bank management thus must be able to justify its cross-hedge, *i.e.*, demonstrate 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 will 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.[24] Accordingly, the Bank may engage in cross-hedging, provided the Bank's EIC is satisfied that the Bank has adequate risk management and measurement systems and controls to conduct the activities on a safe and sound basis.

The Bank's processes must also 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-propriety trading business. The compliance monitoring program must include policies, training, independent surveillance and well-defined exception approval and reporting procedures.

Further, the Bank must conduct these activities in a safe and sound manner, consistent with prudential limits established by Bank management. Such prudential limits are subject to the satisfaction of the Bank's EIC that, at any given time, the prudential limits are adequate. The

[23] *See, e.g.*, OCC Interpretive Letter No. 878 (Dec. 22, 1999) and OCC Interpretive Letter No. 632 (June 30, 1993).

[24] *See* IL No. 935, *supra*.

EIC may permit the Bank to net a short and long position in the same bond, as long as any residual or basis risks are measured, in order to comply with any EIC imposed prudential limit on such holdings.[25]

Conclusion

OCC precedents have previously recognized the authority of banks to engage in customer-driven derivative transactions and to hedge the risks arising from those transactions through a broad range of risk management tools including below-investment grade debt securities.[26] We conclude that the Bank may engage in the transactions it proposes, subject to standards and requirements applicable to derivative activities set forth herein, rather than those set forth in 12 C.F.R. Part 1. However, before the Bank commences the proposed activities, the Bank's EIC must be satisfied that the Bank has adequate risk management and measurement systems and controls to conduct the activities on a safe and sound basis. Our conclusions herein are specifically based on the Bank's representations and written submissions describing the facts and circumstances of the subject transactions. Any change in the facts or circumstances could result in different conclusions. If you have any additional questions, please do not hesitate to contact Tahmineh Maloney, Attorney, Securities & Corporate Practices Division at (202) 874-5210.

Sincerely,

signed

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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[25] In calculating compliance with Part 1, the Bank may not net positions acquired under its derivatives hedging authority with investment securities holdings. Because securities purchased under different authorities are purchased for different purposes, netting would not be appropriate.

[26] *See, e.g.*, IL No. 892, *supra* (national banks may take positions in equity securities solely to hedge customer-driven, bank permissible equity derivatives transactions).