



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

June 27, 2002

Interpretive Letter #937
June 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

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.

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 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

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) (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."

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 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* 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* 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,

³ See, e.g., OCC Handbook: *Risk Management of Financial Derivatives* (January 1997) (“*OCC Derivatives Handbook*”); 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.

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 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

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* (e.g., at 20-21 and Appendix B) as primary component measures of option sensitivity.

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.

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 U.S.C. § 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 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

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 *Matched 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 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. 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.

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.

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

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 U.S.C. § 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**. *See, e.g.*, 2000 CFTC Ltr. LEXIS 248 (December 4, 2000).

¹⁵ (emphasis added). *See* P.L. 106-102, 113 Stat. 1338 (1999), §§ 201, 202, 206.

¹⁶ H.R. Rep. No. 106-434 at 163 (1999) (Summary of Title II in Managers’ Statement).

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 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 x 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 cashflow 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).

¹⁷ 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* 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 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 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*.

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 '34 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

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*.

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 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* 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

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*.

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 C.F.R. §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 § 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* 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.

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 through 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.

Sincerely,

-signed-

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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 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).