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National Banks Cautioned on Derivatives in Fiduciary Accounts

WASHINGTON, DC -- The Office of the Comptroller of the Currency (OCC) issued guidance today on managing the risks of derivatives and mortgage-backed securities investments by national banks for their fiduciary accounts. The guidance reflects risk management principles set forth in the OCC's 1993 circular on risk management of financial derivatives.

Today's guidance makes clear that a national bank acting as a fiduciary must address credit, interest rate, liquidity, price, foreign exchange, transaction, compliance, strategic and reputation risk, just as in the managing of proprietary activities. The OCC cautions national banks that derivatives investments that are acceptable transactions for the bank's own account may not be acceptable for a bank acting as a fiduciary.

"We are cautioning banks, with respect to fiduciary activities specifically, that they must carefully manage all risk," said Douglas E. Harris, Senior Deputy Comptroller for Capital Markets. "We are particularly concerned about collateralized mortgage obligations and structured notes."

Today's guidance sets forth risk management principles to be followed when derivatives are invested for fiduciary accounts, including the establishment of:

- policies and procedures, risk measurement and reporting systems, and independent oversight and control processes that are in place before a national bank invests in derivatives for a fiduciary account;

- an effective audit program addressing the fiduciary investment process;

- a system that separates the traders and those making investment decisions from the risk monitoring and control functions;

- mechanisms to determine accurate market values for derivatives instruments, including scenario analysis that uses stress tests to measure cash flow and economic values under varying market conditions.

The OCC guidance also addresses the practice of dividing or participating a derivatives instrument among several fiduciary accounts. Before engaging in this practice, the OCC says a national bank should consider the resulting loss of liquidity which diminishes the value of the instruments. When a national bank seeks to compensate for the loss of liquidity by selling participations between fiduciary accounts, the OCC notes that the sale must be fair to both accounts and not prohibited by governing law.

A copy of the guidance can be obtained through the OCC Information Line at (202) 479-0141 (request document number 29625) or on the Internet at http://www.occ.treas.gov/.

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