Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

Interpretive Letter #878
January 2000
12 USC 24(7)

December 22, 1999

Re: **[ ]** Bank, National Association/**[ ]**, Inc.
Nonqualified Employee Deferred Compensation Plan

Dear **[ ]**:

This responds to your letter of December 20, 1999 on behalf of your client,**[ ]** (the "Bank") requesting that the Office of the Comptroller of the Currency ("OCC") not object to the Bank's subsidiary **[ ]**, Inc.,[1] holding various insurance company products and investment funds in order to hedge, on a dollar-for-dollar basis, **[ ]**'s obligations to make payments to employees under nonqualified deferred compensation plans. Based on the representations made by the Bank, the OCC does not object to **[ ]** conducting the proposed activities.

I. BACKGROUND

[ ] proposes to hold various insurance company products and investment funds in order to hedge, on a dollar-for-dollar basis, its obligations to make payments to employees under a non-qualified deferred compensation plan. Under the terms of the plan, a participating employee will defer a portion of his or her income from a bonus for a period of time and select a benchmark fund from among a list of options. At the distribution date selected by the employee, he or she will receive the sum of the changes in values of deferred amounts indexed to the various benchmarks over the period that the employee selected each benchmark. The performance of an employee's deferred compensation account is indexed to the performance of selected benchmark investments. Employees will not own an

[1] In this letter, "**[ ]**" refers to **[ ]**, Inc. and its subsidiaries.

interest in the benchmark funds. Instead, employees will own an unsecured contractual obligation of **[ ]** to pay the deferred amount at the distribution date.[2]

[ ] proposes to offer its employees a variety of registered investment companies and private investment funds managed by **[ ]**, as well as investment funds managed by third parties, as benchmark funds under the plan. These benchmark funds will include funds that invest exclusively in bank-eligible assets, as well as funds that invest in assets traditionally impermissible for investment by a national bank.

[ ] proposes to hedge its obligations under this plan. **[ ]** will acquire the number of units of each benchmark fund selected by each participating employee that equals the value of deferred compensation divided by the net asset value of a unit, and hold those units for the period of time that the employee elects to use that benchmark fund as an index. In this way, all of the increase in value and all of the decrease in value of the units (including reinvested dividends) held by **[ ]** as a hedge exactly equals **[ ]**'s obligations under the plan.

[ ] seeks to make its hedging investments in a way that is most neutral to **[ ]** from a tax and financial accounting standpoint. To this end, **[ ]** may invest in insurance company products such as variable life or variable annuities that are funded by the insurance companies through an investment in an insurance company separate account. This separate account will invest in an underlying registered investment company or private investment company that is managed by **[ ]** or a third party, or in a separate account that is managed in a way and invested in assets substantially identical to the benchmark fund selected by the employee. In the alternative, **[ ]** may instead invest directly in the benchmark funds, or invest through a "Rabbi Trust" in the benchmark funds.

II. DISCUSSION

[ ] is an operating subsidiary of the Bank. As a general matter, a national bank may engage in activities that are part of or incidental to the business of banking by means of an operating subsidiary.[3] An operating subsidiary is subject to the same banking laws, regulations and OCC examinations and supervision as the national bank, unless otherwise provided by statute or regulation.[4]

---

[2] **[ ]**'s obligation is unsecured in order to avoid current inclusion of the deferred compensation in the employee's taxable income. *See* Internal Revenue Code § 83.

[3] *See* 12 U.S.C. § 24(Seventh).

[4] *See* 12 C.F.R. § 5.34(d)(1).

A. National Banks May Compensate Employees and Provide Employee Benefit Plans As Part of the Business of Banking

The National Bank Act, in relevant part, provides 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 receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes … .[5]

The Supreme Court has held that the powers clause of 12 U.S.C. § 24(Seventh) is a broad grant of power to engage in the business of banking, including but not limited to the enumerated powers and the business of banking as a whole.[6]

National banks and their operating subsidiaries have explicit authority to hire various officers. A national bank is expressly permitted "[t]o elect or appoint directors, and by its board of directors to appoint a president, vice president, cashier, and other officers, define their duties, require bonds of them and fix the penalty thereof, dismiss such officers or any of them at pleasure, and appoint others to fill their places."[7] In order to exercise this express authority, a national bank must have the power to compensate reasonably those employees it hires.[8] The power to compensate is a logical and necessary outgrowth of the power to employ officers and other employees, provides banks and their customers with substantial benefits, and involves risks banks have managed since their inception.[9]

---

[5] 12 U.S.C. § 24(Seventh).

[6] *See NationsBank of North Carolina, N.A. v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("VALIC").

[7] 12 U.S.C. § 24(Fifth).

[8] *See* 12 U.S.C. § 24(Seventh) ([a national bank shall have the power] [t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking).

[9] There are three general principles used to determine whether an activity is within the scope of the "business of banking": (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking function; (2) would the activity benefit bank customers and/or strengthen the bank; (3) does the activity present risks of a type similar to those already assumed by banks. *See, e.g.,* Interpretive Letter No. 845 (October 20, 1998), *reprinted in* [1998-99 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-300; Interpretive Letter No. 812 (December 29, 1997), *reprinted in* [1997-98 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-260; Interpretive Letter No. 742 (August 19, 1996), *reprinted in* [1996-97 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-106. The power to compensate also is "convenient or useful" in performing an expressly stated power. *See Arnold Tours, Inc. v. Camp,* 400

While federal banking law does not expressly limit the form of compensation that a national bank may provide its employees, that compensation must be consistent with safety and soundness considerations.[10] National banks and their operating subsidiaries may establish and operate benefit plans for their employees.[11] Consistent with safety and soundness standards, a national bank also may provide its officers and employees deferred compensation through reasonable means.[12]

B. National Banks May Hedge Risks Arising From Employee Benefit Obligations Under Incidental Authorities

Section 24(Seventh) authorizes national banks to engage in activities that are incidental to enumerated bank powers as well as the broader "business of banking."[13] Prior to *VALIC*, the standard that was often considered in determining whether an activity was incidental to banking was the one advanced by the First Circuit Court of Appeals in *Arnold Tours, Inc. v. Camp*.[14] The *Arnold Tours* standard defined an incidental power as one that is "convenient or useful in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act."[15] Even prior to *VALIC*, the *Arnold Tours* formula represented the narrow interpretation of the "incidental powers" provision of the National Bank Act.[16] The *VALIC* decision, however, has established that the *Arnold Tours* formula provides that an incidental power includes one that is convenient and useful to the "business of banking," as well as a power incidental to the express powers specifically enumerated in 12 U.S.C. § 24(Seventh).

U.S. 45 (1970) (per curiam), 472 F.2d 427 (1st Cir. 1972); Letter from Ellen Broadman, Director, Securities and Corporate Practices Division (January 19, 1995)(Unpublished).

[10] *See* 12 U.S.C. § 1818(b); 12 C.F.R. part 30.

[11] *See* 12 C.F.R. § 7.2011(a) (A national bank may adopt a bonus or profit-sharing plan designed to ensure adequate remuneration of bank officers and employees).

[12] *See* Letter from Christopher C. Manthey, Senior Attorney, Bank Activities and Structure Division (June 21, 1996)(Unpublished).

[13] *See VALIC*, 513 U.S. at 258 n.2.

[14] 472 F.2d 427 (1st Cir. 1972).

[15] *Id.* at 432.

[16] *See* Interpretive Letter No. 494 (December 20, 1989), *reprinted in* [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083.

Incident to the permissible activity of compensating employees, **[ ]** proposes to hedge its deferred compensation obligations, on a dollar-for-dollar basis, by holding insurance company products and investment funds. Hedging risks arising from banking activities is “convenient and useful,” and incidental to the business of banking.[17] The proposed hedge is particularly effective since it virtually eliminates all risks to the Bank and **[ ]** from the employee compensation program.

(1) Proposed Holdings Do Not Conflict with Section 24(Seventh) Restrictions

Section 24(Seventh) limits the authority of a national bank to underwrite and deal in corporate debt and equity securities. A national bank dealing in securities and stock is “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.”[18] **[ ]**, however, will not be acting as a “dealer” or “underwriter” with respect to the shares that it owns in the investment funds. Therefore, **[ ]**’s proposed investments would not implicate the prohibitions on underwriting and dealing in securities in Section 24(Seventh). Moreover, **[ ]** will not rely on the authorization in Section 24(Seventh) to purchase “investment securities” to make the proposed fund investments.

The 1933 Act also added the following new sentence, “Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association of any shares of stock of any corporation.”[19] In a 1996 memorandum in support of a revised operating subsidiary regulation, OCC staff argued that it is important to recognize what this sentence is, and what it is not.[20] The staff argued that it is not a bar on national bank ownership of corporate stock. Rather, it is a disclaimer which clarifies that “nothing herein contained”, *i.e.*, nothing in the amendments to Section 24(Seventh) made by Section 16 of the 1933 Act, should be construed to increase the authority of national banks to own stock. The staff also stated that the sentence recognizes that if a national bank’s stock-ownership is “otherwise permitted by law”, it remains permissible. Such “law” includes the powers sentence at the beginning of Section 24(Seventh), which dates back to 1864 and was not altered by the Section 16 changes. Thus, the proposed fund investments to hedge employee benefit obligations, which are authorized by the powers clause, rather than the provisions added in Section 16 of the 1933 Act, would not be restricted by the disclaimer provision.

---

[17] *See generally Arnold Tours, Inc. v. Camp*, 472 F.2d 427 (1st Cir. 1972).

[18] 12 U.S.C. § 24(Seventh).

[19] *Id.*

[20] *See* Memorandum from Julie L. Williams, Chief Counsel, to Eugene A. Ludwig, Comptroller of the Currency (November 18, 1996) (Legal Authority for Revised Operating Subsidiary Regulation), *reprinted in* [1996-97 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 90-464.

OCC precedent has recognized that national banks may acquire equity investments and make noncontrolling investments that are necessary to conduct a banking business, and not motivated by speculative purposes. **[ ]**'s proposal lacks the speculative characteristics for the Bank and its operating subsidiaries with which Congress was concerned in passing the prohibitions of Section 24(Seventh). The Bank and **[ ]** will own the assets only as a necessary incident to engaging in the permissible banking activity of employee compensation. In addition, all gains and losses attributed to these investments will ultimately be passed-through to the participating employees. Section 24(Seventh) thus does not restrict **[ ]**'s proposed investments.

(2) National Banks May Fund or Hedge Exposures From Banking Activities Through Acquisition of Bank Eligible and Ineligible Assets

In the past, the OCC approved various plans by national banks for hedging risks, while not permitting speculative activities as prohibited by the National Bank Act.[21] Previous OCC opinions recognize the importance of hedging liabilities under employee benefit plans as a legitimate banking activity.[22] For example, national banks may purchase and hold life insurance under 12 U.S.C. § 24(Seventh) in connection with employee compensation and benefit plans.[23] National banks may use permanent insurance to finance or recover the cost of pre- and post-retirement employee benefit plans.[24] A national bank may purchase whole life insurance and use the death benefits eventually received under the policies to recover the cost of payments made to officers and directors, or fund remaining payments owed to beneficiaries.[25] Payments to beneficiaries may be made on an installment basis.[26]

---

[21] For example, a national bank may purchase an interest in an insurance company separate account that in turn invests in bank-eligible securities. *See* Interpretive Letter No. 826 (March 17, 1998), *reprinted in* [1997-98 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-275. As part of this investment strategy, the separate account, for purposes of hedging price and interest rate exposure, may enter into exchange traded and over-the-counter futures and options transactions; interest rate swaps, caps and floors; short sales of U.S. Treasury and Agency securities; and covered dollar rolls, with the proceeds reinvested in short-term investments maturing within five days of the maturity date of the corresponding dollar roll. *See id*.

[22] *See generally* OCC Bulletin 96-51 (September 20, 1996), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 35-491; Interpretive Letter No. 848 (November 23, 1998), *reprinted in* [1998-99 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-303.

[23] *See* OCC Bulletin 96-51, *supra*; Interpretive Letter No. 848, *supra*.

[24] *See* OCC Bulletin 96-51, *supra*.

[25] *See* Interpretive Letter No. 848, *supra*.

[26] *See id.*

A national bank may establish a "rabbi trust" to provide reasonable, deferred compensation for its officers and employees consistent with safety and soundness considerations.[27] The trust may hold investments beyond those allowed for national banks, without violating Section 24(Seventh) and 12 C.F.R. part 1, if the Bank does not receive any income or profit from the trust's assets, and the trust meets all other applicable requirements under state and federal law, the Internal Revenue Code, and ERISA.[28]

National banks and their operating subsidiaries may offer equity derivative swaps, where consistent with safe and sound banking principles.[29] At times, banks may hedge swaps exposure by acquiring or selling non-swap financial derivative instruments, such as exchange-traded equity futures or options. This hedging transaction serves the same purpose as offsetting contracts between shorts and longs, to counteract the risk associated with the initial swap.[30]

A national bank also may offer a non-transferable time deposit account paying interest based in part on movements in the S&P 500 Index, and hedge its interest obligations by purchasing or selling futures contracts on the same index.[31] The hedging activity is an important complement to the bank's expressly authorized deposit-taking authority, and provides a prudent means of managing the bank's interest rate exposure risk. This strategy also provides national banks with the flexibility to establish the amount of the payments to be made and received under their deposit and loan contracts based on market conditions and the needs of their customers.[32]

A national bank may act as principal in unmatched commodity price index swaps with their customers.[33] As part of such a strategy, the bank may hedge any unmatched commodity price risk exposure by purchasing and selling exchange-traded commodity futures with the intention of entering

---

[27] *See* Letter from Ellen Broadman, *supra*; *see also* 12 U.S.C. § 24(Fifth).

[28] *See generally* Letter from Ellen Broadman, *supra*.

[29] *See* Interpretive Letter No. 652 (September 13, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600.

[30] *See id.*

[31] *See* Decision 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).

[32] *See id.*

[33] *See* No Objection Letter No. 90-1 (February 16, 1990), *reprinted in* [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095.

into offsetting commodity price swaps if they become available. The bank may not use the unmatched contracts or futures to speculate in commodity price movements.[34]

In addition, a national bank may, subject to limitations, hedge the financial exposure arising from otherwise permissible banking activities in markets that involve physical delivery of commodities.[35] In some cases, exchange-traded and over-the-counter transactions do not provide the most accurate hedges possible, thereby exposing the bank to basis risk.[36] Access to the physical markets provides a more precise hedge in these cases. Such hedging activity is limited in scope, used only to supplement a bank's existing hedging activities, and is customer driven and not for speculative purposes.[37]

In each case cited above, the hedging investment was viewed as an asset held incidental to a permissible banking activity in order to hedge the bank's obligations, rather than as a security held by the bank for investment. The transactions were used to manage risks arising from otherwise permissible banking activities and not entered into for speculative purposes. In much the same manner, incidental to the permissible banking activity of providing deferred compensation to employees, **[ ]** may hold otherwise ineligible assets for the sole purpose of hedging on a dollar-for-dollar basis its obligations to employees under nonqualified deferred compensation plans. This conclusion is consistent with the foregoing OCC precedents permitting bank-impermissible investments for hedging purposes to manage risks arising from permissible banking activities. The hedges proposed by **[ ]** offer a particularly well matched and effective risk management mechanism. As the cases above illustrate, offsetting banking risks in this manner is a prudent and desirable goal for national banks.

For these reasons, we now conclude that **[ ]** may hold interests in investment funds, "Rabbi trusts," and variable life insurance and annuities[38] products through separate accounts for the sole described purpose of hedging employee deferred compensation plans.

---

[34] *See id.*

[35] *See* Interpretive Letter No. 632 (June 30, 1993), *reprinted in* [1993-94 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,516.

[36] Basis risk is the risk that the price fluctuations of the hedging instrument will not exactly match the price fluctuations of the underlying transaction.

[37] *See* Interpretive Letter No. 632, *supra*.

[38] Moreover, we note that there are strong arguments for the assertion that variable annuities are not "securities" for purposes of Section 24(Seventh).

III. CONCLUSION

For the reasons discussed above, the OCC will not object to the Bank or **[ ]** holding interests in insurance company products, investment funds, and “Rabbi trusts” in order to hedge, on a dollar-for-dollar basis, their deferred compensation obligations to employees. This position is based on the facts and representations made in your letter and any material changes in the facts or conditions may result in a different conclusion. Please note that we take no position regarding **[ ]**’s possible future plans that differ from the described voluntary deferral of compensation by participating employees.

Very truly yours,

/s/

Julie L. Williams
First Senior Deputy Comptroller and
Chief Counsel