Comptroller of the Currency Administrator of National Banks

Washington, DC 20219

August 21, 2000

Interpretive Letter #896 October 2000 12 USC 24(7)

Dear []:

This is in response to your letter of July 29, 1999, requesting confirmation that the [], [*City, State*] (the "Bank") may buy cash-settled options on certain commodity futures contracts where the underlying commodity is the primary collateral on an agricultural loan. The Bank would purchase the options to hedge its risk with respect to the value of the collateral.¹

For the reasons discussed below and subject to the limitations described herein, we believe that the proposed hedges may be legally permissible as part of the business of banking, however, given the potentially large financial and reputation risks associated with the proposed hedging activity, it would not be safe and sound for a national bank to engage in the proposed activities unless it has an appropriate risk management process in place. Prior to any bank purchasing options on futures contracts on bank impermissible commodities to hedge the credit risk in its loan portfolio, the Assistant Deputy Comptroller responsible for supervision of the bank and the Director of Treasury and Market Risk would need to affirm that the bank has an effective risk management process in place. As detailed further in the Comptroller's Handbook "Risk Management of Financial Derivatives" (January 1997) and OCC Banking Circular 277,² an effective risk management process would include Board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification, measurement and management information systems, as well as effective risk control

¹ The options are cash-settled, used only to protect against credit risk on the Bank's loan portfolio, and not purchased for speculative purposes. The Bank will never exercise the options and enter into futures contracts to sell the underlying commodities or take physical possession of the underlying commodities.

² OCC Banking Circular 277 (October 27, 1993) (BC-277).

functions that oversee and ensure the continuing appropriateness of the risk management process.

Since the Bank has not provided sufficient information regarding the operation of the proposed hedges, we are unable to conclude that it would conduct the activity in a safe and sound manner. Accordingly, we cannot advise that this activity is permissible for the Bank, at this time.

II. Background

The Bank indicates that the purpose of buying cash-settled options based on the collateral securing the Bank's agricultural loan portfolio is to hedge against price fluctuations in the commodities market. More particularly, the Bank intends to buy put options on futures contracts for commodities that serve as the primary collateral for agricultural loans made by the Bank.

An option generally gives the buyer of the option the right, but not the obligation, to acquire an asset at a specified price by or on a specified date. In the case of options on futures contracts, the immediately underlying asset is a futures contract on the specified commodity. The option-holder has the right to enter into a futures contract to buy or sell the commodity at a certain price by a certain date.³ A "put" option on a futures contract represents the right to enter into a short futures position at a certain price.⁴ A short futures position is the right to sell the underlying commodity at a certain price for delivery on a certain date.⁵

The use of options is a common method to hedge against adverse price movements affecting the value of assets. More particularly, put options can protect against a decrease in the price of an asset. For example, if an investor owns 100 shares of stock in XYZ Corporation and seeks protection against a decline in the value of the stock, the investor may purchase a put option that gives the investor the option to sell 100 shares at a particular price, commonly referred to as the strike price of the option. If the market drops below the strike price, any loss to the investor on the 100 shares of stock will be offset by the increased value of the put option.

For hedging purposes, options on futures contracts function similarly and have certain advantages over options on the actual commodity. Each instrument derives its value from the future price of the underlying commodity and represents the right to purchase that commodity. A futures price is easily determined from the futures exchange; however, the cash or spot price for the underlying asset may not be as readily available.

³ John C. Hull, *Introduction to Futures and Options Markets* 289 (3d ed. 1998).

⁴ *Id*.

⁵ Id. at 1.

⁶ Michael C. Thomsett, *Getting Started in Options* 166, 191(2d ed. 1993); The Options Institute, *Options: Essential Concepts and Trading Strategies* 160 et seq. (1990).

The Bank indicates that it encourages its borrowers to hedge the value of their collateral with options in the futures markets but that about one third of its borrowers do not hedge for a variety of reasons, including lack of familiarity with the futures and options markets. As a result, the Bank proposes to enter into put options on commodity futures to hedge its risk on this portion of its loan portfolio. The Bank indicates that it would like to manage the hedging activity on a portfolio basis, rather than on an individual loan basis. Managing the activity in this manner would be both less costly and more efficient. Purchasing cash-settled options to hedge on an aggregate basis would diminish the number of transactions, thereby saving on transaction costs and minimizing the number of individual transactions that the Bank will need to monitor.

II. Discussion

A. Hedging Risks Arising from Bank Permissible Banking Lending Activities is Integral to Those Permissible Activities

Making loans is an express power listed in the National Bank Act and is recognized as a core part of the business of banking.⁷ It is also well established that banks may accept as collateral interests in assets that the bank is not authorized to purchase directly.⁸ Making loans secured by agricultural commodities is a permissible banking activity, even though banks are not authorized to invest directly in the agricultural commodities.⁹ Loans, deposits, and other contracts involve risks that banks must manage as part of the business of banking.¹⁰ Banks hedge loans, deposits, and other contracts as a means of managing those risks.¹¹ Banks must manage or "hedge" the risk in their loan transactions to

⁷ The National Bank Act provides, in pertinent part, 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 loaning money on personal security." 12 U.S.C. 24 (Seventh).

⁸ Knowlton v. Fourth Atlantic National Bank, 264 Mass. 181, 162 N.E. 356 (1928) (citing first National Bank v. Anderson, 172 U.S. 573(1899); Lucas v. Federal Reserve Bank, 59 F. 2d 617 (4th Cir. 1932); Michie on Banks and Banking, Chapter 15, § 185 (1999).

⁹ The general lending limit set forth in 12 U.S.C § 84 specifically provides exceptions from applicability of the limit for a variety of secured loans, including certain loans secured by livestock and marketable staples.

¹⁰ OCC "Bank Supervision Process Booklet" Comptroller's Handbook for National Bank Examiners (April 1996). In fact, a 1992 decision by an Indiana court and a class action filed in 1991 in the U.S. District Court of the Southern District of Texas suggest that a duty exists for corporations to hedge their exposures to changing commodity prices and currency values. Brane v. Roth, 590 N.E. 2d 587 (Ind. Cir. App. 1992); In re Compaq Securities Litigation, 848 F. Supp. 1307 (S.D. Tex. 1993).

OCC Letter from Ellen Broadman, Director, Securities and Corporate Practices Division, OCC, to Barbara Moheit, Regional Counsel, FDIC (October 29, 1998)(unpublished)("Broadman Letter"); OCC Interpretive Letter No. 725 (May 10, 1996), *reprinted in* [1995 - 1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,040; OCC No. Objection Letter

operate profitably. Hedging risks arising from those permissible banking activities is an essential and integral part of those banking activities.

The OCC has long recognized that hedging against the risks associated with bank permissible lending activities is an integral part of those permissible banking activities. National banks hedge against the risk of loss due to the interest rate fluctuations inherent in their own loan operations.¹² National banks also hedge bank loans to minimize the credit risk in those transactions.¹³ Hedging loans secured by agricultural commodities is similarly an integral part of permissible lending activities.

B. Banks may Purchase Options on Futures on Agricultural Commodities to Hedge Loans as an Activity that is Part of the Business of Banking

The OCC has long permitted national banks to use futures, options, and options on futures to manage or "hedge" risks in its loan and other contracts as a permissible banking activity. Despite their difference in form, options, futures, and options on futures serve a similar function: enabling banks and investors to hedge against risk of interest rate and price changes relating to the underlying instruments. ¹⁴ The use of options on futures contracts on agricultural commodities to hedge bank permissible lending activities, is not materially different from hedging loans with futures and options and therefore, is permissible for national banks. ¹⁵

90-1 (February 16, 1990), reprinted in [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095 (the "Unmatched Swaps Letter"); 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 ("MII Deposit"); OCC No-Objection Letter No. 87-5 (July 20, 1987), reprinted in [1988 - 1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034 (the "Matched Swaps Letter").

¹² Comptroller's Handbook, "Mortgage Banking" (March 1996); OCC Letter to Gregory Crane (October 26, 1976); OCC Letter to Alan E. Rothenberg, Vice President, Bank of America, from Robert Bloom, First Deputy Comptroller (Policy)(October 11, 1976). Similarly, the Department of the Treasury recognizes that the interest rate risk of fixed-rate loans can be neutralized by hedging with appropriate interest rate swap, forward, futures, or option contracts. Department of the Treasury, Banking Industry - Trends and Current Issues: Report titled "Modernizing the Financial System" (November 6, 1995).

¹³ OCC Banking Bulletin 96-43: Credit Derivatives, Guidelines for National Banks (August 12, 1996); OCC Interpretive Letter No. 356 (January 7, 1986), *reprinted in* [1985 - 1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,526. In addition, national banks may assist customers in hedging their own loans against cash market risks, by obtaining, or by assisting customers in obtaining, hedging instruments. OCC Letter to Jeffrey S. Lillien, The First National Bank of Chicago (June 19, 1986); OCC Letter to Randall R. Kaplan, Caplin & Drysdale from Judith A. Walter, Senior Deputy Comptroller (June 13, 1986); OCC Interpretive Letter No. 356 (January 7, 1986), *reprinted in* [1985 - 1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,526; OCC Letter to Thomas N. Rose, Eldredge & Clark, from Michael A. Mancusi, Senior Deputy Comptroller for National Operations (November 5, 1985).

¹⁴ See OCC Letter to Lee Pickard, Esq., Pickard & Djinis from Michael Patriarca, Deputy Comptroller for Multinational Banking (February 26, 1986).

¹⁵ Comptroller's Handbook "Interest Rate Risk," (June 1997); Comptroller's Handbook "Risk Management of Financial Derivatives" (January 1997).

Banks may use futures, options, and options on futures to hedge risks arising from lending activities. In 1976, the OCC issued BC-79, which advised all national banks that the use of T-bill futures and GNMA mortgage futures to hedge interest rate risk could be a permissible banking activity. Subsequently, BC-79 was revised to cover more generally financial futures contracts, as well as certain other types of contracts, that could be used effectively to reduce interest rate risk in permissible commercial banking activities. The guidelines in the circular indicated that a bank's board of directors should endorse specific written policies and procedures authorizing the use of such contracts and that the policies' objectives should be specific enough to outline permissible contract strategies and their relationships to other banking activities. The 1983 revision of BC-79 recognized that the use of financial futures contracts to hedge interest rate risks was a permissible banking activity.

Since the third revision of BC-79, the OCC issued a number of letters concluding that national banks may purchase futures and options for hedging purposes as an activity permissible for national banks. The OCC has recognized the permissibility of such activities both for the purpose of providing bank customers with the ability to hedge their own risks and as a means for banks to hedge directly the risks that arise from permissible banking activities.¹⁹ Furthermore, although many decisions involve the use of futures and options where the bank is authorized to purchase and sell for its own account the underlying asset, the OCC has also recognized the permissibility of a bank's use of derivatives for hedging risk

 16 See OCC Banking Circular 79(November 2, 1976)(BC-79). See also OCC Interpretive Letter (September 21, 1977, reprinted in [1978 - 1979 Transfer Binder] Fed. Banking L. Rep. (CCH) \P 85,037.

¹⁷ BC-79 was amended by BC-79(Supplement 1)(August 1, 1977), then revised by BC-79(2nd Rev.)(March 18, 1980), then amended by OCC Banking Circular 79(3rd Rev.)(April 19, 1983). On October 27, 1993, the OCC issued OCC Banking Circular-277, *supra*, which provided comprehensive guidance on all forms of derivatives and simultaneously rescinded BC-79(3rd Rev.).

¹⁸ OCC Banking Circular 79(3rd Rev.), *supra*. OCC documents that address derivative hedges and predate *NationsBank of North Carolina v. Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) often characterized the activity as "incidental" to the business of banking. Upon reexamination, the OCC has concluded that hedging with cash-settled derivatives is an activity that is part of the business of banking. *See, e.g.*, Broadman Letter, *supra*.

¹⁹ See OCC Interpretive Letter No. 356 (January 7, 1986), supra, (bank registered as a futures commission merchant ("FCM") could execute customer orders for agricultural and metals futures in connection with its loans to the customers); MII Deposit, supra, (bank could offer a deposit with a rate of return based in part on the return on a stock index and could hedge the bank's interest rate risk by purchasing futures on that stock index); Matched Swaps Letter, supra, (bank could act as principal in commodity price index swaps with its customers); Unmatched Swaps Letter, supra, (bank could act as principal in unmatched commodity price index swaps with its customers and hedge its price risk exposure using exchange-traded commodity futures); OCC Letter from Horace G. Sneed, Senior Attorney, Legal Advisory Services Division (March 2, 1992) (unpublished) (the "Swaps Warehousing Letter") (bank could manage its commodity index swaps on a portfolio basis and hedge the swaps with swaps, exchange-traded futures or OTC options); OCC Interpretive Letter No. 652 (September 13, 1994), reprinted in [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600 (bank could engage in equity and equity derivative swaps and hedge risk using futures contracts, options and similar over-the-counter (OTC) instruments).

where the derivatives are based upon commodities that the bank is not permitted to trade or invest in directly.²⁰

In OCC Interpretive Letter No. 356, the OCC allowed a bank's operating subsidiary, already established as a registered FCM under the Commodity Exchange Act, to execute customer orders for agricultural and metals futures in connection with its loan business with those bank customers.²¹ The OCC found that performing FCM business in agricultural and metals futures for loan customers' hedging transactions was a permissible banking activity, noting that "futures are often used as a risk management tool to hedge against price and other risks incurred in the cash markets for commodities." In reaching that conclusion, the OCC further noted that banks often advise, or in some cases require, their loan customers to hedge against risks underlying their loans by engaging in futures transactions.²²

Although OCC Interpretive Letter No. 356 focused on the use of futures contracts as a risk management tool for bank customers, the OCC subsequently applied the same rationale where a bank was permitted to purchase futures to hedge its own bank permissible transactions. In *MII Deposit*, the OCC considered the permissibility of the bank's use of futures contracts on the Standard & Poor's 500 Composite Stock Index ("S&P 500 Index") to hedge its interest rate exposure on deposits that paid interest at a rate based in part on the S&P 500 Index.²³ The threshold issue the OCC confronted was whether the bank had the authority to offer a deposit product with interest based in part on a stock index. The OCC concluded that the offering of the deposit was permissible under the express authority of 12 U.S.C. § 24(Seventh) for national banks to receive deposits. The OCC then went on to conclude that the use of futures contracts on the S&P 500 Index to hedge the bank's interest rate exposure on the deposits was also a permissible banking activity.

In the *MII Deposit* analysis, the OCC noted that national banks are permitted, and indeed encouraged, to manage prudently the exposure arising out of bank activities, and they must be allowed the flexibility to use the most suitable risk management tool. What was important in *MII Deposit* was the fact that the futures hedging activities were conducted in connection with expressly authorized banking activities. Whether the futures hedge was for the benefit of bank customers, as in OCC Interpretive Letter 356, or for the bank's own account, the OCC has concluded that futures hedges are permissible for national

²⁰ See Unmatched Swaps Letter, supra; Swaps Warehousing Letter, supra; OCC Interpretive Letter No. 652, supra.

²¹ OCC Interpretive Letter No. 356, *supra*; *see also* OCC Letter from Judith A. Walter, Senior Deputy Comptroller (June 13, 1986)(unpublished).

²² In OCC Interpretive Letter No, 356, *supra*, the bank specifically represented that it would not purchase and sell the futures contracts for its own account, and the OCC's opinion addressed only a bank's ability to execute customer orders for hedging transactions in connection with bank loans to the customers.

²³ MII Deposit, supra; see also Investment Company Institute v. Ludwig, 884 F. Supp. 4 (D.D.C. 1995) (controlling effect given to MII Deposit in denying plaintiff's motion for summary judgment in suit claiming that the MII program violated the Glass-Steagall Act).

banks if conducted in accordance with safety and soundness considerations. The OCC also specifically rejected the argument that purchasing S&P 500 Index futures contracts was impermissible because the bank was not generally permitted to purchase the underlying securities.

Other OCC precedents have reached similar conclusions permitting bank use of futures and options on futures where the underlying asset is not one the bank is generally authorized to trade or invest in directly, although the OCC was cautious in extending its conclusions to bank activities involving derivatives based on agricultural commodities outside of the limited context described above. Soon after the issuance of Interpretive Letter No. 356, a question of the permissibility of bank activity involving agricultural futures contracts and options on futures arose in the context of a proposed bank acquisition of a firm that was both a registered broker-dealer and a registered futures commission merchant.²⁴ At the time of the acquisition, the firm provided a variety of services for its customers, who were primarily traders, including execution, clearance, and, in some cases, margin financing. In this context, the OCC declined to opine on the permissibility of executing transactions for customers involving agricultural commodities other than for hedging purposes. The OCC noted that the purchase and sale of agricultural futures and options on futures for customers to hedge risks associated with customers' loans from the bank was permissible, but that outside of this limited context, the OCC had not decided whether national banks are authorized to execute transactions for their customers in agricultural futures and options on those futures. In response to another inquiry just three years later, the OCC concluded that such activity could be permissible.

In OCC Interpretive Letter No. 494,25 the OCC considered a proposal under which a bank operating subsidiary would provide execution, clearing, and advisory services for customers in agricultural, petroleum and metals futures contracts and options on those futures contracts. The OCC noted that, in the earlier OCC Interpretive Letter No. 380, this issue had been reserved for further analysis. In OCC Interpretive Letter No. 494, after a detailed legal analysis, the OCC concluded that any power with regard to futures and options on futures is not limited to transactions where the bank has the same power with respect to the underlying item. The letter found that agricultural futures contracts and options thereon are financial instruments in their own right. Because banks have the power to broker financial instruments for customers, the letter concluded that the proposed activity was permissible. The letter further noted that the power of banks to purchase and sell agricultural futures and options on those futures for its own account would require further analysis that would take into account additional considerations. The letter specifically suggested that a bank's use of agricultural futures or options thereon might be permissible where, for example, the bank is using the instruments to hedge its own exposure on the underlying commodity.

OCC Interpretive Letter No. 380 (December 29, 1986), reprinted in [1988 - 1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604.

²⁵ OCC Interpretive Letter No. 494 (December 20, 1989), *reprinted in* [1989 - 1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083.

The ability of a bank to use cash-settled commodity futures and options on commodities not permissible for purchase by national banks to hedge its own risk was expressly analyzed in two subsequent OCC precedents. In the Unmatched Swaps Letter, the OCC concluded that a national bank could act as principal in unmatched commodity price index swaps with its customers and hedge any unmatched commodity price risk exposure using exchange-traded commodity futures.²⁶ The futures would always be cash-settled, and the bank would not be required to receive or deliver any of the underlying commodities. Citing BC-79 and *MII Deposit*, the OCC stated that the purchase and sale of futures contracts to hedge unmatched swaps is equivalent to using futures to hedge exposure on deposits or loans with interest rates linked to movements in the price of a commodity.

In a subsequent letter, the OCC considered a proposal for a swaps program that involved warehousing commodity index swaps and managing them on a portfolio basis.²⁷ In this case, each swap would be hedged with another swap transaction, an exchange-traded futures contract, or an OTC option. As before, the hedging transactions would all be cash-settled and at no time would the bank accept delivery of the underlying commodity. The OCC concluded that these activities were essentially the same as those covered in the Unmatched Swaps Letter and approved the proposal. The OCC specifically noted that banks may use cash-settled commodity futures or options to hedge the risk from a permissible activity, in this case, the swaps transactions, but in no case may purchase those derivatives for their own account. The OCC specifically acknowledged that cash-settled OTC commodity options can serve as hedges and that other cash-settled derivatives involving closely related commodities would also be permitted as hedges.

Finally, in OCC Interpretive Letter No. 652²⁸, the OCC concluded that a national bank may enter into equity swaps and equity derivative swaps and related hedging activities.²⁹ Citing the Unmatched Swaps Letter and the Swaps Warehousing Letter, both of which considered commodity price index swaps, the OCC concluded that similar activity involving equity-based swaps would be permitted and that the bank could hedge the risk arising from the swaps using cash-settled futures contracts, options and similar OTC instruments.

As described above, there is significant OCC precedent permitting bank use of futures and options

²⁶ Unmatched Swaps Letter, *supra*. In the Matched Swaps Letter, *supra*, the OCC had already concluded that engaging in matched commodity price index swaps was incidental both to the business of banking in general and the express power of "loaning of money on personal security." The OCC concluded that such swaps, even though based upon commodities that the bank could not buy and sell directly, were financial arrangements only, because the swaps did not involve delivery of the underlying commodity.

²⁷ Swaps Warehousing Letter, *supra*.

²⁸ OCC Interpretive Letter No. 652 (September 13, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600.

²⁹ The OCC has also concluded that national banks may use cash-settled options to hedge interest rate risk on deposits that pay interest at a rate based on the gain in designated equity indices. Broadman Letter, *supra*.

thereon for hedging risks arising from permissible banking activities. In prior OCC letters, the banks were seeking to hedge against the direct effect of a change in market values on obligations to make payments tied to a particular asset. In all cases, the risk to be hedged was one that naturally arises from a permissible banking activity. OCC precedent permits the use of futures and options for hedging banking risks where the derivatives are based upon assets that ordinarily are not permissible national bank investments and are cash-settled. Although the OCC has not opined on the permissibility of a bank's purchase of options on commodity futures for hedging the specific lending risks presented here, the rationale in these OCC precedents supports the permissibility of the proposed hedging activity as long as it is conducted in a safe and sound manner. Just as in the OCC precedents described above, the activity is a permissible banking activity, the potential risk that naturally arises from that activity has been identified, and a derivative instrument may be used as an effective method to hedge against that risk.

The OCC has clearly acknowledged the utility and permissibility of a variety of derivatives for hedging purposes, including both exchange-traded and OTC options. The OCC has also clearly acknowledged the permissibility of the use of cash-settled futures and options even where the bank typically would not be authorized to trade or invest in the underlying commodity. Most relevant for the present request, the OCC has acknowledged the permissibility of hedging risk on commodity-based swaps with cash-settled commodity futures and options.³⁰

Here, the Bank would, when necessary, sell the options on commodity futures to realize value to offset loan losses in its agricultural portfolio. At no time would the Bank exercise the options and take on the obligation under a futures contract to sell the underlying agricultural commodity. Because the proposed hedging transactions would be cash-settled and the Bank would not make or take delivery of the underlying commodity, the use of options on futures on agricultural commodities for hedging purposes, if effectively managed, would present no greater or different risks to the bank than the use of other cash-settled derivatives on tangible commodities that the bank is not authorized to deal in directly.

C. Supervisory Concerns

As with any activity conducted by the Bank, the hedging activity proposed by the Bank must be carried out in accordance with safe and sound banking principles. The Bank should review carefully the

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³⁰ In OCC Interpretive Letter No. 632, *supra*, the bank indicated that it was engaged in a variety of commodity-linked transactions including making loans, taking deposits and issuing debt instruments, and that it ordinarily used exchange-traded futures and options as well as over-the-counter spot, forward, and options contracts to hedge the risk on its commodity-linked transactions. In response to the bank's request in that case, the OCC ultimately concluded that the bank could also hedge in certain circumstances using the physical commodities because, in those circumstances, the physical commodities offered a more nearly perfect hedge.

³¹ The Bank may, when appropriate, foreclose on the loan collateral. Disposition of foreclosed collateral would be a separate transaction and would not be used in connection with the proposed hedging transactions. We do not address if and when it could be appropriate for a bank to make or take delivery of commodities underlying hedge transactions.

Comptroller's Handbook "Risk Management of Financial Derivatives" (January 1997) and BC-277 on risk management practices for banks engaging in derivatives activities, to obtain guidance in developing the information necessary to demonstrate to the OCC that the proposed activity could be structured to achieve the Bank's risk management objectives. The Bank would not be expected to have fully developed all of the risk management systems called for in the handbook and BC-277 prior to requesting formal OCC concurrence that the proposed hedging activity is permissible. However, the information must be sufficiently detailed to demonstrate that the proposed risk management systems would effectively manage the activities to achieve the Bank's risk management objectives in a safe and sound manner.

As already noted, the Bank should provide detailed information regarding management expertise and the Bank's internal controls and policies and procedures as they apply to the cash-settled hedges. Given the nature of the hedging activity proposed, the Bank's policies and procedures governing the activity should establish both entry and exit strategies. The Bank would need to develop a clear methodology for determining the amount of credit risk in its loan portfolio that the Bank needs to hedge and the price at which the options should be purchased to provide adequate protection against that credit risk. The policies and procedures must also address questions of timing: when to purchase the options and when and under what circumstances to sell the options. Although sale of the options in a declining market but in anticipation of actual loan losses may be appropriate, the Bank's policies and procedures must establish objective criteria for sale of the options sufficient to demonstrate that the options would be used solely to hedge against losses and not for speculation or to provide an independent source of profit for the Bank. Finally, given the size of the Bank and its limited experience with the use of derivatives, your request proposing a new context for the use of derivatives for hedging purposes may raise unique supervisory concerns that need to be addressed. Before commencing the proposed cash-settled hedging activities, the Bank would need to obtain the affirmation of the Assistant Deputy Comptroller responsible for supervision of the Bank, and the Director of Treasury and Market Risk.

We hope that this information is helpful. If the Bank wishes to obtain OCC approval of the proposed hedging activity, we recommend that you contact Assistant Deputy Comptroller Leigh R. Hoge at (918) 492-2082 or Kathyn E. Dick, the Director of Treasury and Market Risk at (202) 874-5670, to discuss how to proceed with developing the necessary information.

Sincerely,

-signed-

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel