



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219
July 24, 2006

**Interpretive Letter #1065
August 2006**

Re: Authority of a National Bank to Engage in Financial Intermediation Transactions

Dear []:

This responds to your request on behalf of [] (“Bank”) that the Office of the Comptroller of the Currency (“OCC”) confirm that the Bank may engage as a financial intermediary in customer-driven, perfectly matched, cash-settled derivative transactions with payments based on reference assets that fall within the following categories or indices: petroleum products, agricultural oils, grains and grain derivatives, seeds, fibers, foodstuffs, livestock/meat products, metals, wood products, plastics and fertilizer. For the reasons discussed below, based on the facts and representations provided by the Bank, we conclude that the proposed transactions are legally permissible. Before the Bank may engage in such transactions on reference assets not previously reviewed by the Bank’s examiner-in-charge (“EIC”), the Bank must notify its EIC, in writing, of the proposed activities and must receive written notification of the EIC’s supervisory non-objection, based on the EIC’s evaluation of the adequacy of the Bank’s risk measurement and management systems and controls to enable the Bank to engage in the proposed activities on a safe and sound basis, and the EIC’s evaluation of any other supervisory considerations relevant to the particular proposal.¹

I. Background

The Bank currently engages in a variety of financial intermediation transactions involving a wide range of reference assets and indices. In OCC Interpretive Letter No. 1039 (September 13, 2005)

¹ In addition, the Bank may engage in customer-driven, portfolio-hedged, cash-settled derivative transactions on coal, emissions, electricity, oil, and precious metals. *See, e.g.*, OCC Interpretive Letter No. 1060 (April 26, 2006); OCC Interpretive Letter No. 1040 (September 15, 2005); OCC Interpretive Letter No. 1025 (April 6, 2005); OCC Interpretive Letter No. 962 (April 21, 2003); OCC Interpretive Letter No. 693 (November 14, 1995); OCC Interpretive Letter No. 685 (August 5, 1995); OCC Interpretive Letter (March 2, 1992) (published in Lexis-Nexis) and OCC Interpretive Letter No. 553 (May 2, 1991). As with perfectly matched transactions listed above, before the Bank may engage in such portfolio-hedged transactions on reference assets not previously reviewed by the Bank’s EIC, the Bank must notify its EIC, in writing, and receive written notification of the EIC’s supervisory non-objection, as described above.

(“IL 1039”), the OCC determined that the Bank may engage in customer-driven, perfectly matched, cash-settled derivative transactions on the reference assets and indices identified in that letter as part of bank permissible financial derivative transactions.² These perfectly matched transactions are financial arrangements involving exchanges of payments, with the Bank acting as a financial intermediary between customers, a traditional and permissible banking function. IL 1039 provided that before the Bank may engage in such transactions, the Bank’s EIC must be satisfied that the Bank has established adequate risk measurement and management systems and controls to ensure that the Bank can engage in the proposed activities on a safe and sound basis.

On the basis of the legal analysis set forth in prior OCC interpretive letters, including IL 1039, we conclude that the Bank may similarly act as a financial intermediary in customer-driven, perfectly matched cash-settled derivative transactions on the proposed reference assets. The expansion of the Bank’s derivatives business to include the proposed transactions is a natural extension of the Bank’s existing financial intermediation activities. As discussed below, before the Bank can engage in the proposed transactions, the Bank must provide the EIC prior written notice of such activities based on reference assets not previously reviewed by the EIC and the EIC must be satisfied that the Bank has established adequate risk measurement and management systems and controls to conduct the proposed activities on a safe and sound basis, and that any other relevant supervisory considerations have been satisfactorily addressed by the Bank.

II. Safety and Soundness Considerations

For the Bank to permissibly engage in the proposed activities, the Bank’s risk measurement and management capabilities must be of appropriate sophistication to ensure that the activity can be conducted in a safe and sound manner and in accordance with applicable law. Consequently, the Bank must demonstrate to the satisfaction of its EIC that the Bank has established an appropriate risk measurement and management process for the proposed activities. As detailed further in the *OCC Handbook: Risk Management of Financial Derivatives*³ and Banking Circular 277,⁴ 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. The Bank’s risk control processes should include the Bank’s compliance with accounting and reporting as stipulated by the instructions for the Consolidated Reports of Condition and Income and generally accepted accounting principles.

When implementing policies, procedures, and controls for particular derivative activities, the Bank shall commit to conducting a full evaluation of: (i) pricing, hedging, processing, recordkeeping, documentation, accounting, “back office” and risk management; (ii) the

² The OCC has issued interpretive letters addressing additional permissible reference assets for customer-driven, perfectly matched, cash-settled, derivative transactions. *See, e.g.*, OCC Interpretive Letter No. 1059 (April 13, 2006) and OCC Interpretive Letter No. 1056 (March 29, 2006).

³ *OCC Handbook: Risk Management of Financial Derivatives* (January 1997).

⁴ OCC Banking Circular No. 277 (October 27, 1993).

development of adequate knowledge, staff, oversight management and technology (including contingency planning) to accommodate the activity; (iii) the implementation of appropriate controls; (iv) the establishment, implementation and monitoring of appropriate risk management limits with respect to various types of risks —such as credit and market risk —associated with derivative transactions on the proposed reference assets; and (v) Compliance Department training of personnel and development of a supervisory framework designed to ensure compliance with policies and procedures, including trading practices. 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 derivatives business.

In addition to a satisfactory 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 relating to new derivatives activities, including the commitment to continue to conduct its financial intermediation activities as a customer-driven and non-proprietary trading business. In addition, the compliance-monitoring program should ensure that the Bank has a supervisory framework that protects against manipulative practices of any kind. An adequate and effective compliance-monitoring program will include policies, training, independent surveillance and well-defined exception approval and reporting procedures.

III. Conclusion

We conclude that the Bank may engage in the proposed transactions; however, before it may begin to engage in transactions on reference assets not previously reviewed by the Bank's EIC, the Bank must provide written notice of the proposed activities to the EIC and must receive written notification of the EIC's supervisory non-objection, based upon the EIC's evaluation of the adequacy of the risk measurement and management systems and controls, as described herein, to enable the Bank to engage in the proposed activities on a safe and sound basis, and the EIC's evaluation of any other supervisory considerations relevant to the particular proposal. Our conclusions herein are specifically based on the provided representations and written submissions describing the facts and circumstances of the subject transactions. Any change in the facts or circumstances could result in different conclusions. If you have any questions concerning this letter, please contact Tena M. Alexander, Special Counsel, Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

signed

Julie L. Williams
First Senior Deputy Comptroller
and Chief Counsel