Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

April 19, 2007

Interpretive Letter #1079
May 2007

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 that it is permissible for **[ ]** ("Bank") to engage in customer-driven,[1] perfectly matched, cash-settled derivative transactions on inflation[2] indices. For the reasons discussed below, based on the facts and representations provided by the Bank, we conclude that the proposed transactions are legally permissible for the Bank. Before the Bank may engage in the transactions, the Bank must notify its examiner-in-charge ("EIC"), in writing, of the proposed activities and must receive written notification of the EIC's supervisory no-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.

I. Background

The Bank is seeking confirmation that it may engage in perfectly matched, cash-settled derivative transactions on inflation indices as part of its customer-driven financial intermediation business. These indices will include the U.S. consumer price index ("CPI"), CPI sub-indices,[3]

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[1] A "customer-driven" transaction is one entered into for a customer's valid and independent business purposes. *See* OCC Interpretive Letter No. 892 (September 13, 2000).

[2] Inflation is the overall general upward price movement of goods and services in the economy, as evidenced by an increase in an inflation index over a period of time. *See e.g.*, http://www.investorwords.com/2452/inflation.html. Changes in inflation can affect companies' profitability. As developed further below, derivative transactions based on those changes in inflation can help manage this risk.

[3] The Bureau of Labor Statistics ("BLS") publishes CPIs for Urban Wage Earners and Clerical Workers, All Urban Consumers, and Chained CPI for All Urban Consumers, each of which contains numerous sub-indices, such as the Housing Index, the Transportation Index, and the Medical Care Index. *See* http://www.bls.gov/news.release/pdf/cpi.pdf.

and the producer price index ("PPI").[4] Under the proposal, the Bank will offer swaps, caps, floors, and swaptions to corporate and institutional customers to manage their inflation exposure. Customers may include corporations, life insurance companies, utilities, transportation providers, and real estate property managers that have exposure to inflation under contractual payment obligations or through providing goods and services or maintaining inventories. Representative examples of the proposed transactions are described below.

Example 1: A real estate property manager receives rent payments that are used to service a fixed rate debt obligation on the property. By contract, the annual rent increases are linked to an inflation index. The property manager wishes to lock in a fixed income stream that will cover the fixed rate debt service requirement. By entering into an inflation swap with the Bank, where the manager makes payments to the Bank that are tied to inflation and receives a fixed rate payment from the Bank, the manager obtains a fixed income stream.

Example 2: An insurance company offers customers insurance and investment products linked to inflation such as long term care insurance or annuity style products. Insurance company customers can guarantee the purchasing power of their future benefits by purchasing insurance and investment products that link the benefits to inflation. The insurance company wishes to mitigate this risk and enters into a swap transaction with the Bank to receive inflation-linked payments and make fixed rate payments.

Example 3: A corporation offers its employees a defined benefit plan where retirement payments are a function of its employees' last year's salary. If wage inflation increases faster than expected, then the liabilities of the pension plan will be higher than estimated, potentially threatening the funded-status of the plan as well as the company's cash flow and liquidity. Given that wage inflation is highly correlated with the CPI, the pension plan can enter into a cash-settled inflation-linked option with the Bank that protects the plan against inflation rising above a certain level.

The Bank's counterparty for all perfectly-matched inflation derivative transactions will be its affiliate.[5] Accordingly, the Bank will not assume market risk that arises from the activity. Credit risk will be subject to and approved in accordance with the Bank's credit policy. The affiliate, and not the Bank, will conduct the back office trade processing and retain the operational and transactional risk for the proposed transactions. The Bank will manage legal, compliance, and counterparty credit risk in the inflation-linked derivative transactions, in part, by documenting the transactions under ISDA Master Agreements, Schedules, Confirmations, and

[4] The PPI is a family of indices that measure the average change over time in the prices received by domestic producers of goods and services. PPIs measure price change from the perspective of the seller, while CPIs measure price changes from the purchaser's perspective. Seller and purchaser prices can differ due to government subsidies, sales and excise taxes, and distribution costs. The BLS reports PPIs and CPIs every month for virtually every sector of the U.S. economy. BLS is constantly creating new PPIs. *See* http://www.bls.gov/news.release/pdf/ppi.pdf.

[5] The affiliate is active in this market in Europe and has established an inflation products desk in New York for this same purpose.

Collateral Support Agreements. Counterparty credit risk will be further managed through the Bank's standard counterparty credit approval and monitoring process.

The Bank represents that it will comply with the requirements of section 23A and 23B of the Federal Reserve Act, the Federal Reserve Board's Regulation W, and the Bank's section 23A and 23B and Regulation W policy when engaging in the proposed activities.

II. Discussion

For the reasons discussed below, based on the facts and representations provided by the Bank, we conclude that the Bank may engage in customer-driven, perfectly matched, cash-settled inflation derivative transactions. Before the Bank may engage in the transactions the Bank must notify its EIC, in writing, of the proposed activities and must receive written notification of the EIC's supervisory no-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.

A. National Banks Already Engage in Activities Involving Inflation-indexed Instruments

The Bank's proposed transactions would be in furtherance of the Bank's already authorized ability to engage in inflation-linked products, such as investment securities, certificates of deposit, and derivatives on these instruments. For example, the Bank has unlimited authority to deal in, underwrite, purchase, and sell Treasury-Inflation Protected Securities ("TIPS") under 12 U.S.C. § 24(Seventh) and Part 1.[6] TIPS are issued by the Department of the Treasury and backed by the full faith and credit of the U.S. government. TIPS are indexed to inflation. The principal of TIPS increases with inflation and decreases with deflation, as measured by the CPI. When TIPS mature, the investor is paid the inflation-adjusted principal or original principal, whichever is greater.

Currently, the Bank offers customers certificates of deposit with interest payments tied to the performance of inflation indices. These products are called Inflation-Protected Certificates of Deposit ("CDIPs") and Inflation Floater Certificates of Deposit ("IFCDs"). CDIPs and IFCDs use the CPI as a reference to measure inflation. CDIPs are similar to TIPS; the *principal* amount of the deposit is adjusted periodically to reflect changes in inflation. Conversely, IFCDs pay a monthly *coupon* that changes periodically based on the change in the CPI. CDIPs and IFCDs are deposits backed by the full faith and credit of the U.S. through FDIC insurance.[7] The OCC has

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[6] *See* 12 C.F.R. §§ 1.2(j)(2) and 1.3(a).

[7] The Federal Deposit Insurance Corporation ("FDIC") has specifically acknowledged the deposit status of certificates of deposit with payments tied to the CPI. http://www.fdic.gov/regulations/laws/rules/4000-10290.html.

previously determined, in *MII Deposit,* that this type of deposit product is permissible for national banks.[8]

Because it is legally permissible for the Bank to buy and sell TIPS and offer customers time deposits linked to inflation, the Bank may engage in derivative products on these instruments. In longstanding precedent, the OCC has found banks may engage in derivatives that reference bank permissible instruments, such as United States Treasury securities and certificates of deposit.[9] Under this line of precedents, the Bank may permissibly engage in derivative transactions on bank permissible Treasury investment securities and deposits, such as inflation-indexed TIPS,[10] CPIDs, and IFCDs. Moreover, because national banks may offer deposits with embedded derivatives on inflation indices, it is permissible for the Bank to engage in derivatives based on such indices, provided the Bank provides written notice of the proposed activities to its EIC and receives written notification of the EIC's supervisory no-objection.

B. Financial Intermediation Transactions on Indices are Authorized as Part of the Business of Banking

The proposed inflation derivatives are permissible under OCC precedent finding national banks may engage in customer-driven index derivative transactions as permissible financial intermediation activity under 12 U.S.C § 24(Seventh). The OCC has previously concluded that national banks may engage in index derivative transactions and hedges, such as options, forwards, and swaps, as part of a bank permissible financial intermediation business.[11] These derivative and hedging activities involve exchanges of payments with the bank acting as a financial intermediary between customers, which is a traditional and permissible banking

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[8] 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) ("*MII Deposit*"). In *MII Deposit*, the OCC concluded that a national bank may offer a time deposit with interest payable at a rate tied to the S&P 500 Index. The OCC determined that, subject to safety and soundness limitations, there is no restriction on the type or amount of interest a bank may pay on time deposits, nor is there any prohibition against a time deposit accruing interest at a variable rate based on an index ostensibly unrelated to interest rates or compiled by an entity other than the bank offering the deposit. The OCC recognized that the deposits were an exercise of the bank's expressly authorized power to receive deposits and make loans and as part of the business of banking. *See also, Investment Company Institute v. Ludwig,* 884 F. Supp. 4 (D.D.C. 1995) (upholding Comptroller's decision that the hedged deposit in *MII Deposit* is a bank permissible product).

[9] *See, e.g.,* OCC Interpretive Letter No. 494 (December 20, 1989) (national banks may purchase and sell financial futures for their own account in United States Treasury and Agency securities, domestic and Eurodollar money market instruments, bank certificates of deposit, foreign currencies, and gold and silver, among others); and OCC Interpretive Letter No. 422, (April 11, 1988) (national bank may purchase and sell instruments in the spot, forward , futures and over-the-counter market related to Treasury bills, Treasury notes, GNMA obligations, certificates of deposit, Eurodollar time deposits, and interest-rate denominated instruments).

[10] The Chicago Board of Trade ("CBOT") listed futures contracts on TIPS in 1997. The CBOT has since de-listed TIPS futures contracts; however, TIPS futures were permissible holdings for national banks. *See, e.g.,* http://www.cftc.gov/anr/anrdesig97.htm.

[11] *See, e.g.,* OCC Interpretive Letter No. 1065 (July 24, 2006) ("OCC IL No. 1065"); OCC Interpretive Letter No. 1039 (September 13, 2005) ("OCC IL No. 1039"); and *MII Deposit*.

function. For example, a bank may engage in a swap transaction involving the exchange of fixed payments for payments based on a coal index, and then assume an offsetting swap position or hedge. In assuming an offsetting swap, a bank acts as a financial intermediary by interposing itself between customers who initiate swaps and counterparties who provide offsetting cash flows or returns. These derivative transactions assist bank customers in managing financial risks or meeting other financial needs.

Banks have long served as financial intermediaries between customers, most traditionally by taking deposits and making loans, to facilitate the flow of funds in the economy and meet various customer financial needs. National bank derivative activities may extend beyond traditional deposit taking and lending, but these activities are merely modern forms of financial intermediation. Through intermediated exchanges of payments, banks facilitate the flow of funds within our economy and serve important financial risk management and other financial needs of bank customers.[12]

Based on this line of reasoning the OCC permitted national banks, in *MII Deposit,* to hedge deposits linked to the S&P 500 index with futures contracts on that index as bank permissible financial intermediary activity.[13] In OCC IL No. 1065, the OCC concluded that national banks may engage as a financial intermediary in customer-driven, perfectly matched, cash-settled derivative transactions with payments based on indices related to a number of commodities.[14] Other indices the OCC has approved for national bank financial intermediary activity include those on equity indices,[15] the Dow Jones AIG Commodity Index ("DJ-AIGCI"),[16] and the Dow Jones CDX Emerging Market Index ("CDX.EM index").[17]

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[12] The OCC has permitted national banks to engage in a variety of financial intermediation transactions, where a bank notifies its EIC, in writing, of the proposed activities and receives written notification of the EIC's supervisory no-objection. The no-objection is based on the EIC's evaluation of the adequacy of the Bank's risk measurement and management systems and controls to enable the Bank in 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.

[13] The financial intermediation authority used in *MII Deposit* similarly applies to the Bank's hedging activities with respect to its CDIPS and IFCDs. The Bank hedges CDIPs and IFCDs with CPI linked swaps. The Bank may also use derivatives such as the Chicago Mercantile Exchange traded CPI futures contracts ("CME® CPI futures") to hedge the deposits. CME® CPI futures were launched on February 8, 2004. This derivative contract is based on the market's expectation for future inflation rates in the U.S. and trades exclusively on CME.Globex®. http://www.cme.com/search/ searchresults.html?cmeSections=allSections&news AllDatesHidden =true&advAllDatesHidden=true&advisoryDropDown=all&queryText=CPI.

[14] OCC IL No. 1065, *supra*, addressed the permissibility of national banks engaging in customer-driven, perfectly matched, cash-settled derivative transactions on reference assets and related indices such as agricultural oils, grains and grain derivatives, seeds, fibers, foodstuffs, livestock/meat products, wood products, plastics and fertilizer.

[15] *MII Deposit;* OCC Interpretive Letter No. 949 (September 19, 2002).

[16] OCC Interpretive Letter No. 1059 (April 13, 2006).

[17] OCC Interpretive Letter No. 1064 (July 13, 2006).

The Bank currently engages in a variety of financial intermediation transactions involving a wide range of reference assets and indices addressed in OCC IL No. 1039. In OCC IL No. 1039, the OCC determined that national banks 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.[18] A national bank may engage in OCC IL No. 1039 activity once it establishes to the satisfaction of its EIC, an appropriate risk measurement and management process for the activities.

On the basis of the legal analysis set forth in prior OCC interpretive letters, including OCC IL 1039, we conclude that the Bank may act as a financial intermediary in customer-driven, perfectly matched, cash-settled derivative transactions on inflation indices. The proposed transactions involve payments analogous to those under swaps and other derivative transactions that the OCC has determined national banks may engage in as financial intermediaries. The proposed activities are a natural expansion of the Bank's inflation-indexed and financial intermediation businesses. The Bank's role in the proposed transactions will be the same financial intermediation activity already approved by the OCC with respect to other indices. The Bank will exchange payments with one customer and then exchange offsetting payments with another counterparty, based, in part, on the performance of an inflation index, rather than an already authorized index related to, for example coal or freight, but, still serving as a financial intermediary facilitating the flow of funds in our economy. The proposed transactions will not result in any substantive change in the type or nature of financial intermediation activities provided by the Bank, but only in its underlying basis (*i.e.,* inflation indices). As illustrated above, the offering of these inflation-indexed derivative products will enable bank customers to manage their exposure to inflation risk. Accordingly, the Bank may engage in the proposed activities subject to safety and soundness requirements and a written no-objection from its EIC.

III. Safety and Soundness Requirements and EIC No-Objection

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, in order for the OCC to conclude that this activity is permissible for the Bank, the Bank must provide written notice of the proposed activities to its EIC and must demonstrate to the satisfaction of its EIC, that the Bank has established an appropriate risk measurement and management process for its proposed activity. As detailed further in the OCC *Handbook: Risk Management of Financial Derivatives*[19] and Banking Circular 277,[20] 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

[18] OCC IL No. 1039, *supra,* addressed the permissibility of the Bank engaging in customer-driven, perfectly matched, cash-settled derivative transactions on reference assets and related indices such as jet fuel, naphtha, ethane, propane, butane, isobutene, coal, benzene, dairy, cattle, coffee, rubber, cobalt, and freight.

[19] OCC Handbook: *Risk Management of Financial Derivatives* (January 1997).

[20] OCC Banking Circular No. 277 (October 27, 1993).

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.

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 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.

The Bank may not commence the proposed activities unless and until its EIC concludes that the foregoing standards are met and provides a written supervisory no-objection to the Bank. Provided these standards are met, the Bank may commence the proposed activities.

IV. Conclusion

We conclude that the Bank may act as a financial intermediary in customer-driven, perfectly matched, cash-settled derivative transactions on inflation indices. Before the Bank may engage in the transactions, the Bank must notify its EIC, in writing, of the proposed activities and must receive written notification of the EIC's supervisory no-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. Our conclusions are specifically based on the Bank's 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,

/s/

Julie L. Williams
First Senior Deputy Comptroller
and Chief Counsel