Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219
May 15, 2007

Interpretive Letter #1081
June 2007

Subject: Authority of National Banks to Engage in Financial Intermediation Transactions

Dear **[ ]**:

[ ] ("Bank") is seeking confirmation from the Office of the Comptroller of the Currency ("OCC") that it is permissible for the Bank to engage in customer-driven,[1] perfectly matched, cash-settled derivative transactions on property indices. For the reasons discussed below, based on the facts and representations provided by the Bank, we believe that the proposed activities are 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

OCC has long permitted national banks, including the Bank, to act as a financial intermediary in customer-driven, perfectly matched, cash-settled derivative transactions on commodities and indices as part of its financial intermediation business. Perfectly matched derivative transactions are financial arrangements involving exchanges of payments, with the Bank acting as a financial intermediary between customers, a traditional banking function. In these transactions the Bank first negotiates the type, size, and price of the transaction with the customer. Then, if the Bank

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

reaches agreement with the customer, the Bank concurrently will execute an offsetting, perfectly matched transaction with a counterparty. The Bank's transactions with a counterparty will match all the economic terms of the transaction between the Bank and its customer (*e.g.*, index, amount, maturity, and underlying reference asset or index). The Bank does not take an ownership interest in any commodity, asset, or instrument underlying, or related to an index referenced in, a perfectly matched financial intermediation derivative transaction. Rather, these financial arrangements settle in cash. These transactions assist customers in managing financial risks associated with a particular commodity, asset, or instrument and meeting other financial needs.

The Bank now proposes to act as a financial intermediary in customer-driven, perfectly matched, cash-settled derivative transactions on property indices as part of its customer-driven financial intermediation business. These indices will include the Investment Property Databank ("IPD") UK Annual Index or a sub-index of that index,[2] the House Price Indices ("HPI"),[3] the S&P/Case-Shiller® Metro Area Home Price Indices,[4] and the Halifax House Price Index ("HHPI").[5] Under the proposal, the Bank will offer cash-settled swaps, forwards, and options to customers to assist them in managing financial risks associated with real estate and meeting other financial needs. Customers will include investment funds, pension funds, property investors, corporations, financial institutions, high net worth individuals, and affiliates of the Bank. The Bank's customer base for these products will not include retail customers. The Bank will not take an ownership interest in real estate in connection with the proposed derivative transactions.

Property index derivative transactions are attractive to customers as a means of managing financial risks associated with real estate or related payment obligations and meeting other financial needs. Property index derivatives can be used by customers to gain or reduce real estate exposure without dealing in physical assets. Customers can also use property index derivatives to diversify their investment portfolios by receiving payments based on the appreciation or depreciation of property as determined by reference to a property index. Moreover, these derivatives can diversify a customer's financial exposure to real estate markets as a whole or to specific sectors, whereas real estate purchases tend to provide exposure to a

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[2] The IPD UK Annual Index is an index of commercial property values in the United Kingdom. The IPD UK Annual Index tracks three market sectors, industrial, retail, and office. The IPD Annual Index is published as an All Property Index that covers all three of these market sectors and as individual sub-indices for each sector. *See* www.ipdindex.co.uk and http://www.ipdglobal.com/derivatives/uk_annual.asp.

[3] The HPI is published by the Office of Federal Housing Enterprise Oversight ("OFHEO") using data provided by Fannie Mae and Freddie Mac. The HPI reflects changes in the value of single-family homes in the U.S. as a whole, in various regions of the country, and in the 50 states and the District of Columbia. The HPI includes house price figures for the Census Bureau's nine census divisions. OFHEO also produces indexes for many Metropolitan Statistical Areas ("MSA") and Divisions. http://www.ofheo.gov/HPIOverview.asp.

[4] The S&P/Case-Shiller® Metro Area Home Price Indices are based on changes in home prices in the U.S. They measure increases or decreases in the market value of residential real estate in 20 MSAs. http://www2.standardandpoors.com/spf/pdf/index/121906_CaseShiller_NewIndices.pdf; http://www2.standardandpoors.com/spf/pdf/index/SPCS_MetroArea_HomePrices_Methodology.pdf.

[5] The HHPI is an index of home prices derived from the mortgage data of the UK's largest mortgage lender, HBOS plc. http://www.hbosplc.com/economy/indexmethodology.asp.

single property at time. In addition, customers can benefit from these financial arrangements without the costs and filing requirements associated with purchasing real estate. Property index derivative transactions are cost efficient and can be executed quickly. A property index derivative is simply a contractual payment obligation that involves making payments based on the performance of a property index. Accordingly, the Bank wishes to make these products available to customers as a means of managing their financial risks and meeting other financial needs. The Bank represents that the most commonly traded property index derivatives are property index swaps and forwards. Representative examples of these transactions are described below.

Example 1: A commercial lender has concentrated property exposure as a result of secured loans extended to real estate developers. To mitigate that exposure, the commercial lender enters into a property index swap with the Bank. Under the swap, the commercial lender pays the Bank an amount equal to the appreciation of the property index. In return, Bank pays the commercial lender an amount equal to the depreciation of the property index plus a floating rate of interest. The Bank offsets the transaction with a perfectly matched property index swap.

Example 2: Same as Example 1, except that the commercial lender mitigates its property exposure by entering into a forward transaction with the Bank. Under the property index forward, the commercial lender will make a payment to the Bank if the value of the property index increases above an agreed upon price at a future date. The Bank will make payments to the commercial lender if the value of the property index decreases below the agreed upon price on the agreed upon future date. The Bank offsets the transaction by entering into a perfectly matched property index forward.

Example 3: A pension fund is interested in diversifying its portfolio with real estate exposure. The pension fund obtains exposure to real estate by entering into a property index swap with the Bank. Under the property index swap, the pension fund receives an amount tied to the appreciation of a property index. The Bank will receive an amount tied to the depreciation of the property index plus an amount tied to a floating rate of interest. The Bank offsets this transaction with a perfectly matched transaction with a counterparty.

Example 4: A developer with an inventory of commercial properties wishes to manage the financial risk of holding these properties through a synthetic sale of real estate. The developer enters into a swap transaction with the Bank, where the developer pays appreciation on a property index, and receives (from the Bank) depreciation on the property index plus payments tied to a floating rate of interest. Under the swap, the commercial builder has effectively transferred real estate exposure without selling its properties. The Bank offsets that exposure with a perfectly matched swap with a counterparty. The counterparty is able to receive cash flows tied to real estate without the cost, expense, and burden of investing in the real estate itself.

The Bank will not assume market risk in connection with the proposed transactions since it will perfectly match all of the proposed property index derivative transactions.[6] The Bank will manage legal, compliance, and counterparty credit risk in the transactions, in part, by the use of ISDA documentation, including Credit Support Annexes where required, to evidence and govern the transactions. The Bank will further manage credit risk by entering into a property index derivative transaction only when the Bank can determine a loan-equivalent credit exposure generated by a transaction and when the credit lines to the counterparties are sufficient to accommodate that exposure. The Bank will manage operational risks by conducting the proposed transactions in accordance with the trade booking and capture systems and procedures that the Bank has in place for its equity derivatives business. All property index derivative transactions will be subject to the Bank's Appropriateness Policy and may be subject to review by the Bank's Reputation Risk Committee.

The Bank states that its ability to engage in the proposed transactions will enable it to compete more effectively, meet customer demand, and capitalize on its financial intermediation expertise. For example, the Bank states that many of its existing customers wish to use the proposed transactions to increase or decrease their exposure to property risk. Indeed, the Bank has identified two-way demand for managing property exposure and believes that, with its strong credit rating and its derivatives expertise, it is well placed to financially intermediate this customer demand. In addition, the Bank believes that by offering customers a broader range of risk management products that more effectively address their individual risk management needs, it will have the ability to attract a broader customer base. Accordingly, the Bank believes that the ability to offer the proposed products will enable it to operate its financial intermediation business more competitively and meet customer demand for property index derivatives.

The Bank believes that the expansion of its derivatives business to include the proposed transactions is a natural extension of the Bank's existing perfectly matched, customer-driven financial intermediation products. The Bank represents that the purpose of expanding its financial intermediation business to include property index derivatives is to provide risk and portfolio management tools to Bank customers in substantially the same manner as currently done with respect to its existing perfectly matched derivatives business. The major difference between the perfectly matched financial intermediation transactions currently engaged in by the Bank and the proposed activities is that the derivative transactions here will reference property indices.

The Bank states that the terms and circumstances of all transactions between the Bank and Affiliate in conducting these transactions will be at least as favorable to the Bank as those prevailing at the time for comparable transactions between the Bank and similarly situated counterparties or will be such that the Bank, in good faith, would offer to, or that would apply to, such entities. The Bank represents that it will comply with the requirements of sections 23A and 23B of the Federal Reserve Act, Federal Reserve Board's Regulation W, and the Bank's policies

[6] The Bank may act as financial intermediary in customer-driven, perfectly matched derivative transactions where an affiliate of the Bank, **[ ]** ("Affiliate"), is a counterparty.

designed to ensure compliance with these requirements when engaging in the proposed property index derivative transactions.

II. Discussion

The proposed property index 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.[7] 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 function. For example, a bank may engage in a swap transaction involving the exchange of fixed payments for payments based on an inflation 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, at their essence, 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.

Based on these principles, the OCC permitted national banks, in *MII Deposit*,[8] to hedge deposits linked to the S&P 500 index with futures contracts on that index as bank permissible financial intermediary activity. 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.[9] Other indices the OCC has approved for national bank financial intermediary activity include those on equity

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

[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*"). *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] 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.

indices, the Dow Jones AIG Commodity Index ("DJ-AIGCI"), and the Dow Jones CDX Emerging Market Index ("CDX.EM index").[10]

The Bank currently engages in a variety of financial intermediation transactions involving a wide range of reference assets and indices. In OCC IL No. 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.[11] The permissibility of the OCC IL No. 1039 activity was conditioned on the Bank having established, to the satisfaction of its EIC, an appropriate risk measurement and management process for the activities.[12]

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 property 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 expansion of the Bank's derivatives business to include the proposed activities is a natural extension of the Bank's 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 a property index, rather than an already authorized index related to, for example coal or freight, but, still serving as a financial intermediary. 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.*, property indices). The Bank will not take title to real estate when engaging in the proposed transactions**.** As illustrated above, the Bank's offering of property index derivative products will enable bank customers to manage financial risks and meet other financial needs. Accordingly, we conclude 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 property index derivative transactions, the Bank's risk measurement and management capabilities must be of appropriate sophistication to

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[10] OCC Interpretive Letter No. 1064 (July 13, 2006); OCC Interpretive Letter No. 1059 (April 13, 2006); and OCC Interpretive Letter No. 949 (September 19, 2002).

[11] 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.

[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 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.

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*[13] and Banking Circular 277,[14] 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.

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 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 property indices as described above. 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

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

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

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