



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

September 11, 2007

Interpretive Letter #1088
October 2007
12 USC 84
12 CFR 32

Re: Request for a legal opinion

Dear []:

This letter responds to a request from [*Bank*], [*City, State*] (“Bank”), for a legal opinion on the application of the legal lending limit, 12 U.S.C. § 84 and 12 C.F.R. § 32, to the Bank’s participation in a centralized clearing and netting facility for participants in the repurchase markets for European government securities. Specifically, the Bank has inquired whether, for purposes of calculating its lending limit exposure to the netting facility, it may net against the funds advanced to the facility those funds borrowed by the Bank from the facility. For the reasons discussed below and based upon your representations, under the specific legal arrangements and agreements in this case that define the legal obligation of the parties, we believe that the Bank can use the aggregate daily net repayment obligation, calculated as described below, to determine its compliance with the legal lending limit.

Description of the Facts

The Bank, through its London branch, is a member (“Member”) of LCH.Clearnet Ltd. (“LCH”). LCH operates the RepoClear System (“RepoClear”) to facilitate netting among participants in the repurchase markets for European government securities. RepoClear enables a Member to transform a series of bilateral relationships for repurchase transactions into a single relationship with LCH acting as the central counterparty for all transactions cleared through RepoClear.

Once transactions are accepted by and registered in the RepoClear system, the Bank has agreements covering two types of transactions with LCH – reverse repurchase transactions and repurchase transactions. In a reverse repurchase transaction, the Bank purchases European government securities from LCH subject to an agreement by LCH to repurchase the securities on a specified future date for a fixed price. The Bank purchases the securities by transferring cash to the account of LCH. In a repurchase transaction, the Bank sells European government

securities to LCH subject to an agreement by the Bank to repurchase the securities on a specified future date for a fixed price. To purchase the securities, LCH transfers cash to the Bank's account.

Through the RepoClear system, LCH provides settlement and payment netting services for the transactions. The RepoClear system and the relationship between LCH and its Members are governed by a series of LCH Rules and Regulations ("LCH Regulations") and LCH Procedures. Pursuant to the LCH Regulations and LCH Procedures, the Bank and LCH have contractually committed to net their obligations on all contracts that settle on the same day, such that the repayment obligation for the day is the net obligation of one party to the other under the maturing contracts.¹ If, in contracts maturing on a given day, the Bank has advanced more money to LCH than it has received from LCH, then at settlement for that day LCH will pay the netted amount due to the Bank. Conversely, if, in contracts maturing on a given day, LCH has advanced more money to the Bank than it has received, then at settlement for that day the Bank will pay the netted amount due to LCH.²

Thus, the LCH Regulations require that repurchase and reverse repurchase transactions maturing on the same day, regardless of dates on which the contracts were entered, be settled on a net basis at the end of the business day. As a result, the party with a net receivable will not need any cash to accomplish settlement, while the party with a net payable will need only to have available the required net amount payable to settle the day's obligation.

The Bank has inquired whether the sum of the individual daily net obligation amounts, as determined under the LCH Regulations, can be treated as the amount of its legal lending limit exposure to LCH. We believe that, under the specific legal arrangements and agreements in this case that define the legal obligation of the parties as the net amount, the Bank may use the aggregation of the individual daily net obligation amounts due *from* LCH for purposes of determining its compliance with the legal lending limit. However, as explained below, when aggregating the individual daily net obligation amounts, the Bank must exclude those days for which the net obligation amount is an amount payable by the Bank *to* LCH.

¹ Each day the RepoClear System runs a multilateral netting process to determine a Member's cash and securities delivery obligations for the next day's settlement. LCH Procedures § 2B; LCH Regulations § 15. All of the repurchase and reverse repurchase transactions between LCH and a Member that settle on the next business day are netted by RepoClear. LCH Procedures § 2B.4. This net settlement process results in a single RepoClear payment or receivable obligation per currency per day between LCH and each Member. LCH Procedures § 2B.4.2. *See also* "How It Works," available at http://www.lchclearnet.com/markets_and_services/fixed_income_products/repoclear/how_it_works.asp (describing the settlement and netting process).

² The LCH Regulations also provide that upon default of LCH, the Member shall net the amounts due to and the amounts due from LCH to determine a net default repayment amount. Once the required netting takes place, the Bank shall look to LCH for repayment, and LCH shall be obligated to repay, only the net default repayment amount. LCH Regulations § 39A.

Legal Framework and Analysis

Generally, a national bank’s total outstanding loans and extensions of credit to one borrower may not exceed 15 percent of the bank’s capital and surplus. 12 U.S.C. § 84(a). Section 84(b)(1) defines “loans and extensions of credit” to include:

all direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person ...

This definition has two components: “all direct or indirect advances of funds” to a borrower and the borrower’s “obligation ... to repay the funds...” Consideration of both components is consistent with established court precedent holding that the lending limits apply only to repayment obligations which arise when the bank advances money to a borrower.³ Thus, Section 84 would not preclude parties engaged in a series of funds exchanges from agreeing, as the Bank and LCH have agreed, that the legal obligation arising from the series of exchanges will be the net obligation amount. Rather, it would be consistent with the language and intent of Section 84 to give effect to that legal arrangement in complying with the legal lending limit.

As described above, the LCH Regulations require the parties to settle repurchase and reverse repurchase transactions maturing on the same day on a net basis. Therefore, at any moment in time, the Bank may calculate LCH’s repayment obligation, based on all outstanding repurchase and reverse repurchase transactions, for the current day and for all future days.⁴ By aggregating these individual daily net repayment obligations, the Bank can calculate LCH’s total repayment obligation to the Bank. For example,

	Contracts that settle on ...		
	Day 1	Day 2	Day 3
Aggregate reverse repos (total receivables from LCH)	\$ 5 mm	\$ 10.4 mm	\$ 7.5 mm
Aggregate repos (total payables to LCH)	\$ 4.5 mm	\$ 10.3 mm	\$ 7.25 mm
Daily net obligation of LCH to Bank	Obligation of \$500,000	Obligation of \$100,000	Obligation of \$250,000

LCH’s total repayment obligation to the Bank in the hypothetical three-day period in the above chart would be the aggregate of the individual daily repayment obligations, or \$850,000.

³ *Atherton v. Anderson*, 86 F.2d 518 (6th Cir. 1936), *rev’d on other grounds*, 302 U.S. 643 (1937). See also Interpretive Letter No. 185, *reprinted in* [1981-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,266 (Mar. 11, 1981).

⁴ Most of the Bank’s transactions are for lengths of one to seven days.

Applying the language of Section 84, we believe that the aggregate of the individual daily repayment obligations, as described below, would be the appropriate measure for purposes of the lending limit. The daily netting at settlement is required by the LCH Regulations, and the daily net repayment amount represents the sole repayment obligation of LCH upon settlement of all contracts maturing on a particular day. At any point in time, the Bank can measure the net repayment obligation of LCH at daily settlement on all future dates. The aggregation of these net daily repayment amounts for all future dates – that is, the amount that LCH will be obligated to repay the Bank at the end of each day for which a contract will mature – therefore, is the appropriate measure of the Bank’s total lending limit exposure to LCH. In the language of the lending limit statute, this amount is LCH’s total “obligation ... to repay the funds.”

This netting approach is a logical way to measure lending limit exposure over time. If one ignores all of the funds the Bank has received from LCH, then the Bank’s lending limit exposure to LCH would be overstated because the Bank is legally entitled to receive back from LCH only the net amount owed by LCH (and not the gross amount the Bank has advanced). Substantively, it is as if LCH has “repaid” the Bank for the funds it has received to the extent of the funds it has advanced to the Bank. Those funds it has paid back to the Bank will not have to be repaid again. Focusing on the daily net amounts owed by LCH accurately will measure the Bank’s lending limit exposure to LCH. In the words of the lending limit statute, as a borrower from the Bank, this amount measures LCH’s total “obligation ... to repay the funds.” Operationally, the Bank would keep a running tally of the daily net obligations of LCH. This will enable it to know, at any moment in time, how much money LCH will have to repay it in the future.

The RepoClear system and the LCH Regulations and LCH Procedures are premised upon and incorporate the principles underlying FASB Interpretation Number 41, “Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements” (“FIN 41”).⁵ If elected, FIN 41 requires each party to calculate a net amount, either receivable or payable, for each day going forward by offsetting amounts loaned under reverse repurchase agreements with amounts borrowed under repurchase agreements settling on the same day. If elected, FIN 41 requires the party to aggregate the daily net amounts payable and the daily net amounts receivable on its books. However, FIN 41 expressly does not permit the party to offset one day’s net receivable amount with another day’s net payable amount.⁶

Therefore, in calculating its lending limit exposure to LCH consistent with FIN 41, the Bank should exclude all days where LCH will have no repayment obligation at settlement because it has advanced more funds than it has received from the Bank. For example,

⁵ Available at http://www.fasb.org/pdf/fin_41.pdf. A bank that elects to adopt FIN 41 for financial accounting purposes must use the same netting principles on its Call Report. The Bank has represented that it properly follows the FIN 41 requirements with respect to its membership in RepoClear.

⁶ The drafters of FIN 41 believed that providing separate figures for net amounts receivable and net amounts payable would provide useful information about the “amount of future cash flows that would be lost if these amounts were offset.” *Id.* Thus, the party will have two entries on its balance sheet – the sum of all daily net receivable amounts as an asset and the sum of all daily net payable amounts as a liability.

	Contracts that settle on ...		
	Day 1	Day 2	Day 3
Aggregate reverse repos (total receivables from LCH)	\$ 5 mm	\$ 10 mm	\$ 7.5 mm
Aggregate repos (total payables to LCH)	\$ 4.5 mm	\$ 10.3 mm	\$ 7.25 mm
Daily net obligation between Bank and LCH	LCH owes Bank \$500,000	Bank owes LCH \$300,000	LCH owes Bank \$250,000
Bank's daily lending limit exposure to LCH	\$ 500,000	\$ 0	\$ 250,000

in this hypothetical three-day period, the Bank would have a net payable obligation to LCH on Day 2. Because LCH has no repayment obligation to the Bank on Day 2, the Bank's lending limit exposure to LCH would be the sum of the individual daily repayment obligations of LCH, derived from transactions settling on Days 1 and 3, or \$750,000.

Conclusion

For the reasons discussed above and based upon your representations, under the specific legal arrangements and agreements in this case that define the legal obligation of the parties as the net amount, we believe that the Bank may use the sum of the individual daily net obligation amounts to determine its compliance with the legal lending limit, provided that the Bank exclude those days for which the net obligation amount is an amount payable by the Bank to LCH. Before the Bank may use this figure as the measure for lending limits, however, 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.

Our conclusions herein 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, please contact Steven V. Key, Special Counsel, Bank Activities & Structure, at (202) 874-5300.

Sincerely,

signed

Julie L. Williams
 First Senior Deputy Comptroller
 and Chief Counsel