

**Date: April 3, 2000**

**Currency Exchange Forward Contracts**

A federal savings bank may act as principal in providing foreign currency exchange forward contracts to its commercial borrowers. This activity is permissible as an activity incidental to the powers of federal savings associations, subject to specific limitations.

**Subject:** Home Owners' Loan Act/Savings Association Powers.

**P-2000-5**



Office of Thrift Supervision  
Department of the Treasury

P-2000-5

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6251

April 3, 2000

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Re: Currency Exchange Forward Contracts

Dear [ ]:

This responds to your inquiry whether your client, [ ] (the "Association"), may act as principal in providing foreign currency exchange forward contracts to its commercial borrowers. In brief, we conclude that this activity is permissible as an activity incidental to the powers of federal savings associations, subject to the conditions and limitations set forth below.

## I. BACKGROUND

The Association is a federal savings association having \$[ ] in assets. You indicate that the Association regularly makes commercial loans and competes for business with other commercial lenders. You state that some of the Association's commercial borrowers regularly purchase goods from businesses in other countries, at prices set in foreign currencies. You report that some of these existing borrowers have asked the Association to provide a service, as part of the borrowers' lending relationship with the Association, that would allow the borrowers to lock in an exchange rate for a period of time. The borrowers tell you they wish to use the service to reduce their currency risk, and not to speculate in currency markets. The Association wishes to provide those borrowers foreign exchange forward contracts<sup>1</sup> to meet the borrowers' business needs.

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<sup>1</sup> In a foreign exchange forward contract, a contract buyer pays a fee to a contract seller for the right to purchase a specified amount of a particular foreign currency at a future date, at a price set when the contract is originated. At maturity, the buyer would actually purchase the foreign currency from the seller. Because the contract fixes the future price of the foreign currency, the contract buyer bears no risk of loss from a rise in the foreign currency's price during the contract's term. The contract seller, on the other hand, is subject to currency risk because the seller must deliver the foreign currency when the contract matures, no matter what foreign exchange rates are at the time. See, e.g., *OTS Regulatory Handbook, Thrift Activities*, pp. 541.4 - 541.5 (January 1994).

You describe the proposed activity as follows. The Association proposes to provide its service only to its commercial borrowers that have a line of credit at the Association. For those borrowers, the Association would dedicate a portion of the borrower's line of credit for use in the forward contracts. The loan documents would make clear that the borrower would not be able to use the dedicated portion of its line of credit for any other purpose.

If a borrower were to buy one of these contracts from the Association, the Association would also purchase an offsetting contract from [ ] (the "Correspondent Bank"). The contract the Association would sell to the borrower and the contract the Association would buy from the Correspondent Bank would both be for the same term and for an identical amount of the same foreign currency. The Association would buy and sell the two contracts simultaneously. The Correspondent Bank would provide prices for the forward contracts to the Association. The Association would add a fee to these prices in setting the borrowers' prices for the forward contracts. The Association would obtain a line of credit from the Correspondent Bank of \$1 million. The Correspondent Bank would draw on this line of credit to collect the Association's payments to the Correspondent Bank on the forward contracts. Because the Association's payments to purchase foreign currency would come from this line of credit, the line of credit would limit the level of the Association's proposed activity. The amount of foreign currency that the Correspondent Bank would owe at any time to the Association, and that the Association would owe at any time to its borrowers, could never exceed an amount that the parties agree to buy and sell through forward contracts for \$1 million.

As the two forward contracts would be created simultaneously and have the same term, they would mature at the same time. At that time, the borrower would owe the Association the foreign currency purchase price, and the Association would likewise owe the Correspondent Bank payment for the foreign currency. The Association could collect payment from the borrower for the foreign currency in one of three ways: by drawing from any of the borrower's available deposits at the Association; the borrower could elect to pay the Association directly; or the Association could use the designated portion of the borrower's line of credit. Likewise, the Correspondent Bank would draw on the Association's line of credit with the Correspondent Bank for the Association's payment on the matured contract. The Association would use the payment it receives from its borrower to repay the Association's line of credit with the Correspondent Bank.

The Association's simultaneous contracts would operate to transfer the borrower's currency risk to the Correspondent Bank, even though the borrower and the Correspondent Bank would not share a contract. If the price of the foreign currency were to rise during the term of the two contracts, the Correspondent Bank would still be required to deliver the now more costly foreign currency to the Association. The borrower and the Association, however, would have protection against such a price rise through their contracts. Upon originating its contract with the Association, the borrower would fix the price it would pay to purchase foreign currency from the Association. Similarly, upon originating its contract with the Correspondent Bank, the Association would fix the price it would pay to purchase foreign currency from the Correspondent Bank. As long as the Correspondent Bank meets its obligations on its forward contracts, these fixed prices would fully protect the Association from a rise in the price of the foreign currency.

The Correspondent Bank and the commercial borrower both would present credit risk to the Association. If the borrower were to default at contract maturity, the Association would still be obligated to purchase foreign currency from the Correspondent Bank. If the Correspondent Bank were to fail to deliver the foreign currency at contract maturity, the Association would still be liable to deliver foreign currency under its forward contract with the commercial borrower.

The Association proposes to manage its credit risk through its normal credit risk management procedures. The Association would extend and secure lines of credit to commercial borrowers only pursuant to its standard lending criteria, and would regularly monitor the borrowers' financial performance and condition. Additionally, the Association would designate a portion of the borrower's line of credit to the forward contracts, so that if the borrower were unable to pay for its purchase at contract maturity, the Association would be able to use the line of credit to pay for the borrower's purchase. If the borrower were to default on its line of credit, the Association would have available its normal collateral and loan default remedies. The Association has analyzed the Correspondent Bank's creditworthiness and would periodically update its analysis as appropriate. Further, you represent that the Association would restrict the number and size of its forward contracts so that its aggregate credit risk at any point in time under all the contracts would be limited to \$1 million. The Association's credit risk management procedures would serve to reduce the chances that the Association would incur currency risk.

## II. DISCUSSION

### A. Incidental Powers Analysis

Section 5(c)(2)(A) of the Home Owners' Loan Act (HOLA)<sup>2</sup> expressly authorizes federal savings associations to make commercial, corporate, and business loans.<sup>3</sup> Federal savings associations also possess “incidental powers,” i.e., powers that are incident to the express powers of federal savings associations as set forth in the HOLA. OTS uses a four-factor analysis in determining the incidental powers of federal savings associations under the HOLA. Briefly, these factors are: (1) Does the activity relate to the financial intermediary role that all federal savings associations were intended to play; (2) Is the activity similar to, or does it facilitate the conduct of, an activity that Congress expressly authorized; (3) Is the activity consistent with the purpose and function Congress envisioned for federal savings associations; and (4) Is the activity necessary to enable the federal savings association to remain competitive and relevant in the modern economy?<sup>4</sup> The relative weight given to each factor may vary depending upon the type of activity in question, and it is not critical that each question be answered in the affirmative.<sup>5</sup> Based on a review of the Association’s proposed activity under each of these four factors, we conclude that the Association has incidental authority to conduct the proposed activity.

#### 1. *The Activity Relates to the Financial Intermediary Role That All Federal Savings Associations Were Intended to Play.*

In conducting the proposed activity, the Association would be acting as a financial intermediary. By acting as principal with two counterparties to simultaneous foreign exchange forward contracts, the Association would be acting as a financial intermediary, receiving and transferring funds (payments on the

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<sup>2</sup> 12 U.S.C.A. § 1464(c)(2)(A) (West Supp. 1999).

<sup>3</sup> 12 U.S.C.A. § 1464(c)(2)(A) (West Supp. 1999). We note that although OTS has addressed derivatives activities in 12 C.F.R. § 563.172 (1999) and Thrift Bulletin 13-a (Management of Interest Rate Risk, Investment Securities, and Derivatives Activities), these do not address using foreign exchange forward contracts as the Association proposes.

<sup>4</sup> OTS Op. Chief Counsel (Mar. 25, 1994) (surveying law related to incidental powers).

<sup>5</sup> Id. at 8.

contracts) between the borrower and the Correspondent Bank.<sup>6</sup> Additionally, the Association would act as intermediary by transferring currency risk from the commercial borrower to the Correspondent Bank.

The Association would also serve as a financial intermediary by providing services to the Correspondent Bank and the borrowers without which the parties might not be able, as a practical matter, to enter into the forward contracts. Without the Association operating as financial intermediary, the Correspondent Bank could incur significant expenses to find and analyze the creditworthiness of its various forward contract counterparties. The Association already evaluates and analyzes its borrowers' creditworthiness as part of its standard lending operations. The Correspondent Bank would only need to find and evaluate the creditworthiness of one counterparty, the Association. Similarly, the borrowers may not have the expertise necessary to find counterparties with whom to enter into forward contracts or to evaluate the ability of such entities to pay their obligations. The Association has this expertise and would periodically review the Correspondent Bank's creditworthiness to address the Association's credit risk, thereby eliminating the borrower's need to do so. The Association's services as intermediary would thus enable the parties to conduct their financial transactions.

2. *The Activity Facilitates or is Similar to the Conduct of an Activity That Congress Expressly Authorized.*

Congress expressly authorized federal savings associations to make "[s]ecured or unsecured loans for commercial, corporate, business, or agricultural purposes."<sup>7</sup> The Association's proposed activity would facilitate the Association's expressly authorized commercial lending operations in two ways. First, the proposed activity would provide its commercial borrowers with some protection from adverse changes in foreign exchange rates. The borrowers are active in foreign markets and thereby incur currency risk as part of their normal business operations. Should the borrowers realize losses from their currency risk, they may be less able to make their loan payments to the Association. Because the forward contracts would reduce the borrowers' currency risk, the contracts could strengthen the borrowers' ability to make loan payments to the Association during periods of adversity in foreign exchange markets. Strengthening the borrowers' ability to

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<sup>6</sup> National banks act as financial intermediaries by accepting and making payments in offsetting swap transactions. See OCC No Objection Letter No. 90-1 (Feb. 16, 1990) (concerning national banks' entry into commodity price index swaps, one between a national bank and a commodity producer, paired with a swap between a national bank and a commodity user).

<sup>7</sup> 12 U.S.C.A. § 1464(c)(2)(A) (West Supp. 1999).

repay their loans to the Association would facilitate the Association's lending operations.

Second, the activity would facilitate the Association's commercial lending operations by allowing the Association to offer borrowers that are exposed to currency risk a financial product tailored to manage their currency risk. Offering this financial product would help the Association attract more business from its existing commercial borrowers, some of whom have asked the Association to provide this service. It could also help the Association expand its commercial lending portfolio by drawing in additional qualified borrowers. New commercial borrowers may bring substantial deposits into the Association, and may provide an opportunity for the Association to extend multiple loans to its new customers.

We also note that the Association's proposed activity is similar to the expressly authorized activity of commercial lending because in conducting both activities, the Association would evaluate borrowers' creditworthiness and assume credit risk. These activities are a normal part of federal savings associations' commercial (and other) lending operations.

3. *The Activity is Consistent With the Purpose and Function Congress Envisioned for Federal Savings Associations.*

Congress created federal savings associations to, among other things, "provide for . . . the extension of credit . . . ." <sup>8</sup> More specifically, Congress gave federal savings associations broad authority to make a variety of loans, including commercial loans.<sup>9</sup> The proposed activity would facilitate the Association's commercial lending operations by strengthening the borrowers' ability to repay their loans from the Association, and by helping the Association attract commercial borrowers and expand its business with them, as discussed above. The activity would strengthen, facilitate, and therefore be consistent with, the purpose and function of providing commercial loans to meet customers' needs.

4. *The Activity is Necessary to Enable the Federal Savings Association to Remain Competitive and Relevant in the Modern Economy.*

Federal savings associations compete with national banks and other lenders in making commercial loans. You represent that many commercial banks in the

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<sup>8</sup> 12 U.S.C.A. § 1464(a) (West Supp. 1999).

<sup>9</sup> 12 U.S.C.A. § 1464(c)(2)(A) (West Supp. 1999).

Association's market area offer foreign exchange forward contracts to the public. The proposed activity would allow the Association to compete with national banks offering this type of service to commercial borrowers. As noted above, some of the Association's borrowers have requested that the Association provide this service. If the Association cannot meet the needs of its existing commercial borrowers, some of them may go elsewhere to obtain the services they need.

Moreover, Congress, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency have implicitly acknowledged that federal savings associations and other insured depository institutions may use forward contracts in the same manner.<sup>10</sup> It is reasonable to infer that the ability to offer such contracts can enable federal savings associations to remain competitive with national banks and others in the modern economy.

## **B. Compliance With Applicable Law and Conditions**

We conclude that the Association has incidental authority to conduct the proposed activity. In conducting such activity, the Association must comply with applicable laws and with certain conditions. The Association may only use foreign exchange forward contracts that are exempt from the Commodity Exchange Act.<sup>11</sup> The Association and all other parties to the forward contracts must be "eligible swap participants," as defined in applicable regulations.<sup>12</sup> The Association must comply with the loans to one borrower restrictions,<sup>13</sup> and in conducting the activity

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<sup>10</sup> In the statutes governing conservators and receivers for insured depository institutions, Congress included provisions covering the treatment of certain agreements, including forward contracts. *See* 12 U.S.C.A. § 1821(e)(8)(A)(i) (West 1989 & Supp. 1999) (governing treatment of qualified financial contracts at insured depository institutions), and § 1828(e)(8)(D)(i) (West 1989) (defining qualified financial contracts to include, among others, forward contracts). These statutes do not distinguish between the types of institutions that may use the contracts. The Federal Deposit Insurance Corporation, in construing and administering these statutory provisions, likewise does not distinguish between types of insured depository institutions. *See* 12 C.F.R. § 360.5 (1999). Similarly, the Office of the Comptroller of the Currency noted that in enacting these provisions, Congress recognized that both banks and thrifts use qualified financial contracts. OCC No Objection Letter No. 90-1 (Feb. 16, 1990).

<sup>11</sup> 17 U.S.C.A. §§ 1 - 25 (West 1980 & Supp. 1999). The Commodity Exchange Act regulates trading in certain derivatives, including commodities futures. Generally, the Commodity Exchange Act requires trading in covered derivatives to be conducted in registered markets by registered parties, and to comply with trading restrictions. *See also*, Commodities Futures Trading Commission regulations at 17 C.F.R. § 35.2 (1999). Additionally, the Association must not act as a broker or dealer unless it is properly registered as such under the Securities Exchange Act of 1934. 15 U.S.C.A. §§ 78a - 78mm (West 1997 & Supp. 1999).

<sup>12</sup> 17 C.F.R. § 35.1(b)(2) (1999).

<sup>13</sup> 12 U.S.C.A. § 1464(u) (West Supp. 1999); 12 C.F.R. §560.93 (1999).



the Association should be guided by TB 13a. Further, the Association must conduct its activities in a safe and sound manner and comply with any other conditions and limitations the OTS Northeast Region determines to be appropriate.<sup>14</sup>

In reaching the foregoing conclusions, we have relied upon the factual information and representations you have provided to us, as set forth in the background discussion above. Our conclusions depend on the accuracy and completeness of those representations. Any material change in the facts, such as if the borrowers were to use the forward contracts to speculate in foreign exchange markets, may result in different conclusions.

If you have any questions regarding the foregoing, please contact Christine Harrington, Counsel (Banking and Finance), at (202) 906-7957.

Very truly yours,

A handwritten signature in cursive script that reads "Deborah Dakin". The signature is written in black ink and is enclosed within a large, hand-drawn oval.

Deborah Dakin  
Deputy Chief Counsel

cc: Regional Directors  
Regional Counsel

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<sup>14</sup> Other federal savings associations that may be interested in conducting this type of activity should first contact their OTS Regional Office. In evaluating and approving such proposals from other institutions, OTS may set appropriate supervisory guidelines on the activity, and may establish individual minimum capital requirements, if appropriate.