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

Dear [ ]:

This letter responds to your request that the Office of the Comptroller of the Currency (“OCC”) confirm that [ ] (“Bank”) may enter into customer-driven, perfectly matched, cash-settled derivative transactions referencing: (i) paraxylene, (ii) purified teraphthalic acid, (iii) polyethylene terephthalate, and (iv) iron ore.¹

For the reasons discussed below, we conclude that the proposed transactions are part of a financial intermediation business that is legally permissible provided the Bank has controls in place to conduct the activity on a safe and sound basis. The OCC determined in Interpretive Letter 1065 that a national bank may engage in customer-driven, perfectly matched, cash settled derivative transactions with payments based on reference assets within certain categories, including plastics, petroleum products, and metals.² The reference assets identified in this letter are encompassed within those categories. Prior to engaging in this activity, the bank should: (i) provide written notification to its examiner-in-charge (EIC); and (ii) evaluate the risks posed by the activities to ensure that it can identify, measure, monitor, and control the associated risks.³ Additionally, the Bank should monitor the risks of its derivatives activities on an ongoing basis to ensure each activity is conducted in a safe and sound manner.

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).

² OCC Interpretive Letter No. 1065 (July 24, 2006) (IL 1065).

³ The written notification to the EIC should include a detailed description of the proposed activity, including the relevant reference asset(s); identification of OCC precedent authorizing transactions involving the reference asset(s) and hedging activity, i.e. perfectly matched or portfolio hedged; anticipated start date of the activity; and a detailed description of the bank’s systems and controls for risk measurement and monitoring.
Background and Discussion

The OCC has long permitted national banks to act as financial intermediaries under 12 U.S.C. § 24(Seventh) in customer-driven derivative transactions on a variety of reference assets as part of the business of banking. The OCC has expressly permitted national banks to enter into customer-driven, perfectly matched, cash-settled derivatives referencing a variety of commodities and commodity indices. In Interpretive Letter 1039, the OCC determined that it was permissible for a national bank to engage in customer-driven, perfectly matched, cash-settled commodity derivatives referencing specified assets and indices, provided that the bank’s EIC is satisfied that the bank has adequate risk management and measurement systems and controls to conduct the activities on a safe and sound basis. The OCC subsequently issued a series of letters approving additional reference assets for customer-driven, perfectly matched, cash-settled derivative transactions. In IL 1065, the OCC determined that it was permissible for a national bank to enter into customer-driven, perfectly matched, cash-settled commodity derivatives referencing assets that fall within one of eleven specified categories.

OCC precedent provides that a bank engaged in a customer-driven financial intermediation business should have adequate risk management and measurement systems and controls to conduct the activities on a safe and sound basis. Derivatives financial intermediation does not automatically qualify as an activity that is part of the business of banking. That is, a proposed activity cannot be part of the business of banking if the bank in question lacks the capacity to conduct the activity on a safe and sound basis. The nature of this business requires appropriate systems and controls, and qualified personnel, in order for the activity to be conducted in a safe and sound manner. A bank must not only demonstrate that it can conduct the business in a safe and sound manner at the inception of the activity, but also on an ongoing basis. It is for these reasons that the OCC is adjusting the EIC no-objection process set forth in prior interpretive letters to the procedure discussed in this letter. This EIC notice requirement, pre-activity risk evaluation, and ongoing risk monitoring replace the EIC no-objection process in IL 1065 and other OCC interpretive letters concerning derivatives financial intermediation. A national bank

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5 See, e.g., OCC Interpretive Letter No. 1110 (Jan. 30, 2009) (IL 1110); IL 1065; OCC Interpretive Letter 1059 (Apr. 13, 2006) (IL 1059); OCC Interpretive Letter No. 1039 (Sept. 13, 2005) (IL 1039). The OCC has also issued interpretive letters that address the permissibility of a customer-driven financial intermediation business that is hedged on a portfolio basis. See e.g., OCC Interpretive Letter No. 1040 (September 15, 2005); OCC Interpretive Letter 1060 (April 26, 2006); OCC Interpretive Letter No. 1060 (April 26, 2006).

6 See, e.g., OCC Interpretive Letter No. 1063 (June 1, 2006); IL 1059; OCC Interpretive Letter No. 1056 (March 29, 2006).

7 The categories in IL 1065 are petroleum products, agricultural oils, grains and grain derivatives, seeds, fibers, foodstuffs, livestock/meat products, metals, wood products, plastics, and fertilizer.

8 See OCC Interpretive Letter 949 (September 19, 2002).

9 Id.

10 This change is limited to financial intermediation activities in derivatives.
that seeks to commence a derivatives financial intermediation business for a reference asset that is addressed in prior OCC interpretive letters may rely on the procedures set forth in this letter. The OCC notes that limitations and conditions in prior interpretive letters concerning perfectly matched and portfolio hedging still apply. For example, a national bank may not rely on this letter to portfolio hedge its customer-driven financial intermediation business if prior OCC interpretive letters only authorize perfectly matched hedging for a particular reference asset. The OCC expects that this transition from the no-objection process will enhance prudential supervision of bank derivatives activities by ensuring that banks evaluate the risks of the activities both at inception and on an ongoing basis. Notwithstanding the transition to this notice process, banks may continue to consult IL1065 and other relevant OCC interpretive letters to inform the risk analyses and controls contemplated under this letter.

On the basis of the legal analysis set forth in prior OCC interpretive letters addressing commodity derivatives financial intermediation, including Interpretive Letters 1039 and 1065, 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, subject to the conditions in this letter. The Bank represents that it seeks to enter into transactions referencing the additional reference assets to meet increased customer demand. The extension of the Bank’s derivatives business to include additional reference assets in response to customer demands is a natural extension of the Bank’s financial intermediation activities.

Conclusion

We conclude that the bank may enter into customer-driven, perfectly matched, cash-settled commodity derivative transactions referencing the proposed assets, subject to the EIC notice and safety and soundness conditions in this letter.

I trust that this is responsive to your inquiry. If you have additional questions, please contact Tabitha Edgens, Senior Attorney, Securities and Corporate Practices Division, at 202-649-5510.

Sincerely,

/s/
Karen Solomon
Acting Senior Deputy Comptroller and Chief Counsel