Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1051
March 2006
12 USC 24(7)

February 15, 2006

Re: **[ ]** ("Bank")

Dear **[ ]**:

The Bank is seeking confirmation that it is permissible for the Bank to enter into contingent credit default swaps ("C-CDS") and hold below-investment grade debt to hedge and manage the counterparty credit risks and liability exposures that arise from its derivatives activities. For the reasons discussed below, we conclude that the Bank may engage in the hedging and risk management transactions it proposes, provided the Bank's examiner-in-charge is satisfied that the Bank has adequate risk management and measurement systems and controls to conduct the activities on a safe and sound basis.

Background

The Bank has an active and growing derivatives business. Counterparty credit risk is an important risk of the derivatives business, and the Bank establishes credit limits to control such exposures. When a new derivative transaction would create a potential credit exposure beyond the limit for a client, the Bank may approve the transaction subject to the condition of dynamic management of the resulting exposure. By dynamically managing the credit exposures of the incremental derivative transaction, through a series of credit default swap ("CDS") and bond transactions, the Bank can manage counterparty credit risk more effectively and maintain potential credit exposure within approved limits.

The Bank may hedge the *price* or *market* risk of an incremental derivative transaction by executing a similar transaction in the opposite direction with a third party in the market ("Market

Risk Hedge").[1] Although this transaction protects the Bank from market risks, the Bank continues to face *credit* risk[2] if the counterparty defaults and owes payments to the bank. The Bank also faces a *liability* risk, *i.e.*, it has the obligation to make a cash payment to the counterparty if the Bank is out-of-the-money on the derivative when the counterparty defaults.

The Bank proposes to manage the counterparty credit and liability exposures related to a single OTC derivative contract or a portfolio of OTC derivative contracts in a more cost effective manner, both before and after downgrades by rating agencies,[3] by using CDS and debt instruments. To implement effectively the dynamic management of the underlying exposures requires the ability to purchase and sell securities issued by the derivatives counterparty as credit exposure changes. As a result, the Bank seeks authority to acquire below-investment grade debt.[4] Under the proposed dynamic credit hedging program, the Bank seeks to be economically indifferent whether the Bank owes or is owed money by a defaulting counterparty.

The Bank first hedges its counterparty credit exposure for the original trade by buying a C-CDS ("Asset Hedge"). A C-CDS resembles a traditional CDS. Both instruments settle in the same way. If a credit event occurs, the protection buyer delivers to the protection seller debt issued by the reference entity with a total face amount equal to a notional amount. In return, the protection seller pays the protection buyer an amount in cash equal to the same notional amount. There is an important distinction between the two instruments. While the notional amount of a CDS remains constant over the life of the contract, the notional amount of a C-CDS will change to reflect the current mark-to-market value of a specified reference derivative. The notional amount of a C-CDS is fixed only if and when the specified reference entity defaults on its debt obligations and the reference derivative has positive value for the bank. If the reference entity does not default on its debt obligations over the life of the C-CDS, then the instrument will expire at maturity.[5]

The Asset Hedge protects against the risk that the original trade may be in-the-money to the Bank when the counterparty defaults and the counterparty is unable to pay at settlement on the

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[1] Price risk is the risk to earnings or capital arising from changes in the value of traded portfolios of financial instruments. *See* Comptroller's Handbook: *Community Bank Supervision* (2003) at p. 156.

[2] Credit risk is the current and prospective risk to earnings and capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise to perform as agreed. *See* Comptroller's Handbook: *Community Bank Supervision* (2003), at p. 141.

[3] The Bank represents that statistically, in a portfolio of investment grade names, a small percentage will migrate to below-investment grade status over time as a result of downgrades by the rating agencies. For example, a company with a BBB rating has more than a 15% chance of becoming below-investment grade over a period of five years. As a result, the Bank wishes to hedge the credit risk of its counterparty, notwithstanding the counterparty's below-investment grade rating, or any subsequent downgrade to below-investment grade.

[4] The Bank currently uses CDS, C-CDS, and investment grade bonds to help manage credit and liability risks arising from derivative transactions.

[5] The C-CDS will also not have value to the bank if the reference entity defaults while the reference derivative transaction has negative value to the bank, *i.e.*, the bank has a negative mark-to-market on the transaction.

trade. In an Asset Hedge, the Bank purchases credit protection through a C-CDS from a third party or an affiliate[6] where the reference entity is the counterparty to the original trade. If the reference entity defaults on its debt obligations, and the reference derivative is in-the-money to the bank, the protection seller pays the Bank cash in an amount equal to the notional amount (i.e., the in-the-money amount of the reference derivative) of the C-CDS. In return, the Bank delivers to the protection seller bonds issued by the reference entity with a total face amount equal to this same notional amount. At the time of the reference entity's default, the Bank will need to obtain the requisite amount of bonds to meet this obligation. The ability to realize the value of credit protection on a credit derivative contract requires a protection buyer to purchase below-investment grade debt securities of an issuer that has had a credit event, such as a bankruptcy filing. The Bank can recover all or a portion of the cost of the Asset Hedge by selling credit protection to a third party or an affiliate through another C-CDS ("Liability Hedge").

In a Liability Hedge, the Bank manages the risk of owing money to its counterparty on the original trade by selling credit protection to a third party or an affiliate through a second C-CDS where the reference entity is the counterparty to the original trade, and the reference derivative is the Market Risk Hedge. If the reference entity defaults on its debt obligations, and the reference derivative is in-the-money (*i.e.*, the original client trade is out-of-the-money to the Bank), the Bank pays the protection buyer cash in an amount equal to the notional amount of this second C-CDS. In return, the protection buyer delivers to the Bank bonds issued by the reference entity with a total face amount equal to this same notional amount. Since the Bank is now the current holder of these bonds, the Bank has a claim against the issuer (which is also the counterparty on the original derivative) equal to the face amount of the bonds. If the Bank owes on the original trade at the time of default, the Bank can set-off its claim on the bonds against the amount that the Bank owes the counterparty under the original trade. This set-off can occur with any counterparty, either investment grade or below-investment grade, under the relevant derivative contract.[7] The Bank represents that purchases and sales of below-investment grade debt are essential to administering and maintaining effective Liability and Asset Hedges that enable the Bank to be economically indifferent whether the Bank owes or is owed funds when the counterparty defaults.

There is a concern that, where a counterparty on the original trade is insolvent at the time of default, and the Bank does not hold the bonds it receives in the Liability Hedge at least 90 days before the reference entity's bankruptcy filing date or insolvency, the Bank may be precluded under the U.S. Bankruptcy Code from exercising its right to set-off the bonds it received through the Liability Hedge against amounts the Bank may owe under the original trade. Therefore, to achieve the economically indifferent position it seeks in structuring these transactions, the Bank represents that it must purchase the bonds whenever necessary (including when it enters into the original trade with its counterparty and subsequently). The Bank will periodically adjust its bond

[6] The Bank represents that all transactions with affiliates will be consistent with sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. 371c and 371c-1, and the Federal Reserve Board's Regulation W, 12 CFR part 223.

[7] The Bank represents that each of its counterparties on the original derivative trades has previously agreed to the Bank's right of set-off in the relevant derivative contract.

holdings throughout the life of the original trade to reflect any changes in the Bank's 90-day VAR model amount and the mark-to-market of the derivative. While it holds legal title to the bonds, the Bank will use a total return swap to neutralize the economic risk of holding the bonds.

Discussion

Longstanding OCC precedent establishes that national banks may engage in certain customer-driven derivative transactions as part of a financial intermediation business, subject to safety and soundness parameters.[8] National banks also may manage risks arising from permissible derivatives activities as an essential part of the activities. [9] For example, national banks use credit derivative transactions, including a CDS and C-CDS, to manage credit risks arising from a permissible derivatives business.[10] A C-CDS is identical to a common CDS, except that the notional amount is variable at inception and becomes fixed only upon the default of a reference entity, if a specified reference derivative has positive value. These differences do not affect the ability of a national bank to engage in a C-CDS to manage risks arising from permissible banking activities. National banks can engage in a variety of transactions where one (or more) of the key terms is variable.[11] Further, the OCC has specifically permitted national banks to use below-investment grade debt to hedge the risks arising from bank-permissible derivative activities.[12]

A national bank may use derivatives to hedge the risks arising from the gamut of activities that are reflected on the Bank's balance sheet and income statement, including holding assets, taking liabilities, assuming off-balance sheet risks, and hedging the market risk associated with investment advisory fee income.[13] For example, in *MII Deposit*, the OCC authorized a national bank to purchase equity index futures to hedge interest rate exposures on deposit accounts with interest rates tied to movements in the S&P 500 Index.[14] The OCC noted that national banks are permitted and even encouraged to manage prudently the exposures arising from bank activities and they must be allowed the flexibility to use the most suitable risk management tool. In *DPC Shares*, the OCC permitted a national bank to buy and sell options to manage market risks associated with changes in the value of shares of a company the bank had acquired in satisfaction

[8] *See* 12 U.S.C. 24(Seventh).

[9] *See* OCC Interpretive Letter No. 892 (Sept. 8, 2000).

[10] National banks have engaged in credit derivative transactions since at least 1996. *See* OCC Bulletin 96-43 (Aug. 12, 1996).

[11] *See, e.g., 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* (Aug. 8, 1988) ("*MII Deposit*"), 1988 OCC Ltr. LEXIS 266 (deposit rates tied to performance of S&P 500 Index).

[12] *See* OCC Interpretive Letter No. 935, (May 14, 2002).

[13] *See* OCC Interpretive Letter No. 1037 (Aug. 9, 2005).

[14] *MII Deposit, supra*.

of a debt previously contracted.[15] The OCC found the hedging strategy helped the bank reduce credit risk by protecting against fluctuations in the value of the shares. A national bank may use derivatives to hedge a variety of financial risks, besides price or market risk, that may arise in connection with permissible banking activities.

The Bank already has authority to use below-investment grade debt as a risk management tool and it engages in a variety of customer-driven credit derivative transactions, including credit default swaps.[16] The primary difference between the Bank's current activities and its proposal is the types of risk that the bank would hedge or manage through the use of use below-investment grade debt. Here the Bank proposes to manage both credit and liability risks arising from permissible derivative activities. Banks have long had authority and recognized expertise in managing credit risk.[17] The Bank has designed the Asset and Liability Hedges specifically to manage both credit exposures and liabilities to counterparties, so that the Bank is economically neutral to counterparty performance on the derivative transaction. The Bank represents that purchases and sales of below-investment grade debt are essential to administering those hedges and maintaining their effectiveness. When viewing the Bank's risk management model as a whole, the use of below-investment grade debt in the manner proposed is an essential part of that strategy of managing risks associated with its derivatives business and therefore is permissible.

Safety and Soundness Requirements

For the Bank to engage in the proposed activity, the Bank's risk management and measurement 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. Accordingly, the Bank must demonstrate to the satisfaction of its examiner-in-charge that the Bank has established an appropriate risk management and measurement process for the proposed activity. As detailed further in the OCC Handbook: *Risk Management of Financial Derivatives*[18] and OCC Banking Circular No. 277,[19] an effective risk measurement and management process includes 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. Moreover, the Bank should ensure that the reputation and other risks presented by this program are assessed and reviewed by personnel from appropriate risk management areas within the Bank. We note that the Bank's proposed risk management activities raise unique reputation risk issues because the Bank may use below investment grade debt instruments, with market values below par, to offset payments that the Bank would otherwise owe to the counterparty. The Bank's risk

[15] *See* OCC Interpretive Letter No. 961 (Mar. 17, 2003) ("*DPC Shares*").

[16] *See* OCC Interpretive Letter No. 935, *supra*.

[17] *See, e.g.*, OCC Interpretive Letter No. 1019 (Feb. 10, 2005).

[18] OCC Handbook: *Risk Management of Financial Derivatives* (Jan. 1997).

[19] OCC Banking Circular No. 277 (Oct. 27, 1993).

management systems should include appropriate controls and disclosures to manage those reputation risks.

The Bank may not commence the proposed activities unless and until its examiner-in-charge has expressed no supervisory objection based on these criteria.

Conclusion

We conclude that the Bank may engage in the transactions it proposes, provided the Bank's examiner-in-charge 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 views expressed in this letter are based specifically on the Bank's representations and written submissions describing the facts and circumstances of the Bank's proposed hedging and risk management transactions. Any change in the facts or circumstances could result in different conclusions. If you have any questions concerning this letter, please contact Donald N. Lamson, Assistant Director, Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

signed

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel