

Interpretive Letter No. 02-01 (January 16, 2002)

State banks may sell certificates of deposit with rates of return indexed to recognized equity markets and participate in related hedging activities as part of their general banking business. State banks and corporate fiduciaries can invest in these certificates of deposit subject to certain limitations.

This letter is in response to letters from you and * by which you ask the Office of Banks and Real Estate (the "Agency") to determine whether Illinois state-chartered banks may participate in the * CD Program developed by *. * asks whether Illinois state banks may sell * CDs to their depositors and purchase * CDs as a part of their investment portfolios. * also asks whether Illinois corporate fiduciaries may invest in * CDs on behalf of their trust customers. We conclude that Illinois state-chartered banks may sell and invest in * CDs, and except as noted below, Illinois corporate fiduciaries also may invest in * CDs.

After review of several documents and a multimedia presentation supplied by *, a summary of our understanding of the * CD Program is as follows. Banks participating in the * Program, as sellers, will offer their customers a five-year certificate of deposit (the "CD") with a variable rate of interest tied to the performance of the S&P 500 Index. The actual rate of return will equal 90% of the rate of appreciation in the S&P 500 Index during the CD term (calculated on the average of the S&P 500 Index for the 12 quarters preceding maturity). Principal is guaranteed regardless of the performance of the S&P 500. Further, the FDIC will insure principal up to its established limits.¹ Interest is not FDIC-insured because of its contingent nature. Nonetheless, the Internal Revenue Service will require an annual payment of tax based on an imputed rate of return. Substantial penalties may result upon early withdrawal due primarily to the hedging activities banks will undertake after selling the CDs. Thus, bank customers who exercise their early withdrawal option are not guaranteed a return of principal.

The sample Service Agreement you provided us will require Illinois banks participating in the * CD Program to enter into equity option agreements with the Federal Home Loan Bank of Chicago (the "FHLB") as a means of hedging their exposure to the volatility of the S&P 500 Index. The equity option agreements will allow banks to receive a rate of return equal to 90% of the S&P 500 Index appreciation after five years (floor of 0%) in exchange for quarterly payments indexed to the London Interbank Offered Rate ("LIBOR"). LIBOR will reset quarterly, but the spread to LIBOR will remain fixed during the term of the equity option agreement. The FHLB payment will be an exact match of the interest payment a bank owes to its customer at maturity, so the resulting effect for the bank is a swap of an equity market risk for a more familiar short-term interest rate risk.

Based on this understanding, it is the Agency's position that Illinois state-chartered banks may participate in the * CD Program. Illinois banks may offer the CDs to their customers pursuant to their power to accept deposits and engage in a general banking business as granted by Section 3 of the Illinois Banking Act (the "Act").² The underlying hedging activities described above are incidental and germane to offering the CDs, so a bank may also engage in these activities, again pursuant to Section 3 of the Act. Further support for Illinois banks to engage in this type of hedging derives from the "wild card" power embodied in Section 5(11) of the Act.³ Because national banks are permitted to engage in equity derivatives hedging through swap contracts,⁴ Illinois state-chartered banks may do so as well.

¹ See August 21, 2000 letter from FDIC Counsel Joseph A. DiNuzzo to West Virginia Banking Commissioner Sharon G. Bias.

² 205 ILCS 5/3.

³ 205 ILCS 5/5(11).

⁴ See OCC Interpretive Letter No. 652 (September 13, 1994).

However, this authorization should not be construed as an endorsement of the * CD Program, nor should it be viewed as a pronouncement that the * CD Program is suitable for all Illinois state-chartered banks. * is hopeful that banks will participate in the * CD Program to lower their funding costs. It is essential for a participating bank to fully understand its funding costs when issuing the CDs so that meaningful comparisons can be made to other funding options. In addition, a bank must be able to adequately identify and measure the interest rate risk associated with participation in the * Program and be able to assess how its participation affects its balance sheet and earnings. In its proposed Equity Option Transactions Disclosure Statement, the FHLB addresses a number of critical assessments that its member banks must make before participating in the * CD Program. In summary, the FHLB indicates that banks will need to evaluate the credit risk associated with equity options, the additional accounting issues presented by offering equity-linked CDs, and the capacity and reliability of *.

Please note that our opinion applies only to the * CD Program as detailed by the materials you supplied.⁵ In the materials, we observed:

- (a) the use of a rate of return based on an established equity market index,
- (b) a disclosure statement a bank gives to its customers which provides comprehensive terms and conditions regarding the CDs, including detailed provisions governing rate of return calculations and early withdrawal penalties,
- (c) a written service agreement between your company and the bank, and
- (d) a well-conceived hedging mechanism designed to limit a bank's exposure to the volatility of the equity markets.

Any modification of the * CD Program could affect these attributes and lead to a reversal of our position.

An Illinois bank may purchase * CDs for its own account, but Section 32 of the Act will govern these purchases.⁶ Pursuant to an Illinois Attorney General Opinion, application of the loan limitations set forth in Section 32 of the Act with respect to certificate of deposit transactions between banks is reasonable and in accordance with the intent of Section 32.⁷ Three separate limitations are involved. First, the total of the purchasing bank's CD purchases, when aggregated with all other money loaned to the selling bank, may not exceed 25% of the unimpaired capital and unimpaired surplus of the purchasing bank. Second, the total liabilities of the selling bank to the purchasing bank for CDs sold, money borrowed, or otherwise, may not exceed 25% of the deposits of the purchasing bank. Third, the total liabilities of the selling bank to the purchasing bank for CDs sold, money borrowed, or otherwise, may not exceed 50% of the unimpaired capital and unimpaired surplus of the purchasing bank. Finally, all transactions between affiliates are subject to the limitations of Section 35.2 of the Illinois Banking Act, which generally limits such transactions in the case of any one affiliate to 10% of the bank's unimpaired capital and unimpaired surplus.⁸

⁵ The primary materials supplied were a PowerPoint presentation, Service Agreement (Version *), Product Description and Disclosure Statement (Series *), and FHLB Equity Option Transactions Disclosure Statement.

⁶ 205 ILCS 5/32.

⁷ 1048 Op. Att'y Gen. Ill. (1976).

⁸ 205 ILCS 5/35.2. See also Section 23A of the Federal Reserve Act (12 U.S.C. 371c) and 12 U.S.C. 1468 and 1828(j).

You also asked whether an Illinois corporate fiduciary may purchase * CDs when acting as a trustee pursuant to the Trusts and Trustees Act⁹ and as a guardian of a ward's estate. The Trusts and Trustees Act governs the administration of trusts created by "will, deed, agreement, declaration or other instrument."¹⁰ The Trusts and Trustees Act would permit the investment of trust assets in * CDs if, in the particular circumstances, such an investment would comply with the Prudent Investor Rule, unless the governing instrument or a court order prohibits an investment of this type.¹¹ Under the Prudent Investor Rule, the extent to which a trustee may invest trust assets in * CDs, if at all, will depend on each trust's unique circumstances, including its purposes, terms, and distribution requirements. Again, however, our determination that a trustee can, in some circumstances, invest trust assets in * CDs should not be construed as an endorsement of the * CD Program.

Corporate fiduciaries investing the assets of minors and disabled adults are governed by the investment rules for wards set forth in the Probate Act of 1975.¹² Section 21-2.06 of the Probate Act allows the investment of a ward's assets in CDs of a state bank, but only to the extent such deposits are insured by the United States or one of its agencies. The absence of deposit insurance for the contingent interest component of the CD appears to be problematic. Because the Illinois Legislature has not specifically permitted the investment of a ward's assets in equity-linked CDs, we do not believe it would be permissible for a corporate fiduciary to purchase * CDs on behalf of a minor or a disabled adult.

⁹ 760 ILCS 5/1 et seq.

¹⁰ 760 ILCS 5/3(1).

¹¹ 760 ILCS 5/5.

¹² 755 ILCS 5/21-2 through 755 ILCS 5/21-2.15.