

INTERPRETIVE LETTER 94-019 (SEPTEMBER 15, 1994)

Bank may trade energy derivatives for its customers pursuant to ' 5(11), provided it has the management and controls necessary to ensure safe and sound banking practices.

We are writing in response to your correspondence dated *. You asked whether Illinois law permits the Chicago branch of * ("Bank") to engage in proprietary trading of commodity-related derivatives, including trading in commodity-related derivatives for other than hedging purposes. You referred to our *, report of examination ("Examination Report") of Bank that described the nature and scope of Bank's proprietary trading activities. For the reasons set forth below, and subject to the enumerated conditions, we conclude that Bank may trade certain commodity-related derivatives.

The only commodities-related derivatives in which Bank trades are energy derivatives (oil and gas). Therefore, we will limit our discussion to those products. Bank is offering energy derivatives to its customers. There is no outright continuing market risk involved with these trading activities. It is our understanding that Bank hedges its energy derivative positions and that the trading activities in which they are engaged are customer-driven. There is no evidence to suggest that Bank is speculating in energy derivatives.

Bank offers its customers a wide array of exchange traded and over-the-counter energy derivatives. Its customers are primarily commercial and investment banks, large multinational corporations and commodities firms. The products are offered to help Bank's customers hedge their risks or to provide an efficient financing vehicle. All transactions are cash settled rather than taking physical delivery. Most transactions are short term with three month maturities since Bank's counterparties generally hedge short term. Bank has a three-year maturity limit on energy contracts. Bank hedges the various risks that result from these trading activities by the purchase or sale of other energy derivative products.

Section 3 of the Foreign Banking Office Act ("FBOA"), 205 ILCS 645/3 (1992), confers upon foreign banking corporations the same rights and privileges as state chartered banks in Illinois. Thus, the Illinois Banking Act defines the rights and privileges of foreign banking corporations in Illinois. The general statutory authority for Bank to conduct banking activities is contained in ' 3 of the Illinois Banking Act ("Act"), 205 ILCS 5/3 et seq. (1992), which states in relevant part, "It shall be lawful to form banks...for the purpose of...doing a general banking business." Additional authority for banks to conduct banking activities is found in ' 5 of the Act which grants banks "chartered under or subject to this Act" enumerated powers. One of these powers is found in ' 5(11) of the Act which is sometimes called the "wildcard" provision. Section 5(11) permits a state chartered bank, and therefore, a foreign banking corporation pursuant to the FBOA, to do any act or to own any asset so authorized or permitted to a national bank. The following

analysis will focus on whether these trading activities are permitted as part of the general banking business and on whether national banks are permitted to engage in these activities and therefore that state chartered banks and foreign banking corporations may do so.

There are no state law interpretations directly on point. Pursuant to the authority contained in ' 5(11) of the Act, we will analyze interpretations by the Office of the Comptroller of the Currency ("OCC") which state that commodities-related trading by national banks is "incidental to banking" under ' 24(7) of the National Banking Act, 12 U.S.C. ' 24(7). OCC Banking Circular 277 ("BC-277") (October 27, 1993), reprinted in 5 Fed. Banking L. Rep. (CCH) &58,717, describes the different purposes for which banks may use financial derivatives. Financial derivatives include a wide range of financial instruments, such as swaps, futures and options, all of which derive their value from the performance of assets, interest or currency exchange rates, or indexes. The OCC states that one application for financial derivatives is for national banks to offer them to customers seeking risk management tools to assist in meeting the customer's business objectives. Our review confirms that Bank is dealing in energy derivatives to provide risk management or to provide an efficient financial vehicle to its customers.

BC-277 further states that national banks whose financial derivatives activities involve dealing or active position-taking should have risk measurement systems that can quantify risk exposures arising from changes in market factors. These systems must be in place to ensure that the banks are acting in a safe and sound manner. Among other general guidelines, BC-277 sets forth market risk management guidelines for banks whose derivative activities involve dealing or active position-taking. Such risk management systems must include the following: 1) initiate prompt remedial action; 2) facilitate stress testing; 3) assess potential impact of various changes in market factors on earnings and capital; and 4) provide supervision by qualified senior management and oversight by the Board of Directors. The systems should enable the banks to quantify the risk exposures that develop from changes in market factors.

The OCC has issued several interpretations confirming that national banks are permitted to engage in commodities-related derivative transactions similar to those being conducted by Bank. In February 1990, the OCC determined that a national bank has the authority to act as principal in unmatched commodity price index swaps with its customers. OCC No-Objection Letter No. 90-1 (February 16, 1990), reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) &83,095. See also, OCC No-Objection Letter (March 2, 1992) (unpublished) (unmatched commodity index swaps may be managed on a portfolio basis) and OCC No-Objection Letter No. 87-5 (July 27, 1987), reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) &84,034 (matched commodity price index swaps). A national bank acting as a principal in an unmatched commodity price index swap is comparable to Bank serving as the counterparty to its customers in energy derivative contracts. In the letters referenced above, the OCC found that in entering into these swap contracts, the national banks were acting in their traditional role as financial intermediaries by helping their customers meet various financial objectives, including

reducing financial risks associated with fluctuations in the prices of commodities the customers use or produce.

The activities in which Bank is engaging are similar to the ones approved for national banks by the OCC in the above referenced issuances. Bank enters into these transactions as a counterparty with their customers to assist them in meeting their financial objectives. Bank has the necessary risk management tools and expertise to deal in energy derivatives in a safe and sound manner.

Bank's energy derivatives sector is managed by the product risk management area. In managing its risk, the sector closely monitors price and volatility relationships between different energy products including the margin that naturally occurs between the prices of crude oil and its refined products due to the physical relationship that exists between the products. Parameters have been set to monitor market risk. Limits are expressed in terms of the size of price fluctuations and the total dollars at risk. Profit and loss is computed on a daily basis. Systems are in place to test theoretical values for all open trades using common input variables such as forward prices, volatilities and interest rates. Bank also has established a system for monitoring customer credit limits. In conclusion, we find that the Bank is trading energy derivatives in a safe and sound manner.

We will not permit a state chartered bank or a foreign bank corporation under our jurisdiction to engage in such activities unless we determine that the bank has the management and controls necessary to ensure that such activities are carried out according to safe and sound banking practices. Therefore, we will require that these banks present a detailed plan to us evidencing proper management and controls before engaging in such activities. We believe that Bank has such management and controls.