Date: December 30, 1999.

Summary Conclusion: A federal savings association may act as principal in interest rate hedges with its commercial borrowers and a third party correspondent bank, subject to limitations. This activity is permissible as an activity incidental to federal savings associations' statutory powers.

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

Office of Thrift Supervision
Department of the Treasury

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

P-99-11

Chief Counsel

December 30, 1999

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Re: Interest Rate Hedges

Dear [ ]:

This responds to your inquiry whether [ ] (the "Association"), may act as principal in interest rate hedging transactions with its commercial loan customers. In brief, we conclude that this activity is permissible for the Association as an activity incidental to its statutorily enumerated powers, subject to the limitations set forth below.

I. BACKGROUND

The Association is a "Federal savings association" as defined in the Home Owners' Loan Act ("HOLA").[1] You represent that the Association routinely makes commercial loans, and competes with commercial banks and other financial institutions for commercial loan business. The Association proposes to act as principal in interest rate hedge transactions with its commercial loan customers. The Association would offer to its commercial borrowers a financial product that would use interest rate hedge agreements, including interest rate swaps, interest rate caps, interest rate floors, or some combination thereof

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[1] 12 U.S.C.A. § 1462(5) (West Supp. 1999).

(collectively, "hedges").[2] The Association would not enter into such hedges on a stand alone basis as part of its proposed activity, although it may otherwise do so to manage its interest rate risk. You describe the proposed activity as follows.

The Association would enter into an interest rate hedge transaction with a customer that obtains a commercial loan from the Association. In connection with each interest rate hedge agreement entered into with a commercial borrower, the Association would enter into a complementary transaction with a correspondent bank. Thus, the Association would use two hedge agreements, one between the Association and its commercial borrower, and the other between the Association and a correspondent bank. All parties to the two hedge agreements would enter into the agreements simultaneously. The two agreements would complement each other, so that when the borrower would pay on its hedge agreement, the correspondent bank would receive hedge payments on its agreement, and vice versa. If either the borrower or the correspondent bank were to default on its hedge, the Association would still be bound to make payments on the other hedge.

The commercial borrower would compensate the Association for providing the borrower with a hedge service. The Association's compensation would result from a difference between the borrower's and the correspondent bank's hedge payments. The hedge payments may be one time fees on caps or floors, or may be periodic payments on swaps. No matter the form, the Association would always pay less to the borrower than it would receive from the correspondent bank, or would receive more from the borrower than it would pay to the correspondent bank.

The simultaneous, offsetting hedges would mean that the borrower would have, in effect, an interest rate hedge with the correspondent bank, although

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[2] An interest rate "swap" is an agreement by which two parties periodically exchange interest payments on some defined, or notional, principal amount. Commonly, one party pays a fixed rate and the other pays a floating rate. The parties net their obligations, so that only one party actually pays for any period. In an interest rate "cap," one party buys from another the right to receive periodic interest payments on a notional amount of principal if market rates exceed a defined level. If rates stay below that defined level, there are no periodic payments. In an interest rate "floor," the reverse of a cap, one party buys the right to receive interest payments if market rates fall below a defined level. The Association also proposes to offer combinations of the foregoing, including collars and corridors. A "collar" is a combination of a cap and floor, where a party buys a cap for protection from rising rates and sells a floor for protection from falling rates, thereby limiting the party's interest rate risk to a range above the floor and below the cap. In a "corridor," a party buys one cap for protection from rates rising above a certain level, and sells another cap, at a higher interest rate, to help pay for the purchased cap. A corridor fixes interest costs within a corridor of rates, but outside that corridor interest costs float. See OTS Regulatory Handbook, Thrift Activities, pp. 543.1, 543.7 (January 1994); OTS Thrift Financial Report Instruction Manual, Schedule CMR p. 230 (March 1998).

those two parties would have no contractual relationship and the hedge payments would pass through the Association. Because the Association would simultaneously receive payments from one party and make payments to the other party, the Association would not incur any interest rate risk on the hedges. The Association, however, would incur credit risk.

Before entering into a matching hedge agreement with a correspondent bank, the Association would analyze the credit risk presented by the correspondent bank. Initially, the Association would enter into a Master Agreement with the [ ] as the correspondent bank, but may add other correspondent banks as hedge counterparties in the future. You represent that the Association would only use correspondent bank counterparties that meet certain criteria. The correspondent bank would be a United States or foreign entity that has at least a single A rating from Standard & Poor's or Moody's. The Association's board of directors would approve in advance each correspondent bank as a permissible hedge counterparty. Each such approved counterparty would engage in a significant volume of brokering and trading derivative products. The Association would establish appropriate counterparty credit exposure limits and overall credit exposure limits for all of its financial derivative activities.

You also indicate that the Association would only select counterparties for its matching hedges whose creditworthiness would be sufficient without collateral securing the Association's credit exposure. In certain cases, the Association, nevertheless, would accept collateral to secure its credit exposure to a counterparty, such as in transactions where the counterparty requests collateral from the Association. The Association would only accept collateral in United States dollars or in assets denominated and marketable in United States dollars.

You represent that the Association would only use hedges that are exempt from coverage under the Commodity Exchange Act ("CEA")[3] by meeting an exemption set forth in applicable regulations.[4] You further represent that the Association will use only hedges that are "swap agreements" and the Association and all hedge parties will qualify as "eligible swap participants," as those terms

[3] 7 U.S.C.A. §§ 1 - 25 (West 1980 & Supp. 1999). The Commodity Exchange Act ("CEA") regulates trading in certain derivatives, such as commodities futures. Without an exemption, the CEA generally requires trading in derivatives to be conducted on registered markets by registered parties, and compliance with trading restrictions.

[4] 17 C.F.R. §§ 35.2 (1999) (exempting from the CEA's registration requirements and trading limits specified swap agreements between eligible swap participants).

are defined in regulations promulgated under the CEA,[5] when they enter into the hedges; and the hedges will otherwise meet the requirements for exemption from the CEA.[6] Finally, you represent that the Association will conduct the proposed transactions only in United States dollars.

II. DISCUSSION

A. Incidental Powers Analysis

Section 5(c)(2)(A) of the HOLA[7] expressly authorizes federal savings associations to make commercial, corporate, and business loans, but does not specifically authorize associations to engage in hedge transactions as the Association proposes.[8] OTS has long recognized that federal savings associations 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) Is the activity similar to, or does it facilitate the conduct of, an activity that Congress expressly authorized; (2) Is the activity consistent with the purpose and function Congress envisioned for federal savings associations; (3) Does the activity relate to the financial intermediary role that all federal savings associations were intended to play; and (4) Is the activity necessary to enable the federal savings association to remain competitive and relevant in the modern economy?[9] 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.[10] In the following discussion, we review the Association's proposed

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[5] 17 C.F.R. § 35.1(b)(1) (1999) (swap agreements include interest rate swaps, caps, floors, and combinations of those); 17 C.F.R. § 35.1(b)(2) (1999) (eligible swap participants include savings associations and banks, and large institutional investors and wealthy individuals).

[6] 17 C.F.R. § 35.2 (1999) (exempt swap agreements must not be fungible, standardized agreements traded on an exchange, and the creditworthiness of the parties must be a material consideration to entering into the agreement or to setting its terms).

[7] 12 U.S.C.A. § 1464(c)(2)(A) (West Supp. 1999).

[8] 12 U.S.C.A. § 1464(c)(2)(A) (West Supp. 1999). We note that OTS has addressed derivatives activities in 12 C.F.R. § 563.172 (1999) and in Thrift Bulletin 13-a (Management of Interest Rate Risk, Investment Securities, and Derivatives Activities). However, this regulation, Thrift Bulletin, and their preambles, 63 Fed. Reg. Reg. 20252 and 20257 (April 23, 1998); 63 Fed. Reg. 66348 and 66351 (December 1, 1998), do not address using matched hedges as the Association proposes.

[9] OTS Op. Chief Counsel (Mar. 25, 1994) (surveying law related to incidental powers).

[10] Id. at 8.

activity under each of these four factors. Based on this analysis, we conclude that the Association has incidental authority to conduct the proposed activity.

1. 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."[11] The Association's proposed hedging activity would facilitate the commercial lending that Congress has expressly authorized for federal savings associations.

The proposed activity would facilitate the Association's expressly authorized commercial lending operations in three ways. First, it would help the Association attract commercial borrowers by allowing the Association to offer commercial borrowers a financial product tailored to their individual needs, i.e., a product that addresses their interest rate risk. Second, the proposed activity would aid the Association's commercial borrowers by providing them with some protection from adverse changes in interest rates. Because the borrowers' commercial loans from the Association would have variable interest rates, the loan payments would become more expensive for the borrowers during periods of rising interest rates. But when loan payments become more expensive, the hedges would provide the borrowers with income. Receipt of this hedge income at a time when interest rates, and therefore loan payments, are increasing would be beneficial to the borrowers in making their loan payments.

Third, the activity would allow the Association to better manage the interest rate risk it incurs from its commercial lending by encouraging borrowers to select variable rate loans. Variable rate loans are often more advantageous to a federal savings association's interest rate risk profile than fixed rate loans, but borrowers often prefer fixed interest rate loans. With the proposed hedge, the Association can offer its borrowers protection from interest rate fluctuations, and thereby encourage borrowers to select variable rate loans. This, in turn, might help the Association make more variable rate and fewer fixed rate loans, which could reduce the interest rate risk inherent in the Association's lending operations. For these reasons, we conclude that the proposed activity would facilitate the Association's commercial lending.

We also note that the Association's proposed activity is similar to expressly authorized commercial lending because in conducting both activities,

[11] 12 U.S.C.A. § 1464(c)(2)(A) (West Supp. 1999).

the Association would analyze the parties' creditworthiness and assume credit risk. Under the proposed hedge program, the Association would enter into the two hedges simultaneously, so that the Association would not have interest rate risk from the hedges. The Association would, however, undertake credit risk, that is, the risk that one of the hedge participants may not make its required payments to the Association.

To minimize the credit risk arising from the hedges, the Association would analyze the creditworthiness of the hedge participants — the commercial borrower and the correspondent bank — before entering into the hedges. Analyzing borrowers' creditworthiness and assuming credit risk are activities that federal savings associations normally undertake in their commercial and other lending activities.

2. 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 . . . ."[12] More specifically, Congress gave federal savings associations broad authority to make a variety of loans, including commercial loans.[13] The proposed activity would facilitate the Association's lending operations by helping the Association attract suitable commercial borrowers and by allowing the Association to offer a financial product that would assist borrowers in meeting a financial need, 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.

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

As you have described the proposed activity, the Association would not incur interest rate risk exposure from the hedges because the hedges would offset each other.[14] By acting as principal with two counterparties to matched interest rate hedge transactions, the Association would be acting as a financial

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[12] 12 U.S.C.A. § 1464(a) (West Supp. 1999).

[13] 12 U.S.C.A. § 1464(c)(2)(A) (West Supp. 1999).

[14] If a counterparty to one of the hedges with the Association were to default on the hedge, the Association would bear interest rate risk on the matching hedge, unless the Association were to terminate the matching hedge.

intermediary, receiving and transferring funds (payments) between the borrower and the correspondent bank, in exchange for compensation from the borrower.[15]

The Association would also serve as an intermediary by providing services to the borrowers and the correspondent bank without which those parties might not be able, as a practical matter, to enter into the hedges. In the absence of the Association, the borrowers and the correspondent bank could incur significant expenses to find and analyze the creditworthiness of their hedge counterparties, while the Association can provide these services efficiently. Because the Association already analyzes borrowers' creditworthiness in its lending operations, the correspondent bank would not incur this cost. The Association would need to find and evaluate the creditworthiness of the correspondent bank, but could do so one time in support of multiple hedges with the bank. This would be more efficient than each borrower independently finding and analyzing the creditworthiness of each counterparty for each hedge. Further, the borrowers may not have expertise in credit analysis, but the Association does through its existing credit staff. Thus, the Association's participation would make the proposed hedges more efficient and cost effective for the parties. The proposed activity, in effect, would allow the borrowers and the correspondent bank to conduct financial transactions, with the Association serving as a financial intermediary.

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. For years, national banks have been permitted to offer to their borrowers financial products similar to the one the Association proposes.[16] The proposed activity would allow the Association to compete with national banks in this area.

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[15] The Office of the Comptroller of the Currency ("OCC") has found that national banks act as intermediaries in matched and unmatched swaps by accepting and making payments, as they do in their deposit and lending activities. OCC No Objection Letter No. 90-1 (Feb. 16, 1990).

[16] See e.g., OCC No Objection Letter No. 87-5 (July 20, 1987) (national bank may act as principal in offsetting commodity price index swaps with commodity producers and users); OCC No Objection Letter No. 90-1 (Feb. 16, 1990) (national bank may enter into unmatched commodity price index swaps); OCC Interpretive Letter No. 652 (Sept. 13, 1994) (national bank may enter into equity swaps and equity index swaps even though it may not purchase the underlying equity instrument); OCC Interpretive Letter No. 725 (May 10, 1996) (national bank's operating subsidiary may enter into interest rate swaps and other derivatives with third parties and simultaneously enter into offsetting transaction with parent bank, allowing bank to take advantage of operating subsidiary's higher credit rating to obtain better terms in the marketplace). OTS does not, by this letter, express an opinion that federal savings associations may permissibly engage in the various activities discussed in these OCC letters.

Moreover, in the statutes governing the appointment of conservators and receivers for insured depository institutions, Congress included provisions governing the treatment of certain hedges, including hedges of the type the Association proposes to use.[17] Notably, Congress did not distinguish between the types of insured depository institutions that may have entered into such agreements. The Federal Deposit Insurance Corporation ("FDIC"), in construing and administering these statutory provisions, likewise does not distinguish between types of insured depository institutions.[18] Similarly, the OCC noted that in enacting these provisions Congress recognized that both banks and thrifts use qualified financial contracts.[19] Congress, the FDIC, and the OCC have all at least implicitly acknowledged that both national banks and savings associations may use interest rate hedges in the same manner. It is reasonable to infer that interest rate hedges can enable federal savings associations to remain competitive with national banks and others in the modern economy.

Additionally, the proposed activity would allow the Association to keep pace with changes in the economy. Courts and the Federal banking agencies have permitted banks and thrifts to engage in evolving activities.[20] Historically,

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[17] 12 U.S.C.A. §§ 1821(e)(8)(D)(i), (vi) (West 1989 & Supp. 1999) (defining qualified financial contracts, for conservators and receivers of insured depository institutions, to include, among other agreements, any rate swap agreement, rate cap agreement, rate floor agreement, rate collar agreement, or similar agreement, and combinations of such agreements). Congress added these provisions to the Federal Deposit Insurance Act (the "FDIA") as part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 212, 103 Stat. 183, 237-39 ("FIRREA"). Before FIRREA, there were no comparable provisions in either the FDIA or HOLA.

[18] In clarifying the definition of "qualified financial contract" under 12 U.S.C.A. §§ 1821(e)(8), the Federal Deposit Insurance Corporation ("FDIC") does not distinguish between types of depository institutions. Rather, the FDIC distinguishes between types of contract, no matter what types of institutions use them. "Qualified financial contracts are accorded special status under the FDI Act and are treated differently from other contracts upon appointment of the FDIC as conservator or receiver for an insured depository institution." 60 Fed. Reg. 66863, 66864 (December 27, 1995) (discussing 12 C.F.R. § 360.5).

[19] OCC No Objection Letter No. 90-1 (Feb. 16, 1990) ("Congress has specifically recognized commodity swaps as products offered by banks and thrifts" by including commodity swaps, rate swaps and other agreements in the definition of "qualified financial contract" in 12 U.S.C.A. § 1821).

[20] For instance, the Ninth Circuit has said "we believe the powers of national banks must be construed so as to permit the use of new ways of conducting the very old business of banking." M & M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377, 1382 (9th Cir. 1977). OCC has summarized the law by stating that "the evolutionary nature of the business of banking and the necessity of banks developing new products to keep up with the changing financial needs of the economy are new well established in case law." OCC No Objection Letter No. 90-1 (Feb. 16, 1990). OTS has opined that thrifts are also permitted evolving incidental powers. "[T]he proper scope of permissible incidental activities must be allowed to evolve with the economy." OTS Op. Chief Counsel (March 25, 1994) (citing FHLBB Op. G.C. (July 29, 1981)).

commercial lenders made loans without providing interest rate hedges. As financial markets have evolved, however, participants have become increasingly active in hedging interest rate risk through interest rate swaps and similar vehicles.[21] Providing interest rate hedges in connection with commercial loans is one way to keep pace with changes in the financial landscape. Providing hedges in connection with commercial loans is merely a more modern form of thrifts' traditional lending, facilitation, and intermediation services, and will enable thrifts to remain relevant and competitive in the modern economy.

B. Compliance With Applicable Law and Conditions

While we conclude that the Association has incidental authority to conduct the proposed activity, the Association must comply with applicable laws and with certain conditions in conducting such activity. For example, the Association must not act as a broker or dealer unless it is properly registered as such under the Securities Exchange Act of 1934.[22] The Association may only use hedges that are exempt from the Commodity Exchange Act, and the Association and all other parties to the hedges must be "eligible swap participants," as defined in applicable regulations.[23] Further, the Association must conduct its activities in a safe and sound manner and in accordance with TB 13a and other safety and soundness conditions and limitations the OTS [ ] Region may determine to be appropriate.[24]

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[21] For example, the notional amount of interest rate swap agreements, excluding those traded on exchanges, increased from approximately $29 billion in March 1995 to $48 billion in June 1998, a growth rate of 19% per year for the period. Central Bank Survey of Foreign Exchange and Derivatives Market Activity 1998, (Bank for International Settlements, Monetary and Economic Department) May 1999, p. 20-21, and Table C-4.

[22] 15 U.S.C.A. §§ 78a - 78mm (West 1997 & Supp. 1999) ("Exchange Act"). In this regard, you represent that the proposed activity would not render the Association a broker or dealer under the Exchange Act. You also represent that the proposed hedges would not be "securities" under the Exchange Act. Should these representations become incorrect, the Association would need either to cease its activity or comply with applicable Exchange Act provisions.

[23] See, e.g., Commodities Futures Trading Commission regulations at 17 C.F.R. § 35.2 (1999).

[24] In conjunction with this opinion letter, the OTS [ ] Region is sending the Association a letter listing safety and soundness guidelines for the Association's proposed activity. Those guidelines require the Association's board of directors to approve the activity, set aggregate and individual counterparty dollar limits, and identify the personnel to conduct the activity. The guidelines further require the Association to properly train its personnel who take part in the proposed activity; ensure the transactions are suitable for the Association's customers; monitor and control the counterparty credit risk and set appropriate general loss allowances; use effective internal controls and periodically audit the hedging activity, and use industry standard hedge documents. The guidelines require the Association to obtain the OTS Region's nonobjection before deviating from the activity as described in this letter. The Region may revise these guidelines in the future as appropriate.

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

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 facts from those set forth herein could 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,

Carolyn J. Buck
Chief Counsel

cc: Regional Directors
Regional Counsel