Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1019
March 2005
12 USC 24(7)

February 10, 2005

Re: **[ ]** (“Bank”) Proposed Agricultural Loan Program

Dear **[ ]**:

The Bank has proposed to offer agricultural loans with payments that vary based on changes in commodity prices. For the reasons discussed below and subject to the limitations described herein, we believe that the proposed transactions are permissible for the Bank. The Bank may engage in these proposed transactions as an activity that is incidental to its existing agricultural lending business, provided the Bank has established, to the satisfaction of its Supervisory Office, an appropriate risk measurement and management process for its proposed transactions. In addition, before engaging in the program, the Bank should satisfy itself concerning application of commodity laws to the program and its responsibilities thereunder. [1]

The Program

The Bank proposes to engage in a loan program designed to assist borrowers to reduce volatility in farm income. The Bank proposes to lend money to its agricultural customers at a rate that is at or below generally prevailing market rates to finance the growing of certain commodity crops (*e.g.*, grain). The Bank also would forgive a portion of the borrower’s debt at maturity to reflect declines in the value of crops resulting from decreases in commodity prices. In return for this below-market rate of interest and possible debt forgiveness, the borrower would agree to give up

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[1] We express no opinion on whether the Bank’s proposed program is subject to the commodity laws, *i.e.*, the Commodity Exchange Act (“CEA”) and regulations of the Commodity Futures Trading Commission (“CFTC”). The CFTC is the federal regulatory agency with primary authority for administering the CEA, including determinations whether instruments are subject to regulation as commodity futures. The Bank should consult with the CFTC regarding these issues.

to the Bank a percentage of increases in the value of his crops resulting from rising commodity market prices. The Bank would make its loans in amounts as low as $5,000 to agricultural customers.

If the price of a commodity decreases over the term of the loan, the Bank would reduce the principal amount of the loan due at maturity. Depending on the amount of price reduction in the commodity, the principal amount of the loan outstanding could be reduced by as much as 50% or more. Conversely, if the market price of the commodity increases over the loan term, then the principal amount of the loan due at maturity would be increased, *e.g.*, by an amount equal to 50%, or more, of the increase in value of the farmer's crop resulting from an increase in commodity prices.

The Bank would hedge the risks it assumes under the program by entering into a series of individual swap transactions with **[ ]** (" ") that separately mirror the risks in the transactions between the Bank and each of its borrowers. At the maturity of the swap, **[ ]** would reimburse the Bank an amount equal to the reduction of principal that the borrowers would receive due to a reduction in commodity prices. Should commodity prices increase over the term of the loans, the Bank would simultaneously pay **[ ]** the increased amount it receives from its borrowers. Further, **[ ]** will pay at the time of loan disbursement any reduction in interest that the Bank would charge its borrowers. The amount of the interest reduction would be a function of a variety of variables, such as volatility in the price of agricultural commodities collateralizing the loan and the amount of risk exposure the borrower is willing to assume. **[ ]** would pay the interest subsidy from a portion of the profit **[ ]** anticipates from its transactions under the program. Depending on the success of the program, **[ ]** will maintain or reduce the amount of the interest subsidy it is willing to pay. Also, **[ ]** will pay the Bank a one percent origination fee at the time of the loan disbursement. The net result of these arrangements is that the Bank would continue to receive a market rate of interest on its agricultural loans plus a one percent origination fee. The Bank benefits under the program by obtaining additional fee income from **[ ]** and reducing the credit risk of its customers resulting from volatility in underlying commodity prices.

Law and Discussion

Financial Intermediation

The Bank's proposal would involve it in lending and certain derivatives transactions, both of which are clearly permissible for national banks.

Lending money is clearly part of the business of banking.[2] The Bank's loans to its customers under the program would be consistent with loans it already makes, except that **[ ]** would subsidize a portion of the interest rate and the principal would be adjusted to reflect changes in the price of commodities collateralizing the loans. The proposed loans are substantively

[2] *See* 12 U.S.C. 24(Seventh) and Interpretive Letter No. 896 (Aug. 21, 2000).

identical to the combination of a traditional loan and a derivative that protects against price fluctuations of the commodity collateralizing the loan. In effect, the borrower has entered into a loan and a collar (*i.e*., sold a call option and bought a put option) with the Bank. The borrower has sold a call option, by giving the Bank a portion of the increase in value of its crops, and purchased a put option, by obtaining forgiveness of a portion of loan principal to reflect reductions in the value of its crop. Those new features are consistent with existing law and recognized banking activities.

A variety of OCC precedents collectively permit the Bank to accept repayment of its loans in the manner the Bank now proposes, by accepting additional payments or reductions in principal depending upon changes in the price of a commodity that collateralizes the borrower's payment obligations. National banks already may make loans with variable interest rates.[3] Banks may take deposits with interest payable at a rate tied to gains in the S&P 500 index.[4] Banks also may take as consideration for making loans a share in the profit, income, or earnings from a business enterprise of a borrower, in addition to or in lieu of interest,[5] and may accept stock warrants as consideration for making a loan.[6] All of these arrangements share features that provide loan and deposit customers payment mechanisms calibrated to their financial needs or that reduce risk to acceptable levels.

The Bank's program similarly can help manage credit risk and reduce volatility by providing relief to borrowers from reductions in collateral value. This is precisely the effect of other strategies that banks and borrowers already engage in to protect borrowers from price fluctuations in agricultural commodities.

The Bank has represented that the transactions with its borrowers are hybrid instruments that are not subject to the commodity laws. The Bank would hedge its exposures to borrowers by entering into a series of swaps transactions with **[ ]** that generally are exempt from regulation under the commodity laws as over-the-counter derivatives. National banks already have authority to engage in a broad range of derivative contracts, including swaps on agricultural products.

The OCC long has permitted national banks to fashion new ways to help agricultural borrowers manage and reduce the risks to collateral values from changing commodity prices. In Interpretive Letter No. 356, a national bank operating subsidiary sought to act as a futures

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[3] *See, e.g*., Interpretive Letter No. 785 (June 3, 1997)

[4] *See* Letter from Ellen Broadman, Director, Securities and Corporate Practices Division, OCC to Barbara Moheit (Oct. 29, 1998) (unpublished).

[5] *See* 12 C.F.R. 7.1006.

[6] *Id*. The borrower's obligation to repay principal, however, may not be conditioned upon the value of the profit, income, or earnings of the business enterprise or upon the value of the warrant received. *Id*. That restriction is inapplicable in this case, because although principal on the loan may be reduced or increased, it is in reaction to a change in the market price of the collateral underlying the loan, rather than in reaction to the profit or earnings of the borrower.

commission merchant with respect to agricultural and metals futures.[7] The OCC found it incidental to the business of banking for a national bank, and therefore its subsidiary, to perform futures commission merchant activities on behalf of bank loan customers who are engaging in futures transactions to hedge risks underlying their loans from the bank. The OCC noted that futures are often used as a risk management tool to hedge against price and other risks incurred in the cash markets for commodities. A bank borrower's cash market risks are often reflected as credit risks to the bank where the cash market volatility might affect the borrower's repayment ability, the value of loan collateral, or otherwise affect the quality of the bank's loan. Banks often advise, and in some cases require, their loan customers to hedge against risks underlying their loans by engaging in futures contracts. Performing futures commission merchant business in agricultural and metals futures for loan customers' hedging transactions represented a convenient and useful adjunct to banks' express lending power and was therefore incidental to the business of banking.

The OCC previously considered virtually the same risk-mitigative structure that the Bank now proposes. In No-Objection Letter 87-5, a national bank proposed to enter into cash-settled swap contracts with producers and users of certain commodities, pursuant to which amounts would be payable based on a designated commodity price index.[8] The bank entered into these transactions only on a matched basis, such that the bank would be matched as to index, amount, and maturity on each side of the transaction. If the commodity index decreased, the bank would make a payment to producers and receive an offsetting payment from a user. Similarly, if the index increased, the bank would make payments to commodity users and receive payments from producers. Because the transactions were matched, the only risk to the bank would be its credit risk with respect to a particular user or producer. The bank's credit risk was further minimized by the fact that a producer would be required to pay only when the price for its commodity had increased. This would occur at a time when the producer would be in the best financial position to pay. Conversely, a user would be required to pay only when the price of a commodity had declined, and the user would be in the best financial position to pay. The OCC found that engaging in the proposed commodity price index swaps is an exercise of the express power to lend and is incidental to the express power to lend. Finally, the proposed swaps were part of the general "business of banking" as a form of funds intermediation.

The major difference between the two activities in Letter 87-5 and the Bank's proposal is the form of the instruments through which the Bank would engage in financial intermediation activities. Rather than engage in mirror swaps with agricultural borrowers and separately lend the notional amounts of the swaps, the Bank would combine the features of both products into one "hybrid instrument." This difference in form does not alter the fundamental credit risk management and financial intermediation features of the activities that the Bank would perform.

The OCC explained the nature of financial intermediation in Letter 87-5. When the bank acts as principal in arranging a matched set of commodity price index swaps for two customers, the bank undertakes the credit risk that would otherwise fall to each party to the transaction. When

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[7] Interpretive Letter No. 356 (Jan. 7, 1986). *See also* Interpretive Letter No. 380 (Dec. 29, 1986) (same).

[8] No-Objection Letter 87-5 (July 20, 1987).

the bank acts as principal, each party is provided with confidence that the swap will be carried out as promised in the contract. The bank supplies expertise to relieve the parties of the burden of undertaking their own credit analysis. In each transaction, the bank assumes credit risk because either party could default in providing its designated payment to the bank. The bank is not undertaking to make or take delivery of the underlying commodity or speculating on future price fluctuations in a commodity. The extension of credit is contingent and analogous to providing standby letters of credit. *Id*. So also in this case, in addition to acting as a lender to its agricultural borrowers, the Bank is intermediating individual, matched payment streams between **[ ]** and those same borrowers.

The OCC previously has recognized that national banks have authority to engage in new forms of transactions designed to address the same economic risk that the Bank's proposal addresses, *i.e*., the risk to a borrower's collateral from changes in commodity prices. In Interpretive Letter No. 896, the OCC found it legally permissible for a national bank to buy cash-settled options on certain commodity futures contracts where the underlying commodity is the primary collateral on an agricultural loan, as long as the bank has an appropriate risk management process in place. The OCC noted that despite the differences in form, options, futures, and options on futures serve a similar function: enabling banks and their customers to hedge against risk of interest rate and price changes relating to the underlying investments. The use of options on futures contracts on agricultural commodities to hedge bank permissible lending activities is not materially different from hedging loans with futures and options and, therefore, was permissible for national banks. Although the form of the contract in the Bank's program may differ from an option on a future, the economic result will be the same. The customer, and therefore the Bank, will be insulated from price volatility due to changes in collateral values.

Lending Limits

No legal barrier to the Bank's participation in these transactions is presented by the legal lending limits of 12 U.S.C. § 84 and 12 C.F.R. Part 32, which provide generally that the total loans and extensions of credit to any one borrower may not exceed fifteen percent of a bank's total unimpaired capital and unimpaired surplus.[9] 12 U.S.C. § 84(a), 12 C.F.R. § 32.3(a).[10]

Under 12 U.S.C. § 84(b)(1) and 12 C.F.R. § 32.2(k), lending limit calculations are determined based on a bank's advance of funds to a person conditioned on an obligation of the person to

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[9] According to the most recent available Consolidated Report of Condition and Income ("Call Report"), as of September 30, 2004, the Bank's capital and surplus for purposes of calculations under 12 C.F.R. § 32.2(b) is $ 44,876,000. Its fifteen percent limit on loans and extensions of credit to any one borrower under 12 C.F.R. § 32.3(a) would therefore be $ 6,731,400.

[10] The statute "is intended to prevent one individual, or a relatively small group, from borrowing an unduly large amount of the bank's deposits for the use of the particular enterprises in which they are engaged." Interpretive Letter No. 15 (Jan. 10, 1978). OCC regulations promulgated pursuant to section 84 describe the purposes of the lending limits as "protect[ing] the safety and soundness of national banks by preventing excessive loans to one person, or to related persons that are financially dependent, and [promoting] diversification of loans and equitable access to banking services." 12 C.F.R. § 32.1(b).

repay. While the amounts owed the Bank by either an agricultural borrower or by **[ ]** can fluctuate based on changing commodity prices, the lending limit will be determined based on the amount of funds advanced by the Bank, which will not be affected by such fluctuations.

Under the Program, for lending limit purposes, the amount of the Bank's loans to each individual agricultural borrower will be based upon the amount of funds advanced by the Bank to the borrower. The increase or decrease of principal as a result of commodity price changes will not affect lending limit treatment. **[ ]** is not a borrower from the Bank because it will have no repayment obligation for the funds the Bank pays to it under the Program. Nor, as discussed below, is **[ ]** a "guarantor" for any agricultural borrower's obligation to the Bank.

(1) Rising principal (when commodity prices increase)

When commodity prices rise, the principal amount of the loan due at maturity will increase. The borrower will owe the Bank more than the original face amount of the loan, and the Bank will owe that surplus to **[ ]**.

It is our view that the Bank's lending limit to each Program borrower will be calculated based on the amount of funds advanced by the Bank, not on the amount the borrower might owe at a later date. Under 12 C.F.R. § 32.2(k), loans and extensions of credit for purposes of the lending limits are defined as "a bank's *direct or indirect advance of funds to or on behalf of a borrower based on an obligation of the borrower to repay the funds…*" (emphasis added).[11] If the commodity price rises, a Program borrower will owe more to the Bank, and therefore the Bank will have greater exposure to that borrower. However, the lending limit is not affected because the amount of funds advanced by the Bank remains the same.[12]

By the same token, in such circumstances, the Bank will owe to **[ ]** the surplus amount received from the borrower, but **[ ]** has no obligation to repay that surplus to the Bank. The Bank's arrangement with **[ ]** is not a "contractual commitment to advance funds" within the meaning of 12 C.F.R. § 32.2(f) because there is no obligation on **[ ]**'s part to repay those funds. It is therefore our view that a rise in the commodity price does not trigger any lending limit exposure to **[ ]**, since **[ ]** is not a "borrower" with an obligation to repay.

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[11] The legislative history of 12 U.S.C. § 84 offers no guidance regarding the meaning of the phrase "advance of funds." However, the term "advance" as used with respect to money generally means to pay beforehand with the expectation of future reimbursement or return of the money. *See, e.g., Trust Company of Morris County v. Nichols,* 65 N.J. Super. 495, 163 A. 2d 205, 209 (1960); *Louchheim, Eng. & People, Inc. v. Carson,* 35 N.C. App. 299, 241 S. E. 2d 401, 404 (1978). This meaning is consistent with the emphasis in the statute on advances based upon a repayment obligation (12 U.S.C. § 84(b)(1) and also with the OCC's position that "loans" under the lending limits do not arise from accrued interest on loans (12 C.F.R. § 32.2(k)(2)(ii)).

[12] According to Statement of Accounting Standards No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases" ("FAS 91) at ¶ 21, as incorporated in the reporting requirements for Call Reports at A-57, the figure a bank would book as the loan amount would be the amount advanced to the borrower (plus expenses incurred in making the loan and less fees charged to the borrower.)

(2) Falling principal (when commodity prices decrease)

When commodity prices fall, the principal amount of the loan due at maturity will decrease. The Bank will forgive part of the loan amount due from the borrower and will recoup the difference from **[ ]**.

As discussed above, the Bank and **[ ]** would be entering into a series of swaps transactions that the Bank represents are generally exempt from regulation under the commodities laws as over-the-counter-derivatives. The Bank unquestionably has credit risk exposure to **[ ]** in the event of a decrease in commodity prices.[13] However, as noted above, a national bank's lending limit is calculated based on the amount of funds *advanced*. The Bank advances no funds to **[ ]** in these circumstances. Instead, it is **[ ]** who will be advancing or paying funds to the Bank.

We have also considered whether **[ ]** should be considered a "guarantor" on loans made by the Bank under the Program by virtue of **[ ]**'s obligation to pay money to the Bank when commodity prices fall and an agricultural borrower's loan principal decreases. Under 12 C.F.R. § 32.2(a), a "borrower" for purposes of the lending limit includes a guarantor "who is deemed to be a borrower under the 'direct benefit' or the 'common enterprise' tests set forth in § 32.5."

We conclude that based on applicable law, **[ ]** should not be considered a "guarantor" of an agricultural borrower under the Program. According to the *Restatement of the Law/ Suretyship and Guaranty*, American Law Institute (1995) ("Restatement"), status as a guarantor or surety "gives the secondary obligor a significant set of rights against both the principal obligor and the obligee."[14] Restatement § 1 Comment (a). The guarantor/secondary obligor has rights of reimbursement, restitution and subrogation: it is entitled to be reimbursed by the primary obligor and it is entitled to be subrogated to any defenses the primary obligor has against the obligee. Restatement §§ 17-19.

Obviously this structure and set of rules are inapplicable here. It is not intended by any of the parties that **[ ]** will have any rights of reimbursement or restitution against individual

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[13] **[ ]** has offered to put up collateral in any instance where the amount it would be required to pay under any swap arrangement with the Bank would exceed the Bank's lending limit. Letter from **[ ]**, to James Sgro, NBE (Sept. 20, 2002) at 4. While we conclude here that the lending limit does not apply to these transactions, we believe as a matter of safety and soundness that such collateral should be provided because, depending on the number and amount of loans outstanding, the Bank's exposure to **[ ]** could potentially be considerable.

[14] The difference between a "guarantor" and a "surety" is not significant for this discussion. According to the Restatement, "[d]ifferences between these two mechanisms have been the subject of extended debate, not all of which is illuminating." § 1 Comment (c). Generally, a "guarantor" is obligated to fulfill an obligation upon the default of the principal obligor, while a "surety" is jointly and severally liable with the principal obligor on an obligation to which they are both bound. The difference is of little importance because the provisions in any particular contract can alter the terms of the obligation. Further, some states make no distinction between the two at all. *See, e.g.*, California Civil Code § 2787 ("The distinction between sureties and guarantors is hereby abolished.")

borrowers. On the contrary, the reduction in the borrower's payment obligation in the event of a fall in commodity prices is one of the purported benefits of the Program in the first place. Far from intending that **[ ]** shall have rights against an individual borrower in the event of the latter's "default," the Program contemplates and intends that there be no "relationship or dealings of any nature between the borrower and **[ ]** *nor will the bank provide the name or identity of any borrower to* **[ ]**." Letter from **[ ]**, to James Sgro, NBE (May 17, 2002) at 2 (emphasis added). If **[ ]** does not know the name or identity of the borrower, it can hardly enforce any suretyship rights as described in the Restatement.[15]

Safety and Soundness Requirements and Supervisory Office Approval

For the Bank to permissibly engage in the proposed activity, the Bank's risk measurement and management capabilities must be of appropriate sophistication to ensure that the activity can be conducted in a safe and sound manner. Consequently, in order for the OCC to conclude that this activity is permissible for the Bank because it is part of the business of banking or convenient and useful to conducting authorized banking activities, the Bank must demonstrate to the satisfaction of the OCC that the Bank has established an appropriate risk measurement and management process for its proposed activity. As detailed further in the *OCC Handbook: Risk Management of Financial Derivatives*[16] and Banking Circular 277,[17] an effective risk measurement and management process includes board supervision, 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.

The Bank's risk control processes should include the Bank's compliance with accounting and reporting as stipulated by the instructions for the Consolidated Reports of Condition and Income, and generally accepted accounting principles. The proposed activity has more complex accounting requirements, and demands a stronger control framework, than other, more traditional, bank credit programs. Because the sophistication level of the bank's borrowers will vary, and further because it is possible that the borrower will have to repay an amount greater than the original loan amount, the proposed activity poses significant reputation risks for the bank. The Bank's controls over reputation risk should include, at a minimum, client education programs, marketing materials with a balanced assessment of risks and rewards, and clear product disclosures. The OCC will closely evaluate the bank's control environment for the proposed activity based upon the supervisory standards contained in Banking Circular 277 (Risk Management of Financial Derivatives), with special emphasis on the Bank's program for determining transaction appropriateness and measuring and monitoring reputation risk.

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[15] Since it seems clear that **[ ]** cannot be considered a "guarantor" of individual borrowers under commonly accepted legal principles as expressed in the Restatement, we do not address the applicability of the combination rules—the "direct benefit" or the "common enterprise tests—referred to in 12 C.F.R. § 32.2(a).

[16] *OCC Handbook: Risk Management of Financial Derivatives* (January 1997).

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

The Bank may not commence the proposed activity unless and until its Supervisory Office has concluded that the foregoing standards are met. The OCC will make these determinations regarding the effectiveness of the Bank's control program through the Bank's Supervisory Office.

Conclusion

The Bank may engage in these proposed transactions as an activity that is incidental to its existing agricultural lending business, provided the Bank has established, to the satisfaction of its Supervisory Office, an appropriate risk measurement and management process for its proposed transactions. Before engaging in the program, the Bank should satisfy itself, through consultation with CFTC staff and its own legal advisors, concerning application of commodity laws to the program and its responsibilities thereunder. If you have any questions concerning this letter, please contact Donald Lamson of the OCC’s Securities and Corporate Practices Division at 202-874-5210.

Sincerely,

/s/ *Daniel P. Stipano*

Daniel P. Stipano
Acting Chief Counsel