# Office of the Comptroller of the Currency

## Interpretations - Letter 725

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Cites:

- **12 C.F.R. 5.34**

**May 10, 1996**

**Richard K. Kim, Esquire**
**Assistant General Counsel**
**NationsBank Corporation**
**Legal Department**
**NationsBank Corporate Center**
**NC-1-007-20-01**
**Charlotte, North Carolina 28255**

**Re: Notification of Intent to Establish an Operating Subsidiary to Engage in Certain Derivatives Activities**
**Application Control Number: 96-WO-08-0005**

**Dear Mr. Kim:**

**This responds to the NationsBank, N.A. ("Bank") notification ("Notification") of intent to establish an operating subsidiary to engage in certain derivatives-related activities that are permissible for national banks and in which the bank is currently engaged. The operating subsidiary, which will be wholly owned, will be named NationsBanc Financial Products, Inc. ("NFP"). The Bank has committed to structure and operate NFP as set forth in the Notification and described below.**

**Based on the commitments and representations made by the Bank, we have no objection to the Bank's plan to establish NFP to engage in permissible derivatives-related activities, subject to the condition set forth below.**

**The Bank's Proposal**

**The Bank will form NFP for the purpose of entering into interest rate swaps, caps, floors and swaptions, cross-currency swaps, caps, floors and swaptions, and other derivative transactions permissible for national banks (collectively the "proposed activities"). The Notification commits that NFP will engage only in derivatives-related transactions that are permissible for national banks. The Bank also has represented that it is not establishing NFP to alter or expand the types of**

derivatives transactions in which the Bank engages. Instead, the Bank proposes to establish NFP to engage in certain types of derivatives transactions in which the Bank currently engages.

The Bank has stated that it is establishing NFP as part of an internal restructuring of the Bank's current activities. <NOTE: The Notification provides that in July 1993 the Bank purchased substantially all of the assets of Chicago Research and Trading Group, Ltd., a leading participant in the exchange-traded derivatives market. The Notification further provides that since then the Bank has become one of the most active U.S. banks in the derivatives markets with respect to both exchange-traded and OTC instruments.> The Bank will transfer certain of its existing derivatives-related business to NFP and will structure NFP so that it will be rated AAA/Aaa by Standard and Poor's Rating Service and Moody's Investors Service, Inc. <NOTE: NFP will be a continuation structure in that it will continue to exist in the event the Bank becomes insolvent. If the Bank's long-term senior debt rating falls below A-/A3, a contingent manager will be appointed with a long-term senior debt rating of at least A-/A3. The duties of the contingent manager will vary depending on the extent of the downgrading. The Bank has not yet selected a contingent manager but has represented that it will be a major financial institution with a well developed derivatives business. The Bank will notify the OCC of the identity of the contingent manager as soon as one is retained.> The Bank will transfer derivatives activities to NFP in an incremental manner. Initially, NFP's activities will be limited to interest rate and currency products. Subsequently, the Bank may transfer other types of derivative products, such as energy swaps and options, to NFP.

The Bank will initially capitalize NFP with $300 million. The Bank may provide additional funds to NFP from time to time. NFP will use a sophisticated capital model to ensure that it has sufficient capital at all times to maintain its credit rating. The model will calculate the appropriate level of capital by simulating market rate movements and counterparty rating fluctuations over an extended period of time. The aggregate investment, including loans and advances, by the Bank in NFP will not exceed 15% of the Bank's capital and surplus. <NOTE: Any collateral posted by the Bank to NFP will not be counted toward this 15% limitation.>

The Notification states that the Bank currently does not contemplate that any affiliate of the Bank will make any investments, including loans or advances, in NFP. The Notification also provides, however, that from time to time NFP may enter into transactions with affiliates of the Bank and that these transactions will at all times comply with Sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. 371c and 371c-1.

NFP will generally engage in the proposed activities with counterparties rated A or higher, or of equivalent creditworthiness. Lower rated counterparties will generally enter into derivative transactions directly with the Bank and are not expected to comprise a significant portion of the overall derivatives business of the Bank and NFP.

NFP will transfer market risk to the Bank by entering into transactions with the Bank on mirror terms as those entered into by NFP with unaffiliated parties. NFP will enter into a mirror transaction with the Bank at the same time that it enters into a third-party transaction. These mirror transactions will have exactly opposite terms, except for an intermediation fee, payable by the Bank to NFP on a monthly basis. <NOTE: The Bank will continue to handle portfolio management of market risk for all derivative transactions entered into by the Bank and its affiliates, including NFP. Initially, NFP will not independently hedge its portfolio. Once NFP is fully operational, the Bank will actively explore with the rating agencies the possibility of NFP independently managing its own risk.> NFP will retain the credit risk of its proposed activities but will not bear market risk at any time. If a transaction between NFP and a third-party is terminated, amended or assigned, the corresponding mirror trade will be terminated or amended simultaneously.

The Bank will collateralize its obligations to NFP on a net mark-to-market basis in order to maintain NFP's credit rating. The Bank has represented that posting collateral on behalf of NFP is more efficient than the Bank's current practice of posting collateral in connection with each individual transaction and only netting transactions with the same counterparty. Due to its higher credit rating, NFP will not post collateral on behalf of the Bank. NFP will rarely post collateral to affiliated or unaffiliated counterparties with a rating of A+/A2 or lower.

The Bank has represented that the fundamental reason it is shifting certain of its derivatives business into NFP is to attract those counterparties that will only enter into derivatives transactions with entities with a AA-/Aa3 or higher rating. According to the Bank, market research indicates that a significant number of derivative users will only trade with entities that are rated AA or better, particularly with respect to instruments with maturities over one year. These counterparties include major multinational corporations, domestic and international institutional investors, and governmental and quasi governmental agencies. The Bank views these potential counterparties as a highly desirable segment of the market of derivative products end-users because they actively use derivatives and typically have high credit ratings. In the Bank's view, attracting these counterparties is essential as the derivatives markets develop and business becomes increasingly concentrated among large, highly-rated banks and securities firms.

The Bank has represented that the proposal is consistent with safe and sound banking practices and in fact should enhance the Bank's overall safety and soundness. The Bank believes that establishing a credit-enhanced derivatives program will increase the Bank's derivatives revenues and profitability. The program will also increase the proportion of higher-rated counterparties within the Bank's overall derivatives portfolio and thus improve overall portfolio credit quality. In addition, the Bank expects that the formation of NFP will benefit other lines of business by providing access to a wider range of potential customers.

The Bank has stated that NFP will treat all business dealings with the Bank and its affiliates in an arm's length manner. <NOTE: The Bank will provide certain services to NFP including accounting, credit, documentation, transaction support, risk management and payment services.> According to the Notification, NFP will be managed by its board of directors, not the Bank, and will have at least one officer and two directors who are independent from the Bank. The Notification also commits that the assets of the Bank and NFP will not be commingled, and that NFP will maintain its own corporate records, financial statements, and accounting records.

Similarly, the Bank represents that both the Bank and NFP will hold out NFP as a separate and distinct corporate entity in their written and personal contact with outside parties. All written marketing material will clearly state that NFP is a separate subsidiary of the Bank and the obligations of NFP are not obligations of the Bank. NFP will put in place derivatives documentation with its counterparties that prohibits (i) cross-netting by counterparties to NFP and the Bank, its subsidiaries or affiliates and (ii) cross-default provisions based on a default by the Bank or an affiliate on any type of contract.

**Legal Analysis**

**The Notification provides that the proposed activities will consist of derivatives transactions in which national banks are permitted to engage, and in particular, interest rate swaps, caps, floors and swaptions, and cross-currency swaps, caps, floors and swaptions. The Notification further provides that the Bank currently engages in all of the proposed activities.**

**The OCC previously has determined that originating, trading, and making markets in certain swap products and other derivative instruments such as futures and options, as well as hedging related risk, are within the legally authorized powers of national banks. *See, e.g.*, OCC No-Objection Letter No. 90-1 (February 16, 1990), *reprinted in* Fed. Banking L. Rep. (CCH) 83,095 (bank acting as principal in unmatched commodity price index swaps); OCC Interpretive Letter No. 494 (December 20, 1989), *reprinted in* Fed. Banking L. Rep. (CCH) 83,083 (approval for operating subsidiary to purchase and sell financial futures and options for its own account); OCC Interpretive Letter No. 462 (December 19, 1988), *reprinted in* Fed. Banking L. Rep. (CCH) 85,666 (approval for operating subsidiary to keep an inventory in interest rate and currency swap and cap transactions, as agent commit the parent bank to swap and cap transactions, and engage in related hedging activities). NFP, as an operating subsidiary, may engage in activities that are permissible for national banks to engage in directly. 12 C.F.R. 5.34(c).**

**Risk-Based Capital Treatment**

**The Bank has included with the Notification a memorandum discussing its proposed treatment of NFP for regulatory capital purposes. The Bank proposes to include NFP's capital for purposes of calculating the Bank's risk-based capital and leverage ratios. The Bank's proposed treatment of NFP is consistent with current accounting and regulatory practices and 12 C.F.R. Part 3.**

**Conclusion**

**Based upon the Notification submitted by the Bank and the commitments and representations contained therein, and upon the Bank's compliance with the supervisory condition set forth below, the OCC does not object to the plan to establish an operating subsidiary to perform the permissible derivatives activities as set forth in the Notification.**

**The following supervisory condition is a condition imposed in writing by the agency in connection with the granting of any application or other request within the meaning of 12 U.S.C. 1818:**

**The Bank's aggregate direct and indirect investments in and advances to NFP shall not exceed an amount equal to the Bank's legal lending limit.**

**If you have any questions, please contact Richard Erb, Licensing Manager (202) 874-4610 or Robert Sihler, National Bank Examiner (202) 874-5060.**

**Sincerely,**
**/s/**
**Julie L. Williams**
**Chief Counsel**