



FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

December 20, 1991

DALLAS, TEXAS 75222

Notice 91-105

TO: The Chief Executive Officer of each
member bank and others concerned in
the Eleventh Federal Reserve District

SUBJECT

**Interpretation of Regulation H (Membership of State
Banking Institutions in the Federal Reserve System) and
Regulation K (International Banking Operations)**

DETAILS

The Federal Reserve Board has issued an interpretation that requires state member banks to obtain Board approval to engage in certain commodity swaps and other transactions linked to prices of commodities or stock indices.

Under this interpretation of Regulation H (Membership of State Banking Institutions in the Federal Reserve System), these transactions will be considered to be a change in the general character of a bank's business, subject to Board approval.

The approval requirement will also apply to certain commodity swap activities when undertaken outside the United States by U.S. banking organizations under provisions of the Board's Regulation K (International Banking Operations).

ATTACHMENT

A copy of the Board's notice (Federal Reserve System Docket No. R-0742) is attached.

MORE INFORMATION

For more information, please contact Gayle Teague at (214) 744-7312. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 651-6289.

Sincerely yours,

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 211

[Docket No. R-0742]

Regulation H—Membership of State Banking Institutions in the Federal Reserve System

Regulation K—International Banking Operations

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Interpretation.

SUMMARY: The Board is issuing an interpretation of the provisions of its Regulation H, Membership of State Banking Institutions in the Federal Reserve System, that provides that engaging in certain activities relating to commodities, including commodity- or equity-linked activities such as commodity or stock index swaps, will be considered to be a change in the general character of a bank's business, and that state member banks must obtain the Board's approval under Regulation H to engage in such activities. Under the provisions of the Board's Regulation K, International Banking Operations, this approval requirement will also apply to certain commodity swap activities when undertaken outside of the United States by U.S. banking organizations.

FOR FURTHER INFORMATION CONTACT: For state member banks under Regulation H: Oliver Ireland, Associate General Counsel (202/452-3625), or Lawranne Stewart, Attorney (202/452-3513), Legal Division; or Robert S. Plotkin, Assistant Director (202/452-2782), Division of Banking Supervision and Regulation. For international banking organizations under Regulation K: Kathleen M. O'Day, Assistant General Counsel (202/452-3786), Legal Division; or Michael Martinson, Assistant Director (202/452-3640), Division of Banking Supervision and Regulation. For the hearing impaired *only*., Telecommunications Device for the Deaf ("TDD"), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION: Commodity-linked transactions (transactions in which a portion of the return is linked to the price of a particular commodity or to an index of commodity prices) are offered currently by only a few banks. Recently, however, more and more banks have become interested in offering loans, deposits, debt issues, and derivative products, such as forward contracts, options, and swaps, linked to the prices of commodities or to stock indices. In these transactions, the interest, principal, or both, or the payment streams in the case of swaps, are linked to the price of a commodity, equity, or related index. To date, the bulk of bank activities in commodity-linked transactions has been commodity or equity swaps.¹ Banks also enter into exchange-traded commodity

¹A commodity swap, like an interest rate swap, is a cash-settled transaction. Both types of contracts are based on a "notional" principal amount, and counterparties agree to make

futures and options to hedge the exposure created by commodity-linked transactions.

Under the Federal Reserve Act, the Board is authorized to prescribe regulations concerning state bank membership in the Federal Reserve System, and to impose conditions on membership.² The Board's Regulation H, Membership of State Banking Institutions in the Federal Reserve, requires as a condition of membership that a state member bank seek the approval of the Board before permitting "any change to be made in the general character of its business or in the scope of the corporate powers exercised by it at the time of admission to membership."³ The Board has determined that engaging in certain commodity-linked activities and similar transactions linked to equity securities will be considered a change in the general character of a state member bank's business.

As stated in this interpretation, a state member bank that wishes to commence or continue certain commodity- or equity-linked activities will be required to obtain the approval of the Board. Board approval is not required to engage in transactions linked to commodities or securities that the bank is permitted to hold directly, or when the transactions are engaged in on a perfectly matched basis. Additionally, approval will not be required for a state member bank to offer loan or deposit contracts in which only the interest portion of the return is linked to commodity or security prices or indices. The approval requirement is intended to enable the Board to determine whether state member banks engaging in these activities are adequately prepared to deal with the risks presented by such transactions.

Under Regulation K, this interpretation also will apply to commodity swap activities undertaken outside of the United States by bank holding company and Edge corporation subsidiaries.⁴

Administrative Procedures and Regulatory Flexibility Acts.

The provisions of the Administrative Procedures Act concerning notice and comment are not applicable to interpretative rules. 5 USC § 553(b). Because no notice of proposed rulemaking is required, a statement concerning the effects of the rule on small entities is also not required under the Regulatory Flexibility Act. 5 USC § 604. The Board notes, however, that the interpretation is unlikely to have any effect on small institutions.

payments to one another based on changes resulting from movements in the interest rates or commodity or other price indices to which the swap is linked.

²FRA § 9, ¶ 1 (12 USC § 321).

³12 CFR § 208.7(a)(1).

⁴Under Regulation K, this interpretation would not apply to swap transactions linked to equity instruments. Regulation K provides that bank holding company and Edge corporation subsidiaries may engage in such transactions abroad as incidental to other securities activities. As indicated in this interpretation, perfectly matched transactions may include a swap executed by a state member bank with an affiliate that is authorized under Regulation K to engage in equity swaps.

List of subjects in 12 CFR Part 208:

Agriculture, Agricultural loan losses, Applications, Appraisals, Banks, Banking, Branches, Capital adequacy, Confidential business information, Currency, Dividend payments, Federal Reserve System, Flood insurance, Publication of report of condition, Reporting and recordkeeping requirements, Securities, State member banks.

List of subjects in 12 CFR Part 211:

Accounting for fees on international loans, Allocated transfer risk reserve, Banks, Banking, Export trading companies, Exports, Federal Reserve System, Foreign banking, Holding companies, Investments made through debt-for-equity conversions, Investments, Reporting and recordkeeping requirements, Reporting and disclosure of international assets.

For the reasons set forth in the preamble, Title 12, Parts 208 and 211, of the Code of Federal Regulations is amended as follows:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM

1. The authority citation for Part 208 continues to read as follows:

Authority: Sections 9, 11(a), 11(c), 19, 21, 25, and 26(a) of the Federal Reserve Act, as amended (12 USC 321-338, 248(a), 248(c), 461, 481-486, 601, and 611, respectively); sections 4 and 13(j) of the Federal Deposit Insurance Act, as amended (12 USC 1814 and 1823(j), respectively); section 7(a) of the International Banking Act of 1978 (12 USC 3105); sections 907-910 of the International Lending Supervision Act of 1983 (12 USC 3906-3909); sections 2, 12(b), 12(g), 12 (i), 15B(c)(5), 17, 17A, and 23 of the Securities Exchange Act of 1934 (15 USC 78b, 78l(b), 78l(g), 78o-4(c)(5), 78q, 78q-1, and 78w, respectively); section 5155 of the Revised Statutes (12 USC 36) as amended by the McFadden Act of 1927; and sections 1101-1122 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (12 USC 3310-3351).

2. Section 208.128 is added to read as follows:

§ 208.128 Commodity- or Equity-linked Transactions

State-chartered banks that are members of the Federal Reserve System are required to obtain the approval of the Board under Regulation H (Membership of State Banking Institutions in the Federal Reserve System) before permitting any change to be made in the general character of their business or in the scope of the corporate powers they exercised at the time of admission to membership. The Board has considered whether engaging in transactions linked to commodity or equity security prices or indices would represent a change in the general character of the business of a state member bank.

Banking organizations have developed a number of commodity- or equity-linked transactions in which a portion of the return is linked to the price of a particular commodity or equity security or to an index of such prices. These transactions have been offered in a variety of forms, including commodity-indexed deposits, loans, debt issues, and derivative products, such as forwards, options, and swaps. In these transactions, the interest, principal, or both, or

payment streams in the case of swaps, are linked to the price of a commodity. In addition, banks are also entering into exchange-traded commodity or stock-index futures and options in order to hedge the exposure inherent in these transactions. These types of transactions have been linked to a variety of commodities, including gold, oil, aluminum, and copper, as well as individual securities and stock indices.

With the exception of gold, silver, and, in some cases, platinum, banks are not empowered to purchase or hold the commodities or equity securities that underlie these transactions. Although commodity-linked transactions settle only in cash, they effectively expose banks to commodity or equity market price risks. Thus, linking payments to commodities or equities may present risks with which banks generally are not familiar, and the inability of the bank to purchase the commodity or equity security to which a transaction is linked may increase the difficulty of hedging the exposure created by such transactions.

The Board has determined that engaging in transactions linked to commodities or securities that a state member bank does not have the authority to purchase and hold directly should generally be considered a change in the character of the bank's business unless the transactions are entered into on a perfectly matched basis.⁵ State member banks that wish to engage in commodity- or equity-linked transactions that are considered to be a change in the general character of their business should obtain Board approval before initiating these transactions or, in the case of activities commenced prior to the adoption of this interpretation, to continue such activities. Applications to continue such activities should be submitted within 60 days after the date of publication of this notice.

Transactions linked to securities or monetary metals that a state member bank is authorized to purchase and hold directly will not be considered to be a change in the general nature of the bank's business, and approval will not be required.⁶ Additionally, approval will not be required for a state member bank to offer loan or deposit contracts in which only the interest portion of the return is linked to a commodity or security even if the bank is not authorized to hold the commodity or security.

Applications to engage in commodity-related activities should outline the types of transactions and scope of activities that the bank plans to undertake. The application also should demonstrate that the bank has the expertise to engage

⁵The term "perfectly matched," as used in this interpretation refers to transactions that are entered into on a matched basis, that is, offsetting transactions where the counterparties for both transactions have been found before the bank enters into either transaction and the transactions are consummated on the same day. Offsetting transactions include transactions that have a price differential to provide the bank with its usual and customary fee or commission for its services. The exemption from prior approval for perfectly matched transactions would include mirror image equity swaps executed by a state member bank with any affiliate that is authorized under Regulation K to engage in equity swaps.

⁶Gold and silver are the only commodities that banks generally have authority to purchase. In states where banks have authority to deal in platinum, transactions linked to platinum will not be considered a change in the general nature of the business of a bank.

in such transactions and has developed adequate policies and controls to govern the conduct of these activities and to monitor the associated risks.

Recent revisions to Regulation K (International Banking Operations) permit bank holding company subsidiaries, Edge and agreement corporations, and member banks to act as principal or agent outside of the United States in swap transactions, subject to any limitations applicable to state member banks under Regulation H. Banking organizations that wish to engage in swap transactions based on commodities that the organizations do not have the authority to purchase directly, therefore, must submit applications under Regulation K in order to engage in such transactions. Because Regulation K provides separate authority to engage outside of the United States in swap transactions based on equity securities or indices, approval of these transactions is not required.

PART 211—INTERNATIONAL BANKING OPERATIONS

1. The authority citation for Part 211 continues to read as follows:

Authority: Federal Reserve Act (12 USC 221 *et seq.*); Bank Holding Company Act of 1956, as amended (12 USC 1841 *et seq.*); the International Banking Act of 1978 (Pub. L. 95-369; 92 Stat. 607; 12 USC 3101 *et seq.*); the Bank Export Services Act (Title II, Pub. L. 97-290, 96 Stat. 1235); the International Lending Supervision Act (Title IX, Pub. L. 98-181, 97 Stat. 1153, 12 USC 3901 *et seq.*); and the Export Trading Company Act Amendments of 1988 (Title III, Pub. L. 100-418, 102 Stat. 1384 (1988)).

2. Section 211.603 is added to read as follows:

§ 211.603 Commodity swap transactions

For text of interpretation relating to this subject, see § 208.128 of this Chapter.

By order of the Board of Governors of the Federal Reserve System, November 25, 1991.

(signed) William W. Wiles

William W. Wiles,
Secretary of the Board.

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