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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

December 4, 2008

**Interpretive Letter #1107  
December 2008**

Subject: Appraisal Regulation — Abundance of Caution Exception

Dear [ ]:

This is in response to your letter concerning the OCC's real estate appraisal regulation in 12 C.F.R. Part 34, Subpart C. In particular, you inquired about the application of the "abundance of caution" exception in 12 C.F.R. § 34.43(a)(2) to certain transactions entered into by the bank's operating subsidiary, [ ] ("Subsidiary").

FACTS

Subsidiary provides senior secured financing to middle market companies for various business purposes and also engages in secured lending transactions. In March 2007, Subsidiary entered into a credit relationship ("the Facility") with [ ] ("Borrower"), a new entity that had been formed the previous month to provide short-term financing to real estate owners, investors, or developers who use the funds primarily for the acquisition, development, or operation of commercial real estate. Borrower's loans are evidenced by promissory notes from its borrowers ("Notes Receivable") that are secured by first priority liens on undeveloped land or commercial real property and have a maximum term of 15 months. This is the same type of commercial real estate lending that Borrower's owners engaged in through another entity that they owned, [ ] ("Funding").

The Facility is a senior secured revolving line of credit. Under the Facility, Subsidiary advances Borrower up to 80 percent of the net principal balance of Notes Receivable that Subsidiary chooses to accept. Subsidiary retains a first priority, perfected security interest in these Notes Receivable. Since the Notes Receivable are themselves secured by real property collateral, Subsidiary has an indirect security interest in the underlying real property.

According to a Financing Memorandum ("Memorandum") prepared by Subsidiary in March 2007, the great majority of Funding's loans, from its inception in 2002 through 2006, were repaid from the sale or refinancing of the underlying properties. The initial six Notes Receivable that were funded under the Facility consisted of loans that were originated by Funding and transferred to Borrower after the latter's formation. These Notes Receivable were secured by

office buildings, residential construction, residential rental property, or vacant land. Most of these properties were already for sale or being developed for sale.

The OCC's real estate appraisal regulation, 12 C.F.R. § 34.43(a), requires national banks to obtain appraisals from state-certified or state-licensed real estate appraisers for all loans that finance or refinance interests in real property, unless one of several listed exceptions applies. Your inquiry focuses on whether one of these exceptions, the "abundance of caution" exception, applies to the Facility.

## ANALYSIS

The OCC's real estate appraisal regulation is set forth in 12 C.F.R. Part 34, Subpart C. Advances by Subsidiary to Borrower under the Facility are subject to the regulation because they are real estate-related financial transactions, *i.e.*, loans that make use of real estate as security, 12 C.F.R. § 34.42(i), engaged in by an institution regulated by the OCC, 12 C.F.R. § 34.42(f).<sup>1</sup>

These loans to Borrower are "real estate related transactions" even though the real estate security is indirect. A bank does not need to be engaged in direct real estate lending for an extension of credit to be a real estate-related financial transaction. When a national bank takes a note secured by real estate as collateral for a loan, the appraisal regulation applies to the transaction underlying the secured note. Interpretive Letter No. 569, *reprinted in* [1991-1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,339 (November 26, 1991). This letter is attached for your reference.

As Interpretive Letter No. 569 mentions, there are times when an appraisal is not required under the regulation. One of these exceptions is the "abundance of caution" exception, in which a lien on real estate has been taken as collateral in an abundance of caution. 12 C.F.R. § 34.43(a)(2). For this exception to apply to the six Notes Receivable being considered here, there must be other sources of repayment or collateral besides the real estate collateral that support the decision to extend credit. As the Federal Register preamble describing this exception explains:

To qualify for the amended exemption, the regulated institution's decision to enter into the transaction must be well-supported by the borrower's income or collateral other than real estate.

59 Fed. Reg. 29482, 29489 (1994). Thus, in order to qualify for this exception, Subsidiary must have a reasonable and supportable basis to find that the underlying loans will be repaid without regard to the real estate security. The available facts do not support such a belief.

On the contrary, the Financing Memorandum that Subsidiary prepared clearly demonstrates that Borrower engages in the same type of short-term commercial real estate lending that Borrower's

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<sup>1</sup> The other federal banking agencies have substantively identical regulations. See 12 C.F.R. § 225.62 (Board of Governors of the Federal Reserve System); 12 C.F.R. § 323.2 (Federal Deposit Insurance Corporation); 12 C.F.R. § 564.2 (Office of Thrift Supervision). Legal and supervisory staff of these agencies were contacted and indicated they agree with the position taken in this letter.

owners had previously carried on through Funding. The Memorandum shows that repayment of the six Notes Receivable acquired from Funding is dependent upon the sale or refinancing of the underlying real property. Subsidiary now has a security interest in these loans, and Borrower's ability to repay Subsidiary depends upon the repayment of these loans. Subsidiary has not demonstrated that these underlying borrowers have independent sources of income, unrelated to the sale or refinancing of the real estate, sufficient to repay their loans. This makes the abundance of caution exception unavailable.<sup>2</sup>

You cite Interpretive Letter No. 661, *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,609 (April 19, 1995) as possible support for applying the abundance of caution exception to the six Notes Receivable. This letter involved a syndicated loan to a corporation that acquired, developed, and operated mini-storage facilities in multiple locations. The loan was secured by the mini-storage properties and was structured as a one-year revolving line of credit with monthly payments. The letter recited the bank's representation that the loan would be repaid through the borrower's normal business cash flow and the pledged real estate collateral would be neither a primary nor secondary source of repayment. The letter then concluded that, based on this representation, the abundance of caution exception would apply. The letter has limited precedential value since it accepted the bank's representation that it was not relying upon the real estate collateral without analysis of the underlying facts; however, the facts as represented did describe a plausible source of cash flow to fund monthly payments, not dependent on the value of any real estate collateral. That is not the case in the present situation.

## CONCLUSION

For the reasons stated, the abundance of caution exception is unavailable for Subsidiary's loan to Borrower, the proceeds of which were used to acquire the six Notes Receivable. In the future, appropriate appraisals must be obtained before Subsidiary advances funds under the Facility to Borrower for the purpose of making short-term real estate loans unless Subsidiary can demonstrate that those borrowers have sufficient sources of income, not dependent upon sale or refinancing of the real estate, by which to repay their loans.

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<sup>2</sup> See Letter of William B. Glidden, Assistant Director, Legal Advisory Services Division, 1991 WL 338932 (April 29, 1991), which considered an analogous fact situation. A bank was considering making a loan to borrowers that would be secured by assignment to the bank of a promissory note from someone who had recently purchased a parcel of real property from the borrowers. Repayment to the bank would be funded by payments that the borrowers received on the promissory note. The bank maintained that the abundance of caution exception applied because it was not looking to the underlying real estate for repayment of its loan, but to the payments that would be made to the borrowers by the purchaser of the property. The OCC concluded that the exception did not apply to this transaction because payments received by the borrowers from the sale of the real property would be the basis of their payments to the bank.

I trust that this has been responsive to your inquiry. If you have further questions, please contact Special Counsel Christopher Manthey of my staff at (202) 874-5300.

Sincerely,

*Signed*

Julie L. Williams  
First Senior Deputy Comptroller and Chief Counsel

Enc. - *Interpretive Letter #569*