Interpretations—January 1 to March 31, 2003

Contents

Interpretive Letters

949—September 19, 2002

12 USC 24(7)

Kieran J. Fallon, Esq.
Senior Counsel
Board of Governors of the Federal Reserve System
Washington, DC 20551

Re: Authority of National Banks to Engage in Financial Intermediation Transactions Involving Equity Options and Forwards

Dear Mr. Fallon:

This is in response to your request that the Office of the Comptroller of the Currency ("OCC") confirm that it is permissible for national banks to engage in cash-settled options and forwards on equity securities (the "equity derivatives transactions").[1] The equity derivatives transactions involve exchanges of payments between a bank and its customers based on changes in the value of equity securities. As discussed below, the OCC views the equity derivatives transactions as permissible if they are part of a bank's customer-driven, non-proprietary financial intermediation business and if the bank has in place an appropriate risk measurement and management process for its derivatives and hedging activities. This risk measurement and management process is necessary for a bank to achieve its customer risk management objectives in a safe and sound manner, and thus must be established before the OCC can determine that the proposed activities are permissible. In the absence of particular facts and supervisory knowledge of an individual institution, the OCC is unable to opine whether particular equity derivatives transactions are permissible.

I. Background

You have indicated that the Board of Governors of the Federal Reserve System has received an application from a state member bank for approval to acquire equity securities solely for the purpose of hedging exposure arising from the equity derivatives transactions. You have asked for this

[1] The owner of an equity option contract has the right to buy or sell a specified equity security or group of securities at a specified price on or before a specified date. The owner of an equity forward contract has the obligation to purchase a specified equity security or group of securities at a specific date in the future. The equity forward contract is purchased by the owner immediately, but the securities are not paid for until some future date. Because the equity derivatives transactions are cash-settled, the counterparties do not actually take or make delivery of the underlying equity securities, but rather take or make cash payments based on the changes in market price of those securities. We understand from you that all the transactions in question would be cash-settled as far as the bank engaging in the activity is concerned. If under the terms of certain contracts the customer is permitted to elect physical settlement, an affiliate of the bank will make or receive physical delivery.

opinion to determine whether engaging in the equity derivatives transactions is permissible for a national bank, and therefore permissible for a state-chartered bank pursuant to 12 USC 1831a.[2]

II. Discussion

The equity derivatives transactions may be permissible under 12 USC 24(Seventh)[3] as part of a customer-driven, non-proprietary financial intermediation business if a bank has an appropriate risk measurement and management process for its derivatives and hedging activities.

A. Derivatives Transactions May be Permissible as Part of a Financial Intermediation Business

The OCC has concluded that national banks may engage in customer-driven, non-proprietary derivatives transactions involving exchanges of payments as part of a financial intermediation business.[4] Through a derivatives business, a bank may engage in a modern form of the traditional financial intermediation functions that banks perform in providing payment, loan, and deposit

[2] Under 12 USC 1831a, an insured state bank may not engage as principal in any type of activity that is not permissible for a national bank, unless (1) the Federal Deposit Insurance Corporation has determined that the activity would pose no significant threat to the appropriate insurance fund and (2) the state bank is, and continues to be, in compliance with applicable capital standards prescribed by the appropriate federal banking agency.

[3] A national bank may engage in activities pursuant to 12 USC 24(Seventh) if the activities are part of, or incidental to, the business of banking. The Supreme Court has held that this authority is a broad grant of power to engage in the business of banking, including, but not limited to, the five enumerated powers and in the business of banking as a whole. *NationsBank of North Carolina* v. *Variable Annuity Life Insurance Co.,* 513 U.S. 251 (1995) ("VALIC").

[4] In the 1980s the OCC opined on the permissibility of national banks engaging in interest rate, currency, and commodity price index swaps and caps. See OCC No-Objection Letter No. 87–5 (July 20, 1987), reprinted in [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034 ("matched commodity swap letter"); OCC Interpretive Letter No. 462 (December 19, 1988), reprinted in [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,686; and OCC letter from J. Michael Shepherd, senior deputy comptroller, Corporate and Economic Programs (July 7, 1988) (unpublished). Then, in the 1990s, the OCC recognized that national banks may advise, structure, arrange, and execute transactions, as agent or principal, in connection with interest rate, basis rate, currency, currency coupon, and cash-settled commodity and equity swaps; swaptions, captions, and other option-like products; forward rate agreements, rate locks and spread locks, as well as similar products that national banks are permitted to originate and trade in and in which they may make markets. See OCC Interpretive Letter No. 725 (May 10, 1996), reprinted in [1995–1996 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81,040; OCC Interpretive Letter No. 652 (September 13, 1994), reprinted in [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600; OCC letter from Jimmy F. Barton, deputy comptroller, Multinational Banking, to Carl Howard, associate general counsel, Citibank, N.A. (May 13, 1992) (unpublished); OCC letter from Horace Sneed, senior attorney, LASD (March 2, 1992) (unpublished); and OCC No-Objection Letter No. 90–1 (February 16, 1990), reprinted in [1989–1990 Transfer Binder] Fed. Banking L. Rep. ¶ 83,095 ("unmatched commodity swap letter"). The unmatched commodity swap letter and the matched commodity swap letter predate VALIC and characterized the commodity price index swaps as a financial intermediary activity incidental to a bank's express power to engage in deposit and lending activities under 12 USC 24(Seventh). The OCC has since concluded that swap and funds intermediation activities are part of the business of banking. See OCC Interpretive Letter No. 937 (June 27, 2002), reprinted in [____-____ Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ ______; OCC Interpretive Letter No. 892 (September 13, 2000), reprinted in [2000–2001 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81,411 ("equity hedge letter"); OCC letter from Ellen Broadman, director, Securities and Corporate Practices Division, OCC, to Barbara Moheit, regional counsel, FDIC (October 20, 1998) (unpublished).

services. In conducting a derivatives business, a bank makes payments to, or receives payments from, customers who want to manage financial risks resulting from the variations in interest rates or prices of commodities or equity securities. Customers do not deal directly with one another in these transactions, but instead make payments to or receive payments from an intermediary bank. Thus, a customer-driven derivatives business may be permissible as a modern form of traditional bank financial intermediation activities involving exchanges of payments with a bank acting as an intermediary between customers and not in a proprietary capacity.

Under this rationale, the OCC has found that national banks, as part of a financial intermediation business, may offer equity and equity index swaps.[5] Equity swaps are agreements between two parties to exchange payments. One party makes a stream of payments based on a short-term interest rate index. The other party makes payments tied to the performance of an equity security or equity market index. National banks may hedge risks arising from these transactions either on a matched or portfolio basis and thus act in the traditional role of a financial intermediary exchanging payments with customers on agreed terms.

Cash-settled equity options and forwards may be permissible for national banks under the same rationale provided in OCC precedent addressing equity and equity index swaps.[6] Similar to equity swaps, cash-settled equity options and forwards are privately negotiated contracts between parties that enable customers to manage financial risks relating to price fluctuations in equities and market uncertainties. Similar to swaps, those option and forward products fundamentally involve exchanges of payments based on changes in the value of equities. In fact, comparable payment obligations may be created using equity swaps, options, and forwards.[7] Also, through equity option and forward transactions and hedging activities, banks similarly may act in their traditional roles of financial intermediaries exchanging payments with bank customers. Accordingly, national banks have engaged in cash-settled equity options and forwards and the OCC has viewed these transactions as permissible if they are part of a financial intermediation business and an appropriate risk measurement and management process is established.

[5] See OCC Interpretive Letter No. 725, supra; and equity hedge letter.

[6] See OCC Interpretive Letter No. 937, supra.

[7] A swap transaction is nothing more than a series of forward contracts. Under a swap, one party owes the other a stream of payments linked to the performance of an equity security (or equity market index) and receives a stream of payments based on a short-term interest rate. The payment obligations typically are settled with one party paying the other the difference between these two payment streams. Periodic payments made under a swap agreement can mirror the payment stream on a series of cash-settled forward transactions. Under a cash-settled forward transaction, the parties also exchange the difference between the current market value of the underlying equity and the negotiated contract price for that equity. Cash-settled equity options similarly may generate payment streams comparable to equity and equity index swaps.

B. The Activity Must be Conducted in a Safe and Sound Manner

Cash-settled options and forwards on equity securities offered as part of a customer-driven, non-proprietary financial intermediation business do not automatically qualify as an activity that is part of the business of banking. The nature of these derivatives transactions requires sophisticated risk measurement and management capacities on the part of a bank, and qualified personnel, in order for the activity to actually function as permitted and to operate in a safe and sound manner. Thus, in order for the OCC to conclude that the derivatives transactions are permissible for a national bank as "part of the business of banking," the bank must establish an appropriate risk measurement and management process.[8] As detailed further in the OCC derivatives booklet[9] and Banking Circular No. 277,[10] an effective risk measurement and management process includes appropriate oversight and 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.

In addition to a risk management program, a bank's process must include an independent compliance monitoring program to ensure ongoing compliance with the specific commitments made by the bank, including its commitment to conduct its financial intermediation activities as a customer-driven, and non-proprietary trading business. The bank must have an adequate and effective compliance monitoring program that includes policies, training, independent surveillance, and well-defined exception approval and reporting procedures.

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[8] In other words, a proposed activity cannot be part of the "business of banking" if the bank in question lacks the capacity to conduct the activity on a safe and sound basis. Courts have long recognized this linkage between qualifying activities and safety and soundness. See, e.g., *First National Bank* v. *Exchange National Bank,* 92 U.S. 122, 127 (1875); *Merchants National Bank* v. *Wehrmann,* 202 U.S. 295 (1906). In addition, the OCC considers safety and soundness issues when determining whether an activity is part of, or incidental to the business of banking. See, e.g., equity hedge letter (national bank may engage in equity hedging activities only if it has an appropriate risk management process in place); OCC Banking Bulletin 96–5 (September 20, 1996) (replaced by OCC Bulletin 2000–23 (July 20, 2000) (national bank's purchase of life insurance is incidental to banking if it is convenient or useful in connection with the conduct of the bank's business and consistent with safe and sound banking practices)); OCC Interpretive Letter No. 684, supra (commodity hedging is a permissible banking activity provided the activity is conducted in accordance with safe and sound banking practices); Decision of the Office of the Comptroller of the Currency on the Request by Chase Manhattan Bank, N.A. to Offer the Chase Market Index Investment Deposit Account (August 8, 1988) (national bank may buy and sell futures on the S&P 500 Index to hedge deposits with interest rates tied to the S&P 500 Index); OCC Interpretive Letter No. 376 (October 22, 1986) reprinted in [1985–1986 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶85,600 (indemnification from losses resulting from participation in the bank's fiduciary securities lending program is a permissible incidental activity provided the indemnification is consistent with OCC guidance and safety and soundness); and OCC Interpretive Letter No. 274 (December 2, 1983) reprinted in [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,438 (a national bank's authority to lease its office space provides the authority for it to establish appropriate lease terms if consistent with safe and sound banking practices).

[9] "Risk Management of Financial Derivatives," (*Comptroller's Handbook*, January 1997).

[10] OCC Banking Circular No. 277 (October 27, 1993), reprinted in 6 CCH Fed. Banking L. Rep. ¶ 62–152 ("BC 277").

III. Conclusion

The OCC believes that national banks may engage in equity forward and option transactions as part of a customer-driven, non-proprietary financial intermediation business if the banks have in place appropriate risk measurement and management processes for their derivatives and hedging activities. These processes are necessary for the banks to achieve their customer risk management objectives in a safe and sound manner, and thus must be established before the OCC can determine that the proposed activities are permissible. In the absence of particular facts and supervisory knowledge of an individual institution, we are not able to opine whether particular equity option and forward transactions would be permissible for a particular bank.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

950—December 18, 2002

12 USC 29B
12 USC 84(a)(1)
12 USC 371D

Re: Loans made by a national bank to an entity used as part of the bank's like-kind exchange of bank premises

Dear [ ]:

This letter is in response to your October 18, 2002, letter addressed to Julie L. Williams, first senior deputy comptroller and chief counsel. In your letter, you ask how the Office of the Comptroller of the Currency (OCC) would apply the legal lending limit statute, 12 USC 84, to a national bank ("bank") using the tax-deferred exchange provisions under section 1031 of the Internal Revenue Code of 1986 to effect a like-kind exchange of bank premises.

Briefly, the bank enters into a contract to purchase a piece of new property upon which will be constructed its new office building, assigns the contract to an unrelated entity ("Newco"), and extends credit to Newco to purchase the new property. Newco will be responsible for constructing the new office building. At the same time, the bank enters into a lease with Newco, with the lease payments being large enough to cover debt service on the loan to Newco plus Newco's fee for participating in the transaction. Ultimately, the bank's existing main office is sold, the sales contract is assigned to an affiliate of Newco, and the affiliate sells the old office building. The affiliate then uses the proceeds to buy the new building from Newco and transfers the new building to the bank. At that time, any amount due on the loan to Newco is repaid.

It is my opinion that the bank's loan to Newco would be an extension credit for purposes of 12 USC 84. Section 84(b)(1) defines "loans and extensions of credit" to "include all direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person. . . ." Based upon your fact pattern, the loan by the bank to Newco meets this definition. Therefore, under section 84(a)(1), the total outstanding loans made by the bank to Newco would be limited to 15 percent of the bank's unimpaired capital and surplus.

However, because Newco would hold bank premises,[1] the bank may take advantage of 12 USC 371d. Section 371d provides in part that:

[1] Under 12 USC 29(First), a national bank may invest in real estate that is necessary for the transaction of its business. Twelve CFR 7.1000(a)(2)(i) provides that this real estate includes "[p]remises that are owned and occupied *(or to be occupied, if under construction)* by the bank . . ." (emphasis added). Section 7.1000(a)(3) further provides that national banks may acquire and hold such real estate by means of a leasehold estate. Therefore, the new property that the bank is leasing and upon which the bank's new building is being constructed by Newco is bank premises.

> No national bank or State member bank shall invest in bank premises, or in the stock, bonds, debentures, or other such obligations of any corporation holding the premises of such bank, or make loans to or upon the security of any such corporation— . . . (2) unless the aggregate of all such investments and loans, together with the amount of any indebtedness incurred by any such corporation that is an affiliate of the bank, is less than or equal to the amount of the capital stock of such bank; . . .

Under this section, a national bank must aggregate its direct investments in bank premises and corporations that hold bank premises, its loans to such corporations, and any indebtedness incurred by such corporations that are affiliates of the national bank.[2] This total may not exceed an amount equal to the bank's capital stock (unless certain other requirements are satisfied).

If a national bank has no other "investments" in bank premises, then section 371d would authorize the national bank to lend money to an unaffiliated corporation holding bank premises in an amount equal to the bank's capital stock.[3] Therefore, if section 371d's aggregate limits are otherwise satisfied, it is my opinion that the bank could loan Newco an amount which would exceed the limitations contained in 12 USC 84. Rules of statutory interpretation strongly presume that "[w]here there is no clear intention otherwise, a specific statute will not be controlled or nullified by a general one."[4] For example, with respect to extensions of credit made by national banks to their affiliates, the OCC has determined that the more specific affiliate transaction statute, 12 USC 371c, takes precedence over the general lending limits in section 84.[5]

While the section 84 lending limits would not apply, any extension of credit by the bank to Newco must conform with safe and sound banking practices. If you have any questions, please contact me at (202) 874–5300.

Steven V. Key
Senior Attorney

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[2] Section 371d does not require that corporations holding bank premises be affiliates of the national bank. *See* letter from James J. Saxon, Comptroller of the Currency (March 26, 1964) (unpublished). Rather, this section requires only that the national bank include in its aggregate investment in bank premises any indebtedness incurred by corporations that are affiliates of the bank.

[3] In this case, the bank would have two such "investments"—the investment in its current office building and the loan to—that must be aggregated.

[4] *AT&T Corp*. v. *Iowa Utilities Bd*., 525 U.S. 366, 410 (1999), (*quoting Crawford Fitting Co*. v. *J.T. Gibbons, Inc*., 482 U.S. 437, 445 (1987)). *Accord Morton* v. *Marconi*, 417 U.S. 535, 550–51 (1974).

[5] *See* 12 CFR 32.1(c); letter from Rosemarie Oda, senior attorney, Legal Advisory Services Division (January 25, 1985) (unpublished).

951—January 17, 2002

12 USC 84(d)(2)(b)

Dear [ ]:

This is in response to your letter of December 17, 2001. You have requested the Office of the Comptroller of the Currency's ("OCC's") opinion as to the application of the legal lending limit at 12 USC 84 to loans by [National Bank], [City, State] ("bank") to [ ] ("[Co.]"), Mr. and Mrs. [Mates] (as co-makers), and two land trusts. Based on the information in your letter and subsequent phone conversations, as well as information previously submitted by National Bank Examiners Jeff Leigh and Jason Joy, it is my opinion that for purposes of the legal lending limit at 12 USC 84 the existing loans to [Co.] are attributed to Mr. [Mates] and therefore are combined with the loans to Mr. and Mrs. [Mates], and 50 percent of the loans to the two land trusts are attributed to Mrs. [Mates] and therefore combined with the loans to Mr. and Mrs. [Mates]. However, based on the facts presented, I do not believe that the loans to all five borrowers—[Co.], Mr. [Mates], Mrs. [Mates], and the two land trusts—should be aggregated as a whole for purposes of the legal lending limit.

I. Facts

The bank has five outstanding loans to [Co.] with an aggregate outstanding balance of $2,485,434, net of participations sold, to other financial institutions. [Co.] is a Subchapter S corporation owned 100 percent by [Mr. Mates]. The company is engaged in the business of acquiring and developing lots and constructing single-family residences. The proceeds of the five loans were used for the acquisition of real estate and construction of residential properties. [Mr. Mates] provides a limited personal guaranty of the [Co.] loans.

The bank also has three outstanding loans to [Mr. Mates] and his spouse, as co-makers: a home equity line of credit secured by his personal residence with a current balance of $293,000, a home equity line of credit secured by a rental property owned by Mr. and Mrs. [Mates] with a current balance of $201,000, and a $2,000 credit reserve loan (collectively the "[Mates] loans"). The proceeds of the two home equity loans were used for working capital for [Co.]. The [Mates]' sources of income for the years 1997 through 2000 were as follows (in thousands):[1]

[1] On their joint federal tax returns the [Mates] also report the gross income from [Co.] as part of their adjusted gross income. As a Subchapter S corporation, [Co.]'s gross income and deductions are allocated to its shareholder [Mates] *for federal tax purposes only*. *See* I.R.C. § 1366. Notwithstanding that allocation for tax purposes, [Co.]' undistributed earnings have not been paid to [Mates] and from legal and financial accounting perspectives they remain the property of the corporation. Thus, a more accurate reflection of [Mr. Mates]'s income from [Co.] is the distributions paid to him by [Co.] in the form of salary, dividends, or other cash or property distributions, rather than the corporation's gross income that is allocated to him for tax purposes. Accordingly, for the purposes of the legal lending limit analysis only the salary, dividends, and other cash or property distributions paid by [Co.] to [Mr. Mates] will be included in the [Mr. Mates]' income figures.

Table 1—[Mates]' Sources of Income, 1997–2000

Sources of Income	1997	1998	1999	2000
Salary from [Co.]—[Mr. Mates]	120	120	120	120
Non-Salary Distributions from [Co.]	0	0	0	0
Rental Income—Joint	41	42	46	45
Rental Income—Land Trust	56	100	101	107
Total	**217**	**262**	**267**	**272**

Finally, the bank has two loans to two separate land trusts (the "land trusts") in the amounts of $758,296 and $589,087 (the "land trust loans"). Mrs. [Mates] is a 50 percent beneficiary of each of the land trusts. [Mr. Mates] personally guarantees $100,000 of each of the trust loans. The proceeds of the trust loans were used to acquire rental properties. The expected source of repayment of the trust loans is rental cash flow from the properties, and that cash flow is sufficient to service the trust loans.

II. Legal Analysis

Generally, a national bank's total outstanding loans to one borrower may not exceed 15 percent of the bank's capital and surplus, plus an additional 10 percent of capital and surplus if the amount over the 15 percent general limit is fully secured by readily marketable securities.[2] A "borrower" includes a person who is named a borrower or debtor in a loan or extension of credit.[3] Also, loans to one borrower will be attributed to another person and both will be considered a borrower (1) when the proceeds are used for the direct benefit of the other person, or (2) when a common enterprise is deemed to exist between the persons.

The proceeds of a loan to borrower will be deemed to be used for the direct benefit of another person and will be attributed to that other person when the proceeds, or assets purchased with such proceeds, are transferred to that other person, other than in a bona fide arm's-length transaction where the proceeds are used to acquire property, goods, or services.[4]

A *common enterprise* is deemed to exist when:

1) The expected source of repayment for each loan is the same and neither borrower has another source of income from which the loan and the borrower's other obligations can be repaid;

2) The borrowers are related through common control and there is substantial financial interdependence between or among the borrowers;

[2] *See* 12 USC 84(a); 12 CFR 32.3(a).

[3] 12 CFR 32.2(a).

[4] 12 CFR 32.5(b).

3) The borrowers use the loan proceeds to acquire more than 50 percent of a business enterprise; or

4) The OCC determines that a common enterprise exists based on the facts and circumstances of particular transactions.[5]

Thus, in determining whether a loan to one borrower should be attributed to another borrower for lending limit purposes, one must apply each of the five loan combination/attribution tests set forth above—the one direct benefit test and the four common enterprise tests—to the specific facts of each loan relationship.[6]

1. Direct Benefit Test

The proceeds of the [Co.] loans were used to acquire real property and construct residential housing. The proceeds of the two [Mates] home equity loans were used for working capital for [Co.]. Since the proceeds of the home equity, or assets purchased with such proceeds, were transferred to [Co.], [Mates]'s home equity loans are attributed to [Co.] under the direct benefit test at 12 CFR 32.5(b). Accordingly, the [Mates] home equity loans and the [Co.] loans are combined for purposes of the legal lending limit.

Also, 50 percent of the loans to the land trusts will be combined with all of the [Mates] loans for the purposes of the lending limit under the direct benefit test. In Illinois, true ownership of real estate held in a land trust remains with the beneficiary, even though legal and equitable title to the land lies with the trustee.[7] The bank's loans to the land trusts were used to acquire and improve real estate. Mrs. [Mates] has a 50 percent beneficial interest in the land trust and, therefore, is the true owner of a 50 percent interest in the property held by the trust. Since Mrs. [Mates] is one of the true owners of the assets purchased with the proceeds of the land trust loans, she has directly benefited from those loan proceeds in proportion to her beneficial interest in the land trusts. Thus, 50 percent of each of the land trust loans is attributed to Mrs. [Mates] for lending limit purposes pursuant to 12 CFR 32.5(b). Since Mrs. [Mates] is a borrower on the [Mates] loans, 50 percent of the loans to the land trusts will be combined with the [Mates] loans for the purposes of the lending limit under the direct benefit test.

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[5] *See* 12 CFR 32.5(c).

[6] In addition to the general limit on loans to one borrower, there is an additional limit that applies to loans to a corporate group. *See* 12 CFR 32.5(d). Loans to a corporate group may not exceed 50 percent of a national bank's capital and surplus. 12 CFR 32.5(d)(1). A corporate group is defined as a person and all of its subsidiaries. *Id*. For the purpose of this rule, a corporation or limited liability company is a subsidiary of a person if that person owns more than 50 percent of the voting interests of the corporation or company. *Id*. This limit is independent of the general 15 percent limit on loans to one borrower set forth at 12 USC 84 and 12 CFR 32.3. This special limit applies to a corporate group regardless of whether loans to different members of the corporate group are combined for the general 15 percent limit.

[7] *Podvinec* v. *Popov*, 658 N.E.2d 433, 436 (1995) (*citing People* v. *Chicago Title & Trust Co*., 389 N.E.2d 540 (1979)).

Since the proceeds of the [Co.] loans were not transferred to the land trusts, and the proceeds of the land trust loans were not transferred to [Co.], the [Co.] and land trust loans will not be combined under the direct benefit test.

2. Common Enterprise Test No. 1—Common Expected Source of Repayment

A common enterprise is deemed to exist when:

1) the expected source of repayment for each loan is the same, and

2) neither borrower has another source of income from which the loan and the borrower's other obligations can be repaid.

The expected source of repayment on the [Co.] loans is cash flow from the business' operations and the sale of lots or residences securing the loans. The expected source of repayment for the land trust loans is rental cash flow from the properties held in the trust. Since the expected sources of repayment for the [Co.] loans and the land trust loans are not the same, then the loans to those two borrowers will not be combined with each other for purposes of the legal lending limit under the common source of repayment test at 12 CFR 32.5(c)(1).

The expected source of repayment on the [Mates] loans is the personal income of the [Mates]. Part of the [Mates]' joint income comes from [Mr. Mates]'s salary from [Co.]. As such, [Co.] may be the ultimate source of repayment for the [Mates] loans. I note, however, that the [Mates] have other sources of income, and that other income may be sufficient to repay the [Mates] Loans together with their other obligations. If the [Mates]' other income in not sufficient by itself to repay those loans and their other obligations, then there may be grounds to combine the [Mates] loans with the loans to [Co.] under the common source of repayment test.[8]

3. Common Enterprise Test No. 2—Common Control and Substantial Financial Interdependence

As stated above, one way in which a common enterprise is deemed to exist is when:

1) the borrowers are related through common control, and

2) there is substantial financial interdependence between or among the borrowers.[9]

[8] The common source of repayment test at 12 CFR 32.5(c)(1) specifically states that an employer ([Co.]) will not be treated as a source of repayment because of wages or salaries paid to an employee ([Mr. Mates]), unless the standards of the common control and substantial financial interdependence at 12 CFR 32.5(c)(2) are met. However, as noted in section II.3. below, there is common control and substantial financial interdependence between [Co.] and [Mr. Mates]. Thus, [Co.] can be viewed as a source of repayment on the [Mates] loans under the common source of repayment test because of the salary it pays to [Mr. Mates].

[9] *See* 12 CFR 32.5(c)(2).

Borrowers are related through common control when one person or entity controls another, or two or more entities are each controlled by the same person or entity. For the purposes of this combination rule, control is deemed to exist if a person directly or indirectly, or acting through or together with one or more persons either (1) owns or controls 25 percent or more of the voting securities of another person, (2) controls in any manner the election of a majority of the directors or trustees of another person, or (3) has the power to exercise a controlling influence over the management or policies of another person.[10]

Based on the information in your letter, the land trusts are not related through common control to either [Co.] or [Mr. Mates]. However, [Co.] is related to [Mr. Mates] because of his 100 percent ownership interest in the company. The next question, then, is to determine whether substantial financial interdependence exists between [Co.] and [Mr. Mates]. Substantial financial interdependence is deemed to exist when 50 percent or more of one person's annual gross receipts or gross expenditures are derived from transactions with the other person.[11] In determining whether substantial financial interdependence exists, we look at the borrower's gross receipts or gross expenditures on an annual basis.

Accordingly, if 50 percent or more of [Co.]'s annual gross receipts or gross expenditures were received from or paid to [Mr. Mates], then substantial financial interdependence would exist between [Co.] and [Mr. Mates]. As a result, loans to [Co.] would be attributed to [Mr. Mates] and combined with the bank's other loans to [Mr. Mates]. Similarly, if 50 percent or more of [Mr. Mates]'s annual gross receipts or gross expenditures were received from or paid to [Co.], then substantial financial interdependence would exist between [Mr. Mates] and [Co.], the loans to [Co.] would be attributed to [Mr. Mates], and they would be combined with the [Mates] loans.

Here, for the past four years [Mates]'s salary from [Co.] has represented more than 50 percent of his gross receipts.[12] Thus, substantial financial interdependence exists between [Co.] and [Mr.

[10] *See* 12 CFR 32.2(g). The term "person" as used section 32.2(g) means, among other things, a corporation, limited liability company, partnership or a trust. *See* 12 CFR 32.2(k).

[11] 12 CFR 32.5(c)(2)(ii).

[12] For the fiscal year 2000, Mr. [Mates]'s salary and distributions from [Co.] represented 73 percent of his gross receipts for that period ($120,000 salary/($120,000 salary + $45,000 joint rental income). The [Co.] salary and distributions represented 72 percent, 74 percent, and 75 percent of Mr. [Mates]'s gross receipts for the years 1999, 1998, and 1997, respectively.

As discussed in note 1 *supra*, [Co.]'s gross income that is reported as income on the [Mates]' federal tax return is not included as part of the [Mates]'s "gross receipts" for the purposes of determining whether substantial financial interdependence exists. The lending limit regulation defines the term "gross receipts" to include gross revenues, intercompany loans, dividends, capital contributions, and similar receipts. These examples represent actual transfers of cash, property, or rights to cash or property. Although a Subchapter S corporation's gross income is allocated to its shareholders for federal income tax purposes, the undistributed portion of that income remains the property of the corporation and therefore cannot be considered part of a shareholder's gross receipts. Only distributions paid by a Subchapter S corporation to a shareholder, such as salary and dividends, should be included as part of the shareholder's gross receipts.

Mates], two borrowers that are related through common control. Accordingly, loans to [Co.] are combined with loans to [Mr. Mates] for the purposes of the legal lending limit under common enterprise test at 12 CFR 32.5(c)(2).

4. Common Enterprise Test No. 3—Borrowing to Acquire Control

[Co.], the [Mates], and the land trusts did not use the proceeds of their loans to collectively acquire a 50 percent or more interest in a single business enterprise. Thus, this test is not applicable to the loans to [Co.], the [Mates], and the land trusts.

5. Common Enterprise Test No. 4—Facts and Circumstances

OCC rulings and interpretations reveal that a very strong evidentiary record based upon a number of factors must exist before a common enterprise will be found to exist solely on the basis of the facts and circumstances test.[13] Instances in which the facts and circumstances test will apply where the other direct benefit and common enterprise tests do not will be rare.[14] In administrative opinions and interpretive letters, the OCC has indicated that the facts and circumstances test will be applicable when enterprises "engage in supporting lines of business, use common facilities, have common arrangements, or generally mingle their assets and borrowings."[15] A key factor in this analysis is evaluating the extent of the entities' interrelationships and financial and operational interdependence, and determining whether the failure of one borrower would directly effect the other. Other factors considered include the interchange of goods or services between the borrowers, the extent to which one borrower receives income from the other borrower, the volume of operating transactions between the borrowers, and whether the same collateral secures loans to the borrowers.

Without knowing all of the facts relating to the interrelationships among Mr. [Mates], Mrs. [Mates], [Co.], and the land trusts, I am unable to determine with certainty whether the loans to those entities should be combined for lending limit purposes under the facts and circumstances test. However, based on the information provided by you and the examiners, it does not appear that [Co.] and the land trusts are a common enterprise under the facts and circumstances test. The entities do not operate supporting lines of business, use common facilities, or commingle assets or borrowings. Moreover, the success of one of the entities is not dependent on the success of the other.

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[13] Interpretive Letter No. 563, *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L. Rep. ¶83,314, at 71,439 (September 6, 1991).

[14] *Id.*

[15] Id. (citing Comptroller's Decision AA–EC–87–77 (August 12, 1988)); *see also* letter from Richard V. Fitzgerald, chief counsel (October 11, 1984) (unpublished) (loans will be combined where corporations are commonly owned, are engaged in the same line of business, interchange services and personnel, and are not completely separate in their operations and financial affairs); Rojc, "National Bank Lending Limits—A New Framework," 40 *The Business Lawyer* 903, 923–24 (May 1985) (citing various OCC interpretive letters).

A remaining issue is whether Mr. [Mates] and Mrs. [Mates] are a common enterprise, i.e., whether loans attributed to Mr. [Mates] should be combined with loans attributed to Mrs. [Mates] under the facts and circumstances test. If so, then the [Co.] loans and 50 percent of the land trust loans would be combined with the [Mates] loans. There are some facts here that would lend support to such a conclusion. For instance, both individuals are makers on the home equity and credit reserve loans, proceeds from those loans (secured by jointly owned collateral) were used by Mr. [Mates]'s corporation, and Mr. [Mates] has personally guaranteed a portion of the land trust loans that benefit Mrs. [Mates]. These facts evidence the commingling of certain assets and liabilities, indicating some level of financial interdependence between the two individuals.

Nonetheless, based on the limited facts available, I believe Mr. and Mrs. [Mates] should not be considered a common enterprise for the purposes of the lending limit. Although there is evidence of commingling of assets and liabilities between each other, there does not appear to be any commingling of assets and liabilities between their separate borrowing entities—[Co.] and the land trusts. Indeed, the successful operation of the properties beneficially owned by Mrs. [Mates] through the land trusts is not dependent upon the successful operations of [Co.], Mr. [Mates]'s principal asset, and vice versa. Based upon the facts presented, it appears that the failure of [Co.] should not materially affect the ability of the land trusts to repay their loans. Likewise, the failure of the land trusts should not materially affect the ability of [Co.] to repay its loans. In my opinion, this apparent lack of interdependence between [Co.] and land trusts argues against treating Mr. and Mrs. [Mates] as a common enterprise for the purposes of the lending limit, especially since the result of finding such a common enterprise would be the combination of the loans to both [Co.] and the land trusts to the [Mates]' loans. Nonetheless, additional facts might justify a different conclusion.

In summary, all of the loans to Mr. and Mrs. [Mates] and all of the loans to [Co.] are combined for legal lending limit purposes under the common control and substantial financial interdependence test at 12 CFR 32.5(c)(2). The two [Mates] home equity loans are combined with all of the loans to [Co.] under the direct benefit test at 12 CFR 32.5(b). Finally, 50 percent of the land trust loans are combined with the [Mates] loans under the direct benefit test at 12 CFR 32.5(b). These loan combinations are summarized in the chart below.

Table 2—Possible Combinations of Loans to [Mates] and [Co.]

Combination Tests	[Mates] Home Equity Loans	[Mates] Credit Reserve Loan	Land Trust Loans	[Co.] Loans	Aggregate Subject to Lending Limit
[Mates]/[Co.] Combination under Common Control and Substantial Financial Interdependence Test 12 CFR 32.5(c)(2)	$494,000	$2,000		$2,485,434	$2,981,434
[Mates]/[Co.] Combination under Direct Benefit Test 12 CFR 32.5(b)	$494,000			$2,485,434	$2,979,434
Mrs. [Mates] Land Trusts Combination under Direct Benefit Test 12 CFR 32.5(b)	$494,000	$2,000	$1,347,383 X 50% $ 673,692		$1,169,692

6. Guarantees

In your letter you inquire about the impact of Mr. [Mates]'s guaranty of the loans to [Co.] and the land trusts on the lending limit calculations. The fact that Mr. [Mates] personally guarantees loans to the land trusts and [Co.] does not necessarily mean that those loans are combined with his personal loans for lending limit purposes. The OCC's lending limit regulation provides that a guarantor is considered a "borrower" for the purposes of the lending limit only if that guarantor is deemed to be a borrower under the direct benefit or common enterprise tests set forth at 12 CFR 32.5.[16] In other words, a loan will not be attributed to the loan's guarantor and combined with any of the guarantor's direct loans unless one of the five loan combination/attribution tests discussed above has been met.

Mr. [Mates] personally guarantees a portion of the land trust loans. As discussed above, the land trust loans are not attributed to Mr. [Mates] under the direct benefit, common source of repayment, common control and substantial financial interdependence, or the borrowing to acquire control tests. Assuming the loans to the land trust are not attributable to Mr. [Mates] under the facts and circumstances test, then Mr. [Mates] will not be deemed a "borrower" with respect to the land trust loans. Accordingly, the land trust loans will not be combined with Mr. [Mates]'s personal loans at the bank, notwithstanding his personal guaranty of the land trust loans.

Mr. [Mates] also guarantees a portion of the [Co.] loans. As noted above, all of the loans to [Co.] will be attributed to Mr. [Mates] under the common control and substantial financial interdependence test. The fact that Mr. [Mates] is a guarantor of the [Co.] loan was not relevant to the application of that loan combination/attribution test. Consequently, the loans to [Co.] will be combined with loans to Mr. [Mates] regardless of whether he guarantees some or all of the [Co.] loans.

III. Conclusion

In my opinion the facts presented indicate that the loans to all five borrowers—[Co.], Mr. [Mates], Mrs. [Mates], and the two land trusts—are not combined as a whole for purposes of the legal lending limit. However, in my opinion the [Co.] loans are combined with the [Mates] loans for purposes of the legal lending limit. Further, the 50 percent of the land trust loans are combined with the [Mates] loans.

This opinion is based on the facts set forth in this letter, as provided in your letter and subsequent phone conversations and by National Bank Examiners Leigh and Joy. Different facts may warrant different conclusions.

I trust this is responsive to your request. If you have any further questions, please contact me at (312) 360–8805.

Christopher G. Sablich
Senior Counsel
Central District Office

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[16] *See* 12 CFR 32.2(a).

952—October 23, 2002

12 USC 21–23
12 USC 30B

Mr. Scott A. Cammarn, Esq.
Associate General Counsel
Bank of America, National Association
101 South Tryon Street
Charlotte, North Carolina 28255

Dear Mr. Cammarn:

This is in response to your letter of October 4, 2002, on behalf of Bank of America, National Association, Charlotte, North Carolina, ("Bank of America" or "the bank") requesting the views of the Office of the Comptroller of the Currency (the "OCC") concerning the location of the bank for corporate status purposes in the national banking laws and in determining the bank's citizenship for federal diversity jurisdiction under 28 USC 1332 and 1348. As explained below, we believe the corporate location of the bank is determined by the place where the bank's main office is currently located (Charlotte, North Carolina), not the place where it was located in the bank's historical organization certificate (San Francisco, California).

Background

Bank of America, N.A., is the result of an interstate merger that occurred in 1999. In that merger, NationsBank, N.A., Charlotte, North Carolina, (Charter Number 14448) was merged into the Bank of America National Trust & Savings Association, San Francisco, California, (Charter Number 13044). Charter Number 13044 survived the merger. The historical organization certificate for Charter Number 13044, executed by the organizing directors of the Bank of Italy National Trust and Savings Association on February 26, 1927, stated that its original place of business was San Francisco, California. In the 1999 merger, however, the resulting bank retained the main office of NationsBank in Charlotte as its main office, as it was authorized to do under 12 USC 1831u(d)(1).[1] Hence, the main office of Charter Number 13044 today is in Charlotte. The resulting bank also changed its name to Bank of America, N.A.

Corporate Location of a National Bank under the National Bank Act

The location of a national bank for corporate status purposes under the National Bank Act and other banking laws is determined by the place where the national bank's main office is located. As explained below, at the time of chartering, the main office is located in the place designated

[1] See Decision to Merge Bank of America National Trust & Savings Association, San Francisco, California, and NationsBank, N.A., Charlotte, North Carolina (OCC CRA Decision No. 94, May 20, 1999).

in the bank's organization certificate and original articles of association. Subsequently, if the bank changes the location of its main office to a new place, then the new location determines the location of the bank for corporate status purposes. Such changes of location are evidenced in the bank's articles of association, since the articles must be amended to reflect the change of the main office to a new place.

When organizers propose to form a national bank, they apply to the OCC. Among the materials and information they must submit are an organization certificate and articles of association. 12 USC 21–23. The articles of association and the organization certificate are typically prepared at the same time at the first meeting of the organizers and sent to the OCC together. *See Comptroller's Corporate Manual,* "Corporate Organization," at 19–20 (April 1998) (sample minutes for first meeting of organizers). Both the organization certificate and the articles contain the name of the proposed bank, its location, and the amount and structure of its capital stock.[2] In particular, both documents will include "[t]he place where its operations of discount and deposit are to be carried on, designating the State, Territory, or District, and the particular county and city, town, or village." 12 USC 22(Second).

The national bank's "main office" (a term used in 12 USC 30(b) and other banking statutes) is located within the "city, town, or village" designated as the "place where its operations of discount and deposit are to be carried on." Indeed, for location purposes, the "main office" and the "place where its operations of discount and deposit are to be carried on" are the same. Section 30(b) now uses the term "main office." But when originally enacted in 1886, the provisions now codified in 12 USC 30(b) used the same terminology as section 22:

> SEC. 2. That any national banking association may change its name or the place where its operations of discount and deposit are to be carried on, to any other place within the same State, not more than thirty miles distant with the approval of the Comptroller of the Currency, by the vote of shareholders owning two-thirds of the stock of such association.

Act of May 1, 1886, ch. 73, 2, 24 Stat. 18 (1886). When the statute was amended in 1959, the provision limiting moves to places within the same state was removed, and the new term "main office," was introduced. Pub. L. No. 86–230, §3, 73 Stat. 457 (1959).[3]

Another relevant provision is 12 USC 81. Under section 81, the "general business of each national banking association shall be transacted in the place specified in its organization certificate and in the branch or branches, if any, established or maintained by it" under 12 USC 36. When

[2] 12 USC 22 (organization certificate); *Comptroller's Corporate Manual,* "Corporate Organization." at 33–35 (April 1998) (instructions for organization certificate and sample document); *Comptroller's Corporate Manual,* "Corporate Organization." at 21–32 (April 1998) (instructions for articles of association and sample document).

[3] See generally Decision on the Applications of Bank Midwest of Kansas, N.A., Lenexa, Kansas, and Bank Midwest, N.A., Kansas City, Missouri (OCC Corporate Decision No. 95–05, February 16, 1995) (pages 12–18), reprinted in Fed. Banking L. Rep. (CCH) ¶ 90,474 (discussion of sections 22, 30, and 81).

section 30 was added allowing changes in location and then amended to refer to the main office, an apparent inconsistency with section 81 was created, inasmuch as section 30 allowed the bank to move to a new place and even to cease operations in the old place, but section 81 continued to refer only to the place specified in the organization certificate. The OCC addressed the inconsistency by concluding that the "place specified in its organization certificate" in section 81 "is meant to include not only the place originally specified in the organization certificate but also subsequent changes of location as authorized under section 30." *OCC Bank Midwest Decision* at page 13, note 5. Thus, for location purposes, the terms are interchangeable. The main office defines the place, because the place is the city or town (and state) within which the main office is located.

While many national banks continue to operate at the place originally designated, a national bank can change its place of operations under other statutory authority. Under 12 USC 30(b), a national bank may change the location of its main office to another location within the original city or to another location outside the original city, but within 30 miles of the city limits of the original city. Once the bank moves its main office outside its original city, the bank is now located at the new place, and the old place is no longer the place where its banking operations are carried on, in the section 22 sense, even if it retains branches in that city.[4] Moreover, a national bank can change the location of its main office into a new state.[5] It can do so without retaining any branches or other operations in its original state.

A national bank may also change the location of its main office in the context of an interstate merger with another bank under the Riegle–Neal Act. Under 12 USC 215a-1 and 1831u(a), an insured national bank may merge with another insured bank with a different home state. When such a merger occurs, the resulting bank may retain, as its main office, any office that any bank involved in the merger was operating as a main office or a branch immediately before the merger. 12 USC 1831u(d)(1). In other words, the resulting bank may designate as its main office, any one of main offices or branches of any of the banks in the merger, including a main office or branch in a state other than the state in which the acquiring bank's former main office was located. Bank of America, N.A., is the result of such an interstate merger.

[4] In the organization certificate and original articles, even if a bank proposes to have branches in several cities upon opening, only one place is the place designated in section 22 and the articles. The articles will also refer to conducting business at authorized branches. In this regard, it is important to note that the main office is primarily a term of legal, rather than business, significance. It is the office designated as such. The bank must carry on the business of banking at its main office, but the main office need not be the office at which the bank conducts the principal portion, or any required minimum portion, of its business. See *OCC Bank Midwest Decision* at page 12. See also *Ramapo Bank* v. *Camp*, 425 F.2d 333, 341–42 (3d Circuit 1970).

[5] See, e.g., *Synovus Financial Corporation* v. *Board of Governors of the Federal Reserve System*, 952 F.2d 426 (D.C. Circuit 1991) (moving main office into new state under section 30, keeping no branches in old state); *McEnteer* v. *Clarke*, 644 F. Supplement 290 (U.S. District Court for the Eastern District of Pennsylvania 1986) (same). See also *OCC Bank Midwest Decision*, supra (moving main office into new state, and keeping branches in old state).

If a national bank's main office is changed to a different place (a different city, town, or village), that change must be reflected in the articles of association.[6] But there is no statutory provision or regulatory procedure to change the organization certificate to reflect current conditions. It is a fixed historical document that was used in the organizing process but is not used subsequent to the issuance of the charter by the OCC and, therefore, has no reason to reflect the current status of the institution.[7]

When a national bank has changed the location of its main office to a new place, it is the new place that determines the bank's location for corporate purposes. Moreover, the location of a national bank, and in particular the location of its main office, is a factor in determining the applicability of many banking statutes. Some of the statutes use the location as a reference point for a substantive provision of federal law. Others use the location to determine which state's law is made applicable to the national bank by federal law. In all these determinations, the place used is the location of the current main office as shown in the bank's current articles of association, not the place designated in the organization certificate and the original articles.[8] For example, in the OCC's recently adopted regulation addressing electronic activities, the rule specifies the manner to determine the location, for purposes of 12 USC 85, of a national bank that operates exclusively through the Internet. It provides that the main office of such a bank is "the office identified by the bank under 12 USC 22(Second) or as relocated under 12 USC 30 or other appropriate authority." See 67 Fed. Reg. 34992, 35006 (May 17, 2002) (to be codified at 12 CFR 7.5009).

Finally, when Congress had occasion to identify a national bank's home state, it used the location of the bank's main office as the reference point. In the Riegle–Neal Act, Congress authorized mergers between insured banks with different home states. The "home state" of a national bank

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[6] *See* 12 USC 21a (authorizing amendments to articles of association); 12 CFR 5.40(d)(2)(ii) (amendment of articles if main office location is changed outside original city, town, or village). Similarly, when other items that were included in the organization certificate and original articles are changed, the articles of association must be amended to reflect the changes. *See* 12 CFR 5.42(d)(2) (amendment of articles for change of name); 12 CFR 5.46(g)(2) and 5.46(i)(3)(iv) (amendments of articles for changes in capital stock).

[7] *Compare Comptroller's Corporate Manual,* "Corporate Organization." at 21 (instructions for articles include directions regarding amendment) *with Comptroller's Corporate Manual,* "Corporate Organization," at 33 (instructions for organization certificate cover only original filing). *See also Decision on the Applications of American Security Bank, N.A., Washington, D.C., and Maryland National Bank, Baltimore, Maryland* (OCC Corporate Decision No. 94–05, February 4, 1994) (at page 11, note 4), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 89,695. In addition, the certificate of corporate existence the OCC issues to a national bank, when requested, to certify it is a national bank formed under the laws of the United States and authorized to transact the business of banking on the date of the certificate lists the location of the bank at the main office on the date of the certificate, not the original location in the organization certificate. The certificates the OCC has issued to Bank of America (Charter Number 13044) since the 1999 merger show Charlotte, North Carolina, as the bank's location.

[8] For some statutes, a national bank may also be "located" in states in which it has branches. That is a separate matter from the issue here whether the current main office or the original place is the place used when referring to a bank's location.

is the state in which its main office is located. 12 USC 1831u(g)(4)(A)(i). Moreover, the home state of a state bank is the state by which the bank is chartered. 12 USC 1831u(g)(4)(A)(ii). This suggests Congress viewed the main office of a national bank as a way to designate a state that was comparable to the state of incorporation for a state bank.

Location of a National Bank for Federal Court Jurisdiction

For purposes of diversity jurisdiction in federal courts, "[a]ll national banking associations shall, for the purposes of all other actions by or against them, be deemed citizens of the States in which they are respectively located." 28 USC 1348.

Over the years, the courts have taken three positions regarding the location of a national bank for diversity purposes. Recently, some district courts adopted the position that a national bank was located in, and hence a citizen of, every state in which it maintains a branch or otherwise has a substantial presence.[9] On the other hand, an older court of appeals decision and some district courts took the position that a national bank was located for this purpose only in the state of its principal place of business.[10]

However, the leading recent court of appeals case followed neither of those approaches. In *Firstar Bank, N.A.* v. *Faul*, 253 F.3d 982 (7th Circuit 2001), the Seventh Circuit, relying upon the history and context of the provision, determined the national bank jurisdiction statute should be construed to maintain jurisdictional parity between national banks and state banks or other state corporations. 253 F.3d at 987–93.[11] For diversity jurisdiction purposes, state banks and other state corporations are potentially citizens of two states—the state of incorporation and the state where it has its principal place of business. See 28 USC 1332(c)(1). And so the court concluded that national banks should be similarly treated. Since a national bank is not incorporated by a state, the court looked to the state designated in a national bank's organization certificate to serve as an analogue and concluded that a national bank is a citizen, for jurisdiction purposes, both of the state of its principal place of business and the state listed in its organization certificate. 253 F.3d at 993–94.

[9] The first case to adopt that position was *Connecticut National Bank* v. *Iacono,* 785 F. Supplement 30 (U.S. District Court for the District of Rhode Island 1992). Others have followed it. *See, e.g., Ferraiolo Construction, Inc.* v. *KeyBank, N.A.,* 978 F. Supplement 23 (U.S. District Court for the District of Maine 1997); *Norwest Bank Minnesota, N.A.* v. *Patton,* 924 F. Supplement 114 (U.S. District Court for the District of Colorado 1996); *Bank of New York* v. *Bank of America,* 861 F. Supplement 225 (U.S. District Court for the Southern District of New York 1994).

[10] *American Surety Company v. Bank of California, N.A.,* 133 F.2d 160 (9th Circuit 1943); *Baker* v. *First American National Bank,* 111 F. Supplement.2d 799 (U.S. District for the Western District of Louisiana, 2000); *Financial Software Systems, Inc.* v. *First Union National Bank,* 84 F. Supplement 2d 594 (U.S. District Court for the Eastern District of Pennsylvania 1999).

[11] The OCC filed an amicus brief in *Firstar Bank, N.A.* v. *Faul,* arguing in support of the position that section 1348 should be interpreted in a manner to achieve jurisdictional parity with state entities.

We believe the interpretation of the statute and fundamental reasoning of the *Firstar Bank, N.A.* v. *Faul* court are correct. National banks are to be treated for diversity jurisdiction purposes in a manner similar to state banks. However, the court's use of the state listed in the organization certificate as the analogue to the state of incorporation was incomplete. While most national banks do not change the location of their main office from the state originally listed in the organization certificate, some do. As set out above, the state that was listed in the original organization certificate can be changed under statutes that provide for changing the location of the main office. When this occurs, the original organization certificate document itself is not changed. The change in designation of the place of operations (including state) is reflected in other documents, particularly the articles of association.[12]

Thus, a more complete statement of the position would be that a national bank is a citizen of the state in which its principal place of business is located and of the state that was originally designated in its organization certificate and articles of association or, if applicable, the state to which that designation has been changed under other authority (i.e., the state in which its main office is currently located). We think this better comports with the underlying national bank corporate statutes and practice. It is also consistent with the reasoning in *Firstar Bank, N.A.* v. *Faul*. A national bank's change of its original designated state is akin to a state entity changing its state of organization by reincorporating in a new state. Moreover, if only the state actually listed in the original organization certificate is used, without some method to take account of later changes of main office, that could lead to the result of a national bank being deemed a citizen of a state with which it no longer had any contacts whatsoever.

Conclusion

Accordingly, we conclude that, since Bank of America's main office is now in Charlotte, North Carolina, the bank should be treated as a citizen of North Carolina for that part of the test in *Firstar Bank, N.A.* v. *Faul*.

Eric Thompson
Director
Bank Activities and Structure

[12] In *Firstar Bank, N.A.* v. *Faul,* the city and state of the bank's main office (Cincinnati, Ohio) was the same as it was when the bank was chartered in 1863 as The First National Bank of Cincinnati (Charter Number 24). Thus, the facts in the case did not present the issue raised by a subsequent change in the designation of the place of operations.

953—December 4, 2002

12 USC 24(7)
12 USC 24(10)

Re: Proposal to enter into residual purchase agreements

Dear Mr. [ ]

This responds to your letter requesting the OCC's concurrence that [bank], [*City, State*] ("bank") may enter into residual purchase agreements with other unrelated, third-party equipment lessors ("proposed activities"). For the reasons discussed below, we believe the proposed activities are permissible.

A. Background

The bank engages in the leasing of personal property pursuant to 12 USC 24(Tenth) and 12 CFR Part 23 ("CEBA leasing").[1] In the normal course of its CEBA leasing, the bank purchases equipment, relies upon its expertise to estimate the residual value of the equipment at the end of the lease term, and determines the lease payments it will receive. For each lease, the bank then uses its reasonable estimate of the residual value in determining whether the lease qualifies as full-payout.

The bank proposes to use the expertise it has developed in estimating the residual value of leased equipment to enter into the residual purchase agreements described below. Prior to entering into any agreement, the bank will undertake its normal CEBA leasing analysis, including review of the equipment to be leased. The same professionals who perform this analysis for the bank's CEBA leasing business will perform the analysis for the proposed activities. Furthermore, if any leased equipment suffers a loss—from theft or physical damage—during the term of the lease, the bank's obligation under the residual purchase agreements will be extinguished.

The bank proposes, for a fee, to enter into agreements with unrelated, third-party equipment lessors such that:

- *at lease expiration*, the lessor must either sell the off-lease equipment to the bank for the pre-determined purchase price ("purchase price")[2] or appoint the bank to serve as its exclusive agent to sell the equipment.[3] As the exclusive agent of the lessor, the bank will

[1] A permissible CEBA ease must be of personal property, be a net, full-payout lease, and have a minimum term of 90 days.

[2] If the bank is required to purchase the off-lease equipment pursuant to an agreement with the lessor, the bank represents that it would dispose of the off-lease equipment within the period allowed by Part 23.

[3] The agreement between the bank and the lessor would prohibit the lessor from selling or re-leasing the equipment or extending or renewing the subject lease.

arrange the sale of the equipment. Regardless of the sale price, the lessor will receive the purchase price, with the bank entitled to any excess of the net sales proceeds over the purchase price as a commission;

- *if a lease terminates early,* the lessor must either sell the off-lease equipment to the bank for the greater of its then fair market value ("FMV") or the pre-designated purchase price or appoint the bank to serve as its exclusive agent to sell the equipment. As the exclusive agent of the lessor, the bank will arrange the sale of the equipment. Again, regardless of the actual sale price, the lessor will receive the greater of the FMV or the purchase price, with the bank entitled to any excess of the net sales proceeds over the FMV or purchase price as a commission.

The bank proposes to enter into this residual purchase agreement both for CEBA leases originated by unrelated third parties and for CEBA leases originated and sold by the bank. The bank represents that all leases for which it will enter into this residual purchase agreement will meet the requirements for CEBA leasing in Part 23. The bank further represents that it will not be involved in the underlying lease negotiations between the third-party lessor and the lessee (except in those instance in which the bank itself originates the CEBA leases).

The bank expects that its estimates of the purchase prices, essentially the off-lease equipment's residual values, would be accurate on a portfolio basis. For this reason, and because the bank will receive fee income for entering into the residual purchase agreements, the bank believes that the proposed activities would be profitable.

B. Discussion

The Supreme Court has held that the National Bank Act, in 12 USC 24(Seventh), contains a broad grant of the power to engage in the "business of banking." Specifically, the Court has said that the business of banking "is not limited to the enumerated powers in Section 24(Seventh) and that the Comptroller therefore has discretion to authorize activities beyond those specifically enumerated."[4] In exercising this discretion, the OCC is guided by several factors reflected in case law and followed by OCC precedent: (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; (3) does the activity involve risks similar in nature to those already assumed by banks; and (4) whether the activity is expressly authorized by law for state-chartered banks.[5]

[4] *NationsBank of North Carolina, N.A.* v. *Variable Life Annuity Co*., 512 U.S. 251, 258–59, n.2 (1995).

[5] The OCC recently codified these four principles in the electronic banking regulation. *See* 12 CFR 7.5001(c).

The proposed activities need not satisfy all four factors in order to be permissible as part of the business of banking. Rather, the OCC recognizes that one or more of the factors may predominate, depending on the specific facts and circumstances presented.[6] For the reasons discussed below, we believe that the proposed activities are part of the business of banking.

1. The proposed activities are the functional equivalent of and a logical outgrowth of recognized banking activities.

The proposed activities are the functional equivalent of a recognized national banking activity—originating or purchasing loans, and specifically loans with balloon payments.[7] One example is an automobile loan with a balloon payment. Such a loan is an installment loan, secured by the automobile, with a large (or "balloon") payment equal to the estimated residual value of the automobile included in the final monthly installment. At the time of the final monthly payment, the borrower typically may choose (i) to sell the vehicle, pay the residual value, and keep the difference; (ii) to use the vehicle as a trade-in, paying the residual value as part of the transaction; (iii) to refinance the residual value as a used vehicle loan; or (iv) to return the vehicle to the lending bank.

When originating or purchasing a balloon loan, a national bank assumes the necessity of disposing of the collateral if, at the time of the final monthly payment, the borrower chooses to return the vehicle to the bank in lieu of the balloon payment ("residual disposal risk"). In addition, when estimating a residual value for the vehicle, the bank assumes the risk that the estimated residual value is set too high. If the estimated residual value is set too high and the borrower opts to return the collateral, the bank may receive an amount less than the estimated residual value when disposing of the returned vehicle ("residual value risk").

The proposed activities represent a functionally equivalent activity. Before the bank enters into a residual purchase agreement with an unrelated, third-party lessor to purchase, or act as exclusive agent for the sale of, off-lease equipment, it would establish the purchase price for the off-lease equipment. Establishing the purchase price for off-lease equipment is the functional equivalent of estimating the residual value of collateral in a balloon loan. In both instances, the bank would be assigning the value at which it will accept the property—either the off-lease equipment or the balloon loan collateral. Then, by entering into a residual purchase agreement with a third-party

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[6] *See* 67 *Federal Register* 34855, 34994–95 (May 17, 2002); Interpretive Letter No. 928, *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–453 (December 24, 2001); *Merchants' Bank* v. *State Bank*, 77 U.S. 604, 608 (1871); *M&M Leasing Corp*. v. *Seattle First Nat'l Bank*, 536 F.2d 1377, 1382–83 (9th Circuit 1977), *cert. denied*, 436 U.S. 987 (1978); *American Ins. Assoc*. v. *Clarke*, 865 F.2d 278, 282 (D.C. Circuit 1988).

[7] National banks may originate and purchase such loans. Interpretive Letter No. 364, *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,534 (July 9, 1986); letter from Wallace S. Nathan, district counsel (December 2, 1985) (unpublished). *See* 12 CFR 5.34(e)(5)(v)(D) ("[p]urchasing . . . extensions of credit, or interests therein"); Corporate Decision No. 2001–27 (September 27, 2001) (national bank may purchase loan participations).

equipment lessor, the bank is agreeing to engage in an activity that is the equivalent of disposing of collateral returned in lieu of a balloon payment. The bank would receive off-lease equipment (or, in the case of a balloon loan, returned collateral) that has been used for a period of time and would employ its expertise in disposing the equipment (or collateral).

Moreover, the proposed activities rely upon the core competencies developed by the bank in originating and purchasing both balloon loans and CEBA leases.[8] The bank proposes to purchase equipment residuals after using the same expertise and the same analytical criteria the bank applies when it originates or purchases a whole lease. The bank would then dispose of these residuals in the same manner, with the same expertise, and subject to the same criteria in which it disposes of off-lease property from CEBA leases it originates or purchases. The same professionals who perform CEBA lease analysis and sales for the bank today would undertake this analysis and sales activity.

2. The proposed activities involve risks similar in nature to those already assumed by the bank.

By originating or purchasing a balloon loan, the bank would assume the residual value risk and, if the borrower opts to return the collateral in lieu of making the balloon payment, the residual disposal risk. The proposed activities place the bank in a comparable position, with an agreement to accept the off-lease equipment and the residual value risk. As described above, the bank represents that the risk analysis and risk management that it would undertake in connection with the proposed activities in estimating the residual value, in assigning a purchase price, and ultimately in selling the off-lease equipment is identical to the risk analysis and risk management that the bank currently undertakes in connection with its origination and acquisition of CEBA leases.

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[8] The development of core competencies has important implications under the logical outgrowth analysis. As the OCC has observed:

> Among other things, the "logical outgrowth" test recognizes that the "business of banking" is defined not only by the services and products that banks provide, but also the core competencies that banks use to produce them. . . .
>
> Clearly, "the business of banking is not static. . . ." *New York State Ass'n of Life Underwriters* v. *New York State Banking Dept.,* 632 N.E.2d 876, 880 (N.Y. 1994). OCC recognizes that the evolution of "business of banking" is not restricted to lines of business reflecting only products banks have sold or functions banks have served previously. Rather, the "business of banking" must be—and is—sufficiently flexible to enable banks to develop and exploit their unique core competencies and optimize the return on those competencies by marketing products and services reflecting or using those competencies. . . .

Interpretive Letter No. 928, *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–453 (December 24, 2001). In Interpretive Letter No. 743, *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,108 (October 17, 1996), the OCC concluded that providing mortgage reinsurance on mortgage loans originated or purchased by a bank was the functional equivalent to or a logical outgrowth of the lending business because, *inter alia*, it involved credit decisions based on core competencies developed in the lending business—the same underwriting criteria and comparable credit risks.

Satisfactory risk analysis and management systems are an important part of identifying, measuring, and controlling risk. Therefore, the bank may not commence the proposed activities unless and until the bank has received the approval of its examiner-in-charge that the risk analysis and management systems for the proposed activities are satisfactory.[9]

C. Conclusion

For the reasons set forth above, the proposed activities are part of the business of banking and, therefore, are permissible for national banks.[10] If you have any questions, please contact Steven Key, senior attorney, at (202) 874–5300.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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[9] Subject to the same requirement, we believe that the bank may also engage in the proposed activities as a correspondent service. A national bank may offer correspondent services to its affiliates or any other financial institution. 12 CFR 7.5007. Because national banks assume the residual value risk of off-lease equipment and disposal of that equipment in connection with their personal property leasing activities, they may perform these services for other lessors. As described above, the bank represents that it has developed an expertise in these activities. One rationale for authorizing a national bank to provide correspondent services is to permit the bank to pass on the benefits of its expertise in certain activities which are central to banking. Interpretive Letter No. 137, *reprinted in* [1981–1982 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 85,218 (December 27, 1979); letter from Peter Liebesman, assistant director, Legal Advisory Services Division (May 2, 1990) (unpublished). OCC precedents generally support the position that the bank may engage in the proposed activities as a correspondent service. *See* Interpretive Letter No. 567, *reprinted in* [1991–1992 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 83,337 (October 29, 1991) (disposal of off-lease property for other lessors); letter from Peter Liebesman, assistant director, Legal Advisory Services Division (June 15, 1981) (unpublished).

[10] This letter does not address accounting and capital issues raised by the proposed activities. These issues will be addressed in later communications with the bank.

954—December 16, 2002

12 USC 85

Dear [ ]:

This is in response to your inquiry on behalf of [ ] ("bank"), and its wholly owned operating subsidiary [ ] ("the mortgage subsidiary"). In that letter, you request confirmation that the mortgage subsidiary may rely on 12 USC 85 and export Michigan's interest rate for real estate-secured loans made by the mortgage subsidiary to residents of states other than Michigan or secured by real estate located in states other than Michigan. For the reasons described below, as a national bank operating subsidiary, the mortgage subsidiary may export the Michigan interest rates under the same terms and conditions applicable to the bank.[1]

Both the bank and the mortgage subsidiary are headquartered in Michigan. The mortgage subsidiary makes real estate-secured loans to residents of all states except Hawaii. At this time, the mortgage subsidiary is principally involved in making first-lien, residential mortgage loans, but it intends to expand its subordinate-lien, residential mortgage lending activity in the future. The bank, through the mortgage subsidiary, seeks to establish lending programs in certain states with uniform pricing policies based on the interest allowed by its home state of Michigan, including fees that are considered interest under federal law and regulations. The mortgage subsidiary would include in its loan documents a governing law clause disclosing to borrowers that interest and loan charges that are considered to be interest under federal law would be governed by federal and Michigan law. The mortgage subsidiary also would comply with all requirements and limitations imposed by section 85 and OCC regulations and interpretations regarding section 85.

Because the mortgage subsidiary is a subsidiary of the bank within the meaning of 12 CFR 5.34(e)(2), and engages solely in activities that are permissible for the bank to engage in directly, the mortgage subsidiary qualifies as an operating subsidiary of the bank under 12 CFR 5.34. As such, it is subject to the same terms and conditions that apply to the bank. As stated in the relevant OCC regulations—

[1] Our review of the preemption issues involved in the bank's inquiry is not subject to the notice-and-comment procedures required under certain circumstances by 12 USC 43. That provision requires the OCC to publish in the *Federal Register* notice of any preemption inquiry concerning a state law in the areas of community reinvestment, consumer protection, fair lending, and the establishment of interstate branches. However, notice is not required for requests that raise issues of federal preemption that are essentially identical to those on which we have previously issued an opinion letter or interpretive rule. Id. Section 43(c)(1)(A). As explained in this letter, the request involves two issues that are resolved by OCC regulations: (1) the ability of a national bank to export interest rates (see 12 CFR 7.4001(c)), and (2) the extent to which state law applies to an operating subsidiary of a national bank (see id. Sections 5.34(e)(3) and 7.4006). This letter simply outlines the relationship between these two well-settled principles of federal banking law.

> *Examination and supervision*. An operating subsidiary conducts activities authorized under this section pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank.[2]

Elsewhere, our regulations specify that "[s]tate laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank."[3] Recent legislation also has recognized the permissibility of national banks engaging in activities through operating subsidiaries. In section 121 of the Gramm–Leach–Bliley Act, Congress expressly acknowledged that national banks may own subsidiaries that engage "solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activities by national banks."[4] Operating subsidiaries are often described as equivalent to a department or division of their parent bank, and our regulations ensure that operating subsidiaries will be subject to the same federal laws and standards that govern their parent bank, including any state laws and standards that are made applicable to the parent bank by federal law.[5]

One such law is the limit imposed by section 85 on the maximum amount of interest a national bank may charge. Under section 85, a national bank is authorized to establish interest based on the laws of the state in which the bank is located.[6] OCC regulations provide that:

> A national bank located in a state may charge interest at the maximum rate permitted to any state-chartered or licensed lending institution by the law of that state.[7]

This "most favored lender" lender status permits a national bank to contract with borrowers in any state for interest at the maximum rate permitted by the law of the state in which the national bank is located. Generally, that is the state in which the main office of the national bank is located.[8] Under certain circumstances, national banks with branches in more than one state may be required to impose interest rates permitted by the law of a state in which they have a branch. That would happen in circumstances where three functions—loan approval, communication of loan

[2] 12 CFR 5.34(e)(3).

[3] 12 CFR 7.4006.

[4] Pub. L. No. 106–102, § 121, 113 Stat. at 1378, codified at 12 USC 24a(g)(3).

[5] Letter from Charles F. Byrd, assistant director, Legal Advisory Services Division (October 30, 1977), reprinted in [1978–1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,051 (national bank operating subsidiaries are in effect incorporated departments of the bank).

[6] 12 USC 85.

[7] 12 CFR 7.4001(b).

[8] *Marquette National Bank of Minneapolis* v. *First of Omaha Service Corp*, 439 U.S. 299 (1978).

approval, and disbursal of loan proceeds—all occur in a branch or branches in the same branch state.[9] Absent this set of circumstances, a national bank may impose rates permitted by the state where its main office is located.

Accordingly, pursuant to 12 CFR 5.34(e)(3) and 7.4006, the limit on the maximum amount of interest the mortgage subsidiary may charge is governed by section 85, to the same extent as section 85 is applicable to its parent bank.[10]

I hope the foregoing is helpful in your analysis of your client's lending programs. Please do not hesitate to contact my office at (202) 874-5200 or MaryAnn Nash, counsel, in our Law Department at (202) 874-5090, if you have any questions or if you need any additional information.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[9] OCC Interpretive Letter No. 822 (Feb. 17, 1998), reprinted in [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–265.

[10] See *Moss* v. *Southtrust Mobile Services, Inc.*, No. CV–95–P–1647–W, 1995 U.S. District LEXIS 21770 (U.S. District Court for the Northern District of Alabama September 22, 1995). In this case, the court concluded, without analysis, that section 85 applied to the operating subsidiary in question pursuant to 12 CFR 5.34 because it was an operating subsidiary of a national bank.

955—January 31, 2003

12 USC 84
12 CFR 32.3(C)(10)

Dear [ ]:

This is in response to your letter of December 2, 2002, in which you request the Office of the Comptroller of the Currency ("OCC") to reconsider its determination that [bank], [City, State] ("bank") had advanced funds to [ ] ("[ ]") in excess of the legal lending limit in violation of 12 USC 84. Your letter describes proposed modifications to the bank's loans to [ ] that you believe will result in those loans satisfying the exception to the lending limit for certain loans to leasing companies set forth at 12 CFR 32.3(c)(10).

For the reasons set forth below, the bank's loans to [ ] as modified under the proposal will satisfy the requirements of 12 CFR 32.3(c)(10). Accordingly, the loans to [ ], as modified, should be treated as loans to each lessee for the purposes of the legal lending limit.

Background

[ ] is an equipment leasing company. The bank has extended three non-recourse loans to[ ] to finance three pools of existing personal property leases. The original term of the leases in the pools is on average fifty-three months. The leases had been originated by [ ] between two and seventeen months prior to the bank's loans to [ ]. [ ] financed its acquisition of the assets being leased through working capital or borrowings from other banks. The proceeds of the bank's loans to [ ] were used to reimburse it for the purchase of the leased equipment by restoring working capital or repaying the acquisition debt. The loans to [ ] are secured by an assignment of all of [ ]'s rights to specified leases and security interests in the equipment being leased. The bank has analyzed the creditworthiness of each lessee before making the loans to [ ]. The bank represents that the terms of the underlying leases meet the same limitations that would apply to a national bank acting as lessor. The assignment and security agreement provides that lease payments are to be made:

> by each Lessee to [[ ]], in care of [bank], at [bank's] address set forth above and [[ ]] authorizes [bank] to endorse, in [[ ]'s] name, all Lease Payments.

However, in practice the lessees made their payments to [ ] and [ ] remitted the amount it owed on the promissory notes to the bank on a monthly basis.

In the June 30, 2002, report of examination, the OCC cited the loans to [ ] as a violation of 12 USC 84 since the aggregate amount of those loans exceeded the bank's legal lending limit. The examiners determined that the three loans to [ ] failed to satisfy the requirements of the lending limit exception at 12 CFR 32.3(c)(10) and noted that the lessees were making their lease payments to [ ], rather than to the bank.

The bank has proposed a modification to the manner in which lease payments are processed. Under the proposed modification, [ ] will open and maintain a lock box at the bank and notify all lessees to direct all present and future payments due on the leases to the lock box. On the monthly payment due date, the bank will deduct the amount of the monthly payment owed under the note and apply it to the [ ] loan. At the end of each month, the bank will remit any funds remaining in the lockbox to [ ]. [ ] will remain responsible for billing and collections, but will carry out these functions as an independent contractor and not as the bank's agent.

Legal Analysis

Generally, a national bank's total outstanding loans or extensions of credit to one borrower may not exceed 15 percent of the bank's capital and surplus, plus an additional 10 percent of capital and surplus if the amount over the 15 percent general limit is fully secured by readily marketable securities.[1] A "borrower" includes a person who is named a borrower or debtor in a loan or extension of credit.[2] "Loans or extensions of credit" 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 *or repayable from specific property pledged by or on behalf of the borrower*.[3] (Emphasis added).

Here, [ ] is named the borrower on each of the three promissory notes it has executed with the bank. Further, the notes are all repayable from the collateral it has pledged to the bank. Thus, unless an exception to the legal lending limit applies, the bank's advances to [ ] under the three promissory notes are deemed to be loans to [ ] for the purpose of the lending limit, notwithstanding the non-recourse nature of those notes.

However, under 12 CFR 32.3(c)(10) a loan to a leasing company:

> for the purpose of purchasing equipment for lease will be deemed to be a loan to the lessee and not the leasing company, provided that—
>
> (i) The bank evaluates the creditworthiness of the lessee before the loan is extended to the leasing corporation;
>
> (ii) The loan is without recourse to the leasing corporation;
>
> (iii) The bank is given a security interest in the equipment and in the event of default, may proceed directly against the equipment and the lessee for any deficiency resulting from the sale of the equipment;

[1] See 12 USC 84(a); 12 CFR 32.3(a).

[2] 12 CFR 32.2(a).

[3] 12 CFR 32.2(j); see also 12 USC 84(b)(1).

(iv) The leasing corporation assigns all of its rights under the lease to the bank;

(v) The lessee's lease payments are assigned and paid to the bank; and

(vi) The lease terms are subject to the same limitations that would apply to a national bank acting as a lessor.

The exception at section 32.3(c)(10) incorporated a longstanding OCC interpretive position regarding lease-note financing known as the "U.S. Leasing" exception.[4] In 1974 the OCC issued an interpretive letter concerning a lease-note financing arrangement proposed by United States Leasing Corporation.[5] The OCC concluded that in lease-note financing arrangements such as those proposed by U.S. Leasing, the leasing company should be viewed merely as a nominal lessor and servicer of the lease acting on behalf of the lending bank.[6] Under an arrangement that meets the U.S. Leasing exception, the lessee's rent payments are the primary source of repayment of the loan and are understood to be such by all parties to the transaction. As a result, the lending bank should be able to treat the transaction as the equivalent of a secured loan to the lessee. In the event of default by the lessee, the bank has all the rights of a secured creditor, including the right to demand from the lessee any portion of the rent remaining unpaid after the equipment is sold. In essence, the lender must be placed in the same position as if it had directly leased the property to the lessee for the U.S. Leasing exception to apply.[7] The OCC has repeatedly emphasized in its interpretive letters that the U.S. Leasing exception is extremely narrow.

The bank and [ ] attempted to structure the loans so as to satisfy the requirements of the exception at 32.3(c)(10). During the recent examination the OCC determined that the bank's loans to [ ] met only five of the six enumerated conditions to the exception. The lessees were not making their lease payments to the bank as required by 12 CFR 32.3(c)(10)(v).[8] At issue here is whether the revised manner in which the bank proposes to collect payments satisfies the condition at 12 CFR 32.3(c)(10)(v).

[4] See 59 *Federal Register* 6593, Proposed Rule (February 11, 1994); 60 *Federal Register* 8526, Final Rule (February 15, 1995).

[5] See OCC Interpretive Letter, December 5, 1974 [1973–1978 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 97,003 ("U.S. Leasing letter").

[6] Id. See also letter from Peter Liebesman, assistant director, Legal Advisory Services Division (October 21, 1987) (unpublished) ("Liebesman letter"); OCC Interpretive Letter No. 287, April 19, 1984 [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,451.

[7] See OCC Interpretive Letter No. 327, March 15, 1985 [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,497.

[8] The OCC has opined that lease payments collected by the lessor that are forwarded to the lending bank within one business day of the receipt will satisfy the requirement that the "lessee's lease payments are . . . paid to the bank." Liebesman letter. In this case, the lessees made their payments to [ ], and [ ] remitted the amount owing to the bank under the loan on a monthly basis. Since [ ] did not remit the lease payments it received from the lessees to the bank within one business day, the loans did not meet the condition at 12 CFR 32.3(c)(10)(v).

Under the proposed modification to the loan agreement, all lessees will be directed to make all future payments due on the leases to a lock box at the bank. The bank will have sole control over the lock box. On the due date for [ ]'s monthly payment to the bank under the three notes, the bank will deduct the amount of the monthly payment owed and apply it to the [ ] loan. At the end of each month, the bank will remit any funds remaining in the lockbox to [ ]. This manner of payment satisfies the condition at 12 CFR 32.2(c)(10)(v) since the lessees will make their payments directly to the bank. Accordingly, the bank's loans to [ ], as modified under the proposal, will satisfy the six conditions of 12 CFR 32.3(c)(10).

Accordingly, the bank's loans to [ ], as modified under the proposal, will satisfy the requirements of 12 CFR 32.3(c)(10). Consequently, the loans to [ ] as modified should be treated as loans to each lessee for the purposes of the legal lending limit.[9]

The opinion set forth above is based on the facts and representations included in your correspondence dated December 2, 2002, and December 6, 2002, and our subsequent phone conversations. Any changes to the facts may warrant a different conclusion. Also, please note that this letter responds only to the legal lending limit issue raised in your letter and does not address any safety and soundness aspects of the current loans to [ ] or the proposed modifications to those loans.

If you have any questions regarding this letter, please contact me at (312) 360–8805.

Christopher G. Sablich
Senior Counsel
Central District Office

[9] The proceeds of the bank's loans to [ ] were used to reimburse it for its purchase of the leased equipment by restoring working capital or repaying the acquisition debt. Thus, the purpose of the bank's loans to [ ] was to indirectly finance the purchase of the leased equipment securing the loans. The indirect use of proceeds does not offend the theoretical foundation for the exception that the transactions are the functional equivalent of direct lease transactions between the bank and the lessees.

956—January 31, 2003

12 USC 24(7)

Re: Request for Opinion

Dear [ ]:

This letter is in response to your request for a legal opinion confirming the permissibility of several aspects of an agreement entered into by [bank], [City, State] ("bank") and [ ], a California corporation ("[ ]"). The bank and [ ] have executed an opportunity development agreement ("agreement"), pursuant to which the bank finances [ ]'s purchase of real properties and then benefits from the appreciation in such properties. You have requested that we confirm that this lending arrangement is permissible pursuant to Interpretive Ruling 7.1006, 12 CFR 7.1006 (2002), the Office of the Comptroller of the Currency's ("OCC's") regulation permitting national banks to take a share of the borrower's profits as part of the interest on the loan. You have also requested that we confirm that each of the lender covenants imposed by the bank as part of the financing it provides to [ ] is legally permissible. Finally, you have requested that we confirm that the nature of compensation paid by the bank to [ ] is consistent with OCC precedent. For the reasons discussed below, we confirm each of your requests.

A. Background

As represented by the bank, the facts are as follows. The relationship between the bank and [ ]'s principals ("the principals") began in the 1980s when the parties entered into an agreement for the principals to manage certain of the bank's other real estate owned ("OREO") portfolio. Based upon the principals' successful management of the OREO assets, the bank and [ ] entered into the agreement.

Pursuant to the agreement, [ ] seeks out potential real estate investment opportunities for the bank to finance. After identifying an opportunity, [ ] gathers comprehensive information regarding the property and presents that information to the bank to assist the bank in evaluating the lending opportunity.[1] The bank then applies its underwriting criteria to determine whether to make the loan. If the bank extends credit for [ ] to purchase the property ("bank loan"), the purchase money for the property consists of the proceeds of the bank loan (95 percent) and an equity contribution from the principals (5 percent). With limited exceptions, each bank loan has been an unsecured, five-year loan with an 8 percent rate of interest. The agreement requires that [ ] personally manage each property after purchase.

In consideration for the performance of [ ]'s services, the bank contributes to the cost of

[1] The agreement provides that neither [ ] nor its principals are employees or agents of the bank. Further, the agreement states that the bank and [ ] are not engaged in a partnership or joint venture.

[ ]'s general expenses, including the expenses associated with the pre-investment evaluation of potential real property financing opportunities. The bank does so (i) by providing [ ] with office space and associated services and (ii) by contributing, each calendar quarter, $100,000 for [ ]'s expenses.[2] Once the bank approves a bank loan, the deal-specific expenses are included in the loan to [ ] if the deal is consummated or, if not consummated, the expenses are shared 95 percent by the bank and 5 percent by [ ].

In addition to the bank loans, the bank has a right of first refusal to provide conventional, secured commercial financing to either [ ] or the business entity in which [ ] is investing ("primary loan"). Even if the bank chooses to make a bank loan, it may decline to make a primary loan. The bank has made several primary loans secured by the ultimate real estate assets; in other instances, another lender has made the primary loan.

The agreement provides for the use of funds received by [ ], whether realized from the sale or refinance of a property or from some other source. These funds are used first to repay principal and interest on the primary loan and the principal amounts of the bank loan and the principals' equity contribution. Any remaining funds are used next to pay the base interest amount on the bank loan and to provide the principals with a base return on their equity contribution. Finally,

[ ] pays any remaining funds as contingent interest, in the amount of 80 percent to the bank and 20 percent to [ ].[3]

Consistent with its role as a lender, the bank imposes certain lender covenants to protect its loans to [ ].

- First, the bank conditions the continuation of the agreement upon the principals' maintaining 100 percent ownership of [ ];
- Second, the bank requires that the principals maintain a personal services agreement with [ ], pursuant to which they agree to devote as much time as "reasonably necessary for a satisfactory performance of their duties";
- Third, the bank precludes [ ] from purchasing properties not financed by bank loans;
- Fourth, the bank retains approval rights upon the sale of a portion (as opposed to all) of a real property and the distribution of [ ]'s assets;

[2] One-half of this amount is reimbursable out of [ ]'s cash flow. Pursuant to the personal services agreement entered into by the principals, which is described *infra*, [ ] pays the principals $45,000 each quarter for their services.

[3] The agreement also provides that, prior to the payment of contingent interest, [ ] must use any remaining funds to pay the bank an amount equal to the full principal amount of any other bank loan as to which the bank has determined that the prospect of repayment from the related real property underlying such bank loan is for any reason impaired.

- Fifth, the bank imposes a debt to equity ratio of 19-to-1 in cases where it provides the bank loan. As described above, the bank finances 95 percent of the acquisition costs and [ ]'s principals put up the remaining 5 percent; and
- Sixth, the bank requires [ ] to provide various financial statements and reports.

B. Discussion

1. The Lending Arrangement

a. Interpretive Ruling 7.1006, 12 CFR 7.1006

The OCC has long recognized the authority of national banks to share in the profit, income, or earnings from a business enterprise as a full or partial substitute for interest on a loan.

> [a] national bank may take as consideration for a loan a share in the profit, income, or earnings from a business enterprise of a borrower. . . . The share . . . may be taken in addition to, or in lieu of, interest. 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 . . .

This ruling recognizes that extensions of credit may take many forms. In order for national banks to have a greater degree of flexibility in their lending activities, Interpretive Ruling 7.1006 makes clear that repayment of an extension is not necessarily limited to a bank's receipt of principal and a specified amount of interest on a demand or installment basis over time.[4] Moreover, this ruling represents the OCC's long-standing position on the authority of national banks to employ participatory financing arrangements. In November 1966, the OCC added Paragraph 7312 to the *Comptroller's Manual for National Banks*. Paragraph 7312 provided that:

> [a] national bank may take as consideration for a loan a share in the profit, income or earnings from a business enterprise of a borrower. Such share may be in addition to or in lieu of interest. The borrower's obligation to repay principal, however, shall not be conditioned upon the profit, income, or earnings of the business enterprise.

Several interpretive letters in 1969 and 1970, citing to Paragraph 7312, confirmed that a national bank could accept a share in the profit, income, or earnings of a business enterprise as consideration for a loan in lieu of interest or partially in lieu of interest.[5] However, the authority to share

[4] *See* letter from John G. Heimann, Comptroller of the Currency (May 21, 1980) (unpublished); letter from Charles F. Byrd, assistant director, Legal Advisory Services Division (Oct. 18, 1977) (unpublished).

[5] Letter from Patrick Parise, regional counsel (Oct. 16, 1970) (unpublished) (warrants); letter from Thomas G. DeShazo, deputy comptroller of the currency (August 26, 1969) (unpublished) (profits); letter from Robert Bloom, chief counsel (May 26, 1969) (unpublished) (warrants). In 1971, the OCC codified Paragraph 7312 as Interpretive Ruling 7.7312, 12 CFR 7.7312. The current ruling, Interpretive Ruling 7.1006, replaced Interpretive Ruling 7.7312 without substantive change in April 1996.

in the profit, income, or earnings from a business enterprise as a full or partial substitute for interest pursuant to Interpretive Ruling 7.1006 is subject to certain limitations. These limitations are designed to ensure that the bank's role in providing such financing is that traditionally assumed as a lender.[6] First, there must be no risk to loan principal other than that arising from a borrower's default; in this regard, Interpretative Ruling 7.1006 requires that the obligation to repay principal shall not be conditioned upon the profit, income, or earnings of the business enterprise. Second, in keeping with the provisions of 12 USC 24(7) and 29, a national bank can have no possessory or ownership interest in a borrower's business or real estate.

Within these parameters, a national bank may calculate its share of the profit, income, or earnings on the basis of either the appreciation of the borrower's business or the appreciation of individual assets.[7] The OCC has never limited the amount of contingent interest—in the form of a share of the profit, income, or earnings—that a national bank may accept. Rather, OCC precedent treats the percentage of profit, income, or earnings that a bank accepts as a contractual matter to be agreed upon by the parties.

Based upon the facts as represented, we find that the arrangement, as described, between the bank and [ ] is permissible pursuant to Interpretive Ruling 7.1006. The bank provides financing for [ ] to acquire real properties. The principal of these loans is not at risk, beyond the general default risk inherent in any loan transaction. [ ] is obligated to pay the principal and base interest on all outstanding loans regardless of the ultimate profitability of any transactions financed by the bank. Moreover, the bank has not assumed a possessory or ownership interest in [ ]'s business or any real property. By agreeing to "take as consideration for a loan a share in the profit, income, or earnings from a business enterprise" of [ ], the bank is merely exercising its authority under Interpretive Ruling 7.1006. The bank's share is based upon the available funds of [ ] as a business enterprise, and such basis is consistent with Interpretive Ruling 7.1006. Finally, because OCC precedent treats the percentage of profit, income, or earnings that a bank accepts as a contractual matter to be agreed upon by the parties, the bank's 80 percent share is consistent with such precedent.

b. Lender covenants

From a national banking perspective, it is sound public policy for banks to include covenants in

[6] *See*, *e.g.*, Interpretive Letter No. 620, *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,502 (July 15, 1992); Interpretive Letter No. 204, *reprinted in* [1981–1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶85,285 (June 17, 1981).

[7] Interpretive Letter No. 244, *reprinted in* [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,408 (January 26, 1982) (bank may accept a set percentage of the sales price upon sale of each developed real estate unit; bank may also accept a set percentage of the appreciation in the value of a business developed and operated on the mortgaged property); Interpretive Letter No. 216, *reprinted in* [1981–1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,297 (September 8, 1981) (bank may accept a set percentage share of the net appreciation of the mortgaged property at the end of a stated term).

their lending relationships.[8] Indeed, the more lender covenants that a bank includes, the more protection the bank has. In this case, the bank imposes a series of lender covenants. First, the bank conditioned continuation of the agreement upon the principals' maintaining 100 percent ownership of [ ]. Second, the bank required the principals to enter into a personal services agreement with [ ]. With respect to both covenants, the bank believes that the principals' continued involvement is essential to the overall success of its relationship with [ ] and the on-going stability of the bank's unsecured loans. We find that these covenants are permissible prudential measures designed to protect the bank's position given the limited purpose of [ ] and the bank's unsecured position.

Third, the bank precludes [ ]'s purchase of properties not financed by bank loans. The bank's outstanding loans to [ ] are unsecured and its contingent interest payment is based upon the success of [ ]. The bank believes it has a vested interest in ensuring that [ ]'s subsequent investments are economically sound. We find that this covenant is a permissible prudential measure designed to protect the bank's position given the limited purpose of [ ] and the bank's unsecured position.

Fourth, the bank imposes approval rights upon the sale of a portion (as opposed to all) of a real estate property and the distribution of [ ]'s assets. The bank believes doing so protects its right to be repaid on its outstanding loans. We find that this covenant is a permissible prudential measure designed to protect the bank's position given the limited purpose of [ ] and the bank's unsecured position.

Fifth, the bank imposes a debt to equity ratio of 19-to-1 in cases where it provides the bank loan. The bank does so to ensure that [ ] has an equity interest in each transaction. We find that this covenant is a permissible prudential measure designed to protect the bank's position given the limited purpose of [ ] and the bank's unsecured position.

Sixth, the bank requires [ ] to provide various financial statements and reports to permit the bank to monitor the financial condition of the business. We find that this covenant is a permissible prudential measure designed to protect the bank's position given the limited purpose of [ ] and the bank's unsecured position.

Finally, we find that these covenants, taken collectively, are a permissible prudential measure designed to protect the bank's position.

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[8] *See* Interagency Guidelines for Real Estate Lending Policies, at Appendix A to Subpart D of 12 CFR Part 34. *See generally Comptroller's Handbook*, "Agricultural Lending" (December 1998), "Loan Portfolio Management" (April 1998), and "Commercial Real Estate and Construction Lending" (November 1995).

2. Compensation Paid by Bank to [ ]

Rather than paying a per-loan fee, the bank compensates [ ] for its services by providing [ ] with office space and paying a portion of [ ]'s operating expenses. Twelve CFR 7.1004(a) provides that "a national bank may use the services of, and compensate persons not employed by, the bank for originating loans." As a legal matter, the OCC has neither specified nor limited the nature and amount of compensation that a bank may pay a third party for originating loans.[9] Therefore, the nature and amount of the bank's compensation to [ ], in the form of office space and expenses, is consistent with OCC precedent.

C. Conclusion

For the reasons discussed above, we conclude that the bank's lending arrangement with [ ] is permissible pursuant to Interpretive Ruling 7.1006. We further conclude that the lender covenants described above, individually and collectively, are permissible prudential measures designed to protect the bank's position. Finally, we conclude that the nature of compensation paid by the bank to [ ] is permissible. If you have any questions about the foregoing analysis, please feel free to contact me at (202) 874–5300.

Eric Thompson
Director
Bank Activities and Structure Division

[9] *See* letter from Charles F. Byrd, assistant director, Legal Advisory Services Division (October 30, 1977) (unpublished). As a supervisory matter, the bank must not compensate the third party in a manner that adversely affects the safety and soundness of the bank.

957—January 27, 2003

12 USC 484
12 CFR 5.34(e)(3)
12 CFR 7.4006

Scott A. Cammarn, Esq.
Associate General Counsel
Bank of America
NC1–002–29–01
101 South Tryon Street
Charlotte, NC 28255

Dear Mr. Cammarn:

This responds to your letter of January 23, 2003, on behalf of Bank of America, N.A. ("bank") in which you request a determination (i) whether federal law prevents the California Department of Corporations (the "department") from conducting an examination of the bank's operating subsidiary, BA Mortgage LLC ("operating subsidiary"), and (ii) whether the operating subsidiary is required to maintain a license under the California Residential Mortgage Lending Act.

You represent that the operating subsidiary is a wholly owned operating subsidiary of the bank and engages solely in the servicing of residential mortgage loans originated or held by its predecessor, NationsBanc Mortgage Corporation, or by its parent, the bank. As an operating subsidiary of a national bank, the operating subsidiary is subject to ongoing supervision and examination by the Office of the Comptroller of the Currency ("OCC") in the same manner and to the same extent as the bank.[1] You represent that the operating subsidiary has maintained a license under the California Residential Mortgage Lending Act ("California Act"). The bank believes, however, that recent changes to the OCC's regulations clarify that the operating subsidiary is not required to maintain a license under the California Act. The bank further believes that the department is

[1] Twelve CFR 5.34(e)(3) provides that:—

> [a]n operating subsidiary conducts activities authorized under this section pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank. If, upon examination, the OCC determines that the operating subsidiary is operating in violation of law, regulation, or written condition, or in an unsafe or unsound manner or otherwise threatens the safety or soundness of the bank, the OCC will direct the bank or operating subsidiary to take appropriate remedial action, which may include requiring the bank to divest or liquidate the operating subsidiary, or discontinue specified activities. OCC authority under this paragraph is subject to the limitations and requirements of section 45 of the Federal Deposit Insurance Act (12 USC 1831v) and section 115 of the Gramm-Leach-Bliley Act [GLBA] (12 USC 1820a).

The provisions of the Federal Deposit Insurance Act and the GLBA referenced in the regulation pertain to the functional regulation of securities, insurance, and commodities firms. These provisions are not relevant to mortgage lending and servicing activities conducted by the operating subsidiary.

barred by federal law from conducting an examination of the operating subsidiary. The bank is requesting a determination that the OCC concurs with the bank's positions.[2]

As discussed in detail below, pursuant to 12 USC 484, and 12 CFR 5.34(e)(3) and 7.4006, the OCC has exclusive visitorial authority over national banks and their operating subsidiaries except where *federal* law provides otherwise. This authority pertains to activities expressly authorized or recognized as permissible for national banks under federal law or regulation, or by OCC issuance or interpretation, including the content of those activities and the manner in which, and standards whereby, those activities are conducted. As a result, states are precluded from examining or requiring information[3] from national banks or their operating subsidiaries or otherwise seeking to exercise visitorial powers with respect to national banks or their operating subsidiaries in those respects. Thus, federal law precludes examination of the operating subsidiary by the department. Moreover, for the reasons discussed below, operating subsidiaries—like their parent national banks—need not obtain the approval of a state to engage in an activity permissible under federal law. Accordingly, state licensing requirements do not apply to the bank or the operating subsidiary.[4]

Background

The OCC's exclusive visitorial authority over national bank operations is established by 12 USC 484.[5] Paragraph (a) of that section states that—

[2] OCC Advisory Letter 2002–9 (Nov. 25, 2002) ("AL 2000–9") generally describes the principles that govern the applicability of state law and the OCC's exclusive visitorial authority to national banks and their operating subsidiaries. That advisory letter indicates that national banks should contact the OCC in situations where a state official seeks to assert supervisory authority or enforcement jurisdiction over the bank.

[3] The OCC currently maintains information sharing agreements with 48 states, the District of Columbia, and Puerto Rico. These agreements provide a mechanism through which state regulators may seek and obtain supervisory information from the OCC. Typically, the OCC will make confidential bank examination information available to state bank regulatory agencies if they demonstrate a specific regulatory need for the examination information (*e.g.*, in connection with a merger of a national bank into a state bank, where the state bank regulator must approve the transaction), and if the state agency has entered into an appropriate information sharing/confidentiality agreement with the OCC governing the use of the information. In AL 2002–9, the OCC outlined a procedure to address circumstances when state officials raise issues concerning potential violations of laws by national banks, including when state officials may seek information from a national bank about its compliance with any law or for other purposes. The advisory letter is available on the OCC's Web site at www.occ.treas.gov/ftp/advisory/2002-9.txt.

[4] We note that the California Act already contains an exemption from state licensing requirements for national banks, Cal. Fin. Code 50003(g), but fails to recognize the status of national bank operating subsidiaries under federal law and regulations.

[5] "Visitorial powers" generally refers to the power to "visit" a national bank to examine the conduct of its business and to enforce its observance of applicable laws. *See, e.g., Guthrie* v. *Harkness*, 199 U.S. 148, 158 (1905) (the word "visitation" means "inspection; superintendence; direction; regulation") (internal quotations omitted).

> [n]o national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice or such as shall be, or have been exercised or directed by Congress or by either House thereof or by any committee of Congress or of either House duly authorized.

Paragraph (b) of the statute then permits lawfully authorized state auditors or examiners to review a national bank's records "solely to ensure compliance with applicable state unclaimed property or escheat laws upon reasonable cause to believe that the bank has failed to comply with such laws."

This provision, enacted with the creation of the national banking system in 1863, is integral to the design and structure of the national banking system and fundamental to the character of national banks. Congress enacted the National Currency Act ("Currency Act") in 1863 and the National Bank Act the year after for the purpose of establishing a new national banking system that would operate distinctly and separately from the existing system of state banks. At that time, both proponents and opponents of the new national banking system expected that it would supersede the existing system of state banks.[6] Given this anticipated impact on state banks and the resulting diminution of control by the states over banking in general,[7] proponents of the national banking system were concerned that states would attempt to undermine it.

The allocation of any supervisory responsibility for the new national banking system to the states would have been inconsistent with the need to protect national banks from state interference. Congress, accordingly, established a federal supervisory regime and created a federal agency within the Department of the Treasury—the OCC—to carry it out. Congress granted the OCC

[6] Representative Samuel Hooper, who reported the bill to the House, stated in support of the legislation that one of its purposes was "to render the law [*i.e.*, the Currency Act] so perfect that the State banks may be induced to organize under it, in preference to continuing under their State charters." *Congressional Globe,* 38th Congress, 1st Session 1256 (March 23, 1864). Opponents of the legislation believed that it was intended to "take from the States . . . all authority whatsoever over their own State banks, and to vest that authority . . . in Washington . . . ." *Congressional Globe,* 38th Congress, 1st Session 1267 (March 24, 1864) (statement of Representative Brooks). *See also* statement of Representative Pruyn (stating that the legislation would "be the greatest blow yet inflicted upon the States . . . . ") *Congressional Globe,* 38th Congress, 1st Session 1271 (March 24, 1864); statement of Senator Sumner ("Clearly, the [national] bank must not be subjected to any local government, State or municipal; it must be kept absolutely and exclusively under that Government from which it derives its functions.") *Congressional Globe,* 38th Congress, 1st Session, at 1893 (April 27, 1864).

[7] *See, e.g., Tiffany* v. *National Bank of the State of Missouri*, 85 U.S. 409, 412–413 (1874) ("It cannot be doubted, in view of the purpose of Congress in providing for the organization of national banking associations, that it was intended to give them a firm footing in the different states where they might be located. It was expected they would come into competition with state banks, and it was intended to give them at least equal advantages in such competition. . . . National banks have been national favorites. They were established for the purpose, in part, of providing a currency for the whole country, and in part to create a market for the loans of the general government. It could not have been intended, therefore, to expose them to the hazard of unfriendly legislation by the states, or to ruinous competition with state banks."). *See also* B. Hammond, *Banks and Politics in America from the Revolution to the Civil War*, 725–34 (1957); P. Studenski & H. Krooss, *Financial History of the United States*, 155 (1st ed. 1952).

the broad authority "to make a thorough examination of all the affairs of [a national] bank,"[8] and solidified this federal supervisory authority by vesting the OCC with exclusive visitorial powers over national banks. These provisions assured, among other things, that the OCC would have comprehensive authority to examine all the affairs of a national bank and protected national banks from potential state action by establishing that the authority to examine and supervise national banks is vested *only* in the OCC, unless otherwise provided by *federal* law.[9]

In *Guthrie* v. *Harkness*, 199 U.S. 148 (1905), the Supreme Court recognized how the National Bank Act was designed to operate:

> Congress had in mind, in passing this section [*i.e.*, section 484] that in other sections of the law it had made full and complete provision for investigation by the Comptroller of the Currency and examiners appointed by him, and, authorizing the appointment of a receiver, to take possession of the business with a view to winding up the affairs of the bank. It was the intention that this statute should contain a full code of provisions upon the subject, and that no state law or enactment should undertake to exercise the right of visitation over a national corporation. Except in so far as such corporation was liable to control in the courts of justice, this act was to be the full measure of visitorial power.

Id. at 159. The Supreme Court also has recognized the clear intent on the part of Congress to limit the authority of states over national banks precisely so that the nationwide system of banking that was created in the Currency Act could develop and flourish. For instance, in *Easton* v. *Iowa*, 188 U.S. 220 (1903), the Court stated that federal legislation affecting national banks—

> has in view the erection of a system extending throughout the country, and independent, so far as powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States . . . . It thus appears that Congress has provided a symmetrical and complete scheme for the banks to be organized under the provisions of the statute . . . . [W]e are unable to perceive that Congress intended to leave the field open for the States to attempt to promote the welfare and stability of national banks by direct legislation. If they had such power it would have to be exercised and limited by their own discretion, and *confusion would necessarily result from control possessed and exercised by two independent authorities*.

Id. at 229, 231–232 (emphasis added). The Court in *Farmers*' *and Mechanics' Bank*, 91 U.S. 29 (1875), after observing that national banks are means to aid the government, stated—

[8] Act of June 3, 1864, c. 106, § 54, 13 Stat. 116, *codified at* 12 USC 481.

[9] Writing shortly after the Currency Act and National Bank Act were enacted, then-Secretary of the Treasury, and formerly the first Comptroller of the Currency, Hugh McCulloch observed that "Congress has assumed entire control of the currency of the country, and, to a very considerable extent, of its banking interests, prohibiting the interference of State governments. . . ." *Congressional Globe,* 39th Congress, 1st Session, Miscellaneous Document No. 100, at 2 (April 23, 1866).

> Being such means, brought into existence for this purpose, and intended to be so employed, the States can exercise no control over them, nor in any wise affect their operation, except in so far as Congress may see proper to permit. Any thing beyond this is "an abuse, because it is the usurpation of power which a single State cannot give."

Id. at 34 (citation omitted).

Congress recently affirmed the OCC's exclusive visitorial powers with respect to national banks operating on an interstate basis in the Riegle–Neal Interstate Banking Act of 1994 ("Riegle–Neal").[10] Riegle–Neal makes interstate operations of national banks subject to specified types of laws of a "host" state in which the bank has an interstate branch to the same extent as a branch of a state bank of that state, unless the state law is preempted by federal law. For those state laws that are not preempted, the statute makes clear that the authority to enforce the law is vested in the OCC. See 12 USC 36(f)(1)(B) ("The provisions of any State law to which a branch of a national bank is subject under this paragraph shall be enforced, with respect to such branch, by the Comptroller of the Currency."). This approach is another, and very recent, recognition of the broad scope of the OCC's exclusive visitorial powers with respect to national banks.

The OCC's exclusive visitorial authority complements principles of federal preemption, to accomplish the objectives of the National Bank Act. The Supremacy Clause of the United States Constitution[11] provides that federal law prevails over any conflicting state law. An extensive body of judicial precedent has developed over the nearly 140 years of existence of the national banking system, explaining and defining the standards of federal preemption of state laws as applied to national banks.[12] Visitorial power is a closely related authority, which Congress specifically addressed in section 484 to enable national banks to avoid inconsistent and potentially disruptive application of standards by state authorities. Together, federal preemption and the OCC's exclusive visitorial authority are defining characteristics of the national bank charter.

[10] Pub. L. 103-328, 108 Stat. 2338 (September 29, 1994).

[11] U.S. Constitution Article VI, clause 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.").

[12] *See, e.g., Barnett Bank of Marion County, N.A.* v. *Nelson*, 517 U.S. 25, 26, 32, 33 (1996) ("grants of both enumerated and incidental 'powers' to national banks [are] grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law." States may not "prevent or significantly interfere with the national bank's exercise of its powers."); *Franklin National Bank*, 347 U.S. at 378–379 (1954) (federal law preempts state law when there is a conflict between the two; "The compact between the states creating the Federal Government resolves them as a matter of supremacy. However wise or needful [the state's] policy, . . . it must give way to contrary federal policy."); *Anderson National Bank* v. *Luckett*, 321 U.S. 233, 248, 252 (1944) (state law may not "infringe the national banking laws or impose an undue burden on the performance of the banks' functions" or "unlawful[ly] encroac[h] on the rights and privileges of national banks"); *First National Bank* v. *Missouri*, 263 U.S. 640, 656 (1924) (federal law preempts state laws that "interfere with the purposes of [national banks'] creation, tend to impair or destroy their efficiency as federal

Application of Federal Law to the Operating Subsidiaries

In section 121 of the GLBA, Congress expressly acknowledged that national banks may own subsidiaries that engage "solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activities by national banks."[13]

Consistent with section 121, the OCC regulations state that "[a]n operating subsidiary conducts activities authorized under [12 CFR 5.34] pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank."[14] Addressing this point in the context of state laws, our regulations state that "[u]nless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank."[15]

The operating subsidiary conducts mortgage servicing activities permissible for a national bank pursuant to 12 USC 24(Seventh), 12 USC 371, and 12 CFR 5.34(e)(5)(v). As such, it is subject to the OCC's exclusive visitorial authority, and, pursuant to 12 USC 484, state regulatory authorities do not have the right to exercise visitorial powers over the bank or the operating subsidiary in the conduct of these activities, except where that visitorial authority is specifically granted by *federal* law, which is not the case here.

It is relevant to observe that while state authorities may not examine and supervise the operating subsidiary, the operating subsidiary is subject to an extensive regime of federal law and regulations and the bank and the operating subsidiary are subject to comprehensive and continuous supervision by the OCC. Since the bank is part of the OCC's Large Bank Program, its activities and

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agencies or conflict with the paramount law of the United States."); *First National Bank of San Jose* v. *California*, 262 U.S. 366, 368–369 (1923) ("[National banks] are instrumentalities of the federal government. . . . [A]ny attempt by a state to define their duties or control the conduct of their affairs is void whenever it conflicts with the laws of the United States or frustrates the purposes of the national legislation, or impairs the efficiency of the bank to discharge the duties for which it was created."); *McClellan* v. *Chipman*, 164 U.S. 347, 358 (1896) (application to national banks of state statute forbidding certain real estate transfers by insolvent transferees would not "destro[y] or hampe[r]" national bank functions); *First National Bank of Louisville* v. *Commonwealth of Kentucky*, 76 U.S. (9 Wall.) 353, 362–63 (1870) (national banks subject to state law that does not "interfere with, or impair [national banks'] efficiency in performing the functions by which they are designed to serve [the Federal] Government"); *Bank of America et al*. v. *City and County of San Francisco et al*., 309 F.3d 551, 561 (9th Circuit 2002) ("[s]tate attempts to control the conduct of national banks are void if they conflict with federal law, frustrate the purposes of the National Bank Act, or impair the efficiency of national banks to discharge their duties.") (citation omitted); *Association of Banks in Insurance, Inc*. v. *Duryee*, 270 F.3d 397, 403–404 (6th Circuit 2001) ("The Supremacy Clause 'invalidates state laws that "interfere with, or are contrary to," federal law.' . . . A state law also is pre-empted if it interferes with the methods by which the federal statute was designed to reach th[at] goal.") (citations omitted).

[13] Pub. L. No. 106–102, § 121, 113 Stat. at 1378, *codified at* 12 USC 24a(g)(3).

[14] 12 CFR 5.34(e)(3).

[15] 12 CFR 7.4006.

those of its subsidiaries are examined on a continuous basis by teams of examiners specifically assigned to, and in most cases physically present at the facilities of, the bank and its subsidiaries.

Finally, a state may not condition a national bank's exercise of a permissible federal power on obtaining the state's prior approval. It is well established that a national bank's exercise of its federally authorized powers is not subject to conditions or restrictions imposed by state law,[16] including state licensing requirements.[17] Accordingly, pursuant to 12 CFR 7.4006, the operating subsidiary also is not subject to state or local licensing requirements and is not required to obtain a license from the State of California in order to conduct business in that state.

This conclusion that the OCC's exclusive visitorial powers preclude the State of California from asserting supervisory authority or enforcement jurisdiction over the operating subsidiary is not intended to imply that any of the substantive provisions of the California Act apply to the operating subsidiary. Instead, under federal law[18] and principles of preemption established by the courts,[19] provisions of the California Act may well be preempted. This opinion, however, addresses only the issues of licensing and visitorial authority.

I hope the foregoing is helpful in explaining the applicability of the OCC's exclusive visitorial powers and the inapplicability of state licensing laws to the operating subsidiary. Please do not hesitate to contact my office at (202) 874-5200 or MaryAnn Nash, counsel, in our Law Department at (202) 874-5090 if you have any questions or if you need any additional information.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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[16] *See Barnett Bank of Marion County, N.A.* v. *Nelson*, 517 U.S. 25, 34 (1996); *Franklin National Bank of Franklin Square* v. *New York*, 347 U.S. 373, 378 (1954); *Bank of America National Trust & Savings Association* v. *Lima*, 103 F. Supplement 916, 918, 920 (District of Massachusetts 1952); Letter from Julie L. Williams, first senior deputy comptroller and chief counsel, to Thomas A. Plant and Daniel W. Morton ("To the extent that a state asserts the right to restrict or condition a national bank's exercise of . . . Federally granted powers, that state's law will be preempted."). 66 *Federal Register* 28593 (May 23, 2001).

[17] *See First National Bank of Eastern Arkansas* v. *Taylor*, 907 F.2d 775, 780 (8th Circuit 1990) (the National Bank Act precludes a state regulator from prohibiting a national bank, through either enforcement action or a license requirement, from conducting an activity that the Comptroller has reasonably determined is authorized by the National Bank Act); *Ass'n. of Banks in Insurance, Inc*. v. *Duryee,* 55 F. Supplement 2d 799, 812 (U.S. District Court for the Southern District of Ohio 1999), *aff'd,* 270 F.3d 397 (6th Circuit 2001) (even the most limited aspects of state licensing requirements such as the payment of a licensing fee are preempted because they "constitute impermissible conditions upon the authority of a national bank to do business within the state"). The OCC also has opined previously that state laws purporting to require the licensing of activities authorized for national banks under federal law are preempted. *See* OCC Interpretive Letter No. 749 (Sept. 13, 1996) *reprinted in* [1996–1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–114 (state law requiring national banks to be licensed by the state to sell annuities would be preempted); OCC Interpretive Letter. No. 644 (March 24, 1994), reprinted in [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,553 (state registration and fee requirements imposed on mortgage lenders would be preempted).

[18] *See*, *e.g*., 12 USC 371, 1735f–7, 1735f–7a, and 3801 *et seq*.

[19] *See, e.g.,* the cases cited in note 12, *supra*.

958—January 27, 2003

12 USC 484
12 CFR 5.34(e)(3)
12 CFR 7.4006

Thomas A. Plant, Esq.
Senior Vice President
Assistant General Counsel
National City Corporation
1900 East Ninth Street
Cleveland, OH 44114

Dear Mr. Plant:

This responds to your letter of November 8, 2002, on behalf of National City Bank of Indiana ("bank") and its wholly owned operating subsidiaries, National City Mortgage Company, First Franklin Financial Corporation, and Altegra Credit Company ("subsidiaries"). In that letter, you request guidance as to the ability of state regulatory authorities to exercise visitorial powers over the bank and the subsidiaries in the conduct of their mortgage banking and servicing businesses.

You represent that the subsidiaries conduct mortgage lending and mortgage servicing activities as permitted for a national bank and its operating subsidiaries pursuant to 12 USC 24(Seventh). As operating subsidiaries of a national bank, the subsidiaries are subject to ongoing supervision and examination by the OCC in the same manner and to the same extent as the bank.[1] You represent that state governmental authorities have sought to exercise examination or other visitorial powers over the subsidiaries, including by requesting documents and other information. You question the extent to which state authorities may engage in such activities in connection with national banks and their operating subsidiaries.

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[1] Twelve CFR 5.34(e)(3) provides that—

> [a]n operating subsidiary conducts activities authorized under this section pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank. If, upon examination, the OCC determines that the operating subsidiary is operating in violation of law, regulation, or written condition, or in an unsafe or unsound manner or otherwise threatens the safety or soundness of the bank, the OCC will direct the bank or operating subsidiary to take appropriate remedial action, which may include requiring the bank to divest or liquidate the operating subsidiary, or discontinue specified activities. OCC authority under this paragraph is subject to the limitations and requirements of section 45 of the Federal Deposit Insurance Act (12 USC 1831v) and section 115 of the Gramm–Leach–Bliley Act [GLBA] (12 USC 1820a).

The provisions of the Federal Deposit Insurance Act and the GLBA referenced in the regulation pertain to the functional regulation of securities, insurance, and commodities firms. These provisions are not relevant to mortgage lending and servicing activities conducted by the subsidiaries.

As discussed in detail below, pursuant to 12 USC 484, and 12 CFR 5.34(e)(3) and 7.4006, the OCC has exclusive visitorial authority over national banks and their operating subsidiaries except where *federal* law provides otherwise. This authority pertains to activities expressly authorized or recognized as permissible for national banks under federal law or regulation, or by OCC issuance or interpretation, including the content of those activities and the manner in which, and standards whereby, those activities are conducted. As a result, states are precluded from examining or requiring information[2] from national banks or their operating subsidiaries or otherwise seeking to exercise visitorial powers with respect to national banks or their operating subsidiaries in these respects. Thus, states may not exercise visitorial powers over the bank and the subsidiaries in the conduct of their mortgage banking and servicing business.

Background

The OCC's exclusive visitorial authority over national bank operations is established by 12 USC 484.[3] Paragraph (a) of that section states that—

> [n]o national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice or such as shall be, or have been exercised or directed by Congress or by either House thereof or by any committee of Congress or of either House duly authorized.

Paragraph (b) of the statute then permits lawfully authorized state auditors or examiners to review a national bank's records "solely to ensure compliance with applicable state unclaimed property or escheat laws upon reasonable cause to believe that the bank has failed to comply with such laws."

This provision, enacted with the creation of the national banking system in 1863, is integral to the design and structure of the national banking system and fundamental to the character of national banks. Congress enacted the National Currency Act ("Currency Act") in 1863 and the National Bank Act the year after for the purpose of establishing a new national banking system that would

[2] The OCC currently maintains information-sharing agreements with 48 states, the District of Columbia, and Puerto Rico. These agreements provide a mechanism through which state regulators may seek and obtain supervisory information from the OCC. Typically, the OCC will make confidential bank examination information available to state bank regulatory agencies if they demonstrate a specific regulatory need for the examination information (*e.g*., in connection with a merger of a national bank into a state bank, where the state bank regulator must approve the transaction), and if the state agency has entered into an appropriate information-sharing/confidentiality agreement with the OCC governing the use of the information. In Advisory Letter 2002–9 (November 25, 2002), the OCC outlined a procedure to address circumstances when state officials raise issues concerning potential violations of laws by national banks, including when state officials may seek information from a national bank about its compliance with any law or for other purposes. The advisory letter is available on the OCC's Web site at www.occ.treas.gov/ftp/advisory/2002-9.txt.

[3] "Visitorial powers" generally refer to the power to "visit" a national bank to examine the conduct of its business and to enforce its observance of applicable laws. *See, e.g., Guthrie* v. *Harkness*, 199 U.S. 148, 158 (1905) (the word "visitation" means "inspection; superintendence; direction; regulation") (internal quotations omitted).

operate distinctly and separately from the existing system of state banks. At that time, both proponents and opponents of the new national banking system expected that it would supersede the existing system of state banks.[4] Given this anticipated impact on state banks and the resulting diminution of control by the states over banking in general,[5] proponents of the national banking system were concerned that states would attempt to undermine it.

The allocation of any supervisory responsibility for the new national banking system to the states would have been inconsistent with the need to protect national banks from state interference. Congress, accordingly, established a federal supervisory regime and created a federal agency within the Department of the Treasury—the OCC—to carry it out. Congress granted the OCC the broad authority "to make a thorough examination of all the affairs of [a national] bank,"[6] and solidified this federal supervisory authority by vesting the OCC with exclusive visitorial powers over national banks. These provisions assured, among other things, that the OCC would have comprehensive authority to examine all the affairs of a national bank and protected national banks from potential state action by establishing that the authority to examine and supervise national banks is vested *only* in the OCC, unless otherwise provided by *federal* law.[7]

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[4] Representative Samuel Hooper, who reported the bill to the House, stated in support of the legislation that one of its purposes was "to render the law [*i.e.,* the Currency Act] so perfect that the State banks may be induced to organize under it, in preference to continuing under their State charters." *Congressional Globe,* 38th Congress, 1st Session 1256 (March 23, 1864). Opponents of the legislation believed that it was intended to "take from the States . . . all authority whatsoever over their own State banks, and to vest that authority . . . in Washington . . . ." *Congressional Globe,* 38th Congress, 1st Session 1267 (March 24, 1864) (statement of Representative Brooks). *See also* statement of Representative Pruyn (stating that the legislation would "be the greatest blow yet inflicted upon the States . . . .") *Congressional Globe,* 38th Congress, 1st Session 1271 (March 24, 1864); statement of Senator Sumner ("Clearly, the [national] bank must not be subjected to any local government, State or municipal; it must be kept absolutely and exclusively under that Government from which it derives its functions.") *Congressional Globe,* 38th Congress, 1st Session, at 1893 (April 27, 1864).

[5] *See, e.g., Tiffany* v. *National Bank of the State of Missouri*, 85 U.S. 409, 412–413 (1874) ("It cannot be doubted, in view of the purpose of Congress in providing for the organization of national banking associations, that it was intended to give them a firm footing in the different states where they might be located. It was expected they would come into competition with state banks, and it was intended to give them at least equal advantages in such competition. . . . National banks have been national favorites. They were established for the purpose, in part, of providing a currency for the whole country, and in part to create a market for the loans of the general government. It could not have been intended, therefore, to expose them to the hazard of unfriendly legislation by the states, or to ruinous competition with state banks."). *See also* B. Hammond, *Banks and Politics in America from the Revolution to the Civil War*, 725–34 (1957); P. Studenski & H. Krooss, *Financial History of the United States*, 155 (1st ed. 1952).

[6] Act of June 3, 1864, c. 106, § 54, 13 Stat. 116, *codified at* 12 USC 481.

[7] Writing shortly after the Currency Act and National Bank Act were enacted, then-Secretary of the Treasury, and formerly the first Comptroller of the Currency, Hugh McCulloch observed that "Congress has assumed entire control of the currency of the country, and, to a very considerable extent, of its banking interests, prohibiting the interference of State governments. . . ." *Congressional Globe,* 39th Congress, 1st Session, Miscellaneous Document No. 100, at 2 (April 23, 1866).

In *Guthrie* v. *Harkness*, 199 U.S. 148 (1905), the Supreme Court recognized how the National Bank Act was designed to operate:

> Congress had in mind, in passing this section [*i.e.,* section 484] that in other sections of the law it had made full and complete provision for investigation by the Comptroller of the Currency and examiners appointed by him, and, authorizing the appointment of a receiver, to take possession of the business with a view to winding up the affairs of the bank. It was the intention that this statute should contain a full code of provisions upon the subject, and that no state law or enactment should undertake to exercise the right of visitation over a national corporation. Except in so far as such corporation was liable to control in the courts of justice, this act was to be the full measure of visitorial power.

Id. at 159. The Supreme Court also has recognized the clear intent on the part of Congress to limit the authority of states over national banks precisely so that the nationwide system of banking that was created in the Currency Act could develop and flourish. For instance, in *Easton* v. *Iowa,* 188 U.S. 220 (1903), the Court stated that federal legislation affecting national banks—

> has in view the erection of a system extending throughout the country, and independent, so far as powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States. . . . It thus appears that Congress has provided a symmetrical and complete scheme for the banks to be organized under the provisions of the statute. . . . [W]e are unable to perceive that Congress intended to leave the field open for the States to attempt to promote the welfare and stability of national banks by direct legislation. If they had such power it would have to be exercised and limited by their own discretion, and *confusion would necessarily result from control possessed and exercised by two independent authorities*.

Id. at 229, 231–232 (emphasis added). The Court in *Farmers*' *and Mechanics*' *Bank*, 91 U.S. 29 (1875), after observing that national banks are means to aid the government, stated—

> Being such means, brought into existence for this purpose, and intended to be so employed, the States can exercise no control over them, nor in any wise affect their operation, except in so far as Congress may see proper to permit. Any thing beyond this is "an abuse, because it is the usurpation of power which a single State cannot give."

Id. at 34 (citation omitted).

Congress recently affirmed the OCC's exclusive visitorial powers with respect to national banks operating on an interstate basis in the Riegle–Neal Interstate Banking Act of 1994 ("Riegle–Neal").[8] Riegle–Neal makes interstate operations of national banks subject to specified types of

[8] Pub. L. 103–328, 108 Stat. 2338 (Sept. 29, 1994).

laws of a "host" state in which the bank has an interstate branch to the same extent as a branch of a state bank of that state, *unless* the state law is preempted by federal law. For those state laws that are not preempted, the statute makes clear that the authority to enforce the law is vested in the OCC. *See* 12 USC 36(f)(1)(B) ("The provisions of any state law to which a branch of a national bank is subject under this paragraph shall be enforced, with respect to such branch, by the Comptroller of the Currency."). This approach is another, and very recent, recognition of the broad scope of the OCC's exclusive visitorial powers with respect to national banks.

The OCC's exclusive visitorial authority complements principles of federal preemption, to accomplish the objectives of the National Bank Act. The Supremacy Clause of the United States Constitution[9] provides that federal law prevails over any conflicting state law. An extensive body of judicial precedent has developed over the nearly 140 years of existence of the national banking system, explaining and defining the standards of federal preemption of state laws as applied to national banks.[10] Visitorial power is a closely related authority, which Congress specifically addressed in section 484 to enable national banks to avoid inconsistent and potentially disruptive application of standards by state authorities. Together, federal preemption and the OCC's exclusive visitorial authority are defining characteristics of the national bank charter.

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[9] U.S. Constitution, Article VI, clause 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.").

[10] *See, e.g., Barnett Bank of Marion County, N.A.* v. *Nelson*, 517 U.S. 25, 26, 32, 33 (1996) ("grants of both enumerated and incidental 'powers' to national banks [are] grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law." States may not "prevent or significantly interfere with the national bank's exercise of its powers."); *Franklin National Bank*, 347 U.S. at 378–379 (1954) (federal law preempts state law when there is a conflict between the two; "The compact between the states creating the Federal Government resolves them as a matter of supremacy. However wise or needful [the state's] policy, . . . it must give way to contrary federal policy."); *Anderson National Bank* v. *Luckett*, 321 U.S. 233, 248, 252 (1944) (state law may not "infringe the national banking laws or impose an undue burden on the performance of the banks' functions" or "unlawful[ly] encroac[h] on the rights and privileges of national banks"); *First National Bank* v. *Missouri*, 263 U.S. 640, 656 (1924) (federal law preempts state laws that "interfere with the purposes of [national banks'] creation, tend to impair or destroy their efficiency as federal agencies or conflict with the paramount law of the United States."); *First National Bank of San Jose* v. *California*, 262 U.S. 366, 368–369 (1923) ("[National banks] are instrumentalities of the federal government. . . . [A]ny attempt by a state to define their duties or control the conduct of their affairs is void whenever it conflicts with the laws of the United States or frustrates the purposes of the national legislation, or impairs the efficiency of the bank to discharge the duties for which it was created."); *McClellan* v. *Chipman*, 164 U.S. 347, 358 (1896) (application to national banks of state statute forbidding certain real estate transfers by insolvent transferees would not "destro[y] or hampe[r]" national bank functions); *First National Bank of Louisville* v. *Commonwealth of Kentucky*, 76 U.S. (9 Wall.) 353, 362–63 (1870) (national banks subject to state law that does not "interfere with, or impair [national banks'] efficiency in performing the functions by which they are designed to serve [the Federal] Government"); *Bank of America et al*. v. *City and County of San Francisco et al*., 309 F.3d 551, 561 (9th Circuit 2002) ("[s]tate attempts to control the conduct of national banks are void if they conflict with federal law, frustrate the purposes of the National Bank Act, or impair the efficiency of national banks to discharge their duties.") (citation omitted); *Association of Banks in Insurance, Inc*. v. *Duryee*, 270 F.3d 397, 403–404 (6th Circuit 2001) ("The Supremacy Clause 'invalidates state laws that "interfere with, or are contrary to," federal law.' . . . A state law also is pre-empted if it interferes with the methods by which the federal statute was designed to reach th[at] goal.") (citations omitted).

Application of the OCC's Visitorial Powers to Operating Subsidiaries

In section 121 of the GLBA, Congress expressly acknowledged that national banks may own subsidiaries that engage "solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activities by national banks."[11]

Consistent with section 121, the OCC regulations state that "[a]n operating subsidiary conducts activities authorized under [12 CFR 5.34] pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank."[12] Addressing this point in the context of state laws, our regulations state that "[u]nless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank."[13]

In order for a subsidiary to operate in the manner contemplated by section 121 of GLBA, the subsidiary must be subject to the same regulation and supervision as is its parent national bank. As described at the outset of this letter, our regulations at section 5.34(e)(3) require that result. The terms and conditions governing the conduct of activities in an operating subsidiary include being subject to the same visitorial powers as are exercised with respect to the parent. Accordingly, the OCC's exclusive visitorial authority extends to operating subsidiaries of national banks.

The subsidiaries are national bank operating subsidiaries conducting mortgage lending and servicing activities as permitted for a national bank pursuant to 12 USC 24(Seventh), 12 USC 371, and 12 CFR 5.34(e)(5)(v). As such, they are subject to the OCC's exclusive visitorial authority, and, pursuant to 12 USC 484, state regulatory authorities do not have the right to exercise visitorial powers over the bank or the subsidiaries in the conduct of these activities, except where that visitorial authority is specifically granted by *federal* law, which is not the case here.

It is relevant to observe that while state authorities may not examine and supervise the subsidiaries, the subsidiaries are subject to an extensive regime of federal law and regulations and the bank and the subsidiaries are subject to comprehensive and continuous supervision by the OCC. Since the bank is part of the OCC's Large Bank Program, its activities and those of its subsidiaries are examined on a continuous basis by teams of examiners specifically assigned to, and in most cases physically present at the facilities of, the bank and its subsidiaries.

Our conclusion that the OCC's exclusive visitorial powers preclude states from asserting supervisory authority or enforcement jurisdiction over the subsidiaries is not intended to imply that

[11] Pub. L. No. 106-102, § 121, 113 Stat. at 1378, *codified at* 12 USC 24a(g)(3).

[12] 12 CFR 5.34(e)(3).

[13] 12 CFR 7.4006.

any particular state laws concerning the mortgage banking and servicing business apply to the subsidiaries. Instead, under federal law[14] and principles of preemption established by the courts,[15] provisions of state law may well be preempted. This opinion, however, addresses only the issue of visitorial authority.

I hope the foregoing is helpful in explaining the applicability of the OCC's exclusive visitorial powers to the subsidiaries. Please do not hesitate to contact my office at (202) 874-5200 or Mary-Ann Nash, counsel, in our Law Department at (202) 874–5090 if you have any questions or if you need any additional information.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

[14] *See*, *e.g*., 12 USC 371, 1735f–7, 1735f–7a, and 3801 *et seq*.

[15] *See, e.g.,* the cases cited in note 10, *supra*.

959—February 13, 2003

12 CFR Part 3

Dear [ ]:

This letter responds to your letter dated August 6, 2002, concerning the risk weight for tax refund anticipation loans (RALs) and the timing for reporting capital ratios. With respect to the risk weight for RALs, the OCC (Office of the Comptroller of the Currency) has determined that 100 percent is the appropriate risk weight for this type of consumer lending. With respect to reporting, capital ratios are regularly reported on each quarterly Consolidated Reports of Condition and Income (call report). However, additional reporting requirements, which are described below, apply if a material event occurs that could cause a bank to be placed in a lower capital category.

Background

[ ] ("the bank"), has requested that the OCC consider a risk weight of 20 percent for RALs and has provided a legal opinion arguing the case for a lower risk weight.

RALs are bank loans made to individual taxpayers in anticipation of tax refund payments. To apply for a RAL from the bank, the taxpayer must retain tax preparation services from an IRS-approved *e-file* tax preparer with which the bank has an agreement, open a deposit account at the bank, and direct the refund to that account. The account, which the bank controls, is set up for the sole purpose of receiving the electronic refund from the IRS. The bank account is required because the IRS (Internal Revenue Service) will not pay a refund to a third party even though the IRS provides guidelines for RAL programs.

The bank charges an RAL borrower an application fee, a finance charge, and, if applicable, an earned income tax credit (EITC) fee. The RAL borrower also pays tax preparation, *e-file*, and other fees to the tax preparer. Based on an average maturity of 10 days, the APRs (annual percentage rates) for RALs with EITC ranged from an estimated 66.15 percent for a $5,000 RAL to an estimated 1880.3 percent for a $100 RAL according to the bank's 2000 RAL application.

The bank limits the amount of an RAL to $5,000 and further limits the amount of an RAL covered by an EITC refund to $1,200. The bank will not make the RAL until the IRS provides a debt indicator (DI) that verifies that there are no federal claims outstanding on the tax filer. If the DI indicates the IRS will offset the tax refund, the bank rejects the RAL application and only provides the deposit account and refund transfer services. Delinquent RALs from any prior year are deducted from the current refund due per an agreement among other banks that have RAL programs.

Activity in the bank's RAL program generally begins in mid-January, peaks in early to mid-February, and is virtually completed by the end of March. At the end of the second quarter, the bank writes off the balances of any outstanding RALs. According to the bank, past experience indicates that 1.5 percent of RAL borrowers manage to circumvent controls put in place by the IRS and the bank, which results in losses to the bank.

In November 2000, the bank set up a special purpose subsidiary corporation for the purpose of securitizing RALs. In the first quarters of 2001 and 2002, the bank sold some of its RAL assets into this conduit. By the end of the second quarter in each year, the securitization balances were reduced to zero. In 2002, the bank retained an 8 percent first loss position in the RAL assets it sold to the conduit.

In the opinion of the bank's outside counsel, a zero risk weight might be appropriate but counsel does not press the case. Rather, the legal opinion argues for a 20 percent risk weight on the basis that the RAL Program is (1) effectively collateralized by a direct obligation of the U.S. government and (2) a 20 percent risk weight is prudent and consistent with regulatory intent. The legal opinion argues that the bank's perfected security interest in the RAL borrower's bank account is the equivalent of an ownership interest in a claim on the U.S. government. The opinion also suggests that RALs are analogous to general obligations of states and other political subdivisions, instruments conditionally guaranteed by the U.S. government, and obligations guaranteed by Fannie Mae or Freddie Mac. Citing the OCC's reservation of authority[1], the opinion further argues that the OCC can determine that RALs merit a 20 percent risk weight even though the U.S. government does not actually guarantee a RALs transaction.

Discussion

Risk weights—The OCC's risk-based capital regulations permit a 20 percent risk weight for assets that are "conditionally guaranteed by the United States Government or its agencies"[2] or are "collateralized by cash or securities issued or directly and unconditionally guaranteed by the United States Government or its agencies . . . [and do] not qualify for the zero percent risk weight category."[3]

Lowering the risk weight on RALs from 100 to 20 percent relies primarily on the OCC's concurrence with the bank's position that the IRS conditionally guarantees payment of a tax refund claimed by an individual taxpayer, which effectively guarantees the repayment of a RAL. Despite the arguments in the bank's legal opinion, the bank's actual loss experience suggests RALs do not perform as if the U.S. government guarantees them. The bank has taken a number of steps to minimize losses including perfecting a security interest in the deposit account of the RAL borrower, requiring a positive DI from the IRS before making the RAL, providing incentives to tax

[1] 12 CFR Section 3.4(b).

[2] 12 CFR Part 3, Appendix A, Section 3(a)(2)(v).

[3] 12 CFR Part 3, Appendix A, Section 3(a)(2)(iv).

preparers based on above average-screening of tax returns and RAL applications, and signing the recovery agreement with other banks that offer RALs. Nonetheless, the bank's losses are larger than would be expected in the case of a U.S. government guaranteed obligation. [ ]'s 10Q for March 2002 describes the risks and losses as follows:

> There is a higher credit risk associated with refund loans than with other types of loans because (1) the Company does not have personal contact with the customers of this product; (2) the customers conduct no business with the Company other than this once a year transaction; and (3) contact subsequent to the payment of the advance, if there is a problem with the tax return, may be difficult because many of these taxpayers have no permanent address. . . . Credit risk has been lowered in the last three years because of the debt indicator provided by the IRS. . . . However, the charge off rate for RALs still remains approximately five times higher than for the rest of the Company's loan portfolios. (page 43)

Furthermore, the IRS does not compensate the bank for any losses that it has incurred. In the section of the *IRS e-file Handbook* that discusses RALs, the IRS specifically states that the "Department of the Treasury is not liable for any loss suffered by taxpayers, EROs, or financial institutions resulting from reduced refunds or Direct Deposits not being honored causing refunds to be issued by check."[4] The IRS also does not recognize the assignment of the payment of individual tax refunds to a third party. The extension of credit through an RAL relies primarily on information provided by the individual filer. If the IRS determines, pursuant to its statutory discretion, that the tax return is not accurate and reduces or denies the expected refund claim, the repayment of the RAL defaults to the individual's creditworthiness. Furthermore, there is no contractual relationship between the bank and the IRS establishing any form, express or implied, of government guarantee. Accordingly, the bank's RAL program does not meet collateral or guarantee provisions that would qualify RALs for a 20 percent risk weight. Nor does the RAL program have the characteristics that would make RALs analogous to general obligations of municipalities and assets issued by other entities that qualify for a 20 percent risk weight.

Reporting—In addition to the requirement to report capital levels and ratios in quarterly call reports, the OCC's prompt corrective action regulations[5] require notification if a material event occurs that may result in a lowering of the bank's capital level or capital category. If a bank determines that such an event may have lowered its capital category, the bank must notify the OCC in writing within 15 calendar days. The OCC will then determine whether the bank's capital category should be changed and advise the bank accordingly.

[4] *IRS e-file Handbook,* Publication 1345 (Rev. 1–2001), Internal Revenue Service, Department of the Treasury, p. 51.

[5] 12 CFR Section 6.3(c).

Conclusion

Based on a review of the bank's RALs program and the request for a lower risk weight, the OCC has determined that 100 percent is the appropriate risk weight for this type of consumer lending. In an August 6, 2002, letter, the bank states, "We have been told that we may assign RALs other risk-weightings we consider appropriate when capital ratios are computed at times other than at calendar quarter's end." This is not correct. For regulatory capital purposes, the risk weight for RALs is always 100 percent, whether the calculation is at quarter end or intra-quarter.

Furthermore, if the bank determines that a material event has occurred that may lower the bank's capital category, the bank must notify the OCC within 15 days of that event. The bank's notification, pursuant to this requirement, that such an event may have occurred does not, in and of itself, constitute in a change in a capital category.

Additional Significant Issue

During our review of your request, an additional significant issue related to the bank's securitization of RALs came to our attention. Revised risk-based capital rules for asset securitizations were published on November 29, 2001 (66 FR 59614; see OCC Bulletin 2001–49). These rules determine the capital charges that apply when a bank sells an asset and retains a larger than pro rata share of the credit risk associated with that asset. Among other things, the revised rules provide for a dollar-for-dollar capital charge on unrated, first loss positions retained on securitized assets. For example, if the bank sells RAL assets into a conduit and retains a first loss position on its balance sheet, the risk-based capital charge will equal at least the carrying value of the retained position, regardless of the risk-weights of the underlying assets.

If you have questions or need additional information, please contact Nancy Hunt at (202) 874–5070.

Tommy Snow
Director, Capital Policy