Interpretations—April 1 to June 30, 2003

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Interpretive Letters

960—February 28, 2003

12 CFR 14

Ms. Beth L. Climo
Executive Director
American Bankers Insurance Association
1120 Connecticut Avenue, NW
Washington, DC 20036

Mr. James D. McLaughlin
Director
Regulatory and Trust Affairs
American Bankers Association
1120 Connecticut Avenue, NW
Washington, DC 20036

Re: Insurance Consumer Protection Rules

Dear Ms. Climo and Mr. McLaughlin:

This is in response to your letter dated March 6, 2002, in which you requested our agencies to clarify the position we expressed in our August 17, 2001, letter concerning the applicability of the disclosure requirements in section 305 of the Gramm–Leach–Bliley Act[1] ("GLBA") and our insurance consumer protection regulations[2] to renewals of insurance policies sold prior to October 1, 2001 ("pre-existing policies"). Your request provided additional information concerning the feasibility and practicality of providing the insurance and credit disclosures in connection with renewals of pre-existing policies.

Our August 17, 2001, letter stated that while other sections of the agencies' regulations implementing section 305 of the GLBA apply to renewals, the disclosure requirements in 12 CFR 14.40, 208.84, 343.40, and 536.40 do not apply to renewals. However, the letter also indicated that these disclosures "should be made" to customers at the time of the first renewal if a policy was initially sold before the rule's effective date (October 1, 2001), and the consumer did not receive the disclosures at the initial sale. You expressed concern in your March 6 letter that this position posed significant practical difficulties for depository institutions.

You also stated in your March 6 letter that nothing in section 305 of the GLBA suggests that the insurance and credit disclosures are required in connection with renewals of pre-existing policies.

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[1] 12 USC 1831x.

[2] 12 CFR Parts 14, 208, 343, and 536.

In supplementary materials submitted by Ms. Climo on June 12, 2002, you reiterated your position that section 305 of the GLBA by its terms does not necessarily require that the insurance and credit disclosures be made in connection with renewals of pre-existing policies. In addition, you provided a detailed explanation as to why it would be difficult for depository institutions to make the disclosures in connection with renewals of pre-existing policies. You stated that a depository institution typically has no contact with the customer after the depository institution sells the customer an insurance policy, and the underwriter (or its agent) completes the renewal of an insurance policy.

In addition, you noted that a depository institution usually does not have lists of customers who purchased insurance offered by an agent who solicited on behalf of the depository institution prior to October 1, 2001, nor do agents that sold insurance policies prior to October 1, 2001, on behalf of a depository institution always track the source of their insurance business after the policies are in effect. You advised us that it would be very difficult, or impossible, for an agency to examine its records and determine solicitations and sales on behalf of a depository institution.

On the basis of this additional information, as well as the terms of section 305 of the GLBA itself, this is to clarify that our implementing regulations do not *mandate* disclosures for renewals of policies sold prior to October 1, 2001. Accordingly, in our view section 47(c)(1) of the Federal Deposit Insurance Act, 12 USC 1831x, as added by section 305 of the GLBA, and our implementing regulations at 12 CFR 14.40, 208.84, 343.40, and 536.40, do not require that the disclosures be furnished at the time of renewal of a policy, including a pre-existing policy. Renewals, however, continue to be subject to the other provisions of section 305 of GLBA and the agencies' regulations. Moreover, we also expect that, consistent with applicable safety and soundness requirements, depository institutions will take reasonable steps to avoid customer confusion in connection with renewals of pre-existing policies.

We hope that this clarification is helpful and responds to the concerns you have expressed on behalf of your members.

J. Virgil Mattingly, Jr., General Counsel
Board of Governors of the Federal Reserve System

William F. Kroener, III, General Counsel
Federal Deposit Insurance Corporation

Julie L. Williams, First Senior Deputy
Comptroller and Chief Counsel
Office of the Comptroller of the Currency

Carolyn J. Buck, Chief Counsel
Office of Thrift Supervision

961—March 17, 2003

12 USC 24(7)

Subject: Hedging Risks of DPC Stock Holdings

Dear [ ]:

This is in response to your letter of March 5, 2002, requesting confirmation that [ ] (the "bank") may buy and sell options on the shares of stock of a company when the bank has acquired shares of the company in satisfaction of debts previously contracted ("DPC shares"). The bank would buy and sell the options to hedge the market risk associated with changes in the value of DPC shares. For the reasons discussed below and subject to the limitations described herein, we believe that the proposed hedging activity is permissible for the bank.

Background

In carry out its lending activities, the bank sometimes receives DPC shares as part of contractual workout arrangements. The terms of the workout arrangements sometimes restrict the ability of the bank to dispose of the DPC shares it receives.[1] The bank believes it would be prudent to hedge the risks of holding DPC shares against fluctuations in market value. The bank proposes to use a hedging strategy known as a "butterfly option." Under this hedging strategy, at the time the bank receives DPC shares, the bank will (1) buy a "put" option at a strike price lower than the current market price of the DPC shares and (2) sell a "call" option at a strike price higher than the current market price of the DPC shares. The bank's management believes this hedging strategy will reduce market risk.[2]

The bank commits that it will use the options solely to hedge risk of DPC shares and will not engage in speculation. The bank plans to purchase the butterfly options at the time the bank acquires the DPC shares and anticipates holding the options without adjustment until it disposes of the DPC shares.[3] The bank represents that it will not take anticipatory short positions or maintain residual positions in the options that do not operate as a hedge of market exposure in DPC shares, except as necessary to the orderly taking or unwinding of a hedging position.

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[1] The bank sometimes also may acquire DPC shares that have limited marketability for other reasons. For example, the shares may be thinly traded or their transfer may be restricted under the federal securities laws.

[2] The amount the bank receives for selling the call offsets in part the amount the bank pays for purchasing the put. The butterfly thus allows the bank to receive protection against market declines at a reduced cost.

[3] Should the bank wish to change its planned procedures for purchasing and holding the options, the bank should confer with its examiner-in-charge ("EIC") prior to making such a change.

Discussion

National banks are authorized to lend under express authorities in the National Bank Act and as part of the business of banking. They may acquire securities, including shares of stock, through foreclosure or otherwise in the ordinary course of collecting a debt previously contracted (DPC). Such securities may be held for up to five years unless the OCC extends the holding period for up to another five years.[4] Hedging risks arising from that permissible banking activity is an essential and integral part of that banking activity. In our opinion, the bank may buy and sell options as a technique to hedge its market exposures from DPC shares, provided that the bank establishes an appropriate risk measurement and management and compliance process to conduct such hedging activities. This process is necessary for the bank to achieve its risk management objectives in a safe and sound manner and, thus, must be established before the OCC can determine that the proposed activities are convenient and useful in conducting permissible banking activities and thereby permissible as an activity incidental to the business of banking.

A. The National Bank Act ("Act")

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. Section 24(Seventh) expressly provides that national banks shall have the power:

> To exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes.[5]

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.[6] National banks also are authorized to engage in an activity that is incidental

[4] *See* OCC Interpretive Letter No. 643 (July 1, 1992), *reprinted* in [1991–1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,551; OCC Interpretive Letter No. 511 (June 20, 1990), *reprinted* in [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,213.

[5] 12 USC 24(Seventh).

[6] *NationsBank of North Carolina* v. *Variable Annuity Life Insurance Co.*, 513 U.S. 251 (1995) ("*VALIC*"). Judicial cases affirming OCC interpretations establish that an activity is within the scope of the "business of banking" if the activity: [1] is functionally equivalent to or a logical outgrowth of a traditional banking activity; [2] would respond to customer needs or otherwise benefit the bank or its customers; and [3] involves risks similar to those already assumed by banks. *See, e.g., Merchant Bank* v. *State Bank*, 77 U.S. 604 (1871); *M&M Leasing Corp.* v. *Seattle First National Bank*, 563 F.2d 1377, 1382 (9th Circuit 1977), *cert. denied*, 436 U.S. 956 (1978); *American Insurance Assn*. v. *Clarke*, 865 F.2d 278, 282 (2d Circuit 1988). In *IAA* v. *Hawke*, 211 F.3d 638 (D.C. Circuit 2000), the court expressed the position that the "logical outgrowth" rationale needed to be kept within bounds, but endorsed the "functional equivalent" component of the test.

to the performance of the five enumerated powers *or* incidental to the performance of an activity that is part of the business of banking.[7] Incidental activities are activities that are permissible for national banks, not because they are part of the powers expressly authorized for banks or the "business of banking," but rather because they are "convenient" or "useful" to those activities.[8]

B. Making Loans and Hedging the Associated Risks Are Part of the Business of Banking

Making loans is an express power listed in the National Bank Act and is recognized as a core part of the business of banking.[9] Lending involves risks that banks must manage as part of the business of banking. Banks hedge loans as a means of managing those risks.[10] The OCC has long recognized that hedging the risks associated with bank-permissible lending activities is an integral part of those permissible banking activities. National banks hedge against the risk of loss due to the interest rate fluctuations inherent in their own loan operations.[11] National banks also hedge

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[7] *VALIC, supra,* at 253.

[8] The leading case defining when an activity is authorized as "incidental" under section 24(Seventh) is *Arnold Tours, Inc.* v. *Camp,* 472 F.2d 427, 431–32 (1st Circuit 1972). In that decision, the First Circuit held that the term "necessary" in section 24(Seventh) should be broadly construed to encompass "incidental" activities that are "convenient or useful" to an expressly enumerated power. The Supreme Court later clarified in *VALIC* that these incidental powers include activities that are convenient and useful to the business of banking as well as those that are convenient and useful to the expressly enumerated powers under the National Bank Act. See *VALIC, supra.* Recently, the Ninth Circuit confirmed that these incidental powers should be broadly construed, stating that "[t]he incidental powers of national banks are thus not limited to activities deemed essential to the exercise of enumerated powers but include activities closely related to banking and useful in carrying out the business of banking." *Bank of America* v. *San Francisco,* 309 F.3d 551, 562 (9th Circuit 2002)

[9] 12 USC 24(Seventh). The National Bank Act provides, in pertinent part, that national banks shall have the power "[t]o exercise . . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; . . . by loaning money on personal security." *Id.* This power is often referred to generally as a national bank's lending authority.

[10] OCC Interpretive Letter No. 896 (August 21, 2000), *reprinted in* [2000–2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–415 ("agricultural loan hedge letter"). Other banking activities also involve risks that banks must manage as part of the business of banking. *See, e.g.* OCC Interpretive Letter No. 892 (September 13, 2000), *reprinted in* [2000–2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–411 ("equity hedge letter") (national bank may hedge risk of derivatives activities by purchasing equity securities); U.S. General Accounting Office, *Equity Hedging—Report to the Honorable James A. Leach, House of Representatives*, GAO–01–945 (August 2001); *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) ("*MII Deposit*") (national bank may buy and sell futures on the Standard & Poor's ("S&P") 500 Index to hedge deposits with interest rates tied to the S&P 500 Index).

[11] *Comptroller's Handbook,* "Mortgage Banking" (March 1996); OCC letter to Gregory Crane (October 26, 1976); OCC letter to Alan E. Rothenberg, vice president, Bank of America, from Robert Bloom, first deputy comptroller (Policy) (October 11, 1976). Similarly, the Department of the Treasury recognizes that interest rate risk of fixed-rate loans can be neutralized by hedging with appropriate interest rate swap, forward, futures, or option contracts. Department of the Treasury, Banking Industry—Trends and Current Issues: Report titled "Modernizing the Financial System" (November 6, 1995).

bank loans to minimize the credit risk in those transactions.[12] As discussed below, hedging these lending risks by buying and selling options on DPC shares can be part of a bank's permissible lending activities.

C. Buying and Selling Options to Hedge Market Risk on DPC Shares as an Activity That is Incidental to the Business of Banking

Section 24(Seventh) authorizes national banks to engage in "all such incidental powers" as shall be necessary to carry on the "business of banking."[13] An activity is incidental to the business of banking if it is "convenient" or "useful" to an expressly enumerated power or to the business of banking as a whole.[14]

1. Hedging through options can be an effective hedging strategy.

The bank has demonstrated that the proposed option hedging can be an effective hedging strategy. For example, if the market price of DPC shares falls, the bank could exercise its put option and receive cash equal to the strike price of DPC shares. Thus, the proposed hedging can facilitate and improve the bank's ability to reduce credit exposures to its borrowers by protecting the value of DPC shares it receives in a workout.[15]

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[12] OCC Banking Bulletin 96–43: Credit Derivatives, Guidelines for National Banks (August 12, 1996); OCC Interpretive Letter No. 356 (January 7, 1986), *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,526. In addition, national banks may assist customers in hedging their own loans against cash market risks, by obtaining, or by assisting customers in obtaining, hedging instruments. OCC letter to Jeffrey S. Lillien, The First National Bank of Chicago (June 13, 1986); OCC letter to Randall R. Kaplan, Caplin & Drysdale from Judith A. Walter, senior comptroller (June 13, 1986); OCC letter to Thomas N. Rose, Eldredge & Clark, from Michael A. Mancusi, senior deputy comptroller for National Bank Operations (November 5, 1985).

[13] 12 USC 24(Seventh).

[14] In considering whether an activity is "convenient" or "useful" and therefore "incidental" to the business of banking, the OCC may consider whether the activity facilitates the operations of the bank as a banking enterprise, enhances the efficiency or quality of the content or delivery of banking services of products, optimizes the use and value of a bank's facilities and competencies, or enables the bank to avoid economic waste in its banking franchise. *See* OCC Interpretive Letter No. 845 (Oct. 20, 1998), *reprinted* in [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,300. *See also* 12 CFR 7.5001(d).

[15] The OCC also permits national banks to engage in certain activities to preserve the value of their real estate DPC property. For example, national banks can make necessary advances to run a business and thereby preserve its going concern value when the business is acquired to secure or collect debt previously contracted. *See* 12 CFR 34.86; OCC Interpretive Letter No. 576 (March 27, 1992) *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,346; OCC Interpretive Letter No. 12 (December 7, 1977) *reprinted in* [1978–1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,087.

2. The proposed equity hedging is similar to activities the OCC has previously approved as convenient and useful to bank permissible activities.

The OCC also has long permitted national banks to use futures, options, and options on futures to manage or "hedge" risks arising from permissible banking activities. The OCC has recognized the permissibility of such activities both for the purpose of providing bank customers with the ability to hedge their own risks and as a means for banks to hedge directly the risks that arise from permissible banking activities.[16] For example, in 2000, the OCC considered a proposal to hedge the risk in a bank's agricultural loans by purchasing cash-settled options on futures on commodities that serve as the primary collateral for the loans. The OCC determined that using options on futures contracts on agricultural commodities to hedge bank-permissible lending activities is permissible for national banks.[17] However, the OCC would not permit the bank to engage in the proposed activity until it had an appropriate risk management process in place.[18]

The proposed options hedges are similar to equity hedges the OCC has previously approved for certain national banks as convenient and useful to bank-permissible activities. The OCC has determined that, subject to specified conditions and standards, the national banks could purchase and hold equity securities to hedge risks arising from permissible equity derivative transactions.[19] The OCC concluded that the equity hedges provided the national banks in question with a cost-ef-

[16] *See* OCC Interpretive Letter No. 356, *supra* (bank registered as a futures commission merchant could execute customer orders for agricultural and metals futures in connection with its loans to the customers); *MII Deposit*, *supra*, (bank could offer a deposit with a rate of return based in part on the return on a stock index and could hedge the bank's interest rate risk by purchasing futures on that stock index); OCC Interpretive Letter No. 937 (May 14, 2002) *reprinted in* [2001–2002 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,462 (bank could hedge risks arising from intermediation transactions based on electricity prices); OCC No Objection Letter No. 87–5 (July 20, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,034 (bank could act as principal in commodity price index swaps with its customers); OCC No Objection Letter 90–1 (February 16, 1990), *reprinted in* [1989–1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,095 (bank could act as principal in unmatched commodity price index swaps with its customers and hedge its price risk exposure using exchange-traded commodity futures); OCC letter from Horace G. Sneed, senior attorney, Legal Advisory Services Division (March 2, 1992) (unpublished) (bank could manage its commodity index swaps on a portfolio basis and hedge the swaps with swaps, exchange–traded futures, or over-the-counter (OTC) options; OCC Interpretive Letter No. 652 (September 13, 1994), reprinted in [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,600 (bank could engage in equity and equity derivative swaps and hedge risk using futures contracts, options, and similar OTC instruments).

[17] Agricultural loan hedge letter, supra.

[18] *Id.*

[19] Similarly, the OCC has determined that national banks may take physical delivery of commodities to hedge bank-permissible commodity-linked derivative transactions as a convenient and useful means to manage the risks arising from those permissible banking transactions. OCC Interpretive Letter Nos. 632 and 684, *supra*.

fective means to hedge risks arising from customer-driven equity derivative transactions and thus were a convenient and useful activity incidental to the business of banking for those banks.[20]

The OCC also has permitted national banks to hedge obligations to make payments on bank-permissible employee compensation and benefit plans with incidental life insurance.[21] The OCC later concluded that it was convenient and useful for a national bank to hedge an employee compensation program with bank–impermissible insurance company products and investments because the hedge virtually eliminated all the risk arising under the program to the bank.[22]

In each case cited above, the hedging instrument was viewed as an asset held incidental to a permissible banking activity in order to hedge the bank's risks or obligations, rather than as a security held by the bank for investment. The transactions were used to manage risks arising from otherwise bank-permissible banking activities and not entered into for speculative purposes. In much the same manner, incidental to the express permissible banking activity of lending, the bank would buy and sell options on equity securities for the sole purpose of hedging its market risk on DPC shares. This conclusion is consistent with the foregoing OCC precedents permitting bank-impermissible investments for hedging purposes to manage risks arising from permissible banking activities.

3. The hedging must be conducted in a safe and sound manner.

Buying and selling options for the stated purpose of hedging market exposures on DPC securities does not automatically qualify that activity as an activity that is incidental to banking, however. The nature of the hedging activity proposed requires specialized risk measurement and management capacities on the part of a bank, and qualified personnel, in order for the activity to be conducted so it will actually perform the function of hedging market risks. Thus, in order for the proposed activity to be permissible for the bank because it is "convenient" or "useful" to conducting authorized banking activities, the bank must establish an appropriate risk measurement and management process for its DPC share hedging activity in accordance with applicable require-

[20] *See* equity hedge letter, *supra*. *See also* OCC Interpretive Letter No. 684, *supra* (national banks may take physical delivery of equities and commodities to hedge bank-permissible derivative transactions as a convenient and useful means to manage the risks arising from those permissible banking transactions). The General Accounting Office has issued a report agreeing with the OCC's conclusion. United States General Accounting Office, *Equity Hedging—Report to the Honorable James A. Leach, House of Representatives*, GAO–01–945 (August 2001).

[21] OCC Interpretive Letter No. 848 (November 23, 1998), *reprinted in* [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–202; OCC Bulletin 96–51 (September 20, 1996), *reprinted in* Fed. Banking L. Rep. (CCH) ¶ 35–491.

[22] OCC Interpretive Letter No. 878 (December 22, 1999), *reprinted in* [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-373.

ments contained in the OCC's derivatives handbook[23] and OCC Banking Circular No. 277.[24] As part of the bank's risk management process, the bank's management should:

- Document its decisions on hedging DPC share market exposures;
- Develop a clear methodology for determining the amount of market risk from DPC shares that the bank needs to hedge; and
- Establish objective criteria for the purchase and sale of options sufficient to demonstrate that the options will be used solely to hedge against losses.

In addition, the bank should develop and implement compliance policies and procedures to ensure that any potential conflicts of interest are appropriately considered and that the hedges will comply with applicable securities laws, including applicable insider trading standards. Because buying and selling options in respect of DPC shares may raise issues under the federal securities laws, the bank should consult with competent securities counsel to ensure its activities comply with federal securities laws before entering into such transactions.

Finally, the bank's audit or another qualified independent control unit should conduct a review to evaluate the adequacy and effectiveness of the bank's risk and compliance management policies and procedures to ensure that the DPC share hedging activity is conducted in conformance with the applicable requirements of BC–277 and securities laws.

D. Use of Options to Hedge Banking Risk is not Prohibited Underwriting or Dealing under Section 24(Seventh)

Section 24(Seventh) addresses the ability of a national bank to underwrite or deal in securities. Specifically, section 24(Seventh) provides that:

> [t]he business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: Provided, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe.

[23] *Handbook for National Bank Examiners*, "Risk Management of Financial Derivatives" (January 1997) ("derivatives handbook").

[24] October 27, 1993, *reprinted in* [1993–1994 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 62–152, as supplemented by *Supplemental Guidance 1 to BC–277* (January 1997) ("BC–277").

Here, the bank is not "dealing" in or "underwriting" securities as prohibited by section 24(Seventh). Although "dealing" and "underwriting" are not defined in section 24(Seventh),[25] "underwriting" is generally understood as encompassing the purchase of securities from an issuer for distribution and sale to investors.[26] Case law confirms that one cannot be an underwriter in the absence of a public offering.[27]

"Dealing" in securities is generally understood to encompass the purchase of securities as principal for resale to others.[28] Dealing is buying and selling as part of a regular business. A dealer typically maintains an inventory of securities and holds itself out to the public as willing to purchase and sell and continuously quote prices.[29]

Under the above definitions, the bank's use of options on equity securities for hedging exposures resulting from DPC shares is not "underwriting" or "dealing." The bank has committed to sell and purchase debt securities solely for the purpose of hedging. The bank will not purchase securities from an issuer for sale to investors in connection with a public offering—essential elements of underwriting. Further, in conducting hedging activities, the bank will not engage in a regular business of buying and selling equity options in the secondary market, will not publicly offer the equity options from hedging DPC shares to investors and will not hold itself out as available to buy and sell securities.[30]

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[25] Although the securities laws definitions are not dispositive in determining whether a particular type of securities activity is permitted for banks, these definitions provide a useful starting point for characterizing a bank's securities activities. Under section 3 of the Securities Exchange Act of 1934, a "dealer" is defined as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not part of a regular business." 15 USC 78c(a)(5). Under the Securities Act of 1933, an "underwriter" includes "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security." 15 USC 77(b)(a)(11).

[26] OCC Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612; OCC Interpretive Letter No. 329 (March 4, 1985), *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499.

[27] *SIA* v. *Board of Governors*, 807 F.2d 1052 (D.C. Circuit 1986), *cert. denied*, 483 U.S. 1005 (1987).

[28] *See* equity hedge letter, *supra* (banks' purchase of equity securities for hedging customer-driven equity derivative transactions is not "dealing" or "underwriting"). *See also* OCC Interpretive Letter No. 393 (July 5, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,617 (national bank with limited market presence not considered a dealer); Louis Loss, *Securities Regulation* 2983–84 (3d ed. 1990).

[29] *Citicorp, J.P. Morgan & Co. Inc., Bankers Trust New York Corporation*, 73 *Federal Reserve Bulletin* 473 n.4 (1987); OCC Interpretive Letter No. 684, *supra;* equity hedging letter, *supra*.

[30] Although securities law is not determinative in interpreting banking law, we note that the Securities and Exchange Commission (SEC) has recognized that entities that purchase and sell securities to hedge their own risks, and that do not hold themselves out as available to buy and sell securities are not dealers under the GSA. *See Fireman's Fund Mortgage Corp.*, 1987 SEC No-Act. LEXIS 2330 (July 20, 1987). *See also Citicorp Homeowners, Inc.*, 1987 SEC No-Act. LEXIS 2596 (October 7, 1987) (involving mortgages and hedging with government securities); *Meridian Mortgage Corp.*, 1987 SEC No-Act. LEXIS 2020 (April 7, 1987) (involving mortgages and hedging with government securities).

Conclusion

The bank may purchase and sell options on DPC shares to hedge the risk of holding those shares against fluctuations in market value, provided the bank has established effective risk measurement and management processes as described in section C.3, above, to conduct the proposed hedging as described herein.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

962—April 21, 2003

12 USC 24(7)

John H. Huffstutler
Associate General Counsel
Bank of America Corporation
NC1–002–29–01
101 South Tryon Street
Charlotte, NC 28255

Re: Authority to Expand Customer-Driven Financial Intermediation Transactions in Electricity Derivatives to Include Transitory Title Transfers

Dear Mr. Huffstutler:

This letter responds to your request for approval from the Office of the Comptroller of the Currency ("OCC") for Bank of America, N.A. ("bank") to expand its financial intermediation business to include customer-driven, electricity derivative transactions that involve transfers of title to electricity.[1] For the reasons discussed below and subject to the limitations described herein, we believe that the proposed transactions are permissible for the bank.

I. Background

The bank engages in a variety of cash-settled, customer-driven financial intermediation transactions involving exchanges of payments based on interest rates, and the value of equities and commodities. The bank's cash-settled financial intermediation derivative transactions involve a wide range of energy-related commodities, including electricity. The bank received authority to engage in customer-driven, cash-settled electricity derivative transactions and hedges in OCC Interpretive Letter No. 937 to assist customers in meeting their financial and risk management needs.[2] The bank now proposes to settle and hedge electricity derivative transactions by accepting and immediately relinquishing title to electricity, as a party in a "chain of title" transfers ("transitory

[1] For the purposes of this letter, the term "electricity derivative transactions" encompasses electricity linked transactions of every type—including derivative products such as futures, forwards, options, swaps, caps, floors and collars, and options thereon—where a portion of the return (including interest, principal, or payment streams) is linked to electricity or the price of electricity.

[2] OCC Interpretive Letter No. 937 (June 27, 2002) *reprinted in* [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–462.

title transfers").[3] The bank represents that it does not intend to ever be in a situation where it is required to receive or deliver actual power as a result of an electricity derivative transaction. And, the bank represents that it will engage in transitory title transfers solely for the accommodation of customers or for its own risk management purposes.

The bank has obtained an order from Federal Energy Regulatory Commission ("FERC") granting it general authority to act as a power marketer, thus enabling the bank to engage in transitory title transfers in electricity in interstate commerce at market-based rates.[4] As part of the FERC order, the bank received a number of waivers and authorizations granted to other power marketers (including a waiver of certain FERC filing and accounting requirements, and a blanket authorization to issue securities and assume obligations and liabilities without prior FERC approval).[5]

Under the bank's proposal, it will settle all of its customer-driven electricity derivative transactions in cash or by transitory title transfers. Currently the bank acts as a financial intermediary under electricity derivative contracts that provide for cash settlement.[6] In certain electricity derivatives markets, contracts do not specifically provide for assignment, termination, or offset prior to a transitory title transfer. Instead, participants in these markets settle electricity derivative contracts through title transfers. Financial intermediaries in these markets enter into back-to-back-contracts providing for the receipt and immediate transfer of title to electricity. In order to participate in these markets, the bank seeks to engage in transitory title transfers where the bank takes title to electricity in a "chain of title" and relinquishes title instantaneously.[7]

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[3] Examples of a cash-settled electricity swap, forward, and option transaction are contained in OCC Interpretive Letter No. 937, *supra.* The swap, forward, and option transactions at issue are similar, except that the transactions will provide for transitory title transfer to settle the contracts. The bank expects that less than 20 percent of the total volume (in megawatt hours) associated with the bank's electricity derivative transactions (electricity derivative contracts and hedges) will involve transitory title transfers. The bank will consult with its OCC examiner-in-charge ("EIC") and address any supervisory concerns raised before exceeding the 20 percent of total volume limit.

[4] FERC asserts jurisdiction over entities such as the bank that engage in transitory title transfers. See *Bank of America, N.A.,* 101 FERC ¶ 61,098 (Oct. 30, 2002) (the "FERC order"). Other financial institutions that participate in electricity derivatives markets—including affiliates of Credit Suisse First Boston, Goldman Sachs & Co., Merrill Lynch & Co., Morgan Stanley & Co., and UBS—have also received FERC approval to operate as power marketers authorized to sell electricity in interstate commerce at market-based rates.

[5] By declaratory order, dated Dec. 19, 2002 (Docket Nos. EL02–130–000 and EC02–120–000), FERC granted in part the bank's request for a blanket authorization to acquire "securities" of public utilities without prior FERC approval, subject to certain conditions. Because such declaratory order did not grant all aspects of the bank's request in this regard, the bank has petitioned FERC for a reconsideration of certain of the conditions set out in the order. Any such acquisitions would have to be permissible under federal banking law.

[6] OCC Interpretive Letter No. 937, *supra.* The term "cash-settled electricity derivative transactions" includes any electricity derivative contract that is cash-settled or that can be assigned, terminated, or offset prior to any transitory title transfer.

[7] Accordingly, as noted above, the bank will not enter into transactions where it will hold title to electricity for more than a legal instant. The bank expects that only a small volume of electricity derivative transactions that it enters into (in general, less than 20 percent) will involve transitory title transfers. (*See* note 3 above.)

The bank states that it will engage only in wholesale electricity transitory title transfers. "Wholesale" electricity transitory title transfers are principally to and from other market intermediaries, some of which may, in turn, affect retail delivery. "Retail" delivery involves the transmission of power to an end-user customer and involves a more extensive scheduling function than wholesale delivery.

The bank represents that transitory title transfer transactions pose risks[8] similar in nature to those inherent in cash-settled electricity derivative transactions and it has a demonstrated ability to successfully manage and control such risks. And, because transitory title transfer transactions typically do not entail the physical possession of commodities, these transactions do not appear to involve the customary activities relating to, or risks attendant on, commodity ownership, e.g., production, transportation, transmission, distribution. While transitory title transfer transactions will require the introduction of some new operational processes (e.g., scheduling of power flows), the majority of operational functions, such as passing notices, document transfers, and payments are similar to those regularly performed by national banks in their role as financial intermediaries. Moreover, national banks that engage in transitory title transfer transactions face risks such as counterparty credit risk that are not significantly different than the risks associated with cash-settled electricity derivative transactions.

The bank will manage the market risks in its electricity derivative transactions on a "portfolio basis," and will hedge the resulting net risk exposures. Because the market risk exposures arising from transactions with customers may offset each other, the bank will not need to hedge each transaction individually. The bank will use both cash-settled hedges and those that involve transitory title transfers. There will normally be some market risk that will not be hedged and this residual exposure will be subject to risk management limits as discussed below. The bank represents that residual market risk arising from this activity at all times will be *de minimis* relative to the bank's earnings and capital and will be consistent with a customer-driven business strategy.

The bank believes that electricity transitory title transfers are a natural extension of the bank's existing financial intermediation activities in electricity that will benefit customers as well as the bank. The bank represents that its ability to engage in transitory title transfers will enable the bank to offer customers a broader range of intermediation services that more fully accommodate customers' financial, risk management, and liquidity needs. In many areas of the United States, contracts reflecting the market convention provide for settlement through transitory title transfers. If the bank cannot engage in transitory title transfers it will not be able to provide customers with the option of participating in these markets to address financial and risk management needs. For the bank to provide effective liquidity and risk management solutions for its electricity derivatives

[8] Risks that are similar in nature include credit, compliance, market, transaction, and reputation.

customers, the settlement terms in the electricity derivative transactions it intermediates need to satisfy each customer's particular needs. Accordingly, the bank believes that its ability to settle electricity derivative transactions by transitory title transfer is vital to its ability to assist customers with their particular financial, risk management, and liquidity needs.

The bank states that its ability to participate in a broader range of markets, and offer a broader range of products, also enables the bank to compete more effectively with other intermediaries, diversify its business risks and operate more efficiently and profitably. The bank's proposed expansion of its existing electricity derivatives business will enable the bank to compete more effectively with other market intermediaries that offer customers the option of selecting electricity derivative contracts that settle in cash or by transitory title transfer. By offering customers a broader range of risk management products that more effectively address their individual financial needs, the bank has the ability to attract a broader customer base. Also, as a participant in more than one type of electricity derivative settlement market, the bank will have greater access to relevant price and other related information. And, with greater access to market information, the bank can provide more extensive services to current and prospective customers. In addition, by participating in a broader range of markets and expanding its customer base, the bank may diversify and reduce credit and other risks arising from its electricity derivatives business. Consequently, transitory title transfers enable the bank to operate its electricity derivatives business more competitively, efficiently, and profitably.

The bank represents that the ability to engage in electricity transitory title transfers can reduce the risk that it will be subject to a "market" or "liquidity" squeeze. The bank contends that being limited to electricity derivative transactions that require cash settlement may be disadvantageous because market participants know that the bank is constrained in its ability to cover and exit electricity derivative transactions. In addition, the bank believes if there is limited liquidity or substantial volatility in the electricity derivatives market, the bank's inability to enter into electricity derivative transactions settled by transitory title transfer constrains its ability to choose among various risk management tools to guard against a possible "market" or "liquidity" squeeze.

The bank also represents that the ability to engage in transitory title transfers will increase the bank's hedging options and its ability to control risks in its electricity derivatives business. The bank asserts that this capability will enable the bank to broaden its ability to hedge, on a portfolio basis, its electricity derivative business.

The bank has expertise in conducting energy derivative transactions. Consistent with this expertise, the bank has well-established policies, procedures, and controls that it applies to its customer-driven, cash-settled oil, gas, and electricity derivatives businesses. For example, the bank: (i) hedges the price risk arising from commodity derivatives on a portfolio basis and values transactions using data sets and models implemented in accordance with bank standards; (ii) records credit exposure against customer credit limits; (iii) documents cash-settled customer transactions

using the ISDA Master Agreement, with appropriate confirmations;[9] and (iv) uses operations systems that permit booking and settlement of commodity derivatives transactions. The bank represents that it will continue to conduct its activities in customer-driven electricity derivatives consistent with the same policies, procedures, and controls it applies to its existing energy commodity derivatives business (the "commodity derivative product controls").

The bank commits that before engaging in transitory title transfers it will adopt and implement all necessary policies, procedures, and controls to assure that (i) its electricity derivative business is customer-driven and meets all required regulatory standards for conducting a customer-driven derivative business, and (ii) the bank has in place all appropriate mechanisms to identify, monitor, limit, and control the risks inherent in conducting this business so that it complies with all applicable OCC guidance and requirements.[10]

To manage the risks in its expanded electricity derivatives business, the bank represents it will implement those policies, procedures, and controls set forth in OCC guidance, e.g*.,* OCC derivatives handbook and BC–277, to assure the ongoing function and maintenance of an effective risk management process. The bank specifically acknowledges that, as contemplated by the OCC derivatives handbook and BC–277, an effective risk management process includes appropriate oversight and supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification, measurement and management information systems, and effective risk control functions that oversee and ensure the continuing appropriateness of the risk management process.

In implementing those policies, procedures, and controls, the bank commits to conducting a full evaluation of (i) pricing, hedging (including portfolio hedging), processing, recordkeeping, documentation, accounting, "back office," and risk management; (ii) the development of adequate knowledge, staff, oversight management, and technology (including contingency planning) to accommodate the activity; (iii) the implementation of appropriate controls (including the commodity derivative product controls discussed above); (iv) the establishment, implementation, and monitoring of appropriate risk management limits with respect to various types of risks—such

[9] We would expect the bank to document all electricity transitory title transfer transactions with appropriately comparable confirmations.

[10] *See, e.g.*, *OCC Handbook*: Risk Management of Financial Derivatives (January 1997) ("OCC derivatives handbook"); OCC Banking Circular No. 277 (October 27, 1993), *reprinted in* 5 Fed. Banking L. Rep. (CCH). ¶ 62–152 ("BC–277"); OCC Bulletin 94–31 (May 10, 1994), *reprinted in* 5 Fed. Banking L. Rep. (CCH) ¶ 62–152.

as market risk, credit risk, and liquidity risk—associated with transitory title transfers;[11] and (v) compliance department training of personnel and development of a supervisory framework designed to ensure compliance with policies and procedures, including trading practices. Such a framework will strictly prohibit manipulative practices of any kind, including patterns of trading related to so-called "round tripping" of electricity derivatives transactions and will promote compliance with FERC and other relevant regulatory requirements.[12] Risk control, operations, accounting, legal, compliance, audit, and senior and line management will all be involved in assuring that the risks undertaken by the bank are comparable to, and are addressed in ways comparable to those applicable to, the bank's existing energy-based derivative products and business.

The bank further commits that: (i) it will not run a proprietary book in electricity/electricity derivatives, (ii) any trading in derivatives will be done exclusively to hedge residual open positions related to customer transactions (or incurred in anticipation of customer transactions), and (iii) its electricity derivatives business will be conducted in a safe and sound manner and consistent with prudential risk management practices as prescribed in the OCC derivatives handbook and BC–277.

Furthermore, the bank commits that complex structured transactions involving electricity derivatives will be subject to appropriate review and oversight of the bank's risk management approval process to ensure that such transactions conform to the bank's standards of appropriateness and integrity. In this risk management approval process, committees that are independent of the sponsoring business will review complex structured transactions. These committees will review the transactions for risks presented by the transactions, including credit risk, market risk, operations risk, legal risk, and reputation risk. Furthermore, in the normal course of risk management, the bank will typically evaluate the purpose of transactions to assess whether the client has attempted to achieve a financial statement objective that could be construed as materially misrepresent-

[11] For example, in the context of market and related risks of electricity derivatives, the bank will specifically address such matters as price volatility and concentration of market participants on a geographic and power exchange/power pool/individual customer basis. In the context of options, it will specifically address all of those characteristics identified in the OCC derivatives handbook (e.g., at 20–21 and appendix B) as primary component measures of option sensitivity.

[12] To illustrate, the head of the electricity derivatives desk will be provided with a "best practices" policy that describes the responsibilities of the position in monitoring transactions for market manipulation, including round-tripping. This individual will receive daily position and activity reports to review and monitor consistent with the best practices policy. The bank's compliance division will also receive and review position and activity reports on a daily basis, test for proprietary trading, test the appropriateness of derivative transactions and hedges, and review documentary support on a quarterly basis. Bank employees involved in this business will be subject to applicable "Standards of Professional Conduct" and will be required to attend compliance training. Furthermore, the bank's legal department will provide guidance to the compliance department to ensure FERC rules and regulations as prescribed by the National Power Act are understood with appropriate compliance policies and procedures developed and implemented.

ing its financial condition, even if in conformance with generally accepted accounting principles ("GAAP"). In any instance where it is determined that a proposed transaction may result in materially misleading financial statements, the bank will decline the transaction, condition approval upon the counterparty making express disclosures regarding the nature and financial impact of the transaction on the counterparty's financial position, or take other steps to assure that the bank's role is appropriate. The bank will also have an appropriate process for verifying customers have satisfied any conditions the bank establishes concerning disclosures. As part of the process to determine the appropriateness of a transaction, the bank may seek representations and warranties from the counterparty to the complex structured transaction stating the purpose of the transaction, how the counterparty will account for the transaction, and that the counterparty will account for the transaction in accordance with GAAP, consistently applied.

II. Discussion

In our opinion, the proposed title transfer transactions may be permissible under 12 USC 24(Seventh) as an activity incidental or "convenient and useful" to its electricity derivatives business, provided the bank has established an appropriate risk measurement and management process for the activity that is satisfactory to the bank's EIC.[13]

National Banks May Engage in Electricity Title Transfers to Settle and Hedge Customer-Driven Electricity Derivative Transactions as Activities Incidental to the Business of Banking

The OCC previously determined that the bank may engage in electricity derivative transactions and hedges that are cash-settled.[14] The bank proposes to settle and hedge electricity derivative transactions by transitory title transfers where the bank takes title to electricity in a "chain of title" and relinquishes title instantaneously. The proposed transitory title transfers will enable the bank to participate in markets using this form of settlement and provide customers with a broader range of sophisticated risk management tools to address their financial, risk management, and liquidity needs. Further, the proposed transitory title transfers will enable the bank to compete more effectively and operate more efficiently and profitably. Transitory title transfer capability also will increase the bank's hedging options and its ability to control risks in its electricity derivatives business.

Engaging in transitory title transfers will subject the bank to risks similar in nature to those inherent in cash-settled electricity derivatives where the bank has demonstrated risk management procedures, systems, and controls to appropriately manage and controls such risks. Transitory title transfer transactions typically do not involve taking physical possession of commodities, and thus

[13] This process is necessary for the bank to achieve its customer risk management objectives in a safe and sound manner and, thus, must be established before the OCC can conclude that activities are permissible for the bank.

[14] OCC Interpretive Letter No. 937, *supra.*

do not appear to involve the customary activities relating to commodity ownership. While transitory title transfer transactions will require the introduction of some new operational processes (e.g., scheduling of power flows), the majority of operational functions, such as passing notices, document transfers, and payments, are similar to those regularly performed by national banks in their role as financial intermediaries.

The OCC has previously concluded in a variety of contexts that national banks may engage in instantaneous title transfers as an activity permissible under 12 USC 24(Seventh). In OCC Interpretive Letter No. 684, for example, the OCC determined that it was permissible for a national bank to engage in instantaneous warehouse receipt transfers in furtherance of managing the risks in financial intermediation transactions with customers, involving the exchange of payments based on the value of commodities.[15] The instantaneous warehouse receipt transfers entailed the bank taking possession of a warehouse receipt and instantaneously passing it on to a third party under an offsetting transaction. In OCC Interpretive Letter No. 684, as here, the bank did not propose to take actual delivery by receipt of physical quantities of commodities on bank premises. Rather, transitory title transfers preclude actual delivery by passing title down the chain from the initial seller to the ultimate buyer in a series of instantaneous back-to-back transactions. Each party in the chain has title for an instant but does not take actual physical delivery (other than the ultimate buyer which, in no case, will be the bank). The OCC determined that the warehouse receipt transfers were permissible, where consistent with safe and sound banking principles, and with prior written authorization from OCC supervisory staff.

Analogously, the OCC has previously determined that a national bank may instantaneously acquire and transfer equity and debt securities in the secondary market under 12 USC 24(Seventh), in financial intermediary transactions with customers.[16] The bank purchased the equities and debt securities only for immediate resale to an ultimate purchaser as a riskless principal. The OCC approved the transactions because the bank did not assume any of the customer's risk of loss, did not assume any liability as guarantor or endorser of the value of the securities, and did not have any beneficial ownership of the securities. The purchases and sales of equity and debt securities were in furtherance of bank permissible brokerage activities.

In sum, the ability of the bank to engage in transitory title transfers in connection with its customer-driven electricity derivative transactions will allow the bank to provide customers with a broader range of tools to address their financial, risk management, and liquidity needs. Transitory title transfer capability also will permit the bank to conduct its electricity derivatives business

[15] OCC Interpretive Letter No. 684 (August 4, 1995), *reprinted in* [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,632. Warehouse receipts evidence title to commodities. While OCC Interpretive Letter No. 684 characterized the transactions in that letter as involving the "physical delivery" of commodities, included within that characterization were instantaneous warehouse receipt transfers.

[16] OCC Interpretive Letter No. 626 (July 7, 1993) *reprinted in* [1993–1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,508.

more competitively, efficiently, and profitably and increase its hedging options. The risks to which the bank is exposed are similar in nature to cash-settled electricity derivative transactions where the bank has a demonstrated ability to manage and control such risks. The bank's proposed transitory title transfers are functionally comparable to other title transfers that the OCC has permitted under 12 USC 24(Seventh). Accordingly, subject to satisfying the safety and soundness factors discussed below, the bank's proposed transitory title transfers are incidental or "convenient and useful" to the bank's financial intermediation activities in electricity derivative transactions.

Safety and Soundness Requirements and EIC Approval

For the bank to permissibly engage in transitory title transfers, the bank's risk measurement and management capabilities must be of appropriate sophistication to ensure that the activity can be conducted in a safe and sound manner. Consequently, in order for the OCC to conclude that this activity is permissible for the bank because it is convenient or useful to conducting authorized banking activities, the bank must demonstrate to the satisfaction of the OCC that the bank has established an appropriate risk measurement and management process for its transitory title transfers. As detailed further in the OCC derivatives handbook and BC–277, an effective risk measurement and management process includes board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective risk control function that oversees and ensures the appropriateness of the risk management process. Risk control processes will need to become increasingly sophisticated as this business activity grows in size and complexity.

Additionally, the bank's risk management approval process must subject complex structured electricity derivative transactions to appropriate review and oversight to ensure that these transactions conform to the bank's standards of appropriateness and integrity. This should include review and approval of these transactions by independent and qualified individuals. The structured transaction approval process should consider all relevant risks, should require review of transaction appropriateness, and should include evaluation of the purpose of these transactions to determine whether the bank's customer is attempting to achieve a financial statement objective that materially misrepresents its financial condition, regardless of being in conformance with GAAP.

In addition to a satisfactory risk management program, the bank's process must include an independent compliance monitoring program to ensure ongoing compliance with the specific commitments made by the bank in its proposal, including the commitment to continue to conduct its financial intermediation activities in electricity as a customer-driven and non-proprietary trading business. The compliance monitoring program should also ensure that the bank has a supervisory framework that protects against manipulative practices of any kind, including "round tripping," and promotes compliance with FERC and other regulatory requirements. An adequate and effective compliance monitoring program will include policies, training, independent surveillance and well-defined exception approval and reporting procedures.

The OCC will make these determinations though the bank's EIC and the bank may not commence the proposed activities unless and until its EIC has concluded that the foregoing standards are met.

III. Conclusion

The bank may settle and hedge its customer-driven bank permissible electricity derivative transactions by transitory title transfers as an activity incidental to its existing electricity derivatives business, provided the bank has established, to the satisfaction of its EIC, an appropriate risk measurement and management process for its transitory title transfers.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

963—April 14, 2003

12 USC 548
12 USC 52

Subject: Arkansas Franchise Tax and Par Value of National Bank Shares

Dear [ ]:

This is in response to your letter inquiring whether 12 USC 52 prohibits a national bank from decreasing the par value of its shares to $0.01 per share with an offsetting increase to the bank's "capital in excess of par" account. For the reasons discussed below, we conclude that section 52 does not prohibit a national bank from decreasing the par value of its shares and increasing the bank's capital surplus. To the extent that a national bank avails itself of these options, it may affect its state tax obligations pursuant to the operation of 12 USC 548.

I. Background

You have indicated that banks located in Arkansas are required to pay an annual franchise tax pursuant to the Arkansas Corporation Franchise Tax Act of 1979[1] (the "Arkansas Franchise Tax Act"). For a bank with all its property located in Arkansas, the amount of the franchise tax is computed by multiplying the number of the bank's shares outstanding times the par value per share times 0.27 percent.[2] The par value of a bank's shares thus significantly affects the amount of franchise tax payable.

II. Discussion

The National Bank Act does not prohibit a national bank from having shares with a par value of $0.01.[3] Section 52 provides that "[t]he capital stock of each association shall be divided into shares of $100 each, or into shares of such less amount as may be provided in the articles of association." That provision thus establishes a maximum par value per share for a national bank's shares, but does not establish any minimum par value. Prior to December 27, 2000, 12 USC 51 imposed on national banks a minimum aggregate par value requirement ranging from $50,000 to $200,000. Section 51 was repealed in the Financial Regulatory Relief and Economic Efficiency

[1] Ark. Code Ann. §§ 26–54–101 *et seq.* (Michie 2001).

[2] The product of shares outstanding times par value per share may be considered the "tax base." The 0.27 percent may be considered the "tax rate."

[3] You have represented that it is legally permissible under Arkansas law for a state bank organized in Arkansas to have shares with a par value per share of $0.01.

[4] Pub. L. No. 106–569, Title XII, § 1233(c), 114 Stat. 3037.

Act of 2000 (the "2000 Act").[4] The legislative history of the 2000 Act indicates that Congress considered the section 51 minimum capital requirement obsolete since Congress had granted the federal banking agencies the regulatory authority to establish minimum capital requirements in 1983.[5] The minimum capital requirements currently applicable to national banks under this authority are set forth in part 3 of the Office of the Comptroller of the Currency's ("OCC's") rules.[6]

The OCC has previously determined that a national bank could decrease the par value of its shares to $0.01 per share, provided that the bank continued to meet applicable capital requirements.[7] Because the National Bank Act no longer contains a minimum aggregate par value requirement and because section 52 provides only for a maximum par value of $100 per share, a national bank may decrease the par value of its shares to $0.01 and transfer the amount resulting from that decrease to capital surplus.[8] In effecting the decrease in par value and increase in capital surplus, a national bank would of course need to comply with all other applicable legal requirements, including requirements for procedures to amend its articles of association[9] as well as requirements for notifying the OCC.[10] In this connection, the bank must, of course, continue to comply with all applicable capital requirements set forth in the OCC's part 3. National banks

[5] 146 *Congressional Record* H11991 (daily edition December 5, 2000) (section-by-section analysis inserted into record by House bill sponsor, Representative Leach); 146 *Congressional Record* S11607 (daily edition December 5, 2000) (section-by-section analysis inserted into record by Senate bill sponsor, Senator Allard).

[6] 12 CFR 3.1 *et seq*.

[7] *See* Interpretive Letter No. 275 ("IL 275"), *reprinted in* [1983–1984 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 85,439 (October 21, 1983) (national bank could meet aggregate par value requirement with a combination of common and preferred shares). Subsequent to IL 275, the aggregate par value requirement was eliminated by the repeal of section 51. *See also* letter from Anthony DosSantos, licensing manager, Northeastern District Office, OCC, to John H. Smith, associate counsel, Mellon Financial Corporation (March 3, 2003) (to be published) (bank converting from state to national bank charter may issue zero or no par common shares).

[8] The national bank would not be reducing its capital but merely transferring amounts between two permanent capital accounts. Thus, 12 USC 59, which establishes procedures for a national bank to reduce its capital, would not apply. Except as provided in section 59 and 12 CFR 5.46, a national bank may not withdraw, or permit to be withdrawn, by dividend or otherwise, any portion of its permanent capital. Transferring amounts between the two permanent capital accounts will not affect the bank's obligations under 12 USC 56 (prohibition on withdrawal of capital) or 12 USC 60 (restrictions on dividends). *See* 12 CFR 5.63(a).

[9] The shareholders of a national bank must approve any amendment to the bank's articles of association to change the par value of the bank's capital stock. A certified copy of the amendment to the articles of association also must be forwarded to the OCC. *See* 12 USC 21a. A national bank with shares that are registered under section 12 of the Securities Exchange Act of 1934 must file proxy materials with the OCC pursuant to 12 CFR Part 11.

[10] Changing the par value of a national bank's capital stock when the change is offset by an equal change in the bank's capital surplus does not require prior approval of the OCC. The change, however, does require notice to the OCC and does not become effective until the OCC certifies the change. *See Comptroller's Corporate Manual, Other Changes and Activities, Capital and Dividends* (April 1998).

also should be cognizant that a reduction in par value may affect future directors' qualifying share requirements under 12 USC 72.[11]

When a national bank decreases the par value of its shares, it may have an effect on the bank's state tax liability if the relevant state taxes its state banks, to any degree, based on the par value of those banks' shares. This occurs because 12 USC 548 provides that:

> For the purposes of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located.

Without reaching the question of whether the Arkansas franchise tax is the type of tax authorized by section 548,[12] were such to be the case, a national bank nevertheless may still take advantage of corporate options available to it under federal law with regard to its corporate or business configuration, such as setting the par value of its shares. In certain states, that look to the par value of a bank's shares in calculating a bank's tax obligations, taking advantage of such corporate options may, pursuant to section 548, affect the national bank's tax obligations.

I hope the foregoing is responsive to your inquiry.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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[11] Under section 72, a national bank director must own a qualifying equity interest of $1,000 in the stock of a national bank or its holding company. In an interpretive ruling, the OCC has stated that the qualifying equity interest may include common or preferred stock that has an aggregate par value of $1,000, an aggregate shareholders' equity of $1,000, or an aggregate fair market value of $1,000. The value of the qualifying interest is determined as of the date purchased or the date on which an individual became a director, whichever value is greater. *See* 12 CFR 7.2005.

[12] *First Agricultural National Bank* v. *State Tax Comm'n*, 392 U.S. 339, 341–46 (1968) (states may only tax national banks as specifically permitted by Congress). *See also, U.S.* v. *State Board of Equalization*, 639 F. 2d 458 (9th Circuit 1980), *cert. denied* 451 U.S. 1028 (1981) and *Michie on Banks and Banking*, chapter 19, section 1 (1998).

964—March 17, 2003

12 CFR 3

Subject: Risk-Based Capital Treatment of GSE Preferred Stock

Dear [   ]:

In your letter of November 13, 2002, you requested confirmation regarding the appropriate risk weight for a national bank's investment in preferred stock issued by United States Government Sponsored Entities (GSEs). The Office of the Comptroller of the Currency ("OCC") applies a 20 percent risk weight to preferred stock issued by a GSE.

The OCC's capital regulations provide for a 20 percent risk weight on "Securities issued by, or other direct claims on, United States Government-sponsored agencies." 12 CFR 3, app. A, section 3(a)(2)(vi). For purposes of this regulation, the term "security" includes preferred stock. Therefore, GSE preferred stock is a security issued by a U.S. government-sponsored agency and receives a 20 percent risk weight. Please be aware, however, that the capital regulations of the other U.S. banking agencies are not identical to the OCC's in this regard. This letter is applicable only to the risk weighting by national banks of their holdings of GSE preferred stock. The treatment described herein supersedes the supervisory policy stated in the 1992 OCC letter that you referenced, which indicated that certain GSE preferred stock should be risk weighted at 100 percent.

If you have any questions, please contact Amrit Sekhon, risk expert, Capital Policy, at (202) 874–5070.

Tommy Snow
Director, Capital Policy

965—February 24, 2003

12 USC 24(7)

Subject: [ ]—[Co.]

Dear [ ]:

This is in response to your letter concerning a purchase of stock that [ ] ("bank"), has made, through an operating subsidiary, in a reinsurance company domiciled in Bermuda. You requested that we review this purchase and permit the bank to retain the stock. We have completed our review and have concluded that this is a permissible activity and the bank may retain its shares of stock in the Bermuda company.

Background

You indicate that the bank has a wholly owned operating subsidiary, [ ] ("sub"). [Sub] is a *[State]* general insurance agency and broker specializing in commercial lines of insurance. Last year, [sub] needed to obtain professional liability insurance for its insurance agents. Professional liability insurance in this context provides protection against legal liability and the cost of defending claims alleging errors and omissions of insurance agents. Under current market conditions, it is a highly specialized type of insurance that is difficult to obtain, and as a result distribution through surplus lines brokers is common. [Sub] contacted over 25 carriers in its search for professional liability coverage, Most declined to even offer quotes, Others offered only limited coverage, had higher deductibles, or had unacceptable ratings. In the end, [sub] management concluded that obtaining the coverage through a program offered by [ ] ("Co."), was the best option.

[Co.] is domiciled in Bermuda and is licensed under the Bermuda Insurance Act of 1978. It does not maintain any offices outside Bermuda. Under the [Co.] program, the insurance is underwritten by [InsurCo.], a large American company whose principal office is in *[State],* and reinsured through a wholly owned subsidiary of [Co.]. According to [Co.]'s private placement memorandum of May 22, 2002, [Co.]'s sole business is underwriting professional liability insurance through this program, and its success depends entirely on the extent to which its shareholders place their business through the program. Coverage under the [Co.] program requires ownership of [Co.] stock, and ownership is limited to participants in the program.[1]

Thus, in order to obtain the coverage that it needed, [sub] was required to purchase 3,470 shares of Class A stock in [Co.] in an amount equal to 20 percent of the first annual premium for the insurance, or $69,400. This amount represents less than 1 percent of the outstanding voting stock

[1] Ownership of [Co.]'s Class A shares is limited to two primary insurers, [InsurCo.] and another American insurance company, and insurance agencies that are insured under the program, all of which are large, domestic insurance agencies like [sub].

of [Co.]. Shares are subject to a call by [Co.] in the event the shareholder terminates its insurance policy and to a put by any shareholder who has owned the shares for at least five years and is no longer insured.

Analysis

Under 12 USC 24(Seventh), national banks possess "all such incidental powers as shall be necessary to carry on the business of banking." The Supreme Court's decision in *NationsBank of North Carolina, N. A.* v. *Variable Annuity Life Insurance Co. ("VALIC")*[2] established that the "business of banking" is not limited to the five powers that are enumerated in section 24(Seventh) but encompasses more broadly activities that are part of the general business of banking. The *VALIC* decision further established that national banks may engage in activities that are incidental to the business of banking as a whole, as well as those that are incidental to the enumerated activities. "Necessary" has been judicially construed to mean "convenient or useful."[3] Thus, since *VALIC*, it is clear that incidental powers under 12 USC 24(Seventh) are those that are convenient or useful to carrying on the general business of banking.

There are several broad categories of activities that the courts have recognized as being incidental to the business of banking. One of these categories consists of activities that facilitate the operation of the bank as a business enterprise. Even though they are not substantive banking activities, they are necessary (i.e., convenient or useful), to the operation of the bank as a business. These activities include such things as hiring employees, owning or renting business equipment, borrowing money, and advertising the bank's services.[4]

Purchasing insurance for the bank's own risk control needs is another such activity. Similar to any other business, there are certain risks involved with operating a bank, and banks must be able to manage these risks. The Office of the Comptroller of the Currency ("OCC") has long recognized that national banks may purchase insurance for themselves as an activity that is incidental to banking.[5] Thus, it is permissible for [sub] to acquire the liability insurance that it needs to conduct its business in a prudent manner.

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[2] 513 U.S. 251 (1995).

[3] *Arnold Tours, Inc.* v. *Camp*, 472 F.2d 427 (1st Circuit 1972).

[4] *Franklin National Bank* v. *New York*, 347 U.S. (1954) (advertising); *Wyman* v. *Wallace*, 201 U.S. 230 (1905) (borrowing money).

[5] E.g., 12 CFR 7.2013; OCC Bulletin 2000–23, *reprinted in* 4 Fed. Banking L. Rep. (CCH) ¶ 35–491 (July 23, 2000); Interpretive Letter No. 845, *reprinted in* [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–300 (October 20, 1998); Interpretive Letter No. 554, *reprinted in* [1991–1992 Transfer Binder] Fed. Banking L.Rep. (CCH) ¶ 83,301 (May 7, 1990); letter of James M. Kane, Central District counsel (June 8, 1988) (unpublished); Interpretive Letter No. 429, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,653 (May 19, 1988).

Even though national banks generally may not purchase shares of stock for investment purposes, the ownership of stock is incidental to banking, and thus permissible, when it is convenient or useful to the operation of the bank as a business and there is no speculative or investment motive. For example, the OCC has found the ownership of equities to be permissible in instances where such ownership has facilitated the management of risk inherent in equity-related banking activities being conducted by the bank.[6] Stock ownership has also been held to be permissible when it was deemed to be necessary to facilitate a bank's participation in a permissible banking activity or, as in the present case, obtain a product or service that the bank needed for its business.[7]

Accordingly, the OCC has previously approved stock ownership in insurance carriers where it was necessary in order to obtain directors' and officers' liability insurance, a type of coverage analogous to that involved here.[8] The situation you describe in your letter falls squarely within these precedents. As in those letters, it was necessary for [sub] to own shares of [Co.] stock in order to obtain coverage under the [Co.] program. [Sub] was unable to obtain the needed liability insurance from virtually any other source. The only other alternatives were to accept an inferior policy or self-insure.

You note that there is no anticipated return on the [Co.] stock other than dividends and no market for the stock other than repurchase by the issuer at book value under certain circumstances. You believe this demonstrates that the bank and [sub] had no investment or speculative motive in purchasing the stock. The OCC has, in fact, viewed limits on the transferability of stock as evidence of a lack of investment motive[9] and has found that the possibility of receiving dividends does not necessarily indicate the presence of such a motive.[10]

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[6] The OCC has found that it is legally permissible for a national bank to purchase and hold equity securities that banks do not generally have authority to purchase in order to hedge customer-driven, bank-permissible equity derivative transactions. "Equity derivative transactions" are transactions in which a portion of the return is linked to the price of a particular equity security or to an index of such securities. They include such things as equity and equity index swaps, equity index deposits, and equity-linked loans and debt issues. Interpretive letter No. 935, [___–___]Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–460 (May 14, 2002); Interpretive Letter No. 924, [___–___Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–449 (January 2, 2002); Interpretive Letter No. 892, *reprinted in* [2000–2001 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–411 (September 8, 2000).

[7] E.g., Interpretive Letter No. 878, *reprinted in* [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–375 (December 22, 1999) (national banks may invest in equity mutual funds in order to hedge employee deferred compensation obligations that are tied to the value of the same funds); Interpretive Letter No. 421, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988) (ownership of shares of Government Securities Clearing Corporation to obtain securities clearing services); Interpretive Letter No. 380, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 (December 29, 1986) (shares of an options clearing corporation in order to obtain options clearing services); letter of John E. Shockey, deputy chief counsel (December 19, 1975) (unpublished; purchase of shares in Depository Trust Company to obtain securities clearing and custody services).

[8] Interpretive Letter No. 554, *supra* note 5; letter of James M. Kane, *supra* note 5.

[9] Interpretive Letter No. 421, *supra* note 7.

[10] Interpretive Letter No. 554, *supra* note 5.

Under these circumstances, the bank's indirect purchase of [Co.] stock through [sub] should be treated as a cost of obtaining insurance for the bank, an activity that is permissible under 12 USC 24(Seventh). The investment is nominal, amounting to less than one percent of [Co.]'s outstanding shares and a tiny fraction of one percent of the bank's capital. Accordingly, we conclude that it is permissible for [sub] to retain the shares of [Co.] stock purchased in connection with obtaining liability insurance coverage for itself.

Regulation K of the Board of Governors of the Federal Reserve System, 12 CFR part 211, governs international operations of U. S. banks. The bank should determine whether Federal Reserve approval for the purchase of [Co.] stock is required pursuant to this regulation, and we offer no opinion on that question.

This opinion is based on the representations in your letter. Any material change in the facts could require a different conclusion. I trust that this has been responsive to your inquiry. If you have further questions, please contact Christopher Manthey, special counsel, Bank Activities and Structure Division, at (202) 874–5300.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

966—May 12, 2003

12 USC 29A
12 USC 24(7)

Re: Request by [ ]

Dear [ ]:

This letter responds to your request on behalf of [ ] ("sub"), a wholly owned subsidiary of [ ] ("bank"). [Sub] provides relocation-related services for corporate customers' relocating employees. As part of these services, [sub] wishes to acquire, for a short period of time, title to the relocating employees' residential real estate. The bank believes that [sub] needs to acquire title in order to provide a package of relocation services that is competitive in the marketplace. For the reasons discussed below, and subject to the conditions below, we believe that [sub] may permissibly acquire an interest in the residential real estate of relocating employees.

I. Background

A. [Sub]'s Current Activities

[Sub]'s primary current activity is that of a finder—bringing together unaffiliated companies that provide relocation-related services, i.e., movers, realtors, insurers, with its corporate customers and their relocating employees. [Sub] also makes advances to the relocating employees based on valuations of their homes provided by third-party appraisals. Repayment of these loans is made through the sale proceeds of the homes and is guaranteed by the corporate customers.[1] The bank charges corporate customers an overall fee for the package of relocation services, and the costs of services provided by third parties—such as movers and realtors—are the responsibility of the corporate customers.

The transfer of the residential real estate from the relocating employee to the ultimate purchaser occurs through a "deed-in-blank" process.[2] Once [sub] and the relocating employee agree upon a sales price—based upon the third-party appraisals—the relocating employee signs a limited pow-

[1] Prior to entering into an agreement with a potential corporate customer, [sub] conducts a full evaluation (including credit risk rating) of the financial condition and prospects of the potential customer. [Sub] only contracts with those potential customers for which the evaluation leads [sub] to believe it will be able to rely upon any future guarantees made by the potential customer.

[2] In this process, the relocating employee signs a deed but the buyer's signature remains open. When the property is sold and the transaction closes, the name of the eventual purchaser is inserted on the deed. Title to the property remains vested in the relocating employee's name until the physical closing of the property with the eventual purchaser, at which time the purchaser becomes the title-holder. This process does not require [sub] to take title to the property.

er of attorney and a deed-in-blank (which are held by [sub]), receives the advance from [sub], and moves away. On behalf of its corporate customer, [sub] finds an unrelated third party as realtor to list and market the property. Upon receipt of an acceptable offer, typically not less than 95 percent of the appraised value, [sub] completes the sale on behalf of the departed employee per the power of attorney and the deed is transferred. The sales proceeds are used to repay the advance, with the relocating employee receiving any excess funds. If the actual sales price is less than the agreed-upon sales price, the corporate customer reimburses [sub] for the difference.

The bank represents that approximately 70 percent of the real estate transfers involves [sub]'s holding the deed-in-blank for less than two weeks. In the remaining transfers, [sub] holds the deed-in-blank for some longer period of time. The bank further represents that, during this period of time, [sub] does not manage the real estate. Rather, on behalf of the corporate customer, [sub] finds an unrelated, third-party real estate management company to manage the real estate.

B. [Sub]'s Proposal

For competitive reasons, [sub] wants to start using a "two-deed" process for real estate transfers. Under the two-deed process, rather than sign a blank deed, the relocating employee would deed title to the real estate to [sub]. [Sub] would hold title to the real estate until a purchaser could be located and then would deed title to the purchaser. All other aspects of the two-deed process are identical to the deed-in-blank process.

The bank represents that [sub]'s competition in the employee relocation industry has adopted the two-deed real estate transfer process. The switch to the two-deed transfer process was driven by the reliance of IRS Employment Tax offices on a 1997 Tax Court decision to deny favorable federal tax treatment to relocation home purchase transactions using the deed-in-blank process.[3] In May 2001, the Employee Relocation Counsel—an association of employee relocation companies and professionals—recommended that its members adopt the two-deed real estate transfer process.[4] The bank represents that [sub]'s competitors have adopted the two-deed process and that [sub], in order to remain competitive in the relocation services market, must make use of the two-deed process.

[3] *See Amdahl Corp*. v. *Commissioner*, 108 T.C. 507 (1997). Prior to the *Amdahl* decision, the Internal Revenue Service ("IRS") afforded favorable federal tax treatment to relocation home purchase transactions using the deed-in-blank process. Since the decision, several IRS Employment Tax offices have denied favorable tax treatment to deed-in-blank transactions, instead holding that all home relocation purchase expenses incurred by a corporation on behalf of its employee are taxable as income to the employee and subject to employment taxes. The two-deed transfer process continues to receive favorable federal tax treatment.

[4] *See* http://www.relo-center.com/PDF_Files/ERC_TwoDeed_WhitePaper.pdf (report of the Employee Relocation Council).

II. Discussion

[Sub]'s current activities—acting as a finder and making loans—are part of the business of banking and were approved in an earlier letter.[5] The bank now indicates that [sub] needs to take title to the residential real estate, as part of the two-deed transfer process, in order to provide a competitive package of relocation services. The only issue in permitting [sub] to acquire title to the residential real estate is based upon the restrictions of 12 USC 29. We believe that [sub] may permissibly acquire an interest in the residential real estate of relocating employees, sufficient to permit [sub] to use the two-deed transfer process, subject to the following conditions and restrictions:

(1) [Sub] must use an unrelated third party as nominee to acquire and hold legal title.

(2) [Sub] must not make use of or enjoy the benefit of the property.

(3) [Sub] must contract with an unrelated third party to manage the property.

(4) [Sub] may not hold any property for longer than ninety days and must establish internal policies and procedures for the immediate disposition of properties when that time limit is reached.

Arguably, section 29 is not implicated by the severely circumscribed interest [sub] would acquire.[6] However, for purposes of the following analysis only, we will assume that [sub]'s interest is subject to the restrictions of section 29.

Numerous Office of the Comptroller of the Currency ("OCC") precedents and case law have confirmed that national banks may provide a variety of ancillary nonbanking products and services to promote consumer use or demand for banking products.[7] Indeed, the OCC has found that the acquisition of an interest in real estate may be incidental to a primary permissible transaction. In Interpretive Letter No. 770, the OCC confirmed that a national bank could acquire a leasehold

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[5] Letter from Donelle H. Ward, director for Analysis (December 20, 1990) (unpublished).

[6] *See* Corporate Decision No. 2001–30 (October 10, 2001) (acquisition of an interest in real estate that does not encompass the full right to possess, use, and convey the property does not implicate section 29).

[7] For example, in Interpretive Letter No. 880 the OCC approved, as incidental to a package of permissible real estate investment advisory services, a national bank's taking part in the negotiation of Internal Revenue Code Section 1031 exchange transactions involving real estate. The letter found that such negotiation services were necessary for the bank to compete successfully with types of firms that offered a full range of real estate investment advisory services. The letter also found that the negotiating services constituted an extremely small part of the overall advisory services. Interpretive Letter No. 880, *reprinted in* [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–373 (December 16, 1999). This proposition is also supported by case law. *See Clement National Bank* v. *Vermont*, 231 U.S. 120 (1913) (to promote use and demand of its banking service, national bank may compute, report, and pay tax levied on interest earned by bank customers on their deposits); *Miller* v. *King*, 223 U.S. 505 (1912) (to encourage use of bank's deposit services, national bank may institute lawsuit on behalf of customer to collect funds); *Corbett* v. *Devon Bank*, 299 N.E.2d 521 (Ill. App. 1973) (as means of promoting its banking business, national bank may sell state motor vehicle licenses).

interest in the real estate underlying a fuel facility, incidental to the acquisition of the facility for the purposes of leasing, if such leasehold interest is necessary to provide security for the lender's ability to repossess the facility and continue to use or sell the property in the event of default by the lessee. This position was predicated on the real property interests being, in fact, incidental to the primary transaction—the personal property lease.[8]

Here, several factors indicate that [sub]'s acquisition of an interest in the residential real estate is incidental to the relocation services. First, the ability to acquire such interest is necessary to [sub]'s ability to compete successfully with other relocation services providers. If [sub] cannot perform the services in a manner that provides its corporate customers with favorable tax treatment, the bank represents that [sub] would be unable to compete in the relocation services marketplace.

Second, [sub] need not advance any additional funds to acquire the interest in the residential real estate. [Sub] would continue to make an advance to the relocating employee, with that advance secured by the real estate and guaranteed by the employer. Therefore, there is no additional cost to [sub] to acquire the interest under the two-deed transfer process. Third, [sub] will derive no additional revenue as a result of its acquisition of such an interest. [Sub] would continue to charge corporate customers an overall fee for the provision of services but would not charge an additional fee for acquiring the interest in the residential real estate.

Fourth, once the residential real estate is sold to the ultimate purchaser, there would be no additional benefit or detriment to [sub]. Sales proceeds would still be used first to repay the advance from [sub], with the corporate customer guaranteeing any shortfall. Any excess sales proceeds remaining would still flow to the relocating employee, and the costs of services provided by third parties—such as movers and realtors—would remain the responsibility of the corporate customers. Therefore, there is no additional financial upside or downside to [sub]'s acquisition of such an interest.[9]

Fifth, as a result of the conditions and restrictions listed above, [sub]'s interest in the residential real estate would be severely circumscribed. [Sub] must engage a nominee to hold legal title. [Sub] lacks the major elements of beneficial ownership: [sub] must not make use of or enjoy the property, and it must not manage the property. [Sub] may only hold the indicia of ownership in the property for a short period of time and must have policies and procedures in place to dispose

[8] Interpretive Letter No. 770, *reprinted in* [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81–134 (February 10, 1997). *See also* 61 *Federal Register* 66554, 66556 (December 18, 1996) (reaffirming in the preamble that real estate leasing may be an incidental component of personal property leasing and that OCC would make this determination on a case-by-case basis).

[9] In each case where [sub] acquires an interest in a relocating employee's residential real estate, the contract between [sub] and the corporate customer would require the corporate customer to maintain, at its own expense, a homeowner's insurance policy on the residential real estate. The contract between [sub] and the corporate customer would further provide that the corporate customer will indemnify [sub] for any liability that may arise out of [sub]'s taking an interest in the property.

of the property when that time limit is reached. Indeed, [sub]'s circumscribed interests would not be inconsistent with any of the purposes underlying the restrictions of section 29.[10] The bank's funds, through [sub], would not be removed from the channels of commerce because the bank would not advance any additional funds to acquire the indicia of ownership. There is no speculation in the value of the real estate because any sales proceeds remaining after the equity advance is repaid flow to the relocating employee. Finally, no significant amount of real estate will be accumulated and held by the bank as the bank would be required to dispose of each property within a short time period.

Therefore, for the reasons stated above and subject to the conditions and restrictions listed above, we believe that [sub] may permissibly acquire an interest in the residential real estate of relocating employees incidental to the provision of its package of relocation services. 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

[10] For example, the Supreme Court in *Union National Bank* v. *Matthews*, 98 U.S. 621, 626 (1878), stated that the three purposes underlying section 29 were "to keep the capital of the banks flowing in the daily channels of commerce; to deter them from embarking in hazardous real estate speculations; and to prevent the accumulation of large masses of such property in their hands, to be held, as it were, in mortmain."

967—June 6, 2003

12 USC 24a
12 CFR 5.39

Subject: Insurance Financial Subsidiaries—Risk Management Services

Dear [ ]:

This responds to your letter requesting the Office of the Comptroller of the Currency's ("OCC's") confirmation that [bank] *[City, State]* ("bank") is not required to file a notice if the bank's previously approved insurance agency financial subsidiaries provide risk management services as part of their insurance agency activities. Specifically, the bank would make available training and safety programs designed to reduce the insurance risks of customers in the trucking business.

For the reasons discussed below, we believe the bank's previously approved insurance agency financial subsidiaries are authorized to offer the proposed risk management services as part of their existing insurance agency activities. The bank therefore is not required to file a notice under 12 CFR 5.39.

A. Background

National bank operating subsidiaries and financial subsidiaries are authorized to act as insurance agents or brokers.[1] Operating subsidiaries that act as insurance agents qualify for the OCC's notice procedures,[2] and financial subsidiaries that act as insurance agents also qualify for the OCC's notice procedures, provided the bank has filed a financial subsidiary certification.[3] The bank already owns financial subsidiaries that are engaged in insurance agency activities. The bank submitted the requisite notice and certification to form and operate these financial subsidiaries as insurance agencies in October 2001 ("financial subsidiaries").

You have indicated that many of the larger insurance agencies assist businesses and individuals in managing their risk of loss by providing consulting services to manage risk of loss.[4] You represent that these services include safety programs tailored to specific businesses, such as providing

[1] 12 CFR 5.34(e)(5)(v)(P) and 5.39(e)(1)(ii).

[2] 12 CFR 5.34(e)(5)(v).

[3] 12 CFR 5.39(i)(1) and 5.39(e)(1)(ii).

[4] We understand that insurance agents and brokers often assist customers in selecting insurance carriers and oversee the services being provided to customers by insurance company safety professionals. The insurance agents and brokers provide risk management services to identify new insurance agency business, retain existing profitable insurance business, reduce claims, reduce transactions costs, reduce premiums, improve service, and ensure appropriate insurance coverage.

training and safety programs for customers in the trucking business. You also enclosed materials demonstrating that insurance brokers and agencies routinely offer risk management services.[5] Among these materials were advertisements for insurance agencies demonstrating that insurance agencies are providing risk management services variously described as "Transportation and Fleet Safety"[6] and "Driver Safety Training"[7] courses.[8]

B. Discussion

The bank has requested the OCC to confirm that the bank is not required to file a notice with the OCC if the bank's previously approved insurance agency financial subsidiaries provide risk management services as part of their insurance agency activities. A bank is required to file a notice for an existing financial subsidiary if the bank seeks OCC approval to commence a new activity in the financial subsidiary authorized under 12 USC 24a.[9]

As you have demonstrated, the financial subsidiaries' proposed risk management activities are part of an insurance agency's activities. The Federal Reserve Board has similarly concluded in a letter dated July 10, 2002, that an insurance agency owned by a financial holding company may provide risk management services in connection with its insurance sales activities.[10] The Federal Reserve Board confirmed in its letter that risk management services are encompassed within 12 USC 1843(k)(4)(B) insurance activities, and thus may be conducted by a financial holding company, if the services are provided by an insurance agent or broker in connection with its other insurance sales activities.

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[5] The bank identified several insurance brokers or agents that provide risk management services, including Wachovia DavisBaldwin, Hamilton Dorsey Alston Company, Rebsamen Insurance, ABD Insurance and Financial Service, and Arthur J. Gallagher & Co.

[6] Wachovia DavisBaldwin.

[7] ABD Insurance Service.

[8] Examples of other risk management services provided by the insurance agencies included services variously described as Occupational Safety and Health Administration compliance programs, Department of Transportation. compliance programs, substance abuse programs, ergonomics, safety compliance, and training courses.

[9] 12 CFR 5.39(i)(1)(ii) and 5.39(i)(2).

[10] *See* 2002 Federal Reserve Interpretive Letter LEXIS 5 (July 10, 2002). The types of risk management services reviewed by the Federal Reserve Board in its letter included: (i) assessing the risk of a client seeking insurance and identifying the client's exposure to loss; (ii) designing programs, policies, and systems such as workplace safety programs to reduce the client's risks; (iii) advising clients about risk management alternatives to insurance such as self-insurance, securitization, or derivatives; and (iv) negotiating insurance coverages, deductibles, and premiums for an insurance client.

The bank's proposal to provide risk management services similarly fits within the bank's existing authorization to engage in insurance activities pursuant to the bank's notice and certification to form and operate its existing financial subsidiaries as insurance agencies in October 2001. Accordingly, the bank is not required to file a notice with the OCC for the bank's insurance agency financial subsidiaries to engage in the proposed risk management activities.

If you have any questions concerning the foregoing, please contact Asa L. Chamberlayne, counsel, at (202) 874–5210.

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel