Quarterly Journal

Interpretations — April 1 to June 30, 2004

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986—February 24, 2003

12 USC 24(7)

[Summary: Letter discusses the distinction between technology advisory services that are part of the business of banking (advice on processing banking, financial or economic data) and can be offered to anyone versus advisory services that are incidental and, thus, can be offered only to customers of linked banking products (advice on general technology that customers can use to connect to on-line bank services).]

Richard E. Brophy Jr.
Naman, Howell, Smith & Lee
P.O. Box 1470
Waco, TX 76703

Subject: Operating Subsidiary Application by Extraco Banks, N.A., Waco, TX, to Expand Activities of Extraco Institutional Services Corp., Application Control Number: 2002-WO-08-0002

Dear Mr. Brophy:

By letter dated June 28, 2002, OCC Corporate Decision No. 2002-11 (the "approval letter"), the OCC approved an application by Extraco Banks, N.A., (the "bank"), Waco, TX, under 12 CFR 5.34 to expand the scope of activities performed by an operating subsidiary of the bank, Extraco Institutional Services Corporation (the "company"). Based on the commitments and representations in the bank's application and other materials, OCC approved the company's proposal to provide advisory and consulting services to bank customers who use the bank's electronic retail or wholesale transactional services; the advice would cover the hardware, software, and other technologies necessary to use those services. Likewise, based upon these commitments and representations, OCC approved the company's proposal to provide advisory and consulting services to business customers on the hardware, software, and other technology necessary to enable those customers to process for themselves banking, economic, and financial information. The bank now seeks clarification from the OCC on whether the company can provide the second category of advisory activities to persons or entities not currently "bank customers." For the reasons below, the company may do so under the approval letter.[1]

As you note, in the approval letter, the OCC approved essentially two categories of advisory activities. Under the first category, the company would provide advisory and consulting services to

[1] Since the proposed activities fall within the intent and scope of the approval letter, I conclude that the proposed activities are not "new" activities for purposes of 12 CFR 5.34(e)(5)(i) and, thus, that no additional application under that section is required.

bank retail and business customers with regard to the installation of necessary hardware, software, telephone lines, modems and other devices in order to operate the bank's Internet-based banking products.

Under the second category, the company would provide advice and consulting services to business customers on the processing of banking, financial, and economic data for themselves, including the hardware and software needed to enable customers to process such data. With regard to the second category, the bank represented that such banking, financial, and economic data would include accounts receivable, accounts payable, revenues, expenses, and similar financial data and that the advisory and consulting services would be limited to the type of banking, financial, and economic data that the bank would be permitted to process on behalf of its customers.

The approval letter concluded that both categories of advisory activities came within the provision of the OCC's final regulation on electronic activities of national banks that codified the existing OCC position on a national bank's authority to engage in data processing activities. The new regulation provides in relevant part:

> It is part of the business of banking under 12 USC 24(Seventh) for a national bank to provide data processing, and data transmission services, facilities (including equipment, technology, and personnel), data bases, advice and access to such services, facilities, data bases and advice, for itself and for others, where the data is banking, financial, or economic data, and other types of data if the derivative or resultant product is banking, financial, or economic data. For this purpose, economic data includes anything of value in banking and financial decisions.

12 CFR 7.5006(a) (emphasis added.)

The approval letter stated:

> Here, . . . the proposed advisory services entail providing advice on the processing of banking, financial, or economic data. The company proposes to advise retail and wholesale bank customers, who use the bank's electronic transactional services, on the hardware, software, and other technologies necessary to use those services. Such advice is clearly focused on the processing of banking data. The company also proposes to provide advisory and consulting services to business customers on the hardware, software, and other technology necessary to enable bank customers to process banking, economic, and financial information for themselves. This would include processing of information on the customer's accounts receivable, accounts payable, revenues, expenses, and similar financial data. The bank has committed that it will limit its advisory and consulting services to the type of banking, financial, and economic data that the bank would be permitted to process on behalf of its customers.

(Footnote omitted.)

The first category of approved advisory activities was intended to be limited to persons or entities that had an existing business relationship with the bank. The advisory activities approved were those that related to the technology needed to support that banking relationship. Limiting the advice to the customer's underlying bank service relationship assures that the first category of advisory services will pertain only to "banking" data and, thus, will fall within 7.5006(a).

However, the second category was not intended to be so limited. With respect to the second category, the bank expressly committed that the advisory and consulting services would be "limited to the type of banking, financial, and economic data that the bank would be permitted to process on behalf of its customers." This commitment is sufficient to assure that the second category will be within 7.5006(a) irrespective of whether the specific business customer of the company also has a banking relationship with the bank.

As you point out, what matters under 7.5006(a) is the nature of the data being processed, not whether the entity receiving the processing also receives other banking services from the bank. As demonstrated in the first category of approved services, one way to assure that data being processed is "banking" data is to require that the data be connected to the consumption of banking services. However, this is not the only way to satisfy 7.5006(a). An express commitment that processing will be limited to financial data permitted for national banks, which the bank provided and which formed the basis for the approval of the second category, is equally effective.

Thus, the approval letter's reference to "bank customers" in the second category was intended only to reflect the bank's commitment that the company would be limited to the type of advice the bank would be permitted to provide to "bank customers." However, there was no intent to limit the company to providing the second category of advice only to customers of the bank.

This letter merely interprets the scope of the approval letter and is not itself a new or additional approval. For this reason, the proposed activities discussed in this letter remain subject to all the commitments and representations referenced in the approval letter. We expect that the company will conduct all its advisory activities in conformance with OCC Corporate Decision No. 2002-11.

Sincerely,

Julie L. Williams

First Senior Deputy Comptroller and Chief Counsel

987—March 17, 2003

12 CFR 3

[Summary: Letter opines that in most instances second mortgages liens will not constitute recourse because second mortgage liens generally do not function as credit enhancements under the risk-based capital guidelines.]

Dear [ ],

Thank you for your letters requesting clarification on the appropriate capital treatment for second liens in structured mortgage transactions. As you know, the agencies [Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, and the Office of Thrift Supervision] issued a final rule on November 29, 2001, titled the ". . . Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations" ("final rule"). The final rule addresses a variety of exposures retained or assumed by a banking organization. In the preamble to the final rule, the agencies stated that "second liens will not, in most instances, constitute recourse. Second mortgages or home equity loans generally will not be considered recourse arrangements unless they actually function as credit enhancements." [66 *Federal Register* 59621]

In drafting the final rule, the agencies' determined that second mortgages generally would not meet the definition of a recourse arrangement, even when the first and second mortgage were made to the same borrower at the same time. The agencies view the second mortgage as a separate transaction that does not—in and of itself—serve as a credit enhancement. Generally, the holder of the first mortgage has a senior claim on the collateral supporting the mortgages but would not have any rights to payments made on the second mortgage. This is in contrast to a typical recourse arrangement where any payments made by the underlying borrowers are first used to satisfy the claims of the senior investors in accordance with the terms and conditions of the transaction. Further, the credit risk present in most structured second liens is similar in most aspects to second liens originated on a standalone basis, which are not considered to be recourse obligations under our existing rules. For these reasons, the agencies do not believe that the second mortgage liens referenced in your letters meet the definition of recourse as set forth in the final rule.

The agencies are aware of elevated credit risk related to high loan-to-value financing. Institutions with concentrations of second liens in structured mortgage programs are often subject to higher examiner scrutiny and, in some cases, higher capital requirements. For example, the agencies have issued subprime and high loan-to-value residential real estate guidance that indicates when examiners should assess higher capital charges for loans that pose a higher degree of credit risk. We will also consider your concerns, particularly with regard to the high loan-to-value structured mortgage programs, in future revisions to our capital standards as part of our efforts to more closely align regulatory capital requirements with risk.

Please contact Tom Boemio, Senior Supervisory Financial Analyst at the Federal Reserve Board on (202) 452-2982; Amrit Sekhon, Risk Expert at the OCC on (202) 874-5211; Jason Cave, Chief, Capital Markets Policy at the FDIC; or Michael Solomon, Senior Program Manager for Capital Policy at the OTS on (202) 906-6669, if you have any further questions with regard to this clarification of the capital treatment of second liens in structured mortgages.

Sincerely,

Tommy Snow
Director, Capital Policy
Comptroller of the Currency

Norah Barger
Deputy Associate Director
Federal Reserve Board

John C. Price
Director, Supervision Policy
Office of Thrift Supervision

George French
Deputy Director
Federal Deposit Insurance Corporation

988—July 28, 2003

12 CFR 3

[Summary: Letter examines various synthetic securitizations using credit derivatives. Reaffirms application of joint agency guidance on synthetic collateralized loan obligations, OCC Bulletin 99-43, "Risk-Based Capital Interpretations [for] Credit Derivatives: Joint Agency Statement" (November 15, 1999) (with attached revisions to "Annex"), and final rule on ". . . Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations," 66 Federal Register 59614 (November 29, 2001), to synthetic securitizations of residential mortgage loans that employ credit default swaps (CDS) and credit-linked notes (CLN) to provide credit protection to mezzanine positions. It also concludes that mezzanine credit protection provided by the bank in a government-sponsored enterprise (GSE) transaction is considered credit support under the recourse provisions in final rule amending the risk-based capital guidelines.]

Dear [ ]:

This is in response to your letter to Michael L. Brosnan and Stuart Desch dated March 5, 2003, requesting a risk-based capital interpretation for [ ] (the "bank") for three proposed transactions. In your letter, you describe two synthetic securitizations of residential mortgage loans (transactions 1 and 2) and a government-sponsored enterprise (GSE) transaction (transaction 3) and request approval to apply a risk-based capital treatment based on both the November 15, 1999 joint agency guidance on synthetic collateralized loan obligations ("joint agency guidance"),1 and the November 29, 2001 final rule titled ". . . Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations" ("final rule").[1] The Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board (FRB) staffs have determined that, while transactions 1 and 2 are not specifically described in the joint agency guidance or the final rule, the principles established in that guidance and rule may be applied to those proposed synthetic transactions. For transaction 3, the mezzanine credit protection provided by the bank should be considered credit support under the final rule and receive the capital treatment described therein. The risk-based capital treatment that should be applied to each of the transactions is described below. The risk-based capital treatment for transactions 1 and 2 described in this letter is conditional upon the bank satisfying the risk management and disclosure conditions detailed in the annex to the joint agency guidance, as amended by this letter.

Transaction 1

In this synthetic structure, the bank will select and isolate a static reference pool of whole loan residential mortgages, which remain on the bank's balance sheet. The credit risk of the reference

[1] OCC Bulletin 99-43, FRB SR Letter 99-32.

pool will be stratified into notional segments or tranches that are expected to consist of equity, mezzanine, and senior positions. The bank will retain the risk of the equity and senior positions, and all of the positions above the equity position will be rated by two nationally recognized statistical rating organizations (NRSROs). The mezzanine tranches are expected to be rated in the range of B to A, and the retained senior tranches will be rated AA and AAA. The bank will subsequently enter into credit default swaps (CDS) with either an OECD bank, a securities firm counterparty that qualifies for a 20-percent risk weight, or with a bank-sponsored variable interest entity. If a variable interest entity is used, the entity will issue credit-linked notes (CLNs) to unaffiliated third parties equal to the notional amount of the CDS. The proceeds from the issuance of the CLNs will be invested in OECD government and GSE securities that will be held as collateral for the CDS. Regardless of whether a variable interest entity is used, the CDS will reference the payment and credit performance of the loans in the reference pool and will provide the bank with credit protection in the event credit losses exceed the retained equity position. The maturities of the CDS will match the maturities of each referenced tranche, which will match the maturity of the longest loan in the reference pool.

The proposed transaction 1 is similar, but not identical, to structure 2 in the joint agency guidance.3 In both structures, the bank retains the first loss position and the senior position and obtains credit protection on the rated mezzanine positions. However, in the joint agency guidance, the mezzanine position includes a tranche rated AAA. As a result, the retained position is senior to a AAA-rated position. In transaction 1 proposed by the bank, the highest rating on the mezzanine position is A and the retained senior positions are rated AA and AAA. Additionally, the credit protection obtained for the mezzanine position in structure 2 in the joint agency guidance was in the form of CLNs collateralized by OECD government securities. In the proposed transaction 1, the credit protection on the mezzanine position may be in the form of either CDS or CLNs collateralized by both OECD government securities and GSE securities.

Risk-Based Capital Treatment for Transaction 1

The preamble to the final rule states, "With the issuance of this final rule, the agencies reaffirm the validity of the structural and risk management requirements of the [November] 1999 guidance on synthetic securitizations issued by the Board and the OCC, while modifying the risk-based capital treatment detailed therein with the treatment presented in this final rule."[2] This statement was further clarified by the "Interagency Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations" ("interagency Q&A").[3] The interagency Q&A modified the qualification requirements for structure 2 in the joint

[2] 66 Federal Register 59614-67, ["Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations; Final Rules" (November 29, 2001)]. [Also in OCC Bulletin 2001-49, "Risk-Based Capital-Recourse, Direct Credit Substitutes, and Residual Interests: Final Rule" (December 6, 2001).]

[3] OCC Bulletin 2002-22, FRB SR Letter 2002-16, May 23, 2002.

agency guidance to eliminate the restriction on the size of the first-loss position. Consequently, the final rule does not alter the risk-based capital treatment for this type of transaction: dollar-for-dollar capital on the retained first loss piece, recognition of the collateral to reduce the risk weight on the mezzanine position, and a 20-percent risk weight on the retained senior position if it is senior to AAA-rated CLNs.

The final rule explicitly references credit derivatives as examples of recourse and direct credit substitute exposures. A bank or bank holding company (a banking organization) providing credit protection through a credit derivative would therefore be considered to have a recourse or direct credit substitute exposure, the capital treatment for which is described in the final rule. However, the final rule does not explicitly address the situation where a banking organization has purchased credit protection through the use of a credit derivative. While the bank in transaction 1 has obtained credit protection through a credit derivative in a synthetic securitization, it has neither retained credit risk on sold assets (recourse) nor assumed credit risk associated with an asset that was not previously owned by it (direct credit substitute). Therefore, the risk-based capital treatment for either recourse or direct credit substitute positions established by the final rule is not directly applicable to the retained senior position in transaction 1.

The OCC and FRB staffs believe that the principles established in the final rule, the joint agency guidance, and the interagency Q&A may be applied to the synthetic securitization described by the bank as transaction 1. The bank may recognize the AA and AAA ratings received on the retained senior positions and assign a 20-percent risk weight to those untraded positions in accordance with the ratings-based approach of the final rule. The bank must hold dollar-for-dollar capital for the retained equity position. If the credit protection obtained on the mezzanine position is in the form of CDS, the bank could risk-weight that position according to the risk weight appropriate for the counterparty. If the credit protection is in the form of CLNs collateralized by OECD government securities, the bank could risk-weight the position at 0 percent according to the joint agency guidance. If the credit protection is in the form of CLNs collateralized by GSE securities, the bank could risk-weight the position at 20 percent according to the agencies' risk-based capital rules for the recognition of collateral.

The OCC and FRB staffs consider this risk-based capital interpretation as a new case under the joint agency guidance, and therefore, the capital treatment is subject to the bank satisfying the risk management and disclosure requirements contained in the annex to that guidance. After reviewing the conditions in the annex in the context of industry advances in the risk measurement and management of synthetic securitizations since the publication of the joint agency guidance, the OCC and FRB staffs have decided to modify the requirements of that annex. Those modifications are described later in this letter.

Transaction 2

Transaction 2 is identical to transaction 1 except for the addition of a call option and loan removal provisions. The call option permits the bank to call a tranche of the synthetic securitization that has third-party credit protection under two circumstances: (1) if a tranche with third-party credit protection receives a rating upgrade to AAA from all NRSROs rating the position; or (2) if all of the loans in the original reference portfolio are no longer on the bank's balance sheet. The call option allows the bank to "right size" the credit protection when the credit quality of the portfolio has improved significantly or the protection is no longer needed. If CLNs were issued, the bank would pay a premium on the CLN redemption if it exercised the option within five years of closing the transaction.

The on-balance-sheet loans that the bank selects for the reference portfolio will be loans that are held for asset and liability management purposes. As part of its liquidity management process, the bank may find it necessary or advantageous to sell or securitize the earmarked loans. The terms of transaction 2 permit the bank to sell or securitize such loans provided the loans are no more than 30 days past due.

As described in your letter and in follow-up conversations among OCC, FRB, and the bank's staff, you have represented that the call feature and loan removal provision are not intended to provide credit support to the synthetic securitization. The bank generally may only exercise the options when the credit quality of the portfolio has improved or remains constant. If the credit quality of the pool has deteriorated, the CLN tranches would be less likely to receive a rating upgrade to AAA, making those tranches ineligible to be called.

Risk-Based Capital Treatment for Transaction 2

The bank may apply the same risk-based capital treatment for transaction 2 as described above in this letter for transaction 1. If the bank exercises its call options so that all of the mezzanine CDS and CLNs are called, the structure would no longer be considered a securitization since there would no longer be any risk transference. The bank would now be exposed to the entire remaining amount of the mortgage portfolio, including that portion initially protected by the mezzanine tranches issued to third parties. The residential mortgages would be risk-weighted as loans held on the balance sheet according to the OCC risk-based capital rules contained in 12 CFR 3, Appendix A Section 3(a) and the FRB rules contained in 12 CFR 208, Appendix A, section III.C, and 12 CFR 225, Appendix A, section III.C.

Additionally, if the OCC or FRB determines that the bank is exercising the call option or loan removal provision in order to provide credit enhancement or support to the counterparties providing the mezzanine credit protection, such actions will be considered implicit recourse and will alter the capital interpretations described in this letter.

As with transaction 1, the bank must satisfy the risk measurement and management conditions described in the annex of the joint agency guidance, as modified later in this letter.

Transaction 3

In this structure, the bank would select a pool of whole loan residential mortgages and transfer the loans to a GSE in exchange for investment-grade, GSE-guaranteed mortgage-backed securities that have an undivided interest in the cash flows of the transferred loans. The bank expects to sell to third parties all of these securities and will pay the GSE an annual agency or guarantee fee for the GSE's guarantee of the timely payment of principal and interest on the securities. Contemporaneous with the transfer of loans, the bank will provide a mezzanine-level credit enhancement to the GSE on the pool sold, which may take the form of an upfront bank-funded spread account or a credit default swap. The bank will receive market compensation for this enhancement, either in the form of fees received or a reduced rate for the guarantee fee paid by the bank to the GSE.

The GSE will take the first-dollar loss risk on the sold mortgage pool. The bank enhancement will be structured to provide second-dollar loss protection above the GSE first loss position, up to a specified amount of cumulative losses. This position will be either unrated or rated by two NRSROs at BB and/or BBB.

Risk-Based Capital Treatment for Transaction 3

The OCC and FRB staffs generally agree with the risk-based capital treatment described in your letter. Based on the final rule, the credit support provided by the bank should be treated as a recourse exposure, a residual interest, or a credit-enhancing interest only strip, depending on its exact structure. For example, if the enhancement is provided through an off-balance-sheet credit default swap, then the position should be treated as a recourse exposure. If the protection is provided through an on-balance-sheet spread account, then the position should be treated as a residual interest, or possibly a credit-enhancing, interest-only strip. In addition, the applicable risk-based capital treatment might also depend on whether the enhancement is rated. Regardless of the precise form that the credit protection might take, the final rule should be used to assess the appropriate risk-based capital treatment.

Any GSE securities held should be accorded a 20-percent risk weight based on the GSE guarantee.

As you note in your letter, we would expect the portfolio to be continuously monitored and, if actual loss experience approaches or exceeds the GSE's equity position, the bank should make appropriate valuation adjustments to the CDS or the spread account and, as applicable, risk-based capital adjustments consistent with any changes in NRSRO ratings.

Modifications to the Annex of the Joint Agency Guidance

The 1999 joint agency guidance includes risk management, measurement, and disclosure requirements that a banking organization must satisfy in order for a synthetic securitization to qualify for the risk-based capital treatment described in the guidance. At the time the guidance was written, synthetic securitizations were a recent innovation, and both banking organizations and the regulatory agencies were just beginning to assess and understand the risks of such structures. As a prudential measure to ensure safety and soundness at banking organizations obtaining credit protection through such structures, the OCC and FRB developed preconditions for the preferential capital treatment described in the guidance that were intended to ensure a banking organization's ability to measure and manage the risk of both the protected on-balance-sheet portfolio, as well as its unprotected positions. Since the OCC and FRB published the guidance, synthetic securitizations have become more commonplace and the technology to measure and manage the associated risks has improved. In addition, implementation of the final rule has provided a framework for a more risk-sensitive approach to assessing regulatory capital than was available when the guidance was published. The OCC and FRB staffs have therefore decided to modify the conditions of the annex of the joint agency guidance to better reflect these developments. The OCC and FRB plan to include these modifications in a future interagency issuance on securitization. [Editor's note: issuance is forthcoming.]

Condition 1 of the annex requires a banking organization to "demonstrate that a transfer of virtually all of the risk has been achieved." The OCC and FRB have modified this condition to require banking organizations to "demonstrate that risk transference has been achieved." Similarly, condition 1.1 has been amended from "Produce credible analyses indicating a transfer of virtually all of the credit risk to substantive third parties" to read, "Produce credible analyses indicating the degree of transfer of credit risk to substantive third parties." The OCC and FRB have also amended condition 1.7, which was intended to ensure that a banking organization transferred all of the credit risk of the protected portfolio and did not reassume it in another form. The revised condition now permits institutions to retain the senior risk position. However, it continues to preclude the re-assumption of any credit risk transferred to third parties in another form for purposes of lowering the risk-based capital requirements.

Condition 1.5, which requires that the mezzanine position that is sold to third parties include a tranche that is rated AAA, has been eliminated. Condition 1.6, which limited the size of the retained first loss position to no greater than the expected loss on the portfolio, was previously eliminated with the publication of the interagency Q&A.

Condition 3 of the annex requires a banking organization to disclose in its annual and SEC regulatory reports details of synthetic securitization transactions, including the amount of reduction in economic and regulatory capital as well as risk-weighted assets. The OCC and FRB staffs have modified these disclosure requirements to apply only when synthetic securitization transactions result in a material reduction in economic or regulatory capital.

A revised version of the annex incorporating the changes discussed above is attached.

Conclusion

The risk-based capital treatments described above apply only to transactions that meet the descriptions and satisfy the conditions outlined in this letter. The treatment of other transactions will depend on the structure and terms of those transactions. The OCC and FRB staffs will continue to review and issue risk-based capital interpretations on synthetic securitizations using credit derivatives on a case-by-case basis.

If you have further questions, please contact the resident OCC examiners, Margot Schwadron on (202) 874-6022 or Amrit Sekhon on (202) 874-5211 in the OCC Capital Policy Division, or Tom Boemio on (202) 452-2982 in the FRB Supervisory and Risk Policy Section.

Sincerely,

Tommy Snow
Director, Capital Policy
Comptroller of the Currency

Barbara Bouchard
Assistant Director
Federal Reserve Board

Revised Annex

[to attachment "Capital Interpretations-Synthetic Collateralized Loan Obligations" in both OCC Bulletin 99-43, "Risk-Based Capital Interpretations—Credit Derivatives: Joint Agency Statement" (November 15, 1999) and in FRB SR Letter 99-32 (SUP), "Capital Treatment for Synthetic Collateralized Loan Obligations" (November 17, 1999)]

Minimum Conditions that Sponsoring Institutions Must Meet To Obtain the Synthetic Securitization Capital Treatment

The agencies [Office of the Comptroller of the Currency and Federal Reserve Board] may impose additional requirements or conditions as they deem necessary to ascertain that the sponsoring banking organization has sufficiently isolated itself from the credit risk exposure of the hedged reference portfolio.

Condition 1: Demonstration of transfer of virtually all of the risk to third parties

Not all transactions structured as synthetic securitizations transfer the degree of credit risk needed to receive a reduced ~~20 percent~~ risk weight on the retained senior position. To demonstrate that ~~a transfer of virtually all of the~~ *risk transference* has been achieved, institutions must:

1. Produce credible analyses indicating ~~a transfer of virtually all~~ *the degree of transfer* of the credit risk to substantive third parties;

2. Ensure the absence of any early amortization or other credit performance contingent clauses;[4]

3. Subject the transaction to market discipline through the issuance of a substantive amount of notes or securities to the capital markets;

4. Have notes or securities rated by a nationally recognized credit rating agency;

5. ~~Structure a senior class of notes that receives the highest possible investment grade rating, e.g., AAA, from a nationally recognized credit rating agency;~~

6. ~~Ensure that any first loss position retained by the sponsoring institution in the form of fees, reserves, or other credit enhancement -- which effectively must be deducted from capital -- is no greater than a reasonable estimate of expected losses on the reference portfolio; and~~

7. Ensure that they do not reassume any *transferred* credit risk ~~beyond the first loss position~~ through another credit derivative or any other means.

[4] Early amortization clauses may generally be defined as features that are designed to force a wind-down of a securitization program and rapid repayment of principal to asset-backed securities investors if the credit quality of the underlying asset pool deteriorates significantly.

Condition 2: Demonstration of ability to evaluate remaining banking book risk exposures and provide adequate capital support

To ensure that the sponsoring institution has adequate capital for the credit risk of its unhedged exposures, institutions are expected to have adequate systems that fully take into account the effect of such transactions on the institutions' risk profiles and capital adequacy. In particular, those systems should be capable of fully differentiating the nature and quality of the risk exposures an institution transfers from the nature and quality of the risk exposures it retains. Specifically, to gain capital relief institutions are expected to:

1. Have a credible internal process for grading credit risk exposures, including: (1) adequate differentiation of risk among risk grades, (2) adequate controls to ensure the objectivity and consistency of the rating process, and (3) analysis or evidence supporting the accuracy or appropriateness of the risk grading system.

2. Have a credible internal economic capital assessment process that defines the institution to be adequately capitalized at an appropriate insolvency probability and that readjusts, as necessary, its internal economic capital requirements to take into account the effect of the synthetic securitization transaction. In addition, the process should employ a time horizon sufficiently long to allow necessary adjustments in the event of significant losses. The results of an exercise demonstrating that the organization is adequately capitalized after the securitization transaction must be presented for examiner review.

3. Evaluate the effect of the transaction on the nature and distribution of the non-transferred banking book exposures. This analysis should include a comparison of the banking book's risk profile and economic capital requirements before and after the transaction, including the mix of exposures by risk grade and by business or economic sector. The analysis also should include identification of any concentrations of credit risk and maturity mismatches. Additionally, the bank must adequately manage and control the forward credit exposure that arises from any maturity mismatch. The agencies retain the flexibility to require additional regulatory capital if the maturity mismatches are substantive enough so that they raise a supervisory concern. Moreover, as stated above, the sponsoring banking organization must demonstrate that it meets its internal economic capital requirement subsequent to the completion of the synthetic securitization.

4. Perform rigorous and robust forward-looking stress testing on non-transferred exposures (remaining banking book loans and commitments), transferred exposures, and exposures retained to facilitate transfers (credit enhancements). The stress tests must demonstrate that the level of credit enhancement is sufficient to protect the sponsoring bank from losses under scenarios appropriate to the specific transaction.

Condition 3: Provide adequate public disclosures of such transactions regarding their risk profile and capital adequacy

When synthetic securitization transactions result in a material reduction in economic or regulatory capital, sponsoring institutions must provide adequate disclosure to the marketplace in their 10-K and annual reports on the accounting, economic, and regulatory consequences of such transactions. In particular, institutions are expected to disclose:

1. The notional amount of loans and commitments involved in the transactions;

2. The amount of economic capital shed through the transactions;

3. The amount of reduction in risk-weighted assets and regulatory capital resulting from the transactions both in dollar terms and in terms of the effect in basis points on the risk-based capital ratios; and

4. The effect of the transactions on the distribution and concentration of risk in the retained portfolio by risk grade and sector.

989—August 18, 2003

12 CFR 3

[Summary: Letter states that the actual operating income of a multifamily residential property must be used by the bank in order to determine whether the loan secured by a first mortgage on a multifamily residential property would satisfy the annual net operating income (debt service ratio) requirements, and therefore, quality for the 50-percent risk weight under the risk-based capital guidelines.]

Dear [ ]:

This letter is in response to your December 4, 2002, letter to Lance Cantor. In that letter you requested confirmation that an operating statement prepared by a qualified asset manager following an annual site inspection would meet the annual net operating income requirement for a loan to a multifamily property to qualify for a preferential risk weight. The OCC has determined that the on-site inspections and analyses described in your letter are not sufficient, by themselves, to satisfy the criteria outlined in section 3(a)(3)(v) of 12 CFR 3, Appendix A.

In order to qualify for a 50-percent risk weight, a loan secured by a first mortgage on a multifamily residential property must satisfy certain criteria. One of the criteria is based on the ratio of annual net operating income generated by the property to annual debt service on the loan (debt service ratio). That ratio may not be less than 120 percent for a fixed rate loan or 115 percent for a floating rate loan. The OCC has determined that actual operating income of the property must be available as a prerequisite for a lower capital requirement on multifamily residential mortgage loans.

The regulation also requires that a loan must be seasoned by requiring one year of timely interest and principal payments before the loan may qualify for the 50-percent risk weight. This seasoning requirement for the preferential risk weight is consistent with the requirement that actual net operating income be used in the annual calculation of the debt service ratio.

When a bank has timely information on the financial condition of the property securing the loan, it is able to implement appropriate actions in response to changes in asset quality and market conditions. Thus, from a safety and soundness perspective, the OCC believes a bank should have access to actual revenue and expense information on the property securing the loan in order to apply the preferential 50-percent risk weight.

If you have further questions, please contact the resident OCC examiners or Margot Schwadron on (202) 874-6022 in the OCC Capital Policy Division.

Sincerely,

Tommy Snow
Director, Capital Policy

990—October 17, 2003

12 CFR 3

[Summary: Letter concludes that merchant processing intangible (MPI) assets do not satisfy the separability, valuation, and marketability criteria, and therefore, would not constitute a qualifying intangible asset permitted to count as tier 1 capital under the risk-based capital guidelines.]

Dear [ ]:

This letter responds to your letter dated May 20, 2003, concerning the capital treatment for merchant processing intangibles (MPIs). [ ] ("the bank") requested that MPIs be included in qualifying intangible assets subject to the same limitations as purchased credit card relationships (PCCRs) for purposes of calculating tier 1 capital. The OCC has concluded that the current capital treatment of MPIs is appropriate and that the bank should continue to deduct MPIs from tier 1 capital and from assets in calculating regulatory capital.

Background

Generally, goodwill and other intangible assets are deducted from tier 1 capital.[1] Mortgage servicing assets (MSAs), nonmortgage servicing assets (NMSAs), and PCCRs, however, are qualifying intangible assets and, subject to certain limits, need not be deducted from tier 1 capital. Currently, the limit for all qualifying intangible assets is 100 percent of tier 1 capital and NMSAs and PCCRs are subject to a further sublimit of 25 percent of tier 1 capital.[2] Qualifying intangible assets are also subject to valuation at least quarterly at the lesser of 90 percent of the fair value of each intangible asset or 100 percent of the remaining unamortized book value.[3]

When the OCC amended its capital regulations in 1993, it eliminated a three-part test for determining qualifying intangibles from the regulatory language. The OCC indicated, however, that it would continue to use these criteria as guidance in deciding whether to expand the list of qualifying intangible assets. The three-part test required that:

1. The intangible asset must be able to be separated and sold apart from the bank or from the bulk assets of the bank;

2. The market value of the intangible asset must be established on an annual basis through an identifiable stream of cash flows, and there must be a high degree of certainty that the asset will hold this market value notwithstanding the future prospects of the bank; and

[1] 12 CFR Part 3, Appendix A section 2(c)(1)(i) and (ii).

[2] 12 CFR Part 3, Appendix A section 2(c)(2)(i).

[3] 12 CFR Part 3, Appendix A section 2(c)(2)(ii).

3. The bank must demonstrate that a market exists which will provide liquidity for the intangible asset.

The *Comptroller's Handbook* defines the business of merchant processing as, "The settlement of electronic payment transactions for merchants. It is a separate and distinct business line from credit card issuing. Merchant processing activity, which is off-balance-sheet, involves gathering sales information from the merchant, collecting funds from the issuing bank, and paying the merchant."[4] Your letter indicates that a merchant processing intangible arises when a buyer pays a premium for a merchant processing business or a merchant contract portfolio. The premium is based on the expected future cash flows generated by the underlying merchant contracts.

In the fall of 2000, the OCC reviewed the appropriate capital treatment for MPIs and determined that MPIs should continue to be deducted from tier 1 capital. As part of that review, the OCC concluded that MPIs did not meet the requirements of the three-part test described above. Among other factors, a sufficiently liquid market for these assets did not exist.

Discussion

The bank has proposed that, for risk-based capital purposes, MPIs should be treated in the same manner as PCCRs for the following reasons:

- The merchant processing industry has matured in recent years and the marketability and salability of MPIs are equivalent to that of PCCRs.
- MPIs are valued according to GAAP based on projected cash flows similar to PCCRs.
- The Federal Reserve Board's regulations with respect to MPIs are unclear.
- Deducting MPIs from tier 1 capital puts banks at a competitive disadvantage with respect to nonbank competitors.

To support the proposal, the bank provided information documenting sales of businesses and portfolios and discussed the method used to value MPIs. In revisiting the capital treatment for MPIs, the OCC considered the requirements of the three-part test for separability and valuation and sought to determine whether the market for MPIs has become sufficiently liquid that it meets the liquidity requirement for qualifying intangibles.

Separability—Are MPIs able to be sold separately from a bank? The bank suggests that the number of sales of both businesses and portfolios demonstrates that MPIs are a separately saleable asset. The bank's data for sales of merchant processing portfolios and businesses for 1994 through

[4] "Merchant Processing," booklet (December 2001), Comptroller's Handbook, p. 1.

early 2003 identified numerous transactions. The bank also indicates that portfolios where the merchant processing is done under the original bank's name have a higher value.

While the number of transactions suggests that merchant processing assets can be sold separately from a bank, the OCC notes that many portfolios are sold on a "flow" basis; i.e., the seller agrees to generate and sell new accounts to the buyer. The OCC believes that these continuing relationships with the seller suggest that the "separability" provision of the three-part test may not be fully met.

Valuation—Can the market value of MPIs be established through an identifiable stream of cash flows and is there a high degree of certainty that MPIs will hold this market value independently of a bank? The bank argues that the valuation issues for PCCRs and MPIs are similar and predictable and, in both cases, are based on credit card activity. As evidence of stable valuation, the bank notes that estimated earnings per share for publicly traded merchant processors closely track actual earnings per share and that the earnings behavior of "pure play" credit card companies is actually less predictable and more volatile. As further support for stable valuation, the bank observes that current prices for merchant processing assets range from 2.5–3.5 times net revenue.

Pricing of merchant processing is a fairly standard process based on projected net cash flows, but the OCC's analysis indicates that pricing can vary widely as a multiple of net revenue. Prices vary depending on the types and number of merchants in a portfolio, charge back and loss rates, and attrition rates. Growing portfolios also command a higher price than static portfolios. The OCC is also concerned about the variability of the key underlying assumptions on which the valuation of MPIs is based. There appear to be significant annual revisions in attrition and revenue assumptions.

Marketability/Liquidity—Does a liquid market exist for MPIs? In 2000, the market for merchant processing portfolios was comprised of four to eight buyers of large portfolios and businesses and about 20 buyers of smaller portfolios. On average, there were four to six large transactions of over $500 million in annual volume per year and at least 12 smaller deals a year. Based on the information the bank has provided, the market today for MPIs appears to be more active than in 2000. The number of buyers of merchant processing businesses and portfolios increased in 2001 and again in 2002.

While the market is more active, the OCC believes that the saleability of merchant processing portfolios and businesses varies widely depending on the degree of concentration of national merchants or types of merchants, the existence of proprietary processing systems, and other unique characteristics. Based on these considerations, the OCC believes the market for MPIs does not meet the liquidity requirement of the three-part test.

Conclusion

For the reasons cited above, the OCC has determined that the list of qualifying intangible assets should not be expanded. Consequently, MPIs should not be considered as qualifying intangibles in the calculation of tier 1 capital. This conclusion is based in part on the failure of MPIs to meet the three-part test for separability, valuation, and marketability. We have consulted with staffs of the other U.S. banking agencies and they are in agreement with this policy.

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

Sincerely,

Tommy Snow

Director, Capital Policy

991—March 11, 2004

12 USC 1972

[Summary: Letter concludes that for this particular situation involving a solicitation letter offering homeowners insurance products to loan customers of a national bank subsidiary, the OCC's review does not indicate a prohibited tying arrangement.]

Re: *["ABC Mortgage Co."]*

Dear [ ]:

I am providing this written response to follow-up on the telephone discussion you and I had concerning your inquiry on tying by a national bank subsidiary. Your letter was addressed to Mr. Craig D. Stone, Deputy Ombudsman, Office of the Comptroller of the Currency (OCC) and submitted pursuant to the July 2001 regulatory cooperation agreement between our two offices. You enclosed correspondence your office received from the [ ], which had attached to it a copy of a letter from *["ABC Insurance Co."],* addressed to Ms. [ ], and noting *[ABC Mortgage Co.]* as the lender ("insurance letter") (copy attached *[attachment omitted]*). As we discussed, *[ABC Mortgage Co.]* is a subsidiary of a national bank and subject to the OCC's jurisdiction.

The insurance letter indicates *[ABC]* customers are eligible for a unique homeowners insurance program offered through *[ABC Insurance Co.]* In particular, the letter states a customer may be eligible for: "up to 10% discount for a new loan." The letter further provides "[y]ou are under no obligation to call and the insurance company you select will have no effect on your credit with *[ABC]."* You asked whether a lender subject to the OCC's jurisdiction, such as *[ABC Mortgage Co.],* could vary a loan interest rate conditioned upon a borrower purchasing insurance on collateral through an insurance agency affiliated with the lender. More generally, you raised several questions related to application of the federal tying statute.

The federal tying statute, Section 106 of the Bank Holding Company Act Amendments of 1970, codified at 12 USC 1972, provides in part:

> A bank shall not in any manner extend credit, lease or sell property of any kind, or furnish any service, or fix or vary the consideration for any of the foregoing, on the condition or requirement—
>
> > (A) that the customer shall obtain some additional credit, property, or service from such bank other than a loan, discount, deposit, or trust service;

Section 106 generally prohibits a bank or its subsidiary from tying a product or service to another product or service offered by the bank, with certain exceptions. A bank engages in a tie by conditioning the availability of, or offering a discount on, one product or service (the "tying product") on the condition that a customer purchase another product or service offered by the bank or an affiliate (the "tied product"). Some tying arrangements are permissible under statutory and regulatory exceptions. Congress enacted the anti-tying provisions to keep banks from using bank credit and other services as a means to coerce customers and reduce competition. The Board of Governors of the Federal Reserve System ("Board") has interpretive authority over section 106 and may permit exceptions to the anti-tying prohibitions.[1]

The federal tying statute applies to tying arrangements imposed by a bank and its subsidiaries, but generally not to tying arrangements imposed by a nonbank affiliate of a bank.[2] With respect to insurance products, the plain language of section 106 would prohibit a bank from requiring a person to purchase insurance from the bank's insurance affiliate in order to obtain a reduced interest rate on a loan from the bank.[3] In that example, it is the bank that is varying the price of a bank product (the loan) based on a requirement that the customer obtain another product (insurance) from an affiliate. However, section 106 would not apply to the insurance agency affiliate offering discounts on insurance premiums to customers who also have a loan from the bank because, in that case, it is the affiliate (and not the bank) that has imposed the condition governing the sale of its products.

As we discussed, the information here indicates the insurance letter is an offer of homeowners insurance products by an insurance affiliate of a national bank subsidiary. The lender-national bank subsidiary is not offering any products. A call to the toll-free number listed in the letter connects the customer to the "Hazard Insurance Processing Center." We have verified that the reference in the letter "10% discount for a new loan" refers to a 10-percent discount on homeowners insurance premiums and not on a loan. In addition, the products offered in the insurance letter are not stated as a "condition or requirement" of the customer's *[ABC]* mortgage loan. In fact, the letter specifically disclaims in several places any effect on the customer's credit related to the purchase or nonpurchase of the insurance products.

1 See 12 CFR 225.7 (exceptions to tying restrictions). For general discussion and background, see, for example, OCC White Paper, "Today's Credit Markets, Relationship Banking, and Tying" (September 2003); U.S. General Accounting Office, Report #GAO 04-4, "Bank Tying" (October 2003) (copies available on OCC and GAO Web sites).

2 See, e.g., 62 Federal Register 9290, 9312-16 (amendments to the Board's tying regulation removing earlier Board-imposed tying restrictions on bank holding companies and their nonbank subsidiaries); OCC Comptroller's Handbook booklet, "Insurance Activities" 17 (June 2002).

3 12 USC 1972. See also 62 Federal Register at 9314 (section 106 continues to prohibit banks from using their power over credit to induce customers to purchase insurance products); Letter from J. Virgil Mattingly, General Counsel, Board, to Carl V. Howard, Esq., General Counsel, Citigroup, Inc. (May 16, 2001) (insurance is a non-traditional product).

Accordingly, for this particular situation, based on the insurance letter, the OCC's review, the language of the statute, and Board precedent, the situation under review is not a prohibited tying arrangement. If you have any questions regarding this letter, please contact me at (202) 874-5210. Again, thank you for submitting this inquiry pursuant to our regulatory information-sharing agreement process.

Sincerely,

Suzette H. Greco
Special Counsel
Securities and Corporate Practices Division

992—May 10, 2004

12 USC 24(7)

[Summary: National bank permissibly acquired warrants of borrower in addition to, or in lieu of, interest on loan to borrower (12 CFR 7.1006). Bank wishes to dispose of warrants, but represents that there is no market in which it may sell the warrants. Under the specific circumstances and conditions represented by the bank, the letter authorizes the bank to exercise the warrants in order to immediately sell the resulting stock.]

Re: Disposal of Stock Warrants Acquired Pursuant to 12 CFR 7.1006

Dear [ ]:

This letter is in response to your request on behalf of *[bank], [city], [state]* ("bank"), for confirmation that a national bank that has taken a borrower's stock warrants in addition to or in lieu of interest on a loan to the borrower may dispose of the warrants in the manner described below. Based on the particular circumstances presented, the representations made in your letter, and for the reasons discussed below, we believe that the bank may dispose of the warrants as described below.

Background

The bank made a commercial loan to a borrower and received from the borrower warrants to acquire shares of the borrower's common stock. The bank received the warrants pursuant to its authority in 12 CFR 7.1006 to take such warrants in addition to or in lieu of interest on the loan to the borrower. The bank now wishes to dispose of the warrants. However, in evaluating its ability to sell the warrants, the bank has determined that no readily identifiable market exists for the warrants.[1] With no market in which to sell the warrants, the bank would be unable both to accurately determine a fair market price for the warrants and to sell the warrants for such price.

The bank now proposes to exercise the warrants and convert them into shares of the borrower's common stock, which the bank immediately would sell. The bank would exercise the warrants only after entering into an agreement to sell the resulting shares of the borrower's common stock. To accomplish the sale of the warrants immediately after their exercise, the bank would place a sell order of the borrower's common stock with a registered broker-dealer on a particular date (the "trade date"), but would not deliver the shares of common stock until the third business day following the trade date ("settlement date").[2] The bank would exercise the warrants and convert

[1] The common stock underlying the warrants is publicly traded on the NASDAQ Stock Market.

[2] The bank represents that delivery of the securities three business days after placing the sale order is consistent with industry standards. See Rule 15c6-1 promulgated under the Securities Exchange Act of 1934.

them into shares of common stock effective on the settlement date and immediately deliver the shares it receives to the selling broker for settlement of the trade made on the trade date.[3] The bank would hold the shares only for the instant in which it takes the borrower's transfer agent to transfer the shares of common stock from the name of the bank to the name of the selling broker. For that instant, the bank would own less than 1 percent of the borrower's common stock.

By holding the shares only for the instant required for the borrower's transfer agent to transfer the shares of common stock from the name of the bank to the name of the selling broker, and because it would be holding the shares solely for the purpose of effecting that transfer, the bank would, as a practical matter, never have the ability to vote the shares of common stock. Generally, the "record date" for voting shares is as of the end of business on a particular date. Because the bank would not be the record owner of the shares at the end of any business day, the bank would at no time have the ability to vote the shares.

Discussion

The OCC has long recognized the authority of national banks to share in the profit, income, or earnings of a borrower as a full or partial substitute for interest on a loan to the borrower.[4] The ability to share in a borrower's profit, income, or earnings permits the lending bank a greater degree of flexibility in its lending activities, allowing the bank to offer more competitive financing arrangements. Consistent with this authority, the OCC has found that the means by which a lending bank may share in the borrower's profit, income, or earnings can take different forms. One permissible means of such sharing, long-recognized in precedent[5] and codified in 12 CFR 7.1006,[6] is a bank's acceptance of stock warrants issued by the borrower, provided that the bank does not exercise the warrants. The OCC has prohibited banks from exercising such warrants - and thereby converting them into shares of the borrower's stock-on the theory that doing so would be tantamount to a purchase of stock for its own account.[7]

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[3] The bank represents that it would avail itself of the tacking provisions of Rule 144(d) promulgated under the Securities Act of 1933, as amended, in order to permit its immediate sale of the common stock it receives upon exercise of the warrants. See Rule 144(a)(3)(ii) promulgated under the Securities Act of 1933, as amended; Precision Optics Corp. S.E.C. No-Action Letter, reprinted at [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,627 (January 14, 1993), 1993 WL 12387.

[4] 12 CFR 7.1006 (2004); OCC Interpretive Letter No. 517, reprinted in [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,228 (August 16, 1990); Letter from Thomas G. DeShazo, Deputy Comptroller of the Currency (August 26, 1969) (unpublished) (profits).

[5] OCC Interpretive Letter No. 517, supra; Letter from Patrick Parise, Regional Counsel (October 16, 1970) (unpublished) (warrants); Letter from Robert Bloom, Chief Counsel (May 26, 1969) (unpublished) (warrants).

[6] Recognizing that the authority to accept warrants was well established, the OCC added the authority to 12 CFR 7.1006 in 1996. 61 Federal Register 4849 (February 9, 1996).

[7] OCC Interpretive Letter No. 517, supra; Letter from Richard V. Fitzgerald, Assistant Director, LASD (January 13, 1976) (unpublished).

Section 24(Seventh) includes language added by section 16 of the Glass-Steagall Act (section 16) that is sometimes referred to as a prohibition on any stock ownership. Its purpose, however, was to prevent national banks from engaging in speculative activity through stock investment.[8] The OCC repeatedly has found that national banks may purchase shares of stock without violating Section 16 when the acquisition is not for speculative or investment purposes and the stock ownership is intended to facilitate a bank's participation in an otherwise permissible activity, or to enable the bank to receive needed services.[9]

Here, at no time does the bank have an investment motive. The bank did not use any of its assets to acquire the warrants; instead, the bank received the warrants in addition to, or in lieu of, interest on a loan. The only bank asset used in the initial lending transaction was the loan principal, which the borrower remains obligated to repay. When the bank exercises the warrants and converts them to shares of the borrower's stock, the bank would not use any of its assets to acquire the stock. The bank represents that it would only exercise the warrants and acquire the shares of the borrower's stock with an agreement in place to sell the shares immediately. This series of transactions—purchase and immediate sale—can hardly be viewed as investment-driven.[10] Moreover, in this instance, the authority to exercise the warrants and purchase the shares of the borrower's stock would facilitate the bank's participation in permissible activities-making a loan to a borrower and sharing in the profit, income, or earnings of the borrower as a full or partial substitute for interest on such a loan.

Therefore, for the reasons and subject to the conditions and restrictions stated above, we find that the bank, having acquired the warrants in conformance with 12 CFR 7.1006, permissibly may exercise the warrants and immediately sell the resulting shares of the borrower's common stock under the circumstances and in the manner described herein. If you have any questions, please contact Steven Key, Senior Attorney, at (202) 874-5300.

Sincerely,

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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[8] See Investment Company Institute v. Camp, 401 U.S. 616, 630 (1976).

[9] For example, the OCC has permitted national banks to acquire and hold, for a moment in time, the stock of another depository institution to facilitate a permissible corporate restructuring. E.g., Corporate Decision No. 97-13 (February 24, 1997); Letter from Charles F. Byrd, Assistant Director, LASD (October 1, 1987) (unpublished). The OCC has also permitted national banks to acquire and hold stock in organizations that facilitate access to secondary markets. E.g., OCC Interpretive Letter No. 427, reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988) (stock in Federal Agricultural Mortgage Corporation).

[10] Indeed, the proposed transaction is analogous to riskless principal brokerage transactions. In such a transaction the bank, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own

account to offset an immediate, contemporaneous sale to (or purchase from) the customer. The transaction is considered "riskless" because it is not entered into unless there is already an order from a customer that will generate an immediate, offsetting transaction. The OCC has found that these transactions are permissible under the express terms of Section 16 and present none of the hazards of speculation that the Glass-Steagall Act was intended to prevent. See OCC Interpretive Letter No. 371, reprinted in [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,541 (June 13, 1986); see also OCC Interpretive Letter No. 626, reprinted in [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 49,101 (July 7, 1993).

993—May 16, 1997

12 CFR 24

[Summary: Letter states that the activities, including data and payments processing, of the clearing house at that time were part of or incidental to the business of banking, and thus, that it was permissible for national banks to own interests in the clearing house.]

Dear [ ]:

You have submitted a letter on behalf of the [ ] (the "clearing house") in connection with the proposed reorganization of the clearing house into a holding company with subsidiaries. Your letter seeks confirmation that national banks may lawfully acquire and hold minority interests both in the new holding company and in certain of its subsidiaries. The new holding company will itself conduct the current trade association activities of the clearing house. Subsidiaries of the holding company will conduct the current payment system activities of the clearing house, including: (1) the Clearing House Interbank Payments System ("CHIPS"), (2) the [ ] clearing house ("[ ] CH"), (3) the Clearing House Electronic Check Clearing System ("CHECCS"), and (4) paper check exchange and settlement. For the reasons discussed below, I conclude that the activities of the clearing house are part of or incidental to the business of banking and that the acquisition and ownership of interests in both the holding company and its subsidiaries are permissible for national banks.

A. Background

1. The Clearing House

The clearing house is a not-for-profit, unincorporated association of [ ] commercial banks. Its members are *[Bank 1], [Bank 2], [Bank 3], [Bank 4], [Bank 5], [Bank 6], [Bank 7], [Bank 8], [Bank 9]* and *[Bank 10].* The clearing house operates a variety of payments-related services, including CHIPS, [ ] CH, and CHECCS, offered only to its member banks and to other financial institutions.

2. The Proposed Structure and Activities

The proposed structure consists of a holding company (the "holding company") and several subsidiaries. The holding company will be the successor to the clearing house and will also be a not-for-profit organization. The holding company and its subsidiaries (collectively, the "clearing house LLCs") will each be organized as a Delaware limited liability company ("LLC").

The holding company will have at least two subsidiaries that will conduct the payments-related activities currently conducted through the clearing house. One such subsidiary ("[XXX]") will operate CHIPS. One or more other subsidiaries (collectively, the "SVPCos") will operate the small-value payment systems currently operated by the clearing house ([ ] CH, CHECCS,

and paper check clearing).[1] The holding company also will have a subsidiary ("ServiceCo") that will own and operate the computer facilities and related licenses used by the holding company's subsidiaries in the conduct of their activities.

It is currently anticipated that each of ServiceCo, [XXX], and the SVPCos will be organized as for-profit organizations, although the practicality of establishing one or more as a not-for-profit organization is still being considered. In either case, it is expected that revenues from fees will be priced on a basis that will approximate expenses.

The specific activities of these various entities are described below:

a. Payments-Related Activities

As noted, [XXX] and other SVPCos will collectively conduct the current payments-related activities of the clearing house and provide a variety of payments-related services to members and other financial institutions.

CHIPS: [XXX] will operate CHIPS. CHIPS is a large-dollar electronic funds transfer system in the United States that is the primary wholesale electronic payment system supporting the international transfer of U.S. dollars between domestic and foreign banks. CHIPS links over 100 large banking institutions and currently transfers and settles approximately $1.3 trillion in payments on an average day. CHIPS provides clearing-house functions for these payments among members. Through CHIPS, participating institutions (generally, national and state banks, private banks licensed under [state] banking law, branches and agencies of foreign banks, and qualified Edge Act subsidiaries) can send inter se electronic messages on payment instructions and additional transaction data related to payment instructions. CHIPS also provides processing of those payments and arranges for settlement between its members on a multilateral net basis at the end of each business day.[2]

The other SVPCo will operate the small-value retail payment systems currently conducted by the clearing house: [ ] CH, CHECCS, and paper check clearing services.

[1] There may be a period while the restructuring is being completed, however, during which the holding company will conduct certain of the activities currently conducted by the clearing house (other than CHIPS). The clearing house anticipates that the holding company initially will establish one SVPCo subsidiary that will operate all of the current small value payment systems of the clearing house. Over time, however, the holding company may divide these activities among additional SVPCo subsidiaries and may establish new SVPCo subsidiaries to operate additional small value payment systems.

2 The proposed reorganization will not affect the operational methodology of CHIPS or the current measures that have been implemented to control and reduce operational, fraud, credit and systemic risk. In order to reduce credit and systemic risk, CHIPS currently employs admission standards, same-day settlement, bilateral credit limits, net debit caps, loss sharing rules (additional settlement obligations), and collateral requirements. CHIPS will continue to meet all of the standards set forth in the Policy Statement on Privately Operated Large-Dollar Multilateral Netting Systems issued by the Board of Governors of the Federal Reserve System, 59 Federal Register 67,534 (December 29, 1994).

[ ] CH: Automated clearing houses (ACH), like the [ ] CH, are electronic funds transfer systems designed predominantly to handle repetitive small-dollar payments. Essentially, an ACH operates as an electronic alternative to the traditional paper-based check collection system. Usually, the ACH receives from member originating institutions batch payment instructions for the crediting and debiting of deposit accounts. These instructions are called entries. The ACH processes the entries by editing, balancing, and sorting the payment data in the entries and then transmits the entries directly or indirectly (though other ACHs) to the appropriate receiving institution for further action. The ACH also arranges settlement between the originating and receiving institutions through credits and debits of accounts maintained by those institutions with Federal Reserve banks.

[ ] CH, which operates essentially as described above, is a part of a national network of automated clearing houses linked by the Federal Reserve System and has also formed a network with the two other private ACH operators to process ACH items directly. The [ ] CH currently has more than 800 participants.

CHECCS: CHECCS is a payments processing system that enhances the efficiency of paper check processing by using electronic check presentment. In CHECCS, a banking organization presenting a check encodes the information on the check's magnetic ink character recognition line and transmits it to an electronic switch operated by CHECCS. These data are sorted and stored in the CHECCS system until retrieved by the paying bank. The use of CHECCS permits a bank to identify potential return items before the delivery of physical checks and therefore reduces the bank's exposure to such items. Other components of CHECCS include data processing and transmittal systems that permit (1) immediate identification of certain return items by comparing stored information with master files of closed account and stop-payment information, and (2) permits paying banks electronically to transmit return item notices.

Paper-Based Systems: The SVPCo will also provide conventional paper check clearing services through which members of the holding company will exchange checks, coupons, and other certificates of value among themselves on the premises of the SVPCo. The SVPCo will record the transactions and calculate net settlement amounts and arrange to have the resulting amounts settled through the Federal Reserve Bank of [state].

b. Facilitating Activities and Supporting Services

Holding Company: When the reorganization is completed, it is anticipated that the holding company itself will not conduct any payment systems activities. Instead, the activities of the holding company will consist of holding interests in its subsidiaries and providing "trade association services." Trade association services will consist primarily of submitting comments in respect of regulatory and legislative proposals, filing briefs as amicus curiae in judicial actions and submitting requests for regulatory interpretations, in each case where the proposal, action, or matter

affects the banking industry. The holding company is also expected to own the real property currently owned on behalf of the clearing house (although such property may also be held through ServiceCo).

ServiceCo: ServiceCo will engage solely in the provision of services to the holding company's subsidiaries. Such services will consist primarily of data processing and data transmission services, databases, and facilities. Specifically, ServiceCo will own and operate the computer facilities and related licenses used by the holding company's subsidiaries in their activities. ServiceCo will provide data processing services and access to its facilities to each of the holding company's subsidiaries.

3. Ownership

Each of the 10 current members of the clearing house will become a member of, and acquire an equal limited liability company interest in, the holding company. The affairs and activities of each clearing house LLC are governed by a limited liability company agreement ("LLC agreement").

[XXX] will be owned in part by the holding company and in part by the participants in CHIPS. *[XXX]* will have two classes of members, Class A members and Class B members. Each banking organization that is a participant in CHIPS (or becomes a participant after the date of the reorganization) will become a Class A member, and Class A membership will be limited to CHIPS participants. The holding company will be the only Class B member.

Ninety-nine percent of the common limited liability company interests in *[XXX]* will be held by the Class A members and will be allocated per capita among them. The holding company (as the Class B member) will have only a 1-percent common limited liability company interest, but it will elect a majority of the *[XXX]* board.

ServiceCo and (initially) the SVPCos will be wholly owned by the holding company. The ownership structure of the SVPCos, however, is expected to change over time. It is anticipated that one or more of the SVPCos will in the future become partly owned by the participants in the payment systems operated by it. In that case, the ownership structure of the SVPCo would be modeled after that of *[XXX]*.

4. Governance

Each of the clearing house LLCs will be managed by a board of directors (except ServiceCo). With respect to the holding company, each member of the holding company will be entitled to appoint one director, and each director will have one vote on all matters coming before the board. Each member of the holding company will have one vote on all matters presented to the members, as such.

[XXX] will be managed by a 10-member board of directors. The holding company (as the Class B member) will be entitled to elect six of the directors, and the Class A members will be entitled to elect the remaining four directors. Every director must be an executive officer of a Class A member of *[XXX]* and no two directors may be officers of the same Class A member (or of affiliated Class A members). Each director will be entitled to one vote on all matters coming before the board.

The Class A members and the Class B member of *[XXX]* will vote as separate classes on all matters presented to the members, and all actions by the members will require the affirmative vote of both the Class A members and the Class B member. Although each Class A member will have an equal common limited liability company interest in *[XXX],* each Class A member's vote will be weighted based on the member's usage of CHIPS over a specified period.

As the sole member, the holding company will initially be entitled to appoint all directors of any SVPCo. If any SVPCo becomes partially owned by participants, the participants will become entitled to elect a minority of its directors in a voting arrangement expected to be similar to that of *[XXX].* ServiceCo will be managed directly by the holding company, as sole member, and will not have a board of directors.

5. Other Material Terms of the LLC Agreements

The LLC agreement of each clearing house LLC provides that the LLC shall not directly or indirectly carry on any activity that would prohibit a national bank or a member bank of the Federal Reserve System from being a member of the LLC.[3] In addition, the LLC agreements provide that a member may withdraw for any reason and without the consent of any other member (subject, in the case of *[XXX]* and any SVPCo, to 30 days written notice).

Membership in the clearing house LLCs will be limited to banking organizations. In the case of the holding company, the LLC agreement limits membership to commercial banks and trust companies. In the case of *[XXX],* the LLC agreement limits membership to the holding company and to banking organizations that are participants in CHIPS (or in another electronic funds transfer system that may from time to time be operated by *[XXX]*). Membership in a SVPCo will be limited to the holding company and institutions that are participants in the payment system(s) operated by the SVPCo. Under their respective LLC agreements, membership in the clearing house LLCs (except ServiceCo) will be subject to restrictions on transferability. With certain exceptions, a member may not transfer any part of its interest without the consent of the board of directors.

[3] We interpret this language to mean that the LLCs will engage only in activities that are part of or are incidental to the business of banking. If this interpretation is incorrect, the language in the LLC agreements should be changed to conform to this interpretation.

None of the LLC agreements of the clearing house LLCs will require any member to make any capital contribution other than upon admission. From time to time, however, a clearing house LLC may request additional contributions from members (including for expenses). In the case of the holding company, the failure of a member to make a requested contribution may be grounds for expulsion.

B. Discussion

Your letter raises the issue of the authority of a national bank to make a noncontrolling investment in a limited liability company. In a variety of circumstances, the OCC has permitted national banks to own, either directly, or indirectly through an operating subsidiary, a minority interest in an enterprise. The OCC has said that national banks are legally permitted to make a minority investment in an LLC provided four criteria or standards are met. See OCC Interpretive Letter No. 732, reprinted in, [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-049 (May 10, 1996); Interpretive Letter No. 692, reprinted in [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,007 (November 1, 1995), and OCC Interpretive Letter No. 694, reprinted in [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,009 (December 13, 1995).[4] These standards, which have been distilled from our previous decisions on permissible minority investments for national banks and their subsidiaries, are:

1. The activities of the enterprise in which the investment is made must be limited to activities that are part of or incidental to the business of banking.

2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

4. The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

I conclude, as discussed below, that the proposed investments by national banks in the clearing house LLCs satisfy these four criteria.

1. The activities of the enterprise in which the investment is made must be limited to activities that are part of or incidental to the business of banking

The National Bank Act, in relevant part, provides that national banks shall have the power:

[4] See also 12 CFR 5.36(b). National banks are permitted to make various types of equity investments pursuant to 12 CFR 24(Seventh) and other statutes.

> [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 receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes. . .

12 USC 24(Seventh).

The Supreme Court has held that the powers clause of 12 USC 24(Seventh) is a broad grant of power to engage in the business of banking, including but not limited to the enumerated powers and the business of banking as a whole. *See NationsBank of North Carolina N.A. v. Variable Life Annuity Co.,* 115 S. Ct. 810 (1995) ("VALIC"). Judicial cases reflect three general principles used to determine whether an activity is within the scope of the "business of banking": (1) is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) would the activity respond to customer needs or otherwise benefit the bank or its customers; and (3) does the activity involve risks similar in nature to those already assumed by banks. *See, e.g., Merchants' Bank v. State Bank,* 77 U.S. 604, 648 (1871) (certification of checks has grown out of the business needs of the country and involves no greater risk than a bank giving a certificate of deposit); *M&M Leasing Corp. v. Seattle First Nat'l Bank,* 563 F.2d 1377, 1382-83 (9th Cir. 1977), cert. denied, 436 U.S. 987 (1978) (personal property lease financing is "functionally interchangeable" with the express power to loan money on personal property); *American Ins. Assoc. v. Clarke,* 865 F.2d 278, 282 (D.C. Cir. 1988) (standby credits to insure municipal bonds is "functionally equivalent" to the issuance of a standby letter of credit). Further, as established by the Supreme Court in *VALIC,* national banks are authorized to engage in an activity if it is incidental to the performance of the five enumerated powers in section 24(Seventh) or if it is incidental to the performance of an activity that is part of the business of banking.

a. Payments-Related Activities

Modern electronic clearing-house activities, such as those of the proposed LLCs, involve three distinct services: electronic payments message transmission, electronic payments processing, and payments settlement among members. All three services relate to different aspects of the payments systems that, as OCC recently noted, are central to banking.[5] Each of these three services is clearly within the business of banking and is, thus, permissible for national banks.

Transmission of Electronic Messages Related to Payments: It is well established that a national bank may use electronic means to perform services expressly or incidentally authorized to nation-

[5] "Banks are the most important institutional participants in the nation's payment system. They deal with cash, issue, process, clear and settle checks and similar monetary instruments, administer credit card and debit card programs for consumers and merchants, and transfer funds electronically in a variety of situations and circumstances." OCC Conditional Approval Letter No. 220, 1996 OCC Ltr. LEXIS 140 (December 2, 1996) (the "Mondex Letter").

al banks.[6] The OCC Interpretive Ruling setting forth this authority was recently revised, in recognition of the rapid advancement of technology, to authorize a national bank to "perform, provide, or deliver through electronic means and facilities any activity, function, product, or service that it is otherwise authorized to perform, provide, or deliver." 61 *Federal Register* 4849 (1996) *codified* at 12 CFR 7.1019.

Accordingly, the OCC has found that, as part of the business of banking, national banks may provide for the electronic transmission of banking, financial, or related economic data and thereby establish communication or data networks that support banking and financial transactions.[7] Thus, for example, in OCC Interpretive Letter No. 732, *supra,* the OCC permitted a national bank to assume a minority ownership in a company engaged in the design, development, and marketing of a network for electronic funds transfer and electronic commercial data interchange.[8] Indeed, the OCC recently noted that electronically transmitted payments through clearing houses like CHIPS account for a very large portion of the total dollar value of all financial transactions. Mondex Letter, *supra,* at n. 10.

Electronic Payments Processing: The information and transaction processing that [XXX] and the other clearing house LLCs will provide for participating institutions is permissible. The processing will involve banking, financial, or related economic data and, thus, is part of the business of banking. An earlier version of 12 CFR 7.1019 stated that "as part of its banking business and incidental thereto, a national bank may collect, transcribe, process, analyze, and store for itself and others, banking, financial, or related economic data." Interpretive Ruling 7.3500, 39 *Federal*

[6] See OCC Interpretive Letter No. 677, reprinted in [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,625 (June 28, 1995); OCC Interpretive Letter No. 284, reprinted in [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,448 (March 26, 1984); and OCC Interpretive Letter No. 449, reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,673 (August 23, 1988).

[7] See OCC Interpretive Letter No. 653, reprinted in [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601 (December 22, 1994)(national bank may establish a network to act as an informational and payments interface between insurance underwriters and their agents); OCC Interpretive Letter No. 516, reprinted in (1990-91 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,220 (July 12, 1990) (national bank may provide electronic communications channels for persons participating in securities transactions); OCC Interpretive Letter No. 513, reprinted in [1990-91 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,215 (June 18, 1990) (national bank may provide an electronic network for the transmission of visual, voice and data communications for other financial institutions); OCC Interpretive Letter No. 346, reprinted in [1985-1987] Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 85,516 (July 31, 1985) (national bank may establish an electronic gateway for financial settlement services).

[8] The clearing house LLCs will transmit not only payment instructions, but also information related to payments instructions. This will be permissible. As part of the business of banking, national banks can transmit data or information and electronic documents connected with funds transfer, such as electronic data interchange (EDI) services. See OCC Interpretive Letter No. 732, supra (a national bank may offer EDI services that allow businesses to electronically send and receive payments, invoices and orders worldwide). See also OCC Interpretive Letter No. 419, reprinted in [1988-1989 Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 85,643 (February 18, 1988) (national bank providing specialized electronic payment systems for health care providers and insurance carriers can also transmit as part of that payment service treatment information from the health care providers to the insurance carriers that was used by the insurance carrier to determine how the amount to be paid should be allocated among potential payers).

Register 14195 (April 22, 1974). Although in its 1984 revision of the ruling, the OCC deleted this statement because it believed that "specific examples [of permissible electronic activities] are inappropriate given the imprecision of terms and rapid pace of change in the data processing industry," 49 *Federal Register* 11157 (March 26, 1984), the "analytical framework" embodied in the ruling remained the same. Id. There was no intent to narrow or restrict the substantive effect of the rule.[9]

Clearing and Settlement of Payments among Members: The OCC has long held that national banks may invest in and hold stock in clearing house associations in which they participate. Unpublished letter from James J. Saxon dated October 12, 1966; Unpublished letter from William B. Camp, dated November 18, 1966; Unpublished letter from Peter Liebesman dated January 26, 1981. Cf., Unpublished letter from James J. Saxon dated January 28, 1964; Unpublished letter from Robert B. Serino dated July 26, 1989; and OCC Interpretive Letter No. 692, supra. Case authority also holds that this is a permissible activity for national banks. *Philler v. Patterson,* 168 Pa. 468, 32 A. 26 (1895); *Crane v. The Fourth National Rank,* 173 Pa. 556, 34 A. 296 (1896). Cf., Andrew v. Farmers & Merchants Savings Bank, 245 N.W. 226, 229 (Iowa 1932). The use of electronic technology to conduct clearing and settlement activities does not change this conclusion. OCC Interpretive Letter No. 737, supra (the collection, processing, and settlement of payments in a stored value system is part of the business of banking).[10]

b. Facilitating Activities and Supporting Services

The holding company and ServiceCo will not conduct any payment systems activities, but instead will provide general services to facilitate and support the business operations of the other clearing house LLCs. These supporting activities are not part of the business of banking per se, but they are permissible incidental activities because they facilitate, support and, hence, are "necessary to" the operation of the other LLCs as businesses.

Some permissible incidental activities of national banks are not necessarily incident to specific banking services or products, but rather to the operation of the bank as a business: they facilitate general operation of the bank as a business enterprise. These facilitating activities include hiring

[9] OCC Interpretive Letter No. 677, supra. See also OCC Interpretive Letter No. 737, reprinted in, [Current Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81-101 (August 19, 1996) (to be published) (national bank may provide transaction and information processing services to support an electronic stored value system); OCC Interpretive Letter No. 653, *supra,* (national bank may act as an informational and payments interface between insurance underwriters and general insurance agents); OCC Letter No. 346, *supra,* (national banks may maintain records on commodities transactions).

[10] See also Mondex letter (national banks may invest in an LLC providing clearing and settlement for an open stored value system); OCC Interpretive Letter No. 731, reprinted in [Current Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 81,048 (July 1, 1996) (national banks may enter into a contract with a public authority to operate on behalf of the authority an electronic toll collection system); OCC Interpretive Letter No. 732, *supra* (national banks may provide electronic data interchange services that, among other things, provide for payments by EFT); and OCC Interpretive Letter No. 419, *supra* (national bank may provide a service that facilitates settlement and payment of health claims using EFT technology).

employees, issuing stock to raise capital, owning or renting equipment, borrowing money for operations, purchasing the assets and assuming the liabilities of other financial institutions. While no express grants of authority to conduct these activities exist, various federal statutes have implicitly recognized and regulated these business activities of national banks. For example, the statutes refer to limits on persons who can serve as bank employees.[11] In each case, the statutes have assumed the existence of the corporate power to conduct the activity. These powers are incidental to the general grant of power to conduct a "business" under 12 USC 24(Seventh) and do not need express enumeration.[12]

The power to operate through optimal corporate structures, such as subsidiary corporations or joint ventures is an example of such permissible operational incidental activities. Such stock ownership is not among the powers expressly granted to national banks in 12 USC 24(Seventh) nor does it fall within the "business of banking" in the sense that it is a banking activity. Nevertheless, statutes refer to the existence of bank subsidiaries, indicating that subsidiaries were contemplated as permissible and that the incidental power to hold and operate them is implied.[13]

In this case, the holding company will hold interests in its subsidiaries. This would be a permissible activity for a national bank; it is an exercise of the business facilitating incidental power to reconfigure the structure of what the banks own, i.e., the clearing house, into a more desirable structure through which to conduct payments related activities on behalf of the investing banks.

Another "trade association service" provided by the holding company will be external communications and relations. The external communications conducted by the holding company will be relevant to banking industry issues and, specifically, payment system issues. Also, as part of this function, the holding company will become involved in litigation relating to issues of concern to the holding company's owners. These are permissible incidental facilitating activities.[14]

[11] See, e.g., 12 USC 78 (persons ineligible to be bank employees).

12 Memorandum dated November 18, 1996, to Eugene A. Ludwig, Comptroller of the Currency, from Julie L. Williams, Chief Counsel, "Legal Authority for Revised Operating Subsidiary Regulation," reprinted at [Current Transfer Binder] Fed. Banking Law. Rep. (CCH) ¶ 90-464 ("Williams Memo").

[13] 12 USC 24(Seventh) (limitations on presupposed authority of national bank to own a subsidiary engaged in the safe deposit business); 12 USC 371d (limitations on the amount of investment permitted in a bank premises corporation subsidiary); and 12 USC 371c ("affiliates" includes subsidiaries owned by national banks). See also Williams Memo, supra.

[14] The holding company may also own the real property currently owned on behalf of the clearing house that is used to house it operations. Under 12 USC 29, national banks are permitted to own real property "as shall be necessary for its accommodation in the transaction of its business." The ServiceCo will own and operate the computer facilities and related licenses used by the holding company's subsidiaries in the conduct of their activities. These activities are clearly permissible for national banks.

2. The banks must be able to prevent the LLC from engaging in activities that do not meet the foregoing standard, or be able to withdraw their investment

This is an obvious corollary to the first standard. It is not sufficient that the LLC's activities are permissible at the time the bank initially purchases LLC membership shares; they must also remain permissible for as long as the bank retains an ownership interest in the LLC.

The LLC agreements will effectively provide that the LLC will only engage in activities that are part of or incidental to the business of banking. In addition, investing banks may withdraw from the clearing house LLCs without the consent of the other investors for any reason, including that an LLC is engaged in activities that are not permissible for a national bank.[15]

3. The banks' loss exposure must be limited, as a legal and accounting matter, and the banks must not have open-ended liability for the obligations of the enterprise

a. Loss Exposure from a Legal Standpoint

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that a bank's investment not expose it to unlimited liability. This is the case here. As a legal matter, investors in a Delaware LLC will not incur liability beyond their investment in the LLC by virtue of being a member or manager of the LLC-even if they actively participate in the management or control of the business. Del. Code Ann. Tit. 6, section 18-303(a) (1994). Additionally, the LLC agreements will provide that the investing banks will not be liable for any debt, obligation, or liability of an LLC by reason of having invested in the LLC.

b. Loss Exposure from an Accounting Standpoint

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the appropriate accounting treatment for a bank's less than 20 percent ownership share or investment in an LLC is to report it as an unconsolidated entity under the equity method or cost of accounting. Under the equity method of accounting, unless the investor has extended a loan to the entity, guaranteed any of its liabilities, or has other financial obligations, the investor's losses are generally limited to the amount of the investment shown on the investor's books.[16] Similarly,

[15] Under the LLC agreements, 30 days written notice will be required to withdraw from [XXX] and the SVPCos.

[16] See genera1ly, Accounting Principles Board, Op. No. 18 section 19 (1971). Under the equity method, the investor records the initial investment at cost, and then adjusts the carrying amount to recognize the investor's pro rata share of subsequent earnings or losses in the LLC. When losses equal or exceed the carrying amount of the investment plus advances, the investment is reduced to zero value and no further losses need be recognized, unless the investor has guaranteed obligations of the LLC or is otherwise committed to provide further financial support of the LLC. In contrast, under the cost method, the investor records the initial investment at cost, and then adjusts the carrying amount to recognize dividends actually received. Operating losses are recognized if a series of losses or other factors indicate that a decrease in the value of the investment has occurred that is other than temporary. However, losses under the cost method are generally recognized only to the extent of the adjusted carrying amount of the investment.

under the cost method of accounting, the investor records an investment at cost, dividends, or distributions from the entity are the basis for recognition of earnings, and losses recognized by the investor are limited to the extent of the investment. In sum, regardless of which accounting method is used, the investing banks' potential loss is limited to the amount of its investment. The banks investing in the clearing house LLCs will meet this requirement.

4. The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business

A national bank's investment in an enterprise or entity that is not an operating subsidiary of the bank also must satisfy the requirement that the investment have a beneficial connection to the *bank's* business, i.e., be convenient or useful to the investing bank's business activities, and not be a mere passive investment unrelated to that bank's business activities. "Necessary" has been judicially construed to mean "convenient or useful." See *Arnold Tours,* 472 F.2d at 432. The provision in 12 USC 24(Seventh) relating to the purchase of stock, derived from section 16 of the Glass-Steagall Act, was only intended to make it clear that section 16 did not authorize speculative investments in stock. See OCC Interpretive Letter No. 697, reprinted in [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-102 (November 15, 1995). Therefore, a consistent thread running through our precedents concerning stock ownership is that it must be convenient or useful to the bank in conducting that bank's banking business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.

That requirement is met here. The clearing house LLCs will be providing services to the investing banks that will enable the banks to offer payments services and carry out their banking business more efficiently and effectively. *[XXX]* will provide the investing banks with wholesale international electronic payments support. The SVPCo will provide the investing banks with small value payment support through [ ] CH, CHECCS, and a paper check clearing system. Thus, the LLCs will provide direct suppport for the business operations of the investing banks. Moreover, while the clearing house LLCs may be established as for-profit organizations, it is expected that revenues from fees will be priced on a basis that will approximate expenses. Finally, there are substantial restrictions on the ability of investing banks to sell their interests in the clearing house LLCs. These factors establish that the investment in these LLCs will be neither passive nor speculative.

C. Conclusion

On the basis of the representations specified in your letter and other submitted materials, the OCC finds that national banks may invest in the LLCs in the manner and as described herein, provided:

1. the LLCs will engage only in activities that are part of, or incidental to, the business of banking;

2. the banks will withdraw from any LLC in the event it engages in an activity that is inconsistent with condition number 1;

3. the banks will account for their investment in the LLCs under the equity or cost method of accounting;

4. the LLCs will be subject to OCC supervision, regulation, and examination; and

5. a copy of this letter will be provided to all national banks proposing to invest in the LLCs.

These conditions are imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that the proposed investment is permissible under 12 USC 24(Seventh) and, as such, may be enforced in proceedings under applicable law.

Sincerely,

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel