Comptroller of the Currency
Administrator of National Banks

Central District Office
One Financial Place, Suite 2700
440 South LaSalle Street
Chicago, IL 60605

February 16, 1999

Interpretive Letter #853
March 1999
12 USC 24(7)

Dear [ ]:

This is in response to your letter dated December 16, 1998, supplemented by a letter dated February 4, 1999, requesting confirmation that [ ] ("Bank") may lawfully acquire and hold a non-controlling 30 percent interest in a joint venture with a mortgage company. The joint venture will be structured as a limited liability company ("LLC") and it will engage in the business of making residential mortgage loans. For the reasons set forth below, it is our opinion that this transaction is legally permissible in the manner and as described below.

I. Background

The Bank proposes to hold a 30 percent non-controlling interest in a newly-formed LLC. [ ] Corporation (" ")[1], a non-affiliate located in [*City, State*], will acquire and hold the remaining 70 percent interest. The LLC will be established under Michigan law pursuant to a written agreement between the two members, the Bank and [ ]. One manager will be selected by [ ]. Otherwise, each member will have one vote on all matters reserved for member action, notwithstanding the Bank's 30 percent non-controlling equity interest. The LLC will be located in [*City*], Michigan, and will be capitalized in cash on a pro rata basis

[1] [ ] was founded in 1985 and is a mortgage company marketing conventional and sub-prime debt consolidations and home financing loans, secured by a first or second mortgage on one-to-four family, owner occupied residences. It originates through approximately 26 offices (18 in [*State*]) and through its marketing and call centers. In 1997, [ ]'s conventional mortgage lending division originated over 6,500 loans totaling more than $867 million, and its subprime and high LTV second mortgage paper divisions, on a combined basis, originated over 6,100 loans totaling more than $335 million.

by the Bank and [ ] in accordance with their investment interests ($300,000 from the Bank and $700,000 from [ ]).

Under the terms of the Operating Agreement, no member shall be required to advance or contribute any additional funds to the LLC, except upon the unanimous consent of the members. The Bank represents that in no event will its total investment in the LLC exceed 5 percent of its capital and unimpaired surplus. The LLC will engage in the business of making residential mortgage loans, and in any other activities (determined by the unanimous consent of the LLC members) permissible for limited liability companies under the applicable state law. However, the Operating Agreement specifically requires that any such activity must be legally permissible under the National Bank Act and any regulations or interpretive rulings issued thereunder. Moreover, as a result of its equal voting rights, the Bank will have the authority to veto decisions of the LLC manager that will result in the company engaging in activities that are inconsistent with activities that are part of, or incidental to, the business of banking. The Bank is also authorized to initiate the dissolution of the LLC in the event the company either: (1) engages in activities which are in violation of the National Bank Act; or (2) engages in activities which if engaged in by a national bank or a bank subsidiary would be considered a violation of the National Bank Act.

The LLC will be the mechanism through which the Bank will continue to offer residential mortgage loans to its current and prospective customers.[2] These loans will be closed in the name of the LLC and will be funded by the LLC through a mortgage warehousing and security agreement between the Bank and the LLC. Funds will be disbursed at the offices of third parties. The Bank represents that this arrangement will be structured and maintained as an arm's length transaction, subject to the lending limits of 12 U.S.C. § 84 as well as 12 C.F.R. Part 32. It is anticipated that the LLC will either: (1) sell loans it originates to [ ], which will then resell the loans in the secondary market or to its investors; or (2) establish direct correspondent relationships and sell loans it originates to such investors, including the Bank as an investor. In the latter case, the Bank will purchase for its portfolio subject to a correspondent/investor agreement and the transaction will be structured and maintained as an arm's length transaction.[3]

The Bank may provide administrative services to the LLC under a services agreement. Likewise, [ ] will provide loan processing services to the LLC under a services agreement. Some LLC employees will be physically located at designated Bank branch locations. The Bank represents

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[2] The Bank currently makes, buys and sells residential mortgage loans through its in-house Residential Mortgage Banking Department. The Bank desires to restructure this aspect of its business into the LLC so that it can continue to offer the same types of mortgage loans while allowing for expanded operations in the future through the LLC. It is anticipated that the LLC will have originations of 4,100 loans totaling $453 million at the end of its first full 12 months of operation. The current pro forma projects that subprime loans will comprise approximately 7.5 percent of the total loan volume, or $34 million.

[3] The Bank anticipates this will be limited to purchasing existing proprietary residential loan products with features that prevent resale on the secondary market as well as occasional accommodation loans to established customers. The Bank has represented that it will first conduct a review of all loans to be purchased utilizing its independent standards and that it will not purchase any subprime loans from the LLC.

that it will in all cases adhere to the supervisory conditions and guidance for sharing space and guidance contained in 12 C.F.R. § 7.3001.[4]

II. Discussion

A. National Bank Express and Incidental Powers (12 U.S.C. § 24(Seventh))

In a variety of circumstances the OCC has permitted national banks to own, either directly, or indirectly through an operating subsidiary, a non-controlling interest in an enterprise. The enterprise might be a limited partnership, a corporation, or a limited liability company.[5] In recent interpretive letters, the OCC concluded that national banks are legally permitted to make a non-controlling investment in a limited liability company provided four criteria or standards are met.[6] These standards, which have been distilled from our previous decisions in the area of permissible non-controlling investments for national banks and their subsidiaries, are: (1) The activities of the entity or 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 or entity 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; and (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.

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[4] The Bank notes that the arrangement between the LLC and itself in conducting mortgage lending services will likely constitute an "affiliated business arrangement" ("ABA"), as defined under the Real Estate Settlement and Procedures Act of 1974 ("RESPA"). The proposed transaction will be structured such that all activities will fully comply with RESPA and all applicable regulations, including specifically the ABA rules.

[5] *See also* 12 C.F.R. § 5.36(b). National banks are permitted to make various types of equity investments pursuant to 12 U.S.C. § 24(Seventh) and other statutes.

[6] *See* Interpretive Letter No. 692 (November 1, 1995), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,007, and No. 694 (Dec. 13, 1995), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,009. *See also* Letter of Steven J. Weiss, Deputy Comptroller, Bank Organization and Structure (December 27, 1995 unpublished) ("Weiss Letter"). In other recent letters, the OCC has permitted national banks to make a non-controlling investment in an enterprise other than an LLC, provided the investment satisfies these four standards. *See e.g.*, Interpretive Letter No. 697 (November 15, 1995), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,012; Interpretive Letter No. 705 (October 25, 1995), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. ¶ 81,020.

Based upon the facts presented, the Bank's proposal satisfies these four standards.

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

Our precedents on non-controlling ownership have recognized that the enterprise in which the bank holds an interest must confine its activities to those that are part of, or incidental to, the conduct of the banking business.[7]

The LLC will originate and sell residential real estate mortgage loans. It is clear that these activities are legally permissible under 12 U.S.C. § 24 (Seventh) (general ability of national banks to make loans) and 12 U.S.C. § 371 (ability of national banks to make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real property).[8]

Accordingly, the first standard is met.

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.

The activities of the enterprise in which a national bank may invest must be part of, or incidental to, the business of banking not only at the time the bank first acquires its ownership, but for as long as the bank has an ownership interest. This standard may be met if the bank is able to exercise a veto power over the activities of the enterprise, or is able to dispose of its interest.[9] This ensures that the bank will not become involved in impermissible activities.

Pursuant to the proposed Operating Agreement, the LLC will not engage in activities which would be impermissible for the Bank or a subsidiary of the Bank. Also, the Bank will have the authority to veto activities or decisions by the LLC's manager that are inconsistent with activities that are part of, or incidental to, the business of banking, as determined by the OCC.[10] This

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[7] *See, e.g.*, Interpretative Letter No. 380, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (December 29, 1986) (since a national bank can provide options clearing services to customers it can purchase stock in a corporation providing options clearing services); Letter from Robert B. Serino, Deputy Chief Counsel (November 9, 1992) (since the operation of an ATM network is "a fundamental part of the basic business of banking," an equity investment in a corporation operating such a network is permissible).

[8] *See* Interpretive Letter No. 645, (April 29, 1994), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,554.

[9] *See, e.g.*, Interpretive Letter No. 711, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-026 (February 3, 1996); Interpretative Letter No. 625, *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,507 (July 1, 1993).

[10] The Operating Agreement also provides that the LLC will be subject to OCC supervision, regulation and examination.

provision will enable the Bank on an ongoing basis to prevent the LLC from engaging in new activities which may be impermissible. Furthermore, the Operating Agreement authorizes the Bank to terminate the agreement and dispose of its interest in the LLC if the company engages in any activities that are not part of, or incidental to, the business of banking.

Therefore, the second standard is satisfied.

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.

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 the national bank's investment not expose it to unlimited liability. As a legal matter, investors in a Michigan limited liability company will not incur liability with respect to the liabilities or obligations of the limited liability company solely by reason of being a member or manager of the limited liability company - even if they actively participate in the management of control of the limited liability company.[11] The legal structure of the LLC will ensure that the Bank is shielded from unlimited liability with respect to the LLC. Thus, the Bank's loss exposure for the liabilities of the LLC will be limited by statute.

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 20-50 percent ownership share of investment in a limited liability company is to report it on an unconsolidated basis. Under the equity method of accounting, unless the bank has guaranteed any of the liabilities of the entity or has other financial obligations to the entity, losses are generally limited to the amount of the investment, including loans and other advances shown on the investor's books.[12]

As proposed, the Bank will have a 30 percent ownership interest in the LLC. The Bank will account for its investment in the LLC under the equity method. Under the Operating Agreement, an unrepaid capital contribution is not a liability of the LLC or of any member. A member is not required to contribute or to lend any cash or property to the LLC to enable it to return any member's capital contribution. Thus the Bank's loss from an accounting perspective would be limited to the amount invested in the LLC and the Bank will not have any open-ended liability for the obligations of the LLC.

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[11] Mich. Comp. Laws. Ann. § 450.4501(2) (West 1997).

[12] *See generally*, Accounting Principles Board, Op. 18 § 19 (1971) (equity method of accounting for investments in common stock); Interpretive Letter No. 692, *supra*.

Therefore, for both legal and accounting purposes, the Bank's potential loss exposure relative to the LLC should be limited to the amount of its investment in those entities. Because the Bank will not have open-ended liability for the liabilities of the LLC and its exposure will be quantifiable and controllable, the third standard is satisfied.

4. The investment must be convenient and 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 must also 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 constitute a mere passive investment unrelated to that bank's banking business. Twelve U.S.C. § 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful".[13] Our precedents on bank non-controlling investments have indicated that the investment must be convenient or useful to the bank in conducting *that bank's* business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.[14]

The Bank is currently actively involved in the mortgage lending business and intends to remain so, through its involvement in the LLC. The Bank believes the best way for it to continue to offer a ready source of residential mortgage lending services to its customers and prospective customers is to become a member of an LLC with another established mortgage lender such as [ ]. Although the Bank will not make residential mortgage loans itself, it will refer Bank customers and prospective customers to the LLC. Thus, the Bank is not exiting this line of business. Rather, it is seeking to create a channel whereby it can provide an increased level of residential mortgage lending services it believes its customers desire. Furthermore, the Bank represents that this transaction will not result in a passive investment, as it will play an active and significant role in the LLC. The Bank reiterates that there are only two members in the LLC - [ ] and itself - which suggests that this will not be a passive investment. For these reasons, the Bank's investment in the LLC is convenient and useful to the Bank in carrying out its business and is not a mere passive investment. Thus, the fourth standard is satisfied.

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[13] *See Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972).

[14] *See, e.g.*, Interpretative Letter No. 697, *supra*; Interpretative Letter No. 543, *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (February 13, 1991); Interpretative Letter No. 427, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988); Interpretative Letter No. 421, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988); Interpretative Letter No. 380, *supra*.

B. Affiliate Relationship Between the Bank and LLC

You have also requested our opinion with regard to the affiliate status of the LLC under Sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c and 371c-1, as well as under the Community Reinvestment Act.

1. Transactions with Affiliates

Sections 23A and 23B place restrictions on certain transactions between a bank (and its subsidiaries) and its affiliates. These restrictions appear not to apply to extensions of credit made by the Bank to the LLC[15] and loan purchases by the Bank from the LLC since the Bank's 30 percent ownership of the LLC will qualify the LLC as a subsidiary of the Bank for purposes of both section 23A and section 23B[16] and nonbank subsidiaries are excluded from the definition of "affiliate" in these provisions.[17]

2. Community Reinvestment Act

The OCC's regulation implementing the Community Reinvestment Act, 12 U.S.C. § 2901, *et seq.* ("CRA"), allows a bank to include loans made by its affiliates for consideration during an evaluation of its CRA record.[18] By virtue of the Bank's 30 percent ownership interest, the LLC meets the definition of "affiliate" under the OCC's CRA regulation.[19] Accordingly, the Bank may elect to have the OCC consider home mortgage loans made by the LLC when evaluating the Bank's performance under the CRA regulation's lending test, subject to the limitations and conditions contained in 12 C.F.R. § 25.22(c).

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[15] As you noted in your letters, extensions of credit from the Bank to the LLC will be subject to the lending limits established by 12 U.S.C. § 84 and 12 C.F.R. Part 32.

[16] Under section 23A a "subsidiary" is a company that is controlled by another company, 12 U.S.C. § 371c(b)(4); and a company is deemed to control another company if, inter alia, it has the power to vote 25 percent or more of any class of voting securities of that company, 12 U.S.C. § 371c(b)(3)(A)(i). The position is the same under section 23B. *See* 12 U.S.C. § 371c-1(d)(2).

[17] 12 U.S.C. §§ 371c(b)(2)(A), 371c-1(d)(1). This exclusion from sections 23A and 23B is subject to the authority of the Federal Reserve Board to determine, in certain circumstances, that a company, including a nonbank subsidiary, is an affiliate. *See* 12 U.S.C. § 371c(b)(1)(E), (2)(A).

[18] 12 C.F.R. § 25.22(c)(1).

[19] 12 C.F.R. § 25.12(a) defines an affiliate as "any company that controls, is controlled by, or is under common control with another company." For purposes of this definition, the term "control" is defined at 12 U.S.C. § 1841(a)(2)(A) as the ownership, control or power to vote 25 percent or more of any class of voting securities of that company.

III. Conclusion

Based upon the information and representations you have provided in your letters of December 16, 1998 and February 4, 1999, and for the reasons discussed above, it is our opinion that the Bank is legally permitted to acquire and hold a non-controlling minority interest in the LLC in the manner and as described herein, subject to the following conditions:

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

2. the Bank will have veto power over any activities and major decisions of the LLC that are inconsistent with condition number one, or will withdraw from the LLC in the event they engage in an activity that is inconsistent with condition number one;

3. the Bank will account for its investment in the LLC under the equity method of accounting; and

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

These conditions are conditions 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 U.S.C. § 24(Seventh) and, as such, may be enforced in proceedings under applicable law.

If you have any questions, please contact me or Roger Bainbridge, Senior Attorney at (312) 360-8805.

Sincerely,

/s/

Coreen S. Arnold
District Counsel